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PROFITABILITY OF DIFFERENT DISTRIBUTION CHANNELS

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Panelists: ROGER R. HEATH
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This session will educate actuaries on the profitability of different distribution channels for life, health, and annuity products. Panelists will discuss compensation issues and the impact of marketing costs on surplus strain and other profit objectives.

MR. JOHN M. FENTON: We have three speakers. Let me briefly mention what each of them is going to address. First, I am going to lay out the areas that we will cover as well as those that we will not. Since our focus is on profitability, we will discuss some of the key drivers of profitability. Then we are going to have Roger Heath talking about measuring performance and profitability of the agency distribution business. Roger will focus on the captive agency channel.

Roger Heath is a principal of Tillinghast/Towers Perrin. He is based in Dallas and specializes in distribution effectiveness, corporate strategy, marketing strategy, competitive analysis, and financial analysis in the life, health, and annuity markets. Roger is a frequent author of articles for insurance publications like, *A.M. Best's Review*, including such articles as "Measure What You Manage or Profits May Be History," "How to Win the Productivity Challenge" and "Reinventing Agency Distribution."

Our final speaker will be Mike Shumrak. Mike will be talking about the profitability of nontraditional channels, such as stockbrokers, banks, and affinity groups. Mike manages his own firm based in Atlanta and specializes in applying his actuarial finance background to marketing and distribution issues. He has over two decades of experience, including four years as a senior vice president and chief actuary of a New York City-based life insurance company. He also has several years of actuarial management and consulting experience with the Big 6 CPA and actuarial consulting firms. He was also at Tillinghast, where he was the national insurance industry practice leader for distribution issues. Mike's area of practice includes development of strategic business plans, marketing strategies and the design and pricing of customized product offerings aimed at specific markets and customer orientations. He is considered one of the leading authorities in the area of starting up market-driven business units.

I know that many of you have different perspectives. Therefore I thought it would be a good idea to lay out what we are going to cover and what we are not going to cover. We will cover the key drivers of profitability for the life insurance industry. Is it compensation, persistency, mortality, other expenses? We will go into some of those issues. I would argue that for most channels, the biggest driver of profitability for a given distribution channel is distribution cost. To the extent that you can reduce your distribution costs by 10–20%, you have a huge advantage relative to your competition.

After defining the drivers, we will take a look at some of the appropriate measures to analyze distribution profitability. You cannot tell if you are profitable unless you have the appropriate means to measure cost. Roger will look at some issues involved with the captive agencies. Then Mike will deal with issues related to the alternative methods and channels.

We are not going to cover specific profitability figures for each distribution channel. We are not going to say, career agencies earn 9.6704% ROI, while personal-producing general agents (PPGA) earn 11.2206%. If that is on your agenda, this may not be the appropriate session for you. I would argue that each and every distribution channel is capable of earning a good return or adding value. I also think that each and every distribution channel has companies that are successful and profitable in that particular channel, while other companies are not. Therefore I think the key is to take your distribution channel and make it successful, and I would argue to do that you need to know the key drivers of profitability.

Before we looked at the key drivers, I thought it would be helpful just to touch upon what the term *profitability* means. Roger is going to go into this in more depth in his session. There are obviously a variety of measures that are being used out there. The first is statutory. Every company is required to present statutory results, which is the basis on which regulators measure solvency. Of course, we know that it does not always provide reasonable results for new and rapidly growing companies. For that reason, GAAP was created. It is required of stock companies and now for mutuals as well. Generally, GAAP provides a more reasonable earnings pattern than statutory. However, I would argue that it does not necessarily tell you whether new business is profitable or not; it takes time to emerge. There are some issues involved with GAAP as well. Roger is going to cover that in more detail.

For that reason we are going to introduce the concept of net present value (NPV) or economic value. This is based on statutory results and reflects the future profits discounted at a hurdle rate. I believe many of you are familiar with this concept. When we talk about the economic value added by a distribution system, we need to look at all the factors. We do not just look at distribution costs. Other factors can differ significantly from one distribution channel to another. We also need to look at product characteristics. Some channels are much more likely to sell one type of product versus another; for example, high-target premium universal life (UL) relative to low-target premium. There are going to be differences in assumptions that are driven off their particular product features.

The next one is experience assumptions. There are mortality, surrender, premium level, premium pattern, replacement business, and mix of business. There can be major differences here by channel. For example, on UL it might be nice and easy to price with target premiums paid in all years. However, I do not think everyone has the same particular type of premium pattern. It may be appropriate to look at three different types of levels: high funding, medium funding, and low funding. A particular distribution channel might be more likely to experience one level of funding versus another.

This also applies to surrenders as well. We know that on annuity business, persistency experience and also expectations can be significantly different for banks relative to career agents, as well as relative to the warehouses. This obviously impacts your profitability.

Where is replacement business coming from? A related question is whether it will go back there after you reach the end of the surrender charge period. Differing mixes of business can also have a significant impact: age, sex, band, separate account versus fixed account on variable business, and different commission scales can all impact your overall results.

The next area is expenses: commissions, overrides, home office acquisition, and home office overhead. Obviously this area is one of the major drivers, and we are going to be focusing probably more on this than other aspects. Direct field costs can vary significantly from one company to another, even by agency. Roger is going to address some of those issues. Home office acquisition and home office overhead expenses tend to be fixed costs, but typically in pricing we translate them to a per unit cost. Regarding taxes, normally we just use the appropriate tax assumption, whether it is premium tax, federal income tax, deferred acquisition cost (DAC) tax, tax on taxable gain or surplus tax. But there can be differences depending on the distribution channels we use, and whether it is a stock subsidiary or the mutual company.

The last one is capital requirement. Obviously there is the impact of the NAIC risk-based capital (RBC). Some channels require much higher ratings than others. For example, to sell through banks, the conventional wisdom is that you need to be highly rated. For other channels, such as independent agents, this is perhaps less of an issue.

With variable annuities, for example, it is generally perceived that the main drivers of profitability and variable annuities are persistency, maintenance expenses and acquisition expenses. The factors can be quite different by channel. If you are selling through to the national wirehouses, you can sell a lot of business, so it actually may be easier to meet your acquisition expense and maintenance expense goals. However, persistency is a big concern on this type of business. When you get down to modeling, there are going to be offsets either way. In summary, each distribution channel will have its own set of experience assumptions, which need to be reflected in your modeling.

MR. ROGER R. HEATH: There are several things that I would like you to take away from this session. One of them is that the core of the life insurance business, that is its regular premium paying insurance sold through agents, is in trouble. The agency distribution system is at the root of the problem. But, just as important, it is the potential source of its success. To use it for success requires fundamentally rethinking our approach to managing our agents, and what role they serve versus the role of the home office. A key beginning is in measuring appropriately the performance of the agent distribution business. I use the words *performance measurement* as opposed to *profitability* because there is more to be gleaned than just some sort of bottom line approach to it. Finally, to avoid being marginalized, the actuaries need to be involved. The key analysis is at the heart of actuarial science, but there are other skills that need to be involved or else home office folks just do not buy into it.

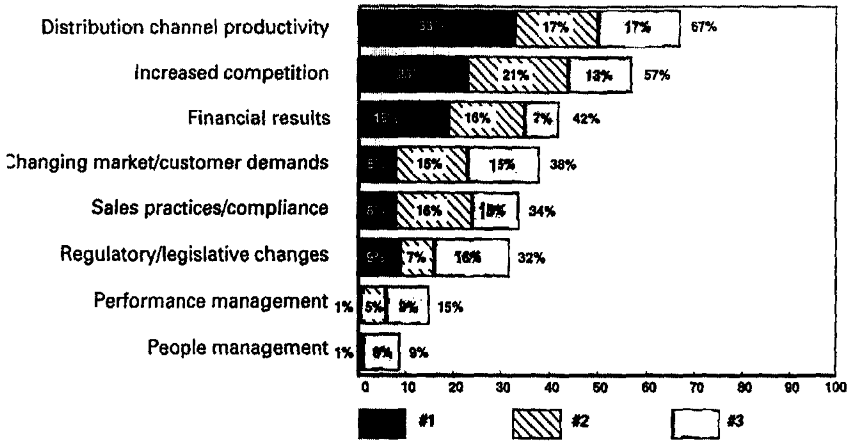
How are we going to go about this? I will reference analysis that we have done over the last three or four years, including two surveys of the top 300 or 400 insurance companies, to get their sense of the strategic issues. This also includes a unique look into competitive and comparative expenses and productivity, and some insights we have gathered by combining some of those things.

A subtitle to this is that you cannot manage well what you do not measure. There really are problems in the agency distribution business and current measures of performance measurement. What is wrong with them? That present value is sort of in line with John's promise that we will not get into all of the actuarial minutiae. This is a quick overview of what it is, how it can be used, and what analysis we have performed so far. Implementation is how we keep in the fray as actuaries in the company and add value. Also, I will have a couple of concluding remarks.

Acquiring new business is the largest cost of an agency company. This is based upon the work that we have done with proprietary expense survey, and then expanding that to the top hundred life, health, and annuity insurance companies. About two-thirds of expenses are in one form or another used in an agency company to acquire new business.

Distribution productivity is the most critical strategic challenge facing the industry (Chart 1). Life insurance CEOs surveyed in April 1995 indicated that over 67% of them felt that distribution channel productivity was among their top three issues, followed by increased competition and financial results. In 1993, when we performed the same survey, distribution channel productivity was third on the list.

CHART 1
1995 LIFE CEO SURVEY RESULTS—TOP STRATEGIC CHALLENGES

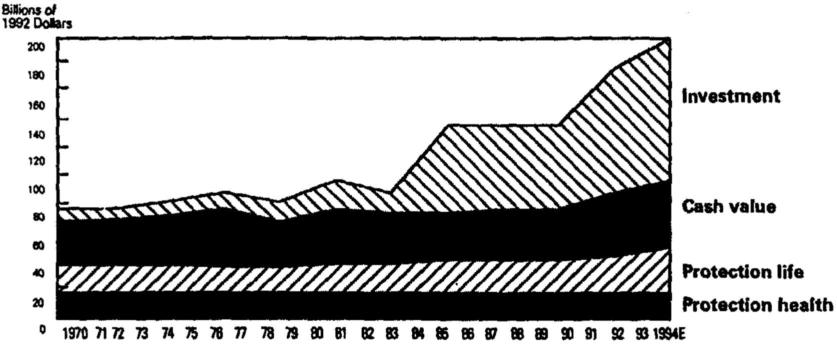


Source: Tillinghast-Towers Perrin, *1995 Life Insurance Industry CEO Survey Report.*

CEOs are struggling with those top three interdependent challenges. They talk about it being distribution management, but if you look at the other two, increased competition and financial results, they come in large measure because of a failure to be able to come to grips with the first one.

With all of this there is a backdrop of limited prospects in the individual life insurance industry (Chart 2). Since 1970 the life insurance industry, at least that part of the business that we are talking about, is dead flat. What we have done is to take industry statistics and divide them up into protection and investments. Protection includes periodic premium on whole life and UL. Investments includes annuities and single premium from UL products. Then we have normalized them, using in this particular case, I think, 1992 dollars. And as you can see for protection health, protection life and the cash cow of the life insurance industry, cash value, premium growth has been dead flat.

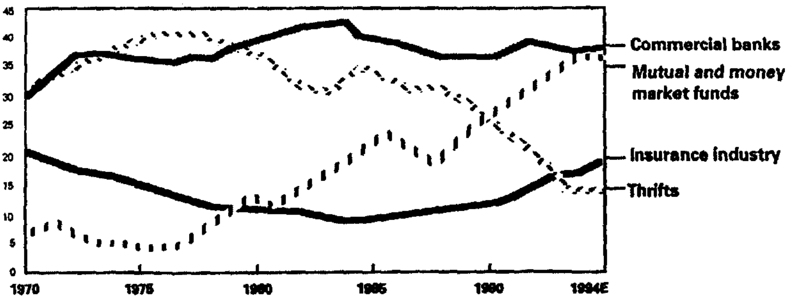
CHART 2
REAL GROWTH OF U.S. LIFE INDUSTRY
TOTAL PREMIUM INCOME—FOR INDIVIDUAL LINES



Source: Data from ACLI, Best's, Tillinghast Analysis.

This is at the same time when mutual funds continue to gain a market share. Chart 3 shows the market share of personal assets held by intermediaries, so it includes bank accounts and mutual funds, but it does not include things like your home.

CHART 3
MARKET SHARES OF PERSONAL ASSETS HELD BY INTERMEDIARIES—U.S.



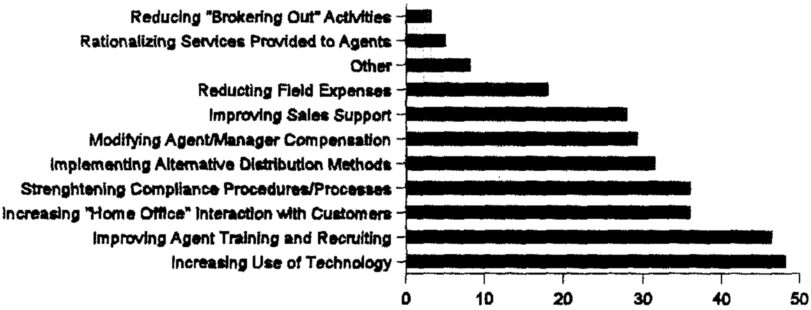
You will note that commercial banks, the insurance industry, and the thrifts all have been losing market share. The insurance industry lost market share down to 1995, but has grown somewhat since then. That is the good news. The bad news is that more than all of the growth has come from the investment business. If you just look at only regular premium cash value business, the market share has continued to decline right until today.

Part of it that is that growing (annuities), more than half is coming from sales through banks, direct response, and stockbrokers, rather than some form of agency distribution.

Have we all been asleep? I do not think so. Senior management is keenly aware of the challenge. The most significant distribution challenges that the industry indicates are high costs and low productivity. Who has not complained about that? Recruiting, training and retention of agents, customer attention and relationship development all are sort of imponderable problems. And the industry has done something about it, but the initiatives taken to date have not reversed a declining distribution productivity trend.

Chart 4 shows management is taking steps by increasing the use of technology, improving agent training and recruiting, and several other issues that are listed there. But unit costs for the last six years have continued to increase. This is from the comparative expense performance survey, and I think the most important part of this graph is we normalized them all in 1988. And while in force has been decreasing, which we would all expect, and new business has gone sort of up and down, the total expense index has continued to grow (Chart 5).

CHART 4
MANAGEMENT'S STEPS



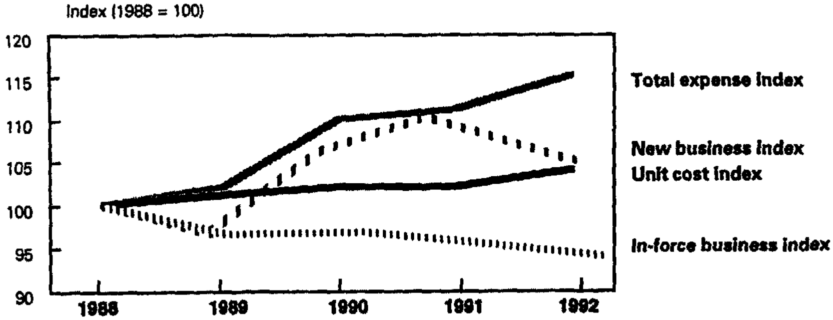
Source: Tillinghast-Towers Perrin, *1995 Life Insurance Industry CEO Survey Report.*

What is required of insurers? We think that basically they must reinvent their approach to agency distribution to produce a more cost effective and efficient system. It requires a marketing discipline that actually focuses on what the marketplace is, the market base. You must also have a particular focus. I would say to you that the estate planning marketplace is not a particularly narrow focus. You also should have active management of your agents as opposed to having them actively manage you.

To have active management of your agents, one must measure appropriately to manage well. Appropriate measures capture the essential goals of the owners, and transfer those broad goals to employees. In my view, and we can argue about this after the case, one goal overshadows all others: we need somehow to make the owners wealthy. For those of you who are mutual companies, I would say that you are ultimately in the same marketplace, and need to pay attention to the same economics. The key is to make the goal real.

How many of you have encountered problems where sales have been down and you have given the agency management people the goal of increasing sales and they did? And then came the bad news that they used some kind of sales incentive to get the sales in. Or you told them to increase agent recruiting and paid them a bonus to increase agent recruiting, and you found out that you have several hundred new agents now working for you. However, only about three of them have produced any business for you. But the general agents who recruited them all have a good bonus from having recruited all those folks.

CHART 5
UNIT COSTS CONTINUE TO INCREASE



Source: Tillinghast-Towers Perrin, *Survey of Life Insurance Company Comparative Expense Performance.*

The key is to get the agents to buy into the goals, which are consistent with the goals of the corporation. And I guess I am suggesting that a good goal to start with is to make the owners wealthy and think about how to make that happen.

How would we do that? Would you think of the money spent to acquire new sales as an investment in your distribution business? If you are an owner and you were thinking about investing in this distribution business, how would you go about thinking about that? Among our group, brokerage companies are probably the best equipped to think about it in those terms. Because they have clearly separated the two functions, manufacturer/ underwriting and distribution, whereas with PPGA and captive companies, that egg gets scrambled.

Good measures also are the keys for sound management decisions. We have talked before about how some forms will give you counterintuitive results. We are so used to dealing with things like statutory accounting, but we do not get beyond that and come up with something useful.

Speaking of statutory accounting, current financial measures may be incomplete or give incorrect conclusions. GAAP and statutory financial reports do not separate new business. It's impossible to tell how well your distribution and sales are doing. Even if they did, somehow somebody at the NAIC would let us report new business results versus in-force business results, and it would report losses on new business. What would that tell us about what we ought to do with our new business activity?

Profit studies are something that are near and dear to all of our hearts. They are interesting but they are typically not based upon actual sales, actual expenses or actual experience. Aside from that they work fairly well.

Let us take a look at the measures used by the agency side. They use other measures, and those measures I would contend are incomplete or wrong. Some people focus on things like agent retention or issued premium in determining how well their agency distribution business is doing, or how well a particular agency is doing.

Let us take a look at some work we performed for some companies (Chart 6). On the *y*-axis of this scatter plot is annualized issued premium. On the *x*-axis is economic value. Each of those dots reflects the economic value and annualized premium for a particular agency of an agency life insurance company. We do have a correlation, if you look at that straight line, which is the least-squares line. However, it is not a particularly satisfying least-squares line from the statistician's point of view.

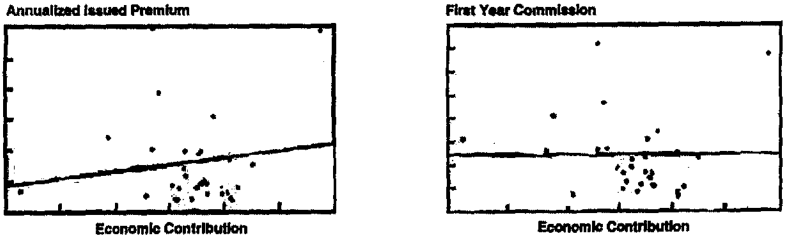
CHART 6
ECONOMIC VALUE AND ANNUALIZED PREMIUM

Incomplete

- Agent retention does not address revenue, benefits or other costs
- Issued premium is revenue for one-year only

Wrong

- Face amount is exposure to risk
- Commissions are expenses

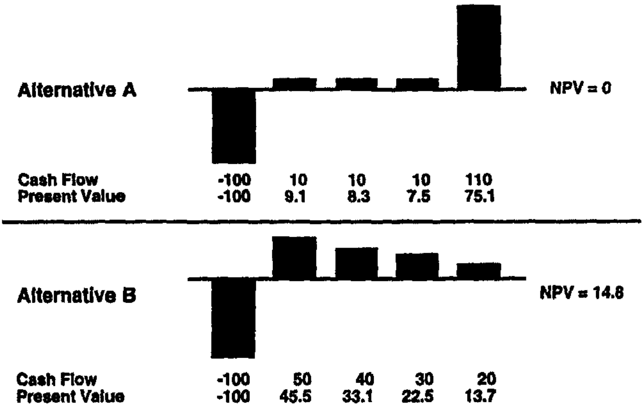


On the other side, things that are just wrong are face amount; companies actually use face amount as a measure. Face amount is an exposure to risk statistic, not an indication of how well the distribution system is doing. Or some use commissions, or some variety of it, which is an expense to the corporation. Again, this is not an indication of how well the agency distribution is doing.

For one of our clients we actually took a measure of economic value and plotted it versus first-year commissions. You can tell absolutely nothing about economic value by looking at commissions, at least from this particular client. In other words, the least-squares line was absolutely flat. It is better than some of the others. This particular client used to tell how well the agents were doing by looking at how big the agency is or in what kind of awe the client held a particular agency or general agent. We correlated some of those things. Most of those things are negatively correlated with some form of economic value.

What do owners use? To all of you this is really no big deal (Chart 7). It is on page 17 of every financial analysis textbook. It was the basis of Jim Anderson's first approach in what some of us call "Anderson's Method." Owners make decisions sometimes rationally based upon a given hurdle rate. Which alternative has the highest net previous value (NPV)? What we would like to propose is that we treat distribution as a business and, when treating it as a business, that we actually look at what amount we are investing, and what the expected return might be. We are proposing to calculate the NPV of new business acquired.

CHART 7
OWNERS USE NPV TECHNIQUES
TO CHOOSE BETWEEN ALTERNATIVE INVESTMENTS



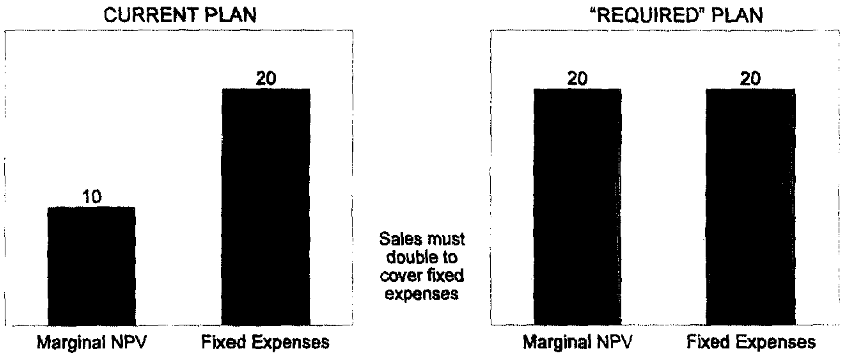
- Each alternative involves $100 investment in year 1
- The investors hurdle rate is 10%
- For Alternative A, NPV of 0 implies an expected return of 10%
- For Alternative B, NPV >0 implies an expected return >10% hurdle rate

These techniques can be applied to new sales. They test the performance of all those involved in acquiring new sales, not just the agents, but you can learn a great deal by performing the calculations by agency.

The NPV of new sales helps answer some crucial questions that are pretty simple to get at, but I do not think are ones that are asked often. Or if they are, they are certainly not answered. What exactly is our investment and expenses and capital in new sales? What is our return? Does it meet the needs of our owners? If not, why not? The "why not" is there because the typical NPV at a typical hurdle rate that I encounter is negative, as opposed to positive. Which agencies meet the minimum requirements, and what can we do to help all the agencies meet them?

The NPV analysis helps define the challenge for the distribution system, for the company, and for the industry. In some of the analysis that we have performed, at the front end of it we utilized marginal expenses. But you might also think about it as variable expenses. If you calculate the NPV using variable expenses, you get a NPV, and if you compare that to the fixed cost of the organization, it defines for you how short you are and the amount of business that you have to sell. In Chart 8, the NPV using marginal expenses of new business of this company was 10 and it had fixed expenses of 20. As a result it needed to increase its sales. It needed to double its sales to actually have an NPV of zero, which is the goal at the hurdle rate.

CHART 8
NPV ANALYSIS DEFINES THE CHALLENGE
FOR THE DISTRIBUTION SYSTEM, THE COMPANY, AND THE INDUSTRY



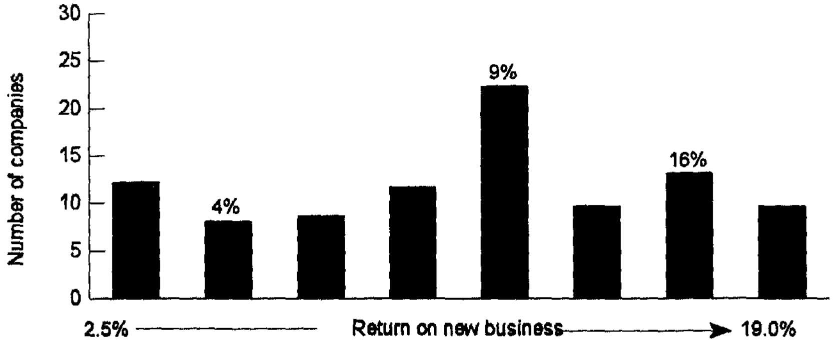
Note: Calculate NPV using all product characteristics, experience, taxes, and capital requirements, but only variable expenses for all products sold by the distribution system in a year.

NPV of new business also allows management to compare performance of alternative distribution systems. Some analysis that we have performed shows that most companies do not realize an adequate return on new business. Chart 9 shows the estimated new business rates of return for the top 100 life insurance companies. This shows the effect of the expenses of each of these hundred companies on the profitability of a standard permanent premium product. It does not reflect the varying permanent products that they sell. It is meant to give an indication of what expenses do to different companies on profitability. The range goes from 0% to 19% ROI.

The real challenge for us as actuaries is to help in the implementation of this. This technique may seem complicated, but it can be simplified pretty easily. It is well accepted in other industries, and it is well accepted by the CEOs who have come from those other industries. The concept is pretty easy to understand and apply. From the perspective of CEOs, it does not require brilliant strategies or leading edge software, but it does require a certain amount of backbone, vision, persistence, and objectivity.

For us to succeed in having this happen internally, we need to get four successful things to happen. First is support by senior management. If management people do not care how well the distribution system is doing, then it does not really matter. And there is no reason for us to come up with a new fangled way to tell them how well distribution is doing.

CHART 9
ESTIMATED NEW BUSINESS RATES
OF RETURN OF TOP 100 LIFE INSURERS



Source: Tillinghast-Towers Perrin analysis.

It needs to be fact, not personality driven, so we do not get into big arguments with the marketing people about how well they are doing. It needs to be disciplined and objective. The scope should be limited only by the goals of the owners, as opposed to some other agendas.

There are common elements and implementation that each company should follow. The real point here is that, along the steps of whatever project you come up to, you come up with you need to quantify the situation, and test it with the current stakeholders. Many times that I have been involved in actuarial work and coming up with models, whether it is GAAP or actuarial appraisals, we spend a large amount of time at our computers coming up with what we think is the right answer. Then we take it to somebody and are crushed to find out that they do not agree with us. The way to solve that is not to be more precise about the numbers, but to get them involved early on and go ahead and modify it, and not have such a pride of authorship in it.

There are pitfalls and other issues that should be anticipated. If you are managing a project, do not get so wrapped up in the actuarial minutiae. On the other hand, actuarial rules of thumb need to be tested for significance. In some of the work that we have done, we were told by all the actuaries that lapses were the most important thing that we had to take care of. We found out that in large measure when we were looking at it, their products were pretty immune to lapse rates. They had big problems with premium paying patterns. They had some agencies that had significantly different premium paying patterns from agency to agency. We almost missed it because of actuaries using rules of thumb from having done their pricing.

It is pertinent to answer the "whys" of people who do not understand it and be patient. Surprises surface when somebody is convinced that the Hartford agency is the best agency in the company and your initial analysis shows that that agency is down in the middle of the pack. You need to be prepared to talk to people about why that happened.

Consider allocation of fixed expenses. It is a never ending discussion but stay realistic. And when you are using these NPV measures, I would use them on a strategic basis early and do not think about it. It is really easy to get wrapped up in this and say "Oh." You know, if I use these NPVs, I can use them to modify compensation for people and actually drive incentives. While I would say that it is going to take you awhile to get it accepted. People do not want their incentives modified until they understand exactly how it is going to effect them, so I would use them later rather than earlier.

In conclusion, we have discussed the keys to success for agency distribution or marketing as a discipline, and managing the agency distribution channel. After all, life insurance is a mature fragmented industry. Any individual company's gains will come from each other. It is not a growing industry. It is going to come from getting it from your competitors. Marketing is a key. An agency distribution is the largest source of our problems and our opportunities. It is our largest cost, it is the greatest potential source of value. Agents understand client relationship management needs analysis, and hand holding better than any of them. The largest source of problems is the most expensive and the least susceptible of disciplined management.

Proper performance measurement is critical to the agency management and marketing. It needs to be realistic and complete. Consistent with owners goals, it has to be simple to explain to people, and it has to be accepted. To get it accepted by us, we have to illicit criticism from people early on. Use facts, get opinions, and get buy in.

MR. DOUGLAS S. VAN DAM: I was wondering if you could talk more about fixed expenses.

MR. HEATH: Typically in calculating NPVs, that issue occupies about two-thirds of the beginning of the project. The first question is, What are all the expenses that one would include in an agency distribution or calculating that present value of new business? And the way I usually deal with that is to say, imagine a company in which you were not acquiring any new business. Of the thousand people here, which dozen would be required to pay attention to the needs of the in-force policyholders? Then, that is the way you think about what are new business expenses. Everything else needs to be folded into the analysis. Now it is possible to take that analysis to different levels and use it for different things. As you noticed, we did some calculations with just variable expenses. When you start talking to agency managers about what they can do, and what it is they can control, you might for some purposes use only variable expenses that they can deal with. But ultimately in defining the challenge for yourself, you have to use all of the expenses that you have—fixed and variable.

MR. JOE B. PHARR: I think your presentation has been very stimulating. I would like to make a couple of comments. And the first one has to do with value. I think it really simplifies things if we can talk in terms of economic values, and that is what really ought to drive our pricing, that is, in terms of internal rates of returns and NPV. And then the other set of values is the accounting value. I think there is a great deal of confusion that goes on in the companies because we tend to mix the two. I found it very useful to be able to say, let's first talk about the economics of the product. And then once we get that settled and all agreed to, then let's talk about how we account for it. Both of them are important. But, I just think if you put all of the economic and accounting values and run them together, you do have quite a problem. I like to make that comment. If you could make a question out of it so you can respond John or Roger, that would be fine.

The other thing I would like to maybe challenge you about. You made some remarks about profit testing. I think you implied maybe profit testing was not very realistic. It seems to me in the context of what we are discussing here in terms of professionalism and ethics, that we as actuaries really ought to be pushing to make this profit testing routine realistic. We could talk all day about what that encounters. I think in particular that is a challenge you could throw stones at if you like, but I think it is up to us to be professional and ethical about it. That involves communications right up the line. I think you talked about communications for marketing, investment, and management. We are in a unique position to make sure that the insurance industry stays professional and ethical about the pricing.

MR. HEATH: Regarding the second comment about the profit tests, I think there are two situations, one of them is it currently exists. There are people who do not include all expenses and there is some difficulty about forward looking projections. But, just ignoring that for a minute and assuming that all was fixed, there are still inherent difficulties in profit testing. But almost by definition, the profit tests that you use to establish the pricing comes before you know how much has been sold. Before you know how profitable it is, you have to wait and see how much has been sold if nothing else to get the actual sales involved in the whole thing. Any other questions or comments?

MR. COLM FAGAN: I have just a slight change of perspective from the other side of the Atlantic. There is a sense of rearranging the deck chairs on the Titanic. Just to give you my own perspective, from 1986, recruiters by the Bank of Ireland started to look at a new life insurance company and we started off with a few premises. One is that insurance salespeople are incredibly inefficient no matter by whom they are employed. The second one was that bankers could not sell insurance. But we had decided for the salespeople, 80% of their time was spent prospecting for business and only 20% selling. Basically, we got the bankers to do the referrals. We got the salespeople then working off those referrals and received five times the productivity. I am talking about full-line, high value-added business. If you can achieve that sort of productivity improvement and paying those people about the same as you would a reasonable salesperson, then you transform the economics of that business and you challenge the traditional methods of selling business.

MR. HEATH: I agree with you completely and this is a first step for many of us. Once you look at the profitability of new business and you use hurdle rates of your investors. You do that first calculation to find out that the NPV of the new business that you wrote last year is minus $100 million. It is supposed to be a positive number and still cover some of your fixed costs—it gets your attention very quickly. Then translate that into "we need to double our sales." You start investigating all the ways that you can do that.

MR. H. MICHAEL SHUMRAK: Over the past several years we have seen a number of traditional agency companies respond to their frustrations like Roger has described, with their lack of progress to improve agency productivity by seeking what they hope would be greener pastures in nontraditional distribution. We have watched these companies launch a wide array of activity, such as direct marketing and selling through banks and stockbrokers. These companies were hoping that these alternatives to the traditional agency distribution channels would increase sales volume, lift profit margins, and increase sales volumes, or reduce the high level of first year investment to acquire new customers. While we have seen some successes, particularly in the sales of annuities through banks and some of the stockbrokers, many of these efforts, particularly much of the direct response and other nontraditional efforts have fallen far short of expectations. Why is this?

In my view there are three primary causes. First, many of the end results of these new ventures targeted unrealistic end results, based on false premises about some of the economics or strategic advantages of these alternatives. The second reason for the disappointments was the lack of top management commitment, and of course, Roger emphasized that for turning around an agency. It is even more important for starting something that you do not even know anything about. And then the third reason is, if companies even got through that point and actually started something up, many companies would typically not put in place people with the expertise or the access to the expertise of people who really knew what they were doing in these strange and different businesses. You have the blind leading the blind in many cases.

Despite these disappointments, we see a growing number of competitors, successfully apply nontraditional distribution methods to access alternative distribution channels. They have lowered acquisition costs, raised profit margins, and increased sales volume. The success is based on real versus imagined competitive advantages, strong commitment from top management, and effective execution focused on transforming the potential advantages into realities. As the boundaries between different sectors of financial services industry continue to blur, even those insurers steadfastly committed to maintaining and surviving with traditional agency distribution channels, should want to gain an understanding of the very real and growing competitor threat, and also, the opportunities posed by alternative distribution channels and methods. Ignorance is not bliss in this environment.

The object of my comments is to start this education process. And in so doing, replace some of the myths about the economics of the various nontraditional distribution channels with some truths. We hope this will help you formulate sound strategic decisions with realistic expectations about how alternative distribution channels and methods might fit into your strategic marketing mix.

I am going to start by defining what I mean by the terms *nontraditional channel* and *non-traditional method* and describe some of the channels. To me, a method is a sales process or a sales media. And a distribution channel is a sales source or a root. Of course, one of these items could be one in the same: face to face and captive agents, for example. But it is interesting to note, I intentionally put the order of the methods as face to face, selling by telephone, mail, print, and broadcast. I throw in the Internet just for fun because that is just starting. Basically the cost-per-contact or per-prospect is the greatest for the face to face and the least for the broadcast. But if done effectively, especially for a complex product, nothing can beat face to face from going from the prospect to the closed sale. The other end of the spectrum, broadcast television can reach a large part of the nation pretty quickly, but you are not really sure who you are going to get.

In terms of channels you have the captive agents whom Roger discussed, and insurance brokers. You also have banks, which sell both in an agents sense, and using third party marketers and commissioned representatives to make the sales, and also some direct marketing activity, where the banks basically direct mail or sometimes telemarket certain products themselves. Stockbrokers are another channel, mainly selling annuities and some variable life products. And affinity groups could also be a bank list where the affinity is to their bank. It could also be a professional association group like American Association of Retired Persons (AARP) or smaller professional associations. But then you have kiosks and lobbies. The lobbies could also intersect with the banks, in that they sometimes sell insurance in the lobby.

For direct marketing, we often use two or more of these methods in tandem to complete the sales process. For example, when you see *The Wall Street Journal* ads for high-amount term insurance, they are basically looking for an inbound 800 phone lead from somebody seeing the ad and calling in. Then they will send out information on the product and application. Through direct mail, they use the phone again for people calling in with questions. As we just heard, in terms of a case at an agency in Ireland, there are also opportunities to mix methods. For instance, dividing the sales process and the prospect in a closing and using direct response methodologies are probably the best prospects in selling situations, then turning the closure loose on those prospects.

I want to just quickly overview distribution cost and compensation. Then I will get into some measures that I want to discuss, in terms of trying to relate all this to margins and returns, and that sort of thing. For banks and stockbrokers, even though they are nontraditional channels, the compensation structures are typically similar to the agency forces. Commissions are within the same range as agency, where stockbroker commissions might be at the high end and banks might be more middle road. In direct response the distribution task can conclude anywhere from one to three elements. You know, the first element would be the marketing cost for the direct mail, to develop the kit and process the leads for filling customer orders. A second cost that exists in some products is the incentive. For example, a reduction in the cost for the first month. Even though you could do that as a reduction in a premium, it is really an investment of the lost premium in a marketing cost investment.

Then the third element can be very much like agency compensation. And these are situations where in affinity groups, banks and other situations, the people providing the list to the direct marketing insurer is extracting a commission under a certain list fees for access to the list. Also, in many of these situations, brokers are involved in terms of matchmaking and running the marketing for the list so they also get commissions.

I want to talk about three measures in terms of distribution and impact on product economics. The first one I am going to define is strain, which is going to impact statutory internal rate of return (IRR) and GAAP ROE. The second one will be distribution compensation for dollar of revenue. This impacts what I call the profit margin. Then, finally I will discuss an index that is return on distribution cost, which measures the value produced. It is similar to what Roger was talking about, but uses a slightly different methodology so you get an index. As Roger said, if you use the hurdle rate for the discount rate in any kind of a process you might be having indices that have zeros all over the place.

Let's define the first one. Distribution cost strain is defined as the first-year distribution cost. And this would be all the distribution costs incurred in the first year, including commissions, marketing, sales, all those elements I described, divided by the first-year revenue. We will define revenue later. In a traditional product it would be the premium. On investment products, it would be the spreads and other sources of revenue like surrender charges. Of course, the traditional definition of strain would include other first-year costs, including reserves and RBC. But, again, here we are trying to focus on the impact of the distribution cost.

Distribution cost per dollar of premium is the margin driven measure. It is the present value of all the distribution costs in all years. Again, if it is direct marketing where you just market it up front and do not owe anybody anything else, it is really just what you spend the first year. But in cases where there are commissions or fees paid in all years, you take the present value of that and then take the present value of the revenues.

Let's get back to this index of distribution effectiveness. This would be the present value of distributable surplus—in other words, the present value of profits including RBC, but instead of discounting at the hurdle rate where again, realistically in many situations, you might be at or below zero. The index will not give you anything to work with. Here again, because we are just looking for an index, I would discount at the earned rate. Think of it as sort of a GAAP-type ratio, where you would not include the adverse deviations. You are really just trying to get a gauge on the relationship of how much money you are investing in acquiring the new business versus what you are getting back on it.

As Roger said, there can be wide differences. Even if it is business within banks and in the category in terms of distribution channel and the distribution method is all direct mail, there could be a wide array of results. You really have to also consider the unique characteristics of the channel and method as to the product mix, including types of products within a category that are sellable. If it is all direct mail without much sales support, it has to be pretty simple benefits. And in certain markets, the level of the premiums has to be in a certain range.

On the quality of business, you might typically find the persistency will be better in some of the endorsed markets. But the claims experience could either be much better or much worse, just based on the demographics and the nature of the people in the group. Also, regarding sales volume, we have seen lists that could be very responsive, but if there are only 50,000 of them, the printing process will be spread over a pretty small base as opposed to a list of 500,000.

I will now go through an example to illustrate how these measures work. I want to create a very generic baseline and run this through on typical agency products. This is to say, here is what we are dealing with, and if we are going to greener pastures, what is the deal? I think we have parity across channel and method. And, as we can price products for say a 7% after-tax return if it is a spread product after tax, a margin of say 35 basis points or 18% of revenues are the spreads and the surrender charges.

Acquiring a new customer is what we're talking about. Again this gets very confusing. For example, you could take an offer from Vanguard on a variable annuity, where there are no surrender charges and extremely low mortality and expense (M&E) fees. But you do not realize that maybe they are cross-selling it to good customers whom they already own or have a relationship with. So again, for the start of this discussion, we are just going to talk about going after the first sale to a new customer. Then later on we will contrast that to what happens if you are able to control the marketing of subsequent products.

Start with a whole life product with an annual premium of about $2,000 a year. The distribution cost is, and again this is everything, not just to the writing agent, about 130% first year and 10% in the other years. Again, we will use that parity profit margin. The present value of revenues is $12,000, and the present value of the profits, at the earned rate not the hurdle rate, is $840.

Then we have our other three measures. The first one obviously is 130%. The second measure, what percent of the pie of a dollar of premium are going to distribution costs, is 30%. This is pretty typical from much of the industry analysis we have seen. If you throw everything in and say, What percent of the present value of premiums go to distribution? Then the productivity index is $840 over $3,600, or 23%. It does not mean anything yet, but we will see how it compares as we go along.

Next we will do the same exercise for a high amount term with increasing premium. We have $500 premium with distribution costs relatively higher, as a percentage of first year premium equal to 150%. We have the same profit margin. The present value premium is $3,500, and present value of the profits is $1,050. The strain is obviously 150%. Again we see that the distribution cost per dollar or 30% is just like the whole life. It is just that the magnitude of the cost per sale and the revenues we will get per sale are lower. The same thing goes, of course, for the index. It is much lower profit, much lower investment, $1,050, and much lower profit per sale.

Now we will look at an annuity product, a typical agent or bank single premium deferred annuity (SPDA), $20,000 initial premium, distribution cost of 5.6% commission and a 1% bonus which, for this illustration I am using as a marketing cost or marketing incentive. So we are spending $1,320 to put the policy on the books. The revenue margin you know, would be 18%. The spread and surrender charges are worth an equivalent level effective rate of 200 basis points on assets per year, so the present value of revenues is $4,400.

Let's look at the three measures. Interestingly when you view the revenues for what they are in the annuity, the strain here is tremendously higher than the life products, which is why the margin, that 18% margin is higher because the higher margin is required to make up that huge strain. This is sort of in the ballpark of products on the street. Also, of interest is the present value of the distribution process; the percent of revenue happens to be very much similar to the life products. The big difference, mainly because of the higher required profit margin driven by that high strain, is that the value measure of the productivity measure turns out to be much higher, 60% instead of the 23% we saw in the other products.

Table 1 recaps what we just went through. And you know, the notable thing is that higher strain on the annuity forces us to go for that higher margin, if you measure things that way. So we come up with a better value index. It is interesting to see how much you spend when you make a sale in each of these situations. Then right below that is the profit per sale (PPS). How much do you get back on it? As we saw in all cases, we're spending 30% on distribution per dollar of revenue.

TABLE 1
AGENT AND BANK SOLD PRODUCT RECAP

Measure	Whole Life	Term	SPDA
First-year distribution strain	130%	150%	350%
Margin	7%	7%	18%
Value/Defined contribution	23%	23%	60%
Cost per sale (CPS) ($)	3,600	1,050	1,320
PPS ($)	840	245	792

Note: Present Value(Defined Contribution)/Present Value (Revenue) = 30% for all products

A few comments on the bank-sold annuities, just to talk about compensation. Total commissions are typically about 6%, and if there is a third-party marketer brokering the business, then the bank keeps 75–80% of that. We see an increase in the desire of banks to want to get even more of that, maybe managing the assets or participating in the profits in some way and the experience can be similar to agency. We will talk about the stockbroker business next.

As John has already commented, I think you can get higher premiums. You have to provide the latest bells and whistles like annual ratchet and minimum-guaranteed death benefits on variable annuities. There is pressure for high product performance. There is a great deal of lapse volatility after the surrender charge period. On the big wire houses it is tough to get shelf space. Lots of companies are competing with many other insurance companies, plus you are competing against their core products. Smaller regional companies tend to have less volatility and operate more like some of the banks.

Finally, let us turn our attention in terms of looking at these indices relative to direct response. Typical direct response is selling supplemental life and health products. And here we are looking at what happens when we are doing the first sales to acquire a customer with the idea that maybe we would like to have more then one product relationship with the customer. Premiums are $200 because again it is a limited benefit, a lower premium product. Distribution cost should be about $300. But again, if we are writing a list or getting the names directly, that is our only costs, so it is just a first-year cost. Present value of revenues is $1,000 and the profit margin again is 7%. In my experience there are not opportunities unless there is some competitive edge like owning customers or having some new market you have identified that you could price for a higher profit margin and agency business. The present value of the profit is $70.

The three indices are basically the same as the high amount term for the agency. The distribution strain is 150%, fairly high. Again, that is one of the myths, that you can cut back on the distribution strain. The answer is, not really, unless you have a proprietary list or you already own customers who know the cost can be that much higher. Also, the present value of a dollar of revenue, 30%, still goes to the acquisition cost. The index of value is the same 23%.

Here is where there is a competitive advantage possible. Once you have acquired the customers, then it stands to reason that, if you know something about them, and can offer them relevant second or third offers, the response and penetration rates will be higher. And so in this example we are seeing the same deal, the same type of products, but we only have to spend about $200 instead of $300 to acquire. Now our strain is favorably impacted. We are down to 100–150% and our present value of revenues going to marketing cost is down from 30% to 20%, which puts us in a much more competitive position. In this case I put it all to the profit margin, but in practice you could take some of that as the higher margin, and put some of it back in, in terms of a higher quality product. This is presuming you price a separate product for the cross-sell as opposed to when you sold the same product to get a customer. Of course, the value index is dramatically higher, 85% versus the 23%.

Putting it together on a number of customers over a number of years—if you are able to have a book of business where 80% of the policies were in the acquired mode, and 20% were second or subsequent sales, then the weighted average (80/20) would be $280, and the present value of the distribution cost, the revenue is at 28%. You have dropped that by 7%. You decreased your distribution cost by 7% and increased your efficiency index by 39%. The key here in basic fundamentals is, if you can identify markets and operate in the markets, using any of those channels or methods assuming you are not having to pay it all out in commissions, that is where the leverage is, in the opportunity to leverage down your distribution cost. I think a lot of companies were misled into thinking that, since we pay so much for agency distribution, any reasonable direct response effort to get a new customer is cheaper. I do not think it is, I have seen many more worse examples. But if you have the back end opportunity, that is what differentiates it from the other channels.

We are starting to see a great deal of activity in this low term, which is defined as the higher amount term agency product. It is where a company would be in *The Wall Street Journal* promoting the convenience and the low cost, and use the low term; again, it is a tricky term. Because their marketing cost, and the way I look at it is, from the other example we saw with a high amount term from agency, the present value of the distribution cost is about $1,050, with a 150% commission and the 10% renewals. Roughly speaking, if you can go out and advertise in *The Wall Street Journal* or some other publication, get interested leads, convert them to sales, and it is something under a $1,050, then maybe you have something going. Maybe there is also better persistency or mortality possible. In some agency markets, that controls the field underwriting process in terms of how the questions are answered, and how the business is moved, might not be present depending on how you would run this kind of a business.

But the fact of the matter is, if you study those rates versus the cheapest term rates through agency companies, they are not the lowest rates. I would say that so far the ability to get that cost per sale much under $1,000 is not there. It could be something as simple as the brand recognition. Sophisticated buyers know they want to buy term, but they want to really be sure from whom they are buying.

Some of the competing efforts that are similar to that are the select quote type services. But they are really agency broker products repackaged through a bureau that will give you information on products and their ratings. The approach is similar, but there are commissions payable, and the same products are otherwise available through certain brokers.

Let's take the direct response model we work with and look at the so-called affinity groups: banks and associations. It is the same kind of products, when it is not an annuity, many of the direct marketed products are supplemental products, with relatively low premiums and coverage, life, health, term life, limited disability income, and supplemental health. The response rates are always higher. The question is about how much higher versus the list fees and the commissions? Unfortunately in many cases the list fees and commissions are not derived to pay for value. In other words, we think the response will be this much higher, and this will pay for so much compensation. It is the other way around. The brokers and the banks and the affinity groups say, here is what we want. You plug that in and do your pricing. If you are pricing IRRs and ROEs because of the lower strain, you could probably make things fly with a lower margin than the other example. But the question really is, in many of these cases, for the value you are paying, what value are you receiving? We will go through the same kind of examples as we did before.

Let's say because of the higher response rate, the distribution costs are $230 instead of the $300. But we have to pay 10% of premiums to the brokers and/or the affinity group. The first-year strains are reduced favorably from 150% to 115%, but the piece of the revenue dollar, present value of cost to revenues, is actually 10% higher than it was under all the other distribution situations, it goes from $30 to $33. The way I like to look at it is that $23 of the $33 is the impact of the reduced marketing cost, which is nice. We are at $23 and the industry is at $30.

Not every situation is like this. Again, if your strategic approach is to identify partners who are willing to price it the other way around, in other words, let's pay for the value, then it can work out. This is maybe more typical of what I have seen. So the higher distribution cost, coupled with the fact that the strain pressure is less, ends up with maybe a lower margin that went from 7% to 4%, and then the profit is down to $40–70, and the index is only 12%.

The last topic I wanted to talk about is some recent developments that I think are having an impact beyond the fundamentals. Basically we have all said so far that, if you can control customers in back end market, then maybe you have a competitive advantage, but otherwise there is parity on the face of it. Well, there may be three areas where companies are cutting into that. I think one of them was alluded to by one of our questions. Database marketing and predictive modeling is the idea of, through computer relational databases, and communication managed process with your prospects and clients, you have information exchanges where you learn more about them. You then use predictive models to say, what is the next product that we should offer? And how do the customers like it and why or why not? The United Services Auto Association (USAA) I think contacts pretty much each of its customers at least once a year, and asks them questions to try to trigger things that could be done differently or product needs that are not being met. That can be applied to, as we heard earlier, the agency situations as well in terms of taking over the lead generation process.

Second, consider integrating distribution channels and methods. I touched on it when I described the difference between channels and methods by saying, you just do not need to pick one or two. You can blend and mix them. The stronger point I want to make here is, there are situations I know of where a direct marketer has mainly used that method, but then the marketer identified a pocket of prospects who might qualify and be very receptive to long-term care. It is a very tough product to sell just through the mail and over the phone. And so a marketer might not go out and develop an agency distribution system from scratch. But either through renting one, sending out some consultative salespeople, you can capitalize on those opportunities. The same thing is true the other way. In other words, the point being is in my mind most customers are not predisposed to always buying direct, or always buying through an agent. It is a function of the buying situation not of the product.

Consider product base distribution prompts structures, which I was alluding to with the affinity groups. If you could work with partners and say, let's set a basic level of compensation, but then have this other layer that is a function of the value you are really bringing us, that gives an opportunity for the endorsers to make even more. The endorsers can share in the profit, but then their downside is, if things do not work out, their compensation is reduced dramatically below those kinds of levels I illustrated in my example.

Finally to wrap up, the key, as I see it, is you have to figure out ways to own or share rather then rent your customers. So in the agency part it is the example of let's help them identify prospects and learn some of this information about the customers. So we are not just leaving the whole thing to them because if we do, they should own the customers and the information. Direct response is really the lifeblood of what can distinguish blockbuster performance from just selling one or two products per customer to the USAAs that sell three, four, five, or sometimes six products. We need to gear compensation to value and maybe some of these indices have helped you do that. In other words, look at it as an investment as Roger said, instead of an expense and see what value it generates. Finally, use relevant performance measures.

FROM THE FLOOR: Mike, you talked about cross-selling. But is cross-selling being used in the captive agencies? Has it been successful?

MR. SHUMRAK: I talk about this marketing database, which sounds like this mystical black box. But basically a real smart agent can do this with a set of index cards, and checking up on his client when there is another kid or a new house and so on. Does the client need more life insurance, if the company offers other products, the smart agents will jump on those opportunities. If those agents are not trained in that particular product or not familiar with it, they are smart enough to broker with someone else or make some referral to get some value out of it; it happens but it is the exception. I think with most of the captive companies, the ratio of all policies to total policies, the first sales is like you know, 1.1 or 1.3, it is very low; it is really the exception.