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A Call to Arms: Breaking the Barriers to Life Insurance Distribution Reform

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Summary: The disparity between the economics of nontraditional and traditional methods of distributing life insurance products presents a compelling argument for delivery reform. At the same time, nontraditional distribution channels are increasingly becoming the preferred choice of consumers for purchasing many of our products, especially "commoditized" products such as term insurance. Despite the urgency of these messages, surprisingly few of the leading life insurers have made significant changes in how they address the distribution function.

Mr. Carl E. Meier: The Insurance Advisory Board is a research organization based in Washington, D.C. with about 150 member companies, most of which are insurers. The organization specializes in research in the areas of marketing, product development, distribution, and benchmarking. Derek Frost is the associate director of member education for the Insurance Advisory Board.

At Mr. Frost's request, his formal remarks are presented here in summary only. The question and answer period that followed his presentation is reported in its entirety.

Mr. Frost began his presentation by noting that his firm periodically revisits their previous research studies to update the material. This is especially true if the subject matter is something in which their membership is keenly interested. This presentation summarizes the findings of just such a recent report to member companies, which updates a study on distribution originally done in the mid-1990s by addressing recent developments regarding direct distribution, the Internet, etc.

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Note: Per Mr. Frost's request, this is not an actual *RECORD* transcript but a summary of his presentation.

In the first part of Mr. Frost's talk, he explored how changes in demographics and in client behavior are affecting the outlook for life insurance sales in the U.S.

To set the stage, he reviewed the recent history of life insurance sales. While the number of new ordinary life policies sold has fallen by about one-third since the mid-1980s, the average face amount of policies has been increasing. First-year premium income actually rose about 10% over that period in nominal dollars. That is certainly far from a robust growth rate, and, after adjusting for inflation, it indicates declining new ordinary premium sales over the period.

Turning to the changes in demographics, he noted that U.S. census figures indicate that the age cohorts that are most predictive of life and annuity sales should see very respectable growth over the next several years, which is clearly a positive factor for the future demand for life products. However, he said, the Insurance Advisory Board's research suggests that a number of factors will contribute to a continued constriction of the marketplace for new sales of individual life products.

The first constricting factor he cited is declining family household size. Smaller families mean smaller protection needs, as well as fewer lives to protect. The second factor is the rise in demand for so-called living benefit products, as people are worrying more about the financial issues associated with a longer life than those caused by a premature death.

The third constricting factor for the outlook for new life insurance sales is substitution: the replacement of life insurance by other products and services. While this may mean the sale of other insurance products in some cases, many of these products, such as disability income or long-term-care insurance, have lower margins than our traditional core whole life business. In other instances, the outlook is even worse, because it means that consumers will leave the insurance fold altogether. This has happened already in many cases with savings and investments, where consumers are turning to mutual funds, stocks, etc. Thus, consumers are going elsewhere to meet their accumulation needs, and coming to insurers more and more simply for their protection needs; they're buying term from us and investing the difference elsewhere.

The final factor that Mr. Frost identified as constricting the potential growth of life premium income is declining price. As demand for simple term products grows, as more competitors emerge, as people's purchase behavior becomes more sophisticated, and as channels diversify, price becomes a main point of differentiation, and price wars ensue. These falling prices will put still more pressure on the outlook for new premium income.

To see what the direction of new insurance sales would be over the next several years, the Insurance Advisory Board modeled the impact of both the positive demographic forces and these constricting factors. Netting everything out, the researchers came to the conclusion that the overall size of the individual market will continue to fall.

The projection for first-year premiums in 2005 is approximately $9 billion. Expressed in 1995 dollars, that's roughly a 3% real compound annual decline over the period between 1995 and 2005. The flat growth that the industry has been experiencing in recent years is coming to an end, and from here forward there will be an actual deterioration in new premiums.

Mr. Frost also noted the potential for decreased persistency on existing business as factors influencing the need for new life insurance continue to deteriorate. If this were to occur, it would have an even more deleterious impact on our business.

He pointed out that another big concern is company profitability. As the mix of products that we sell shifts from permanent life to term life and other kinds of products, industry profit margins will inevitably continue to decline significantly.

Mr. Frost concluded the first section of his presentation with the observation that what's going on in our business right now warrants not only attention, but, for many insurers, some serious strategic rethinking as well.

The second section of Mr. Frost's presentation was devoted to a look at the rise of alternative distribution channels.

In both the U.S. and the U.K., the percentage of life sales from direct channels has increased markedly in just the last few years. In the U.S., it quadrupled from 1% to 4% between 1989 and 1996. The Insurance Advisory Board thinks this trend will not only continue but will accelerate. A study from the Life Insurance Marketing and Research Association illustrating how people bought individual life insurance between October of 1996 and October of 1997 indicates that 44% of households said they had bought their policy from an insurance agent. Forty percent, however, indicated that they had purchased their insurance directly, either from an insurance company, buying through a professional trade or another association, through some form of insurance quote service, or from a credit card company. Nine percent bought insurance through the workplace, and 7% purchased their coverage from a bank, savings and loan, or other financial institution.

Of course, the purchases made directly were often very small policies; an analysis of sales by premium would not result in these kinds of percentages. However, in terms of individual policies sold, these results represent a real shift in people's attitudes toward alternative delivery.

Clients of financial services, in general, have more savvy than they used to have, and they're less and less willing to do business the old-fashioned way. Pioneering institutions are using their knowledge of this phenomenon to start rethinking their strategy and their business model.

For decades our industry has focused on high-cost distribution channels, geared to complex customer needs and high premium potential. However, these channels are the ones that will feel the full impact of the continuing decline in life sales and the shift from permanent to term insurance.

The growth market of the next decade, said Mr. Frost, lies in low-cost distribution channels, oriented to low-value clients with relatively simple needs. These distribution channels include direct mail, direct response telephone, the Internet, and so on.

The Insurance Advisory Board's research has identified two basic kinds of alternative direct sales strategies in the marketplace: The first is a high-volume, low-margin approach, which is essentially a scale-driven business involving the sale of commodity-like products. The second is a low-volume, high-margin approach that requires finding a way to sell more complex products profitably on a direct basis.

Mr. Frost went on to explain how each of these approaches has been employed at an actual company (whose identity was disguised by the use of a pseudonym). In each case, the results of the direct marketing venture were not only very positive from a sales standpoint, but both companies learned valuable lessons regarding product design, marketing strategy, the streamlining of administrative processes, etc. Most importantly, though, each of these strategies was proved to be workable, and they can be executed successfully.

Intuit, the maker of the popular money management software Quicken, was presented as an example of still a different approach. Intuit's experience points out an important lesson about choice. A strong correlation was observed between the number of carriers who offer a product through Intuit, the number of quotes that are requested, and the number of sales actually closed. As Intuit has brought more and more carriers to its on-line supermarket, the number of quotes per customer, as well as the number of sales in relation to leads, has continued to increase.

An insurance company must understand that going through a third party rather than creating its own proprietary channel has a price, though, and that price is total transparency. There may be 100 or more other companies involved, and the only ways you can differentiate yourself are by price, brand, and, of course, your rating. The Insurance Advisory Board believes that, despite the advantages of proprietary channels, it will be the supermarket approach that will win out.

Mr. Frost pointed out that, besides the transparency issue, there is another problem with the supermarket approach: You give up control over the customer. This phenomenon has occurred in the mutual fund marketplace. The fund manufacturers know nothing about their customers; instead, distributors such as Schwab have all the customer information and have established the relationships that could spell success when offering other products (e.g., life insurance) to these customers.

Mr. Frost cited the following as factors that appear to be requirements for success in the direct business marketplace: the need for product simplicity, the need to reengineer products for the direct channel, the importance of streamlining administrative processes, and the importance of choice when it comes to a supermarket approach. What really drives the economics of direct marketing, however, are the response rates and the conversion rates.

At this point, Mr. Frost shared some lessons from direct marketing pioneers on how to boost response rates through branding and education, and how to boost conversion rates by simplifying the purchase process for the customer.

He pointed out that building a brand can be expensive, but that it's part of the ante if you want to play in the direct marketing game. Once brand begins to play a role, it gets more and more expensive. In the U.K. auto insurance market, for example, the amount of advertising has more than tripled in the last five years, with the result that it's now almost as expensive to purchase a new auto policy from a direct insurer as it is to go through an agent.

Another key to raising response rates is education. If your product makes sense for clients and is in their best interests, the more they know about it, the more likely they are to respond to your advertising. He cited the Vanguard mutual funds as being the quintessential example of the educational approach in the U.S., and noted that, while the company clearly highlights its own product, its ultimate goal is simply to educate consumers to the advantages of indexed funds and lower expenses. Vanguard believes that a more knowledgeable consumer will act in his or her best interest by selecting low-cost indexed funds and, in particular, will

ultimately select some of the funds offered by Vanguard. The company is acting on its belief that, by increasing overall demand for a product, everyone will end up winning; a bigger pie means a bigger slice for everybody.

Product simplicity is even more important on the conversion side than on the initial response side. He held out Virgin Direct in the U.K. as the prime example in this area. Expensive, complex products characterize the pension market in the U.K., and an independent financial advisor or other intermediary is involved in virtually every sale. Virgin took advantage of the popularity of personal pension plans, developing a product that was both simpler and cheaper than the more insurance-oriented products that were in the market. As a result, they have jumped from nowhere to being a major player in this business in just over 2.5 years.

Mr. Frost concluded this section of his remarks by discussing distribution channel conflict. Most companies today are dealing with a multichannel environment. One of the most difficult issues that insurers have to face is, thus, how to build new channels when there is a strong existing traditional intermediary channel. The company must not only figure out how to reduce agent resistance to the new channels, but also come to grips with managing all of the channels on an ongoing basis.

One approach for easing agents into accepting the introduction of a new channel, which has been tried with some success, is to pay them to do so. At one such company, when a customer who has an existing relationship with an agent phones into the call center and a sale is made, the sales credit accrues to the agent, and the agent is compensated just as if he or she had made the sale. If the customer is completely new, however, with no agent relationship in place, then none of the agents receive any credit.

Of course, this isn't a permanent solution; it is essentially a transition strategy. The company is betting on the fact that most of their direct customers will be people who don't have a relationship with an agent already. Furthermore, if a client expresses an interest in a certain product to an agent, but the agent doesn't want to handle the transaction because there isn't much in it for him financially, the agent can refer the client to the direct channel and still get the credit. Thus, the company is trying to motivate their agents not only to accept the channel, but to actually contribute to its growth.

He then discussed a method for managing channel conflict on an ongoing basis used by a different insurer. This company created what are, in effect, internal free markets. In other words, each product and each channel must operate and be

successful on its own. Instead of being tied together, distribution and manufacturing must each stand on its own two feet. One result of this arrangement is that when the product side manufactures the product, it then has to convince the distribution channels that they should sell the product. Thus, the product must be competitive.

In the third section of his presentation, Mr. Frost reviewed the Insurance Advisory Board's "report cards" on the emerging alternative channels in our industry: telephone-based direct response, direct mail, and the Internet.

Items that were included in the analysis for each channel were: the cost per dollar of new premium, the typical response rate, the product lines being sold this way, the target market, the barriers to entry and challenges to success, consumer attitudes towards the channel, and indicators of the market size to date. Finally, for each channel there was a projection of sales to the year 2001.

The report card for the Internet, for example, indicated that start-up costs could be quite high, starting at around $5 million for the most basic site. For all the bells and whistles of a top-quality interactive site, the cost could be as much as $20–23 million. However, some observers have estimated that using the Internet can produce an acquisition cost advantage in the range of 58–71% over a customer's lifetime.

Most of the products sold on-line to date have been term policies, although you can also find auto insurance, universal life, and annuities as well.

One of the biggest barriers to entry for the Internet channel is the start-up costs, which are much higher than most people think. Another is channel conflict.

A major challenge to the success of Internet marketing will be the need to maintain the confidentiality of information; people are very reluctant to give institutions their complete medical history on-line.

The Internet presents quite a lucrative target market. It's estimated that 57% of Web users have a college degree. It has also been reported that 44% of them are between 21 and 35 years old.

The market size to date has been modest because transactional capability is still fairly limited. At last count, eight out of ten insurers have a Web site, which is quite high penetration, but only 1% can actually process an application on-line, and only 11% plan to have this capability by the end of the year. Services such as InsMart

and InsWeb seem to be the real players in Internet marketing, and insurers are turning to such supermarkets for the transaction piece of the pie.

Internet sales of auto insurance are predicted to increase dramatically over the next three years, with the potential of homeowners' insurance and life coverages being significantly less.

In the concluding section, Mr. Frost briefly discussed the challenges facing the agent channel. He noted that companies have tried different possible solutions to this situation with varying degrees of success. In particular, he cited moves toward levelized commissions and converting captive agents to an independent status. He then identified two strategies that the Insurance Advisory Board feels are the most promising for this channel.

The first of these is the "financial steward" strategy, which is basically the strategy employed by American Express and other financial planning companies. The idea is to offer consumers a plethora of financial products, to become a full-fledged financial services provider, to know everything about those customers, and to gain a greater and greater share of their wallets. While this would be a challenge for traditional insurance companies, it is not an insurmountable one.

The other strategy is becoming a "case expert." Such a company would specialize in a narrower range of products, typically geared toward the higher end of the market. This is a strategy being employed by companies who, for example, are developing relationships with brokers, in addition to agents, and are targeting the estate planning market or the business owner market.

With those observations, Mr. Frost concluded his prepared remarks and opened the floor for questions.

From the Floor: I have a question regarding telephone call centers. You said there is a wide divergence in the conversion rate attained that ranges from as low as 1% to as much as 30%. What distinguishes a provider who can get a 30% conversion rate from one who can only get 1%?

Mr. Frost: If we had the absolute answer to that, we would probably be independent consultants making a lot more money than we are. Clearly, though, one of the major factors is simplification, the streamlining of the process. Suppose a customer calls up and has to go through a number of different people, answering all sorts of different routine questions that are not necessarily applicable to that customer, which lead to still more questions that are equally inapplicable. That

experience is going to turn the customer off and bring down the conversion rate. You need to streamline the process so that, for example, a "Yes" answer to the question "Are you married?" leads directly to the necessary questions concerning dependents. Likewise, if the answer is "No," you need to bypass all of those dependent questions and move on to the next category. It's really such intuitive things that can make a big difference, but some companies just haven't applied them. They're going through a standard needs assessment routine without having attempted any streamlining.

We looked at one carrier in the U.K. that, before they simplified their routines, had an average time spent on the phone of more than 60 minutes per customer. That much time is deadly when it comes to converting. Then they reengineered the process, establishing a series of filters. First, they filtered out people who already had a relationship with an agent. Next, they filtered out people who had fairly simple needs and directed them to a particular group of customer service representatives. Finally, people with more complex needs were routed to representatives who were essentially direct financial planners and financial advisors. This approach reduced the average phone time per client to around 35 or 40 minutes.

Making the product simple goes hand in hand with streamlining your processes. Those two things are the real drivers in terms of boosting the conversion rate. Brand can also have quite an effect, as we noted.

From the Floor: Does this mean that a company needs very skilled telephone representatives then?

Mr. Frost: Good question. That's another thing we've seen: The most successful telephone operations are the operations that allocate labor according to the skill level required. In a study on advisory services, we looked at one direct provider of advice and found out they were using highly compensated, highly skilled advisors for every component of the advisory value chain, from the initial establishing of objectives through the asset allocation through completing the transaction.

We looked at another provider who had segmented that value chain. In the information-gathering process, for example, they would utilize less-qualified, less highly compensated people. Once that part of the process was completed, a more-skilled, more highly compensated advisor would call the client back to actually present the investment advice. The firm avoided having to spend money on highly compensated personnel to address the needs of their many customers, whose needs

were, in fact, fairly simple. By properly screening customers and funneling them to the right channel, a company can have a significant impact on its labor costs.

Mr. Philip J. T. Cernanec: My firm recently helped a company in the U.K. install a fairly sophisticated call center. That company chose to build software that included some artificial intelligence. This software provides the call center operator with information previously gathered from the client as to how that client actually makes decisions. In addition to that, every one of the 450 operators at the center is a college graduate, who can provide high value-added service. This company is trying to sell high-margin products via what would generally be considered direct selling in the U.S. market, but they are using a call center manned by people who are essentially independent advisors.

Mr. Frost: Is this company mainly selling personal pensions?

Mr. Cernanec: It is not selling just personal pensions. They have a very broad product line. Because it's the U.K., they're marketing everything from loans through insurance, as well as personal pensions. It has been very interesting. I've actually listened in on some of their customer phone calls. For example, a client calls in wanting to surrender a policy to have access to cash; as a result of the discussion with the advisor, he ends up taking out a loan, which allows him to retain some tax leverage. In a typical U.S. company, this request would have been handled as a simple customer service transaction. The company representative would only have been interested in the client's name, address, and where he wanted the check sent; that would have been the end of it right there.

Mr. Frost: That sounds a little bit like what USAA did a couple of years ago. They had a pilot program and did something very similar to that. It was very successful.

Mr. Cernanec: Our firm was slightly involved in that one as well. I have two more questions. Both of them concern the dismal information regarding what has been happening to the industry's market share that you showed us early in your presentation. First, given all of the problems you pointed out, why do firms such as banks seem to be so interested in becoming involved in the manufacturing of insurance? Second, given the very fragmented market in the U.S., does your firm see any pockets in the insurance industry where the behavior may be counter-cyclical to the general overall market trend?

Mr. Frost: In answer to the first question, the reason for this paradox is that there are new competitors like the GE Capitals of the world, like the banks, and, in the

U.K., even supermarkets like Tesco, which you're probably familiar with. These new competitors see weaknesses in the traditional industry.

They take a look at the business system of the traditional industry, and they say, "Wait a minute, we have expertise in this particular area." An example would be direct access to customer information. Unfortunately, as insurers, we're saddled with the blessing and the curse of having intermediaries. They have been terrific sales engines in the past, but they are also a filter for information. A supermarket such as Tesco or Sainsbury in the U.K. has a large number of people walking through its checkout counters every day. Thus, they say to themselves, "Wait a minute, we've got a lot of direct information about purchase habits. What if we actually set up a personal finance operation?" And so they did. Tesco teamed up with Royal Bank of Scotland, and Sainsbury teamed up with Bank of Scotland, to build what amounts to a direct bank. They started out with a basic debit card, and now they have expanded their operations to include personal loans and insurance among other financial services. They are leveraging their direct access to information about their clients to become financial services providers.

Other kinds of direct players are able to seize their distribution advantage, a distribution advantage they hold over traditional insurers. CIBC Insurance in Canada, for example, is a direct operation that is quite formidable, quite successful, and not encumbered with a commission-driven intermediary distribution channel. They looked at the value chain of the traditional industry and decided to specialize in this particular component to use the skill advantage they have there over the traditional industry. This advantage, they believe, will allow them to be successful in a market that has been less than promising from a traditional insurer's perspective.

In response to your second question regarding whether there are any countercyclical products, there is clearly a lot of potential in supplementary products: long-term care, disability income, and the different riders that can be attached to those sorts of products. The problem is the margin involved in such products. This is no longer the 1950s and 1960s when we could live on the fruits of selling whole life policies right and left. We don't think that there is a product out there that's going to give our industry those margins. The way to those margins is by rationalizing distribution and rationalizing product design.

Of course, that's easier said than done. Bringing a product to market in this country is a real headache, as we all know; one must deal with 50 states and 50 regulatory processes. To deal with these problems, we are seeing some move toward parallel sequencing as opposed to linear sequencing. Instead of designing a product then

getting the regulatory approval and then going back to put the systems in place to bring that product to market, we are beginning to see some insurers looking at parallel sequencing. While the product is being designed, the company is also going for regulatory approval and, at the same time, building the necessary systems.

Of course, there's a risk there; the product may not fly. But, if it does fly, you're certainly much better situated to bring it to market. That's where we think the real advantage is going to lie.

It's interesting that you brought up the issue of product because the Insurance Advisory Board is looking at that whole issue now. We're beginning work on our next report, which will be on innovation and creativity in the insurance business system. In fact, I sat in on a meeting with our researchers yesterday on the subject. We're still working out the exact direction we will go on this, but we'd like to try to provide some answers to questions like: Where can our industry be more creative? Where do the opportunities lie?

We're also going to do a best product study after that.

Mr. Tom Bakos: Are you aware of any companies that have used the techniques you've described for direct marketing to develop qualified leads for a field force?

Mr. Frost: Yes. In fact, we profiled one in an earlier study we did called "The Gold Standard." In that study, we looked at a particular tactic we labeled value-based lead generation. The carrier we focused on had looked at their portfolio profits and found that the skew was particularly bad—much worse than the classic 80/20 relationship that you would normally expect.

They realized that they had to do something. They had to identify not just valuable customers, but valuable leads as well. They knew that they had to focus their agents on those leads and also on retaining those leads as customers once they were brought in. They were quite successful in what they did. They accessed a lot of external data and a lot of internal data as well. They did a complete segmentation run and came up with three customer templates that they saw as having high value potential. These customer profiles correlated quite well with the top one or two deciles in portfolio profits. They then focused in on their best producers and identified prospects in those best producers' local markets; for example, prospects that were existing customers on the life side, but who were also promising prospects for being cross-sold the company's disability income product.

They encountered great success in the pilot program. Since then, they have expanded their data warehouse, and they've also expanded the program to go after noncustomers who are promising prospects. We are seeing direct marketing being used, and used successfully, to help agents be more productive. It's not as common as we think it should be, but certainly there are pioneers out there who are doing it.

Another company we looked at who came across that same portfolio skew decided to solve their problem by targeting the affluent market. They chose to team up with brokers and go after high-end prospects only. They geared their operation more toward the estate planning types of services and products.

These were two very different approaches, but they both depended on strong data-handling capabilities. In both cases, it was essential to build data warehouses, to be able to do the data mining, and to get the companies' different product databases to talk to each other.