

# RECORD OF SOCIETY OF ACTUARIES 1989 VOL. 15 NO. 2

## MASS MARKETING -- COMPETITIVE STRATEGIES

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- o Both direct response and payroll deduction (and possibly credit) marketing will be discussed. Strategies will include, but not be limited to:
  - Product design
  - Illustrations
  - Niche development
  - Product compensation
  - Underwriting

MR. REX D. HEMME: As I began to focus on the true scope of the topic I became convinced that the subject was probably too broad or too disjointed. The challenge has been to identify the specialties that would be of interest to the largest number of members of the Society. It's clear the first thing one thinks of when mass marketing is mentioned is what's called direct marketing, direct mail, or direct response business. For that reason I immediately decided I needed to find somebody to talk about that subject. The second subject we will be covering in this session will be mortgage insurance. That brings us to the third part of the session. I am with a subsidiary of Lincoln National Life Insurance Company and we do most of the payroll deduction life insurance that is done by the Lincoln family. Having the moderator's prerogative, I will speak third.

MS. AMY HELEN COLGLAZIER: There was a time when there was pretty much one major concern among insurance companies, and that was, "I have a block of policyholders, I'm generating revenue from those policyholders, and the world will truly be in order as long as I keep those policyholders on the books." And, of course, the way to do this was to keep the agents and the brokers who put the customers on the books, and keep them very happy.

The way companies chose to do this -- and many are still trying the strategy -- was to invest a lot of money in agent training, computer support and programming, and lead generation programs, even when they weren't cost effective -- many have not been -- while at the same time increase agent and broker compensation and develop more competitive, low-priced products. Because this relationship between the company, the agent and the policyholder has been so strong, no company dared threaten this menage a trois by developing any alternative distribution systems that might be perceived to be competitive with the traditional manned systems.

The trouble with the system has been that it doesn't always run efficiently. Company overhead and product loadings have been increasing at a rate that's faster than the customer bases have been able to expand. On top of this, particularly in the U.S., the competition within the industry has really been increasing.

As a result of new technology, data base marketing techniques, agent turnover, and replacement, your so-called captive markets -- the policyholder bases your agents assembled over the years at considerable cost to the companies, the customers who were providing you with your vital traditional forms of revenue -- were breaking down. Those old loyalties you thought you could count on, regardless, simply weren't holding up anymore.

So you've got to start protecting your existing customer base. And right now what is happening in the U.S. is happening in Canada as well. The traditional manned systems alone aren't able to compete in the new marketing environment. Your customer base is being bombarded at every turn with insurance and financial services offers through the electronic media, the television, the telephone, through press or mail; and with deregulation coming on the heels of this increased competition, the situation is only going to get worse, particularly for insurers.

## PANEL DISCUSSION

Sometimes when we think deregulation, we think about a hunger frenzy among trust companies and savings companies and life insurance companies -- companies that before weren't either able to or interested in selling certain types of insurance -- rushing into the market and selling life and other types of insurance as if the products had just been invented. And everyone wants to rush in and be a financial services organization until you get to the point where the market simply gets supersaturated with offers.

So now we're talking about two levels of competition -- that from the new players in the game and that from the new distribution channels -- altogether creating a net effect to the customer that is exponentially explosive. And the problem's worldwide. It's not just here in Canada, it's not just in the U.S.; it's in France, Germany and the U.K.

A good example of what's going to happen in a fully deregulated environment is Australia. The four top banks have each acquired or formed their own life insurance companies. The two top life insurance companies have countered by acquiring 45% interest in newly-formed banks. And the process is just going on fast and furious in Australia as well as New Zealand. The banking institutions in France have decided to get into the insurance business with a vengeance. They are projecting they will be writing 45% of the life investment premium in 1989. Proposition 103 in California is the latest and most publicized indicator of what's going to happen here in North America.

So now we've reached the point of no return. And insurance companies in Canada and the U.S. have to start taking action to protect their existing relationships from the shifting loyalties. It's a battle, pure and simple. And the objectives have to be increased market penetration and increased customer understanding so you can better provide for his needs and secure his loyalty.

We might ask, when did the customer stop being right? You know, the customer has shown a particularly interesting side to this deregulated environment. Surveys have shown so far that customers are getting very confused. The herdlike mentality of all these companies rushing into the marketplace with pretty much the same products -- most of the time not what the customer wants or what the customer can understand -- has made this first generation of customers even more resistant. In marketplaces like these, they are doing everything they can to get advice and a sense of direction on what to buy and what to do. As a result, in Australia there's a whole legion of financial planners that have been developed. And as we know, in the U.S. financial planners are an industry all their own and deregulation has only just begun.

So where are we today? Well, we have low agent retention, low persistency and low margin products. We have new data base marketing techniques breaking down our existing customer bases; we have increasing deregulation adding even more competition for eroding customer bases, and we have reduced customer attention because he is confused and uncertain where to turn. So what are you going to do to compete?

There are going to be many corporate issues that you are going to face in a deregulated environment -- joint ventures, mergers, strategic alliances with banks -- so that you can broaden your market reach. But among all these issues, there is one thing that you can begin thinking about that's going to help you no matter what your goals or strategies are. And that's to begin to look at your marketplace, not as distribution driven, where you limit yourself in terms of only traditional methods of distribution and products, but customer driven. You start looking at your marketplace as who is the customer, what are his needs, and then decide what system you are going to use to deliver those products.

So what's your company's strategy? If it hasn't already occurred to you, we need to stop thinking in terms of traditional systems alone. They require people and continuously expanding budgets. All systems have limitations whether we want to face that or not, and traditional systems do have limits in terms of productivity and their geographical reach.

As J. Paul Getty once said, "The heaviest burden in times of rapid change is experience." And it's very difficult for the financial services industry, and companies in particular, to evaluate the effectiveness of traditional sales methods.

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So with a customer-driven approach, you will find one thing that is going to happen instantaneously. You are going to start thinking more creatively about how to reach the customer and how to better serve your sales force. So how do you develop such an approach?

Well, first of all, retain your existing systems, but in addition start adding and expanding those systems by incorporating direct response techniques or other mass marketing distribution and communication methods. In order to survive in the 1990s, one-to-one distribution methods are going to have to be supported or complemented in order to be cost effective. Direct response marketing, which I like to call response marketing, has become a science over the last twenty years. It can be used as a one-to-one distribution system to develop a sale, which is the way most of us tend to think of it, or it can be integrated with a sales force or a team of sales specialists to develop a whole new distribution system.

Response marketing, and the diversified systems that it provides, helps marry the old traditional methods with new, more volume-oriented, target marketing and relationship marketing distribution methods. Such a marriage will permit you and the agent to penetrate new markets that you haven't been able to penetrate before profitably. The ultimate sales objective is not indiscriminate mass marketing, but carefully targeted one-to-one distribution to mass markets -- in many cases as a supplemental tool to the agent.

A recent example in Pennsylvania is, The Mellon Bank. They've developed a really interesting variation on the diversified system approach. They've got an insurance agency that has about twenty products that they sell through a dozen or so banks or mortgage companies and they use many different distribution methods. One of their branches was able to achieve a 23% penetration rate selling mortgage life insurance to customers in the bank on a face-to-face basis. They added another 15% by batch segmentation techniques. Then they gave the names from the batch segmentation that didn't respond to the agents. Now remember, these are people who had already been solicited electronically and turned it down; and the agents were able to achieve another 25%. So, by diversifying their distribution they were able to penetrate 63% of their market versus the 23% they did on a one-to-one basis.

So what is important is that financial institutions recognize that being able to increase market penetration and reach universes of customers of thousands or even millions at one time is going to be essential in the 1990s. And in order to do that, we've got to have a working knowledge of the technology that allows us to do that -- both in conjunction with, and in addition to, our traditional distribution systems. It's also going to require a highly refined data base of new and existing customers to be constructed and maintained so that you can begin offering value added services on an ongoing basis, cost efficiently.

Tomorrow's data bases have to be capable of identifying customers by account type, number of accounts, account duration and size, date of birth, sex, income, size of mortgage -- as much information as you can possibly get. This is the customer-driven process I was talking about. You have to start knowing your customer. Your marketing strategy should begin with your existing customer base so you can identify and target each one with specific offers that demonstrate 1) you know who he is and 2) you know what he needs.

It's this intimacy with your existing customer base and your prospective customers that will help distinguish your marketing efforts from other "hit and miss" mass marketers. Instead of thinking of the numbers of life annuity and health and accident policyholders, you are going to be thinking in terms of what you are doing for each customer and what is yet to be done.

You have to start knowing what policy he has, what he may need, and how profitable those policies are. It's the only effective way to begin rationalizing your policyholder base and making it more profitable. I also believe it's the only way you're going to be able to compete in a deregulated environment and unconfuse, if you will, the new consumer. You've got to know who he is and what his needs are better than any other competitor out there.

So let's talk specifically about what people in financial services are finding about response marketing. First, it can take you into untapped markets -- markets where you simply weren't able to go before because it was too costly to pursue through traditional systems alone.

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Response marketing permits you to test new products without spending huge sums of money. That's because you are able to go to specific customer segments and test before you take it to the general public. And, of course, what we are talking about are products that are going to be sold exclusively through response marketing. The facts show that response marketing requires new simpler, less expensive products which allow you to reach segments in your market who need supplemental insurance that your agents simply can't afford to sell.

These are products which help you in your mix between high profit and low profit products. A corollary to all this is that response marketing can never sell an agent product on its own. It can only make it easier for the agent to sell.

Response marketing can allow you to offer value added services to your existing customers and increase customer loyalty and persistency. Studies have shown that the more products someone buys from you, the more likely they are to keep those products. It can help you improve the productivity and the income of your sales force by generating cost efficient leads, and assisting agents with advance notices in the mail of an agent's intention to call.

As new agents begin to get into client's doors that have been opened by response marketing, agent turnover can even go down. Response marketing should be used to build the relationship between the company and the agent and the relationship between the agent and customer. And in a fiercely competitive marketplace, the concept of agent loyalty may be most vital of all.

Lastly, response marketing can become its own new profit center. As a distribution system on its own -- that is, one that permits the customer to deal directly with the company -- many customers are showing a distinct preference for dealing on the one-to-one basis through the phone or mail.

Response marketing enables you to create an entirely new profit center -- one in which products are designed and costed specifically for that distribution system. The technology permits you to project the marketing investment you are going to need and the return on investment you should achieve five, even ten, years down the road. So for insurers, diversifying distribution can accomplish many things.

As for the issue of alternative distribution systems conflicting with traditional agent methods, worldwide experience shows that just the opposite is true; that agents' goals are being successfully supported and even enhanced by the proper use of alternative distribution methods.

The issue, therefore, is not what distribution system is the best, but what combination of distribution elements will produce the most effective results. So how do you begin achieving these benefits?

Well, you're going to build a customer data base. To achieve any degree of success in a deregulated or even a semideregulated environment, it's going to be critical to be able to access certain customer segments. Some call it batch segmenting, others call it data base marketing. First, this means you have to start thinking about your policyholders as your agents do, as customers. And your current customers are your company's greatest asset.

So begin reviewing the data you have on your existing customers; then determine what information you are going to need to best service them. Then you can make arrangements so that you begin getting all of that information in all your future communications, either through the media or your agents or your prospects. This means every response you receive from the outside -- either producing a new customer or simply an inquiry -- should be kept and a record of the transaction be placed in a customer or prospect file.

It requires that you input as much data on each customer or prospect as you have available -- the age, income, sex, account type, purchase frequency, date of purchase, amount, etc. Keeping a prospect customer file helps you further define your target market. This in turn gives you a finer focus for developing your promotional materials and your future marketing plans. So data base construction and management are an essential investment.

As previously stated, the so-called captive market of yesterday is the most self-deceiving misnomer of today because today's customer belongs to many data bases. It will be the one who can identify or target him most closely who will ultimately win his continued business.

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You have to be able to assess all of your available customer and prospect segments. In assessing your market, you have to know what makes a person a prospect for your product and how he will use it. If it sounds elementary, it's amazing, nine times out of ten the reason a program fails is because the person hasn't done the homework necessary to determine who the market is, what the potential for that market is, and how that market will use or perceive the product. In other words, the effort simply wasn't customer driven.

Also, with your existing customer base, it is important that these market segments be assessed in terms of what is the best and most cost-efficient distribution method. Should agents pursue these products and markets on their own? Or can these segments be best penetrated by response marketing -- maybe because of geographical constraints, or maybe because these are products that have low tickets (small premiums) on them?

And then you've got to decide which segments are going to be best used with both systems together -- the agent and response marketing -- to achieve an entirely new distribution system.

Once you know who your current customers are and what they need, you're going to be better equipped to go after new markets. And the one place you can count on needing every conceivable technology is in the broad marketplace. Every competitor, and some you didn't count on, are going to be out there gunning.

So how do you approach it? You don't need to reach every potential insurance buyer -- just the people who are most likely to need your particular product or service. So begin taking the process apart. Decide which products you can afford to offer to which markets at this particular time considering your administration and computer constraints. It's important to decide well in advance in your short-term planning which market segments or niches you pursue and which distribution methods will be most crucial and penetrate a given marketplace, cost efficiently.

This takes me to my final objective. If there is one principal that best characterizes response marketing, it is the ability to spend only what's necessary to make a program work. You can advertise, you can use public relations, you can have high profile lead generation programs. But traditionally, none of these are disciplined in such a way that you actually spend what is necessary to meet your sales objectives as you would in a pure response marketing program. With the fixed nature of most of the response-marketing-related costs, you know well in advance of any marketing program.

By controlling these costs, two things happen. First, you can develop your products and premiums in a much more efficient manner and project your profits much more accurately. Number two, disciplined cost controls can help you produce more marketing budgets from limited budgets. Many companies are being burned by current lead generation programs which are being set up without any cost controls and even worse, with no way to measure whether the program has been a success or a failure. Many people are simply not taking advantage of the controllable and measurable nature of response marketing to their full financial advantage.

So let's recap. I believe response marketing is the one essential ingredient for any one of us to be able to achieve our corporate goals in the 1990s because it will be one of the key elements in helping us revise marketing and sales policies so that people will begin thinking in terms of a customer driven marketplace. But often when the issue of diversifying distribution comes up, particularly when response marketing is mentioned, people's eyes tend to glaze over and they simply say the agents won't stand for it. And maybe that's the crux of the problem; fear of alienating agents.

You know, there has been this long-standing question, who owns the policyholder -- the agent or the company? The problem is, the answer is that our competitors often own our policyholders and our agents. That's what we have to start protecting against. So, I'm not advocating replacing your distribution system, only enhancing it. And initially some agents are going to feel intimidated by this idea because they have always looked at response marketing as a rival distribution system. But once you can show your agents how it can be used to make them and the company money, particularly in markets that they have never been able to penetrate before, if they're practical businessmen, they'll begin to be excited about this and begin to listen.

## PANEL DISCUSSION

We can't keep living in a world of stereotypes and two stereotypes we have had for a long time are that agents only care about commissions, and actuaries only care about profit, and never the twain shall meet. That was another era and another time. And the fact that we have a nontraditional marketing section in the Society of Actuaries, I think, is a good indication of that.

So the question is clear. Are we sure we know what the customer wants? And if we do, are we afraid to give him what he wants because it will mean we are unable to accept the idea of new distribution systems? The point is, if you don't provide the product and the distribution systems that your customer is most comfortable with, there will be plenty of companies who will. So ask yourself, can you afford to keep ignoring the new customer and the new environment he has created?

MR. WILLIAM R. HORBATT: My topic is "Competitive Strategies for Credit Insurance Products." To give you some background, credit products are primarily mass marketed to first mortgage loan and credit card holders. The mainstay of the mortgage coverages remains level premium, decreasing term life, while additional coverages being marketed are AD&D, temporary disability, and critical period life.

The most popular credit card coverage combines life, disability, and unemployment insurance coverages. Credit insurance products are being marketed at the point of sale, through telemarketing, using direct mail and even through agents.

After spending nine years in this business, I have recently enjoyed the luxury of looking at it from the outside. My speech is going to reflect this by focusing on how strategic planning can be applied to credit insurance companies.

Strategy, in this context, is a high level, direction setting process. There is no single best strategy; nor is there a strategy that is right for every company. Strategic planning involves the identification of your own company's strengths and weaknesses; it involves the understanding of your marketplace, your customers, and your competitors; and it involves the synthesis of that information into an overall corporate plan. It's a touchy, feely process, but it's one that actuaries have a lot to contribute to.

Looking at the credit insurance marketplace, we see two tiers of customers. A life insurance company first has to sell the financial institution before gaining access to that institution's customer base. The financial institution judges us, both on the basis of our ability to effectively direct market and on what kind of upfront compensation we will give them. Sometimes I feel upfront compensation is all they care about.

We're in a mature market with few companies entering and established companies leaving it. I know of only one new entrant, Chubb American, but I know of a number of companies that have recently exited -- companies like INA, Met Life, Transamerica Occidental, and most recently OFLIC. The market is fragmented with no single company dominating its targeted segment -- with perhaps one exception.

New entrants appear to set the competitive standards. Current mortgage sales, for example, focus on takeovers of other companies' blocks of business. Takeover bonuses are being paid equal to 5-10% of annual premiums. Companies are evaluating this business prior to taking it over and they are either adjusting the commissions they are paying to the institution or changing debtor premium rates.

The regulators are developing an interest in takeovers, now that they see the consumers' charges are changing. And we see a trend toward the requirement of positive enrollments. This is another challenge or, in broker terms, opportunity for mass marketeers.

The industry appears to be engaged in a zero sum game. You win only at someone else's expense. Companies with established blocks of mortgage policies are experiencing lapse rates of up to 30%, versus historical levels under 10% as their customers switch carriers. But new carriers protect themselves from the same fate by contractually requiring the institution to repay any unamortized solicitation expenses should they lapse within a period of time, say five years.

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An overriding problem is that enrollment results have been declining. Jay Jaffe feels this is the result of noncreative product design. He may be right, since actuaries seem to spend a disproportionate amount of time fine-tuning existing products.

Chuck Murray from Consumer Marketing in Los Angeles thinks the problem of declining enrollments can be countered by a more effective sales strategy. Starting with an effective point-of-sale approach, he thinks the lending officer can get an enrollment as high as 30%. But that requires providing that lending officer with incentive compensation which brings you into the issues of agent licensing, or is there some other way to do it?

You can follow that up with a solid telemarketing effort, and Chuck knows telemarketing. But here he feels you can only get 8-10%. Sending agents out is probably worth 5%. And finally, the traditional direct mail approach may be worth 1.5%. I think both Jay and Chuck probably are right about the market.

With this background behind us, what can a company do to succeed in this tough marketplace? One thing it can do is adopt a formal strategic planning process. There are at least three basic strategies available to the company.

First, the company has the option of becoming a niche player, focusing upon a particular market segment and serving it better than its competition. The company that comes to mind in this area is CUNA Mutual. CUNA provides a wide range of services -- everything from data processing to directors' and officers' liability coverage. It dominates its marketplace.

Another niche strategy that a lot of companies have considered and are actively following is the strategy of being a geographical player. Unfortunately, as the traditional boundaries between financial institutions break down, particularly the state barriers, this strategy is losing its luster.

The second basic strategy is to become a low-cost producer. For example, a company could farm out mailings and all other services to vendors on a competitive bid basis and focus its attention on reducing internal "manufacturing" costs by strongly reducing product variations and streamlining its administrative processing.

The third, and final, basic strategy is to differentiate yourself from your competitors. This is difficult to do since we can't copywrite our policy forms. Proprietary systems developments are more promising. In this sense, I recommend you buy your nonstrategic systems, such as a general ledger, and build everything else. A good example outside our life insurance industry of a systems approach is Burlington Fabrics, which developed an inventory system that permits its telemarketers to access its complete inventory, process an order, and have it in the mail the next day. In this case, they can outcompete the department stores.

The single most important part of the strategic planning process is making a decision to stay or exit from the credit insurance market. Some companies, like Met Life, have exercised the exit option, while others -- and I would take as an example a smaller company like Credit Life -- couldn't have that option because it is its entire market.

Ask yourself whether credit insurance has a strategic fit. Are there better alternative uses of resources? Does the credit insurance product line complement another line such as SPDA sales through thrifts? Are your administrative capabilities superior to the competition? Do you have a captive customer base such as a portfolio of residential mortgage loans? Are you comfortable with the philosophy of credit insurance?

After answering the basic gut-level question of whether your company fits the marketplace, you're ready to consider the financial aspects of the decision. Even profitable companies can benefit by understanding their sources of earnings, particularly as the mix of business changes. Credit insurance companies were surprised when Prudential entered the bank credit reinsurance marketplace with negative retentions, but quickly realized that investment income should be explicitly factored into pricing decisions.

Expenses appear to be the more important current issue. Companies exiting the business usually cite the lack of critical mass behind their decision. They can't grow fast enough to bring their average unit cost down to the level required to be competitive.

## PANEL DISCUSSION

Companies remaining are developing both expense and client management strategies. You may wish to think of this as a feedback loop. If your pricing expense assumptions, applied to your actual insurance in force, cannot support your existing expense levels, then you have a problem. Successful companies have faced this, and generally solved it, by developing a strategy of unit cost reduction in conjunction with growth. They avoided being all things to all people. They focused themselves to enforce a certain degree of uniformity in their efforts.

Client management strategies are founded upon financial reports prepared at the underwriting level, your client -- the group you can cancel, if you will. A systems solution is essential to having this information available on a timely basis. The results don't have to exactly tie up your general ledger, but they should identify all significant sources of profits including investment income, expenses, and underwriting gain. It's always interesting to see management's reaction the first time they see in-force clients' financial results prepared on a current assumption basis.

Having participated in the divestiture of a credit and mortgage line of business, let me share some insights into the process. The smartest move we made was to engage Gary Fagg as our intermediary. Unencumbered by the psychological baggage that failing organizations accumulate, he quickly and quietly prepared an actuarial evaluation and prospectus. This was confidentially given to a select group of companies that senior management felt comfortable with, and within six months we were completely out of the business. The consumer credit insurance was sold separately from the mortgages, and we found out that consumer credit does not command a very high price indeed.

This brings up another interesting aspect of mortgage life insurance -- benefit reserves. Stock life insurance companies writing on individual policy forms generally held GAAP benefit reserves that would equal roughly half a year's premium. Other stock companies that were writing mortgage insurance using group insurance policy forms didn't hold reserves. They argued that the rates were changeable at any anniversary, and therefore, were not required.

Companies that did hold the reserves could recapture these funds by selling their business while the new owner would not have to establish a new reserve because they wrote it on a group policy form. This particular issue doesn't bode well for the consumer who likes to have level premium rates.

My final topic is financing the acquisition of new business. The life insurance industry traditionally financed new business growth out of either retained earnings or by purchasing surplus relief. As the overall ratio of industrywide capital and surplus to premiums has declined, surplus relief is getting more expensive. What once cost as little as 1%, is now edging up to the 3-4% range. Stock life insurance companies responded by establishing sister agencies that paid out solicitation expenses and were permitted to hold the deferred policy acquisition cost asset on their GAAP books. The life company statutory statements showed only renewal commissions paid to the agency.

This has recently gone one step further, with the agencies obtaining cash to pay the acquisition expenses either by selling the renewal commission stream or by borrowing and using that stream as collateral. The financing costs are reduced to approximately 1% upfront and 1% ongoing.

You may wish to think of this as a natural extension of banks buying tangible assets, such as receivables like agents' balances. Banks in partnerships are now financing an intangible asset, the renewal commission stream.

Should you be interested in this route, keep in mind that bankers, by their very nature, like to be overcollateralized. So don't expect to borrow your entire acquisition expense. Be prepared to document expected results with hard cold analyses of prior mass marketing campaigns. If you disagree with the bank about expected enrollments, you may wish to temporarily borrow your money from the life company, and then when the enrollment results have come in, collateralize them.

MR. HEMME: For several years now the primary dominant product in payroll deduction has been the universal life product. I'm really not sure why it's a flexible premium universal life as opposed to a fixed premium universal life, or interest-sensitive whole life, or whatever you want to call that other beast. You would think that if you were selling regular deductions from



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paychecks, some kind of a fixed premium would make more sense. But the market hasn't drifted in that direction and my suggestions to our marketing people that we try it have met with some resistance.

Usually, in addition to the universal life product, a children's term rider is available; and commonly, another insured or waiver of cost rider is also offered. Some carriers have tried accidental death benefit riders and other types of riders but the basic product is universal life -- I think almost without exception.

The coverage can be offered under either a group insurance or an individual insurance contract. A lot is made in the marketplace about the differences and the relative benefits and disadvantages of individual versus group, but when you get to universal life insurance, I'm not sure why there should be any significant difference or advantage of one over the other.

At present, my company offers payroll deduction under individual policies. We've considered group insurance; we may eventually offer it. We're still trying to figure out how to make Life 70 do group insurance. I'm having problems convincing our systems people that there's not a significant difference between group and individual universal life insurance.

My protestations that there's not a significant difference between individual and group insurance largely falls on deaf ears among our marketing people. In my most cynical moments, a few of which I have these days, I attribute this demand for group universal life to a desire on the part of our marketing people to match very aggressive numbers that they see illustrated by other carriers. It makes no difference that some of the group universal life products available in the marketplace are paying only 35% or 40% agent compensation and so far our marketing staff has not indicated to me that they are interested in marketing with those commission scales. There seems to be some magic in their minds that the word *group* automatically makes the mortality charges lower, the loads lower, and obviously the interest crediting rate higher.

It is true that most of the requests for proposal (RFPs) that we see are couched in terms of group insurance. So to this extent, perhaps there's some advantage to be gained from offering group universal life in the payroll deduction marketplace. I feel the bias in these RFPs is largely due to the comfort zone of the employee benefit consultants who are typically drafting the documents in the first place. Since such consultants are most commonly engaged in diverse employee benefits consulting, they're more accustomed to dealing with group insurers and there is a natural bias that follows from that. To be a little bit more cynical, I think in some cases the consultants have already made up their mind who the carrier is going to be, and they're just engaging in an exercise to satisfy political or legal requirements, particularly in the case of public bodies, of assuring the overseers that they have done due diligence in finding the best deal they can find.

It's a real challenge to our marketing personnel and to other marketing personnel in the payroll deduction marketplace to identify which RFPs warrant their expense of energy and which should be disregarded. But such discrimination is exactly what you have to try to do.

While I've dwelt so far on the group versus individual universal life issue, there's a bit more to product design in payroll deduction than that issue. Of late, I've noticed a new rider -- I guess in the last year or so -- in the individual sale marketplace on universal life insurance. That rider is the long-term care rider of which I've heard discussions in at least two, probably three, sessions that I've attended at this meeting. This rider, if you haven't seen one, and, as I say, you've probably had the opportunity to at least hear about one at the meeting, accelerates the payment of the death benefit upon medically necessary confinement in a long-term care facility. The terms *medically necessary* and *long-term care facility* are both defined in the rider and vary from rider to rider. The amount of the monthly annuity benefit in all products so far introduced, I believe, is 2% of the death benefit of the base policy up to some specified maximum; in some cases, a lesser percentage of any excess death benefit is added to the base amount.

Sales results in the individual sale marketplace have been disappointing so far I am told. In part, this is attributed to the warming up period before a producer becomes sufficiently familiar with a product to feel comfortable selling it. One of our sister companies, First Penn Pacific, has reported an increase in the penetration with their long-term care rider now. I think something like 40% of their individual sale policies now have long-term care riders attached to them.

## PANEL DISCUSSION

At any rate, I believe this long-term care rider will be a valuable arrow in the quiver of a serious competitor in the payroll deduction marketplace. The reason I feel so strongly about this product is that employers are continually expected to provide for their employees' welfare -- even postretirement. Long-term care has recently received significant attention as a life contingency which is very expensive and increasingly likely to occur as life expectancy increases.

While this contingency has been identified, the financial pressures of funding other employee benefits, particularly group health insurance, have dramatically outpaced inflation. As a result, the employer sees himself already strained by existing benefit programs and is reluctant to assume the financial burden of additional benefits. The long-term care rider would offer the employer a way of providing to the employee the option of covering the contingency himself, without the employer having to shoulder the cost burden. Once the rider is offered, the employer may feel somewhat relieved of a moral burden, if you will, even if the employees ultimately decline the rider coverage.

Another insurance coverage for which we are hearing increasing requests is disability insurance, either as a rider to a universal life policy or as a stand-alone policy. I believe the carrier who offers such a product -- and to my knowledge there's not an overwhelming offering of that product in the marketplace -- will sell a heck of a lot of this business. But I have some concern for its long-term survival. While confinement in a long-term care institution has inherent deterrents to elective utilization of the long-term care insurance benefits, past experience in the blue collar marketplace with disability insurance indicates that such deterrents don't exist in sufficient degree for that product, particularly in an economic downturn. Nevertheless, I predict that some carrier will introduce a disability income policy into the payroll deduction marketplace soon.

The second topic I was going to cover is niche development. This is not a particularly innovative strategy. It's pursued in individual sales, and it's pursued in credit insurance as you've just heard. In the payroll deduction business in particular, you see some companies specializing in particular industries or, for instance, New England Life targeting pension and Section 401(k) business. I understand, although I don't know the details about it, that Great West has also recently gotten into the payroll deduction business in response to Section 89. It's not really to say that these companies don't do payroll deduction business outside the qualified plans or the Section 89 tie-in, but they just identify a broad market in which they feel there is sufficient business to warrant their specializing their marketing thrust and targeting for that business.

At the producer level, CBS, my company, has producers who specialize in hospitals and textile manufacturing, for instance. Again, these individuals don't have exclusives with the businesses in the particular industries they specialize in, but they have managed to get themselves known widely enough in a particular circle that their names have become synonymous with payroll deduction insurance in those specialized industries.

Other producers for other companies have identified other industries or public bodies as the focus of their sales activities. It is axiomatic, but the carrier who wants to court the production of a specialist producer must be willing to meet specific needs pertaining to that specialty industry when those needs are identified.

The third topic of competitive strategy is producer compensation. This is probably the most important if you view the producer as your customer. While producer compensation is not limited to commissions, that is at least a good place to start. In fact, we can narrow the focus even further to first year commissions, since renewals seem almost immaterial in our business. I think the focus on first year commissions is probably due to at least three factors.

First, a significant expense is incurred in marketing this business in the first place. I believe that successful marketing of payroll deduction requires that the producer or some representative of that producer sit down individually with each of the employees of the company to try to make the sale. Now that doesn't have to be -- in fact it shouldn't be -- a full-blown financial needs analysis or estate planning engagement. But even sitting down for fifteen or twenty minutes per employee is a significant time commitment. It's going to be the case that the producer himself, if he does the enrollment, is going to realize an opportunity cost (that is, he won't be outselling other cases, but rather he will be sitting down with what we irreverently refer to as "Johnny Lunch Bucket" and trying to sell him payroll deduction life insurance) or he's going to have to hire a contract

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enroller. Contract enrollers are typically interested in helping themselves to 30-35% of premiums or half of the commissions if that amounts to more than 30-35% of premiums.

The second reason for the focus on first year commissions is that the producer has some reason to expect that, if things go well in the first enrollment, he will be allowed to enroll new employees in subsequent years. This provides the long-term annuity offered by renewal commissions in individual sales. In subsequent years he will get first year commissions on the new enrollments.

The third reason for the focus on first year commissions to the detriment of renewals is, frankly I think, the knowledge on the part of the agent that this business isn't going to persist very long. The two primary causes of termination are termination of the employee/employer relationship, which is generally voluntarily induced by the employee, and producer-induced rollover of the business from one carrier to another. That happens more frequently than I would like to admit.

Still focusing on first year commissions, I would say the conventional wisdom -- the larger the case, the lower the commissions -- is only partially true. At CBS we developed three series of products. One pays a high commission and was designed specifically for the small case -- 50-250 lives. The low-commission product, on the other hand, was designed for cases of 1,000 lives or more. While I would say that in many cases producers have adhered reasonably well to these case size guidelines, there have certainly been instances where producers have chosen to use higher commission products in larger case sales. There's this concept called "case control" that they like to talk about.

In some instances you can justify the higher commissions because of circumstances surrounding the enrollment. For instance, if you have a 2,000-employee case, but you have, say, 50 locations, your expenses of doing the enrollment are going to be substantially higher; and you might be able to justify the higher commission in such an instance. Other valid reasons might be advanced for choosing the higher commission product, but I would be less than candid if I denied that greed didn't enter at times.

Occasionally, things get a little bit dicey when the producer has this selection of products and selection of commissions he might offer. For instance, there was the time about two months ago when we had two different CBS-contracted producers offering different commission-level products to the same case. Or there's the other instance where the producer had a "controlling relationship" with a case, so he thought, and led with the highest commission product. When he realized he didn't have the degree of control he thought he had, he tried to go in with a lower commission product. Somehow I think he lost his credibility at that point.

Our lowest first year commission rate is 50% of target premium. I understand there are carriers who have lower commission products, and, judging from their illustrated numbers, I hope this is the case. But my bias is that unless the life insurance product is presented in a face-to-face enrollment, the participation rate will be too low to obtain a reasonable spread of risk.

Accepting that bias for the moment -- and you can disagree with it later in the comment section -- and assuming a competent enrollment will cost a minimum of 30% of premium, it would take a mighty unusual producer to settle for less than 20% of premium as compensation for his sales efforts.

On the high side of the commissions, I am aware of commission scales running significantly above 100% of target premium in the first year. Leaving aside my personal biases about commissions exceeding 100% of premium, I am amazed at the apparent competitiveness of some of the products offering these commissions. My conclusion is obvious, such products are either underpriced or illustrated unreasonably -- maybe both.

Other forms of agent compensation include services such as providing computers and software for enrollments, and persistency and production bonuses which are becoming increasingly important to me personally. Other possibilities might be some equity participation in the business, either through an agent-owned reinsurer or through long-term participation in a less formal arrangement, but I am not aware of these kinds of arrangements having caught on yet in the payroll deduction business. I think this must have something to do with the fact that the agent is really not that interested in the renewal activity of the business. He'd rather have it upfront and he gets it.

## PANEL DISCUSSION

The fourth strategy I wanted to discuss is underwriting. When talking about payroll deduction insurance, I don't think you need to talk about underwriting. What you need to talk about is forgone underwriting. It's been traditional in this market to offer guaranteed issue of a multiple of salary up to a fixed dollar amount -- for instance, 2 times salary to \$100,000 or 3 times salary to \$150,000 -- to any employee who is actively at work on the date of enrollment. That's all he has to be able to say.

I became concerned around the first of this year, when during the course of two or three weeks we got four applications on very ill employees. Two admitted they had AIDS -- one was in a very advanced stage. He only wanted \$111,000 in coverage, and got it. Another had terminal lung cancer -- \$150,000. The fourth had had a mastectomy three weeks prior to the enrollment. What were these people doing at work? Our total exposure on these four lives is a little over \$400,000.

I think there are several factors at work here, not the least of which is collusion on the part of the employer. I'm sure that the employer feels very badly for the very ill employee, and what does he really have at stake in adverse selecting against the payroll deduction business? He doesn't have the experience rating that he would on his group life insurance coverage, so he really doesn't have that much at risk.

The challenge to the insurer is to recognize that this kind of collusion, if you will, exists and to minimize the exposure. Where the typical arrangement is a guaranteed issue of, for example, 2 times salary to \$100,000 and simplified issue based on some five broad health insurance questions for amounts in excess of \$100,000, I think we may see the payroll deduction industry go to a three-tiered approach. We still have guaranteed issue, but the true guaranteed issue (are you here and are you alive?) will be limited to something like \$20,000 or \$25,000. Then there will be a second tier more at the level of guaranteed issue amounts (\$100,000 kind of numbers) for anybody who can say, "Yes I'm here and I've been here for the last 30 days," or "I've not been hospital-confined for the last 90 days." I don't think we can much longer afford to take the kind of risks that we absorbed in January. The third tier will be simplified issue based on the five medical questions for the excess over \$100,000 or whatever.

The final topic I want to discuss is illustrations. I saved it until last because it is something that's concerning me a lot both in the payroll deduction industry and in the life insurance industry as a whole.

"Illustrations" are at the same time the most useful and the most useless paper produced by the insurance industry. To listen to producers, as I must, illustrations are the single most important sales tool they have. To listen to them, the employers who tend to be our buying public focus on that age 65 cash value and not much else. They don't ask what the loads are; they don't ask any intelligent questions.

But as information sources these illustrations are vastly overrated. In my opinion, the illustrations produced by some participants in the payroll deduction arena, as well as in the broader life insurance industry, are more a testament to the creativity of actuaries and marketing personnel than anything approaching a meaningful attempt to inform the prospective buyer about the true features of the product he's buying.

Credited interest rates are sometimes arbitrarily increased at some future point, say beginning in the eleventh year of the illustration, either on the basis that "who knows what the interest rates are going to be in ten years" or on the basis of "current practice." Current practice is an interesting phenomenon. What does it mean for a carrier to illustrate credited rates that increase by 50-100 basis points after ten years based on current practice when the oldest business it has on its books is in its fifth or sixth duration?

In addition to game playing with credited interest rates, we also see illustrations based on mortality charges projected to decrease due to mortality improvements and on reduction or elimination of loads after a period of time -- again, typically ten years.

Other gimmicks are introduced as well, but very seldom are the "enhancements" guaranteed. Usually these guarantees aren't offered on the basis that regulators won't allow them or they make it very difficult. That's all probably well and good, but to me the most disturbing fact about these illustration enhancements is that they're not disclosed anywhere on the illustration. If you know

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what a company's loads are, and you know what their credited rate is, and you find out what their mortality charges are, you would think that a reasonable actuary ought to be able to come up pretty close to their accumulation values. What you often wind up having to do is get a producer to call the company to find out how they obscured the illustration.

It seems to me that this illustration chicanery reflects a very cynical view on our part of the intelligence of our buying public. Perhaps this cynicism is justified based on the fact that so much attention appears to be paid to the bottom line of the illustration, but the regulators ultimately take a dim view of our taking advantage of the intellectual shortcomings of our buyers. I think that doesn't bode well for our future.

I think we had an opportunity with universal life to demonstrate some corporate citizenship or integrity and perhaps minimize the regulation of that product; but we've chosen, in the aggregate, not to take that approach but to go for the gusto right up front.

We're beginning to see now the result of some of our illustrations. One of our producers gave me a copy of a letter from a company president. The company is a significant player in the payroll deduction business. The letter informs the producer that credited rates will be reduced to 7.25% for older business. The implication is that current issues will be offered at competitive current rates, although it's not really so stated in the letter.

From the letter, the reader can learn that "many old products, particularly back-loaded products, assumed much higher spreads than those in the current portfolio." I think it's true that, at the outset, we priced universal life with somewhat higher interest spreads than we do presently. But then I learned from a later portion of the letter that originally we were pricing with 300 to 400 basis points of interest spread. Has anybody in here ever priced a universal life product with over 300 basis points of interest spread? I think the most I ever used was 200. There might be some 250s out there.

The letter goes on to inform the reader that "for any given product series the bulk of the investable funds are generated in the first two or three years." It's kind of interesting given the commissions we're paying in the first year. The letter continues, "Cash flow in later years is offset by surrenders and benefit payouts. During the years when a product is first offered for sale the company has adopted a very short-term investment strategy to allow it to respond to market changes and interest rates. Once a block is closed to new sales the company invests funds longer to achieve its necessary spreads. Accordingly, the yield available on a given product series is somewhat determined by the interest rate environment prevailing at the time the block is closed to new sales." I'm not sure what all that means, but it seems to me what the producer is being encouraged to do is to explain to all of his unhappy policyholders that somehow this company had to invest long term, thereby locking in a lower interest rate; and somehow that's to the policyholders' advantage. I think the real message is that the policyholders have to live with it because after all we have to continue crediting these aggressive interest rates for the new business, and they are just out of luck.

I think this insurance company is issuing primarily back-loaded products, or products with surrender charges, and probably would be less than unhappy if some surrender activity occurred because they would be able to realize those surrender charges.

I think we have a real problem in the life insurance industry with these illustrations. I think by doing what we're doing we're going to alienate the buying public, if we haven't already. And my comments aren't restricted to payroll deduction. We're also going to alienate the regulators, if we haven't already. After all, who is the regulators' constituency? It's the buying public, by and large.

I think we can turn this situation around, at least as it regards illustrations, by just adopting some basic integrity in our practices. I think we have to discipline ourselves to illustrate cash value build-ups that are reasonable given current experience; that is, none of this mortality improvement. I don't think that's a reasonable assumption in the day of AIDS. I also don't think, by and large, that we are going to really honor the interest rate kickers or dropping loads. I think the company actuary should be able to affirmatively answer the question, "Can your company continue to live up to the cash values illustrated assuming no changes from current experience?"

## PANEL DISCUSSION

We still won't eliminate some disappointment on the part of some of our policyholders. I had a guy call me late last year. He was very disappointed. He had just gotten an annual statement for his universal life policy, one he had bought in 1982 when we were illustrating and crediting 12% interest. He was an elderly fellow and learned that his policy was going to expire in four years. He was really disturbed by this. He expected to live at least that much longer and he wasn't willing to lose that insurance coverage.

I think there were good reasons to illustrate at 12% back in 1982. After what happened in the late 1970s and early 1980s, I wasn't convinced that interest rates were ever going back down to previously-experienced levels. Fortunately, this fellow was reasonably knowledgeable about the economy and he understood when I explained to him the savings account concept with withdrawals for expense loads and mortality charges. But we will have some of that kind of disappointment and I think we need to expect it and try to patiently make the policyholder understand when it occurs. But I think there's a vast difference between the game playing I see going on and honest differences between original illustrations and the actual experience that pans out.

I am sorry to have dwelled so long on illustrations. It's something that has bothered me, and I am detecting from some of the comments I've heard that it's something that bothers other actuaries in the industry.

MR. RICHARD D. PITTS: Rex, I think you raise a very good point from the payroll deduction side on the regulatory issue and I would ask Amy and Bill if they would address that from the direct response and from the credit side in terms of how a company can follow some competitive strategies for positioning and/or effecting change in state and federal regulations of direct response and credit insurance.

MS. COLGLAZIER: Are you talking in terms of what we should be doing as an industry to have regulators look more favorably on the type of business we're doing?

MR. PITTS: Yes, I think the competitive strategy on regulation could probably fill up a mini-session; but either that and/or what a company needs to do internally to address how it reacts to particular laws in a state or jurisdiction that it's operating in.

MR. HORBATT: You're speaking then of, let's say, how does a company react to an environmental shift? How does it react to a new regulatory approach being implemented?

MR. PITTS: Yes, I think back in credit insurance, when we got into the arena of equity loans and underwriting on equity loans and the ability to underwrite on equity loans and to create loss ratios that would sustain the business. Is there a competitive strategy a company can do or is it just kind of roll with the punches as they come?

MR. HORBATT: There I think you were dealing with the companies reacting to a change in their customer base. Their primary customer, the financial institution, was changing the kinds of loans it was making. It stopped making consumer loans, for example, and started making more home equity loans. I think that's the kind of thing that you really need -- a responsive management, a management that is willing to change, actually looks forward to changes in the environment. I don't believe there is a set strategy to deal with that. But a willingness to experiment is very important and the willingness to put some money behind that experimentation.

MS. COLGLAZIER: The only other comment that I would make relates to the illustrations and relates to what I've seen in Canada. As an industry we can do a lot of things in terms of integrity in the things that we are doing to keep regulators out. In Canada, there is a problem in terms of loss ratios that are shown on the applications. There are numbers on there which can't possibly be true just like there are numbers on illustrations which are highly suspect. And I think what Rex is saying, and more of us should be saying, is that we have a lot of regulation because we can't be trusted. I mean, is that how we want to have our industry reflected? So, in the environments that don't have a lot of regulations yet, like in Canada and other countries, I think we can do some things maybe more proactively by regulating ourselves. When the regulation is already here. I think, the attitude toward the regulation has to be important.