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UNTANGLING DISTRIBUTION

To grow the business

Distribution at center of life insurers' new customer focus

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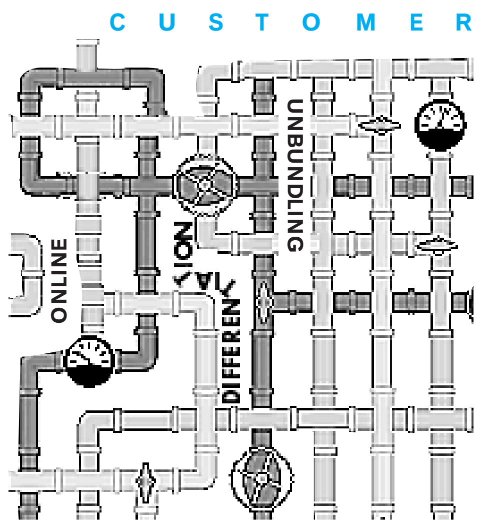

'Instead of saying, 'Let's find a distribution channel to sell this new insurance product,' we're constantly asking ourselves, 'Who are the customers, and how can we help them solve their problems?'"

This clear, plain-speaking statement by Timothy Tongson, vice president of product manufacturing for Allianz Life, points to a major shift in focus among life insurers. Accelerating in recent years, this change directs an insurers' business emphasis away from selling product and toward determining and meeting customers' needs. This shift is still causing upheaval throughout the insurance world, its current wave sweeping largest over life insurance distribution, experts say.

Tongson's statement shows just the beginning of a complex process that includes wide-ranging consolidation, changes in compensation structures, build-up of technological abilities, and outright experimentation.

Tongson, an FSA, was one of four insurance executives speaking to *The Actuary* about the distribution drama taking place today. Also sharing their insights were:

- Bruce Nicholson, FSA, executive vice president and chief operating officer, Lutheran Brotherhood
- Barry Jacobson, FSA, senior vice president, Travelers Life and Annuity Company
- Robert Carlson, executive vice president, Northwestern Mutual Life Insurance

While insurance, like other industries, is undergoing change in many of its segments, distribution is taking center stage today. Observed Jacobson, "In the industry, the focus has shifted. You can develop products until you're blue in the face, but distribution is how you grow the business." And Carlson noted, "Distribution is the scarce commodity today. Anyone can manufacture a product."

Mergers skyrocket, change intensifies

Experts viewing the 1999 distribution scene have last year's experience to reflect on. Perhaps the clearest sign of intensified change in the distribution environment is consolidation among distributors. A chart in *Business Insurance's* Mar. 22 issue noted 183 distribution deals in 1998 vs. 109 in 1997. The dollars involved tell even more. While the 1997 deals were valued at $2.72 billion, the 1998 deals

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product complexity, the nature of the insurer-customer relationship, and the appropriate distribution strategy.
3. Successful companies will work hard to establish precisely how emerging technology and the Internet will be integrated into their vision and related long-term strategies, and such companies will quickly build platforms needed to support this effort.
4. Ultimately, life insurer profits are driven by the quality of the original sale and subsequent customer relationship, which in turn are reflected in measures such as persistency and products per relationships.
5. Life insurance is unique in that it is acquired and then usually "put away and forgotten." Common wisdom has been that life insurance must be sold. Some nontraditional competitors are challenging this mantra, particularly in middle markets.

Most companies need thought leaders and documented successes in their efforts to rethink and reframe their businesses and the distribution "heart" of these businesses. Our hope is that we move you to share your insights and experiences with us and other members of our profession.

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weighed in at $55.9 billion — more than 20 times the year-earlier dollar figure. Conning & Co., the company authoring the study reported in *Business Insurance,* included mergers of major entities in the 1998 figures to reflect changes in distribution, especially in the financial services area.

Jacobson at Travelers noted, "This is the primary business environment change. For the first time, there is tremendous consolidation among distributors as well as insurance carriers. Life insurance is a mature industry, we have to get price in line, and scale helps this." Nicholson of Lutheran Brotherhood agreed, saying, "Mergers and acquisitions are commonplace as companies try to gain critical mass."

What's fueling this industry restructuring? What factors are forcing an overhaul of life insurance distribution?

Nicholson cited several external and internal factors.

Externally — "from the customer's perspective" — customers are "more demanding, have more choices, and are less loyal than ever before." Aggressive marketing leaves them cold; they use call blocking to avoid sales calls. Add to that, "customer expectations are established by Disney, L.L. Bean, and Federal Express, not by other financial services firms," and you have an usual situation in the history of commerce. Added Nicholson, "Distribution systems need to be clearly perceived as adding value to a customer who is better informed and more demanding."

Internally, said Nicholson, "our industry is undergoing a fundamental restructuring the likes of which we haven't seen before." In addition to the consolidation among distributors, many large mutuals have announced demutualization plans, and the career agency system "is producing fewer new agents every year." To top it off, there's the growing population of the aged — 76 million strong in the United States alone as the baby boomers enter their later years — leading insurers to "write more annuities and less life insurance than ever before."

From his post at Travelers, Jacobson sees seven points of change regarding distribution:
1. Consolidation among distributors
2. Financial and estate planning becoming the dominant source of consumer financial product sales
3. Variable life passing whole life in total market share, "a dramatic change for the industry,"
4. Decline of the career agency system
5. The rise of new distributors, such as banks, work site programs, and the Internet
6. A change in the regulatory environment, "moving toward zero tolerance" for any type of market misconduct
7. Technological changes and advancements; "the Internet is probably the biggest change — getting direct sales, generating leads, providing faster information flow"

Oddly enough, while many decry the problems of the career agency system, many also say part of the problem is that it isn't big enough. Said Carlson at Northwestern Mutual, "While the industry grew, companies failed to develop cost-effective distribution through the agency system. Most companies didn't grow distribution while the market was growing in the '60s, '70s, and '80s."

That has led to a shortage of trained agents at a time when the insurance industry is watching expenses more closely than ever. If the supply of agents met or exceeded the current demand, thereby keeping costs down, the career agency approach might be more viable today than economics allow (although the system would still need to change, probably to a financial planner model). Noted Nicholson, "Much of the higher cost associated with agency distribution stems from the high cost of developing a career

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agent from scratch" and, at the same time, "the failure rate associated with new agents is inordinately high." This is not a time when insurers will embark on high-cost, high-risk programs. "So far, however, no other distribution system has shown the consistency of performance that the agency system has over many years, or the predictability of premium income," said Carlson of Northwestern Mutual.

The compensation question

The world of business and consumers has changed. There's no going back. How must the insurance industry change its distribution methods in this new world?

"The biggest change needed relates to our compensation systems for agents," Nicholson said. His further thoughts summed up others' comments: "Today's customer seems willing to pay for advice and counsel. Unfortunately, the agent is still usually paid a commission only for making a sale."

All those interviewed saw the financial planner model as one possible wave of the future, especially for upscale customers. Noted Jacobson, "Advanced sales will require a face-to-face consultation — the financial and estate planner approach. Consolidation will allow money to be spent on advancements that will allow distributors to serve high-net-worth customers this way."

Said Nicholson, "It is fairly well documented that the agency system is higher in cost than most other financial service distribution systems," at least in part because "only those who actually purchase a product pay for the cost of advice." He added, "A fee-based planning system would allow more equitable allocation of that cost. This in turn should lower the cost of the product, perhaps enough to make it more competitive with products offered through other distribution channels."

How can insurers successfully transform the entrenched career agency mindset in the sales force? How do you change compensation, build an advice-based system, and also perhaps continue selling through the established agency patterns?

Tongson cited Allianz Life's growth in alliances and joint ventures with distributors. Once heavily dependent on the traditional agency models, Allianz now focuses on product development and, like others, continues to seek the optimal distribution method.

Today, Allianz uses a mix of career and independent agents through strategic alliances, acquisitions, and joint ventures. Examples are Allianz Life's 50% ownership interest in Allmark, Allianz's primary long-term care marketing company, and Allianz's recent offer to purchase marketer Life USA to access its distribution and administrative capabilities.

Tongson mentioned several new approaches to compensation, especially where alliances and joint ventures are concerned. Two are "equity participation in the value created in the distribution company" and profit sharing based on hitting specified financial targets. Compensating correctly is important to any life product manufacturer, including Allianz. "Ideally, we want to align the interests of the distribution force with those of the manufacturer," Tongson noted. "Often in distribution, the motivation to sell is still based on a high first-year commission, and the quality of that business isn't tremendously good. We believe compensation agreements must align the distributors' interest with the quality of the business."

The technology card

Smart insurers are playing the technology card more often in the game to ring up sales. Several types of technology have a major role to play in distribution, many experts say. (See "The fastest track: Internet rapidly forcing major shifts in the insurance industry," *The Actuary*, November 1998.)

The face-to-face, financial planner approach "will not be used to sell commodity products such as low-face-amount term insurance," noted Jacobson. "Such products will be sold through the new technology, mainly the Internet. Telemarketing and direct mail selling will still exist, but they will be impacted by the Web and will not exist to the same degree."

Said Carlson, "We have to recognize that distribution sorts itself along the lines of product complexity. People are willing to pay for relationships where agents bring knowledge to the table. With commodities, little knowledge is needed, and so that kind of distribution can be done with less cost. You can't turn a product requiring a knowledge-based sale into a commodity simply by pricing."

Tongson said e-commerce insurance sales would continue to rise, in part because "commoditization of products will continue, resulting in lower profit margins."

But equally important is a slight variation of Tongson's original statement: "How can you make it easy and convenient for customers to solve their problems?" The convenience of such tools as the Internet — "where customers can find information when they want it, all day, every day, all year" — is just the beginning. Taking a longer view, Tongson points out that the business world, dramatically different from that of 20 years ago, will undergo more transformations as a result of technology. "Consumer attitudes and behaviors will continue to change as technology becomes even easier to use than it is now, and it will be much easier to use in the future" for both insurers and consumers.

That means that even some upscale, complex sales will move away from face-to-face venues, Tongson predicted. "It's just a matter of time before customer sophistication and the convenience provided by information technology moves some upscale sales to other mediums."

The technology card will change the game in many ways, including the relatively long time it takes to underwrite policies, Tongson noted. A problem plaguing many distributors, this challenge is most likely to be met by technology yet to emerge as well as changes in the law. "Technology isn't that far away from getting vast amounts of information from a simple blood drawing or even a strand of hair," Tongson said. With adequate legal changes, "it's technology that will get us there" — that is, to near-instantaneous underwriting. (The need for faster underwriting also was cited in "The fastest track," *The Actuary*, November 1998.)

'You can't do everything well'

Career agents still thrive at Northwestern Mutual, one of very few organizations that operate profitably with that system, some experts said.

Carlson, a senior executive at Northwestern Mutual, said career agency "is highly productive for us" because the company sells largely individual life insurance products, "and our agents are very productive because of the large number of lives and the amount of premium written each year. One thing that's true is that insurers will have to specialize. You can't do everything well" in the new insurance world. "There is only so much product diversity that can be sent through an agency pipeline. Agents ultimately end up specializing, whether they are exclusive to a company or members of a producer group."

Northwestern still hires and trains its own general and district agents as well as career agents. "We believe the quality and complexity of our products makes it productive for us," Carlson said. Echoing Tongson's concern for the types of sales an insurer gets, he noted, "The biggest challenge insurers face is persistency, and this goes back to the quality of the sale." Career agents produce good-quality sales, he said, and two primary elements help produce and maintain a top-notch agency force: "the culture, that is, the way of doing business" and "a fair reward for the insurers and agents."

Actuaries: become visionaries

The need for new agent compensation methods and for high-quality, high-profit products puts actuarial skills at the center of the new insurance world, the experts said.

Carlson suggested that actuaries who want to contribute to the marketing function, either via product or compensation, should "walk in the distributors' shoes" for a period of time. "They don't actually have to sell, but they should do the same things an agent, a Web page, or any other provider does. Creative ideas can't be constructed in a vacuum."

Jacobson echoed Carlson's comments, but the Travelers executive would have actuaries go a step further. "I would suggest that actuaries get an agent's license and sell insurance for a time to really understand the issues distributors face," he said. But actuaries who won't take that step should at least "spend more time listening to distributors" so that actuaries can develop better solutions to distribution problems.

Nicholson reminded actuaries that "we are often accused of 'extrapolating the future.'" He cited the old joke comparing an insurer to a car being steered by the company president, powered by the marketing vice president with a foot on the accelerator, and protected by the controller with a foot poised over the brake; the actuary is calling out directions while looking out the back window. "Our skills are needed to help create the future, but from a different perspective. We need to look out the front window," Nicholson said.

Tongson agreed, emphasizing the need for actuaries to become visionaries. "Actuaries can help develop innovative methods in which compensation or profit-sharing arrangements can be constructed," he said. "Be more futuristic in your vision, and help bring that approach into the product development process. Actuaries are already good with the numbers; they need to focus more on innovative concepts that create value for the customer and distributor on a profitable basis to the company."

Above all, actuaries "shouldn't be afraid to ask the question, 'How does what we're doing meet the needs of the eventual customer, not just the agent?' Ultimately, we have to sell to customers' needs, so be bold and have the confidence to get that question addressed."

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