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Session 59 OF
Life Insurance and Annuities: Is It Possible to Satisfy Your Distributors and Still Make Money?

Track: Product Development

Moderator: Abraham S. Gootzeit

Panelists: Matthew R. Coleman
Arnold D. Henkel†
Anne M. Katcher

Summary: The life insurance and annuity marketplace has become increasingly competitive. At the same time, distributors are exerting more clout. Product development actuaries are experiencing difficulty in designing profitable products that are saleable. Hear industry leaders discuss their perspectives from the view of the product development actuary, distribution channels and company management.

MR. ABRAHAM S. GOOTZEIT: Welcome to Session 59. We have terrific panelists, and they've put a lot of effort into this. Let me introduce them.

First we have Arnie Henkel. Arnie is a senior vice president of individual distribution at AmeritasAcacia in Lincoln, Neb. He has been with Ameritas for six years. He was previously a senior vice president of retirement plans. Before joining Ameritas he was a general agent with Century Company, so he knows what it's like to be in the market selling the stuff. He later joined the home office as vice president of advanced markets. He also worked for Ministers Life in Minneapolis, where he held the position of executive vice president of marketing and individual operations. Before that Arnie earned his membership in the Million Dollar Round Table (MDRT)

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while with Minnesota Mutual. He is also a lawyer, CLU and chartered financial consultant (ChFC).

After Arnie, we're going to have Matt Coleman. Matt is vice president with Creative Marketing International, which is a marketing organization that specializes in the sale of equity index annuities. Matt is filling in today for Mike Tripses, an executive vice president of CMIC. Matt has been with CMIC for more than two years. He works in the actuarial unit inside the marketing organization, and the actuaries assist their core client companies with product development, product ideas, modeling and market research—traditional product development actuarial work within a marketing organization, which I find fascinating. He also was in the pricing unit at BMA, where he worked for seven years.

We also have Anne Katcher. Anne is senior vice president and an actuary for AXA Financial Equitable. Anne has 25 years of experience in the financial services industry. She heads up the product development services area, which is responsible for life, individual annuity and pension product implementation, pricing, filing, proposal developments and quality assurance for all of AXA's distribution channels. Before Equitable, Anne worked for New York Life and Aetna.

My name is Abe Gootzeit. I'm a consulting actuary with Aon's consulting services practice in St. Louis.

This is an open forum, which means we'll have some presentations, but we're also going to leave time for discussion, comments and questions. The agenda is as follows: Arnie will speak first from his perspective as head of distribution for an insurer, Matt will discuss profitability and competitiveness from his perspective as an actuary working for a marketing organization and then Anne will play the role of the product development actuary with a large insurer (she plays that role well). We will leave a significant amount of time for spirited discussion and questions.

MR. ARNOLD D. HENKEL: As we look at this from a company point of view and look to answer the question of whether you can make profit and satisfy distribution, in some respects, the answer from a company point of view is going to be no, you can't ever satisfy distribution and make money if you're going to satisfy distribution the way they want. We, of course, analyze it from a standpoint of, what are the competitive factors that are impacting us now and how do we address them? I'll run through them.

This one is from the insurance company's standpoint and is beginning to drive us nuts. You start with products that are relatively complex, such as universal life (UL) and variable universal life (VUL) on the life side in particular. Add to them extended secondary guarantees and add those to second-to-die policies, and the complexities become fairly significant. The costs of administration challenge us from a pricing standpoint. In addition, and I'll talk about this in a minute, we're getting to the point where life cycles of the products are so short that you have so many products up on your system that costs have become a significant factor for us.

Regarding increasing costs of distribution, Matt will certainly represent what's happened in the marketplace as there have been a number of changes in distribution format. In terms of some of the traditional things that we had in the old days of marketing organizations that were more likely to occur to a distribution system where you thought you could manage costs or a personal-producing general agent (PPGA) where you could make a complete variable cost system, the negotiating power and situation have changed dramatically, and I think you'll see from this group of presenters that's certainly true.

The absence of new distribution coming into the marketplace is true in the traditional insurance company situation. Few companies are truly recruiting new, what we would call "career," agents into the system any more, so people are getting into the business, if at all, from different methodologies. Independent marketing organizations (IMOs) certainly are doing a significant job of recruiting, and broker-dealers are doing a significant job of recruiting. The insurance companies are not doing a significant job of recruiting, and that has changed the financial dynamics of the enterprise from our standpoint. It has also changed dramatically what they're selling, how they sell and how they approach it. One of the things that has become significant that I'll get to in a minute is commoditization.

Focusing on the affluent is a factor. Almost every company that would call itself a "traditional" insurer focuses on the affluent, the mass affluent or some terminology referring to where you can get more premium dollars. That's fine, except for the second part of that. As you think about pricing products and the decreasing policy numbers across the industry that has been going on for at least 10 years now, you see that's become a relevant factor for us.

We could have a lot of discussion about ROIs across the industry, but as we look at pricing from a company standpoint, ROIs are no longer what we originally would have thought and targeted approximately 15 percent for most companies. A few are in the 15 percent ROI on the life side. I don't think anybody is on the annuity side anymore, although there might be one or two exceptions. The cost to capital is becoming a significant factor, and it's becoming even more significant as most companies not only aren't pricing for a 15 percent ROI anymore, but they're not meeting pricing assumptions for their expenses.

Abe, from his standpoint, could maybe comment on this more across the industry as a whole, but if you look at real ROIs across the industry, they're probably in the 5 percent to 10 percent range for the bulk of the industry and maybe even 5 percent to 8 percent, with only a few companies regularly achieving double-digits. That has challenged us as we look at capital deployment across our organization and have discussions, as we do all the time, about capital deployment. You look at life insurance and annuity ROIs on those levels, and it becomes a challenge for capital.

We've also seen a new element come in, particularly in the annuity business, but we're starting to see it in the life business, as well. The Merrill Lynches of the world did not used to be in our business. With the equity markets and variable annuities (VAs) taking grip in the 1990s in such a dramatic sense, a lot of that new business was sold through the large broker-dealers. It drove us to commoditization, as you well know, in the VA and to some degree in the fixed-annuity business. To some extent we're seeing that with a few companies penetrating those large broker-dealers on the life side, as well, and that changes the dynamics of distribution as we have looked at in the past and changes some of the economics for us. That's a significant change, I think, over the past five to 10 years. There are some products now, from our standpoint as a company, that we won't compete heavily in because commoditization and scale have become such significant factors. That has been coming for a number of years, but it has become more relevant.

The increasing impact of new features is the discussion of everything. There's a discussion next door, and the volume of the people in the room understand. What that means today is, with the new features that come into the VA world and with the May filings, if you fall in the May filings on VUL, we're starting to see a transposition of new formats into the VUL world, as well. We're starting to see some of these new features come into the marketplace on the life side as well as the annuity side. We've seen a maturing of those on the annuity side, but people still don't know the long-term financial ramifications. How the economics of this in various markets, equity markets in particular, will play out is relatively unknown.

Hedging strategies are maturing significantly, and asset allocation models are maturing significantly, but it's still a fairly moving target. You will probably notice with the May filings that MassMutual, Hartford and a couple of others have come out with VUL/UL combo products, and that's something we've been anticipating. We knew they were coming, but we've seen the first couple on the market now, and their profitability is unknown. I think the companies think they have a good sense of it, but we don't have any long-term playout. We have some uncertainty in pricing.

I don't need to talk about this too much, but reserving requirements when the stock market is going down on variable products are significant, as is margin compression on fixed products, but it does lead you to some product conclusions in terms of which products you'll offer, how you'll price them, and what you put on and take off the market. We have had a couple of examples in our company of taking products off the market because of interest rate compression, and it's no surprise that a number of companies have done that. A number of companies have changed minimum guarantees on fixed products.

Another issue of concern is the increased costs of product development with shorter shelf life. Our chief financial actuary rails about this constantly, asking, "Can we not develop products that build on the same chassis, so we don't have second-, third- and fourth-generation chassis of UL and VUL products?" Those are expensive products to put up and maintain, and trying to put them on a similar chassis where you don't have to go in and put up a new product is a significant factor. With shelf life now being several years only, we're into multiple generations of our primary accumulation in the form of VUL, and if you have to put up a new product every time, that becomes extremely expensive, particularly on the maintenance side. I mentioned that earlier, but maintenance of these products over a long period of time is hard to meet in pricing, particularly on the variable side. Our numbers are about three times more expensive to maintain on the in-force variable product than on the in-force UL product, so that becomes a significant factor.

We are beginning to see some scale take hold in the industry. For years this has probably been the most diffused industry in the world. If anybody ever got a 5 percent, 6 percent or 7 percent market share of our industry, it was miraculous. We're starting to see some consolidation, particularly on the fixed-annuity and VA sides with a couple of the large carriers, and that does impact. As a medium-sized carrier on the VA side, and for a lot of organizations, this becomes a significant factor in the areas of revenue sharing from the fund companies and costs of administration. All those things become significant in providing a product like VAs, and that has been true on the fixed-annuity side for some time.

We are increasing our reliance on outsourcing. We are doing more of that, as is probably everybody, and the industry continues to change there. We have to look all the time.

We're continuing consolidation, particularly at achieving scale. With what used to be the old, big mutual companies demutualizing, becoming public and getting into acquisition arrangements, the industry has chased after scale significantly.

Here is a big factor for us from the competitive standpoint. We put up a product with secondary guarantee on UL. We also did one on VUL, although the structure is different. If you're not big enough to carry that risk yourself, reinsurance is going to become a significant factor, I think, after January 1, 2005. It may or may not even be available. The cost of letters of credit has increased dramatically, as there are only one or two players left in that marketplace, and this could drive some of the small- to medium-sized companies out of the UL and secondary guarantee end of the UL business and will probably be a significant C-change if it comes in January. It does have a lot to do with how we do product design.

What can we do from a company standpoint? To position, we're a medium-sized company, and so scale of distribution is not accessible to us easily. We're a fairly capital-rich company, so in a general sense capital constraints aren't a major factor for us, but scale of distribution is. Asset bulk is a significant factor for us, so we work on focusing on manufacturing versus distribution focus. We have separated those functions, clarified focus and clarified negotiation between them. Sometimes we're in the manufacturing business, and sometimes we're in the distribution business, and they lead us to different conclusions as to how we'll handle one product versus another.

As a simple example, we want to be in the manufacturing business on VUL and various forms of VUL. We don't think we want to be in the manufacturing business of fixed annuities, but on the distribution side, we need to provide them one way or another. It leads to different conclusions as to how you develop product, how you outsource or insource that development and how you make your profit, whether it's a skim from using somebody else's product or you want to embed a profit in the product.

Streamlining the product development process has been a significant factor for us, and this results in picking spots. As we develop distribution and as we develop our product development process, we have a more narrow focus on spots where we think we can make money and where there are still places left in the market. It has allowed our product development process to not do a lot of things. We have outsourced, brought in consultants and brought up other people's products in areas where we have not been able to make the type of ROEs we think we can off of our own manufacturing. A lot of it has to do with scale, but a lot of it has to do with expected ROEs and costs.

We aggressively take out costs at all internal levels. We're in the middle of that. The corporation is going through, on the individual division, a fairly significant reorganization. That's an ongoing business, but it has probably gotten more aggressive in the past 12 months than it has been for a long time.

We developed what we call a "sense-and-deliver" model. One of the things that you make a decision about regarding your company's standpoint is, are you going to be an innovator, a fast follower or a slow follower? We have concluded that a company our size is not going to be an innovator. You can have a lot of discussion about that, but from a company point of view, we think the only way you can make innovation pay is if you have significant distribution, because this industry follows so quickly. Assuming these lawsuits we're starting to see in terms of patenting of product ideas don't change the landscape dramatically, we don't think it's worth it to be an innovator, so we take a fast-follower methodology and have developed what we call a "sense and deliver." We have teams of people who are sensing the marketplace. When anything hits the street, as soon as the filings are in some of the key states, we know what's coming out and start taking a look at whether it's core to our market or core to our primary products and decide whether we have to start paying attention to it right away. That model has worked for us pretty well.

We are developing a core strategy. That model had led us to ask what our strategy is regarding variable products and fixed products. We'll be in some product lines and out of some product lines. It led us to a decision from our company point of view that we don't think you can be highly competitive in the VA marketplace if you don't have huge scale and if you aren't willing to take some of the risks that are associated with guarantees around account value, withdrawal benefits, etc., and so we've focused instead on some VUL benefits and some VUL product designs that allow us to be much more in the front end of it.

We've done another thing that has been a change for us. You might think that this is counterproductive. We do systems releases of our primary administration system on the individual insurance site three times a year. We now time our product launches around those systems releases. You might think that tying a sense-and-deliver process that you want to be rapid to marketplace to three delivery dates would be slower, but for us it has worked faster because we know when our product releases are going to be.

Three times a year is pretty quick for a mid-sized company, so we back everything up from release date, a May 1 prospectus date for example, and know what we have to start working by July of the previous year. That has speeded the process up for us dramatically by having targeted release dates. It has also kept us from having release dates of new products float, because if you miss a release date, you're four months out until the next one comes down, so it has created some time pressure that's been positive for us.

This is the sensing process. Every two weeks we have a group of our marketing people meet and report to distribution and report to the product actuaries what they're seeing on the screens with the filings of the state and in the general press. It's not much more. Twenty years ago John Naisbitt wrote the book *Megatrends*, and he was called a futurist. He said, "I'm not a futurist. All I do is read today's paper, and instead of being a couple of years out of date, I know exactly what's happening currently." His system of megatrends was to clip current newspapers from across the world and get a sense of what was going on. That's what we do. We view this business of looking in the future as getting a hold of the present and going from there.

We have streamlined this process. There was a joke going around. Most of you use consultants, so you know consultants use diagrams with 8,000 circles, lines and pictures going on for pages and pages. No offense, Abe. We laugh about the consulting actuaries. We got our product development process down to two pages and only five circles. Anyone on the outside would say that's pretty complex, but from the inside we think it's reasonably simple. One of the things that is critical for us is the second step into the process. Once we've done what we call an "opportunity assessment," we start getting approvals from company presidents.

We're like most of you and have five different companies and have to get approvals from various presidents of the companies, depending on whether you're in the variable or the fixed business and which distribution system you're in, plus there's our executive office. We're getting the preliminary approvals early on. We categorize them into some key elements. If there's a new risk, if there's significant financial risk or if there is a new product design that we don't understand, we run to the executive offices early in that process to give them a heads-up and to get tentative approval that this is the kind of risk we're willing to take.

This is the model where we do business case. Most of you are familiar with that portion of it. Our launch teams have been successful. I assume most of you do this, but this has been a positive. We have broken our launch teams into external and internal. The internal makes sure all the administration system stuff is done, and the external provides all our marketing support. The formalization of our launch teams and designation of team leaders has helped, as well.

I've said this a couple of times now. We picked limited spots at which to compete and work on selling there. In our company we focused on UL and VUL. Different companies will make different decisions, but we focus on those products as opposed to VA and fixed annuities, and then look for places where we can find cells to compete. We're heavily into market research now. We're looking at the impact of the Baby Boomers, who are age 40 to age 58, and trying to understand their financial needs, what they're buying today and what they'll be buying over the next couple of years. We're starting to see some research on those issues, and we're getting heavily into that end of the market design. We think it fits well with a VUL product design, so we price, as most of you do, around key cells. That's another thing that has been positive for us, so we match ourselves to our marketing strategy.

We stay away from commodity offerings because of our size. Different companies are going to cut back differently, but we stay away from the commoditization end of it.

We focus on higher-margin products. Our joke is that's what has not deteriorated too dramatically and on what you think you can still make some reasonable ROI. One business in our enterprise has a 15 percent to 18 percent true ROI business, and another business in our company has a 25 percent ROI. When you go in to get capital from our company and make a good argument—we're a 10 percent to 12 percent ROI business—it's a challenge, and that's one of the things we face and why we do look hard for product where you at least can represent a reasonable chance of getting this type of ROI.

We are getting out of the traditional distribution systems, although we still have a form of career distribution. We have PPGA, independent broker-dealer marketplace and a direct system. We use fee-based advisors. We do all of those things, but we now design distribution around our marketing plan and particularly around the product sales. If we were to go to a marketing organization like Matt's, and it was heavily into the annuity business, we wouldn't have much conversation. It would have to be in the type of business and in the type of product sales that we'd be after. We're after those niches where we can attract distribution and fit in well.

Today the issue for all of the companies is, which risks are you going to elect to take? We've elected not to take many of the risks on the VA side, where we will take that similar risk on the variable life side. That took a lot of analysis in our company, but the reason we did that is because on the variable life side, you don't accumulate the same amount in assets, and the buying public is not as concerned about how its assets are mixed in a VUL policy as it is in a VA policy. VAs are one of the places where the mutual fund industry has gotten into trouble because there are timers, and there are lots of people paying significant attention to what their investments are in a VA. Our research tells us that's not so true in a variable life policy, so you can use asset allocation models to control your risk better in a variable life policy.

We think that combination of not as much asset accumulation in a variable life as VAs and the ability to manage that risk better with asset allocation models and allocations to fixed account allows us to take some risks on the variable life side that we don't on the VA side.

Risk management is one of the functions that we've added, as well as how do we manage what our investment strategies are, what do we keep ourselves, and what do we sub out in terms of taking those risks? The world is changing, and it's going to change dramatically again over the next six months on the VUL side.

We've done a lot in the past six months on the cost side. We've had Wards and everybody else in to look at costs, do cost comparisons and take out costs on both field distribution and the home office side. There's a lot going on. There's a lot more in the planning than there has been in the execution on this, but we know where we are from a cost standpoint, and I think almost all the companies are there.

We set short-, mid- and long-term objectives of where we need to be. We're like most companies. We're right now outside of pricing in a couple of spots and have some changes to make to get within pricing. In some places we have a way to go. If you know the industry numbers on both variable life and VA, you know that the industry as a whole is somewhere between 25 percent to 40 percent outside of pricing on distribution expenses and probably 20 percent to 25 percent outside of pricing on cost of administration. Companies are trying to drive toward that with scale, or they're living with lower profits. That last one is not a good choice.

The industry is heading toward variable distribution. You see few career organizations any more with heavy fixed costs.

One of the things we're working hard on is multiple distribution. We have almost as many distribution systems as you can think of in the industry, including direct, and some of the economic numbers on direct have some appeal if you can get enough people driven to your Web site or driven to your 800 number, so we're in a variety of those distribution systems.

MR. MATTHEW R. COLEMAN: Somebody told me once that you can tell an actuary is getting soft when he listens to the marketing person before saying "No," so I consider myself soft and much below you fellow actuaries because not only do I listen to marketing, but I work for marketing. I realize I've taken a treacherous step by moving as an actuary into the marketing role, but I think that I've learned a lot heading into a marketing organization. I see a lot of things now as a part of that culture that I did not see as an actuary, and I'd like to highlight some of those perspectives that I've found. Let me give you a quick view of Creative Marketing.

It's basically a managing general agent (MGA). It is a large MGA, at least as far as I understand MGAs to be. We're going to sell quite a bit of life insurance, but our main business is annuity product development. We'll sell a significant amount of that. We have a number of employees. It's larger than my experience for MGAs, and we are full-service. We work hard as an intermediary between companies and the agents who sell their products.

We feel that we're filling the niche that has been vacated by the career distribution. In the past we saw a lot of career distribution as the chief mechanism for delivery of insurance products, and companies built large systems to manage those distributions. As the shift has moved away from career and toward independence, companies have also taken on less cost and less service. They say, "We're paying more commission to these guys. Let them fend for themselves. That's what we're paying them for, right?" CMIC has stepped into that void and is trying to compete in that part of the market—the service end of the market.

We have six actuaries. I say all these things because the fact that CMIC exists and is as large as it is is a case study about where the market is going. Whereas in the past we thought of MGAs as mom-and-pop shops, we're seeing that portion of the distribution grow and flourish into companies such as CMIC, which not only sell and are good at selling, but then take their perspectives on sales and turn them back to the company to refresh their core carriers, of which we have a limited number, about the ideas and the trends they're seeing in the marketplace.

Arnie mentioned the work they put into perceiving what's going on in the market. In our humble perspective, who better to tell them what's going on in the market than the people who are selling their products? We are an excellent repository of that type of information.

Let me go back to the question. I think the question is fascinating. I love this question because I think it is uniquely suited to us as actuaries. In fact, in my opinion, the question of whether you can design a profitable product that will sell is the definition of what an actuary does, at least a pricing actuary. This is a core competency, a critical issue that we understand, and I think that those competencies are changing. They're growing with the market. We as actuaries have to develop new skills to get there. Let's take a look at why we've been asking this question.

Obviously, as Arnie said, we have declining profit and wonder why it is happening. As Arnie was saying, it's cost of complexity and cost of product development. I would add to that ratings pressure, capital requirements and limitations on capital. Where are these coming from? Low interest rates. Low interest rates are making our margins smaller. They are driving us toward our guarantees. I think there's a lot there in the low interest rate environment, but I would say that we would probably be in the situation even without the low interest rate environment. The reason is that people are playing in a national market.

Why are they playing in a national market? It's because there's commoditization. Again, Arnie was talking about commoditization and why we have annuities that are similar-looking and ULs that are serving the same function. The differentiating factors are relatively minor. We have agents out there who are no longer looking to serve their core carrier but are looking to find a product that they can sell easily. What this has brought about is a pressure toward commoditization. I would say the key source of all of this is the atrophy of the career distribution. In the past, career was the chief mechanism—the captive agents. That's how insurance products were developed. They were developed for our career agents. We know what they do. We will meet their needs. We will help them sell, and they'll sell for us, and there's this close tie.

I think there are a lot of good reasons why we've moved away from it. I don't think the career-agency model is successful. It's not efficient, but, without getting into that, given the fact that we are headed toward independent agents, what do we do? What can we do? We actuaries have to find some new competencies. I think I mentioned this already, but I don't think there's anyone who is as qualified as we are to answer the question of rightly dividing profits and sales and figuring a way through those limitations and constraints. There's no one who knows the situation as well as actuaries.

If actuaries are the ones to do this, what are we good at? What are you good at? If I were to ask you what your core competencies are, what would you say? What do you bring to the table to answer the question of selling a profitable product? I would say immediately that it's technical expertise. When we look at products, we see variables and parameters. What's the commission? What's the surrender charge term? What are the assets behind this? What are the special benefits? What are the chances of utilization? We see all of these parameters in our products, so we're good at that.

What else do we do? We understand the relationship. We, unlike anyone else, grasp mortality effects. We understand lapse rates; we understand lapse support. We know the calculations that combine these variables and think of products as complex models, so we're good at modeling. We also know how to take these models and run them through scenarios. These are our core competencies. I'm sure there are other things that we're good at, but I would say these are what we're bringing to the table as of now.

If actuaries are the ones who are supposed to answer this question, we are not good at all things. We have weaknesses, and to that point I'd ask, how many of you are actuaries? How many of you have sold an insurance product, and I don't mean to your father-in law? That's a striking survey right there. We are good at understanding these things, but we've never sold them ourselves. Let me take a look at what I think we might improve on, or where we might be weak, and how those weaknesses bear on whether we can answer the question well.

I don't think we're good at understanding what drives the sales process. Why is that? We've never sold. We don't know what it is like to be out there earning your commission on sales. I think that while we would say that we kind of know commissions and we kind of know interest rates, we don't understand the gravity or the immediacy of these issues in the way that we should and that would make us more effective.

I also think, as I mentioned earlier, that you would view me (and you'd be right) as a "soft" actuary because I work for a marketing group. However, I would say that we don't necessarily value and nurture those relationships that we might have with marketing and sales people. I think that we have our way of viewing things. We set up our models, we have our calculations and we have our profit requirements, and if you don't meet those things, we're not going to do this product. I realize I'm probably drawing a brighter line there than we face, but I don't think we, as a group, value grasping what these marketing people bring to the table.

Anyone can tell you that the prototypical actuary is weak at communication, but I would say that we *are* weak at communication. We are weak at taking our models and all of our technical information and bringing it to those decisionmakers, the managers, who would help us to determine what products are reasonable and allowing them to make the decisions they need to make to lead us where we need to go. I realize I haven't fleshed that all out yet, but I'll get into that in a minute.

Many of you have probably heard the story about the two men who were in a hot air balloon. They're lost, see a man on the ground, navigate their balloon to him and ask, "Can you tell us where we are? We're lost." The man says, "You're 200 feet off the ground, and you're in a hot air balloon." The men call back, "You must be an actuary." The man replies, "How do you know?" They say, "You gave us factual and true information that's absolutely useless." The man calls back up to the men in the balloon, "You must be marketing people." "How do you know?" "You're in the same situation that you were in when I found you, and now it's my fault." The point is that this tension does exist, and there's a lack of value between actuarial and marketing.

What does our current product development process look like? It looks like marketing comes up with an idea, but this idea is not well-formed. Why? Because they aren't actuaries. They don't know the details of the relationships between profit and product features. They don't know about mortality and lapse rates, and we do. They form their product ideas without this knowledge, so they come to the table with a half-baked idea. They produce this idea that doesn't meet profit requirements. The actuary refines the idea. We restore the profit. We say, "We see what you want. Let us increase the spread. Let's drop the commission," and everything works well. It meets profit criteria, so we have a product that works, but it doesn't have the marketing zip that they were looking for, and then we fight it out. The result of the process is that the product is mediocre.

What I would suggest as an alternative is that marketing begins by hearing from you—we can lead the horse to water, but we can't make him drink—but what I would propose as a working solution would be that marketing learn from you, and you teach them the rudiments of pricing. They would grasp the details in a way that helps them to inform their ideas. Further, I would say you would, as actuaries, grasp in a deep way—I know many of you would say you already know what the selling process is like, but I would challenge you on that point given that you have not sold—and that you would investigate and know deeply what the selling environment is like and that you become intimately familiar with it.

Furthermore, I would say you would go to management and would understand, as Arnie said, picking spots. He talked about picking spots where we can compete. How deeply do you understand your management? Do you understand what risks they are willing to take? Do they require internal rate of return (IRR) or do they require profit margin? Are there different ways of satisfying their profit need? Is the issue capital constraint or is the issue distribution, that you can't get their products sold? I would say that we want it all. You can't say this. We need to understand the geography of management's requirements.

Marketing and actuarial collaborate deeply about these issues, bring to the table their understanding of management, bring to the table their understanding of the market forces and bring to the table the actuarial's interconnection and modeling ideas. It is out of that collaboration that we come out with a product that is excellent.

As an example, at CMIC, we charge nothing for our product development services. All of our product development fees come from trails on the product, so our fees depend on whether the product sells in quantity, but it also returns better for us if it stays on the books. We've tried to tie as actuaries, and now I am motivated by sales, and not only sales but enduring retention of these policies. I think that's a curious and helpful motivation for an actuary. It does make me soft, but it's helpful.

When we develop products at CMIC, as actuaries, we speak actuarial to the company actuary, so we have this dialogue between the company actuaries and the marketing actuaries. We can actuarially speak, but our models in the end must pass muster with the requirements of the company.

I'm not trying to showcase CMIC here, but I'm illustrating this as something that certainly was unique for me: the advantage that I'd say CMIC actuaries bring is to be immersed in the sales environment and the marketing environment. This is not something I experienced in my seven years at BMA, but now living with the marketers, I am changed, and I would encourage that kind of immersion. I find it to have been valuable.

As I look at my six core carriers, I'm thinking about who fits where. Again, this was the picking spots idea that Arnie was mentioning. I can identify where my high-rated carrier fits. Where does the carrier fit that's willing to take the long asset and that's willing to have some interest rate risk? I can differentiate these companies based on their strengths and on their willingness to take risk.

CMIC has developed products to meet various ideas, to pick those spots. We have seen companies that have brought to us constraints on finances, ones that were concerned about legal risk and ones that were concerned about interest rate risk. We've tried to respond to each one of those with solutions. Each one of those products has been successful in the marketplace.

In conclusion, I would go back to the question, which I think is a fabulous question. Is it possible? This question of whether it's possible and finding a way to make it possible is what we do. We are the ones with the answers, but we won't be able to do it unless we are fully knowledgeable, both about the marketing and about the management risk tolerance and specific profit requirements. We cannot be satisfied any longer to say, "We need maximum profit margin. We need maximum IRR. We need to hold maximum capital." We all tend to the conservative bent, but we want to understand better the features of profit requirement, the geography and the topography of our management requirements, and the same thing is true with the sales side.

Is it possible to satisfy? Do we know what satisfaction means to our marketing people? We don't know this. We need to understand. We are ignorant of knowing what it takes to satisfy people. It may not be what we think. We need to get some help from our marketing friends on this point.

Your distributors, as Arnie mentioned, are different. Even in the independent brokerage market that I play in, there is a huge disparity between different independent agents. Some are not driven by commission; they're driven by a commodity-type product. They want the highest rates. There's a spectrum that ranges from that all the way to people who are generally commission-oriented.

Can you make money? What kind of money? Do you want ROI or dollars of profit? Is capital a constraint, or is distribution more of a constraint? You should suit your product profitability to that limitation. I think the answer is yes, but because the market has changed, the question is more important. I would say that our skills need to grow, particularly with understanding our colleagues in our companies.

MR. GOOTZEIT: We've had Matt, who is an actuary with a marketing organization, and we've had Arnie, who is a marketing person, but we haven't heard yet from a real actuary in a real company. That's the role that Anne plays.

MS. ANNE M. KATCHER: As Abe said, the focus of our discussion today is going to be on the role of the product development actuary. To answer the question asked by this session, I say yes, no and maybe. I don't want you to think I'm indecisive, but I think that this can be the answer for several reasons. The first is that insurance is a long-duration product, and we don't know for a long time whether or not we've made money on a particular product or a particular block of business, so by the time you know that, you might be retired.

The second is that even though we can be rigorous in the development of our product with working on target markets, setting pricing assumptions and assessing risk, there are often certain events that you can't anticipate, such as the AIDS epidemic or perhaps regulatory changes that affect things like reserving requirements.

The third is that, as Arnie mentioned earlier, our business can be easily commoditized. Your distributors may be in love with your product for a few months, and then all of a sudden the company down the street comes out with a better design, and you're in the marketing doghouse.

What's the solution? How do you keep from falling into the abyss of no sales or no profits? The three main areas I'm going to focus on today are three profit partnerships (with distributors, investment providers and customers), risk management and its importance, and a monitoring discipline.

Your distributors want to make money, and their focus has been generally on first-year compensation. However, there are many other forms of compensation that can better align the interests of the company and the producer, and even the customer, as we'll see. Three examples of compensation sweeteners, or risk mitigators, are asset-based trails or chargebacks, agent reinsurance companies or deferred compensation arrangements, and stock options. I'll give some examples of these.

Other than the cash type of compensation that producers can get, there are other things that we can provide in a company/distributor relationship that certainly will not provide cash to the producers but will be something that's going to make it easier for them to do business with us. Their time is money. Any time they spend not selling is time that they're losing money, so these things are important.

The first thing is sales and marketing support. Some companies have case managers who will, in their distribution area, take the producer from start to finish. They're not working with five different people calling the underwriter or the marketing person; they have one person who deals with their business.

The second thing is underwriting support, which is not a euphemism for underwriting concessions. It's where producers have online status to find out what's happening with the contract that they're trying to issue and have dedicated underwriters for high-end producers with whom they feel comfortable talking. Those have proven to be beneficial.

Companies also might have different levels of service and support to higher tiers of producers, and that will certainly incent producers to give more business to your company.

Finally, customer-friendly Web tools and call centers have proven to work well. We recently did a survey of our customers using some of our Web tools for things like address changes, changes in asset allocations and changes in premium payment amounts. We had in our survey a 90 percent satisfaction with being able to use those tools.

This example of a typical VA-deferred product shows some of the tradeoffs that you can get by using different types of compensation arrangements.

"B Share" Variable Deferred Annuity

Type of Compensation	IRR	Profit Margin	Breakeven Year
Yr 1 — 6.5% No trail	15.0%	3.9%	4
Yr 1 — 4% Trail — .25%/.75% (after SC)	14.8%	3.3%	1

You see on this chart that the IRR is similar for both the full front-end trail option and the tradeoff option, where you're providing a longer-term trail. The break-even year is substantially better on the trail option because your front-end costs are less, but you're giving up some profit margin. Everything depends on your assumptions, but in this example, it's 1,000 scenarios. We assume that the persistency is going to be better on the trail option, so that's part of the thing that takes away some of the profit margin, although I would say that not only will the trail option reward the producer for good persistency, but it will also encourage and focus the agent's performance on helping the customer with asset allocation tools. That in itself might ensure that you have a greater return on those assets, and therefore the profit margins might be closer than what's shown here.

A second example that I want to talk about is agent reinsurance companies. I'll explain what they are. At our company we have an agent reinsurance company that we've had since the 1980s. I know there are some IRS issues now with setting them up, so companies are going more toward deferred compensation arrangements. What happens with an agent reinsurance company is that an agent puts in an amount of capital to become a partner or a stockholder in the company, and the agent reinsurance company acts like any other reinsurer.

It will assume, for example, 30 percent of the mortality risk, and usually it has a retention limit such as $250,000 per claim, so it's not too high. What will happen is that the agent reinsurance company may be one of your many reinsurers in the pool that you have reinsuring a particular morality risk. The agent reinsurance company will also take on some of the persistency risk, so it will usually take on 30 percent of the persistency risk. Each year you will do a calculation based on the actual experience of that block of business to determine whether or not the agent reinsurance company will either get a payment or increase to its capital, or some of its capital will be removed and will have to be paid back if the experience is worse.

The recent study that we did of nine years of persistency and mortality on our agent reinsurance company showed that we had few death claims, so the mortality was slightly higher than our average. There are fewer than 25 claims, so it's hard to tell the significance of that, but the persistency was 22 percent better than the overall average. As a company, even though you may be giving up some of the upside, you are insulating yourself against the downside, and producers definitely become partnerships. They think twice about what risk they want to give to you, the company, because they're also taking on part of that risk.

The third example of different types of compensation options is stock options. Stock option awards for higher levels and production growth align not only with sales but also in terms of profit, because as a company is profitable and its stock performs well, the producers will share in that upside.

There are three types of production awards in the stock option program that we have. The first is a production award. For that one you must achieve a certain level of sales before you get any type of award, and then you're awarded some percentage of the overall sales that you've achieved. By sales, I mean commission revenues.

A growth award, which is the second type of award, is given to producers who not only achieve that minimum level but also have a certain growth over the prior year. It has to be significant. I think the minimum is approximately 20 percent.

There's also a new-higher-level award. That means that each time a producer gets to a new higher level, for example, $500,000 or $600,000, the producer will get a one-time bonus. That's a one-time award.

Usually the stock option awards are determined on a dollar amount. For example, if you have $100,000 in commission revenues, your award might be 5 percent, or $5,000. What we do is take that $5,000 and use a Black-Scholes methodology to determine the exercise price, the stock price and the number of stock options depending on the date of the award.

The second partner in the company-and-producer partnership is the investment provider. This applies mostly to variable products, but investment providers can provide a lot of different benefits. The one comment I want to make on this is that many of you may know that companies have to be aware of regulations governing what can and cannot be provided in terms of support. Right now the SEC is reviewing this issue of "soft" dollars provided by fund companies. That may lead to changes in what is and is not acceptable. I think it's a moving target, and so you have to be careful and make sure that you're within those guidelines.

Fund wholesalers will often partner with insurance wholesalers and brokers in terms of providing ongoing training, sponsoring client seminars or coming to client seminars and giving presentations. They may also sponsor an event. For example, recently Peter Lynch was a guest speaker at one of the agency award programs. Those are the types of things that are helpful in terms of producers understanding more about the funds that are underlying these insurance products.

Firms may provide a lot of information on economic analysis, market analysis, etc., for companies and often make their strategists available to the insurance wholesalers for information, which can be helpful. They're also providing reduced fees for breakpoints so that if you get to a certain level in your fund, they'll provide you a reduction in fees, and generally that's something that you can pass on to the customers, which is an added benefit.

Finally, they're being called upon more often now in a lot of different private placement options, things for insurance, to provide innovative structures such as hedge funds tips, so those are the types of new asset classes that we're seeing more of.

The third partner is obviously the customer. Aside from traditional dividend-paying policies, there are many ways you can reward the customer with long-term value. I'm going to show some specific examples of these types of rewards that you can provide to the customer. When you have a happy customer, that's going to make your distributor happy. Once you put these designs in place, the most important thing is to communicate the benefit with the customer, not only when you get a surrender request, but on an ongoing basis when you have annual reports or confirmation notices. Use them to communicate to the customer that in x number of years he will be eligible for reduced fees or enhanced benefits.

The first one is single-premium deferred annuities (SPDAs). Many of the products have had tiered contributions for higher limits for a while. Looking at a recent competitive study, most of the SPDAs provide some type of a tiered benefit, in other words a higher interest rate benefit for more than $100,000. There was a survey recently of approximately 30 companies. For most of them $100,000 was the cutoff, but what was interesting was that the tiered amount, the higher interest rate, ranged from 10 basis points all the way up to 50 basis points.

Examples are coming out more now with the different minimum guaranteed interest rates in the different states. We're starting to see differentiation. Here are two examples. The first-year interest rate is 5.25 percent for 1.5 percent lifetime minimum guaranteed. At the same company it's 5 percent if you have the 2 percent guarantee. The other company has a much bigger differentiation because it has the 3 percent guarantee, so it has 5.5 percent for 1.5 percent guarantee versus 4.7 percent for a 3 percent guarantee.

This is a good example of risk management focus. The only issue is that because of the confusion that this type of thing can create from a marketing standpoint, I think only a few companies have taken the plunge with these types of differentiations.

This next example is of mortality and expense (M&E) charges that variable life companies have used, and they're pretty complicated.

Company A — 0.80% on first $250,000; 0.70% of value over $250,000 and up to $2,000,000; 0.60% of value over $2,000,000 for first 15 policy years. Beginning in policy year 16, the charge is 0.30% on the first $250,000 of account value and 0.20% on amounts over $250,000.

Company B — 0.60% on first $25,000 of cash value; 0.30% on next $225,000 of cash value; 0.10% on cash values higher than $250,000 (years 1-15); 0.60% of first $25,000 of cash value; 0.10% on cash values higher than $25,000 (years 16+).

Company C — 1.20% (years 1-15); 0.00% (years 16+).

Companies also have loan spreads that may exceed 1% during the first 10-20 years and then reduce to 0-25 bp thereafter.

Matt is probably going to say that this is where the actuaries took over from marketing, that this is buried in the prospectus some place and that the only place that the customers are going to see the value of this is through the annual report or when they see their charges go down as the policy ages. What these companies are trying to do is demonstrate the different ways that they've seen that they can reward the customers. Once you've broken even and have the ability to pass on some of your profits to the customers, this is a good way to do it to reward your larger customers and to reward your customers who have stayed with you. I think it's a good balance, but you have to be careful with the complication. I'll admit that the first one, which is the most complicated, is our company's design. Our marketing person is an actuary.

You see in the example that the loan spreads. This is typical. With most of the variable life products, after somewhere between 10 and 20 years, you'll see the loan spread reduced from 100 basis points in the early years to zero to 25 basis points. This, again from the customers' standpoint, provides access to their values and their contract on a tax-deferred basis and allows them to access the money when they need it. At that point I would have hoped that the company has made significant profit and is able to do that.

The last example that I have of customer focus is what we're starting to see on VA riders. Specifically for those who follow this marketplace, guaranteed minimum withdrawal benefits (GMWBs) are quickly replacing guaranteed minimum income benefits (GMIBs) as the preferred income benefit rider. A recent article in *Annuity Insight*, if you read that publication, discusses this trend and talks about how companies are competing by differentiating their offers. Here are several examples of what companies are doing to provide customers with additional value if they don't use the benefit. This is a benefit that if the customer uses it every year has a high cost. When companies do their hedging analysis, they try to figure that cost, assuming a certain level of customers will take the full amount. If they don't take it, the cost is little. If they defer taking the withdrawal for a long time, the cost is reduced significantly.

> Company A — Rider charge is generally waived if no withdrawals are taken during the first 7 years.
>
> Company B — Withdrawal benefit base is increased by 5% in each year in which the withdrawal benefit is deferred up to a maximum of 125% over 5 years.
>
> Company C — Maximum withdrawal benefit increases from 5% to 10% per year if no withdrawals are made in the first 3 years.

In terms of trying to balance the cost with the customer value, companies are now doing things like what is shown here. If you don't take a withdrawal, if you decide to wait, your charge will go away because you paid for a benefit you haven't used. If you don't take the withdrawal, the amount you can take will increase. These are some examples of what companies are doing and what you can do to better balance the customer needs. These types of benefits will be attractive to producers when they're trying to compare product designs of which offers the best value to the customer.

Last, the risk management focus is essential in today's volatile marketplace, and these are some questions for discussion. What are all the product guarantees and what are the risk features? How much do they cost, and are you charging for them? I'll give one brief example.

Recently we've been looking at implementing the NAIC-indexed guarantees on VAs. Right now we have that split of the 1.5 percent and the 3 percent on our different products, depending on state, so we're looking to going to this index methodology. We've been doing some scenario testing on the cost of different interest rates. We looked at the cost of providing a 3 percent guarantee versus no guarantee at all. We found that if you assume a low interest rate environment like we are in now, the cost can range anywhere from 27 basis points to 67 basis points, depending on your volatility assumption.

We then went back and looked at what would happen if we started with that 3 percent guarantee in the interest rate environment that we were in during the mid-1980s. The cost of that guarantee was essentially zero, so that's something that you need to take into account. Producers certainly don't understand the cost of these guarantees. Something like the interest rate minimum is an important guaranty. I think you need to keep that.

There are other guarantees that may not be so important but could have a cost 10 to 15 years down the road. One example is the settlement options that you have in your life and annuity products. Those companies don't bother updating them too often, but with the improved mortality you have to look to see what those guarantees are and whether you need to provide them. For example, on most life products in most states, you do not need to provide a cash settlement option, but people have them in their products. They've had them for years, and if you look at what those settlement options are, you're pricing the life product and don't pay too much attention to them.

Those are the types of little things that have no value to marketing. They might have value to the customer 20 years down the road, but most customers don't annuitize. If they did, though, you're creating a potential risk that down the road your valuation actuary is going to have to set up some large reserve to cover what wasn't anticipated.

The third thing, and I think it's one of the things that we often fall behind in, is monitoring discipline. Especially for a large company, you need to have a robust database. With a lot of the tools that are out there today, it's pretty easy to set up. It takes some time, but once you have it set up, it's a wonderful tool to be able to monitor what's going on with your business and see whether or not the product that you've designed in the market that you've designed it for is being used that way, or if it's being used in a completely different way that you didn't anticipate, which creates significant additional risk for you.

One of the ways that you get an early-warning system on this is to regularly meet with marketing and find out not only how sales are going, but how the agents and the producers are selling the product and where they're seeing the product working the best. You can get a quick indication of whether there is something that you should be watching for or what's happening with your investment allocations or what's happening with the different ages that you're selling in.

You also need to be able to design the product so that if you have to make any changes, you can make them quickly. Last year you saw in the VA marketplace changes going on every week, where companies were removing benefits and increasing costs for benefits, interest rates got low, there were a lot of 100 percent allocations to the general account and companies suddenly were putting in limitations. The more quickly you can react, the better, but from a marketing standpoint the best thing is to try to anticipate these happenings up front, because these quick, rapid changes cause a lot of confusion and unhappiness from the marketing distribution end.

In summary, as everyone has said, communication is the most important thing—the constant flow between the actuary and the marketing and the producer's area. Also, by balancing all of these different factors, everyone can win with an attractive return, and it won't be heaped in one place versus the other.

MR. GOOTZEIT: Thank you, all three of you. We do have a few minutes, and I would encourage questions, comments and discussions. I have a couple of comments. First, Arnie brought up the fact that the big mutuals were demutualizing and acquiring other companies, and I was also thinking of Anne's recent activities as a senior vice president and actuary of products at AXA acquiring that other company in New York. There has been a lot of activity by our panelists over the past few weeks, and I appreciate the energy you put into the presentations.

MR. MICHAEL T. DRAGO: I have a question for Matt. You mentioned that we as actuaries need to grasp the selling environment. Do you have any hints or suggestions on how to do that?

MR. COLEMAN: Work for a marketing firm. When I was a young actuary, I thought how great it would be if there was a rotation program where I could go out and sit with some salesperson. I think part of it is the desire. I don't think actuaries want to know. I don't think they care about what goes on in the selling environment. I know that attitude was fostered and probably has been fostered for years in insurance companies. I would recommend in any way to value it, and then you will find ways, whether it's the way you talk to your marketing person or whether it's your incentive trip. Maybe you get to go on that and rub shoulders with the people who sell. If you care about it, you'll find a way.

MR. KENNETH JOHN LONGERMAN: I'm wondering, when you talk of economies of scale, what you see as the advantages of a large market share in a fixed-annuity product.

MR. HENKEL: The economics are obviously different on a fixed annuity than a VA, so for us scale has to do with administrative costs, system costs, product development and then, probably as much as anything, investment issues around bonus on fixed annuities. With the bonus interest rate, you need to be able to hedge or invest differently. That means that we have to go outside for that investment expertise. It's mostly around administration and investment scale.

MR. GOOTZEIT: Arnie, you had a strategic marketing activity in your organization that I think was helpful in addressing precisely this question. If you would feel comfortable in discussing that, I think it might be helpful.

MR. HENKEL: Yes. I referenced it briefly in the presentation. We've engaged in three of them and are through with about one-and-a-half of the three, but we did what we call a variable strategy. We brought in a variety of outside experts, from consulting companies to some of the mutual fund companies, that were providers of variable product investments and distribution people. We followed a specific format of coming to general conclusions about the variable marketplace and, building on those conclusions, what our recommendations would be for portfolio mix going forward.

It was truly a marketing exercise that we went through on the variable products that led us to a variety of conclusions about the issues of scale, risk we would take and product choices. We followed that same form. It was a specific format that our marketing people developed around research, straw man conclusions, final conclusions, recommendations built from that and then final approvals. We've done that on about half of our fixed products. We started with term products and UL products, and we'll go on to equity index and annuities. We are also doing that around our chosen markets, but it's a specific exercise.

It takes us two to three months to go through that process, get everybody in the room at the same time and get the experts in. We basically used a format of a couple of days of bringing in outside consulting people. Some charge for it, and some don't. As to whether or not they'll charge, it depends on whom you're bringing in and their level of expertise. Obviously, we have some interest in that issue.

MR. GOOTZEIT: Did we answer the question of whether it is possible to satisfy your distribution and still make money?

I have a couple of comments. It's my observation that product development actuaries and marketing people do work together. I think there are a couple of indications of that from the panel today. If you look at Arnie, who is head of individual distribution for Ameritas, he's a lawyer, and he's much more focused and organized than quantitative. He's almost a junior actuary in the way that he's focusing in on the analytical part of the work. I think that's more typical now than it ever used to be, because of all the things that Matt brought up in the increased complexity of trying to answer the question positively.

On the other hand, you also heard Anne say something about ease of doing business and "time is money" from the distribution point of view, so I think that everybody understands the perspective. I think the old jokes about the actuaries saying no to the marketing people only after listening are good jokes, by the way, but hopefully the stereotypes are being broken.

The last comment is that I think marketing organizations are increasingly controlling the distribution of our products. I don't think they'll ever control all of it, but many companies have lost almost all of the control that they have over the people who sell their business to large organizations. I'm attaching no quality to that, but it's an observation. From a journalistic perspective I observe that, and it's up to you to decide whether you think that's beneficial to the organization.