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Session 13PD

How Can a Smaller Company Sell Big Company Products?

Track: Smaller Insurance Company

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Summary: Many smaller companies seem to be shut out of selling products because they are unable to develop, administer and sell such products due to their size. Panelists discuss ways in which a smaller company may make "big company products" available to its field force without becoming bigger. Participants learn how they may offer a portfolio that includes products typically offered only by larger companies.

MR. JIM McWILLIAMS: Today's session is called, "How Can a Small Company Sell Big Company Products?" To start, we had better first address the specific questions: "What is a smaller company?" and "What are big company products?" I think everyone is probably comfortable with the definition of a small company. That's not a new concept, but I do want to talk about what a big-company product is and what kind of issues we are considering for the purposes of this presentation.

Most big company products exhibit at least one of three characteristics. The first is high startup costs. A good example of this is a variable product. Variable products require a more complex administrative system than regular products because there are more values and they have to be tracked on a daily basis. Developing or purchasing an administrative system to handle variable products can cost a company a lot of money before it ever gets a premium dollar in the door.

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The second characteristic is expertise. An example is a high-end estate planning product where specific expertise in the area of taxes is required in order to make a product work correctly.

The third characteristic is critical mass. Critical mass is necessary in order to stay competitive and keep per-unit costs low.

Why should small companies even be concerned about offering big company products? It boils down to competition in the industry. Obviously, companies are growing through a combination of internal growth and merger and acquisition activity. Smaller companies must find ways to grow in order to stay competitive in the market. Ultimately, it could mean the difference between smaller companies surviving and not surviving into the future. I think it's important that we take some time to focus on this subject and talk about different ways that the smaller companies can compete with the larger players in the insurance industry.

I completed a little research to find data describing the relative size of small companies and larger companies in the marketplace. I found some interesting statistics in the 2001 Life-Health edition of "Ward's Insurance Results" [a listing of financial data for life and health insurance companies, put out by Cincinnati-based Ward Financial Group].

The top 50 companies, in terms of net admitted assets, control over 70 percent of the entire industry's assets, nearly half of the industry surplus and over 60 percent of the premium volume. Fifty companies, in an industry of over 1,000 companies—we're talking about 5 percent of the companies in total—control nearly three-quarters of the assets, half the surplus and nearly two-thirds of the premium. That leaves 95 percent of the remaining companies in the industry to fight over a relatively small piece of the pie. Only the strongest companies will survive in this type of environment.

I would like to share one other example of insurance company relative size and how that has changed over the last 10 years. If a company had \$12 billion in net admitted assets at the end of 1991, it was in the top 25 of all companies in terms of admitted assets. At the end of 2000, \$12 billion doesn't even get you into the top 50. I think a statistic like this helps reinforce the fact that small companies must remain aware of where they stand within the industry. They must do all they can to stay competitive to avoid becoming so small that they're easily gobbled up by larger insurance companies.

The big company products that we're going to talk about in this session are competitive term products and variable products. For the purposes of this session, we're distinguishing competitive term products from an ordinary term portfolio. Competitive term products are continuously repriced to keep current, and there is intense pressure in the area of per-unit expenses. These two characteristics help distinguish the products we will discuss today from a term portfolio that is not so

closely managed. I also want to mention that there certainly are other big company products in the market, but our session today will focus mainly on these two.

We are also going to discuss ways smaller companies can get help in offering big company products. Some smaller companies are fortunate enough to remain competitive on their own. For companies that are not as fortunate, today we're going to talk about a couple alternatives. In particular, we will discuss the use of TPAs and joint-venture arrangements and how they may help smaller companies offer products they might not otherwise be capable of offering.

I've been lucky enough to recruit three expert speakers for our topic today. I think it's important to have multiple speakers for a topic like this. There is no single answer and there are few easy answers. Therefore, getting insight into different perspectives is crucial. Each presenter will share his experiences and his particular areas of expertise.

Starting us off will be A. Grant Hemphill, a consulting actuary with Van Elsen Consulting Inc. He is also a founder and an early chairperson of the Smaller Insurance Company Section. Prior to working with Van Elsen, his most recent experience was in providing term products to small and large client companies through joint-venture deals. This morning, Mr. Hemphill is going to talk about the theoretical and practical aspects of joint-ventures in the competitive term market.

Following Mr. Hemphill will be Paul Grinvalds. Paul is vice president of life administration with the Iowa Farm Bureau. He's been with the Iowa Farm Bureau group for about 15 years and has played an integral role in the success of its joint-venture business program. Mr. Grinvalds is going to talk about the details of the Iowa Farm Bureau's joint-venture business—how the company developed this niche and how it has been successful at helping other companies offer products they otherwise could not offer.

And last, but certainly not least, will be Edward S. Burns, a senior consultant with Vector Technologies Inc. He has been with Vector for the last six years and works as a programmer and adviser to other programmers on areas such as actuarial programming issues. Mr. Burns is going to give us insight into the perspective of a TPA and some tips on what to do and what not to do if using a TPA is part of your business strategy.

MR. A. GRANT HEMPHILL: We have some real advantages in a small company. It's possible that we should be focused on our advantages and trying to capitalize on those advantages, rather than dealing with big companies on their turf. Maybe we should make them compete with us on the turf where we have an advantage. I'm just guessing that most of you are in a small, specialized niche, where you know your market better than anyone else. I hope you are, in fact.

The title of this presentation implied to me that someone thinks there must be barriers to entry, and that the big company has an easier time dealing with barriers to entry than the small company. I'm supposed to talk about term insurance. What are the barriers to entry into term insurance? We are talking about very competitive term insurance.

The first barriers you might come up against are your field force and your in force. Why does your field force come to you for business? Maybe they come to you because you give really good service. What does that mean to your agent? It may mean he can come in and visit with your underwriter and talk about that case and, once in awhile, get the underwriter to change his mind.

It's also possible that you feel an obligation to your specific niche market. Maybe you deal with banks and they want you to take care of all their customers. Maybe you have a property/casualty affiliate or parent that wants all its members, its policyholders, to be well taken care of. It doesn't want you to do something on the life insurance side that messes up the property/casualty relationship, so you have to treat them very well. Or, you could be involved in some sort of membership group, and you have to provide for your members.

These situations lead you not to underwrite in quite the way the top broker term companies underwrite. You have a different culture or environment for doing your underwriting.

Your in force raises internal replacement questions. If you have a block of in-force term, you have to think about the implications of coming out with a really competitive term product. You also have to think about the implications for the rest of your product portfolio.

There are some other barriers to entry. You must have really low expenses to sell very competitive term. So the first requirement is probably scale. You have product development costs, ongoing product update costs and implementation costs, and you must have enough units over which to spread that cost.

Then you have underwriting culture, and this is a little different from marketing culture. Your underwriter probably thinks that he owes it to a client to find a way to issue that policy at the best rate possible. He may also think that he wants to be a "real professional." And being a "real professional" underwriter means digging into every case and doing a thorough job on it. He may call the reinsurers' underwriters for their opinion, and he may want to talk to a medical director about the policy. He thinks that being professional means being thorough and giving really good service, an example being the providing of a detailed explanation to the agent about his decision. At the top broker companies, being professional means underwriting a lot of applications really quickly and with some accuracy, and that can be a difficult transition.

There are other possible barriers. If you are focused on something other than very competitive term, it will distract from that focus. Second, you may not have the expertise to do it. However, I think that this related to focus. You probably have the expertise yourself to do competitive term, but your area of focus is going to keep you from ever doing it. It's going to pull away the expertise and cause it to be devoted elsewhere. Coming out with one competitive term product does not permanently solve the problem. It suggests that you may be getting into the competitive term business, but there will be questions. Do you need to update in a year or sooner? Do you monitor the market to keep up with what's going on in competitive term?

So, today, we're here to talk about joint ventures, and I see joint ventures solving several of these problems.

FROM THE FLOOR: Isn't whether or not you can make money on competitive term a barrier to entry?

MR. HEMPHILL: I agree with you. Here's an interesting question. And unless you can get every leader in your company to give the same answer, then you're probably not ready. If you're selling 2,000 term policies a year now, and you think you are making a profit, would you be better or worse off if you were selling 6,000 policies a year, and getting the same profit? I mean the same absolute dollars, not three times your current profit. You are selling three times as many policies, more underwriters are doing more work, there is a lot more activity, and no additional profit. Your marketing guys are going to say you're better off. Would everybody else in your company agree with that?

If you were selling something else that was profitable, and now agents sell the low-margin term instead of what they *were* selling, then you're worse off.

So those are the kind of things that you need to weigh. I agree. Thinking through this, in a way, it can be viewed as a barrier to entry. If you don't know the answer to these questions, then you'd better figure it out before you make this commitment.

Now let's consider how a joint venture can solve some of the problems. Concerning the field force, a good cop/bad cop scenario works out fairly well. Those mean, old underwriters at the TPA wouldn't make the exception that the star agent really needed. He needed preferred plus and that underwriter gave standard. Then he went to the home-office underwriter, who was very sympathetic and would have given preferred plus, but the TPA must make this decision. Now, you can overdo that and sour the relationship. But to a certain level, you can use that. It can let you get into competitive term without upsetting the relationship between your underwriters and your field force.

Your underwriting culture needn't change. Your underwriter can go on thinking that being professional means really digging into every case, spending a lot of time on it, being thorough, etc. Your scale problems are solved because those fixed costs are, for the most part, converted into variable costs.

You don't need to change your focus. That doesn't mean you can ignore this new term thing, but you don't need to focus on it. You can stay focused on what you were doing. You're getting outside expertise, and you have a much lower commitment going forward. That TPA, or the outside helper, is going to, for the most part, do those regular updates and have most of the expense of keeping you up-to-date.

However, I don't see a panacea here. To a great extent, you have traded a certain number of problems that you didn't know how to overcome for a different set of problems. The first new problem is the degree of flexibility. Your company has the way it's always done things, and the TPA has a list of options that it knows how to provide. As you go down the list, going through all the parts of administration, you're going to find a lot of overlap. For 90 percent of it, the TPA can do things the way you've always done it, so you're in good shape. Now, you're down to the other 10 percent. If neither party is willing to compromise, you should probably quit early on. You can't hope to do things the way you've always done them, and the TPA has to be willing to do things outside-the-box from the way they normally do things.

We are talking about low cost. You have to keep your expenses down. You cannot afford to pay the outside resource to do this work, and then have people in your own company duplicating that work. But there are some people in your company who will insist on it. It might even be the actuary, who thinks, "Well, the easiest way for me to get all the reports the way I need them is to run that business through my valuation system." So the outsider will run the reserves, and then you run your own reserves. The more you create redundant processes, the more you will exceed your desired expense levels.

When you set up a joint venture, it needs a champion. I'm talking about the small company getting a product from the outside. It is best if this champion is in charge, but at least he or she should be an advocate. He or she likes this joint-venture thing and is going to keep reminding people why it was done, why it's good, why it's helping the company and so on. You need a champion with those characteristics.

There will be detractors in the company receiving this product who will feel threatened by the joint venture. If the outsider is doing the underwriting, then your own underwriter has lost work. Maybe your actuary will feel threatened.

The champion will help deal with that. I have never seen a situation where the champion had trouble at the beginning. But a year or two later, that initial champion often gets promoted, or goes to work somewhere else, and now a new

person is in charge and has to deal with the relationship. I have seen cases in which the new person was actually a detractor of the joint venture, but seemed like an expert because he was always talking about it.

One of the biggest problems is setting up the integration of the two companies. You have to get all your systems working together. You have to get all your people working together. It's a lot of work. You can't just say, "We're going to outsource all the work," because there is a lot of work you have to do on your own. It's possible that here I should have used the word "interface." That's what your systems people will want to call it.

Another problem is a poorly structured deal. I have a lot to say about this topic. I like looking at deals and seeing how companies work together. There is a variety of relationships. You can get a reinsurer to provide a product for you for free. Well, in a way, it's free; in a way, it's not free. You need to figure out how much you lost in allowances, and how much business you're going to write and that sort of thing. But, nonetheless, you've kept it out of your budget, so it may look like it was free.

You can outsource only the systems work or only the underwriting. You could do in-house brokerage, which is, maybe, the least disruptive thing for your company. Your company becomes a broker and your agent contracts with you to sell that other company's product. It's on their paper. One concern that you will have is that your agents develop relationships with that other company, so you need to weigh the costs of that. But what we really want to talk about today is outsourcing the whole product.

Consider a profit study for a product and how you might split profits with the other party in your joint venture. How will you share your profits? Profits can be measured in a variety of ways, but it will boil down to calculating annual profit results and discounting them. Now you're going to split up that value, so some part of each year's cash flow will be passed on to the other company.

There's an amazing thing that happens. If you pass some cash flow off to the other party and it earns the same internal rate of return (IRR) that you expect for the product as a whole, then what's left behind in your company will still earn that same IRR. I think that looking at it in this way is extremely helpful. If you want to prove that this is true to yourself, you need to look at things like factoring polynomials and the fact that the IRR is the root for the polynomial. This should make it very easy to find a reasonable deal for splitting the business between the two companies.

FROM THE FLOOR: But the IRR is a rate. It's not an absolute number.

MR. HEMPHILL: Yes, but IRR is one of the most common profit objectives. Certainly the total profit for each company is reduced by sharing.

It should be extremely easy to make a deal that works, but it isn't. Here are ways I have seen deals constructed. Some deals are divided up by sources of profit, or earnings. So one company might take the mortality result and be responsible for that. The other takes the expenses and investment returns and is responsible for that.

It could be also be split functionally. The party responsible for certain administrative functions may receive the expense in the profit study for those functions. Another way to do this is strictly proportional; try to divide up everything. So, going in, you decide 70/30 or 50/50 or some kind of split, and then split everything—the premiums, the commissions, the reserves, the expenses and the claims. That's the one I advocate.

The first big advantage is that you've set up win–win and lose–lose. You're either both going to make money doing this or both going to lose money. If it's on competitive term, you're either both going to make a little bit of money, or there's a downside risk to sharing, too. But, at least, you're going to share it. I think nothing will hurt the relationship more than if, a year or two into it, you realize one company is making big profits and the other company is losing a lot of money.

FROM THE FLOOR: How do you split the expenses? There are two companies. You're going to have different expense considerations. Do we work out our costs and then split that?

MR. HEMPHILL: Yes, one company should do the work for the unit costs and receive payment from the other for the other company's share.

Joint ventures have been studied extensively by a certain group of microeconomists, namely agricultural microeconomists. They have a tremendous amount of data on joint ventures because the sharecropper, or the tenant farmer, has been in existence for millennia. They have data on such joint ventures for several centuries from all over the world.

Now, this should alarm you. The joint-venture farm is not as productive as the farm across the road that has a single owner-operator. They have extensive data proving that. Basically, here's what the tenant farm deal is: One guy owns the land and someone else comes in and does the farming work, and, at the end of the season, they share the crop. They split it. So the landowner is responsible for the land, the fence, the barn, the access road and other capital items. The other guy comes in and does the work. He's responsible for the tractor, the plow, the gasoline, all those chemicals they use and the seed. You can imagine that somehow there must be a way to split the crop that's fair for both of them. That's the way it's worked for centuries all over the world, but the work from that joint venture is not as productive as the single owner-operator farm. The economists think they know why.

Imagine that the word is out down at the coffeehouse where the farmers meet that a certain pest has invaded the state, and it's approaching their county. This pest is going to do some damage to the crops. They are all trying to estimate how much it is going to reduce their own yield in the field. They all know the costs of going back into the field and putting down another layer of chemical that will protect the crop, and they are all trying to make a decision. Should they put down more pesticide or just wait and see how much damage this pest actually does?

Every farmer should be a rational actor. He looks at the marginal benefit that he's going to get from that application, and he looks at the marginal cost. That tenant farmer has the same marginal cost in applying the chemical as does the farmer across the road who owns his field. But the farmer across the road gets the full increase in the yield. The tenant farmer only gets his share of the increase in the yield. Same cost, but a lower yield. So he is less likely to make the decision to put down another application of pesticide, fertilizer or whatever. On that basis, those farms are less productive.

You can see a situation like that outside of our own industry and think that those guys aren't very smart. They ought to restructure the deal. The economists say it is simple to correct: Just share everything proportionally. When the tenant farmer decides to put down more chemical, the landowner is going to share the cost of the chemical in proportion to his share of the crop. Then the two farms would be equally productive.

It's exactly the same situation when your underwriter is deciding whether or not to order an extra test. "It's expensive, but on this case, I'm really not comfortable," she thinks. "Maybe I should order this extra test and see if this guy has some disease I'm concerned about." If you've ceded off 90 percent of the risk, then that underwriter knows she's got the full cost, but she's only going to get the benefit on 10 percent of the risk. If she has retained all the risk, she's much more likely to order it, if she's a rational actor. It's the same situation as the tenant farmer.

I don't know if you've noticed it, but underwriters are currently going through a flurry of training and communication with your reinsurers because of first-dollar coinsurance. Reinsurers say we need to communicate more. We need to work together more. From the microeconomic view, they're trying to train your underwriter to act irrationally and order lots of tests for their benefit.

I've read a lot about strategic alliances and joint ventures. You might find that a boring thing to read about, but it is sometimes interesting. As you go through this literature, the marriage analogy will come up over and over. There are many articles written about it. There's the honeymoon period, when either company will make mistakes but they forgive each other. Then there are the little things that irritate you, but that you live with for a while. Eventually, it becomes really irritating and adds to the strain when other problems arise.

Here's one possibly useful marriage analogy. Are you getting into this for a long-term or a short-term relationship? I have seen people try to get into a joint-venture relationship to solve a temporary problem. You have the resources to come out with a product in two years, but you don't have the resources to introduce it now. So maybe you go to this joint-venture relationship, just to get the product for a few years to see if it sells.

Personally, I think this is hard. There's more work setting this up and getting it to work than you are going to be able to recover in two years. If you are going into it for two years, don't ask the administrator providing the service or product to make any exceptions. Just be willing to take something it has on the shelf. That could work out reasonably well for both companies on a short-term basis in some situations.

When I was going through my farmer analogy, I was thinking a lot about the rational actor and the next required activity. I really think you should try to set up a deal so that every activity that's expected of either company is compensated at the time the activity takes place in a way that makes sense. That way, when a company is expected to do something, it realizes that the marginal benefit will exceed the marginal cost.

Your marketers won't always like that. Or maybe *their* marketers won't like that. It's easier to try to sell something by telling the customer that they get things for free. However, we know someday everything has to be paid for. You may get some free benefit early on, but, at some later time, you must do some work for which you're not compensated. Then you will be wondering why you are doing that, and it's going to start souring the relationship.

I think it is better to keep things at a level where you're compensated for what you're doing at the time that you do it. And one way to do that is to keep things proportional. If you're splitting everything proportionally, then it will make good economic sense for you to do the next piece of the work that makes the relationship keep going.

MR. PAUL GRINVALDS: I want to address the question of how a smaller company is able to sell big company products in two parts. First, I want to talk about how we, as a smaller company, are able to have big company products. And, second, I want to talk about how we are able to sell those products successfully through joint ventures.

Before I start telling the secrets of how we were able to do it, I have to give you the obligatory background to set the stage. First, I will define who we are. Second, I'll talk about what our big company products are. And, third, I'll talk about what we consider to be successful regarding joint ventures.

Farm Bureau Life Insurance Company is based in Iowa. We are in 15 Midwestern states and have \$4 billion in assets. And we have a captive agency force, which is a relevant fact that I'll get into later. We also own EquiTrust Life Insurance Company, which was started up about four years ago. It's a subsidiary of Farm Bureau Life and was specifically set up to be a carrier for joint ventures. Its products are available in 44 states, and increasing, and it has about \$1 billion in assets.

Our big company products are our variable products. We introduced variable universal life (VUL) in 1990. We started selling variable annuities in 1994. Last-survivor VUL was introduced in 2000. We also now have variable settlement options attached to variable annuities.

These are the joint ventures that we've done: American Equity Insurance Co.; Berthel Fisher & Co.; Country Financial; Farm Bureau of Missouri; Kansas Farm Bureau Life, which we have now merged into Farm Bureau Life, so that company no longer exists; Modern Woodmen of America; National Travelers Life Co.; Southern Farm Bureau Life Insurance Co.; and United Farm Family.

I'll talk more about the variable products, but first I want to talk about keys to how Farm Bureau Life was able to have variable products. To do that, I have to go back in time because the foundation was laid in the 1970s when we decided to get into the mutual fund business. By starting these funds, we laid the foundation that gave us a head start when we decided to come out with VUL.

First, because we had these funds, we had registered representatives in place already. When we introduced the mutual funds, we actively encouraged agencies to become licensed. Once we came out with VUL, all new representatives of Farm Bureau Life were required to become licensed. So a very high percentage of our agents were already registered representatives.

Second, we already had a broker/dealer established for the mutual funds, so we did not have the added expense nor did we have to take extra time to establish a broker/dealer for VUL. Plus, it gave us an understanding of the broker/dealer operating and compliance issues.

By having mutual fund plans in place, we also developed variable product expertise. This includes not only things like how to deal with the SEC and the National Association of Securities Dealers, but we already had the professionals in place who were managing our retail mutual funds. We didn't have to add additional portfolio managers.

Another thing that helped in developing our own product was that we used our existing systems infrastructure. So, we saved the cost of buying and installing a new system.

We were a fairly early entrant in the VUL market. We started in the mid-1980s. This gave us the advantage of having plenty of time to implement our product. We weren't under pressure from our sales force to come out with variable products, so we did not have to develop our products quickly. This allowed us to spread the implementation costs over several years, as well as develop the additional internal expertise we needed to become a variable insurance products carrier.

As I mentioned, we have a captive agency force and that helped in a couple of ways. When we introduced VUL in 1990, the bull market had already started but variable products were not yet in huge demand, at least not in our market, which is more middle-income. But, because of the control we had over our field force, we could work with them to emphasize VUL and allow the product to get a foothold in our market, which we thought was important strategically. If we had introduced the product to an independent field force that then decided not to sell it, that could have been the end of the product, and the entire investment would have been down the drain.

Companies kept coming out with new features, and they keep designing different variations of features. With a captive agency force, you have a very constant number of agents selling for you. A new feature will not give you a big spike in sales, and the lack of a feature does not cause a big decrease in sales, either. So, although we have added a lot of features, we've done so slowly. When you do it slowly, you don't need to have consultants develop a product; and you don't need to have consultants to do your systems work. Plus, as you watch other companies develop several iterations, you can wait until the feature has reached a mature state, and then introduce the version that you think is best.

Another thing that was probably important was strategic focus. When we were developing a VUL, it was *the* project at the company for a number of years. We had dedicated members of top management that championed variable products as the product of the future. This wasn't done as an agent accommodation, which might have been taken as a distraction from people's day-to-day activities. It was the top priority of those members of top management. When senior management gets involved in a project, it has a higher likelihood of success.

The good news so far is, now you know how we, as a smaller company, are able to offer big company products. However the bad news is that, unless you have a time machine, you can't replicate what we started 30 years ago. Also, our ability to offer variable products depended on specific attributes of our company that are not common to all companies.

Now I'm going to go onto joint ventures, and how we were able to do those. Before I talk about the keys to success, I want to talk about the nature of the deals and how we did them.

We offer start-to-finish service, meaning that we do the product pricing, the product filing, write and file the prospectus and develop systems administrative capabilities. We'll provide policy information through the Internet, develop the marketing materials, train the field force and so on. About the only thing a partner is going to have to do, to the extent it wants to, is to modify its systems to integrate with ours. It also has to get its field force ready to sell, which mostly involves getting them registered.

FROM THE FLOOR: But does the other company have to set up a separate account?

MR. GRINVALDS: Not when it's on EquiTrust paper. How much a company wants to be involved in implementation is pretty much up to it.

The start-to-finish philosophy also carried over to the selling phase. We are set up to perform all administrative functions, from taking the application all the way to paying claims. All the partners now have to do is provide the field force, and we take care of the rest. These arrangements were designed to be as simple as possible for the partner company.

Some of the deals were on EquiTrust paper and some of the deals were on the partner company's paper. In both cases, marketing materials were developed to have the look and feel of the partner company, so that it would look like one of its own products. We did this because we were willing to de-emphasize the EquiTrust brand so that the product would have more of a buy-in from the partner company.

These are the keys to success for joint ventures. The main reason we were able to have all these deals was the low cost of entry. The intent was not to be a loss leader. We went into this with a "build once/use many" philosophy with our infrastructure. We thought that if we got the first one on our system, the next one would be a lot cheaper. We thought, "We'll have a little upfront pain, but we'll get more partners in." We got more partners in, but it ended up that the incremental cost of each deal was not quite what we had hoped for.

The second key was fast implementation, relative to what the partners could have done for themselves. This was especially true when we used EquiTrust paper. For EquiTrust, the prospectus was already filed and the product was ready. All that had to be done was get marketing materials ready and the system interfaces built.

The third key was the modified coinsurance agreements we had. With many joint ventures, a company basically gets a cut of the commission. The deal is done as if the partner company were an agency. With our approach, it's a reinsurance arrangement. We split the premiums so both companies get top-line growth; and we split the risks and profits, so both companies also get bottom-line growth. The way these were developed was to structure the economics of the deal so that both

companies had an equal share in the results. That way both companies would be committed to making the venture successful.

The Farm Bureau identity was another key to our success. If you are familiar with the Farm Bureau network of companies, you probably noticed Farm Bureau companies show up frequently on the list of joint ventures we have.

As a Farm Bureau company, we have longstanding relationships with other Farm Bureaus. When I say relationships, I don't mean legal ownership or affiliation in any sense. All the companies are independent. But the Farm Bureau actuaries get together, the Farm Bureau accountants get together and so forth. We know each other pretty well. And early on, before we had a track record, it was important that the partner company trusted that we could actually get on the street in time with variable products.

Now we have a track record of successful implementations. All the deals have been ready to go by the partner company's deadline. In most cases, we were actually ready before the partner company. A proven track record helps open doors.

We also did this at the right time. We started doing this in late 1997. At the time, the stock market was in the middle of a great bull run. Companies that would not have considered variable products a year or two prior to that time were hearing from their field forces that they were losing sales to companies with variable products. That made our proposal to these companies appear to be more attractive.

With the stock market booming, the companies that did have variable products generally were showing good premium growth. Many of the companies that did not were slowing down. Many companies we visited had heard the same message from A.M. Best: "You need to grow your business." Since there is top-line growth with our deal, it solved some problems.

Company selection also came into play. The companies we were targeting were similar to us, in that they had career agency forces that were not already selling variable products. Many bigger companies either already had variable products or they had more of a broker-type distribution system. This selection criteria resulted in us targeting smaller companies that many bigger companies would not consider for scale reasons.

As when we were doing our own variable products, focus was key. We started an administrative department within our company with the sole function of administering these deals. So again, it was not a distraction from a day-to-day job. Each partner company had a group of people that would have a weekly conference call to discuss the issues that were going on.

These groups involved all the main areas of the company, so whenever decisions were made, all the areas knew about it and decisions were implemented correctly.

Again, just like when we were doing our own variable products, putting a deal on the street was a main project at the company, so it wasn't a distraction from the day-to-day work.

That's one way smaller companies are able to sell big company products.

MR. EDWARD S. BURNS: I thought it would be appropriate to take a few moments to make some remarks about the company I'm with as well as a little bit about my background.

I've been with Vector Technologies Inc. for the past six years. Vector is a software company that supports and licenses a policy administration system for both life policies and annuity business. Vector also offers a service called Vive-Life, which is basically an outsourcing service. With Vive-Life, we like to say that our front office is your back office, or something to that effect.

Vector supports a wide variety of products. And some of the big company products that have been mentioned are supported by Vector systems. I'm not going to say that Vector supports all types of products. There are some products that would require modifications to the system.

One of the reasons I was asked to participate in this panel discussion was because Vector deals with both big companies and small companies. We have a couple of clients that are running well over 1 million policies on our system. But we also support a company that's running as few as 13,000 policies. Right now we're doing some work with a fraternal company that has about 60,000–70,000 policies.

Most of my experience has been in the systems area, so the perspective you're getting from me is from someone sitting at the IT desk. I will add that I did spend eight years in the actuarial department of a mutual company. Among various financial reporting responsibilities, my primary actuarial department responsibility was revising dividend scales annually.

When I saw this question from my perspective, I immediately changed it somewhat and thought to myself, "Really, it is a question of how smaller companies offer big company products at an acceptable cost." How can we do this so it's affordable? When I think of affordable, I think, "You want the product to make money." That's what immediately comes to my mind.

However, not too long ago, I was having lunch with a former chief financial officer (CFO). Before he assumed the CFO role of an insurance company, he was its chief actuary. He brought up a good point. Sometimes you want to have a product in order to satisfy a particular audience in your company. That audience might be the company president. Often he is under pressure from someone in the field force to provide this product. In this situation, you may put up a product from which you don't expect to make a lot of money, but at least you don't want to lose your shirt.

My actuarial experience leads me to translate costs. I told you that I worked with dividends. I tend to translate costs into per-policy costs. I think in terms of what's an acceptable level of expense and naturally translate it into an acceptable per-policy cost. And this implies a couple of things. First, there is a numerator and denominator component to that per-policy cost. From an IT perspective, the per-policy cost is what you tend to be concerned about. You can't really control the mass, the volume. You just know what the cost of trying to support that product will be.

So I think in terms of the initial cost. What is it going to take to get that product up on the system, and what is it going to take to maintain that product over a number of years?

Whenever I think of cost, especially with policyholder administration, I think of the risk involved. In my early years, I was doing some consulting work for a small company, and I remember meeting with a number of people at the company, including the actuary, who had been responsible for pricing this new product, and the treasurer. My purpose was to help make the modifications and the necessary system changes to support this new product, which happened to be a universal life (UL) product.

During the course of that meeting, the treasurer made a comment about how much he estimated it was costing the company per-policy to administer this particular product. I don't remember the exact response of the actuary, but it was to the effect of, "Oh my goodness, I only priced at about half that level."

That particular meeting made a real impression on me then, because I began to realize that there is a risk in estimating the cost of administering products, especially a newer product. At the time, UL was a newer product. You have the risks of the initial investment. What is it going to take to get that product up on your system? You also have the risk of what it's going to take to continue to administer that product.

I propose that a way to manage that risk is to consider outsourcing, and consider it early on in your planning. Outsourcing, in a sense, is a type of joint venture.

I was talking to an actuary recently about this concept of using outsourcing to help manage costs, and he made what I thought was a very good point, one I recognized while working with dividends: Much of your cost problems have to do with overhead allocation. And I am not sure outsourcing addresses that issue, at least in the short-term. I believe that outsourcing can help you manage a lot of your administration costs, but I have to admit that outsourcing may not help with this issue of overhead allocation, at least in the immediate term.

But I do think there are some overhead issues to be seriously considered. If you take a look at the way we structure our contracts for outsourcing, there is a

minimum monthly charge. So, even if you just have one policy on the books, it's going to cost a minimum amount. Of course, you have that same problem if you do the thing in-house.

I worked with a company that had a product that it thought was going to be very popular. I think it ended up selling about 100 policies. It was a difficult policy to administer. There were too few to justify putting it on the system, so the company ended up doing it manually. It tried to get the policyholders to surrender it for something else, but there are always a few diehards who refuse to give up a policy, and you are stuck with it. So you're going to be faced with that dilemma, whether you outsource or keep something in-house.

Generally, we collect a certain amount per-policy per-month. Our charge actually decreases as volume grows. Typically, our contract is going to be for three to five years, so at least you've locked yourself into a certain cost structure for a period of time.

Another point I'd like to make is that all of this is negotiable. Going into an agreement, you can haggle over these things and negotiate a cost structure that might better meet your needs.

So I propose that one benefit of outsourcing is to help manage your administration cost. I think that this would give you a certain confidence level as to what your per-policy costs were going to be during the pricing stage.

If possible, you should consider outsourcing early. Why do you want to do that? It may influence your product design and pricing. If you consider it early and understand what systems are available, it may reduce the need for expensive modifications.

My next topic will be conversion. If you can implement a new product on one system and avoid a conversion, you are much better off. Conversions are costly.

It may sound like it's the tail wagging the dog, but I had an interesting conversation with another consulting actuary just recently that shows how considering outsourcing early may really help. This actuary came to us with a new product idea. His client company was too busy to implement the product. He said the data processing department was too busy with other projects, so he approached us with the product.

Then we took a look at the design. He thought he had a unique idea there, and he did. One of our best people looked at his preliminary design. He gave it some thought and came back to me and said, "I think there's going to be a modification necessary for this particular feature of the product, and it's going to cost about \$20,000."

I went to the actuary and said, "It looks like it will slip in, except for this one modification." The actuary and said, " I can change *the policy form*. That's not a key aspect of the policy. We don't have to do it that way." I said, "Great, we've just dropped \$20,000 off the cost of implementing this product." He'll change his policy form and we'll implement it without this modification. It wasn't essential to the feature of his product. That's why I emphasize that you should consider your systems very early in the process.

The third point I'd like to addresses is timing. It goes back to what that actuary mentioned to me. His department did not want to go through the effort to get this product up and running any time soon. He was hoping to get the product up and running by the fourth quarter of this year, because he had a producer that was very interested in this product. It had to do with tax planning, and he wanted that product available by fourth quarter.

So outsourcing may be a timing issue, besides helping to manage your cost. In summary, outsourcing may help you control your cost. It may help you manage that initial investment. And, it may help you get that product to market sooner.

Now, I am sure there are some concerns about outsourcing, and you probably have those concerns or have read about them. You lose control of the data. You lose control of the service. What happens after that initial three- or five-year period? Does the outsource provider have you over a barrel? You need to address those issues in your contract provisions. Again, I made the point that these things are negotiable. Go in with these things in mind. We are willing to discuss these issues, and I'm sure any outsource provider would be, especially if it is serious about your business.

I would also like to make a point about disaster recovery. Disaster recovery is always an issue regarding your data and the security of your data. At Vector we have to be just as concerned about disaster recovery for our own purposes. We have an investment in software and files, and we have to make sure that if anything happens in our shop, we can restore those files. So our experience with disaster recovery can benefit you.

The other aspect I want to mention is the system license. You may want to get out of the outsourcing arrangement and bring the system in-house. If so, make it part of your contract that you can license that system. Maybe even negotiate the costs of what that license will be. Be alert to what the hardware requirements are going to be and how easy or difficult it may be to maintain the software if you do bring it in-house.

A final point I'd like to make is that, if you're dealing with a serious outsource provider, it wants you to succeed. If you are adding policies to the system, it means more revenue for the outsource provider, at least it does for us. Not only do we

want to see business being added to the system, we do not want to see it lapse. Not only does that help our revenue, but also our reputation.

We are in a situation right now where we are talking to a company that is looking at us as a possible outsourcing service. A representative came to me and said, "I want to know whom else you're doing this for. I want to talk to them." I made sure I got him that Web site address so that he could contact that company.

In the back of my mind, I know he is going to be talking to this company, and what they have to say about us impacts us. So I want to make sure that what we did for the company made everyone happy. We are motivated to make the business a success.

If you consider outsourcing as a way of controlling your costs and getting into business early, with the right kind of negotiation and the right kind of outsource agreement, I think you can have an effective partner.

MR. McWILLIAMS: I'd like to open it up for questions. Mr. Burns, I have a question for you. You discussed system modifications and the expense of those modifications. You work for a business that provides an outsourcing service to multiple companies. Have you ever seen a situation where a system modification was needed for a certain product, and more than one company was interested in that modification, so you came up with a way for those companies to share the cost?

MR. BURNS: Well, that's a good point and that's a very possible situation. We haven't run into that yet, but, in a sense, you do benefit from the fact that things we do for one particular company, or the knowledge we have for one particular company, as far as how to implement a feature, may be a benefit to other companies. So you do have that situation where features that we add to the system or make a part of our base become available to other sources. In addition, that's the type of thing that can be negotiable. If you have a unique feature and feel that it could be sold to other people, you could negotiate sharing the costs. Sometimes, though, you want to keep unique features to yourself.

MR. McWILLIAMS: If the companies were interested in doing something like that, would it be up to them to get together on their own and come to you with a proposal?

MR. BURNS: No, we would probably try to structure that. We would probably be the impetus for trying to do something like that.

MR. JEFFREY ROBINSON: One issue that you really haven't addressed is regulation. All the products you have discussed are heavily regulated. With term products, you have all kinds of considerations. How do you handle that? How does the receiving company work with that regulation for its particular state and

situation? Most of my clients come out of New York and, of course, that's a heavily regulated state.

MR. BURNS: First, it depends on the company. Some of them have their own broker/dealers, and then they're responsible for monitoring their own field force for the compliance and so forth. We also have a broker limited-liability company that they can join, where we do all the broker's work and the company has, essentially, its own line of business within that brokerage, and that's where the commissions flow. The broker/dealer pays commissions. When we do that, the company doesn't need the expertise at all for the broker-type deals. We do all the compliance work for them.

MR. ROBINSON: But what about GAAP and statutory regulations and tax and all of that? I mean, certainly in variable, the broker/dealer is an issue, but if you have 100 policies, the good news is you sold some; the bad news is you sold some. Particularly for a smaller company, handling the regulations behind this is one of the big issues. Does anyone on the panel follow GAAP?

MR. GRINVALDS: We do. Most of the companies that we partner with do not. But even if they did, on a quarterly basis, we have a settlement report. Of course, they all have the statutory statement to deal with. We essentially just give them the numbers, and all they have to do is plug them into their blue books. The premium, and how it affects everything else, is all right there to plug in, so that's not an issue for them.

MR. HEMPHILL: At my former company, where we did term joint venturing, we had some New York clients. I think, after the first one, we realized we had significantly undercharged them for the support we gave them. Product filings were the main headache that I had to deal with. Some of the actuarial work was left to the client company's actuary. I did not want to be their illustration actuary. But I provided all the tests that I did for our company on that product, so they could do whatever they wanted with that. I gave them the testing that showed that it passed.

MR. ROBINSON: And you provided all the reserve factors, GAAP, statutory regulations, and XXX?

MR. HEMPHILL: Yes, we provided everything they needed to file with their states. We provided sets of factors. We provided the reserve runs. Some clients used our reserve runs. There were some that used our factors on their system and ran their own reserves. There were a few that had these "calculate-on-the-fly" systems. Their reserving was independent of us. We provided our own GAAP factors for a few clients, which were probably not quite appropriate, but it was up to them to make that decision.

FROM THE FLOOR: My concern is, once you have a product, the regulatory requirements do not go away, and the states require a lot. The states, the auditors, the SEC all require a lot of information and those situations are changing. Regulation is changing quite a bit. Now, that might be an advantage, because the partner, if it has a few other partners, has to keep up with that. But that's part of your maintenance cost.

MR. HEMPHILL: I think we provided very excellent X-factor support for our client companies, and that was provided using the help of our reinsurers.

MR. McWILLIAMS: I think one of the messages there is not to rush into the deal. Take time to think through all the different reporting requirements, etc., and try to address them up front. Leave some kind of clause in the contract to negotiate new or overlooked requirements in the future. You hope to have a good working relationship where future requests do not cause major problems. However, it's possible for the relationship to sour, especially if you get in the situation where one company is making money and the other is not. At that point, amending the agreement can be an unusually difficult process.

I have one other question for Mr. Grinvalds. In your presentation, you discussed joint-venture business. This often includes complete start-to-finish service. Is that something that Farm Bureau prefers to do, or is it a requirement for all clients? Do you ever have a client that says, "Hey, I want to do my own claims processing. I think I can do it better and/or cheaper than you."

MR. GRINVALDS: We prefer to do everything both in implementation and sales/service. The way we have our expense factors structured, it assumes we'll do everything. And to the extent that they want to be involved in implementation, it means they're going to want to do things more *their* way than our way. And that's going to complicate the deal and make it take longer to get up and running, be more expensive and so forth. So, to the extent that they just let us do everything, the deals are easier to implement.

FROM THE FLOOR: You keep control that way, too, right? Because you're doing everything, you know what's going on, and it's, generally, easier.

MR. GRINVALDS: Right, exactly. We would prefer to do everything.

MR. McWILLIAMS: Any other questions?

MR. LEROY PRUITT: At Farm Bureau, for your client company, what sort of production requirements do you have for your variable products?

MR. GRINVALDS: It's not so much a production requirement. We have expense charges, based on the number of policies issued, and face amount, and so forth. We also have minimum monthly fees, so that, if what they generate through the

policy activity doesn't get up to that monthly fee, then they pay a supplemental charge.

MR. PRUITT: So, essentially, you're conglomerating all your clients to meet the cost of building that infrastructure.

MR. GRINVALDS: Yes, that's the idea. With a captive agency force, it might give us an advantage in some ways, but it's hard to grow fast and reach critical mass. So our impetus in doing it this way was to get a lot of companies together to help grow critical mass for us as a company.

MR. PRUITT: I have one follow-up question on that. Dealing with a group of small companies, what sort of average production do you get from those companies?

MR. GRINVALDS: For a lot of them, it's pretty small. A lot of these companies, especially the Farm Bureau companies, didn't have variable products, and so that was a whole new market. Many of them were just getting started with variable products when the market tanked in 2000. So their first experience with this was, "Now I've got to go back to farmer Brown and tell him that the \$10,000 he gave us is now \$5,000." So we started moving up and then the stock market crash really kind of put a hitch in it. I think we're starting to recover from that now, but it's been very small so far.

MR. McWILLIAMS: OK, we are out of time. Thanks to the panel for putting in the time and effort to present and to the audience for attending our session.