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Is the Next Generation Insurance Business Model the Virtual Insurance Company?

Track: Nontraditional Marketing/Product Development

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Summary: Over the past several years, there has been an emergence of low-cost insurance providers. Does this create a new playing field, which becomes fertile ground for the virtual insurer? This session challenges participants to consider the insurance landscape over the next five to ten years and how existing business models need to evolve.

MR. EDWARD MCKERNAN: We have two panelists to give their perspectives on how their enterprises affect the industry today and how they anticipate it will affect the industry in the future.

One thing that I've observed over the last, say, five years, is major consolidation occurring throughout the industry. You're seeing insurance enterprises, but they're moving slower in delivering product to various distribution channels. Shane Chalke's Ihor Hron's companies are approaching this problem in different ways, but the end result for both is better efficiency in delivering product, getting policies issued, and providing the infrastructure to various channels in order to effectively deliver

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†Mr. Ihor Hron, not a member of the sponsoring organizations, is president and CEO of Midland Life Insurance Company, also known as E-Reassure, in Columbus, OH.

Note: The chart(s) referred to in the text can be found at the end of the manuscript.

policies, which has probably resulted in better experience for the company's persistency and keeping "not taken out" rates to a minimum.

When we talk about a virtual insurance company, we're not talking only about Internet delivery for products. We're not talking about the online insurance agency necessarily, although that's certainly one component of the enterprise. We're also talking about back-office infrastructure and support, perhaps dedicating third parties to support this infrastructure to create an electronic communications medium. A by-product of industry convergence is that you're starting to see the emergence of third-party administrators (TPAs), third-party underwriters, and systems support firms that deliver best practices and efficiencies. To the extent you can tap into those new efficiencies, you are able to deliver better value for the industry in general.

I'd like to introduce Shane Chalke. Prior to AnnuityNet, Shane founded Chalke, Inc., which is a consulting and software development firm servicing the financial industry. Shane founded AnnuityNet in 1997. It supplies various combinations of technology, business engineering, administration, distribution, and marketing to major financial institutions.

MR. SHANE CHALKE: I'm going to talk about my interpretation of what a virtual company is and how we feel that we're helping various entities attain the goal of becoming virtual. In the old days, meaning in the '80s, virtual meant that you outsourced everything. What was a virtual company? It was three smart guys and really nice office space because if you only have three smart guys, you can get really good office space. It's not that expensive. And you outsource everything. You outsource administration. You outsource your actuarial work. You outsource your manufacturing. You outsource all these various components of the business. And in that sense you're virtual. You don't really exist except in the ether. In a very pure way, you're assembling resources from the economy in order to create a project-based organizational structure.

In the past few years, virtual companies meant something different. Virtual meant that you didn't build buildings. Amazon.com is a virtual bookstore because there isn't a place where you can actually drive up and buy a book. The idea of working in cyberspace became the major component of being a virtual company.

Well, we have a little bit different take on it. I think that today we view the idea of being virtual as being portable, that all your processes are disaggregated and portable. The result is that any given player in the entire value chain can accomplish any one component in the business process in any given structure. A major component of virtual for us is deconstruction of the value chain, and I'll talk a little bit about it, how we see this progressing, and how we fit into the world.

AnnuityNet is really about the creation of an operational platform in the annuity business that has the entire vertical chain encapsulated within it. We create a portable platform that doesn't have to reside anywhere in particular by any particular players in the world. That this business started out being entirely vertically integrated is an accident of history, and this vertical integration has become entrenched and idiosyncratic. The idea of an e-commerce platform is our response to this accident of history.

A life office in the old days controlled everything from raw materials, to manufacturing, to distribution, and everything in between. Well, we've seen some substantial disassembling of that value chain. Primarily in the annuity market today, the distribution is almost entirely divorced from manufacturing. Well over two-thirds of distribution is disassociated from the manufacturing process in some meaningful fashion. The needs are very different today than they were 10 or 15 years ago, and there's a very strong need for distributors to have a cohesive business process, in particular one that drives a need for carriers to be able to deal technologically with a distributor-centric business process.

We've taken this idea of an e-commerce platform to the nth degree and encompassed virtually all of the operational components of the carrier itself. AnnuityNet is owned by some of the blue bloods in the business, and we are right now deploying some or all of the components of our e-commerce platform to improve their processes. The one I'm going to talk about today is Charles Schwab because of all the arrangements that we have in the industry today, that's the most purely virtual insurance company arrangement.

We signed a deal with Schwab in January 2001. The nature of the deal was to empower Schwab to create its own virtual insurance operation and to divorce that operation from the manufacturing process such that Schwab could gain control over the entire business processes—to gain control over the customer relationship, most importantly, but to also gain control over manufacturing. We went live with Schwab on May 3, 2001, so it's now out there.

What's notable about Schwab is they deployed our entire platform, the whole vertical value chain (Chart 1). The things that we have deployed on behalf of Schwab with their annuity business are in the big box in the middle. We have moved all of the product administration, shareholder accounting, client communications, the entire issue process, the sales support, and call center to the distributor side of the fence. Virtually everything operationally has moved from the manufacturing side of the fence to the distributor side.

Schwab has five distribution channels, one of which is good, old licensed brokers in branches. They also have a couple of different direct-to-consumer distribution channels. They have an outbound call center distribution channel, and they have a registered investment advisor channel.

The way it works is that the broker logs on. If the broker hits the annuity button, then he or she moves into our annuity space where there is the ability to go through a TurboTax-like wizard and open an annuity account. Once that process is completed, the account is generally funded directly from the Schwab brokerage account. So we're sitting behind the authentication process, and we're sending all the instructions out to have the money cleared directly from the account over to the insurance company.

In Schwab's case, they like to get a signature, so we created a signature page. The broker hits the print button and the signature page pops out. The broker gets the client to sign it, and then faxes it to us. When it is faxed to us, we don't actually have any humans look at it or touch it. It's scanned to make sure there is a signature. It could be "Yogi Bear" or "Snoopy;" we don't know. But there is a signature there, and that's good enough for us.

The account is opened, and then on a virtually immediate basis, that client and that broker can observe that account. Think about this. All these processes around account opening normally exist at the carrier in some fashion. Now bits and components of it are moved to the distributor side over time, but generally it's still a carrier-centric process.

Probably the most profound thing that we do is move the call center capability from the manufacturer to the distributor. That's the second one down in the left on chart 1. We provide a browser-based console that provides all servicing capability for the annuity, and Schwab has taken the opportunity here to regain control over customer service. If a client or a broker calls in for annuity service, that goes into Schwab's call center rather than to an insurance company call center, and they're empowered with transaction capability, account look-up capability, and so forth to be able to affect this complete customer service. It's important because they would very much like to own that customer relationship. It's a very profound shift in the business model, I believe, because the touch point moves from the insurance company to the broker, and every touch point with a customer is a cross-sell/upsell opportunity.

The third box in the graphic is online customer access, which exists in lots of parts of the annuity industry today. What's unique about this implementation is that it's now distributor-centric. For any carrier that does business within the Schwab distribution system, customer access happens in an identical fashion through the Schwab Web site, not through a carrier Web site. We've gradually moved all of these processes over to the distributor side. Our relationship here with the manufacturers is quite unique as well. The model is very much like the mutual fund business. When an account is opened, the manufacturer doesn't even necessarily know that happened. For example, if Janus sells a mutual fund through a Schwab 1 source, Janus doesn't know that the customer event occurred. They know how many millions of dollars went in and out of their funds each day because there's this

omnibus relationship between the distributor and the manufacturer, very similar to the way we've administered the annuity business here, except that the manufacturer gets this omnibus feed into the general ledger system and doesn't necessarily have to know about individual customers. Now they do legally. It's their data. It's their customer in a legal sense, but on a day-to-day, minute-to-minute operational basis, they don't need to act on that data, so it's quite interesting.

The question is, why even do this? We think there are three problems that exist in the annuity business today that we can attack directly. The first is process. Again, one of the accidents of history, the way the annuity business and financial institutions grew up, is by insurance companies placing agents in financial institutions, and this goes back a long time. You really work for the insurance company. We'll provide you with the whole sales kit and the technology. We'll enable you to sell this. But that hasn't kept pace with reality. Now we have financial institutions that are really very powerful distribution systems unto themselves, and the processes have not kept pace with the rest of the world. Probably 85 percent of all annuities today are sold with ballpoint pen technology on an application and a paper check and that is out of step with where the mutual fund industry is today. So first we have a process problem.

In a financial institution, annuities are the most profitable product that a rep can sell. There's nothing that equals the profitability of selling an annuity. So why don't they always sell annuities? One of the issues is that annuities are a lot harder to sell than mutual funds. If I'm a rep, I can sell a mutual fund with a button click. For an annuity, I have to open up four drawers, and I have to get the right forms together for the right product. I have to get the right paperwork. It's just a pain in the neck. And a lot of salespeople, especially in the bank distribution systems, try it once, have a bad time, and they say, "I'm not touching that again."

The second problem is customer ownership. In financial institutions, the retail customer maintains two vendor relationships. They sit at the broker, and they buy an annuity from Merrill Lynch or Paine Webber, for example, and they think that they're the customer of that company's distribution system. Five days later, however, they start getting mail directly from an insurance company whose name they never heard of during the buying process. You have the insurance company contacting the client, and you have the distributor contacting the client, and it causes confusion.

The third problem is management information. If you walked into the top 10 banks in the United States, and you asked them a very simple question, "How big is your book of annuity business?" I would wager 100:1 odds that for eight out of ten banks, it would take them six weeks to answer that question. They'd get on the phone and call their 13 insurance companies, three of which they're no longer on speaking terms with, and they'd ask, "How big is my book of business?" The marketing guy at the distributor sends a request down to IT, "Put this stuff in a

spreadsheet for me so I can understand it." Six weeks later you probably can get 70 percent of the answer, and they can tell you how big their book is plus or minus maybe a billion dollars. That's the nature of where the industry is today.

Those are the three problems we think that need to be solved by a portable insurance company. Our solution looks something like this: We sit in between and neither really distribute a resident nor manufacture a resident with these series of services in the middle: retail customer account access, call center access, sales/service workstation for the broker, and management information (Chart 2). Generally all of these facilities are branded with the distributor. If you go to the Schwab retail Web site, and you click on annuities, you're actually on AnnuityNet servers looking at AnnuityNet screens, but you never know it. It's completely white-labeled to be Schwab. The distributor wants to own the customer. They would very much like to solidify that customer relationship. It's their brand that they want in front of the customer.

With this kind of a construct, they solved their three problems. In many ways we've actually transcended the ease of mutual fund purchase today and gone the whole dimension. So, I think we solved the process issue. On customer ownership, everything the customer sees when he or she goes back to look at their account on the Schwab Web site is branded Schwab, and this solidifies that relationship. The customer doesn't have to go two different places to find out about their products. Customers want to see everything in their Schwab account. They want to log into Schwab and see their IRAs, their brokerage account, their annuity account, and their mutual fund holdings. And the third problem, management of information, we solved really by default. By having a single platform with multiple carriers on it, we can aggregate information across carriers and deliver that back to both sides of the equation and that's actually in many ways the easy part of it. Once you've moved the processes and extracted them from the insurance vertical, all things become possible.

I have one other comment—a lot of financial institutions are now talking about wanting to get into the manufacturing business. Every actuary that I know who works in the manufacturing business scratches his head and says, "Why? I don't get it. Here we are scratching and scraping for business that has a 30-35 basis points pre-tax profit margin, while the distributor gets 725 basis points, and they want my little piece for all my work." When financial institutions talk about manufacturing, what they really want is process control and product control. They already have the profit. They can certainly have a very heavy hand on process control, and that's really what it's all about. I'd say financial institutions already have product control. If you're distributing, anything north of a billion dollars a year of annuities, manufacturers essentially build what you ask them to build, and that's the reality of the market today.

I think that this explains a little bit about the construct and why it's catching on in popularity. I'll take you through examples to explain why it needs to be done by a third party because this is really the change in the market in the past 18 months.

This is our application process. This is what has to happen actually to open an account (Chart 3). To meet distributor needs and to make it electronic and easy, you have to replace the human chain of events that exists on the distributor side. That means that once you're into this purchasing process, you want to make sure that the person who's doing the purchasing process is appropriately licensed. The purchaser not only has to have a state license, a National Association of Securities Dealers (NASD) license, but he or she has to be appointed with the company. There are lots of technical details here that in the paper world actually are glossed over a lot of times. You have this appointment on demand and this kind of stuff. But in the virtual world or the digital world, you can do things on a tighter basis.

The second thing you have to do is figure out whether this purchase violates any product rules. Is it below minimums? Is it above maximum age? And then you have a staging process for Q&A, of which this electronic process eliminates most of it, but you can't go purely electronic. You go paper app together with electronic. So, paper apps come in, and you want to digitize them as early in the process as possible, and that digitization process means that you have incorrect data. Any time someone fills something out with a pen, you have bad data. In the bank market, the error rate in applications runs about 40 percent. In the brokerage market it runs about 20 percent. What business can you run at a 20-40 percent error rate? It's amazing to me. To me, it's like a .25 sigma business. Because we have very high error rates, we have a Q&A staging process for cleaning up bad data. Then we have compliance staging because even though you can electronically adjudicate quite a bit of business, there's a lot that you can't, and you need a Series 8- or a Series 24-licensed person generally to sign off and say this sale's good or this sale's bad. The financial institutions are very jumpy about compliance these days, for good reasons, because there's a fairly nasty liability tail that goes with this. Then you have to do all the nuts and bolts that go behind this business, such as send this data to the carrier back office and clear the money.

Many carriers spent millions of dollars trying to build these kinds of platforms, and some have actually built versions of this technology. The real issue, however, is that distributors found out that they had no customers for this technology because the distributors live in a multi-carrier world, and in a multi-carrier world they want a single business process across multiple carriers.

A good analogy is with the travel industry where the distributor is the travel agent, and the manufacturer is the airlines. The travel agents do not want 42 airline reservation systems for all 42 airlines they write tickets for. They don't want to have to jump out of one system, jump into another system, and have all different quirks in the system that they learn over time. The distributors want a single,

cohesive business process, and it's the same thing in annuities. You learn the nuances of a system. You don't want to learn the nuances of a system for many carriers. In fact, this is one of the primary reasons why financial institutions have pared down the number of carriers they deal with because they're trying to reduce the proliferation of business processes and practices. This kind of technology could reverse that trend and enable distributors to deal with more carriers. This is just one example of why this needs to happen on a third-party basis and become abstracted from the carrier and virtual.

We're providing all the post-issue document management, and pre-issue document management as well, all on a digitized basis. In fact, we can get through the entire annuity process and never touch a piece of paper or use the U.S. Postal Service. But in order to do this, you're starting to get into fairly complex subsystems that have to do with document look-up and attaching documents to various accounts at the distributor level. When Schwab customers click on their annuity account, they see all the documentation and papering around this account: application prospectus, confirms, welcome letters, and account history. This is not the kind of thing that could be done 12 different times with 12 different business processes and practices.

The broker workstation is probably the best highlight that I can make about why data aggregation across carriers is critical. Brokers want to see their book of business across clients and across manufacturers. They don't want to see their book of business with Carrier X and Carrier Y and Carrier Z independently. One of the things that we provide is that when brokers log in they'll see their entire roster of customers that own annuities across multiple companies. This enables them to perform operations not just at the contract level but also at the customer level or at the customer group level. What would you want to do at a customer level? Let's say a customer owns two annuities, and you want to change the customer's address. The address is usually the same for both, so you want to do that at the customer operation level.

Many brokers run asset allocation models for their clients and want the annuity to be part of that, and they may have 15 or 18 clients in a particular asset allocation model. They want to trade them all in bulk so they can form groups and do group activities on it. But the portability of this service is important. The aggregation among carriers is important. But you can see that this will lead to the abstraction of these services and these processes out of the carrier and into some neutral territory. I think this will go the whole distance eventually just like the mutual fund industry. Right now, if you buy or sell a mutual fund, you buy and sell a Janus Fund, for example, Janus never knows about it. Actually, in the mutual fund world they don't even have legal access to that data, which is interesting. That's where the insurance world is very different. Insurance companies actually legally own that customer and have legal access to the data, but do they have operational need for it? No, I don't think so.

The last thing I want to show is about retail access (Chart 4). Again, being able to reach across multiple carriers is the critical component of it. This is essentially the 100,000 foot-level diagram of how we do business. The core of our technology is a transaction broker, which is essentially a platform for staging inter-day data about annuities and being able to do inter-day transaction processing around those contracts. Something as simple as a fund trade or a sub-account transfer obviously happens through one of our various Web layers, one of the various consoles, whether it's through the broker, the retail client, or the call center. That trade pings against the transaction broker. The transaction broker stages that trade inter-day, sits as a pending transaction, and we've done our best to replicate a brokerage account so it sits as an open order. During the day, that trade can be cancelled, corrected, amended, or massaged in various ways. Back office systems in insurance companies are particularly ill suited for this kind of inter-day activity.

At the end of the day, we parse those trades intelligently because most back office systems, if you send them a trade from A to B and a trade from B to C, it's almost a random process to decide which one gets processed first, and they might try to process from an empty account. If that happens, you blow the second transaction, and you have to clean it up the next morning. So we parse those trades and make them intelligent. The back office system does the accounting of record, but it's interesting that this really changes the nature of processing of this business because as time goes on, this transaction broker gets richer in terms of business rules and logic. For us to book a trade we have to know the rules. Are you allowed to trade only three times a quarter, 12 times a year? Are you allowed to trade less than \$500? These business rules begin to reside in the transaction broker and that means that ultimately they don't have to reside in the back office.

Another one of the accidents of history that I love is that in this business, unlike almost any other, what we call an admin system is really a customer relationship management (CRM) system, an accounting system, and a communication system. I don't think any of those three functionalities should ever be in the same box. I think an accounting system ought to be an accounting system. A communication system ought to be a communication system. And a CRM system ought to be a CRM system. We've over-featured these systems so that insurance companies install them for several million dollars, and they run them for 10-11 years. Then the whole thing blows up. Nobody understands it. They trash it and buy another one. That's really how it works.

In any event, if you draw a circle around the Web layer or the transaction broker, where we provide the back office, we are an insurance company in all but legal structure. Obviously we aren't legally an insurance company, but just abstract out the purely operational elements, we have all the operational elements of an insurance company. We're taking the trades and sending trade instructions directly to fund managers' desks. Fund managers send us NAVs. We're converting them and applying them. It's essentially all the operations of an insurance company. And

with this technology I can run the entire Schwab annuity business with about one-and-a-quarter people compared to 320, maybe, in the traditional manner. That's pretty good operating leverage.

What's happening here is that the value chain will eventually move to the middle, but it'll also get parted out. One beautiful thing about Internet technology is you can integrate at the browser level. You can integrate almost any part with any part. We really have the ability for anyone who does one little component of the value chain better than anyone else, to take that over and integrate with other parties. The day of the completely vertically integrated insurance company is waning for some companies. Every phase of the way now can be portable. We don't really care whether client service happens at the distributor, at the manufacturer, or in India, which is where it's all going anyway. It's all the same to us because anyone who can open up a browser with Internet access can perform these services.

MR. MCKERNAN: I've been associated with an agency broker dealer for well over five years now, and I can say that one of the hurdles facing the broker dealer has been in trying to service these various manufacturers and deliver product form. The most difficult task is getting them on a common platform in order to feed the field force. When each manufacturer is trying to feed you product through a different platform, it becomes an impossible task. They're always asking why they aren't getting shelf space, and that's one of the key components.

I'd like to introduce Ihor Hron. He's president and CEO of Midland Life Insurance Company, which is also e-Reassure. Ihor has more than 30 years experience in the insurance industry.

MR. IHOR HRON: I'd like to present to you our company's vision as to the paradigm shift in distribution, which is really driven by the buying patterns that have resulted from e-commerce pressures. Before I go into my presentation, please note this—it's very important. We are a reinsurer, and the solutions that we are providing are driven through our primary company relationships. When we write product, it's not on our paper. It's on your paper, if you are a Swiss Re client.

We're embarking on something that we don't have a 100 percent solution to right now and a 100 percent answer. Will the virtual life insurance operation take hold? Is there a need for it? Depending on which distribution system you talk to, it's either embraced wholeheartedly or looked at with some skepticism. Our attempt is to revolutionize the distribution of insurance products through strategic relationships with intermediaries via the creation and establishment of the virtual insurance company. Here are some of the key phrases that you'll hear me: distribution shift, e-commerce platform, criticality of speed, customer control, customer relationship management, outsourcing, and single business process. They are absolutely critical for the success of the virtual insurance company. They mean a lot of things to a lot of people. So I'll focus on the life side of it. Although we are embracing the total

concept of a virtual insurance company, you'll see that we are beginning very, very slowly. We're going to walk before we run. We are building a simplified issue term product, which was primarily directed through financial institutions.

We believe that there is room in the marketplace for the building of insurance operations that require no bricks and mortar. Companies want to hold risk, but they don't want the infrastructure that comes along with risk, and those companies that we're talking about primarily are banks, Web portals, or other financial institutions. They'd like to enjoy the benefits of profits coming from the mortality side of the business, but, again, they don't want to pay for the infrastructure of the organization.

We believe through the models that we have constructed that we will be able to answer those questions I raised earlier. The key to success is going to be automation. Automation is number one. Number two is outsourcing the services that we don't have, and bringing in the outside third party that has that expertise. It doesn't have to be managed out of Columbus, Ohio, or Stamford or wherever a client operates from, but we have to have the interfaces that are built that will support that infrastructure.

The distributor or a nationally known insurance company will brand products. Some bigger names, for example, Schwab, have a panache and a desire to offer one choice. So there's going to be more than one but less than 50. We hope that with the relationships that we have built and the processes that we have put in place, we'll be able to overcome some of those hurdles.

On the issue of risk bearing, we believe in the strength of our actuarial assumptions and the strength of our underwriting. We bring together the strength of the Midland's direct term experience over the last 10-or-so years, as well as the international prowess of the reinsurance expertise that the Swiss bring to the table. We will take as much risk as a client wants to give us.

The financial steward model is really what we're talking about, the virtual insurance operation. We are not a distributor. But it's critical for us to understand what the distributor needs. We will build product in concert with that distributor, but we will not act as the distributor. Our primary emphasis as we roll out the e-Reassure portfolio will focus initially on banks. After banks we will talk to Web portals. We've actually had some discussion with Web portals. And we will build on that expertise.

What do we see as the necessary ingredients to be successful in our virtual loan officer (VLO)? Price according to risk is one ingredient. We want to use the credit scoring systems that are available out there, not so much today in what we call the traditional underwriting, life underwriting side, but to build on it and pull other sources of information as we build our expert underwriting system. We want to find proxies for underwriting data. Must an underwriter look at a thick file before a rating

can be assigned to a prospect? And we draw on the experience that the Swiss have gathered over the many years by being in the reinsurance business, and, as I said earlier, the experience that the Midland had enjoyed in the impaired risk arena. We need to cull out the bad risks because our product is going to be addressing primarily the preferred and the preferred plus standard policyholder.

Centralized customer data is an important ingredient. Are we using our information efficiently? I would opine that we're not. We have to pull all that information into a single source and build off of that source. Data has to be moved freely as we do our data mining. It has to move between the distributor and the insurance company, the insurance company and the reinsurer, and the reinsurer and the distribution partner. There has to be a free flow of information.

Price by channel is another ingredient. The same product that is available in a bank will not be available, say, to an e-portal. The risk characteristics are different, and we have to reflect that. That's not an easy sell as we talk to potential distributors. But I believe with our understanding of the markets we can price those products. The use of technologies to support our pricing will cause profits to be enjoyed by the distributor, the insurance company, and Swiss Re.

Merchandising or brand awareness, is another ingredient. I've talked about that. We believe that's very, very important. It's one thing to go out with a really superb product; very, very aggressively priced, highly commissioned, and nobody knows the name. We believe that that dog won't hunt. One aspect of the business that I have found particularly troubling is the need to overcome cultural angst within an organization. You talk virtual insurance within a large organization, and people's eyes either glaze over or they start looking over their shoulder. For a company to move into the 21st century, we really have to be able to sell this notion internally. To use a popular metaphor, I don't think it's as bad as trying to change four tires on a moving car on a highway. I think as long as senior management pushes the idea into the doer level of the organization, it can happen. If you put your head in the sand and say, "Just because I told you it's going to be that way, it's going to be that way," it doesn't really work. That is a very critical part of the success paradigm for us.

What does it look like? In chart 5, I want you to focus on everything but what is in the middle circle because everything in the middle circle is what we would offer within the VLO, from starting an organization up, chartering it, licensing it, and providing for capital. Remember, this is our vision for the future. We're starting rather small, and that's with this simplified issue product, which we feel is particularly apropos to the banks. We're not going to get into the distribution game. We will provide everything, or bits and pieces of everything, that appears outside the circle.

The focus is on the control of the insurance customer base (Chart 6). There are two sides, the Web portals and the financial institutions. That is our current thrust as we think about developing future products. Inside the large circle, you'll see Internet-based automatic underwriting, instant issue, automatic Medical Information Bureau (MIB) and motor vehicle records (MVR). That's critical. Without that, we're just doing it the good old-fashioned way, and we're not able to drive out the pricing. You need a good Internet-based management system. The bottom of the graphic really shows what is available out there. If we are a full-service organization, we can go to a potential VLO prospect and offer the whole gamut of products, from the variable annuity, fixed, life, and auto. Today we probably see as competitors out there organizations that have auto and homeowner's insurance already on the Web and are fairly successful at marketing it, much less more on the disability side, and very little currently on the life side. The annuities are moving out there, and now the variable side is going to really pick up some headway.

What are some of the features critical to the virtual insurance company? One is making sure that the customer has a full understanding of what it takes to run a business, and what the legal requirements are for running a life insurance operation. Another is the facility and ability to brand insurance products, and, again, our focus is on the bank market, the simplified issue term. On the drawing board we have a fixed annuity, a whole life, and, a year and a half to two years down the road, a variable portfolio, to include variable life as well as variable annuities. Remember, we don't have to build it. We have to know who is the best provider of that type of technology, and we build a relationship with them and bring them into this consortium. That is the critical path to success as we see it. We want to keep it as paperless as possible.

The bottom section of the graphic is really paperless, from providing company literature, information, policy status, etc. Call center support is another example. I don't believe I can convince my boss to build an expensive call center. There are some very good call centers out there, that are very professional at it. They know how to manage the calls. But we have to know who to build that relationship with. The crux of my whole presentation today is, how do we get it out there as painlessly and as quickly and as profitably as possible?

What do e-buyers want? We believe it's simple and convenient transactions. They want us to make the buying experience pleasurable. I'm stretching it when I say pleasurable because they are, after all, buying a life insurance policy, but we want them to get in there, spend some time, not be overwhelmed by it, and be able to make a decision and click that button that says, yes, charge my credit card. They want us to offer a full compendium of products and services. They want the ability to have packaged products. They should be able to buy life insurance after they buy an auto loan with the money they saved because they got a better deal on their auto loan, they can buy life insurance. Theoretically that's the notion. Quick and easy. And they don't want to get hammered by 15 phone calls from agents

following up. So the pre-sale and the post-sale process should be very smooth and fully integrated.

What do we see as the success factors for the online insurance buying experience? One factor is quality. Right now we believe that we can close a customer in 15-20 minutes through our process and bind online. The loyalty of the customer to the enterprise that has driven them to that Web site becomes very important to that provider, and brand value to cross-sell is a story we hear more and more. The bank has one-and-a-half products per household. They'd like to get that up to three products per household. It's tremendous leverage.

What are we going to start out with? As I said, it's a simplified issue, a term product, Web-enabled, and we have the facility in a bank to make a platform sale. It currently has nine questions, but 60+ reflective questionings underlie that nine-question application. Fifty thousand dollars to \$250 million in face amount, that seems to be okay. The 250 doesn't scare off the banks. Of course, they would like more commissions, higher face amounts, and even fewer questions, but that's not going to work, so that face amount seems to be at an appropriate level. For ages 25 to 55, we offer 10-, 15-, and 20-year fully guaranteed rates. We are in the process of completing Simplified Issue 2. SI 1 was developed for a Web portal, and both organizations agreed that we would just hold off because they ran into some financial difficulties.

As I said earlier, the composition of the product is a little different, particularly from the mortality assumption, going from Web portal to a qualified bank customer. We have just Simplified Issue 1 as our practice product. We didn't burn too much money on it, and now we're in a process of completing the SI 2. We'll be ready to roll this product out in a test market by the end of September 2001. It should be live.

It has to have an end-to-end Web solution. It has to have XML feed into the platform. If we need to bring information in from three other carriers, we have a distributor, and we build term product, and they want to have somebody else's whole life product and another company's universal life product. Our platform envisions handling that type of interface. Automated requirement ordering is a given. We believe that we will get almost instantaneous feedback from the MIB and MVR depending on what state is involved. We're figuring 24 hours. Given the proper response to the nine-question application, we would envision binding at the time of actual completion of those questions, with a caveat that if the information is inaccurate, we probably would disqualify that applicant. On the subject of compensation levels, we have more than one given compensation level that's priced for, and the systems are built that way. And we would be able to give electronic updates continuously back to the distribution network.

The customer is bound online. We will need a wet signature delivered back within 15 days. Clearly we are in a position to handle e-signatures when they are available. The term "minimal underwriting effort" means there is minimal human intervention. The notion behind this project is that it will not work if 40-50 percent of the people who apply have to go through a rigorous human underwriting process. It just will not fly from a price perspective. We have built our expert underwriting system to hopefully weed out most of the bad risks.

What are the customer needs, and what are our solutions to those needs? The customer wants: (1) a simplified sale, a short form application with no fluids, (2) quick transaction closings, (3) immediate online binding, (4) choice—we are in a position to private label and/or bring national names into the equation, and (5) no internal conflict. We believe that the turnkey outsource platform is the proper response.

I talked to a friend of mine who's a product development actuary, and he found our approach very appealing because it would give them an opportunity to pull out of the day-to-day activities this whole mysterious world of e-commerce, which means so many things to so many people. He said you're like a little island within this massive organization. I hadn't thought of it that way, but it works. And it can increase sales support, product, and sales online 24/7, as we go forward.

This was a very quick overview of our vision of the virtual life insurance company. Is anyone doing it today? They're doing bits and pieces. We know it's a good model because the competitive landscape has dramatically increased in the eight or nine months that the Swiss have asked us to pursue this vision, and you have some quality names out there. We believe there's a market for it. Some of the research agencies are showing that the use of the Web will represent up to six to eight percent of potential life sales by the year 2005. That's a huge increase. So, we want to be there on the leading edge.

MR. MCKERNAN: One thing that seems to really come through in these discussions of the virtual insurance company is that it really embellishes quite a bit upon the relationship between the distribution channels and the manufacturers. One question I'd really like to put to both Shane and Ihor is, who do you see as your clients, the traditional manufacturers or the distribution channels in and of themselves?

MR. CHALKE: I think we definitely see the distributor as our client. The biggest lift with this kind of business process shift is on the distribution side, empowering distributors. From the manufacturing side there are cost savings issues, but cost savings are limited. On the distribution side, you're talking about selling more product in a more cohesive manner and, in fact, being able to have a better management and product mix. We look at the distributor as our customer. In our view of the world, this changes nothing about wholesaling. I'm talking about

wholesaling technology, not about the need to vie for usage of your product within any particular distributor. In the annuity market, wholesalers right now are worth so much more than they were a year ago. Typically, wholesalers today, a decent annuity wholesaler will get a \$300,000 guaranteed base salary—40-50 basis points on production, or something like that. It's unbelievable. I don't know where that's going to go. It's not actuarially supportable, I know that.

MR. HRON: I see distribution as the primary customer. If the manufacturer would be the customer, it would be an avoidance of potential channel conflict to go the route that I was talking about. So, indirectly it's also distribution related.

MR. JEFF ROBINSON: What's the regulatory welcome of this model? How did they react to it? You talk about a paperless society. You have to get rid of all the insurance departments before you can have that.

MR. HRON: We haven't put it together in an insurance company, per se. I can't tell you what the broad response is going to be. The problems are going to be from the wet signature going to an e-signature—technical things.

MR. ROBINSON: In some ways this should be better for the regulatory process. There should be less discrimination because machines are essentially making some of the decisions. You should be able to back up all this stuff, so you should have all the information you need. But getting people to change mindsets, particularly in insurance departments, is a whole other thing.

MR. CHALKE: I think it was interesting for us back in '97. In many ways, things were more liberal with respect to e-commerce because the departments were very much willing to experiment with us. I think things have clamped down a little bit since, but the kinds of hoops we'd have to jump through to be electronic primarily revolve around contract delivery. We have probably seven different methods of contract delivery to cover the various states, ranging from: "You're allowed to deliver in a virtual post office box and send a notification, to three states requiring us to send one-way encrypted contracts via e-mail. Some states require different lag times or verification of that.

The other area is licensing, if you want to go direct as an agent. If you have to have a Texas agency in order to do business in Texas. it can't be owned by the company because that's illegal in that state, so you have to get one of your employees to own it and transfer all rights, and you have to have agents, but agents may not ever even talk to anybody or perform any function. So you get into these very Byzantine networking agreements. I'd say that we're really pushing the edges of the regulatory structure, but not in a bad or nefarious way, just in a way that never anticipated this kind of stuff. There's a lot to wade through legally here.

MR. ROBINSON: What do you find the result of it is with regard to the customer? Is the customer in a better-informed position after he or she buys it? Sometimes the customer see an agent, but doesn't know what he or she bought or from whom. But in this situation, maybe it's slower. Maybe customers have a better ability to inquire. Have you looked into that?

MR. CHALKE: I think that it depends on the market. That's a wishy-washy answer, but we have probably more experience selling annuities directly than anybody at this point, and that's after selling a few thousand. These customers are really quite knowledgeable, self-studied, but in a fairly narrow demographic. These are the type of people who study *Consumer Reports* before they buy the Volvo.

MR. ROBINSON: That's not the majority of people. Most people really want recommendations. They want to be empowered, but they want the recommendation from an expert, and I think that the real growth will be in these quasi-direct spaces. Fidelity's a great example in the annuity market. They did something in excess of \$3 billion of annuity premium last year, all on a quasi-direct basis. There's some interface with a human in some fashion in most of it, but it's not a commissioned human. I don't know what you'd call those kind of sales if someone sees something on the Web, they call up the call center, and they talk them through it. Do you call that direct or not? Once you get past term insurance and a small premium a year, you have to get somebody involved to recommend the product.

MR. CHALKE: I think that's so, except for some supplementing part of the market where people are product experts, and there is a market for that, but it's just not very large.

MR. MCKERNAN: I have an additional question, and this would really be more on the cost side of the equation. One thing that comes through with the virtual structure is you would realize a fairly significant cost savings either on the distribution side of the equation or manufacturing side of the equation, and five years from now or even further, to the extent the larger manufacturers are unwilling to accommodate this movement in the industry, do you see that they'd be compelled to outsource these functions in the future or basically die on the vine?

MR. HRON: I'm not even going to attempt to trade off mortality risk versus cost savings. If you're using your marketing hat to ask the question, "Will rates reflect the cost savings?" My answer is, not in a manner that a lot of people would like to see. I think outsourcing is going to become much more prevalent as they that see legacy systems are unable to support efforts in e-commerce.

MR. CHALKE: I think that's true as well. One of the problems with outsourcing, though, is that inherently you have a lot of IT functions that follow a high overhead, low marginal cost model. Any functions that have that kind of cost model are

difficult to outsourcing in part because your marginal cost internally is free, but I think it does happen in specialty markets or when you get backlogged where your marginal cost grows just based on internal inefficiencies. On the distribution side, you mentioned savings in the distribution cost. That's not, I don't think, at all clear right now. I think you get a different kind of customer and better customer reach. You reach customers that maybe can only be reached this way, but I don't know that it's been demonstrated that you can distribute product any cheaper on direct methods than you can on intermediary methods.

Two years ago we gave it a fabulous go on the direct annuity side. We spent about \$8 million on a test advertising campaign. This was back in the days when once you rolled out nationally, you spent \$150 million a year in advertising, and this industry spends an average of \$2,700 to acquire an annuity customer. That sounds like a lot, right? Customer acquisition costs \$2,700. You talk to direct marketing people, and they will say that they can get customers for \$2-300 apiece. Well, the mutual fund industry is somewhere in the \$800 range. The online brokerage market got down into the \$200-250 range, but now it's back up in the \$400-450 range. The best we could ever do was about \$8,000, customer acquisition cost. We have larger contracts than the industry generally gets. Even now in our direct business, our average contract size is something like \$180,000 versus an industry average of \$45,000-50,000, but still that was very disappointing. This is a difficult business. So this is nothing new. Anyone who's been in mass marketing for the past 10-15 years can tell you that it's not necessarily cheaper; it's just a different cost model.

Chart 1

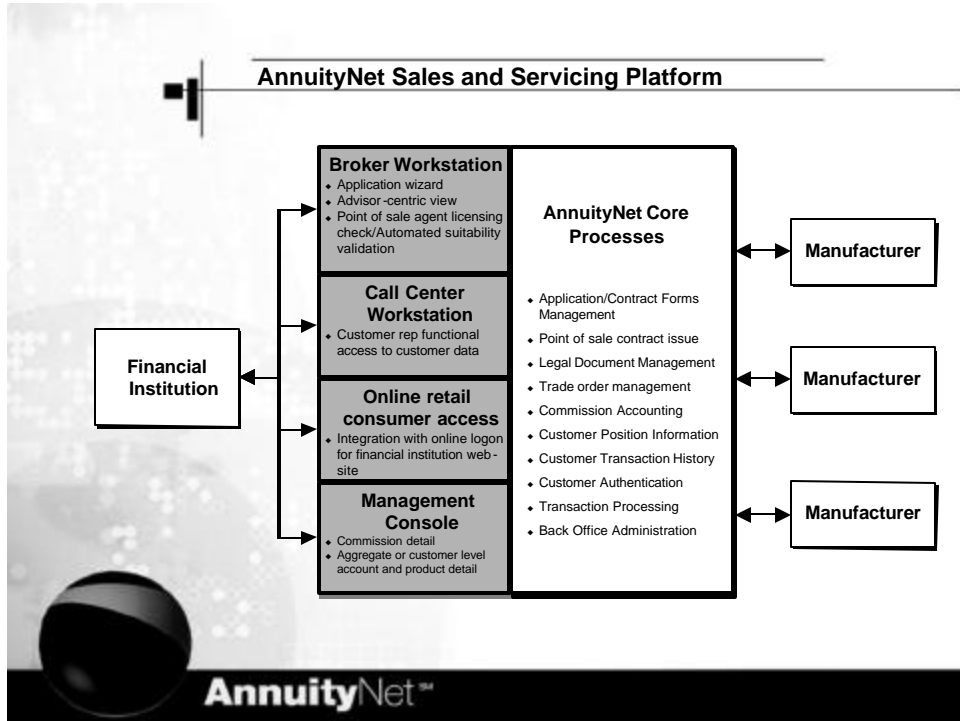


Chart 2

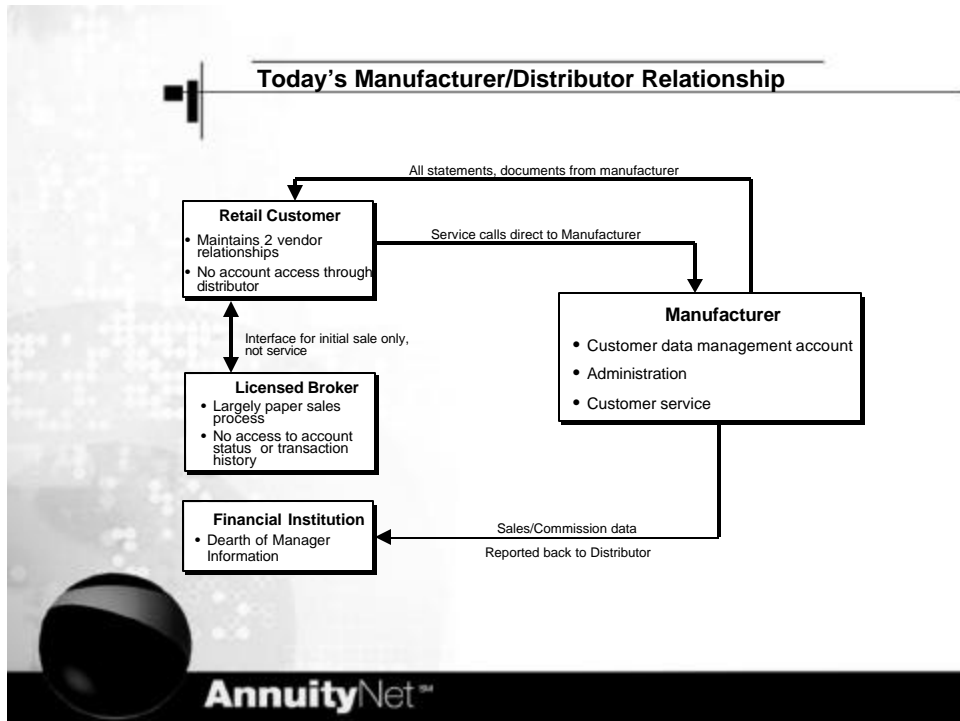


Chart 3

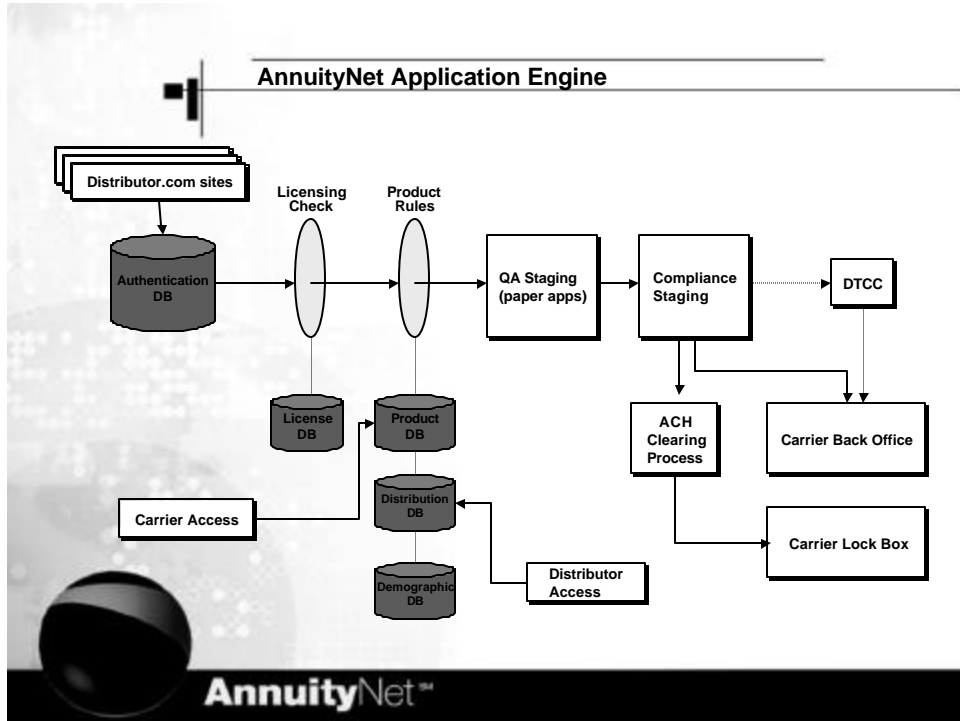


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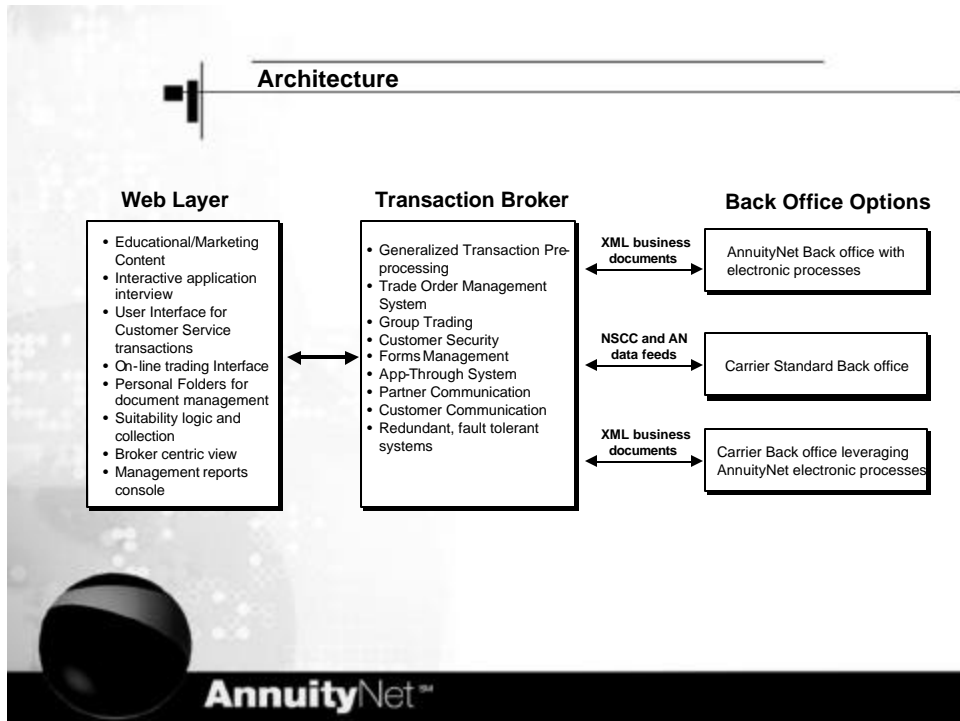


Chart 5

e-Reassure

Virtual Insurance Company: Sample Operations

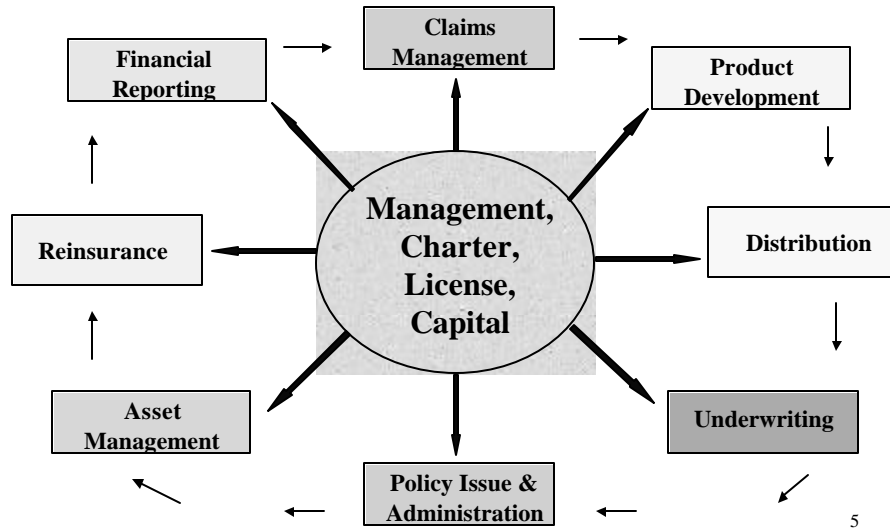


Chart 6

e-Reassure

