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MANUFACTURING ARRANGEMENTS

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Recorder: DANIEL E. WINSLOW

- o Why manufacture for others?
- o What makes a good marriage?
- o Nature of financial arrangements
- o Products being manufactured
- o Who does what?

MR. LEONARD KOLOMS: Marketing arrangements can be described as a joint marketing venture between two insurance companies, one a marketer of products, a company with a distribution system that doesn't have those products available in its own portfolio, and the other a manufacturer.

Manufacturing arrangements have been around for a long time, at least 20 years. The Life Insurance Marketing and Research Association (LIMRA) did a survey in 1985 on this subject. 209 companies answered the survey questions that were sent out -- it asked questions about both life and health. Of the companies that responded in health insurance, 41 said they were distributors, 18 said they were manufacturers. On the manufacturing side, it varied anywhere from 2 to 10 different companies that the manufacturers had contracts with. Today we will cover pretty much the entire gamut of health products that are being manufactured. My company is a manufacturer of group, multiple employer trust (MET), individual medical and blue collar disability products. We will hear a presentation by Tom Stoiber of Time, which is primarily into individual medical manufacturing. He will be followed by Bill Sproul who is with UNUM, which is primarily a group LTD manufacturer and then by Harry Taylor of Paul Revere, which is a non-cancellable disability manufacturer.

As I previously noted, manufacturing agreements have been around for at least 20 years. I think what has happened is that 20 years ago, or back in the early 1960s most companies had a complete array of products. They had a complete portfolio of both life and health products. In the late 1960s inflation became rampant and companies that had medical products as ancillary products started to

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lose money. As a result they pulled out of the business. It was followed in the mid 1970s with the same cycling happening in disability. And then companies pulled out of the disability business for exactly the same reasons. An additional phenomenon also happened with the advent of Medicare. Our lives became complicated as manufacturers of these products. And again companies that had these products strictly as ancillary products decided to pull out.

If the LIMRA study were redone at this point in time, I believe there would be a substantial increase in the number of companies acting as distributors of other companies' products. I think now the distributing companies are recognizing that they are losing more and more of their business to the brokerage companies. Through a manufacturing arrangement they can get some compensation for having a distribution system. And the distributors also use the arrangement to cover some of their agency expenses. And I think this is becoming more common as there is more pressure on companies for covering their agency expenses.

Benefit Trust Life got into this business in an unusual manner. In 1984 Benefit Trust Life was notified by a company that this company had stopped selling individual medical products a number of years ago. In 1984 they were tired of doing the individual medical administration. Therefore they were looking for somebody to take over the risk for the individual medical block of business via assumption reinsurance.

We were able to enter into an agreement with that company and acquired that block of business. At the same time it suddenly struck us that maybe this company would also want to use our products, since they no longer were selling individual medical products. And while this company said go ahead and contact our agents, we never really entered into formal agreement with the insurance company. But we did with the agency.

We followed that with a number of other assumption reinsurance acquisitions. In fact we have now finished nine of them with other companies. The last one was with a company that was a manufacturer itself for other companies. And this led to something which, if we thought about it, we would never do again. We not only acquired a very large block of business, close to $30 million of premium and 40 thousand policies, but immediately entered into a manufacturing arrangement with 12 other insurance companies simultaneously. I think when these other people talk, they will say, well maybe one arrangement every six months is a fine pace.

MR. THOMAS J. STOIBER: I am from Time Insurance Company. I have been dealing with individual health insurance for the last 12 years exclusively and 90-95% of my time is spent in the individual medical insurance. So I'm speaking from the manufacturing end of things. It has been about five years now that Time Insurance Company has been in this business. Some have come to us, some we have looked for. Recently we started looking for these arrangements and then we get hot and cold on them. Some are easy, some are slow, some work and some don't work.

Individual health insurance by itself, especially medical insurance, is a very complex business. Perhaps you heard the individual from Golden Rule say how much trouble it has been. Hopefully it is not that much trouble, but these arrangements are coming about because of the difficulties.

In this business the financial rewards are very great and the financial penalties are very great also. The problem is the results come very, very swiftly. And then the manufacturing arrangements add another degree of complexity in this whole arrangement. We, the manufacturers, are losing some more control because we have another party out there. I want to emphasize the precautions that you can take and discuss a particular arrangement that we use that has worked quite well. We are always refining the arrangement.

The types of arrangements can be really characterized by these two factors, the responsibility for the insurance risk and the administration. Under the "turn-key" you see the manufacturer takes the primary responsibility for the insurance risk. Sometimes the policies are issued on the writer's paper. When I say writer, I'm talking about the distributor as the writing company or the writing client as opposed to the manufacturer which is self-explanatory. The administration is then done in the writer's office.

On the other end of the spectrum is the pure distribution type approach. And here the primary responsibility again lies with the manufacturer and in this case the administration is done by the manufacturing company.

The third point is where we share the insurance risk. It falls somewhat in between, but is more closely aligned with a pure distribution type arrangement. The administration is done by the manufacturer. Now, why do I like to share the insurance risk for individual medical? As I mentioned, this business is extremely tricky and there are too many things that can go wrong. It is too difficult to put in place all of the possible controls ahead of time. So what we want to do is pass on that risk in a form of a shared ownership.

The administration is done by the manufacturer, at least we prefer it this way; it gives us more control. The precautions that can be taken, I think, follow a time line. First, you want to determine whether the reasons for the two parties getting into the arrangements are compatible. If you are satisfied then look at the characteristics of the company. Are they compatible? And if happy with that you go to the business practices.

It is nice if the business practices are compatible but I have not found two companies with the same business practices. When I talk about business practices, I'm talking about things like: How do we take money at the time of application? COD, credit cards? What do the commission statements look like? Do we need computer systems work? How do we bill? This is where your costs start to run up and you need some compromises. If the costs aren't too high then on to next step which is product agreement.

This is where the deal usually breaks down and I'll talk about that in more detail in a minute. Once you have that, get your controls in place and monitor those controls. Very importantly, I think some people get into this and once they put the controls in place, they figure everything is fine. But you have to keep watching it. That's the name of the game in individual health insurance.

Let's look more at the compatibility of the writer's reasons. If the client company has lost an interest in the line of business, you have to ask the question, "Is it due simply to the matter of time and expense?" If the only reason is it is a small line line of business and not worth their time, go on to the next step. But if it is a matter of bad experience, which is very typical in medical insurance, then they have to go with the joint, risk-sharing arrangement.

Think about it for a minute; the primary responsibility for quality assurance in underwriting individual medical insurance lies with the agent. The Home Office underwriter can collect the obvious items but the key element in underwriting is the motivation for purchasing individual medical insurance. You don't have that with group insurance, you don't have that with life insurance. Why does a person buy medical insurance today? That comes in a face-to-face meeting at the time of application. In a manufacturing arrangement, we step back and put that agent even further from the company taking insurance risks. So you need a mechanism to counter that and that is the joint venture.

And complicating this further, I do not know of any writing client company that wants the manufacturing company to mess with its agents directly. So, again the manufacturer is farther away from the agency field, and a joint arrangement works out quite nicely.

If the writer never had an interest in the first place, you have to ask the question: why does he have an interest now? Time Insurance has had some, what I call naive, writing client companies come up to us and say we would like to get into this business and we want to try it first with you. Time Insurance is not going to train them for free. So Time Insurance tries to get this client company for the long ride and the joint venture works pretty nicely. If they are happy and they can make money on the deal with you as a partner, it works out even better.

There are reasons not peculiar to the joint venture arrangement. You want your agency forces to be complementary. If you write on the East Coast, arrange something on the West Coast and vice versa. Regulatory reasons can help. For example, Time Insurance Company is not a New York licensed company. So we are quite attractive to a New York company because we don't have the caps on compensation that they have.

The compatibility of companies' characteristics is also key -- the one necessary to this arrangement is the familiarity with the product. Is the field force familiar? The less familiar they are with the product, the more important the risk-sharing features are. There is an opposite relationship. So again, the less familiar the field forces are, the more risk-sharing features. And this isn't a real problem because the manufacturer should have more negotiating leverage. And the writing client is not speaking from a position of power.

Reputation is important for the two parties. Best rating always helps because everybody is looking for an A plus company to be the manufacturer. Capacity works on both ends; the capacity of the client company must be large enough to make it worthwhile for the manufacturer and vice versa. If the manufacturer can't handle the capacity you're going to run into problems.

In field organization compatibility, the combination of a broker manufacturer and writing client doesn't work as nicely as the combination of a branch office exclusive manufacturer and a managed independent network writer.

After you get through there you have to go to these deal breakers. I am talking about compensation package, that's what I call a deal breaker. Once you start talking about money things can start to collapse.

To gain acceptability of product, obviously the simpler it is the better off you are. Your training costs are minimized for both parties and, very importantly, the quality foul-ups are minimized. The fewer rules there are, the fewer chances an agent is going to screw things up for you. And the writing client company probably is not as sophisticated in the business as the manufacturer is.

Product is the most fun card when it comes to the actuary's role in this arrangement. The "same product" or a "different product," I do not say that one is better, it depends on the circumstances. The manufacturer usually has some type of direct writing field force of its own. The same product refers to the same product for the manufacturer's field force and the distributor's field force.

Obviously the same product saves development expense and administration expense and has one set of rules to memorize. If you do go with this approach, the most important thing is for the field compensation package to be equivalent between all arrangements or at least nearly so. I talk about package rather than the writing agent's commission because it could be in a branch system that has five layers of management out in the field and the writing agent might only get a 10% commission. And the deal with another arrangement is that a writing agent might get 20% and there is only a 10% load for that management.

The reason you have to do that is because if you don't, you can create an animosity between the first arrangement and the second one. And the manufacturer isn't going to accomplish what he is trying to accomplish and that is more business. You are going to get the "robbing Peter to pay Paul" phenomenon where one agent working under this arrangement is going to find it more attractive to move over to that one. And the results are going to be a back and forth movement and that does not make for a good arrangement.

The home office fees are also part of the compensation but this can be different. The manufacturer is buying a distribution system and the fees depend on what that is worth to him. Certainly a distribution system of 200 agents isn't the same as one of 5,000. So that can be worked out differently. That is non-field-related.

A different product I refer to as my Sears approach. It wasn't too long ago that I was looking for a washer and dryer at home. And I walked into this Sears showroom and there's the sparkling new Kenmore, everything is Kenmore at Sears. The fellow says to me, "Oh, Whirlpool makes this. They're good, you know Whirlpool." I said, "Well why shouldn't I just go to Whirlpool and buy their product?" "Oh ours is better, the capacity is better." So I went over to the Whirlpool dealer and said, "This Sears guy says Kenmore is better than your machine and the same manufacturer." And he says, "Yeah, but we use brass fittings, they use plastic." And you go back and forth like this.

The key is they do the same thing in individual health insurance. In individual medical insurance, if you cannot negotiate an equal field compensation package and you are stuck on price, you go to a different product. You can mess with the deductible, the mental illness benefits, the co-payment, or the precertification plan and all of these can make the plan perceived as equivalent and still have a different product and pay different compensation. Don't get too far off the road because the whole objective here is to keep away from robbing from Peter to pay Paul. If you definitely have a better product with the same compensation the agents are going to move.

The most important precaution is establishing controls. Quality and direct compensation are most important for this arrangement; this is where you get into risk sharing. Quality can take the form of a loss ratio bonus arrangement or a loss ratio deferred compensation program. We have done both of these. These are related to each other and more importantly they are directly related to the degree of confidence which the manufacturer has in the writer's ability to write quality business.

A high direct compensation plan coupled with a low bonus arrangement is very appropriate in situations where the manufacturer has a high level of confidence in that writing company's ability to write good business. For example, one client company might have had an arrangement with another manufacturer. He wrote good quality business but for one reason or another wasn't satisfied. He has a good track record. That writing company has every right to expect up-front compensation and you couple that with a lower bonus arrangement. The manufacturer's risk in this case is very low. The return potential for the manufacturer is high, so pay that compensation up front.

Now on the other side, you can get a situation where the manufacturer's risk is high and its potential is great. An example is a client company that has a lot of agents and has a high capacity for producing business, but it doesn't have the experience or there is an unknown quality element. So you would couple a high compensation package with a downside bonus formula. The company is getting the money up front but the bonus is going to work to its disadvantage.

Here's the formula that we've used in a situation with high compensation paid to the field and we had high confidence in that writing company's ability to write good business (Exhibit 1). The A and the T variables stand for actual loss ratios versus target loss ratios. The first one is where the actual loss ratio is better than the target. The bonus we pay would be in the nature of two thirds of the difference in loss ratios but not greater than 5%. The 5% is a factor that is less than the priced for profit margin.

With this formula you are sharing in, the writing company's favor, a priced for profit margin up to a certain point. Now the manufacturer, if he does his job right and if the actuary does his job right, should get his priced for margin. And the manufacturer will get 100% of the excess above the 5% priced for margin. And this can be played with, depending on where you want to be. And if it is a very good year, that risk is passed out in the form of a reward to the manufacturing company.

The other condition is where the loss ratios are worse than expected. The manufacturer will charge, not pay out but charge, 1/3 the difference between the loss ratios. The manufacturer has to ask how are we going to charge this writer? We have to pay him his commission up front. Generally you have a bonus arrangement. Any arrangement of production bonus correlates well with bad loss ratios. When the loss ratios are bad, production is usually up. You are either underpriced or the agent is writing bad business. And bad business is easier to write than good business. So you can charge that difference.

Then thirdly, there is a situation in which we have a brand new client where everything is unknown. With this one a low direct compensation and a very attractive bonus formula that works in both directions and has a very high potential for risk sharing works. We might not pay that first-year commission at all up front. We may pay a level type commission like a MET plan. And it's always been hard for me to fathom (and I've put together a MET program) how

EXHIBIT I

RISK-SHARING FORMULA FOR

HIGH COMPENSATION/HIGH CONFIDENCE

CONDITION	BONUS TO WRITER
IF LOSS RATIO $A - T < 0$,	$2/3\ (A - T) + 5\%$
IF LOSS RATIO $A - T > 0$,	$1/3\ (A - T)$

one-man trusts can sell at a level 5% or 10% commission while I can't sell an individual plan with a 30% commission.

With a very low first-year commission, we set up a contingency bonus fund. Less than 100% of the fund is vested to the writing company. And the contributions of the bonus formula work as in Exhibit 2. Simplistically, it might be the earned premium less the sum of the claims and the change in reserves. I put change in reserves up there because these are not statutory unearned premium reserves but leveled premium reserves (also known as active life reserves). Any commissions paid out, expense allowances that you have and any bonus systems already paid out so far are also subtracted. The writing company then has the vested right to 75% of this fund any time they want to take it out so long as that fund is at least 25% of the year's premium. We let the fund accumulate with interest.

Why 25% of the year's premium? We feel that individual medical business with the loss ratios and the statutory requirements and the filing can be such that loss ratios can grow to 25% over target. We want that much in the fund. If the writer is with you for the long ride, that unvested portion can be a higher percentage payable. If the writer is with you for five years, certainly he never gets his vested 25% earned premium nor into the unvested fund balance. If he is with you for 10 or 20 years, you might give him an attraction to stay.

Now we have done this arrangement once and it is very nice in theory. It doesn't work very well in practice because everybody wants money up front. Although the one company we've done this with didn't produce a whole lot, the experience on that block of business was tremendously good. They benefited better by this formula and they got paid in the long run on a deferred basis. They made more money and we made more money and I as a theoretician liked this approach better.

That gives you an idea of the formulas we use and I want to finish off with monitoring. Account managers are probably your number one control. I like an account manager who manages no more than four or five of these at a time. If they are real small we probably won't get into them, so four or five is a good number. This person is a baby-sitter and keeps the client happy. The account manager needs to be an expert in administration, an expert in compensation, an expert in marketing and can't be some administrative assistant. It's got to be somebody higher level than that. The idea is to keep these people with you for the long run and solve problems before they develop into irreconcilable ones.

And finally there is the production loss ratio report, the obvious one. Once you have formulas based on loss ratios and production, you need to watch what's happening.

I will leave you with an example of a report that we have (Exhibit 3). This is an August report; I changed the name of the company but the figures are pretty much actual. The top half shows detailed information by agent; the bottom half shows the activity for the last five months running in a row. As you can see, in the first column I can find what agency or branch this particular set of agents is working out of. The second column tells how long they have been with the company, the third column gives me some production figures, fourth column gives me earned premiums, the fifth is paid claims and I have my loss ratios in the sixth column.

RISK-SHARING FORMULA FOR LOW COMPENSATION/LOW CONFIDENCE

1. Defer Bonus
2. < 100% Vested Contingency Bonus Fund

   = Conservative Profit Contribution with Interest

   = EP - (IC + AV + C + E Allowance + Bonus)
3. Vested = 75% x Fund $\ngtr$ 25% Years EP
4. Unvested Payable at Termination > n Years

EXHIBIT 3

WHOLESALING PRODUCTION CHART FOR THE MONTH OF AUGUST, 1988

ABC COMPANY

Agency/ State	Appt. Date	Issued Premium in August	1st Yr. 12 Mo. Premium Earned	Paid Claims (12 Month)	12 Mo. Loss Ratio	No. of Agents	No. of Apps. in August
84/AL	04/85	$ 139	1,355	0	0%	2	0
84/AL	04/85	654	1,199	3	0	8	0
84/AL	04/85	202	2,401	0	0	3	1
84/AL	04/85	612	10,508	6,714	50	7	0
84/AL	05/85	1,295	8,274	76	0	7	3
85/OH	03/85	2,334	19,112	37,029	163	7	5
85/OH	03/85	317	4,920	729	16	5	0
85/OH	03/85	147	3,306	0	0	3	0
85/OH	03/85	631	12,199	1,119	9	4	1
85/OH	03/85	1,212	9,187	9,694	86	7	1
86/TN	10/85	2,812	30,136	11,730	24	18	8
86/TN	09/85	442	8,012	6,613	45	7	0
86/TN	09/85	1,647	6,171	6,205	57	8	9
86/TN	09/85	659	6,074	1,897	11	10	4
86/TN	09/86	782	7,867	702	6	5	3
86/TN	09/86	506	5,869	15,449	179	6	1
84/IN	09/86	1,808	33,841	29,810	76	12	1
84/KY	11/86	3,988	30,929	7,500	24	7	3
84/KY	04/87	775	3,099	0	0	8	1
84/KY	06/87	3,074	19,662	5,628	26	3	23
25/OH	05/88	562	1,879	0	0	0	3
25/FL	07/88	0	248	0	0	0	0
25/FL	04/88	1,002	4,218	94	2	0	4
25/FL	03/88	732	4,758	48	1	0	0
25/FL	04/88	52	1,203	0	0	0	2
25/FL	05/88	497	1,490	0	0	0	1
TOTALS		$51,488	500,024	197,657	*39%	216	102

ABC MONTHLY TOTALS

Month	Annualized Submitted Premium/Mo	1st Year Premium Earned (12 Mo.)	Paid Claims (12 Mo.)	12 Month Loss Ratio	No. of Agents	No. of Apps.
03-88	$ 75,228	$314,700	$102,440	32.6%	216	N/A
04-88	103,306	347,800	115,279	33.0	216	109
05-88	N/A	390,740	127,264	32.0	216	101
06-88	51,593	434,745	149,856	34.0	216	134
07-88	49,464	469,503	163,001	34.0	216	89
08-88	51,488	500,024	197,657	39.0	216	102
TOTAL	$331,079	2,457,512	$855,497	34.8%	216	535

As you can see, the fellow about sixth down is not doing so hot. He's got the most production and we probably ought to take a closer look at that fellow. He's got seven agents in his office and he wrote five applications last month. His activity is up. So we are looking at all of this information. We can go into further detail and deal with your client company.

As you can see on the bottom line, we are running a 39% loss ratio on this group. We are dealing only with first-year premiums so that is not as good you think it is. And as you can see on the bottom chart, 39% is the worst month in the last five. You keep an eye on this guy, he has $2.5 million in business in the last five months which isn't too bad an arrangement, 216 agents in this outfit. So this gives you an idea of how we do it at Time. That's the joint venture arrangement.

MR. WILLIAM R. SPROUL: I've been in the reinsurance operation for 13 years and have held various positions in the Underwriting, Administration and Sales area. Currently I am responsible for both the sales and underwriting for our LTD reinsurance operation. What I would like to accomplish for you is to briefly give you an overview of our LTD reinsurance operation. I plan to do that by touching on why we decided at UNUM to develop the product offering and when we entered the market and also the types of reinsurance arrangement that we are providing to our clients and how we market our products and services. Then I will quickly go over some of the key services that we provide as a manufacturer and show you the functions that the distributor (our client company) performs in order to take the product to the marketplace.

UNUM entered the LTD reinsurance market place in 1969 and our objective was to increase our market share with that product and ultimately return additional profits to the company. We can all remember those days when there were relatively few competitors in the LTD marketplace, both direct and reinsurance. The market was relatively untapped. We thought there was a lot of potential there. As a company we felt that this was an effective way for us to distribute our product efficiently and at a low cost to our client companies.

The approach that we are using is private label concept where UNUM provides the policy language, contract, certificate materials and the client markets the product underneath its own name. As Tom mentioned it's a turnkey operation that we have, providing a full range of services. We don't consider ourselves just a manufacturer of products but also a manufacturer of support services for our clients.

Due to the nature of the risk with LTD when we entered the market and the fact that UNUM retains the majority of the risk, we provide our services on a facultative basis which means that each risk is approved by a UNUM underwriter before we accept reinsurance liability. The quota share arrangement that we offer clients cedes anywhere from 50% of the risk all the way up to 100%. 100% is if they are not interested in retaining any of the risk and they use it as complementary product. Traditionally we see the company start with a very small percentage of the risk and increase its participation as its block grows.

Our operation is now and has been periodically off and on a separate strategic business unit that focuses on the needs of the LTD reinsurance marketplace. We do buy some of our services from our direct operation in order to be efficient in delivery of the product. Market research and product development are two areas where we pool our resources in order to be efficient and take the product to the street.

We offer product services to our clients -- Sales, Marketing, Underwriting, Claims, Actuarial and Administration. The various services that go underneath those are modified depending on the client's needs, expertise, and capability.

I am going to just take the top four -- the products, sales, underwriting and claims -- and try to give you a flavor of what we provide and then the services that the client performs. I recognize that most of your companies have the ability to do some of the things that we are doing, if you were to put the effort into it. To me a good marriage is when we, the manufacturer, develop a quality product that meets the needs of our clients and do it faster and at a lower cost than they could develop it themselves. Then we have a good marriage.

What I have here is the services that UNUM provides to our clients, again in various levels, and then the services that the client must provide.

In the products area, the market research and development, we invest heavily in that area to understand the emerging needs and market potential for our LTD products. We use various sources to gather the data, we use some traditional sources like LIMRA studies and we also use our inforce client base. We survey our brokers and we also talk to our reinsurance clients as to what they see happening in the market and what products and services they are going to need. Product development is the obvious key to UNUM. In order to maintain our leadership position, we work very hard to make sure that the products that we have are the leading edge. And we are always looking for ways to find new markets for our existing products, existing products for new markets and new products for new markets. This is critical to our success.

In the policy language area we provide our clients with a complete state filing package. The package includes the language itself, the rates and any actuarial certification that may be required. All of this has been approved by our legal department and has been filed in the insurance department.

On the client side of it, they actually do what we call product packaging. The clients decide which services, which product or product features they want to take to the market. They may not decide to take everything we have. They are also responsible for doing the state filing; again, we have already pre-approved the forms, they just need to file them and get approval. If they do have objections, which sometimes occurs, we will help a client respond to those objections.

And then, we are a private label operation and the policies are written on our client's paper. They actually do the policy issue.

In the promotional/sales marketing area, we provide promotional material, brokerage agent pieces, sales specifics or product specifics and sales brochures for our clients. Again these have been approved by our legal department and are in a photo-ready format. All the client has to do is put its logo on it and print sufficient copies for distribution.

In the training area we provide all of our clients with training manuals and supporting slides. We feel that the training of the LTD product is critical to marketing as the product gets more and more complex. The client is actually distributing the product with its own field force. From a training standpoint the client can use the materials that we provide. The design is that we train them to train their people or we can actually go out and assist them with the training as a service that we provide.

The next two areas that I would like to cover that are critical in the management area are the underwriting and the claims areas. The actual risk selection is developed at UNUM and the actual criteria are developed at UNUM. The actual risk selection can take place either at UNUM or at a client company's office. Many of our clients have quoting authority up to 200 lives and it's a facultative arrangement where the final sold case is reviewed by UNUM before acceptance.

Those cases that are quoted at UNUM are initially reviewed by the client company for completeness and then sent up to us for our review. When we rate the case we provide the reinsurance rate, which includes our reinsurance cost of the risk rate plus our reinsurance cost, back to the client. The clients load on their street rate, their street expenses, which would include commission, premium tax and any home office expense that they may have, and they determine the ultimate street rate.

In the claims area we have a complete claim adjudication facility in Portland, Maine that goes under the names of Claim Services International. We perform all of the front end evaluation and investigation of the claims to determine ultimate liability. In addition we provide Social Security assistance and rehabilitation (rehab) services. All of these claim services are continuing to put pressure on the profit margins.

These services are critical for the LTD lines and these services are provided at UNUM's cost.

Let's talk a little bit about the evaluation. Again we'll do all the front end where we have benefit specialists and examiners who review the claims and determine the ultimate liability, whether we should approve or deny and make a recommendation to our client. The client has the final say, it's on his paper. Should the client follow our advice and in event that there are any punitive damages, we stand 100% behind that.

In the area of Social Security assistance we provide our clients with brochures which outline the process for applying for Social Security and for Social Security appeals we use attorneys throughout the country who specialize in getting the appeal and we also provide our claimants with financial incentive to go after the appeal.

In the Rehab Services we continue as an industry to pump more and more money into the Rehab Service. At UNUM we have certified rehab specialists on staff who work with potential rehab candidates. We have a national network of local rehab specialists to help in the local areas to support our process and then we have full-time physicians on staff at UNUM to identify rehab candidates. Again these services are provided at our expense.

As I mentioned before, the client has the ultimate authority whether to accept the claim or deny it. If we do recommend denial, we actually give them the language to use back to the client. Under the arrangement that we have, our client issues the ultimate claims check to the claimant and we reimburse the client on a monthly basis for our share of the risk.

I hope this gives you just a quick overview of how we perform our services.

MR. HAROLD TAYLOR: In order to properly cover why Paul Revere is a manufacturer of non-cancellable disability insurance products for other companies' distribution systems, I think it is important that I go back to six years ago.

In 1982 and in early 1983 as a company we spent too many hours to recall, consumed too many tons of paper while attempting to articulate not only the future of the disability income business as we saw it, but Paul Revere's role in that future. At that time, like now, as a company we have a career distribution system and we want to keep it and we also have a separate brokerage distribution system which was and is playing an active role in our success.

The end result of the months of exercise was our agreement to concentrate on our strengths. The strengths are our 95 years of disability experience, our now over $300 million of non-cancellable premium inforce and our brokerage delivery system. Our decision was that we would become a specialty disability provider. Along with that agreement came a refurbished mission statement -- that of regaining and retaining national leadership in non-cancellable disability, improving our market share, improving our corporate profits and in the process affecting a lower unit cost.

That represented lofty and noble corporate objectives but nothing really addressed the real world of how we were going to get from where we were to where we wanted to be. More importantly, could we support that activity when we got there?

Back in 1983 we decided that to be successful in wholesaling, we had to consider the business as a supplement to our normal brokerage activities. In other words we weren't going to create an expensive new entity to handle wholesale business. Profits and/or losses were to emerge through normal brokerage numbers.

Initially we saw no acceptable alternative to total success. We saw failure as too costly, reputation-wise, and that philosophy has not changed. Again, initially, as our actuaries modeled anticipated premium averages, persistency, wastage and expenses, our expectations were that our wholesale experience would fall somewhere between our career numbers and the higher numbers generated by our brokerage. Time has shown very little difference between traditional brokerage business and wholesale.

At the beginning we determined that we could not be put in the position of creating extravagant new systems for our client company needs. Today our client company activity is pushing ahead our overall company systems capacity. I would quickly add that very little of this activity is being asked for by the client companies; it all stems from our own desire and need to know.

Six years ago we couldn't change our market emphasis away from the professional and business owners. Time has modified that stance somewhat to the point that in 1986 we developed a gray collar product to better serve the newer producer needs within our wholesale base.

The most important of our original commandments was the belief that nothing could be developed that would replace our brokerage field expertise. Not only did the other companies' producers require field training and point of sales assistance, we needed the field force to provide our initial underwriting screen for qualifying and non-qualifying business.

Today, all of our agreements remain field supported by our brokerage system. They remain the largest single reason for our success. All of our agreements are on Paul Revere paper, I stress Paul Revere paper because, stealing from Tom, we are the pure manufacturer. It's our responsibility for the actuarial work, for the claims, for the underwriting and we even get involved in the distribution. There are other types of agreements within disability income. There is both joint venture and an administrative services only agreement where some companies are actually selling their services to other disability income carriers.

In the six short years our field force has doubled and our geographic locations have almost doubled in support of our business partnerships. With wholesaling as the support mechanism, no longer are there any purely scratch offices opened in the Paul Revere system. There is always an attempt at immediate business flow and payback.

The big plus has been the fact that our brokerage people are compensated to sell disability income only, no life insurance, annuities or other products. As such, they do not represent a threat to the primary lines of our buying companies. Our people act as functional specialists within that other company's distribution system.

The original concerns of how we were going to take our 1982 corporate objectives live were answered in 1983 when we signed our first agreement with the ordinary agency system of Prudential. In an attempt to not only add to business revenues, but to improve our company learning curve, we have signed agreements with other carrier companies, personal producing general agent systems, investment firms, a Property and Casualty (P&C) carrier and producer groups. Again, we drifted away from traditional insurance distributors for our own education. We have learned valuable lessons of what works and what doesn't work and more importantly how much farther we have to go.

In order for us to not just add agreements and possibly risk losing our earliest relationships, we always have to consider the effect or strain on our resources. Unlike traditional business growth curves, wholesaling gives you a step effect with every additional major client added.

One of the items listed for discussion in this workshop is "What Makes A Good Marriage." From the beginning we have worked and reworked our perceived criteria for a good marriage. Regardless of how the wording has changed over time, there are a handful of basic tenets that have not changed in application or intent.

If a client company is currently manufacturing disability income, we ask that they stop. You cannot have two manufacturers doing the same line. We have to have a basic compatibility in our target market. Paul Revere cannot bring people from a blue collar market to an upscale market.

The potential for new business is important. Normally we look for a partner who can do $500,000 to $1,000,000 sales in the first year of our relationship. Client company reputation, as Tom pointed out, is all important. The fit of the prospective client company with other inforce clients and our ability to geographically service their distributors are also important.

A compatible corporate policy and, more importantly, the people chemistry between the two companies and the objectives of the prospective client company in selling your product make the marriage.

If the prospective company is attempting to use your product as its source strictly as an accommodation to some loud voices in their distribution system, I guarantee it will not work.

Without that prospect's firm belief that this relationship will recapture outplaced business, aid in the selling of its own manufactured products, assist in persistency of both people and product or enhance recruiting, I would suggest that whatever your planned results are, you won't achieve them.

To say that luck hasn't played a part would be to mislead you. Had the chemistry or common purpose been different in our relationship with Prudential, we might have cooled toward, and possibly shied away from, any further relationships.

Going ahead, luck has played a part in terms of our field relationships. It appears for the most part that we have the right players in the right places. We have been very fortunate in having dealt with quality people and quality distribution systems.

Attitude is by far the most important ingredient in our form of manufacturing. If the distributing company wants the program to work and continually communicates that to its field force, the chances for success are greatly enhanced. The challenge to the manufacturer is to become integrated as soon as possible into that distributor's selling system and remove the outside broker image.

I would be remiss if I didn't share some of emerging downside concerns. The concerns may vary depending upon the distribution system you employ, but in my opinion the essential concerns will fall squarely on the shoulders of both the manufacturer and the distributing companies.

The company entering into manufacturing must realize that as its manufactured block of business grows, its ability to react unilaterally does become affected. When you agree to discuss wholesaling, you always look at that as a possibility but you don't have the actual production or people to worry about. Decisions to modify your contract, your rates and your compensation become less of a calculated risk and more of a business certainty, positively or negatively.

Speaking only with the knowledge of disability insurance relationships, there is a growing need on the part of the distributor for the manufacturer to become more things to all people. By that I mean the manufacturer as the trainer, the manufacturer as the salesman, the manufacturer as the product developer and the manufacturer as the market driver.

The third area of concern is one we all share, that of our changing producer attitudes and allegiances. Your producers and mine seem to be falling into two general categories, the entrepreneur and those who want to be. As a response to our own field people, we as companies are trying to find ways to provide high touch contacts with our producing base or client company's field force.

In different distribution types, high touch contact takes different forms. Underwriting concessions, more direct access to underwriting and claims, frequent product enhancements and new product introductions, and greater compensation or rewards may all be used.

There is a tendency for the distributing company's producers to measure the manufacturer by its own company's practices. That is good and bad. The manufacturer just cannot follow the distributor's practices in all cases.

On balance, the positives far outweigh the negatives.

Leonard has asked me to speak a little about the financial arrangements used in our relationship. I won't go into great detail, as frankly there is not a lot of detail.

First, all of our memorandums of understanding call for the same monies to be paid. That allows me to sleep nights and not worry about who may be talking to whom.

Paul Revere agrees to pay street or standard commissions to the distributing company's producers. These commissions are no different than are paid to our own distribution system or to a non-relationship broker. In addition, Paul Revere pays to the corporate entity a rental allowance for the use of its field force. That rental allowance is a percentage of collected premium and will vary by formula, based on the actual results over or under anticipated production levels.

In an attempt to wrap up, I want to get back to the initial question of why manufacture for others. To date the answer is simple. From all perceptible bench marks our wholesaling has been a success.

We have grown our broker field resources. Our manufacturing activity is now 40% of what they do on a day-to-day basis. In the changing marketplace, we have provided them additional avenues for their compensation.

Quality factors would appear to be normal by our standards. In 1983 we ended with $500,000 of paid premium. I am happy to say that we will end 1988 with approximately $50,000,000 collected premium. Then, we had one client company; today we have seventeen. We have gotten better control over our expense rates and our manufacturing activity has also given us access to broader markets.

The good news/bad news is there are no rules of the road in what we do. Let me add that even though our manufacturing activities have become an integral part of what Paul Revere does on a day-to-day basis, we are far from knowing all the questions yet, let alone all the answers. Just because the waters may appear to be peaceful and quiet in manufacturing does not mean the alligators are asleep.

MR. ROBIN B. WELCH: I come at this from a slightly different angle in that for three years, from 1984 to 1987, I was in charge of setting up our limited partnership business and running it. And there it's very common to have wholesaling arrangements to do joint ventures, so there are good analogies.

One thing that the first two panelists didn't emphasize was their marketing of the product at either the regional or the local level. My experience in limited partnership business was that because it was a specialty type product, if you didn't have the presence from the manufacturer, then it wasn't being given a fair shake in the system. It needed that extra boost in order to do the marketing. So I would be interested in comments from either Mr. Stoiber or Mr. Sproul.

MR. STOIBER: From the individual angle we look at it as a purchased product more than a sold product. So the amount of marketing expense that we put behind our client companies is really quite minimal. We also have the joint venture arrangement and the bonus production and we feel that those are enough incentives for those folks to come up with their marketing efforts. We are concerned about the types of marketing that they do, and that they run them by us first. But they have such an incentive to write business, and it's purchased anyway, that we are not too concerned.

MR. SPROUL: I guess the way we do most of our marketing support is to train the client companies to market. We do try to work closely in developing strategies and approaches to the market to find some fits where they have high success with their product. And we try to take our product to markets where they should have high success with the LTD and where they have high success with their other product lines and develop strategies to go with those markets. We basically try to stay behind the scenes.

MR. WELCH: Mr. Taylor, with your marketing who would be responsible for your client companies in terms of getting agents up to speed and enabling them to sell disability income?

MR. TAYLOR: We try to train the trainer. And the trainer gets paid by his own company to sell his own company product. Therefore we failed miserably initially in trying to train the trainer. So, enter our field force even more committed than we had originally anticipated. Our field force is committed to do the basic nuts and bolts, missionary training work that is required.

MR. WELCH: Our company has been reasonably successful in selling limited partnerships. One of the reasons is that we made a major effort to get the manufacturers in front of the agent in a favorable situation. I was frankly shocked to find that many other companies don't go to that effort. And in effect I think they waste both the manufacturers' and distributors' resources.

MR. ROGER R. SOLOMON: As the experience develops on your different client companies and you have good experience on one and bad on another, do you combine the experience for rate increases? Or do you have each client company treated as a cell and are therefore able to go out and give different rate increases on different client companies?

MR. STOIBER: We do not rate based on client company experience. We realize that rating medical business is the cost of providing the service. It is not a penalty to the insured for the poor quality of the selection that the agent makes. It is an agent problem, not an insured problem, and rating is a penalty upon the insured. Rating doesn't really hit the agents properly. Indirectly it does, but so indirectly that the impact takes too long. Rating doesn't really make any changes in an agent's life-style. So again it goes to the loss ratio type formulas as our way of hitting the producers.

We can't fire the agent but we can prohibit him from writing more insurance with us. In all our contracts we have the right to prohibit accepting business from a given agent or two.

MR. RICHARD J. ESTELL: We have 20 or 25% of earned premium difference in loss ratios on identical products. The company portion can't be enough to make that up. At least it isn't with ours. Also, what size do you consider the smallest company that makes sense to write on your paper? And if you go out and also do it on their paper, what's the smallest size you consider reasonable to do that?

MR. STOIBER: I think close to $1,000,000 in production is what we are looking for. We've been doing this only for five years or so and it accounts for less than 2% of our total volume. So it has not been a problem. If it were 25% of our business then I might have a different outlook as you have at American Republic.

MR. KOLOMS: We came to the conclusion that it probably should not be on the distributor's paper. If we have two companies and we try to file our same products in two companies simultaneously, we end up with two different products. The same thing would happen with rate increases and everything else. The results are not good.

And also consider the tremendous time span for filing in medical insurance. If you are trying to file in all states, consider the time between the time you start filing and the time it would be approved.

MR. ESTELL: About 40% of all our business now is written through outside organizations and it has not been a problem having two different products or two sets of rates. Thus far we have tried not to write on other people's paper because that administration is too messy as far as we are concerned.

We have stuck to companies that have a strong tie with their field force. We prefer career agency or strong branch office and avoid letting a brokerage do this. Do you do the same thing.

MR. TAYLOR: Our brokerage offices have 60% of their business coming in from traditional brokerage. We have been very careful to try not to set up a system directly opposed to the one in effect. So I totally concur.

MR. STOIBER: Mr. Estell, you have different rates. Are the products identical between different agency forces? Do you control the movement of agents by the alignment of the company with the agent contract?

MR. ESTELL: The products are almost identical. There are very minor differences. We control the movement of agents by (1) controlling the allowable commissions, and (2) we have rules that say you cannot go from one to another unless some agency releases the person. And generally we are very strict about allowing them to do that. But two agents can come to the same household with almost identical products and one of them will be 25-30% different in premium. And that has been justified by their experience.

MR. PHILIP J. T. CERNANEC: How do you handle your relationship with your distributing organizations? How do you keep a handle on that? We find creating a personal relationship with people, chemistry, to be a very important part.

MR. SPROUL: I think you are correct; the personal relationships are critical, as is really understanding how a company operates and what its needs are. At UNUM, we have people specifically assigned from the various disciplines who are responsible for administering that particular client. We have someone in underwriting, claims, products and a sales representative who are a client service team. They operate as a team in responding to any of the client issues.

MR. TAYLOR: There is very little commitment from the client company under our method of manufacturing other than emotional. We don't know their field force and we won't know their field force as well as they do for some years. So we ask that they establish a relationship manager for their corporation. We have a relationship manager from our side whose full-time responsibility is to make that account work.

Although it didn't start off that way, most of the relationship managers of the client companies have bonuses based upon the activity of the plan. So do our relationship managers. So, the corporate relationship is all important because things can happen overnight.

MR. CERNANEC: We have quarterly meetings with our accounts or our partners which involve some of our senior people who are not involved in that day-to-day side of it, so that they can take a look at it and see where it is going in the long run. What are some of your thoughts about involving people beyond the day-to-day relationships?

MR. TAYLOR: The relationship managers do the grunt work. They follow the missing policy as it comes through our system and they answer the agent's screams and the corporate screams. However, they do not replace corporate upper management. Their management's continued emphasis and enthusiasm keeps the client companies in the game. The only way is to keep management informed.

We develop a plan as we start with a new prospect company. We all have an idea of what's success and what's failure. After the first year we get a little more scientific. We have persistency numbers and we have a lot of other numbers emerging.

We put together the market plan which includes underwriting information, areas where we have been stung, and any producers who through our artificial intelligent underwriting system have stung us. We sit down with with the management of the other company at the end of each year. Then we exchange perceptions as to what we are doing right and wrong. Is following the market plan a million dollars more than they want to commit that second year? Do they have particular problems? Amazingly, you share information.

After you have been in business for a year, you talk about things which are fairly close to your vest because you both really want the relationship to work. As examples, plans they may have for changing a manager or plans we may have for personnel changes where there has been a problem may be shared. And then we will review semiannually. And usually the review is short if everything is going along well. If it's not going so well it stretches out a little longer. But open and complete communication with top management is the only thing that really makes it work.

MR. SPROUL: It is important to discuss with your clients what their goals and expectations are. We've created our own client advisory crew which meets twice a year. The mix of clients ranges from our largest producers through a broker distribution to a few of our smaller producers that may use an agent distribution. And we talk about new products and what type of services they need us to provide. It's good to hear from your clients as to where you are hot and where you're not. If you get them together and if they have a problem, you will hear. It is a very good process.

MR. STOIBER: Your account manager really needs to make those decisions whether this needs upper level management baby-sitting. It's his or her responsibility to determine what the needs are. And if that means the president has to meet with president, then that is what we do.

MR. RICHARD MCLAREN KELLMAN: Could you give us some typical examples of the level of the corporate allowance for the distributor for rental of its field force?

MR. TAYLOR: The allowance is a formula based upon actual production. We anticipate what the client company's expectations for success are and our own.

Usually we are not too far off. If a client company does less than a half million dollars, we normally do not do business with that company. If we agree that the anticipated sales are between one half to one million dollars in the first year, then we will normally pay our allowances for one million. However, there is a proviso in our memorandum of understanding that if production drops below a half million we could adjust our allowances downward.

MR. KOLOMS: I am very surprised that Time enters into profit arrangements. I thought that people pulled out of the medical business because they were concerned about the losses. Is this something you are insisting upon? Or are these arrangements because the company actually wants higher compensation than you are willing to give them up front? I'm surprised that companies actually want to participate in a downside and upside on medical insurance because of the volatility of that.

MR. STOIBER: They don't have much choice in the downside formula. We force that on them. They are pulling out and there is a reason they are pulling out. So we do have negotiating power in the downside formula. Our target loss ratios are based on our direct business and we are pretty much of a controlled agency system ourselves. If they feel they can write business at least as good as Time, and everybody thinks they can, then they certainly can work with the downside formula. Nobody thinks that they're going to be hit with it.

MR. KOLOMS: Does Paul Revere have financial arrangements where your commissions will vary based on results?

MR. TAYLOR: Everything is planned out; we do nothing differently in terms of products, rates, and compensation that we don't do for our own distribution.