RECORD, Volume 22, No. 1*

Marco Island Spring Meeting
May 29–31, 1996

Session 48PD
Distribution of Individual Products—A Look into the Crystal Ball

Track: Product Development
Key words: Annuities, Marketing, Compensation

Panelists: CINDY A. DIBIASE†
C. R. DUNCAN‡
PATRICK J. MOORE§
Recorder: C. R. DUNCAN

Summary: This session considers many ways product distribution might evolve in the future. Discussion compares traditional forms in place today with some expected and even some unexpected forms of tomorrow. The impact of distribution on product development and design is explored.

Mr. C. R. Duncan: I'm vice president of individual distribution for Principal Mutual Life in Des Moines, Iowa. Cindy DiBiase is the vice president of NFC Consulting Group, an affiliate of Talbott Financial Corporation. NFC is a Chicago- based financial service consulting firm specializing in product design, joint venture partner searches, technical training, and general marketing consulting. Cindy has designed fixed and variable annuity products and market programs for insurance carriers, mutual fund companies, and financial institutions across the nation. She also has provided continuing education seminars to many financial service professionals and is a frequent speaker at industry meetings.

---

†Ms. DiBiase, not a member of the sponsoring organizations, is Vice President of NFC Consulting Group in Chicago, IL.

‡Mr. Duncan, not a member of the sponsoring organizations, is Vice President, Individual Distribution at Principal Mutual Life in Des Moines, IA.

§Mr. Moore, not a member of the sponsoring organizations, is a Consultant with Benesch Financial Institutions Group in Cleveland, OH.

Patrick J. Moore is affiliated with Benesch Financial Institutions Group, the consulting arm of Benesch, Friedlander, Coplan & Aronoff, the Ohio law firm. He's a member of the network of consultants created by Kenneth Kehrer Associates to serve the strategic and program implementation needs of banks, insurance companies, and security firms. He brings a unique perspective to his role as a consultant to banks and insurance companies on the distribution of investment and insurance through banks. He has been an insurance company executive, he has run insurance programs in a bank, and he has managed banking operations.

Distribution has historically been and will surely continue to be one of the three key points of the markets, products, and distribution triangle. This combination is absolutely vital to the future success of any company in our industry and, in fact, to the industry itself. I will try my best to bring some personal perspective on where individual distribution stands today and where we at The Principal think it is headed.

Basically, two significant distribution-related trends continue to emerge. One is the shift from marketing life insurance to the offering of a broad array of financial products and services, and the other is the shift from a company reliance on a single distribution system to a multidistribution system.

I have some very brief background information you're likely aware of, but which is a stage setter for us for our discussions. In all the years up to about 1982, the life insurance industry was essentially in the life insurance or the risk protection business. A number of regulatory acts supported and strengthened that position for the insurance company and allowed it to move along in a conservative and predictable way. The waters were very calm. During the past dozen years or so, beginning in about 1983 with the looser interpretation of the Glass-Steagall Act and its pending repeal, the trend has been toward deregulation. This has resulted in a broader emphasis on financial product and services, truly triggering the movement towards the financial business. This movement continues with the recent Barnett Bank ruling that extends bank involvement in insurance and is another step to banks' involvement in one-stop financial shopping.

The effects of these regulatory changes, combined with other contributing factors, have had a major impact on our business and, in turn, on the direction of our distribution systems. This impact is primarily from competitive pressures, changing consumer needs, perspectives, and preferences, and shifting interest rates. Let's look briefly at some of those results.

We're all aware of the premium shift that has occurred. Our high-margin life results have shrunk rather significantly compared with the lower-margin annuity slice to the total premium pie.

Another resulting trend has been a meaningful decline in the number of individual life policy sales in recent years. It's interesting to note, however, that face amounts of policies have trended upward. The bottom line is that more people are not being adequately served today with respect to their life insurance needs.

What does this mean to us? We'd probably better find a way to serve them and we'd better find it quickly, because there is a void out there and voids have a tendency to be filled by competition. As new policy sales have trended downward, so has the total number of policies in force in the U.S.: five million fewer policies in the time frame 1984–94. Fewer life policy sales trends reflected—and are probably tied to—the number of agents and fewer recruits. There are a variety of reasons, obviously. There is still a stigma, economics fear, and so forth. The Life Insurance Marketing and Research Association (LIMRA) projects 155,000 what we would call full-time agents by the year 2000. Also, the industry still suffers from retention problems. Agent turnover has risen, in fact, from 24% in 1984 to 28% in 1994. Obviously insurance companies are continuing that search for better ways to support existing marketers and better ways to bring people into our business.

Is there a growing need? Absolutely. Fewer agents and fewer policies add up to people without an agent, somebody representing them on the insurance side. In fact, the number was 78% of the population in 1994. One of the questions that we continually ask ourselves is, how do you reverse this trend, especially in the marketplace of those earning $30,000–$70,000 a year?

There's also a growing perception problem in the public of how people view the life insurance company and the life insurance agent. In the latest findings, only 45% regard the agent as necessary in recommending the right life insurance program, and only 23% consider the agent's advice as being helpful. These are telltale signs for us as we look for distribution answers.

Finally, here's something I find fascinating and perhaps indicative of where the future of distribution might lie at least in part. One insurer with both salaried and traditional compensated agents has seen four to five times the number of sales from the salaried group than from the commission group.

Most everything I've thrown out at you so far is fairly discouraging, at least from an insurance company's perspective. But it is where we are today, and it surely should help us get to where we have to go tomorrow. Frankly, we're quite optimistic about distribution and the movement toward the 21st century. We believe we can build distribution systems that deliver, that are high quality, that are diverse, dependable, productive, cost-effective, and that serve market needs. But to do this the insurance companies will need very strong resolve, creative thinking, the will to change, and putting the allocations toward those changes.

An example I'm familiar with is what's going on at The Principal. I want to share that with you to give you a perspective on how one midwestern mutual company looks toward the 21st century. Our individual insurance department has historically used a single distribution system: the career system. In recent years, however, we've developed and grown other systems. We do believe in multidistribution. We currently have four established systems and we are piloting a fifth, and a sixth and a seventh are on the drawing board. We think that marketing through multiple systems provides multiple benefits. Obviously, certain systems are inherently better positioned and equipped to serve certain markets. Things that work well in one system might be transferable to others. Higher sales volume enhances the potential for product profitability. There's a favorable trade-off between fixed and variable distribution costs, and there's a strong recognition and reception in our target markets of a multisystem. There is also an element of protection against periods of depressed productivity in one system.

The career system is necessary and is firmly established at The Principal. It provides dedicated and dependable efforts and results and is especially well suited to the personal marketplace, one of two primary target markets of ours. It also has a degree of controllability. The question is how we will pay for it in the future. Most importantly, it is the primary provider of personal one-on-one insurance counseling that is available to customers today. It also offers a way to build customer relationships and trust that is overall important to our series of companies.

Certainly a great deal of work needs to be done, and there are many special attention areas that need to prepare our career system for the future: things related to market segmentation, agent and manager compensation, market conduct issues, improved training and development with respect to the array of sophisticated products and systems, and the services that are being offered to our nine million plus customers. Also, we must find a new approach to customers such as through banks, wire houses, CPAs, and lawyers. Experimenting with marketing co-ops of agents rather than individual agents working with selective customers is part of what we are all about as we head toward the 21st century. This will not, obviously, be easy and it won't be cheap.

We also utilize two types of brokerage systems. One is composed of independent brokerage general agents, established marketing organizations with expertise in the business market, our other target market. The other uses employee brokerage managers who work for individual street active brokers and who, in the main, are housed within our career or proprietary system. They also, as you might imagine, require a very demanding, sophisticated marketing resource center. That's both a positive and a negative. It is very much a positive in that it keep us very attuned to what the consumer is all about.

Our supplemental distribution system is our fourth and most recently established system. It's composed essentially of third-party marketers working through bank systems and other financial outlets. In spite of all the rhetoric by our career force, it has been amazing during the last 18 months to watch this experiment with a bank, and the fact that it did not in any way play off against its main area of concentration, which was in the personal marketplace. The system within the banks provides us with an opportunity to develop relationships and the alliances that we think will be so important as we go forward. The interesting thing is we are bringing product and marketer to the bank. We are very concentrated with a few select banks, supplying them with the product and the marketer to go after the bank's customer.

Most recently we have developed a new retail outlet. It's a walk-in store in a mall in Nashville, Tennessee. It offers one-stop financial products and services, kiosks, and state-of-the-art software. It has a nursery, a library, and a seminar room, and it is staffed with salaried consultants. Our job at the head office is to bring the customer to the store. The consultant is in no way responsible for getting the customer through the door; that's our job. The consultant's job is to help plan the customer’s needs, offering mutual funds, insurance, residential mortgages, stocks, bonds, and so forth. This has allowed us to experiment with new approaches and not only apply it to the customers, but also determine how and what they might do to the overall marketplace in general. It's allowed us to experiment with new economic ways of bringing people into our business. It's also another step in our minds in the broadening financial services concept, allowing marketers to serve customers in a variety of related ways. I believe in ways that the customer wants to be served: full financial services.

Earlier I said that major trends in distribution were from life insurance to financial products and services and from single to multidistribution systems. We expect this to intensify into the future as we strive to serve our markets more effectively. The future of distribution is obviously in a state of flux as we constantly adjust to change, expand our horizons, and employ new technologies that continue to explode around us. Alternate ways of reaching customers such as these examples will continue to be observed, considered and, in fact, explored.

Another area in which these new approaches are important, but in providing ongoing service for them as well. From an economic standpoint, look at the expense range in handling service requests from what we are essentially doing in our industry today—the relationship manager—as compared to some other feasible approaches.

Servicing costs and quality concerns have led to yet another trend, at least at The Principal, and that is the value of the existing customer. We think the trend is toward the company taking more control of producing ongoing and expanded services rather than the marketer. A wealth of information may be assembled, stored, and put to effective, productive use in a company's database. Key factors such as household information, occupation, income, product ownership, face value, cash value, and so forth, give us a one-upmanship if we, in fact, work at servicing our own policyholders. As the company expands control of that function, the marketers more strongly support it and more time is freed up to do what they do best: sell. So I think we'll be seeing more direct company association with the customer. We'll continue to work through the marketer to establish personal one-to-one services, specifically in planning and product selection, as well as in building relationships. But the company will begin to go around the agent with respect to orphans, service follow-up, data collection, and determining other needs that the potential customer needs and wants fulfilled.

The bottom line from our perspective is, What's ahead for distribution? Obviously, challenge and change. Challenges from other entities invade our traditional domain and the overall question is how to get our wares out to the customer. There are changes in the ways we bring people into the business and how we compensate them. There will be more emphasis on the salaried approach to sales rather than on the commissioned approach. We also see a continual shrinkage in agents' numbers. Even though they will be more effectively supported and should have greater productivity, there will also be a consolidation of field offices as we apply technologies, allowing more services and support direct from home offices. There will be more strategic alliances between insurers and other financial institutions, as well as among insurers themselves. With those changes, and changes addressed and capitalized on, we think the future for distribution is bright as long as we stay committed to it. I guess if you're going to manufacture a product, you'd better have some form of distribution. Pat will now give you his perspective with a different point of view.

Mr. Patrick J. Moore: What lies ahead for the industries in this new era? As Bob told you, I have been both a banking and insurance company executive. Bank interest in insurance is increasing for a number of reasons. The regulatory environment has improved substantially. Barnett Bank is the biggest recent example. There was a case more recently than that, however, and it is viewed as somewhat compromising the overall situation for banks. However, if you read the case carefully, it doesn't do anything to change Barnett.

There is a desire for more fee income on the part of banks. The spreads between assets and liabilities that banks have been experiencing have been narrowing. The success with annuities certainly whets the appetites of bankers. I think last year 30% of all fixed annuities sold in the U.S. were sold through banks. That number is up from zero in 1982. Customers certainly indicate their willingness to buy from banks. Depending on the surveys you read, it's as high as 35% for certain products. We all ought to be thinking about what customers want, not how we think how they should do business with us. Then there is distribution leverage in banks. We'll get into that a little bit later, but it's probably self-evident to anybody who has a bank account, and 97% of the people in the U.S. have bank accounts. There are branches and ATMs everywhere.

In our view, banks will be agents first; that is they'll be distributors first. Underwriting is too risky for now, although in the future banks might be a very interesting source of additional capital for the life insurance industry, in particular. Most big banks are very highly capitalized versus minimum capital requirements. Key Corporation in Cleveland is required to have 5% capital. It has almost 8.5% capital, and on a $66 billion base that's a great deal of money.

Banks have extensive customer data. They not only get data; they know about transactions at the right time. Obviously, when you go to a bank to get an auto or home loan, that's effectively the same as the renewal date for insurance needs. Banks require large amounts of data. If you bought a home and got a mortgage, you will remember the four-page loan application. You basically told them everything about your life, more than you probably wanted to tell them. Unfortunately, at most banks that doesn't all reside in a system. That sits in a file somewhere, and only a limited amount of information is in the system. However, banks are getting much better at capturing and keeping that data.

Banks have frequent contact with their customers. Not only through branches, but customers receive bills from banks, there are ATM transactions, there are telephone contacts, and those interactions with customers are opportunities to put products in front of them. It also means that there's a built-in distribution on which added products can be layered at incremental cost. You saw the $18.44 relationship manager cost versus the lower cost in Bob’s presentation. The bank distribution already has it or already paid for that $18.44 by selling a bank product.

Then there are payment systems. Banks own the payment system in this country. You know how life insurance policies are paid for. They are often deducted from checking accounts. Well, if you sell insurance to a bank customer, there ought to be an easy way to automatically deduct that premium monthly or have it paid monthly or quarterly by virtue of the bank account and use cash letters instead of sending bills and collecting checks. You know that there is a much easier way to do it through banks. They are highly efficient. This has not yet been actually installed anywhere with a life insurance company or a property and casualty (P&C) company that I'm aware of in any large institutions, but it will be.

The insurance industry will benefit. There probably will be improvement in persistency. People whom I talked to speculate that the relationship of the customer with the bank ought to mean that renewal rates will be higher, assuming that the relationship is good. The billing and collection is automated, as I mentioned. The insurance industry effectively will have access to 53,000 branches, about 55,000–58,000 ATMs, and all the ingoing and outgoing telemarketing systems that banks have in place.

There should be better prospect targeting. One of my clients, which is a large midwestern bank, says that rather than send the typical request for proposal (RFP) out to life companies, saying that if you want to do business with us come and see us, the approach will be as follows. Profile the buyers of our products. We'll match them to the customer database we have. We'll tell you how many prospects there apparently are, and then we'll get together and figure out how they ought to be marketed and what the product menu ought to be for each segment! Now with all the data banks have on customers, it will be a very useful and rewarding task to use that data.

Bob gave you some of the information on the under-served market. I will give you a little more. I hope none of it conflicts, because it also comes from the life insurance industry, but this is on life. I also have information on P&C. The P&C business will go to the direct providers and to the big captives and to direct mail. Forty percent of people have no life coverage. Fifty percent are underinsured. Distribution is heavily skewed to people with incomes of more than $75,000. And 37% of the people have less than $25,000 of life coverage. Now, the whole point of giving some of this information is that these are the people whom banks do business with. The CEO of LIMRA said that "millions of prospects are not getting an opportunity to buy life insurance."

The middle market is poorly served by traditional channels. Another issue: according to Ernst & Young, the average acquisition cost for each new dollar of life premium is as high as 200%. Add to this the agent decline and the large number of policies that are lapsing or orphaned to which Bob referred.

To the banking industry all these facts mean that middle America is not well served. Agent recruiting and retention are down. Direct writing is strong competition. It is estimated that for GEICO Corp. to give Warren Buffett his return on his investment, it will have to grow 25% per year, and GEICO Corp. is already a big provider on the P&C side.

So banks and insurance companies, particularly life companies, ought to be natural allies. Banks have built-in distribution and payment systems. However, banks lack insurance expertise. The insurance industry has the expertise. There's a perceived cultural chasm. The reality is that there is a cultural gap. The insurance industry traditionally sells by way of variable compensation. Banks are process-oriented, service-oriented, and they aren't particularly good at selling. Actually, in most cases they're terrible at selling. That's changing.

The common ground lies in the agent's expertise and in direct response marketing by using database management at least to create prospects and to grow this under-served market. I have a client that does business with two million households. It was able to segment those households by income. Of the two million households, about 1,720,000 households are in the $30,000–$75,000 income bracket. That's just the way America is, so every big bank should normally reflect that. That ought to be a distribution system of some interest to an insurer that wants to serve this underserved market.

Insurers generally do not oppose bank entry. More than 50 large life companies already do business with banks. Agents generally do, but privately agents will tell you that they're not quite as opposed as they are in their public pronouncements in the independent agent lobby political positioning. At the last workshop I attended, I was on a panel and the former president of the independent agent sat on my left. He was actually involved in the 1992–93 debate that was particularly hot and heavy in Washington. He admits he's come off somewhat from his earlier position, because he sees banks as being a more reasonable alternative. Their regulatory limits are fading.

I think all of you are aware of the Barnett Bank 9–0 Supreme Court decision that came out of the shoot faster than Dred Scott. Well, you're probably not aware of Huntington in Ohio. Huntington Bank in Ohio is a $15 billion bank holding company that applied two years ago for an agency license and was turned down by the department. Huntington engaged in litigation with the department, and the case went to the Ohio Supreme Court. The Ohio Supreme Court directed the commissioner of insurance to act on the second application by Huntington, and three days ago Huntington was granted a license. Huntington is a national bank. It's a big retail presence, and Ohio's a pretty tough state on insurance. The independent agents lobby is strong. It is a significant step at least in our part of the world.

There's the perception that banks have undue influence. Now I say perception, because from a banker's point of view the last thing in the world bankers want to do is lose a mortgage loan to sell a homeowner's policy. Where's the sense in that? However, there is a school of thought that says there will be undue influence placed on the bank customer to buy the insurance as a quid pro quo. I don't know where this stands right now with respect to the independent agents lobby, but I read it again in the article about the American Deposit case. So there is a perception that banks have undue influence, and that is a barrier.

The Office of the Comptroller of the Currency (OCC) is writing model regulations to give banks guidelines to make sure that they offer insurance in the right way to avoid some of these perceived problems. What's most important, however, is that customers want to buy from banks. The beta test (banks selling annuities) has succeeded and everybody has much to gain, particularly with this middle market segment. That will become a hot political issue eventually if it isn't resolved.

We see some important elements of bank insurance alliances. They have to be quality partners. I don't mean necessarily just A+ rated by Best & Company and Campbell-rated banks that are number ones. Quality means there are people who can come together with a meeting of the minds to make these things work. A customer focus instead of the process orientation that afflicts most financial institutions is important, as is product flexibility. Products that don't exist currently will be created by virtue of bank and insurance company alliances; it's a new kind of distribution. It must be strong in compliance, and there has to be maximum value from the data relationship.

What kind of business can this generate? A $15 billion bank conservatively should generate $10–20 million in life premium per year, and $6–8 million in P&C premium (new premium per year not renewal). For you in your profession, what would happen if all that business persistency was 20% higher? I know enough from my actuary friends to say that with older business the loss rates are lower, maybe that's on the P&C side, but certainly if a bank’s customer relationship is good and the payment's easy and there's some relationship on the product, persistency ought to be better. Therefore, there's more profitability in it for the company.

Finally, banks will get into insurance; first as agents, second as money managers. Before banks become underwriters of risk, they'll become money managers. One of my clients is negotiating with a life company now to create effectively a proprietary product. Although it's a product off the shelf with the bank name on it, the premium will be managed by the bank on a contract basis in the bank's investment department. Third, banks will be codesigners of new products, and finally someday banks will be risk underwriters. Banks have a hard enough time managing the banking business. The insurance business is something entirely new for them, and there is no need for them to get into that. Although I heard a CEO of a big midwestern bank just two days ago say he thinks his company ought to buy an insurance company. He has the resources to do it.

Ms. Cindy A. DiBiase: In this section of the panel discussion, I will talk about distribution of individual products and some of the other channels that we haven't talked about yet, mainly, the independent broker-dealer (IBD) channel, national broker dealers (NBDs), which are the big wire houses, regional broker dealers (RBDs), brokerage general agents (BGAs), managing general agents (MGAs), and personal producing general agents (PPGAs). We'll start by talking about some of the characteristics that each of these channels have so that you can recognize them. Then we will talk about how you and your company go about choosing the appropriate distribution outlets for your products. From there we'll segue into just what products are necessary, what kind of features are being requested in these different channels. Then we'll finish it all up by making some predictions on how some of these channels might be changing and evolving in the future and how that might impact you.

Now bear in mind that when I make some comments about these different channels that this is a very generalized presentation. There certainly are organizations out there today that you know of that might not fit neatly into any of these categories as I've described them. Let's keep it at a high, macro level.

Let's talk about the independent broker-dealer firms. These firms are characterized by the fact that they do not employ their sales forces. The people who sell the products offered through independent broker dealers are independent contractors, such as certified financial planners. They mainly use the independent broker-dealer firm as a place to hang their securities license (if they're series six or series seven) and to take advantage of some of the services and marketing support that the broker-dealer firm offers to them. People in this channel are much more long-term financial-planning-oriented toward their clients as opposed to being more transaction oriented, like the wire house brokers are. Also, the independent broker-dealer firms don't create their own proprietary products for sale, and normally they clear their trades through a clearing broker dealer.

To bring it all home, what are some examples of some of the independent broker-dealer firms that are out there today? In Atlanta, I have Financial Service Corporation, that might be familiar to some of you. In California there's Linsco/Private Ledger Corp. and Financial Network Investment Corp., so those are just some of the firms you've probably heard of.

Let's talk now about the national broker dealers, the wire houses. Here I know we're all familiar with the names: Merrill Lynch, Smith Barney, and Paine Weber. What characterizes these firms is that they're all members of the New York Stock Exchange and, therefore, they're all clearing their own securities trades. Almost all of them today offer their own proprietary products, whether they be mutual funds or variable annuities. Salespeople here tend to be much more transaction-oriented than those who belong to most of the other distribution channels.

The regional broker dealers pretty much have the same characteristics as the national stock brokerage firms with the exception, of course, that they're located in a specific geographic region of the country. Also, another possible exception there is that the regional may or may not have proprietary products and they may or may not clear their own securities trades, depending on how big they are. Who are the regionals? Well, there are A.G. Edwards, Raymond James here in Florida, and Piper Jaffrey.

Let's move to the brokerage general agents. Most brokerage general agents, not all, are members of the National Association of Independent Life Brokerage Agencies (NAILBA). Brokerage general agents are suppliers of multiple products to agents who really utilize a primary insurance carrier for most of their business. Then the BGAs offer them some multiple product selections that they just can't get through their primary carrier. A best estimate would be that there are about 400–500 BGAs across the country today.

The managing general agents distribution system is very highly organized. It’s established. It has a heavy agent recruiting focus. They do a great deal of advertising in trade journals and, also, by direct mailings to agents. We've all seen their full-page ads in the trade journals touting the 14% rates. Sometimes you have to read the fine print to see whether that is the commission rate or the interest rate. Occasionally, it's both on the product.

Personal producing general agents include agents who might be affiliated with a brokerage general agent or a managing general agent, or they really have no affiliation and they only work with insurance carriers with whom they can contract directly to sell products. Obviously, the experience levels of these agents vary across the country. They're usually somewhat compensation-sensitive. Those are some brief descriptions of the select universe of distributors who sell individual products.

In the era today where distribution has become one of the most paramount contributors to success, how does a carrier go about choosing what channels it should be working with? We have to pay attention to a couple things. There's the culture fit. We have to talk about some control issues; how much control do you want over that channel? How much does it cost to do business there? What kind of technology and service will your company be required to come up with? Also, basically, how much premium do you want to get from these channels?

An example is the easiest way to explain the point I'm trying to make here. If your company is the type of company that makes decisions slowly and deliberately, you like to have a lot of person contact with your producers, chances are that wire house distribution will not be the place for you. The overall key here is that you need to find distributors who have an appreciation for the way you do business and, also, who might have the same overall business philosophies that you do.

What about control? Now control means many different things, but I'm mainly discussing how much control you exercise over what products the channel will offer and how they're offered. Mainly it's how much control you can exert over dictating the terms of the relationship versus how much control the channel will dictate.

Let's take a look. I've kind of done a graphic assumption below of those channels where you can exert higher control versus lower control. One caveat I have to make here is this is assuming that the managing general agent channel here is more of a traditional life insurance MGA.

If this were an annuities house, a big annuities MGA, well, then chances are it would wind up probably being down between the brokerage general agent and the regional broker-dealer (BD) somewhere.

HIGH CONTROL
MGA
PPGA
Independent BD
Regional BD
National BD
LOW CONTROL

What about the cost of doing business in a particular channel and what kind of technology will be required?

HIGH COST/HIGH TECH
National BD
Independent BD
Regional BD
PPGA
MGA
BGA
LOW COST/LOW TECH

Here I guess I included service, too. I'm combining these things because they all kind of tend to move in the same general direction. Requiring a lot of technology and service from you as the carrier usually will translate into a higher cost of doing business. Here the broker-dealer firms are usually a much more expensive distribution channel to be in. Down at the other end of the spectrum are the brokerage general agents. Now, again, I'm not implying that the brokerage general agents are not technologically proficient. All I'm saying here is that they are self-sufficient. They provide that type of support to the agent base, and you don't have to. I guess the overall axiom here is to know your service and your systems limitations as well as your own budget, and then choose your distributors wisely from those variables.

How much premium does your firm want to get and how fast does it want to get it?

ANNUITY PREMIUM SUBMISSION

FAST
National BD
BGA
Independent BD
Regional BD
MGA
PPGA
SLOW

This is also a big consideration when choosing distribution. The national broker-dealer firms, those wire houses and BGAs, can turn on the faucet quickly, but it will take a while to build up annuity premium from life insurance MGAs and the personal producing general agents. That was in eight products, so you can see that they do have the ability of sending a lot of dollars your way if you want to incur the costs and the aggravations, if you will, of dealing in that channel. Now, bear in mind here, too, that this picture would probably be altered somewhat if we were talking about life insurance premium. Then the MGAs and the BGAs would be quick to deliver, and the broker-dealer firms would be slightly slower.

Now that we've looked at the characteristics of the various channels, what are some of the implications of choosing a particular distributor on product design? Here are some of the things we'll quickly take a look at: features, compensation, and persistency. Let's start by looking at some of the product features normally requested by all the broker-dealer firms. In general, the products that you design for this channel tend to be feature laden. The independent broker dealers are looking for products that will help them do financial planning for their clients. The regional and national firms are looking for products that will help them attract more assets on their management. If we're on the variable annuity side of the world, for instance, features such as dollar cost averaging and automatic portfolio rebalancing might be important.

As a matter of fact, our firm's annuity information center (AIC) recently did a survey at some of the national wire houses regarding what their feelings were about the strongest and weakest features of some of the variable annuity products on the market today. Some of you may not be familiar with the AIC, so let me just digress for a second here. We created the AIC about a year ago, and its purpose was to act as an information resource to help companies in their marketing decisions and in their product development efforts. The AIC helps you get answers to any of your annuity-related questions by performing some surveys within the industry or just from general information that we already have in our own databases. Often you just want to know how other companies are dealing with a particular issue and you may not have the time or the resources to perform the research yourself, or it's information that you just can't obtain. The AIC can help. We're not a competitor and our livelihood is based upon the fact that we handle this information very responsibly and ethically. We don't link names to data, if someone doesn't want us to do that. It was in this manner that the AIC set out to do a survey of the wire houses.

Unfortunately, we just completed the survey, so I didn't have time to put everything together, but here are some of the things about product features that they liked and didn't like, especially on the variable side of the world, which came up in the survey. Some of the strong points mentioned over and over again about particular products were that they love the increasing death benefit, so that's definitely still something they're focusing on. Also, the inclusion of good brand name fund managers with strong performance was important. A weakness that was consistently mentioned was the fact that some variable annuities were just single-manager products, or the mortality and expense costs were too high. Another weakness that often gets mentioned is that surrender charges are assessed upon death. Brokers hate this. There were also a couple comments about the maximum issue age being perceived as too low.

What about the rest of these distributors? What kind of features do they want? Well, MGAs seem to like very simple products with some liberal nursing home waivers and accidental death waivers. The products usually have high bonus interest rates and commissions. The downside from a consumer standpoint is that they have high and long surrender charges. As a matter of fact, I think the surrender charge schedules here are usually the least consumer-friendly in the entire universe of annuity products we see out on the market today. BGAs tend to like products that are a little more consumer-friendly than the MGAs, but still with some of the same liquidity-type features.

If they're driven by interest rates or compensation, and some of them are, the personal producing general agents will normally write business through an MGA or a BGA. If they tend to be more consumer-loyalty or consumer-benefits driven, they'll probably be writing business through an insurance carrier that will contract them directly. They look for the same features across the board. Also, there is some simplicity of design.

What about compensation? What's required in the distribution channels that I've talked about here?

COMPENSATION

HIGHER
MGA
BGA, NBD, RBD
IBD
PPGA
LOWER

Here is the graphic depiction of the gross compensation requirements of each of the channels. You'll notice again that the annuity MGAs require the most, with the BGAs and the national and regional broker-dealer firms following them within a couple commission points. Then there are the independent broker dealers. Finally, further down the continuum there are the personal producing general agents, who require about half or maybe even less than half of what's customary in the MGA channel.

What kind of persistency can you expect for those commission dollars you're paying out? Let's take a look at this.

PERSISTENCY

HIGH
PPGA
IBD
RBD
BGA, MGA
NBD
LOW

Direct writing personal producing general agents, the independent broker dealers, and regional broker dealers, to some extent tend to have higher persistency. The BGAs, the MGAs, and certainly the national broker dealers, the wire houses, tend to be on the low side. Don't forget that these are generalities. Certainly some organizations out there have better persistency rates than others, even though as a universal category they may not.

What has been kind of interesting for our firm to note in recent years is that we're finding out that the sacred cow of persistency, the financial institution channel, may or may not be a whole lot better than broker-dealer firms when business is out of the surrender charge period. We don't have formal studies here. We are just listening to things we're hearing anecdotally from some of our clients who deal in that distribution channel. They're telling us that after five or six years of being in that channel, they're now starting to see some lapses. Mainly the culprits appear to be the very large bank insurance programs, so we'll have to continue to kind of watch that situation in years to come.

What will the future bring? Those are some of the issues that companies are facing in the distribution of individual products, but what about tomorrow? How will potential changes in these distribution channels impact insurers? Let's talk about agent distribution first and focus on the life insurance side of the world.

LIMRA recently completed its latest census regarding the number of full-time career life insurance agents who are being hired. In 1992 there were less than 30,000 new hires. That was a 25-year low. The total number of full-time ordinary agents in 1993 was 219,000, and there have been some further steep declines since then. In 1995 there were only 25,000 career agents hired, and less than 15,000 of those people were totally new to the insurance business. The implication here is that the agent channel appears to be shrinking, and it may start to get crowded out by other distribution systems. Now keep in mind here that these statistics are for ordinary life career agents and not for the personal producing general agents (PPGAs) whom I've been discussing. However, I think we can make some leaps of logic here and say that many people who would be categorized as personal producing general agents today probably got their start in the insurance business as career agents somewhere. Therefore, it's probably a reasonable assumption that the PPGA channel is shrinking, too.

With respect to what all this means on the annuity side of the world, we don't really have any of the same kind of hard data telling us how many agents are selling annuities and how their numbers have changed during the years. But what we can look at are some projections for the sale of at least one type of annuity product, the variable annuity, and attempt to draw some conclusions from there.

Currently, many variable annuities are sold by the captive agency and control distribution channels. However, the latest projections from Variable Annuity Research and Data Service (VARDS) in Georgia is that the sales influence of this channel will be cut probably almost in half by the year 2000. Now some of that, of course, will be due to the fact that other channels are growing very rapidly, kind of eclipsing the captive agent channel, but we also can't lose sight of the fact that the captive channel may just be losing ground for some other reasons. Future implication here is that we are already seeing some companies that have historically had agent-only distribution now seeking ways to expand beyond that channel. Our firm has personally worked with a number of companies that were seeking ways to find alternative distributions without upsetting their current agent base. So much of my prediction here is that this search for alternative distribution will probably continue to intensify in the coming years.

Because I also talked about the BGA and MGA channels today, I guess it's only fair to make some predictions there, too. The BGA channel is shrinking rapidly with respect to distribution of annuities. Our firm can't explain this in any way other than the fact that we perceive them as having kind of lost their ability to sell in interest rate environments that don't allow them any longer to be order takers. The life insurance side is a little different story. They're doing OK there. But for annuity distribution, the BGAs seem to have lost some ground. The managing general agent channel will probably continue to grow in the coming years, and I'll let you formulate your own opinions about what I see as the overriding reason for that kind of growth. As long as there are carriers out there that will develop high bonus rate products (and by that our firm defines them as anything more than a 2% bonus) and high commission products), people will certainly be interested in selling them and people will certainly be interested in buying them. The big variable that's subject to adjustment is just how much information gets disclosed to the consumer about the company that stands behind the product and how the product's interest rate's will react in renewal years. So we don't know if that channel will continue to be a kind of "buyer beware" market If you want the highest interest rate on the block, you must pay in some way or eventually some huge consumer backlash will cause it to shrink.

But what about the broker-dealer firms? This was really my purpose for being here today. I was scheduled to talk about them more fully. Let's start with the independent broker-dealer firms. Here there will be an increasing emphasis on fee-based management services. This is where the selling representative receives compensation in the form of an annual or a quarterly fee for managing the client's total portfolio, as opposed to just receiving commission income from each of the products that he or she sells. Throughout most of the last five years conditions were kind to the independent broker-dealer firms. Many are starting to realize that the wave of assets they got from money flowing out of certificates of deposit (CDS) and money market funds in the period of 1991–93 is unlikely to be repeated. So taking last year as an example, many of the independent broker-dealer (IBD) firms saw the revenues just drop drastically throughout the year. By the fourth quarter some of the largest firms that we know of saw their business drop by 15% or more. These firms are now counting on asset management services to help them out in the coming years.

At the big firms, such as Linsco/Private Ledger Corp. and Royal Alliance, asset management revenues were really insignificant back in 1990, and now they're accounting for a bit more than 10% at those firms. A bigger example is Investment Management and Research (IM&R) in Georgia. It got 20% of its revenues from asset management in 1990 and now that figure's closer to 30%. Other firms are looking at the 401(k) market and variable life for their future growth. As a matter of fact, variable life was one of the few product categories that was up almost across the board at independent broker-dealer firms in 1995.

Technology will also grow in importance in the IBD firms in the future. Being able to provide the systems and accounting to handle the fee-based business will continue to be a challenge. So what does that mean for all of us as insurance carriers? Well, there probably will be a need for more no-load and low-load types of products that will fit into fee-based management programs. Also, as the IBDs put more emphasis on technology, insurance companies will have to do the same thing. An example of this is that some carriers today are starting to offer free asset allocation software to salespeople. This includes all the fund managers that the insurance company has in its multimanager VA product. There also seems to be some consolidation going on in this channel, and I think that will continue in the future with some of the smaller players not being able to afford the increasing cost of technology, marketing, and compliance. In future years, carriers may find themselves dealing with larger independent firms that will become perhaps just as expensive and demanding to deal with as the wire houses are today. We can't forget compliance. Broker-dealer firms are finding themselves in an increasingly regulated environment.

What about the national and regional broker-dealer firms? I mentioned that compliance is certainly a headache for the independents, but it will be an even worse headache for the national wire houses and the regional broker dealers in the future. These firms already experience a higher level of compliance headaches than the IBD firms, because their branch managers here have a lot on their plates. They not only have the supervisory responsibility for the brokers, but they also are expected to push proprietary products. They're supposed to run the office as a profit center. They're supposed to recruit big brokers. And, oh, by the way, they're supposed to push their investment banking services, too. Broker-dealer firms of all types and sizes will be subject to increasing scrutiny by the SEC and the National Association of Securities Dealers (NASD) for their sales practices.

What opportunity does this present to you as the insurance carrier? Well, you can help educate brokers either informally or through continuing education courses on the appropriate way to position an annuity or a life insurance product in a client's portfolio. Our firm designs and provides "E" courses to many kinds of distributors. You would be shocked and surprised at some of the misinformation and the misconceptions that we hear about from brokers with respect to annuity and life insurance products.

Technology will also be playing an increasing role in broker-dealer firms in the future, and as a subset of technology I would also add service. We also asked those wire houses that our firms surveyed with respect to product features about service. Those that had derogatory comments about an insurance company's back office will not invite those companies to stay much longer. So that's some of the focus for the national and regional broker-dealer firms.

Also, some things are happening at kind of a macro level today that will affect how insurance carriers do business in any distribution channel in the future. There are some issues here such as the control of time and money, diagnostic tools versus the personal touch, the financial literacy versus illiteracy of our customers, and changing life structures, which really will be the first thing that we will talk about.

A firm in New York called Inferential Focus has done some interesting think tank studies on how consumers have evolved over the years. The people there indicate that the overall structure of people's lives is changing and that sometimes consumers recognize this long before big companies do. For example, McDonald's had three years of down sales before it recognized that its consumers had moved onward to save money at different fast food outlets. In the 1990s, consumers through these studies have recognized that they need to take more responsibility for their own financial security and they also say they want more control over their time and their money. The think tank view of the world, therefore, is that companies need to let go of having strictly a product or a market focus and start providing their consumers with what's called solutions marketing.

Solutions marketing is recognizing a need that the consumers have today, such as the fact that they want more control over their time and their money, and then it's providing them with the tools to fill that need. What kind of tools am I talking about here? Well, an example would be a diagnostic type of tool such as Morningstar software that helps consumers easily compare their mutual funds. Or maybe we're talking about Quicken software, which helps clients prepare their taxes quickly and easily at the end of the year. These types of diagnostic tools are certainly powerful and, as a matter of fact, 40% of all Fidelity mutual fund accounts were opened based on a Morningstar recommendation as opposed to the personal touch of a salesperson recommending it.

We've done some work with the T. Rowe Price organization. The people there tell us that they had a 5% customer conversion rate after consumers read their retirement planning guide. Now we've probably all seen the predictions that people will rely more and more on tools such as Morningstar or the Internet for information about financial products and services. I've even heard some dire predictions that these types of organizations will then have the opportunity to disintermediate our customers, because our customers will get all the information they need to make their decisions without ever talking to us. They will go to some other source.

The solution is supposed to be that we take the bull by the horns first and start providing generic decision support to our customers as opposed to just presenting them with our latest product offerings. I think there's certainly some merit there, but it's one thing to provide a tool and it's quite another to expect clients to understand and use it. There's still this vast financial wasteland out there of people who are financially literate and people who are not literate. For every consumer today who is becoming more financially savvy by reading the retirement guides and using the performance software, another person out there is financially backward and has no intention of ever becoming enlightened enough to do all of his or her retirement planning without help from an adviser of some sort. No matter which distribution channel we sell through, we will continue to reach this mixed bag of consumers.

I personally don't think that any of the distributors that we've discussed today will be put out of business anytime soon by software packages or the Internet. These will probably still be adjunct tools to our selling process for some years to come. There will be that compelling need to have distribution and advice-giving taking place in, I think, the foreseeable future on a personal level.

Let me leave you with some interesting data that kind of supports this fact, at least for the time being. During a ten-year period of time, the Dalbar organization did some studies called the quantitative analysis of investor behavior. One of the things that Dalbar studied was the differences in behavior when investors are advised by an investment professional versus purchasing investments directly from the source and making their own investment decisions. For the period of January 1984 through September 1993, just about a ten-year period there, investors did almost 20 points worse in performance when they invested directly in equity funds without using a salesperson. There the performance was 70.23 versus 90.21 when they were advised. There was almost the same result for fixed-income funds. People who purchased without advice had 77.19 performance during the ten years and those people who purchased with a salesperson had 94.73 performance. The reason for this put forth by the study was that investors who purchase mutual funds through a salesperson were less likely to time the market and to trade in and out of the funds. So the study really showed that do-it-yourselfers, if you will, in contrast to stockbrokers, were more likely to turn their own accounts.

The conclusion I'd like to leave you with today, no matter which distribution channel your company chooses to do business with, is that chances are it will still add value to consumers for some time to come. Even though we have to keep an eye on new technologies and services and how they're affecting our consumers, we shouldn't get too far ahead of ourselves and spend so much time gazing into the crystal ball that we're not really working effectively with the distribution outlets that we have today.