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Perspectives on Various Distribution Channels

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Summary: Distribution of life and annuity products presents many challenges today. Competitive and financial pressures are pushing insurance companies to maintain or even increase market share while they re-engineer distribution approaches to become more cost effective and efficient. This session examines several approaches to life and annuity product distribution.

Mr. Edward A. Turner: Various surveys have indicated that distribution is one of our leading challenges as an industry. Some companies are proactively addressing these issues, examining the perspective of customer value, and moving ahead with new distribution relationships. Some companies are moving very quickly to address new approaches for distribution. I think there's a great deal that we can learn from a global perspective on U.S. distribution and its marketplace.

Doug French is a principal with Tillinghast-Towers Perrin in New York. Doug will discuss the customer's perspective and will provide a case study involving one particularly large bank in this marketplace. George Tang is vice president and

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actuary with American Maturity Life and The Hartford, a joint venture based in Hartford, Connecticut. George will discuss how this joint venture is approaching the distribution of insurance products. Neil Bernstein is a professor of law at Washington University in St. Louis. Neil will bring a global perspective to the distribution topic.

Mr. Douglas A. French: Traditional retail distribution sold permanent life insurance, but recently the product and the agent have been on trial. Sales of permanent life insurance industry-wide have been lackluster at best while the retail financial services sector, in general, has been experiencing strong growth. Many say that the problem is fundamentally fatal. The product and the distribution system are no longer appealing to consumers.

Obsolescence is not a problem. The problem is one of providing value for money to the customer. My presentation is divided into four parts. First, I will discuss the current consumer value proposition and my hypothesis that the bundle of benefits and services imbedded in traditional permanent life insurance still has tremendous appeal to a wide variety of consumers. The value proposition for most agent sold permanent life insurance is currently out of whack. Second, I will review what factors consumers take into account when purchasing a retail financial services product. Third, I will discuss what I think is needed change around the traditional agent distribution channel. I'll conclude with a case study.

Historically, life insurers focused on helping people provide financial security for their families. The whole life product was designed to protect the livelihood of the family in the case of premature death of the breadwinner, to encourage discipline savings via the level premium aspect of the product, and to provide access to emergency funds via policy loans or cash surrender. The early life insurance companies focused on protecting the family.

Currently, attaining financial security remains an important priority, but the mix of consumer needs is shifting. Three areas affecting the mix are demographics, politics and consumer movement. Demographic shifts are changing the face of the consumer. Babyboomers are now moving from net spenders to net savers, creating a shift in demand from credit to savings and investment products. Also, people are having families later and holding on to them longer. Many will have to assume responsibility for their parents. Protection needs are significant, and research shows that there's a gap between what people have and what people need.

The political economic regulatory environment is shifting responsibility for financial security to the consumer. In this area of commitment to balance the federal budget, social programs are more likely to be cut than expanded. In addition, employers

are managing costs in order to compete on a global basis and to accommodate a more diverse employee population. The bottom line of all this is that people are operating under a heightened sense of insecurity. They feel more on their own than ever before.

By promoting education, competition, and focusing attention on product quality, the consumer movement has made the consumer extremely value conscious. Without doubt, from a provider's point of view, these trends are both an opportunity and a challenge. The need for retail financial service products is growing. The needs are not isolated to the affluent market segments that have been the target segment of many life insurers in recent years. Much of the growth is in the middle income market.

The market opportunity is fueling the re-invention of the competitive landscape. Providers are becoming more customer focused, looking to provide a broad menu of products and services to market segments in which they have competitive advantage. This is an important, perhaps radical, change in focus for many life insurance companies.

If you do not believe the anecdotal evidence I just presented, let's review some data. I have summarized growth of life industry, total premium income for the individual lines of business. Increasing at the fastest rate are investment products, primarily single premium deferred annuities (SPDA) and universal life (UL) dump-ins. Protection life, which is increasing at a slow rate, is term insurance and the protection aspect of permanent life insurance. We then have protection health and the cash value element of permanent life insurance products. Total premium income for both the protection and cash value components of regular premium life insurance has almost been flat in real dollar terms for the last 25 years.

The hypothesis I stated earlier is further borne out by looking at the market share of personal assets held by intermediaries. I have grouped intermediaries into high-cost intermediaries and low-cost intermediaries. High-cost intermediaries are defined as commercial banks, thrift and insurance—the cash value portion of permanent life insurance. Low-cost intermediaries are mutual and money market funds and insurance investment products, primarily SPDAs and UL dumpings.

The trend is clear. High-cost intermediaries are steadily decreasing while low-cost intermediaries are increasing. Consumers are extremely serious about maximizing value for money. The opportunities were equal the first time in 1995, and the trend is not likely to reverse any time soon. I now rest my case for the hypothesis that the bundle of benefits represented in permanent life insurance are as relevant as ever.

Let's explore what happens when a typical consumer embarks on a life insurance purchase. The consumer buys benefits and doesn't understand subtle technical differences between different insurance products. The consumer thinks in terms of protecting what they have now, saving for the future, transferring wealth to the next generation, risk management, advice, and counseling. Many consumers are uncomfortable making financial decisions on their own.

While most consumers are skeptical about one-stop shopping, many are looking for few-stop shopping. I'm not sure why. It may be because of statutory accounting for historical organization by function and product type, but life insurers think in terms of policy features, sales literature, advertising, pricing, investment management, advertisers, underwriting, and distribution. Most insurers don't even refer to customers as customers. They call them policyholders. In addition, many cannot identify how many households they have relationships with, how many financial service products are in these households, and how many of those products are theirs.

There are other factors consumers take into account when making a life insurance purchase decision even beyond the financial aspects. These are service or quality, name recognition or reputation, and a relationship. The importance consumers describe to having a relationship with a financial institution is potentially a very powerful positive for traditional agent sold life insurance.

Current research shows that consumers value personal relationships. Many of our customers want help. Over 50% surveyed are not sure that the financial decisions they make are correct. Two-thirds are uncomfortable making judgments. Less than 30% are opposed to a transaction. Almost 80% would like to go to just one person. Seventy percent prefer to do most business in person. Seventy percent think it's important to know my name. Over 50% want long-term relationships and feel that's more important than price. Many are prepared to pay for service and advice. They're more concerned with quality of service than cost. Only about 5% of the consumers have a strong resentment that the financial institution makes money on their business.

I think that is why consumers are willing to pay for the package of benefits and services in a permanent life insurance policy. They will pay for the savings element, a reasonable load on the premium, plus, perhaps, an ongoing fee; a reasonable load on the true cost of insurance for the protection on them; a reasonable fee for counseling and service; and a reasonable rate of return to the owners of the insurance company for the risk they take.

Customers are willing to pay for the benefits and services I just mentioned. Some amount would be for counseling and service. The largest chunk, by far, would be for tangible benefits such as savings protection. A little would be for profit. Anecdotal and data evidence suggests that there's a disconnection between what consumers are willing to pay and the insurer's cost.

For at a typical UL product, a dollar premium received by an insurance company would include approximately 27 cents for counseling and service. Sixty-six cents would be for savings and protection, and 7 cents would go to profit.

If you assume what customers want are prices associated with buying competitive term products and good annuity or mutual fund products, then we estimate that in order to generate a significant market interest in permanent life insurance, current prices for competitive products must decrease 12–15% in the market. The improvement must come from counseling and service.

Why is that you ask. Well, the market is currently smart and educated, and we cannot trick them into lower benefits. We cannot provide lower benefits for the same amount of money, especially in an era of full disclosure. Rates of return for shareholders of insurance companies are barely at acceptable rates of returns. There is no room to take profit from a shareholder. The balance must come out of counseling and service.

Let's move on to the third part of the presentation. While I hope you found the previous information helpful, and the foregoing process for quantifying the productivity gap for agent sold permanent life insurance useful and thought provoking, I wanted to go beyond that and just suggest a few actions that companies might want to take to tackle the problem. How do we narrow the productivity gap? Simplify products, align the company's offer with customer needs and buying preferences, consider alternative agent compensation arrangements, and finally, invest in technology to align insurance company and consumer interest.

Simplifying products, particularly for the middle market, would make it easier to sell, easier to understand, and easier to administer.

We must better align the company's offer with customer needs and buying preferences. This can best be accomplished through market segmentation. The insurance industry is far behind the retailing manufacturing industries and, perhaps, behind other financial institutions in market segmentation. Defining the market as the affluent and sending the agent out to find them is not market segmentation. Market segmentation does not only mean identifying distinct pockets of people, it

involves assessing how a consumer wants to purchase, as well as what product is most appropriate, and then focusing the energy of distribution appropriately.

We should also consider alternative agent compensation arrangements; both federal law and agent compensation with value added to the customer. Perhaps, a component as a percent of assets managed, a component as a percent of premium for protection and a fee for financial planning advice. Changes such as these may be used to induce agents to behave differently during the selling process. Investment in technology will become more critical as we attempt to regain the consumer's investment dollars lost to other financial institutions.

Database management and market segmentation. Who are our customers? What do they need? How do they want their products delivered? What does their household look like? Should we provide a discount for multiple product purchases, and how should that discount be calculated?

Let's discuss prospecting systems. Telephone marketing, call centers, data warehousing. We must be able to assess opportunities provided by customer encounter to sell additional products or acquire new clients. Improved product delivery and customer service. Full automation of the application, product delivery, and customer information management processes will not only reduce costs and improve productivity, but will improve customer service.

I want to give you my perspective on what the future looks like. I believe that the key to achieving success in the financial services market is to use a variety of distribution channels, aligning channels with product and customer characteristics in order to sell a fuller range of products at more acceptable prices to a broader base of customers. Ultimately, we'll need technology to accomplish this seamless web of distribution. The key points are multiple distribution channels, aligning channels with product and customer characteristics, and providing more acceptable prices to consumers.

I want to share with you a case study to show you an organization that is putting these actions I've just discussed into practice. Earlier this year, at the Montreal SOA meeting, Dennis Kosovac addressed one of our sessions. Currently, Dennis is the president and chief executive officer (CEO) of Chase Insurance Agency, which is part of Chase Manhattan Bank. I want to share with you some of what he presented in Montreal.

For those of you who do not know, Chase Manhattan is the second largest U.S. bank. It is also the largest private bank in the U.S. It is a global bank with many markets and customers. They have the scale to compete in almost any marketplace

for ultimately most types of insurance products. Currently, Chase is engaged in the distribution of health, life, annuities, personal and commercial property, and casualty coverages. They distribute both domestically and internationally to Chase customers.

They began to pursue the insurance business with a strategic focus in 1993. Currently, Chase has several market segments that they consider. They term them the super affluent, the affluent, the mass market or middle market, and small commercial, and middle market commercial entities. These are businesses with less than $200 million annual income. They believe that they can offer insurance products to all of these customer segments.

They have four primary distribution channels. To the affluent, they distribute all forms of life insurance base products to meet the protection estate and business planning needs of Chase's private banking customers.

The mass market channel services the Tri-State New York, New Jersey area, and focuses on selling life insurance face to face across bank branch desks as well as kitchen counters. The channel consists of licensed insurance agents and bank employees.

In the direct marketing channel, term life insurance is distributed nationwide by mail and telephone. Lists are developed from mortgage banking, credit cards, consumer finance, and so on. They are now accepting applications over the Internet.

In 1997, they estimate that the life insurance premium income will be approximately $17 million. This is being tagged as an estimation of 10% of their potential. Twenty-five percent of their sales is to the affluent, seventy percent through the mass market channel, and five percent through direct contact and Internet.

In retrospect, when they started in the insurance business, they basically just put the product on the shelf and sold it. However, the Chase experience has allowed them to discover one of their natural markets. Ninety percent of their premium income is generated from households with less than $50,000 annual income.

If we look at Life Insurance Marketing and Research Association (LIMRA) statistics, which represents the industry, this statistic would be 45%. Seventy percent of the Chase premium generated comes from clients younger than age 44. Fifty-one percent, according to LIMRA. Thirty-eight percent of Chase insureds are younger than age 34. Seventeen percent according to LIMRA. Fifty-one percent of the

Chase premium generated comes from female clients. This statistic is 35% for LIMRA.

As the life insurance industry has moved upscale, Chase has moved to the middle market. The direct marketing channel also caters to the middle market. Segments more likely to respond to Chase's direct marketing efforts are nonprofessionals; prospects with lower annual incomes and perhaps lower crediting rating or crediting scores, prospects with children, and those who regularly visit bank branches. There are still some of those people in America. You can basically get a portrait of customers who are, again, middle market or aspiring middle market.

What can we learn from Chase Manhattan? Market segmentation is being employed. Complementary distribution channels are being used. Customer needs are being met in the abandoned middle market. Product design is playing a role. They are selling simple life insurance products with a five question application, issued within five days if you answer yes to all the questions.

Technology is playing a role. They're currently looking to the credit card industry for their technology strategy. Ultimately, they'd like to sell and deliver the product in the same session. They want real time underwriting decisions and confirmation of the price to the consumer at point of sale. They want the process to be paperless.

Finally, the financial dynamics seem to be working. Currently, intermediaries are selling 3.5 policies per week, and this does not include leads generated through direct marketing. The productivity gap is being closed, and they're actually having a chance at making some money. Chase's view is that if you make it simple, understandable, and encouraging, the shareholders will make money while Chase's natural market is served.

Mr. George W. Tang: American Maturity Life is a brand new company. The shareholders are Hartford Life (60%) and Pacific Life (40%).

The joint venture was created to provide annuities to American Association of Retired Persons (AARP) members. You have to be 50-years-old to join, although associate members can be below age 50. AARP has about 33 million members, and we have access to their files. So we can market directly to those folks. American Maturity is still housed at Hartford, and I'm still a Hartford employee even though the name is American Maturity, so it's still basically a Hartford Life Company.

My presentation will mostly be on fixed annuities because we were allowed to sell fixed annuities in the first few years, and we have just obtained the license to sell variable annuities. We're ramping up to the variable annuities. You know where

fixed annuity sales are lately, so we haven't been doing a lot on the fixed annuity side. Hopefully, we can do a little more on the variable annuity side.

When you think about direct marketing, you usually think about the phone call when you're having dinner. Hopefully, we can be a little more scientific than that. The direct marketing really has been used successfully by a lot of insurance companies. The Hartford has been very successful in selling auto insurance to the AARP group through the mail. Their premium is about $1 billion a year. That's a sizable number. Scudder also has sold their mutual funds through the mail to AARP members alone, and their assets under management today is about $13 billion. This channel definitely has some credibility to it, and that's the reason we went into it.

The property and casualty side has been very successful. Group health insurance has also been engaged in the direct marketing side, and there's some success to that. Individual life insurance is really at the beginning stage at this point. There's not too many companies involved yet. One of the reasons is the channel conflict, because for established companies, usually you have brokers and agents who really got you there in the first place. If you're engaging with direct marketing channel, they will have a lot of questions as to why you're doing that and why you want to bypass them. There's some really key concerns there which need to be addressed.

That's one of the reasons many companies are not getting into it. In fact, I know a company who's already staffed up with quite a few people to do direct marketing but, at the last minute, they had to pull out and let go of everybody. That's a very legitimate concern.

Another major hurdle, as a lot of people are wondering, is whether life insurance can be sold over the phone or through the mail. I believe that if the right products are picked and it is executed correctly, that can be done and there will be profit.

How can we address these issues? I would like to define what direct marketing is, at least in my world. The generic definition for direct marketing is to establish a relationship between your company and your client without having any face-to-face contact. There are obviously different models out there. I would like to focus on mail and phone channel. You consummate the sale through the phone and the mail. We had a target population where you isolate the people who you want to send your mail to, and you send your advertising material through the mail to this select group. You follow up by getting a response from them, and you try to send them a fulfillment kit. That's the word for the direct marketing channel. A fulfillment kit is when they respond to your advertising material. For instance, the application form would be included because that's the one item that you would

need to sell them a policy. The description of the product, and any further materials that you want to send them, would also be included. For instance, if you have a variable product, you might want to send them a prospectus. That would be a good thing to have.

Our experience has been that most people respond by mail. Eighty percent of the people would send their response in through the mail. Twenty percent of the people will call you through the toll-free number. So it's a natural tendency for people not to talk on the phone. They would rather just fill out some form and they send it in and wait for a call.

The follow-up is a key here to manage the relationship. You know where they are on your radar screen. Now you can follow-up with your sales call or service call. You can determine what their needs are and you can provide for them. You're actively following-up with your client. That's basically what your agents are doing. In this channel, you're doing it through the phone and mail.

The key is to find the areas where you can more efficiently provide the service. That, in turn, will translate into a better price for your customer and more productivity for your client. It's not that much different from what you're doing today. You will save money.

One example of companies utilizing direct marketing is United States Auto Association, for example. They started with selling auto insurance, and now they're selling annuities and life insurance. Fidelity is a good example. They have sold a lot of variable annuities through the mail and the phone. Vanguard and Charles Schwab are other examples. They're all engaged in this channel in selling variable annuities. There are a lot of companies currently engaged in this channel.

There are many reasons for doing direct marketing. Direct marketing has great potential cost efficiencies. You have to think about what your clients want and how you can service them. If you can service them well, you'll result in a better product, and they will have more value to them. If you bypass the middle man, you will save a lot of money. There's no doubt about that. You can also lose money quickly, and we'll go into that in our example.

Technological advances also change the paradigm for the relationship between a company and the customer. For instance, I had an experience at Charles Schwab. I called the salesperson and the salesperson said, "OK, all right, I'll take care of you." The next time I called a different salesperson said, "Oh, that person's not available, but I can help you out." I said, "No, you can't help me out because you don't know me." "We know you," he responds. The salesperson tells me exactly what I have,

what my needs are, and everything. It turned out that they have my portfolio on their database and somebody else can actually step in and replace the person that you knew. After a few transactions, I became very comfortable in dealing with Charles Schwab and Company instead of a representative from the company.

In your in-force policy, I'm sure you can pull up all the information for your clients. You need to expand that to the people who haven't bought from you yet. Then you have gone a long way, you can actually establish a relationship without having that specific salesperson. A key ingredient is for us to sell the computer system so that multiple people can serve that one person.

The customer is more sophisticated. They have a great deal of information in their hands and everybody thinks they're economists themselves. For instance, we have a lady who is about 72 years old. She was looking at fixed annuity and she asked if she should buy now or next week. I said, "Why do you ask that?" She said, "Well, because Greenspan is speaking next Tuesday." "What are you talking about?" They think they know a lot more than what you think they know. We have to look at that.

Also, the competitive presence outside the industry is a factor. If you look at the distribution channel today, it's very tough for an established company to switch to direct marketing. For those who don't have a presence in the market today, it's very easy to do whatever they want. They are doing that. For instance, mutual fund companies are doing that. They don't have any handcuffs and they can do whatever they want. If they're successful, they will be replacing the established companies in this business. That's how it goes.

The one more important development is for a product from a software company in Seattle. It is developing a universal agent. I think they're going to the TV. The agent can be in your living room guiding you and giving you counsel as to what you can buy, the services, and that kind of thing.

For instance, on the Internet, you can buy books, and they'll give you reviews. You can buy car CBs. When the agent is established he will be servicing you right in your living room. So I don't know how much you will be paying the agent. Probably not much. That's the competition that we see down the line. That's a very real threat to many insurance companies.

There are several key components for success. The first key to success is the integration of distribution channels. If you're an established company, you might want to find niches that your traditional agents or brokers are not into.

For instance, Doug was talking about the low-income market where it is not economically feasible for your agents to go and talk to people. You can look at those markets or for the affiliate market. AARP is a good example. You could examine some banks who might have a good data file for you to prospect. There are some things that you can do to integrate your marketing channel to your existing channel and to minimize any conflict or territorial issues.

The second key to success is to generate a list. Obviously, you can either buy the list from vendors or you can negotiate some arrangement with a group. One source that might be right under your nose is in the in-house database. We found those who have bought products from The Hartford are very likely to buy another one through the mail if they are being offered the chance. The affinity of cross selling within the same company is very powerful, a very powerful tool at this point. You might already have a lot of tools available for you.

It is also important to list what your typical customer would look like. If you have the profile for your customer, you can overlay the data on your list, you can filter out who they are, and then you can load up your mail and just send it out. Hopefully they'll respond. If you do it right, you can be very efficient at it. If you do it wrong, obviously, you can spend a lot of money for nothing.

The simplified products are the key to success for this channel. In Douglas' case, he actually was selling fixed annuities in the beginning, and our response ratio and commercial ratio wasn't very good. We did a focus group and for every group of ten, two people actually came up and said that they didn't know that and I would have bought the product. There's a 20% conversion. This is fairly high. It's very important to have the simple product and be able to communicate that to your clients to make sure they understand it. Simplicity is the key here.

Obviously, equity-index-type products are out at this point. Nobody understands them, at least through the phone.

Interactive sales support system is where you can have your multiple telephone representatives service your client. You should be able to access the data and find out what they look like right away. For instance, the call comes in, it should take you no less than a few seconds to have a good picture of who the client is. We need to jot down things like the names of their children, dogs, and information like that. Establish the relationship further, and immediately, even though you're presumably new to them.

Friendliness is another key. When you're on the phone, they can hang up any time they want. Make excuses and you will never see them again. Capture the data that

you need to know, and track them into a category. For instance, your prime customers would be those who understand the product, and are ready to buy.

Your next classification would be those who understand the product, but who are not ready to buy. Then you have to diary them. For example, they will have a sale of a home or some asset transfer sometime down the road. You would diary that and, hopefully, it will show up on the computer when you access the data.

The third category will be those who really don't understand the product. If they don't understand something, it's very unlikely they will be buying. These people are ready to buy. They're ready to go with the money in their hands, they're ready to do something about it, but they don't really understand the product. Those are the people you need to spend a little bit more time with hand holding, and spend a little more time on the phone with them.

The fourth category would be those who really don't understand the product and who really are not ready to buy, i.e., those who don't have any money. What do you do with those people? You send them a flyer and say, "This is our company and, next time we'll talk to you." The friendliness needs to be drilled into your phone representatives to make sure they have a uniform service level. You always capture the same information every call. You have to monitor your calls, and watch them aggressively to make sure that you're doing that.

Let's explore the two key pricing drivers for the direct marketing channel. The first one is the response rate. This is the number of mail and phone responses from the mailing or advertisement. Remember, 80% is mailing and 20% is phone. We send 100,000 pieces of mail, and you get about 5,000 responses. Now you have a 5% response rate.

Second is the number of purchases resulting from such responses. So if you have 5,000 responses and you have 500 people who bought out of that 5,000 you have a 10% conversion rate. It's a simple concept.

The reason they want to go with the two-tier system, for example, is that some people actually use conversion as a proportion of the number of mail sent. The reason they use the two tier based on the response rate is the numbers look a little bigger and the marketing people like it. You know, 5% instead of 0.5%. The numbers can also be quite minuscule. If you have a large mailing, sometimes you have 0.2%. It can get small, and then it's tough to calculate. So you roll it up to about 5% or 10%.

Another reason is that response rate is quite stable by product. It doesn't fluctuate that much. Human behavior doesn't change that much. That ratio doesn't change that much, but your conversion ratio, that's what you're really keying up on, and that can change quite a bit.

You generally expect response rates to be about 3–5% in the first campaign. In a second campaign, you will be sending the mail to those who have not responded. So you take out those who already responded. Obviously, you will have a declining return because if they don't respond the first time, it's more than likely they'll not respond the second time. By the time you go to the fourth campaign, the rate balances to about 1.2% to 2%. After that, it's probably not worth your while or your pricing to send them again because, if they don't talk to you after four tries, they most likely are not going to talk to you.

Some of the things that could influence this number would be a name recognition, your product, the population that you're sending to (the segmentation), and the strategy. Charles Schwab once sent me about 12 mailings. One after another. I said, "Why are you doing this?" He replied, "We want to build recognition." That's one strategy you want to do. It really sticks in your mind if somebody sends it 12 times. They must be really serious about doing business with you. That is one strategy I thought of.

The expected conversion rates are about 5–10%. Again, this depends on the length of the phone calls. For the fixed annuities, we're looking at about one to three calls to close a sale. Regular annuities, a little bit longer, about three to five calls. For fixed annuities, you probably won't get any takers. The percentage is probably zero at this point. So you can see how dynamic these numbers are.

Segmentation also drives your conversion rate. You can seasonalize it. For instance, before the tax period, a lot of people buy CD and guess what? They usually mature around that time. If you send out your mail at that time to the CD holders, your conversioning will most likely be a little higher than other times of the year. If you mail to people in Florida in June, the snow bird theory, they're probably going back up north without a forwarding address. Your mail will probably not get answered for a while. You need to take that consideration.

The exposure of dedicated market segments also makes an impact. A good rating also helps. Give them some confidence to selling your $30,000–50,000. They like to know that you're legitimate.

Let's look at a simplified example. You send out ten million pieces of mail. The total cost is probably about 50¢ each. The cost for the mailing would be about $5

million. If your responses are at 2.5%, you'll get 250 thousand responses. With the cost for the respond kit or the fulfillment kit at $5 each, the total would be $1.25 million. Your total marketing cost at this point would be $6.25 million. Keep in mind that you're spending money before you even collect one penny from anybody. That's the key that you want to think about. Make sure that senior management understands that.

If your conversion rate is 5%, you will have 12,500 policies. And the total premium for a SPDA fixed annuity at $30,000 each would be $375 million. Your acquisition cost would be $6.25 million. That would be about 1.67% of premium. That looks like a good number if you're into annuity pricing.

The key number here is the $375 million because that's your critical mass. If you want to price out this block of business, you would most likely work backwards from that number to find out what your conversion rate is. You really need to huddle with your sales and marketing people to make sure they commit to that number. If they tell you they are going to price after $1 billion, and they come in at $300 million, you will increase your acquisition cost by quite a bit. It's very sensitive to the conversion rate.

If you know your marketing and sales people like to inflate the numbers, take some discount when they tell you it's $375.

Now, if the conversion rate goes up to 10%, the total premium would be about $750 million. You basically cut your acquisition cost in half. Another way of looking at it is for every dollar that you get over $375 million, it's really no cost to you. This is a very powerful argument for doing this. On the other hand, if your sales is about half of what you expected, you just double your acquisition cost. That's the dynamics for those numbers.

To round up all your costs in terms of acquisition, if you look at a phone sales representative, you can usually hire somebody around $30,000–50,000. It depends on where you are. If you're in Iowa, $30,000 is a very good salary. But if you're in New York or San Francisco, that probably won't cut it. This would also include the bonuses or incentive that you want to pay because you wanted to be a little more aggressive sometimes. The $50,000 salary is probably including the bonuses.

You want to target about $10 million of production off each representative per year. By doing that, you have to make sure that they take or make about 50 calls a day. Of the 50 calls, you want to talk to at least 15 decision makers. If they talk to someone who can't really make up their mind, that really doesn't count. You want a meaningful call of 15.

If they can't get to 15, you want to make sure that they call more than 50 a day. The key is the 15. Out of the 15, they should be able to close 1.5, and so that's 10% of those. Those are some of the key indicators where they will be successful.

At this level, the cost of these calls is now about 50-basis points of premium. So if you add that to the actual acquisition cost at the 5% conversion rate, you will come out to about 2.25%. It's still a good number. Although you can always say that the phone sales are fixed costs versus variable costs. That's for you to decide how you want to play that.

Just a wrap up for the financial indications, the key is the prefunding acquisition cost, plus you spend a lot of money before you actually see a sale. Sometimes that could last to over a year, especially if you incur a lot of cost in December and you have to chew up your annual statement. That could be a major turn of events. The achievement of critical mass is also key. A lower cost per policy is important. Hopefully, you can provide better values for your customers and increase your productivity in this channel.

Mr. Neil N. Bernstein: I will share with you the results of a study that I conducted with a colleague, Dr. James Little, of the Olin School of Business at Washington University. I want to acknowledge and thank the NAIC, who funded this study for us.

We were provoked with the experience of the life insurance industry in the U.S. over the past few years. The 1990s have not been good years for the American life insurance company. The decade started with a number of the relatively substantial life insurance companies going into receivership: Executive Life and Mutual Benefit Life were the most notorious.

We no sooner got those out of the way, then we got into a second set of scandals involving misselling of the life insurance policies. We weren't involved with the smaller ones. We were involved with the larger companies: Prudential, New York Life, John Hancock, and so forth.

We started off with a series of fines from regulatory agencies for misselling, and then the fines were immediately followed by class action suits, which is a lawyer's specialty to try to take advantage of the misselling. The most notorious of this is the class actions against Prudential Life. Prudential has settled that. The latest estimate I saw is it's going to cost Prudential $1.6 billion. John Hancock settled theirs for about $350 million. New York Life paid about $100 million.

The thing that amused me was at one point it was so prominent that you could get even get involved on the Internet. If you were unhappy and you wanted to sue the life insurance company, all you had to do was dial up http//www.westcoast.com life join information, and you could join in the lawsuits. For what it's worth, I checked and that Web page is out of business.

What was it that got the companies into trouble? That is fairly easy to tell. First of all, twisting. Something that goes back years. Agents were convincing people to cash in older policies and use the cash surrender value to buy new ones supposedly at better value, but not. There was a lot of misselling. Selling life insurance products and misrepresenting them as investments and stock market products, and pensions, and other things that they really weren't.

Finally, there was a series of fraudulent promises; the most famous of which was the vanishing premium. If you buy this policy, the first few years of premiums will earn enough interest so that you can have it for the rest of your life, and not have to pay any additional premiums. It's turned out to not be true. Now, the thing that puzzled Dr. Little and me was the fact that, although all of this misselling was going on, and although all of this money was being spent on remedying the problems of the past, there was no real effort at reform. We could not find anything being done to make sure that this didn't happen again in the future.

The NAIC studied the matter at great length and came up with the model regulation on illustrations, which we found to be relatively trivial and which, even at that, has met with a lack of enthusiasm from the states. It was supposed to have gone into effect early in 1996. As of October 1997, there were only 18 states that have adopted it at all. Other than that, in this country, they're content to say, that's the way it goes. The life insurance industry just keep on going, and we will pay what we have to pay.

This puzzled us, and we began to think, now, is this the way things are happening to the whole world? Is something different going on in other countries? We decided to take a look at what's happening elsewhere. We selected four countries that we thought were indications of what was going on: Norway, U.K., Australia, and New Zealand.

We found Norway interesting because in our judgment, the country was where the latest wave of reform got its start. Norway has a small life insurance industry, with about ten companies. However, it had some interesting indications of what was going to happen elsewhere. First, the Norwegian industry is strictly regulated. The same agency regulates banks and insurance companies, and it has a system of

prescriptive regulation where you can only do that which the regulator permits you to do.

In the mid-1980s, the regulators began to become dissatisfied with what was happening in the life insurance industry, and they decided that it needed to have a kick start because it was selling overpriced products and not really meeting consumer needs. The insurance industry was relying on the fact that life insurance premiums were deductibles, and they were using the tax advantages as the primary mechanism.

At the same time, there were a number of bank failures coming about because of improvident loans, and the regulators became concerned that the insurance companies were likely to get into the same mess if they didn't step in. They began to push for a series of regulations.

The first regulation, which was passed in 1988, was primarily intended to take care of the solvency problem and protect against that, but it included a very interesting feature. That was a feature of total portability. Under Norwegian law, life insurance policyholders have the right to move their policies at any time from one company to another. When they move it, they move not only the policy, but all of the reserves associated with the policy. There's no such thing now as a long-term commitment such as we have here with whole life. Somebody becomes unhappy with one company, they move right on to another one.

Second, the Norwegian legislature mandated an extensive disclosure; a disclosure of all of the key elements of all of the policies, and also disclosure of the amount of money that's being paid to agents as commissions. In addition to that, by Norwegian law, every year the companies are required to send all of their policyholders a statement as to their premium income and how much of that premium income was spent for the reserves, on cost, and profit.

Finally, in 1991, legislation was passed that gave the Norwegian companies the right to combine with banks and other securities companies into a single holding company structure. What's been the result of all that? First, the industry has almost totally abandoned the up-front commission structure. The agents now work on a flat fee that they collect for all of the premiums sold. In addition, they have a structure for additional services that the customer has to pay for on an hourly basis.

Third, with this extensive disclosure, the companies are now competing on the basis of the cost and their profit. How much money they're taking in, how cheaply they can sell the product, and how much goes for actual savings versus the profit and versus their cost. That competition is becoming very vigorous.

Finally, there are very active mergers going on between the banks and the insurance companies. The major insurance companies are hooking up with banks in the holding companies, and this process seems to be continuing on a steady basis to where all of the companies will eventually have some sort of a long-term affiliation with the various banks.

The U.K. was the next country we took a look at. What we found there was a situation where, for many years, the industry was not selling insurance as life insurance, but what they were selling were endowment policies which were used primarily to finance mortgages.

If you bought a house, you would take out a mortgage. Let's say that it had to be paid in 20 years. Then you would take an endowment life insurance policy that would pay the full amount of the mortgage off at the end of 20 years. You would pay the premiums on your life insurance policy rather than making the payments of the mortgage. The reason you did that was because the life insurance premiums were deductible, and the payments on the mortgage were not. For tax reasons, this is the primary use of life insurance.

In addition, the life insurance industry had a monopoly on the sale of pensions, but that was not particularly valuable because most people had a compulsory pension system through their jobs. Then along came Margaret Thatcher. The first thing that Margaret Thatcher did was to engage in her privatization. As a part of the privatization, a number of state companies were sold to private investors, and this got people interested in the idea of investing. Prior to that, there had been very little investment in the stock market, or investing by the British public.

The Thatcher government opened up the pension area by providing some incentives to people to convert from their compulsory occupational pensions to private pensions. The Thatcher government also tore down the barriers between banks, building societies, and insurance companies, and allowed them all to compete for the first time in the sale of this new pension market. What happened was, if you will, a feeding frenzy. A huge amount of misselling resulted. Within five years, it became obvious that people were buying pensions and were then forfeiting those pensions, which meant that product was not doing the job it was intended to do.

What the Thatcher government had put in place in 1986 to regulate this all was a system of self-regulation. There was a government agency called the Securities and Investment Bureau (SIB) which had very little power. It supervised a series of what was called Self-Regulating Organizations (SROs). Each of the industries had its own

little self regulator, and the regulator for the life insurance industry was the Life Insurance and Unit Trust Organization.

That whole system collapsed because it was unable to deal with the misselling that was going on. The SIB tried to get involved. It tried to stop the companies. It tried to fine them. It turned out to be totally ineffective, and so it became necessary for the government to step in and take greater control. We still had the Thatcher government, and so they were very reluctant to abandon this system that they had set up.

What they did was to scrap the individual SROs and to replace them with one SRO that was still run by the industry, but that was to be responsible not only for life insurance, but securities as well. That was called the Personal Investment Agency (PIA). The PIA under the prodding of the government agency, SIB, put out a series of very extensive regulations.

The main thrust of that was the concept of disclosure. The insurance industry is now required to do very extensive product explanation to every actual and potential customer: what they have available, what is being recommended, why it's being recommended, and key features. All of this has to be delivered in a very lengthy book to each potential customer. In addition, the agents are required to disclose the amount of commissions that they will receive on the sale of every one of their products.

The companies have direct responsibility for making sure that the agents are properly trained and for making sure that they remain fully competent. They must have a training mechanism in place, and they have to do periodic reevaluations to make sure that their agents are still fully up to date.

In 1997 there has been a change in the political government in England from the Tory government to the labor government, and the labor government has announced that they are fed up with this self-regulatory system.

Under the labor government, a new organization was developed. It had two nicknames; the common nickname is Super SIB and its other nickname is NEWRO. At the first meeting, they were supposed to announce what its real name was going to be. I don't know what it is. But it's taking over responsibility from the old SIB and from all of the self regulatory agencies as well as taking over the regulatory responsibility over banks from the Bank of England.

They have announced that they're going to start doing the regulation next spring. They are going to be much more consumer oriented than all of the structure of agents that the Thatcher government had set up in the past.

What's been the effect of all of this? The industry is now in total chaos. They're finding that the disclosure requirements from the Thatcher regime are extremely expensive. In 1994, the cost of complying with all of the disclosure was 150 million pounds. A pound is roughly $1.75. This is becoming a very expensive operation.

As a result of all of the attention that's been given to dollars and cents, the competition over there is on a cost basis. How much are you charging, and what kind of benefits do we get?

Because of the attention on agent misselling as well as the disclosure of the commissions, the market has opened up with direct sellers. There's two direct selling companies. One's called Scottish Widows Direct. I don't know much about that one. The other is Virgin Direct, which is a subsidiary of Virgin Airlines. They have both been able to make enormous inroads into the market to try to take over the traditional business of insurance. The banks and the building societies are also doing a good job of taking over a larger share of the traditional market.

Finally, we got a lot of consolidation going on. At least 30 companies were sold in the first two years, and about a dozen more are trying to sell. They are both combining insurance companies and entering into combinations with banks and the building societies. They are currently having a substantial revolution in the industry.

As the direct selling has gone up, the number of agents has been decreasing at a very fast rate. During the year 1995, it went from 200,000 registered agents down to about 90,000, and it's anticipated that the number will continue to decline.

The next country we took a look at was Australia. Australia, too, is going through a rather chaotic period. If you look back historically, up until the mid-1980s, Australia was a great place to be in life insurance. There were 25 companies. They were all mutual companies, and they were getting along real well together. They had kind of a gentleman's understanding. I'm not going to steal your customers and you don't steal any of mine. Any agents who took away somebody else's business were blacklisted.

Then in the mid-1980s, a battle developed between the largest companies for shares of the market. They wound up selling new products that were primarily investment

oriented, and then competing to take away the high-volume agents from each other. What they were doing was offering these agents interest free loans, and these loans were in excess of $1 million dollars if they would transfer. They had a vigorous fight going on back and forth.

On top of all of that, in October 1987, there was a major financial collapse of the market. The market collapse was much worse in Australia than it was in the U.S., and it really went on in what you can only call a depression for five years. By 1992, a number of the insurance companies had to go into receivership because of these financial problems.

The government had taken a relatively passive role. Up until 1987, the only regulation was a life insurance commissioner, and the life insurance commissioner only made sure that companies were solvent. That's all he cared about. They set up a board in 1987 called the Insurance and Securities Commission (ISC), and they had responsibility for checking the industry, but they were relatively passive.

In 1992, the Australian Trade Commission came out with a study claiming that the insurance industry had been misselling their product to the native Aborigine. From there, they branched out and said that they had been misselling the product to everybody, and that the industry was a disgrace in terms of consumer orientation. This immediately motivated the ISC to get active, and they announced that they were going on a vigorous series of reforms of the industry. The ISC began introducing new codes of practices, and also announced that they were going to engage in a restructuring of the Life Insurance Act, which, at that point, was 50 years old.

What's happened since then? First, Australia has enacted a new life insurance code. The code does not have any consumer protection features, but the agencies have been issuing series of regulations pushing the industry to modernize and includes full disclosure, and also setting up informal mechanisms for resolving any kind of disputes. Now, in addition, the government has proposed a new series of regulators that is going to combine the regulation of all of the agencies that have been regulating financial services into two new agencies; one of which will regulate solvency, and the other will regulate consumer marketing.

What's been the effect of all this on the industry? First, the industry is totally restructured. They have gone from being mutual companies to being stock companies. As fast as they become stock companies, they have either merged with banks, acquired banks, or become part of larger multinational consolidations.

There have been drastic changes on the marketing level. It's a curious situation because retailing of insurance is unregulated in Australia. Everybody agrees that there should be some regulation, but the government says the industry should do it, and the industry says the government should do it. Nevertheless, it's very clear that the number of people who have been selling insurance in Australia has gone down dramatically. Also, the industry has abandoned its notion of being life insurers, and are now viewing themselves as full financial service organizations.

The largest of the insurance companies have announced recently that they're going to be going into the mortgage business, and into the business of making consumer and small business loans because they think they can do that better and cheaper than the banks are doing it. The industry now is heading off in an entirely different direction.

New Zealand is the final country which we studied. What's happened in New Zealand basically is it's an interesting change. They've had no scandals, but what they've had is an industry that decided that they had to make changes to bring themselves up to the same area that they're finding that have been required in Australia and England. They have accepted full disclosure, and they have accepted the idea of having some sort of mechanism for resolving all kinds of disputes.

The government announced a policy of expanding the private pension area, and providing significant assets for people to set up their own pensions, but on a voluntary basis. As a part of this, the industry has accepted some rather modest reforms which include limited mandatory disclosure and other information available on request. There are no regulatory agencies in New Zealand. The New Zealanders hate bureaucrats, and so they say, we put it in a statute. If you're unhappy, go report it, and sue the people.

The effects are that the insurance industry now is primarily looking at new products, which are going to be focusing on pensions. They have announced that they're going to give up agents altogether and sell these products through banks. The whole thing went into a hiatus last year. They had a new party that wanted to go back to compulsory pensions. They had a plebiscite in September 1997 on compulsory pensions, and the New Zealand population voted by 91% to not go back to compulsory pensions. They're trying to pick up the pieces and go back.

What kind of conclusions do we draw from all of this? For the U.S. life insurance industry, our conclusion is get out of this life insurance business. Get into financial services. Get into savings, and stop thinking of yourselves as selling a product to protect the family. It's old hat. They're going to have to be competing with other financial service industries, and it's going to be cost and price.

Also, there should be consolidations, especially with banks and with securities companies. Life insurance agents are going to have a lot more work. There will be more demands on them, and their compensation is going to have to change radically. Will they survive? I doubt it. As far as regulators, the present system of regulation is obsolete for life insurance. We need to have new agencies, and they have to have newer places. As far as the public is concerned, they can look forward to getting a lot more information, good or bad. They will have more choices, and it's going to come at a higher cost.

How about your actuaries? It's very simple, there's going to be much more work for actuaries. They're going to be in demand. Due to being in demand, they're going to get much higher pay. They will also get great respect from all of their customers, their competitors, the companies they work for, and the public generally.