RECORD OF SOCIETY OF ACTUARIES
1992 VOL. 18 NO. 2

DIRECT MARKETING – THE FUTURE

Moderator: RICHARD L. BERGSTROM
Panelists: GARY A. KAUFFMAN*
EDWARD P. MOHORIC
H. MICHAEL SHUMRAK
Recorder: RICHARD L. BERGSTROM

- Direct marketing growth in the 1980s
- Can it sustain the growth in the 1990s?
- Regulatory constraints in the 1990s
- Impact of continuing postal increase/production cost increase
- New product designs
- What can we do about the declining response rate?

MR. RICHARD L. BERGSTROM: Our first speaker will be Mike Shumrak. Mike is with Tillinghast, a Towers-Perrin company, and he is Tillinghast's marketing and distribution issues practice leader. His major area of expertise is the marketing of insurance and other financial services. Mike was a founder and the first chairperson, in fact, of the Society's Nontraditional Marketing Section, and he's currently in the process of updating the Society's study note on direct marketing product pricing. His portion of the talk will be an overview of the current industry situation, whether it be market-driven, customer-oriented, or capital-focused. He will also discuss measuring and realizing lifetime customer value, and he will be providing us with some practical applications and examples of that.

Our second speaker will be Ed Mohoric. Ed is a consulting actuary with Milliman & Robertson in the Philadelphia office, and his consulting experience has been concentrated in life and health insurance companies, with expertise including management and strategic planning, as well as technical actuarial consulting. Ed has served on the Academy's Committee on Life Insurance and the Society's Nontraditional Marketing Section Council.

Ed will be talking about the future of direct response, and he will also provide us with some candid comments on the individual accident and health guidelines that are currently under consideration by the NAIC.

Our final speaker is Gary Kauffman. Gary is President of the Direct Marketing Advisory Group, and he's based in Rye, New York. Gary is considered one of the nation's leading direct response insurance marketing authorities, and in fact, in 1990 he was voted direct marketing insurance executive of the year. Gary's list of clients includes J.C. Penney Life, John Hancock, Prudential, Blue Cross/Blue Shield, Allstate, Nationwide, and the list goes on and on from there. Gary is not an actuary, so we'll add a little freshness there. He is going to be focusing on how to reverse declining response rates by moving from a mass marketing or even a direct marketing arena to a directed marketing arena; how to make the right offers to the right people at all the

* Mr. Kauffman, not a member of the sponsoring organizations, is President of the Direct Marketing Advisory Group in Rye, New York.

right times; and how to change a company's focus from products to markets; and how to design offers and not products. So with that, our first speaker is Mike Shumrak.

MR. H. MICHAEL SHUMRAK: I'd like to start by characterizing the current industry situation (Table 1).

TABLE 1

Current Situation
• Stagnant, declining new business
• Narrowing profit margins
• Increasing scale requirements
• External threats
• Cultural/organizational roadblocks

We're faced with declining new-business production. The key factor is the economy for this trend (Table 2). We're continuing to define markets in terms of products and overly broad customer groups when we should be focusing on well-defined customer categories and customer situations.

TABLE 2

Stagnant, Declining New Business
• Sales productivity
• Agent retention
• Broad market definition
• Undifferentiated products
• Insufficient focus on customers
• New competitors
• Capital constraints

Another problem is, we're working with products that are undifferentiated, and we're failing to recognize the difference between products and offers, and Gary will get into that in a lot more detail in his talk (Table 3). To make matters worse, the profit margins inherent in our new business are much less than the margins in the old business.

TABLE 3

Narrowing Profit Margins
• High distribution costs
• Undifferentiated products
• Product design limiting gain sources
• Underpricing administrative costs

Distribution costs have increased. Marketing costs continue to be higher than for many of our competitors in other segments of financial services. Response rates have declined. Postage rates are up. Marketing and production campaign costs are up. Product design trends and the industry in general have moved to more complex

products. In particular, products, especially interest-sensitive products, where the opportunity for us to realize upsides in terms of mortality and investment gains, have been severely limited. Finally, our pricing allowances in many of our products are either unrealistically set or inadequate to cover the development, research, issue and maintenance costs, and the overhead that realistically we have to contend with.

Another key issue is the increase in scale requirements (Table 4). Our operations have been overbuilt to handle substantially more capacity in terms of new business and renewal business than we're able to generate. The number of policies and the volume of premium that would be the scale number to support your fixed costs have continually increased to higher levels, almost always running out of reach. Of course, any excess of that over what's in your pricing cross reference with your new and renewal business is a direct source of loss no matter what accounting system you use. Typically, we used to only see this situation with start-up profit centers or start-up companies, where maybe for three to seven years you'd be in that situation. Then, if you were successful, you'd be able to cover these costs and fund whatever development and research would be necessary to keep the business afloat.

TABLE 4

Increasing Scale Requirements
• Increasing product complexity
• More frequent product revisions
• Shorter product life cycles
• Too many "little sellers"
• Undisciplined/insufficient R&D

External threats (Table 5) posed by new entrants, the frequently changing regulatory environment, and the pressure to manage capital to maintain ratings, or go without ratings just to be in a safe position in terms of solvency risk have increased the market volatility and often closed windows of opportunity all too quickly. We're constantly threatened by proposals that will reduce or eliminate our competitive advantage in terms of policyholder income taxation. Also, the trend in federal taxation at the company level is following a similar pattern. Continued adverse developments in both of these areas will either reduce our profits further or increase the cost of our products, and again, these are the other financial service competitors that make us less competitive. New entrants are always a threat. The most visible are the banks. More recently, we've seen some increased activity with the finance company arms of industrial companies, such as the auto industry.

TABLE 5

External Threats
• Reduction/loss of product tax advantages
• Increases in life company FIT
• New entrants in market
- banks
- industrial companies (i.e., auto, tobacco, tractor)

These problems (Table 6) affecting our current situation have been known to us for quite awhile. So a question might be, why have we made so little progress over the last several years? To date, our ability to solve the problems has been severely limited by our tendency to cling to outdated cultural values and organizational structures geared to how the business used to work. We tend to display a reluctance to face the real facts concerning our business. Outdated rules of thumb based on the "good old days" are still being substituted for the real facts of our current environment. Despite a large array of management accounting reports, we remain largely ignorant of the true economics driving our revenues, costs, and profits in our markets.

TABLE 6

Cultural/Organizational Roadblocks
• Reluctance to face real facts
• Ignorance of economics and cost/value drivers
• Bureaucratic approach smothers entrepreneurial sense of urgency
• Arrogant self-satisfaction with current products
• "Order-taker" sales forces

The common organizational impediment we face is the domination of our bureaucratic approach that smothers the entrepreneurial sense of urgency that's essential to profitable growth. We handicap ourselves through an arrogant self-satisfaction with our current products. Too many of us develop products based on our point of view instead of the customer's point of view. Operationally and organizationally we've been concentrating too much on managing functions rather than serving customers.

We suggest that a new paradigm for success in the 1990s could be characterized as market-driven, customer-oriented, and capital-focused (Table 7). The first pillar is that we need to set up a cross-functional company or profit center-wide organization where you have teams that would focus on all of the activities affecting each and every market. This eliminates the tendency for functional areas to build up walls around their departments that result in unproductive turf battles and ineffective end results. We must begin to identify and respond to specific markets, customer groups, and needs.

TABLE 7

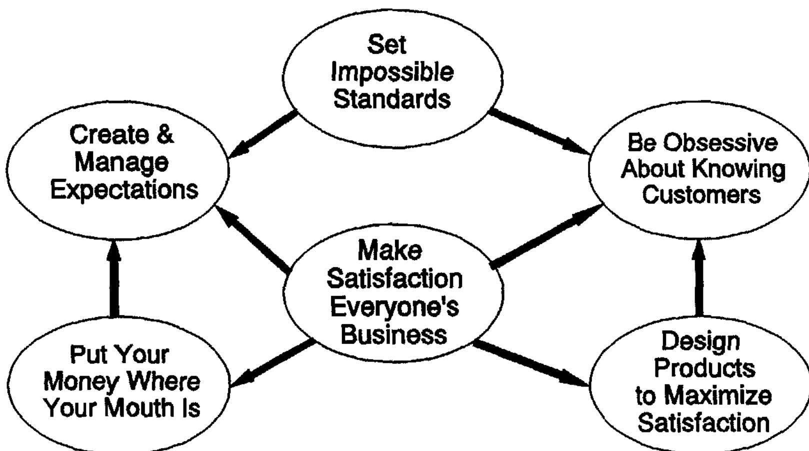
Framework for Success
• Cross-functional teams focus on all activities
• Identify and meet specific customer group's needs
• Competitive product offers leverage-strategic advantages
• Capabilities focused on target markets
• Costs managed to maximize value

Another element is the development of competitive product offers that leverage strategic advantages in areas such as brand equity, customer relationships, customer circumstance, and product offer differentiation. Market-driven management requires all company profit center capabilities to be built around and focused on serving specific target markets rather than simply performing each function in a vacuum. The final element of market-driven management is managing all costs in terms of their

ability to develop and maintain value to either customers, distributors, or to your stockholders or investors.

We've identified a strong customer orientation as the second pillar in our paradigm for success (Chart 1). Customer orientation is achieved by making satisfaction everyone's business throughout the organization. Companies with long-term success in our industry or any other industry are customer-oriented. How do they do it? They do it by setting impossible standards, such as Federal Express getting it there by a certain hour 100% of the time. As all of us who use that service a lot know, Federal Express doesn't get the package to its destination on time 100% of the time, but it get's pretty close, and I think the existence of almost an unreasonable goal has sort of pushed companies such as Federal Express to be that much better than the others.

CHART 1
Customer Satisfaction Creates Market Success



Successful companies are also obsessive about knowing their customers. Their goal is to know their customers better than they know themselves. Customer calls for routine information or service after the sale, or even if they didn't buy, are used as opportunities to learn more about customers, to learn their attitude toward the company image, and their attitude toward company products and services, and also to learn about significant changes in customer circumstances. Using this deep knowledge of their customers, customer-oriented companies create and manage customer expectations and then, in turn, design products to maximize customers' satisfaction. Of course, to do all of this takes money. Therefore, you need to put your money where your mouth is, and that's the fly in the ointment. If your company is functionally managed and focused on short-term financial results, the short-term costs to support strong customer orientation results in what appears to be unproductive, unaffordable expense. You've got a conflict. We need to understand that the long-term value of customer orientation provides long-term returns. In the end, customer orientation cannot be meaningfully achieved unless your culture has been shifted from product-driven to market-driven.

Looking from maybe a different slant in terms of company attitudes and contrasting market- versus product-driven orientations across a number of areas (Table 8), we'd say the objectives of market-driven firms focus on long-term customer relationships while product-oriented companies concentrate on short-run efficiencies. Market-oriented companies make decisions starting with the customer, while product-driven companies impose their decisions on the customer. Market-driven firms make what they can sell. Product-driven companies sell what they can make.

TABLE 8
Market vs. Product Orientations: Attitudes

Market Oriented	Attitudes	Product Oriented
Consumer forces dominate; long-term emphasis	Objectives	Internally focused on efficiency in short run
Decisions start with considering the consumer	Consumer's place	Decisions imposed on the customer
Company makes what it can sell	Product mix	Company sells what it can make
Used to identify customer needs and how product satisfies them	Role of marketing research	Used to determine consumer reaction or not used

Market-oriented companies use market research to identify customer needs and how their products are perceived to satisfy these needs (Table 9). Product-driven companies either don't do research, or just focus the research on why the products that they've created from their own perspective work or don't work. Market-driven companies try to create new markets while serving their present markets. Product-driven companies just keep working on providing product to the same market.

TABLE 9
Market vs. Product Orientations: Attitudes (Continued)

Market Oriented	Attitudes	Product Oriented
Create new markets while serving present market	Marketing strategy	Satisfy existing markets
Focus on market opportunities	Innovation	Focus on technology
Sometimes lead; sometimes follow; offensive posture	Competition	Always follow; react; defensive

Market-oriented firms' innovation focuses on marketing opportunities, while product-driven companies focus on technology. Finally, market-driven firms are proactive toward competition, both protecting their customers and protecting their markets,

whereas product-driven companies are more reactive. A product-driven culture can only thrive in an environment where the company's product is proprietary or the customers are locked up by the company. In our industry, neither of these factors can be in place for any long period of time. We've also explained how market-driven management works and why it must be wedded to strong customer orientation.

The third and final pillar of the new paradigm for success in the 1990s is that we need to be capital-focused. We define this as utilizing risk-based capital budgeting to evaluate and select our available options for growing and maintaining business. Investment in market-driven, customer-oriented activities must also make economic sense. We need a sound financial performance measuring system. Unfortunately, our traditional accounting numbers present serious shortcomings when used to derive decisions regarding capital budgeting and evaluating management performance. Let's review the shortcomings of the various sets of numbers we have to work with.

The weaknesses of focusing on GAAP earnings (Table 10) to evaluate market-driven performance are the wide range and variety of methods and assumptions, the lack of recognition of risk, ignored investment requirements, unconsidered dividend policies, and ignored time value of money; and because of this there are situations where you could have increasing GAAP earnings and at the same time not be creating or increasing economic value. More recently, return on investment (ROI) has gained favor because it seems to be consistent with the way companies view their cost of capital. Under the ROI approach, we assume that if our ROI is greater than our cost of capital, then value is created. The problem is that ROI is an accrual accounting rate of return and it's being compared to cost of capital, which is an economic rate of return. We're comparing apples to oranges.

TABLE 10

Basis for Strategy Formulation
Shortcomings of Earnings
• Variation in accounting methods and assumptions
• Exclusion of risk
• Ignoring dividend policy
• Ignoring the time value of money
• Growth of earnings while economic values drop

We define economic income as the comparison of cash-flow projections at the beginning and end of the year. Accountants neither attempt nor claim to estimate changes in present value. Rather, depreciation represents the allocation of costs over the expected life of an asset. If depreciation and the change in present value differ, then book income will not be an accurate measure of economic income. ROI is not an accurate and reliable measure or estimate of the discounted cash-flow return. There is no systematic pattern of error that allows you to make the correction. Earlier venture ROIs are often understated in later years or overstated.

The shortcomings of return on equity (ROE) are similar to ROI (Table 11). In addition, ROE is very sensitive to leverage. Assuming the proceeds from debt financing can be invested at a return greater than the borrowing rate, ROE will increase with greater amounts of leverage. ROE, in fact, will increase as more than optimal debt is issued

while the economic value of the venture decreases due to the increase in financial risks. The problem in using these various accounting measures to evaluate market-driven strategies and monitoring performance lies not so much in the accounting, but rather in its use for unintended or inappropriate purposes.

TABLE 11

Basis for Strategy Formulation
Shortcomings of ROI/ROE

- Financing decisions heavily influence ROIs
- Current year's outlays for working/fixed capital are ignored
- Depreciation methods often don't match economic values of assets
- Accrual-based returns compared to cost of capital (a true economic measure)
- Composite ROI/ROEs heavily influenced by in-force mix

Accrual accounting conventions such as GAAP and statutory are governed by objectives and institutional constraints. The use of this type of accounting that's designed for exposed external reporting as a basis for strategic planning and financial performance monitoring is dysfunctional. A conceptual basis and a practical means for implementing economically based stockholder value in planning does exist. By estimating future cash flows associated with each market strategy, we can assess the economic value of alternative strategies at both the business unit and the corporate level. The greatest benefit of adopting this approach is the shift of management's focus from the short run to the longer run.

We define lifetime customer value as the risk and cost of capital-adjusted net present value of profits from all the products and services purchased by the customer over the life of the customer's relationship with the company (Table 12). Development of lifetime-customer-value-based reporting provides a rational economic-based framework to evaluate and prioritize marketing ventures, and later measure their value added in terms of the actual results.

TABLE 12

Lifetime Customer Value (LCV) –
Risk and cost of capital adjusted net present value of profits derived from all products and services purchased by the customer over the life of the relationship.

Another application of this analysis is to identify your firm's competitive advantages or weaknesses (Table 13). For example, you could view your company as consisting of, say, four or five distinct businesses. You could view marketing and distribution much like you might look at a third-party marketer. You could look at the risk-bearing function as an underwriter or reinsurer. New-business processing and servicing of in-force business would be the TPA, the third-party administrator. Corporate finance and capital management could be considered the finance company. The management of the people and the setting of the priorities could be the management company, or perhaps these last two could be combined and be called "corporate."

TABLE 13

Value Analysis of an Insurer
• Third-party marketer
• Underwriter
• Third-part administrator
• Finance company
• Management company

Careful analysis of each of these sub-businesses in terms of their activities, their costs, their value creation, and how each compares to the cost of external vendors, when in many cases there are external vendors, either other companies or dedicated vendors, will really help you flush out areas of competitive strengths and weaknesses in terms of acquiring and maximizing customer value (Table 14). In addition, this value analysis can be used to optimize your performance by looking at the allocation of value among the various constituencies involved in the deal -- the customer, the distributor, the stockholders, the investors.

TABLE 14

Value: Define, Create, Allocate
• Customers
• Distributors
• Employees
• Investors

Traditional financial analysis doesn't generally provide us with a clear look at how the value of a transaction or a customer relationship is derived and shared among the involved parties. Careful analysis of these relationships should yield opportunities to improve market position without sacrificing company profitability. This completes our review of the industry situation. We've also presented a formula for success in the 1990s: market-driven, customer-oriented, and capital-focused. Let's now discuss how all of this relates to the future of direct marketing.

There are a number of factors that indicate that the market for direct response sales is growing (Table 15). First is that lifestyle trends continue to favor direct marketing -- more working couples, more single heads of households, even those of us with one person working.

TABLE 15

Significant Growth Factors
1. Changing lifestyles
2. Decline and cost of personal selling
3. Technology
4. Product proliferation
5. Telephone orders and faster fulfillment

We're all just busier than ever, and so the opportunity for well-targeted direct marketing offers provides time-efficient convenience. The second factor is that companies

are no longer investing heavily in expanding and building their agency forces. The cost of supporting the existing sales forces is increasing, and it's a major problem. The ability to either augment or substitute an efficiently run direct-marketing capability is looming more attractive than ever.

Advances in technology, particularly in the area of computer software and database technology, have also created powerful new tools that support efforts to target customers and stay close to customers. Again, while this technology can work for any distribution system, it's much more effective when applied to direct marketing. Product proliferation has neutralized our ability to compete on product alone. So, again, using the technology and using direct response discipline to get the right offer to the right person is going to be an essential ingredient as opposed to a profit enhancement ingredient in the future.

The time-frame expectation of customers (because more and more people are buying direct, and looking for the convenience, and instant gratification of calling up and ordering, and the speed at which we can fulfill customers' inquiries or customers' requests to buy), also gives us a competitive advantage over other sales processes that are more long-winded.

There are strategic advantages to direct response (Table 16). Let's highlight some of the key advantages. There is the opportunity to establish a stand-alone profit center; as we indicated earlier, trends point toward continued growth, so there is a market there. Direct marketing offers much more control of distribution execution and analysis than personal selling or mass marketing approaches. Direct marketing provides greater ability to maximize market penetration. Generally, personal selling agents will sell to their level of economic comfort, and then stop even if there's more to be received from the customer. Establishing new personal selling organizations is very expensive. Direct marketing offers better control of how much you're investing and how much you're risking at each point in time, and more important, it puts you in the position to be able to test, start, stop and expand quickly, something you can't generally do in an agency environment. Finally, direct marketing results are completely measurable and substantially actionable.

TABLE 16

Strategic Advantages of Direct Marketing
1. Establish substantial profit center
2. Control the distribution channel
3. Maximize market penetration
4. Control the risk
5. Marketing program results completely measurable

All the news isn't good. Some of the disadvantages are that, more than ever, direct marketing is a scale business, so that it's not one of the advantages of customer relationship and price; sell and add-on can't be achieved if your customer base can't exceed a certain minimum scale. Also, I think in the insurance markets, in the absence of company or brand equity or name recognition strength, the ability of no-name companies to enter or grow their direct response business is severely limited. If they don't adopt some of the types of things we're talking about in terms of

database marketing and market-driven selling, it would be almost impossible to start a direct marketing operation now, doing some of the same old things within direct marketing.

In contrast, the financially sound brand-name companies have a tremendous opportunity to strengthen their existing customer relationships and acquire additional customers. The problem here is that the cultural roadblocks embodied and the perceived distribution conflicts have severely limited their activities to date.

What are some of the things you should think about when you're either going to continue to use or start to use direct marketing? The first item is it can be very effective if you can identify and reach your targets (Table 17). I think a great market where you can never identify it, or can't get the names, or can't use the names, doesn't help. If you have a lot to say about your product, direct marketing provides the opportunity to get the word out the way you want to do it, versus how you hope the agent might do it. Direct marketing is also most effective when your product or service has continuity, repeat sales, and follow-on sales. I think the duplication here for us is to try to break down complex, comprehensive coverages, and the new product ideas will be more modularization. So let's get the customer with a reasonable value price relationship, and then over time, as we develop the relationship, get the customer's to the point where we know, knowing the product, they needed to be in the first place, but may not have made the buy for that higher premium at the front end. It can also be used to identify buyers for a product or service.

TABLE 17

When Should You Use Direct Marketing?

1. When you can identify and also reach your target audience
2. When you have a lot to say about your product or service
3. When your product or service has continuity, repeat sales, or follow-on sales possibilities.
4. When the product or service is purchased infrequently and you can use direct marketing to identify the potential buyers

Direct marketing should be considered when it's important for you to control the selling message process (Table 18). It's also useful in this era, where capital is short, to know that you can reasonably estimate your test and your roll-out budgetary costs, and probably the only variable is that you may not spend all the money if too many of the things don't work out.

In terms of strategic growth issues, when thinking about direct marketing and moving forward, you do need to be emphasizing sales or profits. Again, an important thing here is the scale effort, getting hung up on, "Gee, if we had a scale direct response operation, we should be able to get a certain return." It's not the thing to worry about if you're not even to the point where you have this scale.

TABLE 18

Key Strategic Growth Issues
1. Build sales or profits?
2. How much to invest in new customer acquisition?
3. Can you profitably contact present customers more often with existing products?
4. Product categories -- grow or penetrate?
5. How to position and price products?
6. Can media or distribution be expanded?
7. Try to develop new markets, products, businesses?

How much should you invest in new customer acquisition? Do you have the opportunity to present your existing products to customers more frequently? Should you broaden your product offer categories, or increase penetration in the existing offers? How should you position and price your product to achieve your growth objectives? Are there opportunities to expand market or product offer penetration? Do you need to develop new markets, new businesses, or new product lines? Finally, let's discuss database marketing.

Database marketing is marketing to individually known customers or prospects using purchase history and lifestyle data to target relevant offers that increase response or bring loyalty more effectively than other media alternatives (Table 19). What does this do for us? Database systems help us find out who's buying so we can identify more of the same. They also generate and track leads for salespeople. Database systems also assist us to welcome new customers, trigger repeat sales, reward frequent buyers, and reactivate former buyers.

TABLE 19

Database Marketing is:
• Marketing to individual, known customers or prospects . . .
• Using purchase history and lifestyle data . . .
• To target relevant offers . . .
• That increase response or brand loyalty . . .
• More effectively than other media alternatives.

Database systems also protect our customer base by providing the means, when it's timely, to react to our competitors' incursions on our customer base. The database helps us measure long-term customer value and the return on our investment in new customer acquisition. There are some common scoring techniques that are used in these market-driven databases. One is really the old classical recency/frequency monetary value, and then another variation of the theme is to look at those factors. Even if you have a category of purchases in a certain amount category, what's the nature and what is the type of product, what is the product line?

Regardless of whether we're operating in a direct marketing, a mass marketing, or primarily an agency distribution channel, one of our major responsibilities is to take advantage of our products and services by offering the best opportunity for achieving our business objectives. Today, in the age of information, we can execute our

responsibilities with more precision than ever before through the use of market-driven databases. Combining this with a strong orientation toward the customer and focusing on capital promises a brighter future.

MR. EDWARD P. MOHORIC: The future of direct marketing seems to be the generic type of title that is used as filler at Society and other meetings. It's good to speak on a subject like this because, as Tom Petty's song goes, the future is wide open. I have given a good deal of thought to direct marketing and where I see it headed over the next few years. In a sense, often it seems to be floundering and in search of an identity underneath all the flurry of activity to obtain new names, to build up the database, and to achieve your marketing allowance costs.

The future, in my opinion, appears mixed. On the one hand, you have technology making possible marketing techniques that were unavailable until recently. All database use -- customer-driven marketing, micromarketing, improvements in mail delivery, use of cable television for focused advertising, computer dialing for telephone efficiency -- can improve our ability to reach our customers with our offers. Of course, technology has no soul. It's neither good nor bad, and it's up to us to really use it for our benefit. I always laugh when I get some direct mail solicitations at work and they say Dear Mr. FSA on the personalized envelope.

It's up to us to use technology and not to use it wrongly. But the new technology is also available to competition, and the competition, although it may have lessened a bit in recent years, is still intense, and the solicitations now are twice as difficult by the fact that the mail is saturated. Television and remote controls make it real easy to change channels, and people watch a lot fewer commercials than they used to. Answering machines made it a lot harder to reach consumers via the telephone. Yet this normal insurance company pressure such as maintaining your Best rating, producing a reasonable return on your investment, or increased regulatory pressures, makes it very difficult to see far ahead.

I'm going to focus on two subjects, and most of my time is going to relate to one very specific change that may soon be on the table for insurers making health offers through direct response, and that's the proposed new NAIC model guidelines, which I believe will make it more difficult to achieve profitability in the future. I'll make you aware of some of the changes that will be coming down the pike possibly there. Second, I'm going to talk a bit on a more general subject, and I'll have some observations I've made that you may be able to turn into some concrete action steps for success in the future.

In December 1991, the NAIC exposed new guidelines for filing premium rates for individual A&H insurance contracts. This was not discussed much at all at the April 1991 NAIC meeting in Seattle, but it was the topic of an intense meeting here in Chicago recently between the NAIC actuaries and the American Academy Health Task Force. First of all, the title is somewhat misleading because it says that it's for individual accident and health insurance plans. I know a lot of people here who offer health insurance through a third-party group trust. The definition of *individual* in the guidelines is meant to be much broader than it seems on the surface, and it's defined in such a way to apply, first, to all contracts and, second, to all certificates that are issued on a group basis with only a few exceptions: long-term care, Medicare

supplement, groups subject to certain other regulations, and large employer groups greater than 25.

In fact, the drafting note in the new guideline reads that these guidelines are intended to apply to coverage sold to individuals outside the insurance marketplace regardless of whether the form is an individual contract or group certificate. So this guideline is trying to get through the old group trust and runaround. The purpose of the guidelines is defined in the guidelines themselves as fivefold. First, they're being proposed to assure that the premiums charged are reasonable. Now, as usual in regulatory guidelines in the U.S., reasonableness is not determined by risk class. It is not determined by actuarial classification, and it's not determined by a reward that's commensurate to the risk taken. It's defined by the all inclusive loss ratio.

The second purpose for the guideline is to provide for regular monitoring, which sounds fair on the surface. I think the issue here is that it steps up the number of regulatory requirements, and thus in doing so, steps up the cost of doing business once again. The third purpose of the guidelines is to facilitate efficient filing of rates. Now, if these guidelines do go through, I do see this as a big plus. For anyone who knows the effort that it's taken recently to get rates approved or to get rate increases approved, if we can get efficient filing going, that would be a plus. The fourth purpose of the regulation is to promote uniformity among jurisdictions. I see this as a big plus also if, in fact, the regulation is passed uniformly in all jurisdictions. Forgive my skepticism, but I don't think I've seen this happen for a long time.

Then the last purpose that's defined in the guidelines is that they are supposed to broaden health insurance availability. As near as I can tell from having reviewed the guideline, this is a politically correct statement that is inserted in the guidelines to have the blessing of everybody. I'm not sure exactly what it does to do this.

Now, I'm going to go into some detail as to what's contained in the guidelines, but before I start I want to throw out some good news. At the meeting in Chicago recently, the NAIC and the AAA actuaries did agree on one major point with the new guidelines. That major point is, contrary to the version published in December 1991 that many of you may or may not have read, the guidelines are planned to apply to medical expense policies only – not hospital indemnity policies, not accident. This is a change, and I think it's a major change, from the original guidelines. I will point out that this understanding is an understanding of the actuaries involved in the process. It's not been agreed to by the commissioners. I also point out that I heard that there were some comments made at the meeting concerning having to do something separate for hospital indemnity plans (HIP) later. We'll have to get to that. Nevertheless, I think the industry should be, right now, thankful for interim victories.

I'm going to go over some of the details within the new guidelines. First of all, the guidelines require filing of actuarial memorandums with rates that contain a good bit of detail. This detail is all described in the guidelines. I'm not going to go through and cross every *t*. Probably for the most part the guidelines ask for information that you already include in any memorandum you send. The one interesting thing about the new guidelines, and you might consider this good or bad depending on your attitude, is that anticipated loss ratios are defined. They're defined to be calculated as

the present value of benefits over the present value of premiums using the maximum reserve interest rate.

In any memorandum that you do, you're supposed to show loss ratios with and without active life reserves; but in calculating the loss ratio, it's clearly defined to exclude active life reserves in the calculation with the exception that at the end of your projection period, after 20 or 30 years, you can include the present value of any remaining active life reserve. But basically, active life reserves are excluded from loss ratios, and that is defined in the guidelines.

The guidelines also ask that you demonstrate that all classes of insureds are reasonable. They state that there is to be no more than a 67% differential between expected results in a class; that is, you can't overcharge any class, age, sex, etc. more than 67% for any type of product. The reason this is in the guidelines is because it's meant to apply to the issue of small group durational rating where you go in with a very low rate and you raise it after six months or a year. Where I see it having an indirect impact on direct marketers is that it could force you to have more premiums than you'd like to show on a piece of literature, because you might need to do more age or sex rating than you've done in the past in order to make sure that no one group is charged a premium that's too far different from any other group.

Now let's get to the more serious parts of the guidelines. First, let's discuss risk classifications. There are certain acceptable risk classifications under the new guidelines. A nonrenewable classification is only for business that's a year or less in duration and that the company won't reissue. This is like travel accident or other limited types of policies. Qualified renewable is a new term to me. This allows for nonrenewability in the event of fraud, overinsurance, or any other items that are not in the best interest of the insured. It also allows for nonrenewability if the carrier's ability to meet its financial obligations are impaired; i.e., if your loss ratios are bad enough and you're going to go into bankruptcy, unless you can cancel, then maybe you can cancel a block of business, but a qualified renewable policy requires the commissioner's approval to cancel.

I think we all know what that guaranteed renewable and noncancelable means. To me, the substantial point is the renewability provision that's not in here. There's no line that says collectively renewable or cancelable for stated reasons only, or some such provision like that. Renewability provision, in a sense, takes away your last leverage against states when you're trying to get rate increases or trying to manage a block of business.

The next serious issue in the guidelines is loss ratios, which are generally patterned under the current regulations in Florida, but in a nutshell will be 60%. This is basically five points higher than the current NAIC model. What's five points? Noncancelable policies are lower and are, of course, normally disability income only, and they're also at 55%, five points higher than the NAIC model. There is some relief for small average size policies. According to a formula (Chart 2) in the guidelines, you're allowed to adjust the loss ratio downward based on an average premium that's less than, as it turns out and although you can't tell this from the formula, $325 a year. This $325 gets adjusted upward annually by a consumer price index factor.

CHART 2
GR Loss Ratio Formula

$$R' = 60\% * \frac{(I * 650) + X}{I * 975}$$

X = Average Annual Premium
I = CPI Factor

The maximum adjustment to the loss ratio downward, however, is 10%; so when it says 60%, no matter what this kind of formula might produce depending on your average premium size, the bottom line is a 50% loss ratio, and you hit that if you've got a premium of about $180 a year or less right now. Just in 1992, if the guidelines were happening right now, Table 20 shows the minimum loss ratios for your policies for varying average premium sizes. As the premium goes above the $400 level, it at 60%. As you go below what's currently about $180 level, you stop at 50% as the minimum loss ratio.

TABLE 20
GR Loss Ratio Impact – 1992

Average Premium	Minimum Loss Ratio
$400	62.43% → Use 60%
350	59.62
300	56.82
250	54.02
200	51.21 → Use 50%
150	48.41

There is some upside that I don't think is very relevant to most direct response insurers, but if your premium is above roughly $1,900 a year, there's an opposite rationing effect that will drive the loss ratio up from 60% to 70%.

Regarding rate revisions, the new regulation also allows you to opt for prior approval if you do regular experience monitoring and if you promise immediate corrective action on loss ratios that come out too low. The advantage of this is it's a preapproval process and you'll be allowed to have your rates filed and approved, and to take rate increases without the delays that unfortunately we've all become accustomed to. However, there is a provision in the guidelines that says rate increases may not be more than 20% in a given year and that they may not be more than 35% over two years. My concern with this provision is my general concern about hard-coding any numbers into a law or guideline that, even if they do sound inherently reasonable based on current conditions – and that's a subject for debate – any hard-coded numbers do not react to conditions when they change, and you can be forced to have some unreasonable standards in a high inflation environment, if one occurs in the future.

The last major issue of the guidelines is for experience monitoring. Monitoring of experience will use an approach, that is kind of similar to the way New York currently monitors experience (Table 21). Annually, a company will have to file policy counts, annual premiums, incurred claims by year of issue, and incurred claims by experience year, and have to make comparisons to actual and expected loss ratios. The guidelines prescribe the degree of tolerance in your actual-to-expected loss ratio that will be allowed and that, before corrective action, can or should be taken.

TABLE 21
A/E Ratio

Number of Claims	Downward Action	Upward Action
1000+	<0.95	>1.10
500–999	<0.90	>1.15
100–499	<0.85	>1.20
25–99	<0.65	>1.30
0–24	0	–

Let's say your loss ratio is supposed to be 60%. If you've got a large block of business that has over 1,000 claims and your loss ratio is 66% or more, more than 10% above the 60% required, this indicates that you should be taking corrective action; translated, you *should* be taking a rate increase in the future. However, if your loss ratio is 57% or less, which is 95% of the 60%, you *need* to take corrective action; i.e., a decrease. You notice in these numbers that there's a little bit of a skewing in such that you're allowed a lot more tolerance before you can make improvement in rates compared to the corrective action you need to take if you fall below.

Also, note that the number of claims is defined as a national number, so that credibility should build rather quickly on most blocks of business. It's not monitored on a state-by-state basis. Although, if in a state, experience is deemed credible, not even just by one year but over a cumulative number of years, states have the option to monitor the experience and force you to report directly on their own state's experience.

There is a little bit of a buffer, at least in the current design of this, that if your experience is below that required for monitoring, you can set up what is called a regulatory liability, which is basically an extra reserve, in recognition that your loss ratio is below the standard, and you can set aside these amounts. In lieu of giving a premium refund or a dividend right now, you can set aside a reserve that's got to be targeted to be exclusively used for the policyholder's benefit in the future. The reason for this is to allow you not to have to make small changes frequently, but to build a little bit of a buffer in. This regulatory liability can't grow to more than 15% of a prior year's earned premium until actual corrective action, i.e., a refund, credit or something, would have to be taken.

This guideline was originally expected to be drafted in a near final form for the June 1992 NAIC meeting. It's appearing now, as is typical, that it will be delayed at least.

After the NAIC meeting, the plan now is that this would not apply directly to hospital indemnity plans (HIP), accident and nonmajor-medical-type products. It is, however, a sobering thought as to how products may need to be priced and how experience may need to be monitored if something like this or similar to this is enacted in the future.

After being Mr. Doom and Gloom a bit about the guidelines, I want to talk just a little bit about where I see the industry headed and maybe want to make one important comment. A lot of direct response companies seem to characterize their business as supplemental -- supplemental life insurance, supplemental health. In recent years, as stamps have risen and as responses have decreased, a lot of the companies I've seen have tried to counteract this by increasing average face amounts, offering just basically higher premium and higher amount products. They're still designed to be supplemental -- hospital indemnity offers of $150 and more a day, greater death benefit, life up to $20,000 and $25,000.

I think what I'd want to emphasize is what I believe Socrates said, if my research is right, in terms of your market and your product. Know thyself. One project I worked on last year for a client had to do with an overall review of a product line from soup to nuts, and it was a product line that the client considered to be supplemental insurance. In fact, that was in the title of the product. It was Medicare supplement. As we looked into it with the client, an interesting observation I made was that the premiums were over $700 per policyholder, and the client was going to take some increases that were going to drive it over $800 per policyholder by the next year. This is clearly not supplemental business. This was a health insurance policy that generally every elderly person over 65 needed to hold. It was a full-scale medical product.

The way you handle this, I think, needs to be different from the way you want to deal with a supplemental sale. I think there is room for companies in direct marketing to maybe go two separate directions. I think on the one hand there's a chance to go what I'll call upscale. I know a number of companies have tried to do annuities, or some universal life through the mail, and there are some failure stories. But there are also a few success stories, and with the right market and the correct approach, I think it may work.

In regard to major medical, all the talk every day in the paper is about health reform. There's a huge group of uninsured people. Agents are reaching them and companies aren't reaching them. Major medical that reaches the uninsured, and that's done appropriately and in a way that can minimize antiselection, is not an easy thing to do; but if direct response could do that, it would be a great product. But to do that, and to do it right, you need an attitude of not being a supplemental insurer, but being a full-service insurer that uses direct response as a marketing approach.

At the same time, if you are a supplemental insurer and you want to be a supplemental insurer, I think your focus has to be different. I don't think it's going to work to sell $300,000 of AD&D or $30,000 of guaranteed issue life insurance; but your task is to keep the product inexpensive, to keep it efficient, and to make a lot of sales. You need to use the techniques Mike talked about and the technology to reduce your unit costs and to streamline the process. You need to invest your resources in

securing the new customers, reaching them, developing an affinity, and capitalizing on these sales.

If your retail market is saturated, maybe you need to turn to the elderly market. If the elderly market is saturated, turn to the student market – talk about the lifetime value of a customer. If the U.S. market is saturated, there are 75 million people in Germany. There are 120 million in Japan. There are 25 million people in Canada. Do you know the market in these countries? Probably not. It's going to take investment, resources, and commitment, but I think it can be done, and there are examples of success stories of going international and going into different markets and really making a success out of it.

I guess the point in saying, know thyself, is that if you're a direct response company, you need to know what your mission is. Are you product-focused or market-focused? Are you a full-service insurer or a supplemental insurer? I think you can succeed either way, but I fear the companies that will fail will be the ones that get stuck in the middle – they just insure and scurry to the next name, the next solicitation, and never quite meet their marketing objectives. I think the answers to these questions, which will be different for each company, are going to dictate how you position yourself as the future of direct marketing turns into today.

MR. GARY A. KAUFFMAN: I want to make one initial comment. One of the questions that comes up frequently, and Mike alluded to it, is whether direct marketing as we know it, direct response marketing, is a mature business or a growth business. Candidly, the answer depends a lot on the attitude within a company, and that's what we're going to address. For the vast majority of companies in the direct response business, unfortunately their response is that it's a mature business; but that's really a function of the way they're running their businesses.

What I want to talk about are the critical success factors that have allowed companies -- and there are companies in the U.S. achieving it right now – to realize unparalleled growth in the areas of direct response marketing. It is the difference in their approach to these success factors that has made them realize that business as usual is a mature business; but that if we start looking at this business in some of the ways like a General Motors or a Proctor and Gamble looks at the way it sells its programs and serves customers, that we can do much better.

The first premise I want to start with is that the comments I'm going to make apply just as readily to the agency distribution system as they do to what we call direct response. When we think about it, we think of direct response as print and broadcast and direct mail and telemarketing. But what is more of a direct response media than sitting across a kitchen table or a living room sofa from an agent? The only reason we distinguish is because of the cultures and traditions we have, the vested interest of not theoretically taking away commission income from an agent. But I look at all of these as a form of integrated marketing, and what I'm going to address in terms of more traditional media for direct response applies as equally if you are in the agency business.

How do we enhance agent or direct response profitability and production? No matter what your financial statements say, no matter what your mission statements say,

you're in the business to do one thing, or at least you should be, and that is to make the right offer to the right prospects or customers at all the right times. That's really the essence of your business, and to the extent you're not doing that, you are wasting resources.

In fact, many of us in the business hate the term *junk mail*. Well, junk mail is really simply direct mail in the wrong person's mailbox. It's some combination of inefficiency in making the right offer to the right person at the right time. When you look at all the combinations, you see the great opportunity for us to be wasting our marketing dollars and be inefficient. The reality is that all of our companies, to one degree or another, are making either the right offer to the wrong person at the wrong time or some other combination. Those who are successful in realizing we are a growth business are those who are coming closer to making the right offer to the right person at all the right times. I will use the word *offer* quite a bit, and I'll explain that to you in a little while.

Our prescription for success, regardless of distribution system, is to change the mix between sales and marketing. We are too sales-oriented, not enough marketing-oriented. The reason for that, especially in our field forces, is that because we're not making the right offer to the right people at the right times, we need to be sellers. We need to try to force and convince people more than market to them. If we move more in a marketing direction, we not only solve problems of distribution, but also we candidly will solve some of the problems inherent in our home office organizations by bringing in individuals who have more of that marketing orientation as opposed to a pure sales orientation.

What are our marketing strategy success factors? I'm not addressing some of the back-end aspects now. We obviously recognize the need to be cost-effective on a unit basis. We understand our loss ratio concerns. But given that we can address those adequately, the three things that affect what we do are market, media, and the offer. I use the word "offer" again instead of products.

Let's first address market. We need to understand more who our market is and we need to use databases. Mike referred to them. We need to understand what a database really is. There are two kinds of information that go into a database. Most of us concentrate most on what I call important information, but that's not the real leverage point. Important information is name, address and telephone number, and that's important information in addressing people. That's what allows us to make our mailings personalized, but that's really a mass marketing approach. You see, we have to move away from this mass marketing mentality of the 1970s which said, "Mail everyone in the hopes of selling a few because we can make money." We went into this direct marketing approach, but we really need to move to this concept called directed marketing, which is really moving us as close to a one-on-one sale as possible – the right offer to the right person at the right time. To do that, you need relational and transactional information, or what I call relevant information.

In other words, it's not enough to address an offer for an auto club membership (and let's say Allstate wanted to market its club to Sears customers and to Allstate customers) to Gary Kauffman, and to say to Gary Kauffman who lives in Rye that he can get auto club membership for $39.95 because he is a Sears customer. But if I

go into that database and I find relevant information that says Gary Kauffman owns a Volvo, and he took it into a Sears Service Center, and he had it serviced recently, and Volvo is a safe car, and then say, "Mr. Kauffman, because you take such good care of your car and you're safety-conscious, as evidenced by the fact that you own a Volvo and you take care of it, we are going to offer you membership in the auto club at a 20% savings." You see, I've taken information in the database and created an offer that's relevant to my situation and my life stage, and I am likely to go through and understand it and use it.

Those are the kinds of things we need to do in our business: the right offer to the right person at the right time. That's the leverage of a database, not just statistical information. We must change our focus from products to markets and products to offers. When I first came into this industry, I was amazed. I started out on my first job in packaged goods, and we were always taught that you go out and you find out what the consumers want and need, not just their real needs but their perceived needs, and you match them to the strengths and weaknesses in your firm; and then you go out and decide where you can have a unique selling proposition, develop a strategic competitive advantage, and move forward.

I came into the insurance business and found that we did it differently. But maybe I was wrong. I was young. We sat in these smoke-filled rooms in pre-nonsmoking days, and we got together marketers, actuaries, and underwriters, and we decided in our infinite wisdom what the consumer should buy. That goes on still to a large degree in our industry. We are not market-focused, and we're also product-focused. I'm going to talk later about offers.

Why is it, for example, that you see companies out there that sell the same accidental death and dismemberment product we sold for 20 years? Maybe it offers $250,000 of common carrier, $100,000 of auto, and $20,000 of regular insurance. The same product has been marginally successful for years, and a couple of years ago a couple of companies came along and said, "Well, we'll offer $1,000 or $2,000 *free* for a year, and you can buy supplemental on top of that." The results went up. The marketing efficiency increased dramatically. Then other companies came along and said, "We'll offer you one or two or three months of this at no cost, and then we'll bill it on your credit card." The product was the same identical product, wasn't it?

All that was different was an offer, but the difference in the offer created a dramatic increase in the number of people who bought and maintained the product. What does that mean from a company standpoint? Not only are we much more effective from a marketing efficiency standpoint, but also we get better selection. We get better risk because, when you think about products versus offers, how many people open up their mailbox and take an offer out from XYZ Insurance Company, and see it's insurance and run salivating to their living room sofa to tear it open so they can go and buy the program? We're selling what consumers think is a necessary evil. If you sell a product, you will get a base level of response, that most of us suffer through, which is composed of a lot of people who think they need it, know they need it, or family history says they should buy it, plus some people who are security-conscious.

It is moving from products to offers that allows us to generate significantly higher response rates from people who didn't know they really need it but now see it as a good value, and people who will generate much more favorable loss ratios because they're not the people selecting against you. We'll go through this later, and what I'm going to explain to you is how each of you for things you can feel, taste, touch, smell and enjoy, it takes offers for us to buy those kinds of programs, and yet we want people to buy because they need it. It just doesn't work exactly that way.

Our prospects are undervalued and underserved, and so are our customers. It doesn't matter whether we're agency or direct response companies. I recently had an opportunity to take a database from a huge mutual insurance company. I wasn't surprised to run it through and find out that the average policies within a household came out to 1.13 -- a pretty poor job of serving our customers, and it's not significantly higher with direct response marketers because we're afraid. We're afraid that if we go out and sell more we'll disturb the existing relationship. That's why agents don't want to go out and sell additional programs. But the person who wants to buy is going to buy whether it's from you or someone else.

I travel all month. I don't have time to go to stores, even though I live in New York. Land's End knows that I buy all my shirts and ties and socks from them, and so I end up getting 42 catalogs a year from them. They know if they don't send it to me, L.L. Bean or Tweed's or someone else will, and I'm going to buy that way. I happen to have needs for those programs. We do not value our customers or prospects sufficiently, so therefore we must change our focus in some of the things we do.

One thing we need to do is change from persistency to quality of customer. I have a concern with the word *persistency*, even though I know how important it is and the power of persistency, but I think by its very nature it creates a connotation in a home office of being reactive instead of proactive. It's too late to go and conserve people once they've made the decision to leave you. We have enough information in our databases and from our research to understand not only the people who will accept our offers, but also those with whom it will be most favorable for long-term relationships from claims and buying more programs to occur.

We need to focus proactively on quality of the customer, and not be as reactive with the term persistency. Again, we need to move from a product focus to a market focus, from a sales focus to a customer focus, and customer focus is important, friends. I can give you an example of a large Blue Cross organization that is in the market Ed talked about, which was Medicare supplement, a commodity market like auto insurance where people who will buy through direct response will switch from year-to-year based on cost savings. There is no risk to them.

What our job to do is, people who will shift because of cost will always shift because of cost; but your job is to increase the value spectrum so that the amount of money that will cause people to shift becomes larger than it was from the last company. You do that through customer focus, through having meaningful inserts in your billing statements -- not the talk about the factor in 40 years and you have an A.M. Best rating, and you'll pay claims. That's kind of self-serving, but meaningful data that reinforce the buying decision, that tell people they've joined the bandwagon, that tens of thousands of other people have decided this is good value and makes sense.

Whether it's Medicare supplement or auto insurance, if you're in those businesses, think of who are the people who don't know you have good service. They're the ones you want to keep, aren't they? They haven't had a claim. The only people who know your service is bad, or the only people switching to you for service are the people you don't want if you're in preferred risk. Therefore, it's more of that proactive customer focus.

We need to have more actionable market research. Market research is important. It has to be the right kind. It doesn't do us any good, again, if we're in Medicare supplement to say we've discovered who buys Medicare supplement. It's either the kind of product we sell or not. It's either the group of people who traditionally like to have freedom of choice of doctors and will pay any amount of money, or people who are cost-conscious because they think all doctors are the same. What am I going to do with it? What risk am I going to take to acquire that information?

It makes a lot more difference if I can understand factors that I can act upon in the marketplace, and too much of our research is more interesting than actionable. To better serve customers, we also have to use the market research to develop offers customers want and not what we want to sell. How many times do we, as direct response marketers, go out and test a new offer against a control offer, and which-ever one wins we expand and use it? They both may have been pliable and profitable, but we use a control. We only send one offer to consumers of term life or accidental death. Until we were mandated with ten versions of standardized Medicare supplement, maybe we limit those to two or three.

How many other companies do you know that address the marketplace that way? If Pepsi-Cola decided that all you should drink is Pepsi, they'd be in pretty bad shape. If they had done a market test of Diet Pepsi against Pepsi, Diet Pepsi would have lost. It would have got lower response, lower premium per thousand. But Pepsi-Cola was smart. The company analyzed it and it said, "Wait a minute. Diet Pepsi isn't cannibalizing 80% of the Pepsi people. It's not the exact same people. We are increasing market share by having two different offers that expand market share. One is less profitable than the other, but both more than acceptable." So then the company got caffeine-free Pepsi and caffeine-free Diet Pepsi. But for us, an example is a company that was selling hospital indemnity. We went out and tested a money-back hospital indemnity. The money-back didn't work quite as well as the hospital indemnity, so the company canned it, instead of doing an analysis to recognize that, even though the products both were more than profitable, the money-back was bringing in a different profile of people, maybe with a 20% overlap that expands market share.

We need to, in our marketing, have a version of our Pepsi, our Diet Pepsi and our caffeine-free. Chevrolet doesn't go out and offer a four-door sedan. Why does it have convertibles and two doors and pick-up trucks and vans? We do not have homogeneous markets, and yet we and our companies try to come out for ease or for other reasons with one offer.

You need to build, buy or lease a market-driven database. It's critical. You cannot succeed without one. It's just too expensive to go out and develop new customers. It's important to do that. That's how you get the lifetime value, but you have to

have the credibility. One company went out to test credibility, and Mike or Ed alluded to what happens if you're a no-name firm and how difficult it is to build critical mass. One company went out to find out how important name is. A large mutual company found through a survey that insurance company name recognition from a group of five could generate over a 60% increase in the premium per thousand, the same offer, the same mailing, unless it was a no-name company.

Some of the companies, not that they were bad companies, like the National Liberties and Union Fidelity fell in this study at the bottom line of lack of name recognition. Up at the top were Prudential, Metropolitan, John Hancock and a few other companies. One of the companies said, "Let's go test it. Let's go out and see what happens if we take a subsidiary name that we have that nobody's ever heard of and take a random sample of half a million of the two million names we're mailing. What's the difference?" They found out the difference was a 62% increase in premium per thousand, which is why so many of your companies go out and seek third-party endorsements, isn't it? You're renting somebody else's credibility and database.

The mistake we make is we think that's the solution. We forget that not everybody who is a member of XYZ Organization or customer of XYZ Bank is the same. You can't mail them all the same offer. Based on age, sex, marital status and income, some people want Diet Pepsi versus Pepsi, and there is just not a control product because you don't expand market that way. So we need to have the database and we need to analyze the data.

By the way, one of the other mistakes we make when we go out and rent names is we make the mistake of thinking all names are created equal. Mike referred to recency and frequency. The fact that somebody has an XYZ Bank credit card doesn't mean he is automatically going to open up the envelope, and that's what you're looking for, isn't it? The reason that the response rates to direct mail are less than telemarketing is that in telemarketing 100% of the people you contact hear your message. What percentage of the people you mail to open up the envelope? If you're mailing from an unknown company, maybe 10% open it and 90% throw it away. You get a third-party name, the stronger it is, more people open it. But then if the third party is sending to a credit card customer who hasn't used his card for four years, the Travelers or John Hancock or Prudential name may have been a lot stronger than the third party's because the company doesn't have a relationship any more.

So we come back down to the relevant information. We need to target events that trigger a desire to buy. When you do a direct solicitation, think of what's happening. Why, when you have offers like birthday life or when you market auto insurance to people right before the expiration date, why do they respond more? There's an event in their life that's causing them to think in those terms.

When you do a general solicitation to a large group, even though the third party creates a greater desire to open the envelope, the fact of the matter is, when it's a general offer, your response is low because 80% of the people who responded had an event occur in their life. You didn't know the event or the person it occurred to. If you can isolate those events, you do much better, so that's why birthday life does well. That's why creating offers for new cardholders does well. If you're a credit

card issuer, people come to you for a new card. They're happy, they're excited, and they want to spend money. They haven't been with you long enough for you to screw up the relationship, so they're still in a favorable mode and they'll buy from you.

If you run out of events, create events. If Lincoln knew how many people would have used his birthday for sales, he would have put royalties on his name. People who run out of events create them. One company had a hospital indemnity product: standard entry age rate, rate for the rest of your life, typical age brackets 40-44, 45-49, 50-54. The company found in its particular market that its best penetration was at ages 44, 49, 54; because those people saw the event that if they waited the rate would go up – the same psychology as birthday life, isn't it? So they said, "Wait a minute. There's an opportunity here." They went out and filed five slightly different hospital indemnity products – one for people 40-44, one for people 41-45, one for people 42-46, and so on. Each person who got an offer received an offer based on the fact they were at an age before the next age band. The results in total increased their premium 40%. They created events that triggered people deciding it was time for them to make a buying decision.

Why is January the best time of year for you to sell programs? People say, "It's a terrible time. People just spent all this money on Christmas." The reason is because people are thinking about this necessary evil. They've just been with their family over the holidays, and people want to satisfy those desires at that time.

Relationship marketing is another buzzword, but is very critical to the lifetime value. Everything in your company, all subsequent communication should be strategically focused. How many companies send out premium notices with nothing in them but a premium notice in an envelope? You're already spending the money for the postage. That's your opportunity – to go after these people who aren't filing claims, who are the people who don't know what your service is like, to reinforce your image of a good decision; not that your company is rated A+ by A.M. Best, but that some independent survey said that 98% of the people who file claims were satisfied by the payments or paid in time.

Let your customers speak for you. I'm going to skip through the media, except to mention that these five media are all direct response media, agents included. When you think about it, this is about the approximate cost to reach them depending on how you do it: Three-thousandths of a cent for broadcast, three-tenths of a cent for a full-page ad, 35-45 cents for most direct mail kits, $3.50 to reach a person through the phone, and $70 for an agent to call. So why would you use one versus the other? This is very important when you're developing your plan. It's clearly based on the amount of information you have.

The degree of information you have can help you make the right offer to the right person at the right time because you have relevant transactional and relationship information, not just important information, which can drive you to spend more money. To the extent you don't have sufficient information, use less expensive media to extract from the general marketplace people who raise their hands and say I'm interested in this kind of insurance offer, but maybe not now. When they call you on the phone responding to the radio or television ad, you extract relevant information

from them -- age, date of birth of their spouse, kids, who they're insured with, etc. -- to create a database; because now you can afford to spend more money on them and move forward.

We don't really profile our media based on that often enough. Some companies say they are direct mail companies. This is a big mistake, because all you're saying is the postage costs go up and unless I find ways of building a database, I'm out of the direct marketing business. I can't fall back to these other media to pull people out, or I can't go forward to use some of these other media where it's justified and I can get a better close rate.

The key thing to understand about telemarketing is that the big advantage there is that, remember, 100% of the people you communicate with hear your offer, and that's why it's different. You only use telemarketing to your best prospects and customers. It's ten times more expensive than direct mail, but 100% hear the offer, and we forget about how many people through direct mail throw the offer out.

We talk about offer. These are the components of an offer. When you or your marketing people are developing something, don't develop a product. Think of all these because some of them can be showstoppers. We don't pay enough attention. Marketers tend to think of benefits and rates and forget the rest of it and let actuaries and underwriters fill it in. You need to work as a team. One quick example of a company with limitations did an accidental death and dismemberment product, had 22 limitations, and didn't do as well as the company thought it would. It went back and did research and what the consumer saw was a limitation paragraph twice as big as any benefit paragraph. The consumers perception was the "I got you" is in there somewhere. I don't understand insurance and I've got you.

The actuaries and underwriters said, "Look at all these 22 things. There's nothing in there that affects more than a few people. It's just the exceptions." But the consumer didn't react that way. So the company went to the actuaries and said, "Look, if we take these bottom 11 out since the incidence is low, what does it do to the premium?" The company said, "Oh, we might have to raise it a few percentage points." They said, "Fine, the product is $7. Raise it 5% and we'll sell it for $7.45 and we'll cut the exclusions to 10." They went out and the perception was changed.

Terms of payment and methods of payment are important. There is a big difference between selling a product for $27 a quarter or $9 a month. If administratively you can't handle $9 a month, you sell it at $9 a month billed quarterly; because the perception of the offer is dramatically different. We don't pay enough attention to how we create all these things. What's the offer enhancement? That's the $1,000 free or the two months at no cost, double benefits for accidental death for 50 cents more a month. It's all the enhancements that do the same thing for direct marketers as these things that relate to us.

You go buy a suit. Unless you gain 20 pounds, lose 20 pounds or rip the one you have, you wait for a sale. You wait for an offer, and not all offers are created equal. A 50%-off offer is buy one, get one free. It's the same merchandise and identical size inventory. The store that says buy one, get one free, even though they're

forcing you to buy two, will push out much more in revenue than the store that says 50% off. Why do companies sell compact discs eight for a penny? We can't do that in insurance. That's a loss leader. We don't need to fortunately, but they do it because after 15 to 18 months they know the revenue generated from the ad will be much greater than had they said, you could buy all the compact discs you want for $9.95.

I was doing a long version of this presentation in a company, and an actuary was sitting in the back reading *The Wall Street Journal* and he had said to me, "I'm only here because I'm forced to be. I don't believe in this stuff. I would never buy through the mail. I don't believe any of this offer stuff. They're gimmicks." He's reading *The Wall Street Journal* and I let it go and about 20 minutes later I said, "Charlie, did you pick up that *Journal* on the way to work this morning?" He said to me, "No, I didn't. As a matter of fact, I was watching a lot of CNN during the Persian Gulf War and saw an ad on there where I could get 26 weeks of *The Wall Street Journal* for the price of 22." I said, "Charlie, you told me you don't buy offers. You don't buy through direct response." His response to me was, "But that's different. It's *The Wall Street Journal.*"

A motor club offers three months at no cost. What's the difference in cost to the consumer between 25% off or three months at no cost? Not a penny difference in the end price, yet this offer generates four times as much premium at the end of the year. So, you see, we have to be concerned about what consumers think. We can't be product-oriented. We can't sit in those smoke-filled rooms and design things in our own wisdom. We have to be a lot more consumer-oriented.

If an unknown company goes out and offers you three months of something at no cost, or you get a magazine subscription where the first six months are free and you don't know the people, it's a gimmick. You don't trust it. It's like a real estate deal in the Pocono Mountains. But if your association or your church or your employer comes back with the same identical offer, it's a benefit. It's a value. It's what you expect from them. So, are they gimmicks or benefits? It depends on who's offering them. Are they real or perceived value? Remember this. As an insurer you have to provide real value for your conscience, and to keep a customer you have to have real value. But it's perceived value that gets a person in the door. It's real value plus perception that keeps them. If you only concentrate on real value, you'll have low response rates and you'll only get the people who are sick and you'll be one of the companies that believes it has hit a mature market.