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MANUFACTURING ARRANGEMENTS

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- o Why manufacture products for others?
- o Why distribute products for others?
- o What types of companies make a good marriage?
- o What services are provided?
- o Who's at risk?
- o What products are being manufactured?
- o Nature of financial arrangements
- o Length of relationship

MR. PAUL JANUS: The topic is manufacturing arrangements. I assume most of you know what this means or you wouldn't be here; but frankly, I wasn't sure, when I was first asked to do this, what it meant. It seems as if this is a term used when one company develops and administers a product that another insurance company sells. My company does that. I know a lot of other companies that do it too. Having thought about this a little more, however, it occurred to me that all insurance companies are manufacturing companies. Some, or most of us, also have our own sales forces, or in the modern day terminology, distribution system. And so, if we could look at ourselves that way, much of what we are talking about is how to expand our ability to move our products through a greater variety of distribution systems and still maintain a level of cost control and administrative simplicity.

From the side of a distribution system looking for a company, the main question is why would a sales organization which already is owned by or owns its own insurance company want to market a different insurance company's product? My copanelists will address these questions as they pertain to their unique company experiences and philosophy. Ray's company, Monarch, specializes in disability income (DI) and is one of the largest writers of that coverage in the United States. Bankers Life and Casualty Company, Sue's company and mine, is the largest writer of individual hospital-medical-surgical coverages in the country. Bankers' parent company, ICH Corporation, has a unique philosophy, or at least I think so, that lends itself to dealing with multiple distribution systems, particularly for life insurance, but also extending to health insurance. I'll attempt to describe that later in the session.

Let me introduce Ms. Morisato. Sue graduated from the University of Illinois in 1977 and achieved her fellowship in 1981. After a brief stint at Aetna, she

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joined Bankers as an actuarial student in 1979 and was named a Vice President in 1986. She is currently a member of the Health Insurance Association of America Long-Term Care Task Force and has served as Secretary to the Chicago Actuarial Association.

MS. SUSAN C. MORISATO: I will discuss the arrangements that Bankers has had with three particular companies to sell our health insurance products. I will discuss why we entered these arrangements, particulars about the arrangements themselves, from both our perspective and one particular company's perspective, and how we think it has worked.

But first a few moments about Bankers in particular. Bankers is a multiline insurance company specializing in individual insurance and even further specializing in health insurance. And while we provide a full line of health, life, annuity and disability products, our major sales come from health insurance products. Within the health insurance line there is a further emphasis on over age 65 business, Medicare supplement, and more recently, long-term care. But, Bankers does provide a very full line of health insurance products, including major medical insurance, temporary insurance, DI, Medicare supplement, long-term care, and hospital indemnity.

In 1984 we were approached by three different companies to sell our health insurance products. The first company is a stock life insurance company that offered a complete portfolio of life, annuity and DI products with some emphasis on securities and mutual funds and similar types of arrangements. Their sales force was a captive agency force, and so they sold only their own company's products or products of other companies that were specifically identified by the parent company by specific arrangements. Their market was identified as being middle income and all age groups. They found that during their financial planning agent prospecting process they were able to offer a fairly full line of insurance products. However, when their clients came across a health insurance need, they found they had no product to offer. They did not believe they wanted to go through the expense of developing their own product and so, therefore, went on a search for a company that would do it for them.

The second company, Company B, is a mutual life insurance company which traditionally concentrated its efforts in life insurance and annuity products. They had a full-time field force but also sold through some brokers. They tended to operate in an economically upscale market and tended to concentrate their efforts on the under age 65 marketplace. We ended up getting involved with this company because we currently had a separate arrangement with two of their general agents to sell our health insurance products. When the company decided that they needed some health insurance support, the entree with these two general agents provided a natural beginning for us to develop some kind of agreement with them. They were also aware of the fact that we were in the midst of negotiation with our first company, so they were encouraged that we were extremely interested in entering these kinds of arrangements.

The third company, Company C, is a large mutual life insurance company which offered its own portfolio of life, annuity, DI and also major medical products at that time. They also tended to operate in an economically upscale market. But their focus was a little bit different. They were also very active in their own DI marketplace and sold professional, executive, noncancellable DI. They found that when they were in that marketplace they would run into situations where they were talking to perhaps a small business concern where they would actually key in on the employer. The employer would tell them that his employees were also interested in DI. Very often this company found that their own product and their own eligibility rules did not allow them to sell to the employees. So they began looking for a company that was willing to sell a DI product to what we would call the blue collar market, and we had such a product available. As our negotiations progressed, they also discovered that they were having some of their own problems with their major medical product. So by the time the contracts were actually finalized, we ended up also making an arrangement to have them sell our comprehensive major medical product (lower deductible levels) and Medicare supplement; but the Medicare supplement was intended to be an ancillary sale.

In looking at these three companies, there are some common threads that ran through all of these arrangements that we determined as being positive from our perspective. One is that all of these companies tended to operate in marketplaces that we were not necessarily as strong in with our own direct writing field force. From our perspective that was important to us. We wanted to maintain our direct writing field force, so it was important for us to have a complementary marketplace where the agents wouldn't be tripping over one another. We saw this as a good way for us to expand our marketplace to get into some new households. It provided an opportunity for us to have additional income and additional profits to the company. From the writing company standpoint, there were also some positives. We were able to offer our product with our expertise to these companies so that they could also broaden their product portfolio but without necessarily having to incur the administrative and development costs that go along with entering a new product line. Then if the agents, in fact, were able to get a wider range of products through arrangements with the parent company, they wouldn't necessarily go elsewhere and could maintain good relationships with their parent company. Finally, the company saw some opportunities for additional income and profits to their organization.

Why did these companies choose Bankers as a company to write health insurance business? First and foremost, Bankers has had a long stable history in health insurance. This was early 1984 when these negotiations began, and 1981, 1982, and 1983 were not good years for health insurance. These companies were looking for a company that was going to be here in the long haul. It was important for them to have a company that they believed knew how to survive in the health insurance market. Another obvious corollary was our ability to react to the marketplace, whether that would be with new products or rate increases or whatever was necessary to maintain a good solid profile in the market. We also were licensed in 49 states and the District of Columbia. The only state we were not licensed in was New York, which was a fairly common situation for many of the health insurance companies. Finally, we were willing to be very flexible in the internal systems arrangements that we had set up for these companies.

All the companies write our products on Bankers Life and Casualty paper. We do not vend them through their own companies. All of the applications are submitted into our home office. We do all the billing, claim administration, and policyholder service handling. We provide marketing support in the sense that we provide the sales materials for these products. Effectively, all of the normal internal operating functions you would find within our direct writing organization we also handled for all these writing agreement companies as well.

However, it is important to note that while everything was done within our own framework, we also found it was extremely important for us to develop a separate accounting system for each of the writing agreement companies. It was important to us as well as to them to keep track of what kind of sales they had, what kind of experience, etc. Ultimately, we could determine if they were carrying their own weight, and we were also able to provide some interesting marketing reports from their perspective as well.

From the financial perspective the arrangements were also fairly simple in concept. We have no profit sharing arrangements with any of these three companies. They write our product, we take the profits. We pay their agents and their management compensation, and those arrangements are fairly flexible within the companies. The overall level of compensation is about the same for all three companies. There aren't any production requirements, or persistency requirements, or loss ratio requirements. We do pay different levels of management, and our system is flexible enough to pay those managers and agents directly; or we can pay the entire amount to the company, so that they can pay the agents.

Let me get into a little bit of how it has worked. I had a discussion, in preparation of this session, with a representative of one of the writing companies. From the standpoint of strengths, or successes, the potential for sales is still extremely strong with this arrangement, recognizing that it has been in effect now for about three to four years. The other thing that she couldn't speak more highly of is that Bankers was obviously extremely committed to having these arrangements work, and that we had a solid core of in-house individuals who were dedicated to these arrangements. We provided the necessary hand holding that was required for these agents. If they submitted a piece of business and had some problems, there would be someone in the home office who could immediately get their questions answered. Be it in the marketing end or in the actual servicing end, there was someone there able to answer the question. This kind of service was extremely positively received within the writing agreement companies. In fact, she told us that once the agreement was reached and some pieces of business were being submitted and they recognized the kinds of strengths that Bankers had with respect to service and response time, they suggested that their home office take some notes for their life underwriters. That kind of service is greatly appreciated.

On the downside, one of the things the representative viewed as a problem or an opportunity is better packaging of the product. Basically the writing companies are providing health insurance as an accommodation; they don't sell a lot in terms of volume so they don't get a chance to really get in the groove with procedures, rules, processing, and so forth. They have to worry about the rules of their own companies or possibly several other companies. Aside from having the obvious application and rate card, there are numerous other pieces of paper that are needed to submit a piece of business. There's a buyer's guide that has to be left with the applicant, there's the outline of coverage, one which has to go to the applicant and one which comes back to the home office. We have our own separate transmittal form that has to be filled out appropriately so that when the business comes in, it gets handled appropriately. If the case has to be issued through check-o-matic, there is a card that has to be filled out with a form that comes into the company as well. The agent statement has to be signed and delivered, and all these pieces of paper in all the right number of copies have to be submitted into the home office correctly or the business can't get processed. We don't have this all in one neat package. We have stacks of pieces of paper, and the writing companies have to keep track of which pieces of paper they have to fill out. They are going to make mistakes, and if they only submit a few pieces of business, it only takes a couple of those failures for them to say, "This is too much trouble, I'm not submitting the business. I'll either go elsewhere or I won't write it, it's just not worth the bother." This is a problem that we are working on.

The other comment that has come to us is that we are not always competitive in certain products in certain areas. While I would like to believe that we are responsive to this, one of the reasons why I believe Bankers has been as successful as it has is that we have not always gone with the tides of change. We do not say if some company is 30% lower in Georgia, we ought to be 30% lower. We don't necessarily believe that we always have to respond to every single influence in the marketplace. While we are concerned and interested in these comments, we are not necessarily eager to "correct" those situations, although it is something we do need to handle. Sometimes it's a matter of understanding that the competitors aren't really competitors in a sense that the benefits aren't really the same, or that there are other facets of comparison that are just as important. We do work with the companies and try to work through those comments as we do with our own field force.

Other comments were that the communication of product and rate changes were not always as timely as they expected. Part of that, I think, are things that legitimately we could be doing better. On the other hand, I think that in part it's the nature of the beast. Health insurance tends to be an extremely volatile changing environment. Products and rates are going to change rather constantly. This is more acute in these writing agreements than in Bankers direct writing field force because our direct writing field force is very involved in health insurance. They want to write health insurance, so these inconveniences are ones that they live with because they feel that that is how they are making their living. But with the writing agreements, the emphasis is clearly not the same.

The last thing is not so much our opportunity as much as one for the writing company. One of the problems that they have encountered is that their total agent training package is very good with respect to financial needs analysis, but there is not really a track to determine whether there is a need for health insurance. The product is just kind of out there, and if the agent happens to trip over the fact that the individual needs health insurance he says, "Oh, we have this product available." But there's not really a good integrated training track to ferret out the fact that there may be a health insurance need.

That's from one company's perspective. I would like to speak a little about what we think is happening with these arrangements. One of the first goals that we had with respect to these arrangements was to get into new marketplaces, and I think we have managed to do that.

Bankers direct writing agency force sells a lot of business at ages 55 and over. Many of these sales are to spouses of Medicare supplement policyholders (Graphs 1 and 2).

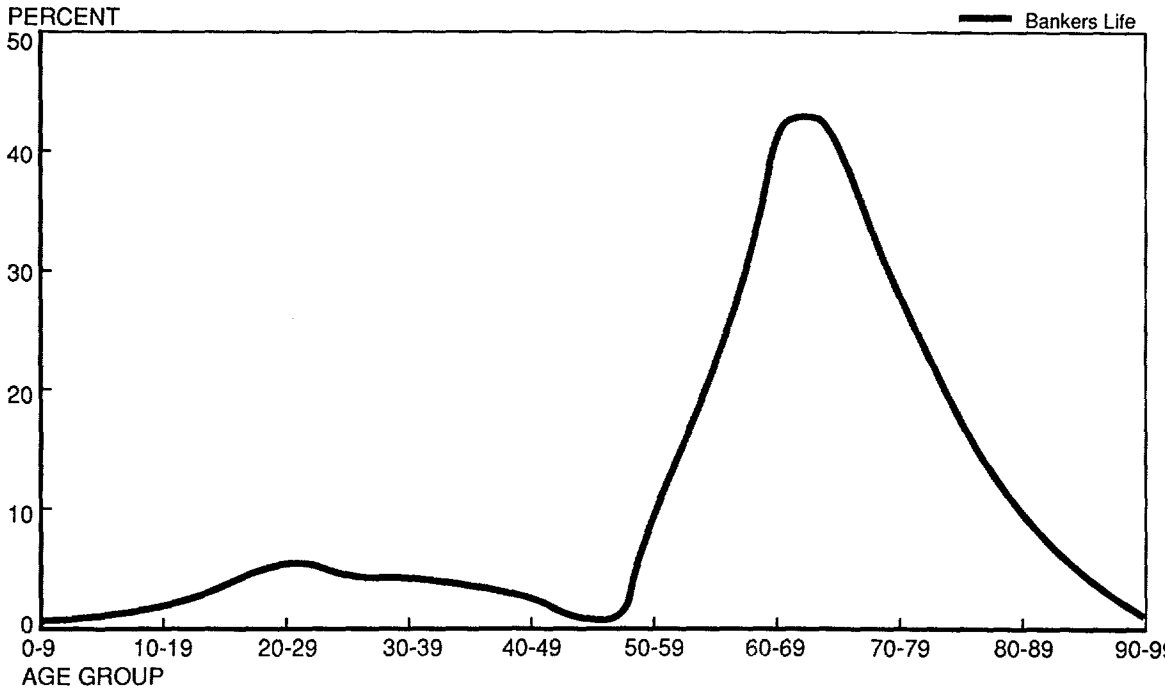
Looking at the writing agreement companies, there is a marked shift towards the younger age groups. Considering one of our goals was to move into new households and new markets, when I saw this graph I said, "WOW, that really works." While one of the companies actually sells a fair amount of business in the over 65 marketplace, we have found that there are not a lot of conflicts with our own

GRAPH 1

BANKERS LIFE & CASUALTY

ISSUE AGE SURVEY – HEALTH AND DISABILITY INCOME ISSUES

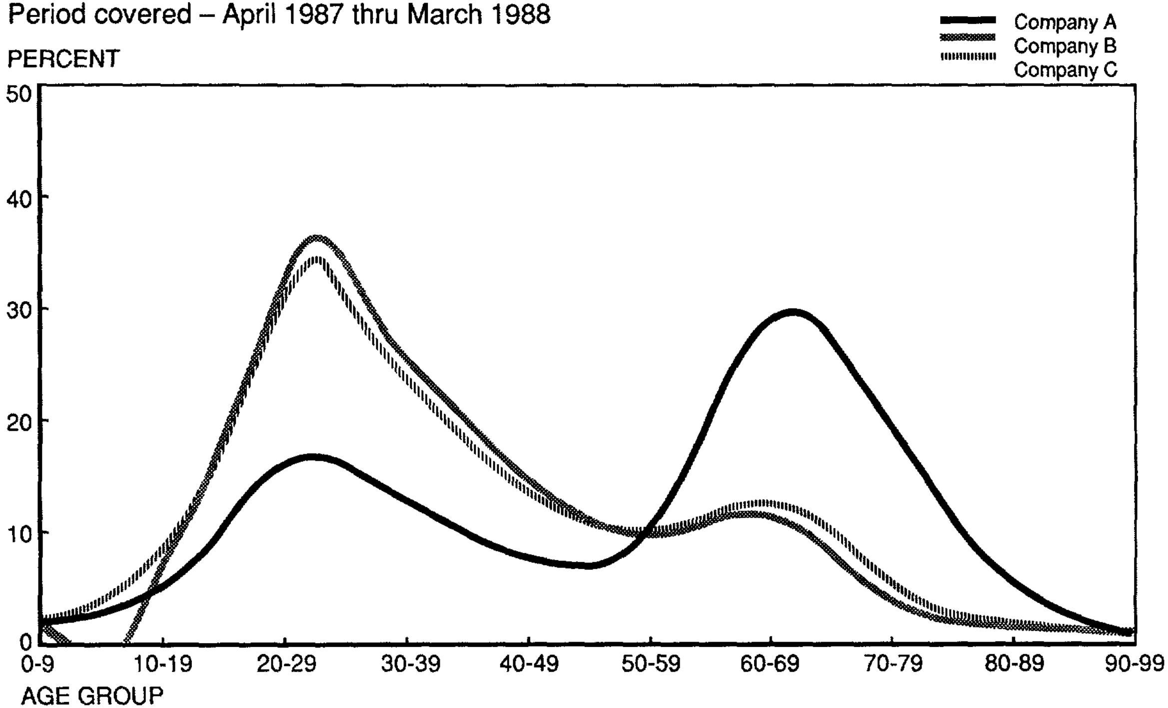
Period covered – April 1987 thru March 1988



GRAPH 2

BANKERS LIFE & CASUALTY

ISSUE AGE SURVEY – HEALTH AND DISABILITY INCOME ISSUES
By writing organization
Period covered – April 1987 thru March 1988



sales force yet. This shift has been relatively recent -- in the last 12 months. In the first couple of years of the arrangement that hump over 65 wasn't there. It's developed as a result of our long-term care product, because it tied nicely with their financial needs analysis planning and estate planning purposes. An encouraging point is that the increase in sales over 65 was not a replacement for the under 65 block that they were also selling. It was really an increase in total sales volume (Graphs 3 and 4).

We have also looked at the market from a different perspective. This is what we call the socioeconomic index. This index rates geographic areas on a scale of 1 through 10 based on various indices -- income, housing, etc. It is based on five-digit zip code breakdowns. There may be differences within a zip code that are not reflected in this index. For example, there may be a senior citizen community that is less (or more) wealthy than the zip code population in general. Therefore, large sales in the zip code don't necessarily mean they reflect sales to the mean economic group in the zip code. With this caveat, it appears that our direct writing force sells to a pretty solid middle income group. The index is in the 4-5 range -- maybe a little bit on the low middle income edge. We already knew that that was our marketplace -- blue collar, rural areas. We had hoped that some of these writing agreement companies would get us into slightly different markets. In fact, we have been somewhat successful in doing that. Two of the companies operate relatively closely to ours, but there is activity at the higher end of the scale. One company is clearly in a more upscale marketplace than the one we operate in. Being more active in the underage marketplace has also kept us on our toes with respect to competition.

While we weren't necessarily going to move with the winds, we have been able to do some product revisions that we believe have helped keep us a little more competitive. Our direct writing field force also benefited since the same products are being offered through both distribution systems.

The last point I'll just briefly touch on: the claims experience from these writing agreement companies to date has been pretty good for us. Persistency has been less favorable, but overall we have been pleased with that.

Overall sales have been somewhat disappointing. They have been under our expectations. While overall the operation is profitable, we believe some of the writing companies need to do better. We have expended a lot of money to do some hand holding, and the fact that we haven't got the volume for it is disappointing. One reason for this may be that when we entered these arrangements, we had no profit sharing arrangements or financial incentives. We had no production or persistency requirements for them, so from their perspective, there wasn't the clear financial incentive for them to place business with us.

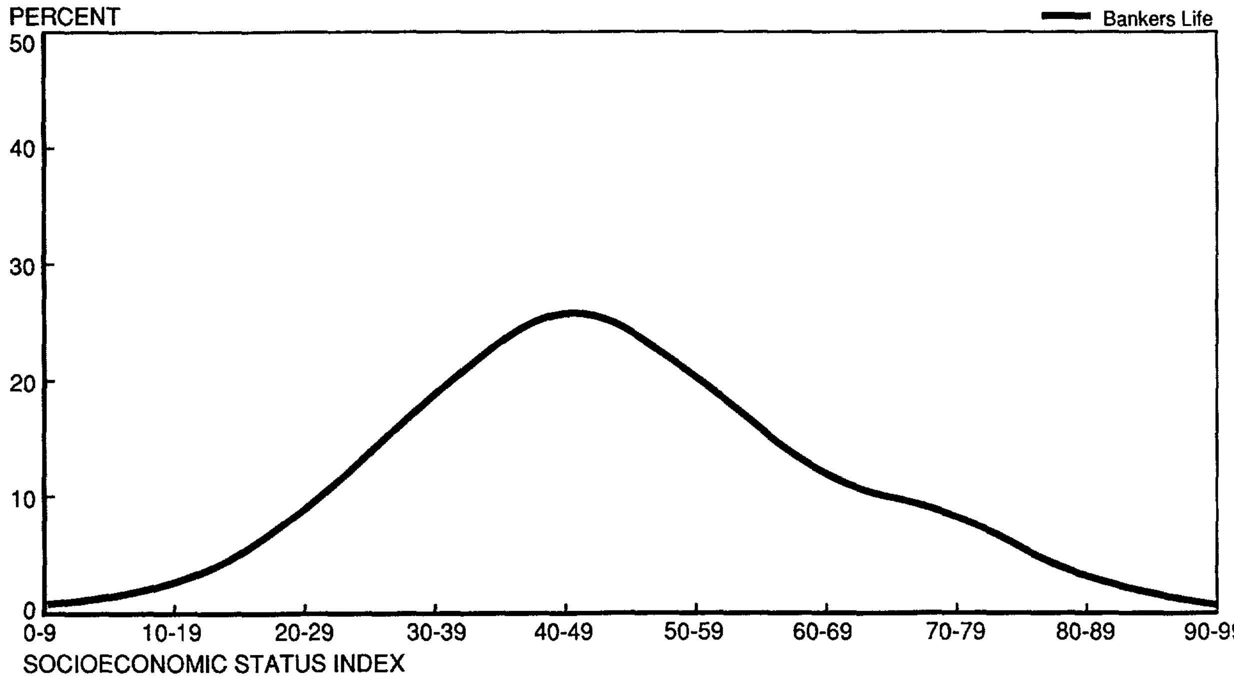
Now, having taken us through the arrangements and the successes and failures, I would like to summarize where we have been and what we have seen.

Here are some things that we think are necessary for developing good arrangements. Recalling we have a strong direct writing field force that is operating in the health insurance marketplace, it is important to have complementary markets and products. We don't want the writing companies to offer products that are in direct competition with the ones we are offering. We believe that only invites adverse selection and would not serve either company well. We also believe that you need strong field management of the writing company with good home office coordination. Because of the environment of health insurance, it is extremely

GRAPH 3

BANKERS LIFE & CASUALTY

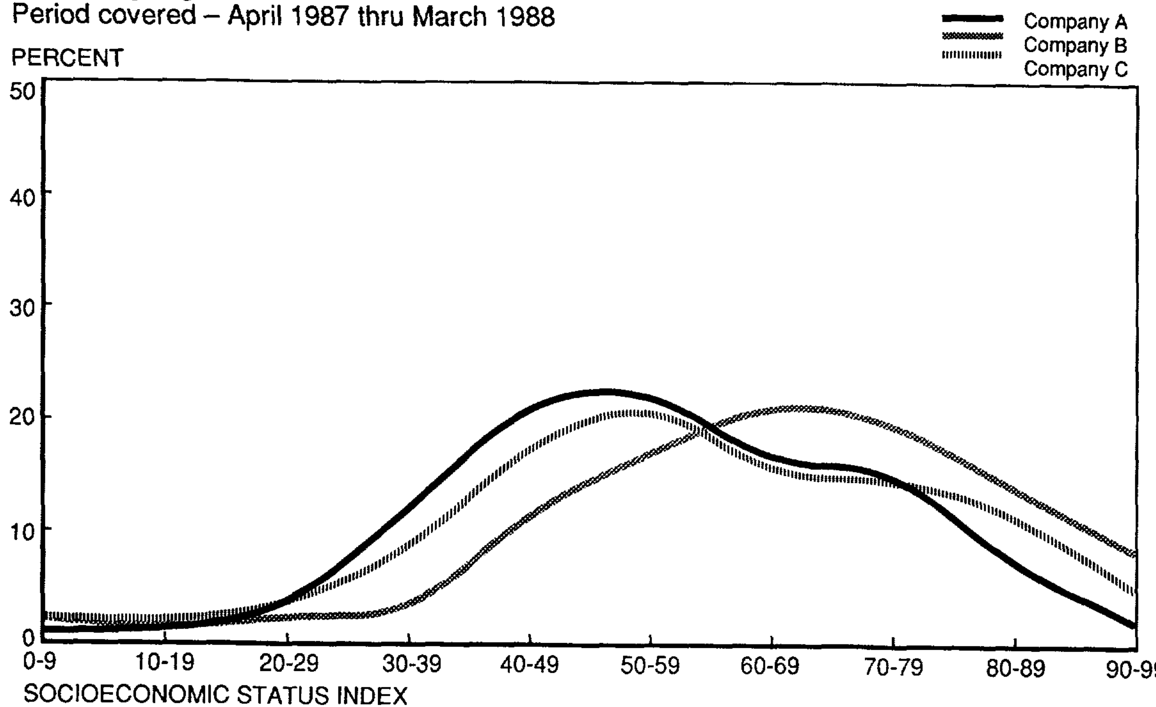
SOCIOECONOMIC STATUS SURVEY – HEALTH AND DISABILITY INCOME ISSUES
Period covered – April 1987 thru March 1988



GRAPH 4

BANKERS LIFE & CASUALTY

SOCIOECONOMIC STATUS SURVEY – HEALTH AND DISABILITY INCOME ISSUES
By writing organization
Period covered – April 1987 thru March 1988



important to always have constant communication between all of the parties involved -- between their agents and their home office and their field management, as well as communications with us. We've got a commitment to have a very strong service-oriented organization within our company, and we believe that that similar kind of commitment has to be made by the writing agreement company. One company that I've talked about, in particular, has a strong organization like that, and we have been very successful with that company relative to the other two companies. We believe that that's something that you really need to look for. Obviously, both companies have to want this to work. It takes constant energy and investment of time to make the arrangement work.

In conclusion, I can say that Bankers has done some things really well in health insurance. We think we know how to market that product, and we think we know how to market it profitably. For organizations that are looking for expertise in that area that don't want to expend their own dollars to develop that product line, some good arrangements can be developed and, in fact, can be very successful.

MR. JANUS: Sue, you said that all the products are on Bankers paper. Why is that? I think most companies would prefer to have it on their own paper.

MS. MORISATO: Initially I think it was important because it allowed us to get into the market very quickly, because there is the whole process of filing all the products with the different companies in all the different states. There is heavy regulation for individual health insurance, and there are constant rate changes. If we were to actually file the products for each company, they may start out being the same, but even with our best efforts, differences in product and rate will creep into the system as each company's contract is reviewed by each state. The most difficult problem is to get the same rate increases approved. It is not feasible to charge different rates in different companies.

MR. LONNIE MILTON GRAUL: We have an experience very similar to Bankers Life. We are primarily an individual major medical company which may make us not quite as similar, but we have had companies coming to us and asking for manufacturing type arrangements. Indeed we have entered into some in the last 6 to 9 months. I have two questions. First of all, what was the primary reason that these companies came to Bankers Life and Casualty and contracted with you, and my second question is now that you have had some experience under your belt, has there been any pressure or any motivation on either your part or the distributor's part to enter into profit type arrangements?

MS. MORISATO: I'll address the first question. When the one company that we have a very good close working relationship with was looking for a carrier in 1984, we were actually in competition with several other carriers. One of the major reasons I believe we were chosen ultimately was because we had a long-standing history of extremely large volume of individual health insurance. In fact, we are one of the largest writers of individual health insurance. We have been in the business for 40 years and obviously are here to stay. Also, we were able to be flexible in the arrangements that were set up in terms of systems and internal operating concerns with respect to compensation from their perspective.

In terms of profit arrangements, Paul, you might want to address that response.

MR. JANUS: Of the three arrangements we have, we have not had any pressure to develop any profit arrangements. I think the companies that want to get into this individual major medical type arrangement tend to want to because they are a little afraid of the losses. They are looking for somebody else to take those risks. We haven't insisted on it from our end. So far it has worked out real fine.

MR. DAVID M. WELSH: I have a couple of questions. First of all, on business like this where you are using corporate surplus presumably for something that helps an organization outside of Bankers, do you have a higher profitability threshold for this kind of business than you have for something you are doing for your own distribution channel? Secondly, on the subject of disappointingly small amounts of business in some cases, and I believe Sue, that in your presentation you mention that as an opportunity, do you have a threshold amount of business that you are looking for in a joint venture partner in something like this?

MR. JANUS: When we first introduced this, our concept was that we would set this up because we thought that largely we had the products, we had the system, and anything we got in addition to current sales was gravy. We were naive; there are special costs relating to this operation that must be covered. We were adealing with some fairly large marketing organizations, and we expected that we would do better than we have. We are making money at this stage, but we are not making quite as much as we make from our own distribution system. We are still willing to try to move this business and even to introduce new companies to that operation. As far as the uses of company surplus, we are willing to sell all the health insurance business we can profitably sell. As long as we are convinced that we are increasing our business and our profits, we will continue. I think, as I mentioned in the introductory comments, there is no difference from the Prudential's sales force selling our product or having some major master general agent sell our product.

MR. JEFFREY S. MARKS: In view of your experience do you see future manufacturing agreements having sales or persistency incentives in them?

MS. MORISATO: Yes, I think so.

MR. JANUS: I'd like to introduce again Mr. Sadler. Ray has been with Monarch for 28 years. He started as a field representative with Monarch, moved into the home office, became Chief Underwriter of the company, Vice President for Underwriting, and then when Monarch decided it wanted to enter the client company arena, he was appointed the Senior Vice President for Client Companies. Ray has been involved in a number of industry activities and among them has been a Trustee of the Disability Income Training Council.

MR. SADLER: I would like to start by telling you a little bit about the Monarch Capital Corporation in order to put what follows in the right perspective. First of all, like most of us today, we have a parent company who are our owners. Under that parent company there are two insurance companies among a lot of others that deal in the insurance marketplace. One of them is a company we call Monarch Resources which provides the variable life insurance product that is mainly distributed by the Merrill Lynch organization. The second one is the Monarch Life Insurance Company, which in a way, is sort of a misnomer because our product and the only thing that we do is DI. This we specialize in, and this is the only thing that Monarch Life Insurance is involved in.

In the process of handling the distribution of the two insurance products, we have three distinct systems that distribute the products. One is our career organization which sells the entire product line of disability as well as the variable life product. The second distribution system is a brokerage organization which is wholly autonomous, has no connection whatever with the career organization and distributes our disability product exclusively. The third is the organization that I am involved with, which is the client company organization. Our system provides the disability portfolio to other companies so that they might distribute it on a private label basis. As far as disability is concerned today, the marketplace for disability is probably the most undersold one in the financial services world. A recent *Wall Street Journal* article indicated that of 109 million workers, 25 million have LTD insurance. In the blue collar clerical area with average incomes of $25,000 plus, just 12% own disability insurance. In the upper middle class with incomes of $44,000 plus, 18% own disability insurance. So as you can see, the opportunities for the distribution of disability products seems virtually unlimited.

For the life insurance agent today, it is important to be associated with a company that provides a DI product with a top-notch program to service it. Such a program provides many advantages to the agent. First of all, it's an excellent new commission source. And in today's marketplace and in the areas in which our agents are operating today, this is very important. Secondly, it improves his policyholder's satisfaction. The agent has an opportunity to provide his policyholder with a total product to fulfill his total financial needs. Thirdly, and not any less important, it keeps the competitors out and prevents any erosion while the agent is not on a face-to-face, day-to-day basis with his policyowner. One of the things that has become apparent and which the Life Insurance Marketing and Research Association (LIMRA) has published several studies about is the fact that it improves persistency for all the products that the agent sells. LIMRA just published a study showing that the individual who owns, from the same company, a life and disability product has a better persistency record than the individual who has his life and disability from different sources or just has life only.

Also, for the agent, it does create new prospects. DI is a selfishly motivated type purchase, and the new prospects many times are difficult to get to by talking about life insurance. However, many are turned on by the opportunity to provide coverage for their problems, and they can see themself using this product. Another opportunity for the agent is the chance to build his own image with a top-notch insurance line in both life and disability products. And finally, for the company, it provides additional name recognition -- just another product with the company's name out into the marketplace.

For the company that does not have a DI product or whose DI product is no longer competitive, Monarch Life Insurance Company has a program that allows a company to enter the DI marketplace on a highly competitive basis using their own company name within a relatively short period of time, almost instantaneously, and with a nominal investment. There are large research problems. The package that is offered is done on a joint venture basis. This program has been operational since 1972, and in the early days it was not that successful and did not become successful until the 1980s when manufacturing became far more popular than it was in the 1970s. Since 1972, we have perfected the operation of our client company program to the point where we have made all the mistakes and have corrected them and we feel now that we have got it right.

The joint venture proposes the combination of Monarch's DI program and the client's distribution system. In other words, each partner in this arrangement brings to the table his or her particular point of expertise. It is an equal partnership arrangement. The arrangement is formalized by the use of two documents signed by each party. The first is a DI agreement which provides the obligations of each company in the joint venture. The second one is a 50% quota share reinsurance agreement which obligates each company to a 50% share in the expenses, in the risk and in the profits. And for those who wish to limit their risk in the DI business, there is an excess reinsurance agreement available with competitively priced renewable term premiums.

Once the agreement is reached, Monarch Life becomes the DI Division of the client company and provides the following services. First of all, we print and file a disability portfolio in the name of the client company. We print all sales support material in the client's name, and on a fee-for-service basis we underwrite and issue the policies, collect the premium, pay the commissions, handle the claims and maintain total records. We also establish and manage a bank account in the name of the client company for the purpose of handling all transactions, from the collection of the premium to the payment of the expenses, 41 commissions and benefits. The client is supplied with all the necessary actuarial and accounting reports to support this process. We have a system of sales training and promotion which is coordinated through the client company's own system, and we guarantee that all enhancements to the product will be provided to the client's product when they occur. Finally, probably as important as any of the other aspects of the services is the fact that we customize software for the use of a personal computer (PC) modem arrangement. This enables the client's field organization to enter applications electronically from their field offices -- a very significant step that we made, since it simplifies the agent's task who sells a policy once a month or once a year and is not really very adept at completing applications. What the PC system does is prevent any application to be entered unless it is correct. Also tied to this capability is the ability of the field office to get into our mainframe, check on pending status, and check on their own policy records. We have electronic mail available; sales illustrations and competitive product comparisons are on the software that we customize for each one of our client companies.

The most difficulty in activating this program arises in the data processing interface, resulting in a time frame that usually takes between 6 and 8 months. The problem is that we do a complete interface, and sometimes we have compatibility problems with codes and methods. The data processing people do take time to get this done since it's labor intensive.

Why should a company choose private labeling versus other methods of obtaining a product for their field force? Well first of all, company name recognition. The company has an opportunity to have its name out there as opposed to taking on a product with the manufacturer's name on it. Secondly, we interface completely with the client company's payroll system. This enables the company to continue the in-house computerized handling of all its fringe benefit programs for the field organizations, the clubs, the conventions, the retirement plans and whatever, and that is done in the process of the data processing interface.

National advertising -- a DI product can piggyback on the national advertisement that's already out there or is about to be put out in the name of the client company. It's a great recruiting device. An awful lot of agents are particularly interested today in having a disability portfolio that's at the edge of competition and that they can sell along with the life products. As I have indicated earlier, it provides to the company a persistency bonus in terms of keeping their life insurance in force as well as the DI that is being sold through their system, and it also fulfills the need for a total financial portfolio.

Further than that, some of the marketing people in the client companies have gone to work with us and have arranged a concerted sales effort combining both the life and the disability together. For example, disability buy/sell; there is a lot of life buy/sell out there, not much disability. Sales efforts with the two presented together have provided increased sales in both. The product is bought by DI experts. As I said at the outset, this is all we do; we don't do anything else. We study it comprehensively and feel that we have some knowledge of what we are doing in this business. And finally, and probably as important to the company, it contributes to their bottom line. They do make a profit; at the moment each of our clients is making a profit.

There is no question that this arrangement is not for all companies. There are some important considerations that both companies should look at before a decision is made to enter into the arrangement.

First of all, we feel that the client's field organization must be controllable and accessible for training. Second, the company must be capable of producing a minimum of $1 1/2 million of premium annually in order for either company to make a profit. Third, there must be a full commitment by the company to succeed in the joint venture. This can't be an accommodation or a loss leader type product if it is to succeed. Fourth, this must be the only DI product that the company sells. And last, and certainly not least, the company to enter a joint arrangement with us should be tilted toward the upscale marketplace.

The product that we provide is our regular noncancellable disability portfolio that we call Advantage. It consists of a number of different policies, all of which are dedicated to the professional small business and the workers in the professional and small business market. We have a noncancellable regular occupation product that stands by itself, and along with that is a companion product. We have combination noncancellable residual products for individual sales. Included in the portfolio is a business overhead expense policy which is for all our occupation classes, a disability buy/sell, key person insurance, a franchise product designed for the workers in the small business market (and by small business we mean a hundred or less employees) and an array of single need riders, some of which sell the product itself. It's the same product that we provide to all our distribution systems, except that to the individual agent who is selling it, it's unique since it is the only product of its kind with his name on it. We have had successful arrangements with various types of companies; we have some with mutual companies, with stock companies, with a fraternal both small and large. As I said, our experience goes back to 1972, and we feel that we have had exposure to the whole business so that we can do a good job in this marketplace.

MR. JANUS: I thought I would spend a little time discussing DI from the side of a potential client company. Bankers and ICH are in the market to be a client company in DI.

Bankers has a captive field force of about 4,000 agents. We have 80% individual health insurance, about 2-3% DI and the rest of it is life and annuity. Our disability products don't come close to competition. Our products are guaranteed renewable, we have overly careful underwriting but no sophistication in that. We tended to be in the blue collar market, and our products have the protective devices that perhaps are necessary in the blue collar market. We once sold 10% of our business in disability, but we let disability get away from us as a product line when in the mid-1970s the whole disability industry was in a crisis, and many significant changes came about. In the 1980s we began to improve the quality of our agents with higher recruitment standards and better training. We always believed that we sold to low middle income people. We find today that even in individual health our sales have now turned toward our higher priced products, our most complete products.

Today about 10% of our field force have clients who would buy noncancellable DI, but they are embarrassed by our product and won't even try to sell it. Of course, some are encouraged by our inaction to broker their business elsewhere. That is against the company rules; but if they don't broker it, then they may go someplace else and leave our company. Since many of our products are available through other distribution systems, other general agencies, agents can leave our company and sell our health insurance products and still sell someone else's DI. We don't want that, so we are looking for a DI carrier.

We don't believe we have the expertise to do it ourselves. Our primary fear is that we will lose money again. Therefore, we are not interested in profit sharing. Secondly, we don't want to license our agents with a second company, so we want it to be on our paper. We don't want these sales to cost us profit by displacing sales that we're making money on. That is, we don't want to lose the profit or overhead margins we are making on our current sales. That means we have to get adequate compensation from the manufacturing company to provide a reasonable profit and overhead margin. That may be a goal we can't entirely achieve in order to maintain our agency force, but that is one of our stated objectives. Finally, we are proud of our service, and we need to feel comfortable that the company we do business with has the kind of service that we would be comfortable with.

We began our investigation process a short time ago, and in addition to Monarch, we've gotten information from several other companies. I have an outline that one of the companies submitted as to what the client company does and what the manufacturing company does.

The manufacturing company says they will recreate the Bankers marketing look. What I think that means is that the client company will print and pay for the sales material; therefore, that gives them the flexibility to change the sales material to some extent. What the manufacturer will do is provide products, product updates, a personalized illustration software package, and competitive information. They will ask the client to screen applications and make the request for medicals, attending physician's statements, and Medical Information Bureau data before submitting them to the manufacturing company.

My understanding is that both the Monarch and a third company we looked at will handle everything. The business doesn't have to go into the client at all if that's the way they want it to happen. This company says it has a special DI underwriting unit that will handle the client's business specifically, and we will have direct access to that unit. The manufacturer will also handle all the claims, all the policy issue and change functions and will give the client a gross commission check. The client will pay his field force from this check. The client company will pay the claims from a check sent by the manufacturer. Both Monarch and the third company pay the claims directly from a Bankers account number.

This company wants the client to be responsible for premium collection, but the other companies, including Monarch, will collect the premium and handle all of those functions as well. The two companies will take all the risk. On the other hand, they will charge service fees up front to assure that some of these costs are met automatically, no matter what volume of business we get. One company has fees ranging from $15,000 to $60,000 a year, depending on the volume of business we do. The other company has a $100,000 initial fee and then a $50,000 annual fee, but they do more administration than the first company.

Both companies have extremely competitive compensation structures. One has an interesting feature in that it puts in its contract a restriction that the commissions to the writing agent can't be greater than the commissions that the company pays its own writing agent. That company quotes one level of commissions and quotes all the other fees as an expense allowance. The other company doesn't do that, but they have up to a 25% additional first-year commission depending on the volume of business.

One of the companies has a stop loss provision for both parties. In a sense it's an incentive for good experience. At the bottom end, if the loss ratios on a paid basis are below a certain level, the client company gets 2/3 of the difference; and at the top end, if they are above another level, the client company pays 2/3 of the difference. The levels are interesting of themselves. In the initial contract the bottom level starts with 5% of premium paid in the first year and goes up to 45% in 5% increments for each policy year following the issue, so that ultimately if your claims experience exceeds 45% the client company gets nothing. If it's less than 45%, it gets 2/3 of the difference. At the other end, those numbers start at 45% in the first year and run to 95%, so as the claims experience exceeds ultimately 95%, then the client company winds up paying 2/3 of the difference.

Ray, what kind of cancellation provisions does Monarch have?

MR. SADLER: The cancellation provision in Monarch's contracts is built right into that DI agreement that I talked about in the beginning. There is a 6-month period of time, a cooling off period, during which we negotiate with the client as to exactly what we are going to do with the remaining business, and it's by mutual agreement. Now mind you, this business is in the name of the client company itself, so in that kind of a situation, the client probably has more at stake than we do. However, we are not averse to taking it over and continuing to process the claims against it on a fee-for-service basis.

MR. JAMES A. LOFFREE: I have a question for any panelist who has any experience in this area. I wonder if you have ever developed any products or any special features for the other company that you have not made available to your own company; and if so, how did you manage that up front, and what experience have you had in a reaction from your own field force?

MR. SADLER: We haven't done it yet, but we have a situation right now where, as I said, our products are tilted toward a middle income, upper class marketplace. One of our clients is heavily into another market which developed as a result of a change in their distribution system. They are asking us to manufacture a special product for them, and we are considering that and will probably do it.

MR. LOFFREE: Have you given any thought to the specifics of how you will manage that with your own distribution system?

MR. SADLER: We'll make it available to our own distribution system, too, if they would like to use it. It wouldn't be an exclusive thing.

MR. RICHARD L. HELMS: Ray, since you share the profits with the client companies, have you encountered any problems in your evaluation of what an appropriate profit for the risk is, compared to their evaluation of the same risk and the appropriate profit?

MR. SADLER: We haven't had a problem. We have a model which is built for the client companies where we will input whatever information is germane to whichever client that we are dealing with. The actuaries discuss the model and the various things involved, and we have not had a problem with any of our clients. All of our companies are making money. One of them is very successful and became so in a short period of time. This company, incidentally, moved into the top 25 in the country in inforce premium for DI just this year. So it's working.

MR. CARL B. WRIGHT: A couple of questions for Ray Sadler. First of all, you didn't mention whether or not you have any up front charges for a new client company when you bring them on. The second question is do you find yourself in any kind of discussions or negotiations with your clients over the fees that they pay for all the services that you provide? I think you said that you essentially tried to have them share equally in putting the business on the books and in the ongoing administration.

MR. SADLER: In answer to the first question, we do not have any up front charges. We thought about it, but the way we begin the operation is to open a bank account which is seeded by the client, and that bank account is in the client's name. We pay initial expenses out of that bank account, and when we reach the end of a quarter, we put the quota share agreement funds into the account. Sometimes at the beginning the account is not seeded enough, so the client has to continue to put money into it; but eventually the premiums that come in take over, and the whole thing works rather automatically. As to the client fees, we have a stipulated fee for each one of the services that we offer. This fee is based on our actual expenses. There is a caveat in the contract saying that we will have the opportunity to renegotiate these fees on an annual basis. We look at them annually and look at our costs annually and discuss these with our clients in the event that we decide there ought to be a change. We have not changed our fees in the past three years.

MR. CHARLIE R. ALLISON: I would be interested to know what percentage of your company's individual health insurance business is represented by these manufacturing arrangements and whether or not you see that opportunity as growing or declining in the future for each company?

MR. SADLER: Currently 28% of our business is from the client arrangement. The rest comes from our own distribution systems.

MS. MORISATO: Currently for Bankers I believe the writing agreements in total are about 3-4% of our total health insurance business.

MR. JANUS: One of the principles I started out with was that manufacturing agreements are really not much different from marketing agreements. We have some noninsurance company marketing agreements in major areas where they have broken down the compensation differently than we would normally break it down, and we have done that in different affiliated companies of Bankers Life and Casualty. Some of these marketing agreements threaten to do a lot of business -- one of them looks like it might turn out to be as much as 15% of our operation.

MR. THOMAS C. FOLEY: One of the techniques we have used in health insurance medical expense for years has been to close out blocks of business and manage those closed blocks of business and open new ones. It appears that there are states that are now wanting to prohibit us from doing that, and that related policy forms are going to have to be grouped together. Have you thought about this in terms of manufacturing? You just mentioned that that's only 3 or 4% of your business, so I assume that's not a problem. Suppose you got 15 or 25% and their loss experience was significant, then you had to group it with your other policy forms. Have you thought about where you are going with that?

MS. MORISATO: Specifically no, although I will answer in a broader sense. While I am aware of some of those state regulations to date, we have tried to argue that the products that we come up with are, in fact, different classes of business because of product changes and underwriting changes or whatever. In fact, that has been a true statement. With respect to the writing agreements themselves, I believe that if there is a clear distinction in experience and, in fact, we were out of that block of business for any reason, we would argue that this, in fact, is a separate class of service that is identifiable. Whether or not the state would agree is an issue, but I think we would have a case and would present that case.

MR. JANUS: People do things differently in different organizations, but we have not made a conscious effort to close out blocks of business and hit them with rate increases while coming in with a new policy form. However, product requirements have caused us to change our product line from time to time, and the actual result may be the same. To the extent that state laws have always required that loss ratios be determined over the lifetime of the policy, there really isn't any difference. And so this is not necessarily new, but maybe it's in a few places where it wasn't there before.

ICH has or plans to have two administrative centers: one for life and one for health, which will handle over 30 different distribution systems. We have almost that many distribution systems in the organization already. These distribution systems in total will produce over $1 billion of new premium in 1989. How can you do that effectively is the question that we are trying to answer. And essentially, what we want to do is have a common manufacturing system; we sometimes call it a model company. Within that concept is a common data processing system for all the organizations, for all the products in all the companies. Products were designed for that one system. Any distribution system must market the same product or products. Each distribution system is given a marketing allowance. That's very similar to the concepts discussed here, marketing allowance wherein a marketing organization's costs and compensation must fit. One can spend anything one wants as long as it fits within the allowance. All product assumptions are standardized. That is, profitability is analyzed as if each distribution system produced the same cost for underwriting, issue, maintenance, persistency, mortality, morbidity. If a distribution system can't produce business which is within the minimum profit objectives, because its mortality is too high or its persistency is too poor, or for one reason or another, then their marketing allowance is reduced. If their marketing allowance is reduced, maybe that means that the distribution system ends, but that's the way we intend it to happen.

We avoid developing a product for only one distribution system. If a new product is developed, it is developed to be used in all distribution systems. The concept, as I said, doesn't always work, and occasionally a new method of distributing products will emerge that requires a new product. To do this we have to have a strong reason to believe that this is going to be successful, that there are ancillary benefits for other distribution systems within the organization.

On the other side, because we are dealing with many distribution systems in many companies, and ICH buys a company every other year, we come across administrative systems that may be working well with the new organization. When we do, our immediate task is to try to see how to make that administrative system work for everybody and to incorporate it into the system -- not to set it up as a separate entity. Once you have reached this point in your thinking, adding new distribution systems is pretty much a snap -- whether it's a large general agency or another insurance company.

When I started investigating this subject, I assumed that it would be smaller companies that would be looking for a larger company's products. This hasn't been the case. Many of these agreements have been with the very large companies acting as the client company. I am aware that the Metropolitan, the Equitable, CNA, all have been or are looking at client company relationships -- having somebody else manufacture products for them. In fact, most of these arrangements seem to be from medium size to large size companies rather than from small companies looking for help. I'm impressed by that, and I think it means that most companies are really looking hard at their own acquisition costs and what they can do profitably themselves and not spend the time and effort to be everything to all people. I think that's a good deal.