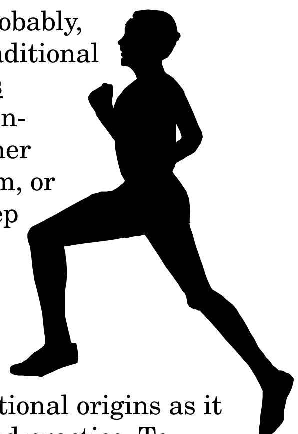
NEWSDIRECT

Newsletter of the Nontraditional Marketing Section

NUMBER 37 SUMMER 2001

Keeping Up With Nontraditional

by Tom Bakos



One dilemma that no one, probably, ever associates with nontraditional marketing is how one <u>stays</u> *nontraditional*. The fact is that a non-traditional marketing approach either succeeds, and enters the mainstream, or fails and disappears. In order to keep the nontraditional fires burning, more new ideas always need to be piled on. Like our youthful exploits, once brilliantly acted out signs of nonconformity, a marketing scheme is remembered only for its nontraditional origins as it takes on the gray hairs of established practice. To remain fresh, new, alive, and vibrant, the Nontraditional Marketing Section must wash off both the successes and the failures and dress in new clothes suited to a traveler in the wild, fringe territories it must explore to confront the ever changing nontraditional market.

One of these new territories is the Internet. The problem waiting to be solved there is how Internet consumers can click-shop for life insurance as easily as they click-shop for books, computer software, or airline tickets.

(continued on page 4)

Chairperson's Corner

What' s Going On With NTM?

by James B. Smith

Several years ago during my consulting career, I was invited to participate in a discussion with the management team of a midwestern insurance company. The team consisted of senior personnel from all areas of the company. My role was to assist them in the development of a new product portfolio. We started the meeting by discussing product features, but the conversation quickly turned to target customer segments and distribution channels.

The discussion of customers and channels was vitally important so that the company's new products could be optimally designed. Such information is needed to increase the likelihood that products will be:

- Reasonably competitive — that is, not too expensive
- Priced properly with reasonable assumptions for persistency/mortality/expenses, and a profit margin that meets or exceeds the minimum hurdle

After twenty minutes of discussion, the investment officer said in a frustrated voice, "Why are we discussing all of this? I thought that we would simply tell you the product that we want, and you would price it out."

I could empathize with his frustration because I also have a bottom-line orientation. However, I had been down the path of prematurely starting the pricing work without a basic understanding of target customers and distribution channels. Except by accident or good fortune, a premature

(continued on page 2, top)

In This Issue

Chairperson's Corner
from page 1

start results in (a) a poorly designed product or (b) the need for a second start after wasting time on the premature start.

I responded to the investment officer by saying, "I can do what you are asking, but I don't think that you want me to do that. Without understanding your target customers and distribution channels, the product portfolio will be sub-optimal to the policyholder, salesperson, and your company." Product development that solely focuses on product features cannot produce results that are as successful as a triangulated approach involving customer, product, and distribution.

In 1999, under the leadership of Ed McKernan and Carl Meier, the Nontraditional Marketing Section adopted a mission statement that includes language about facilitating "research and discussion regarding the relationship among customers, products, and distribution systems." The steps for optimizing this triangulation include:

- Identifying target customer segments
- Determining the financial needs of such customers
- Designing an insurance product with features that address the customers' needs
- Selecting (or confirming) the distribution channel that can link the target customers and insurance products

Product-development triangulation is especially important in nontraditional marketing because the knowledge of customer segments and distribution channels is usually more limited than in traditional markets.

Our Section is addressing triangulation in several ways. For the spring SOA meeting, council member Mike Presley is developing a track of several sessions on customer relationship management. These sessions will advance our understanding of the first step in triangulation.

Another activity sponsored by our Section is the development of the Product/Channel Directory, which can be found online at the SOA Web site.

The directory has a matrix showing the products and distribution channels for each company participating in the directory. For example, you can determine the names of companies selling variable deferred annuities via the Internet. For each company in the directory, there is a contact name and phone number that can be used as a source for market research. Although the directory does not address customer segments, I believe that it is the first SOA document that links products and channels for a large number of companies. Presently, council member Mike Fix is leading the effort to develop a second edition of the directory.

Triangulated product development may be complicated for the product actuary because it involves nontraditional skills. On the upside, triangulation expands the product actuary's skills by using a holistic approach for developing new products, as well as optimizing the impact of a product portfolio.

James B. Smith, Jr., FSA, MAAA, is chief financial officer at SEC, Inc. in Shelby, AL. He can be reached at jbsmithjr@worldnet.att.net.

NEWS DIRECT

Issue Number 37 Summer 2001

Nontraditional Marketing Section
of the Society of Actuaries
475 N. Martingale Road, Suite 800
Schaumburg, IL 60173

Phone: 847-706-3500 Fax: 847-706-3599 Web site: *www.soa.org*

This newsletter is free to Section members. A subscription is $15.00 for nonmembers. Current-year issues are available from the Publications Orders Department. Back issues of Section newsletters have been placed in the Society library, and are on the SOA Web site, *www.soa.org*. Photocopies of back issues may be requested for a nominal fee.

Editor's Corner

by Julie Tani

I am happy to be involved with the Nontraditional Marketing Section and look forward to my stint as co-editor of your newsletter. This is my first experience with direct involvement in an SOA Section, and I am greatly looking forward to it.

In the last edition, my colleague, Chris Hause, introduced himself to you. The two of us will try our best to continue the quality of this newsletter and provide timely, pertinent, and thought-provoking content.

I'd like to start by reiterating part of the mission statement of the Nontraditional Marketing Section: "to facilitate research and discussion regarding the relationship among customers, products, and distribution channels."

The focus of the Section is the exploration of two particular aspects of this relationship: methods of marketing financial products to potential customers other than through conventional channels, and specialty financial products particularly well-suited to alternative methods of distribution.

Basically, this covers niche products and/or new channels; think "emerging," cutting edge, yet in tune with stable channels. For example, a lesson many "dot-coms" have learned the hard way is that the Internet is a necessary but not sufficient ingredient in a successful business model. While direct Internet sales are not yet mainstream (and may not be for a while), many of you are finding ample ways to use the Web to enhance your current channel relationships and add more value to your customers than ever before.

As stated by Chris in the previous edition, our goals for your newsletter are to inform the Section membership of our council and member activities, and to provide quality articles for our NTM members. For example, the auto-dealer article in this edition is not a usual topic for this audience, yet the concepts transfer well from industry to industry. Also, Tom Bakos thinks "outside the box" in his article, "Keeping Up With Nontraditional."

We are always very grateful to our members who graciously provide us articles for your newsletter. We are open to short and long articles on a wide range of topics and can help with editing or not, as preferred by the author.

Julie Tani

We are also open to suggested topics; please send an e-mail, or contact either Chris or me with any suggestions. If you have ideas for an article or would like to contribute, please provide a draft to the editor-in-charge June 1 (Chris Hause for the September 2001 issue, and Julie Tani for the December 2001 issue).

I'd like to thank you for your membership, support, and articles. The more representation we receive from our audience, the more it is "your newsletter." I am looking forward to meeting and getting to know many of you. If you spot me at a conference, please stop by to introduce yourself and say hello.

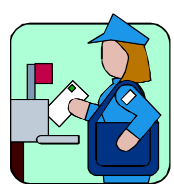
Julie Tani, FSA, MAAA, is director of marketing research at Transamerica Insurance and Investments Group in Los Angeles, CA. She can be reached at julie.tani@transamerica.com.

You've Sent Mail

by Robert E. Winawer

Editor's Note: the following is a summary of an essay written by Mr. Winawer. It will soon be available in its entirety on the SOA Web site.

Many insurance companies have found direct response to be an attractive alternative to traditional distribution because they gain control of the sales process and ownership of the customer. For these companies, the majority of their acquisition costs are spent before any policies are sold. Frequently, their greatest risk is that this expense will never be recovered. This essay shows how to take these advantages and risks into account when making financial decisions. Specifically, the essay shows how to allocate capital to maximize profit in relation to expense and other risks.



Microeconomics is applied to management of insurance solicitations in a hypothetical case example. By using Value New Business from Embedded Values to quantify marginal costs and revenue, risk-adjusted profits are maximized.

This essay answers the following questions:

1) Which costs should management consider when evaluating new ventures? For example, should management try to "cover overhead?"

2) How many times should management solicit prospective customers? Is it best to stop solicitations the first time that acquisition costs exceed the pricing allowable, when on average acquisition costs exceed the pricing allowable, or when the acquisition cost of the last policy sold exceeds the pricing allowable?

3) What is the value of a name? That is, what is the financial worth of the potential relationship with a policyholder including both initial and subsequent sales?

4) What is a simple and effective way to communicate the profitability of each sale to people who are not actuaries?

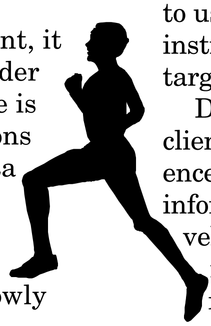
5) Why do cost-to-premium ratios, which are currently used by many direct response companies, prevent management from maximizing risk-adjusted profits?

Robert E. Winawer, FSA, MAAA, is vice president and financial actuary at Sage Insurance Group in Stamford, CT. He can be reached at rwinawer@sageusa.com.

Keeping Up With Nontraditional
from page 1

One thing, in general, that makes it difficult to ***close*** a life insurance sale and actually ***issue*** a policy, regardless of the selling environment, is the need for the applicant to go through some sort of underwriting process. The current, *traditional* sales mechanisms place the underwriting process at the ***back end*** of the sale, making it an ***obstacle*** to success.

Therefore, in an Internet environment, clicking for life insurance is, currently, only an effective way to indicate interest. That means that this wonderful new tool that provides effective two way communication all day, every day can be used only for lead generation. And, its use in that arena has been only marginally successful.



The Internet environment, it should be noted, is still under development. Not everyone is connected. Many connections are at annoyingly slow data transfer speeds and some Web page designers don't seem to account for that. But those problems are slowly being solved.

Some users are not yet very comfortable sharing their private moments and vitals with their keyboard which is, potentially, connected to every other keyboard and monitor in the world. But, we'll probably all get over that.

The thing is, that when all of those Internet performance worries are solved or forgotten, we'll still have to wait for life insurance because the traditional life insurance sales process works like this: apply, then get underwritten, hope for approval at the expected rate, deliver the policy. If the Internet is to ever play a significant role in the sale of life insurance, someone has to start thinking in a Non-traditional way.

A Nontraditional Approach

So, bringing some Nontraditional thinking to bear, why not do the underwriting first? Why not **pre-approve** someone for life insurance so that when they decided they wanted it, or were offered the opportunity to buy it, all they had to do was say yes, and it was theirs? In other words, can we create a selling process in which the order is: get underwritten, *then apply,* get immediate approval with rate guarantee, download issued policy?

One way to handle a pre-approval of underwriting for life insurance is to use the same method financial institutions now use to pre-approve targeted customers for credit cards.

Demographic data in existing client databases can be cross referenced against generally available information databases, like motor vehicle and prescription drug records, and decisions can be made by expert electronic systems about an individual's eligibility for guaranteed issue life insurance.

Life insurance offered in this way would still need to be constrained by some issue rules (for example — limit amounts) and would need to be priced for the broad mortality that could be expected from such a simplified issue class.

But, to be still more Non-traditional in our thinking, I believe that there is a way to make pre-approval an even more workable Nontraditional process.

What if the underwriting function was **unbundled** from the traditional insurance marketing process? That is, underwriting became more than just a function performed within a life insurance company for the exclusive use of that company in its evaluation of a risk applying for life insurance.

That seems to be an inherently wasteful and inefficient process. Underwriting, instead, would be included in the broader function, ***mortality risk assessment,*** and could be positioned as an essential part of an individual's health maintenance program. Here's how it could work.

Risk Assessment Company

A risk assessment company would provide an individual with a reliable, independent risk profile. This risk profile could be used in a number of ways. Individuals would pay for and own this information which would be stored in the risk assessment company's secure database. Only an appropriate portion of an individual's risk profile, authorized for release by the individual, would be made available to registered or authorized users of the data.

These users would be companies, life insurance companies for example, who were pre-approved to access the data and agreed to standards for use of the data. Only companies or organizations with a legitimate business need for the data would be authorized as users.

Since the database would be structured so that it was impossible for an individual to manipulate the data, any user would find it a reliable base for any decision to be made which was dependent on the individual's risk characteristics. The data would be coded in a standard industry format and available immediately, electronically via an electronically transmitted authorization code.

The risk assessment company would operate as follows. It would partner with traditional health care providers, HMOs and PPOs, for example. Typically, individuals who are members of group health plans like those have a right to periodic physical exams for a small co-payment or encounter fee. I suspect that there are many people who do not take advantage of this preventive medical benefit.

They would be encouraged to do so. But, since the standard periodic medical exam ordinarily provided is not likely to gather all of the data necessary to evaluate a risk for a significant amount of life insurance, the health care provider would offer an insurance exam supplement for a small additional fee, paid by the individual requesting the service. The supplement offered could have a few choices of level, which would allow for the possibility of greater refinement in the underwriting classification derived from the data and eligibility for larger amounts of insurance based on the risk profile generated. All of the data collected as a result of these exams would be forwarded to the risk assessment company for evaluation. In addition, the individual would provide his authorization for the company to collect other data to be used in the risk evaluation process.

Individuals could initiate this process because they were interested in the eventual purchase of life insurance. However, they might also be interested in the individualized reports and analysis that the risk assessment company would provide them as part of its service.

For example, the company could provide a detailed report on any medical test results and where they fall within the general population observed range. The report would explain the importance and significance of the results, the correlation that one might have with another, and the likely causes of any result outside of a standard range.

The report could provide a measure of life expectancy based on the profile the company created. With respect to test results that could be affected by diet and lifestyle, the report could suggest ways to achieve some improvement in order to return to the standard range.

> *"Typically, individuals who are members of group health plans like those have a right to periodic physical exams for a small co-payment or encounter fee. I suspect that there are many people who do not take advantage of this preventive medical benefit."*

To the extent that the supplemental medical testing was not covered by the normal physical exam, the examining physician would have additional data available to determine the health status of his patient.

The reporting and analysis service alone might be attractive enough to warrant the additional cost. However, the risk assessment company would create a risk profile that would contain enough information so that an insurance company, for example, could use it to determine the appropriate fit of the individual into its underwriting class structure. If the insurance company were intending to be competitive in its use of the data, it would establish a process in which the data was processed through an electronic, expert system to establish the underwriting class so that fully-underwritten insurance at the most competitive rate could be issued almost immediately. This, clearly, would have a significant impact on the sale of life insurance over the Internet.

Insurers participating in this new, nontraditional sales process, would gain a significant expense benefit. First, they would reduce their own absolute expenditures for underwriting, since a large portion of the cost to underwrite a life insurance policy would be borne by the individual applicant.

This would allow them to offer their fully-underwritten insurance coverages at lower rates than competitors not using the system. The applicant would benefit from the lower premium, which would effectively reimburse him, in whole, in part, or in excess of, the cost of the supplemental exam he paid for. The insurer might reflect its lower cost in a number of ways: a lower annual premium; a first-year lump sum discount; or a combination of the two.

There is an overall expense savings in this new nontraditional sales system because the insurer incurs an underwriting cost only with respect to policies it actually issues. Therefore, it doesn't need to "gross up" its unit pricing expenses to account for policies applied for, underwritten, and **not taken.** In addition, some system-wide expense redundancy is eliminated.

The insurance examination *piggybacks* on the periodic medical exams already provided and paid for as part of the applicant's health plan. In addition, the risk profile created can be used multiple times

(continued on page 6)

Keeping Up With Nontraditional

from page 5

by a number of insurers or other qualified users.

By encouraging people to take advantage of the periodic medical exams provided by many health insurance plans and to be better informed about their own health situation, the new nontraditional process would be encouraging a healthy lifestyle.

The industry could further enhance this goal by continuing to provide a premium discount to individuals who maintained a ***current*** risk profile in the risk assessment company data base. Individuals could maintain their risk profile as ***current*** by updating it periodically on a schedule appropriate for their age and general health. The fact that a risk profile was current would trigger the premium discount. The actual medical result of the update would be significant only with respect to the purchase of new insurance.

The continuation of a discount on existing insurance relying only on a *current* risk profile status could be justified by the belief (which would need to be tested) that the preventive medicine being practiced by periodic examinations effectively increases life expectancy. An added advantage of having a current risk profile status would be that an individual is always eligible for fully-underwritten life insurance that can be issued instantly.

The participating individual's cost could be reduced by charging insurers a small fee to have access to the risk profile data. In addition, other purposes for the risk profile data could be developed. One idea would be to use the risk profile in lieu of a standard pre-employment physical for those companies requiring one.

Another idea is, with proper authorization from the individual, anonymous risk profile data could be made available for use in experience studies. Fees generated by these additional uses of the data could offset the individual's cost for using the service.

Internet Life Insurance Revisited

With this new, nontraditional selling mechanism in place, the sale of life insurance in the new Internet marketplace could be done via one-click shopping. For example, a customer would enter a former "aggregator" site, converted from a lead generation emphasis to a sales emphasis, and key in his vital information and provide authorization to access his risk profile stored on the risk assessment company database.

The customer would authorize access through provision of his unique access code. Only service users pre-authorized by the risk assessment company could utilize the service. Within minutes, the Web site would provide the customer with binding, fully underwritten insurance quotes for the type of insurance requested at the most competitive rate available. The quotes would be from several companies, filtered by criteria provided by the customer, at the best underwriting class that the customer qualifies for in each company.

The customer would need to answer a couple of non-medical questions designed to elicit information on any change in health that might have occurred since the risk profile was established. The customer would make his choice based on the premium and other information provided to him and purchase his policy by clicking the appropriate "buy" button. The initial premium could be paid by credit card, coverage could begin immediately, and a policy could be downloaded for printing on the customer's printer. Confirmation of the sale would be provided in such a way as to satisfy law and custom.

This could be such an attractive and efficient sales process that the Internet, or at least some form of electronic commerce, could become a part of every insurance sale.

Certainly, not every insurance need is self-recognized or easily self-defined. Therefore, it is unlikely that the internet by itself can satisfy every insurance need. Financial advice and financial advisors will still have a role to play. They too, however, can serve their clients better by using the services of a risk assessment company to pre-establish risk characteristics and an underwriting classification.

This risk assessment can occur concurrently with the financial evaluation process, and when the planner is ready to make a recommendation (any time, any day), he can sit down with his client and get instant binding quotes via the Internet for precisely the coverage he is recommending, from either the primary carrier or a number of carriers, and close a sale immediately.

Are you ready?

Tom Bakos, FSA, MAAA, is president of Tom Bakos Consulting in Harrisburg, PA and a member of the Nontraditional Marketing Section Council. He can be reached at tbakos@blazenet.net.

Managing Non-Life Insured Products Sold Through Auto Dealers

Part I - Vehicle Service Contracts

by John Kerper

Introduction

Auto Dealers offer several insurance and insured products through their finance and insurance (F&I) departments other than credit life and credit A&H. Vehicle service contracts, gap and financing are three other products offered by the F&I department that are often insured by property & casualty insurers. We will examine each of these products separately in a three-part series. This first installment covers vehicle service contracts or VSCs.

Product Basics

Coverage

VSCs are a contractual promise to repair certain mechanical breakdowns which occur during the contract term. Coverage has two general forms — listed component and exclusionary. Listed component coverage specifies which parts, by component system, are covered. This type of coverage may range from powertrain coverage (engine, transmission & drive axle) to a comprehensive coverage including all component systems in the car. Exclusionary coverage, better known as "bumper-to-bumper," covers anything not excluded by the contract. Many VSCs include coverage for ancillary services such as roadside assistance, towing and rental car that are required because of a covered breakdown.

What is a breakdown?

A breakdown is often defined as the failure of a covered part to perform its function. A more liberal definition of breakdown is the failure of a covered part to perform within the manufacturer's specifications. Either definition also includes a list of what is not a breakdown. Typical entries on this list are:

- Regular maintenance as specified by the manufacturer
- Body & interior damage
- Failure caused by a pre-existing condition (used cars)
- Failure due to lack of proper maintenance as prescribed by the manufacturer
- Failure due to property damage (storm, collision, fire, etc)
- Breakdown during commercial use
- Repairs covered by the manufacturer

Term

For new and nearly new (used cars still under manufacturer's warranty) vehicles, the term generally runs for a specified number of years from the in-service date (the date when the vehicle was first sold) or until the odometer reaches a specified mileage, whichever occurs first. Some providers will extend the calendar portion of the term from the VSC purchase date rather than the in-service date for nearly new vehicles. Typical terms, in months and miles, are 36 months / 50,000 miles, 60 months / 75,000 miles, and 72 months / 100,000 miles. The term for used vehicles is the lesser of a specified number of months and miles from the VSC purchase date. Typical terms are 3 months / 3,000 miles, 12 months / 12,000 miles, 24 months / 24,000 miles, 36 months / 36,000 miles, and 48 months / 48,000 miles.

Coverage for nearly new cars is often called Extended Eligibility. This term indicates that the coverage may be purchased at a date later than the vehicle purchase date subject to certain conditions, such as at least 1 month and 1,000 miles remaining before expiration of the manufacturer's warranty.

Who is insured?

When sold a VSC by an auto dealer, the consumer gets a promise by either the dealer or a claims administrator to pay for covered breakdowns. He does not have an insurance contract. However, the obligor (i.e. the entity promising to pay) usually purchases insurance to pass this obligation to an insurer. Some states require that an auto dealer be the obligor for a VSC. If a VSC is sold by an entity other than an auto dealer in one of these states (e.g. lenders, internet sites and auto service centers), the VSC may be an insurance contract known as Mechanical Breakdown Insurance or MBI.

(continued on page 8)

Managing Non-Life Insured Products Sold Through Auto Dealers Part I - Vehicle Service Contracts

from page 7

Rates

VSCs are generally sold for a single premium which is either paid or financed at the time the vehicle is purchased. The price charged by the dealer is made up of 3 components - (1) insurance premium paid by the obligor, (2) administrative fees and (3) dealer markup. It is important to note that the total price charged is unregulated in most states. It is also important to note that component (1) is the only portion that is paid to the insurer. Components (2) and (3) are not paid to the insurer, nor are they included in premium for purposes of calculating premium tax or risk-based capital.

Refunds are calculated pro-rata based on remaining months or miles of coverage, whichever is less.

Deductibles

The most common deductible amounts are $200, $100 and $50 per claim, although some VSCs charge a separate deductible for each component system involved in the claim with a maximum of two or three deductibles per claim. Many insurers offer a $0 deductible and/or a disappearing deductible that is waived if the vehicle is brought back to the selling dealer for service.

Reserves

Since this product is usually sold as single premium, there are two primary reserves held — unearned premium and claims in course of settlement. Claim records are generally initiated when a vehicle goes in for service, so IBNR is not material and often not held. The longer the contract term, the greater the relative importance of unearned premium. For a typical book of VSCs, unearned premium is 10 to 20 times as large as the claim reserve. Also, claim reserve estimates based on unpaid amounts for open claims are usually accurate because all claims are known and there is little development.

Unearned premium, however, requires much more effort and judgement to estimate. The NAIC requires that the aggregate reserve held equal or exceed the larger of three quantities for each year of issue (3 year-old and older contracts can be aggregated): (1) the amount of insurance premium refundable to contract holders, (2) premium times future expected claims and expenses, divided by total expected claims and expenses, and (3) the present value of expected future claims and expenses. Several papers in the *CAS Forum, Fall 1999,* discuss this reserve calculation. These papers may be found at *http://www.casact.org/pubs/forum/99fforum/99fftoc.htm.*

Managing VSCs

The keys to managing a portfolio of VSCs are:

- Unbiased estimates of the emergence of claims by coverage and term
- Knowledge about the dealers and agents selling the VSCs
- Flexible program that can be adjusted by dealer in order to reflect the risks generated
- Knowledgeable and accountable claims personnel using appropriate administrative systems

Since the term of a VSC can extend 6 or more years and the entire premium is paid up front, an unbiased estimate of the emergence of claims enables the VSC actuary to make reasonable projections of ultimate losses and profitability of a book of VSCs. An insurer could go several years without making necessary rate increases or may cancel profitable accounts if a biased claim emergence pattern is used for these projections.

The typical patterns used by insurers before the NAIC reserve requirements (effective with 1998 statements) were pro-rata for used car coverages and reverse rule-of-78s for new car coverages. Pro-rata factors tend to underestimate early claims for used vehicles and overstate loss ratios because many purchasers drive more than the pro-rata number of miles per month. Thus their coverage expires based on miles before the time limit and claims decrease at the end of the coverage period. Any simple derivative of reverse rule-of-78s for new car coverages will also miss the mark. New car coverage claims are effectively zero, with the exception of ancillary benefits, until the first manufacturer's warranty expires. Claims then increase until the manufacturers' warranties expire on all covered vehicles, and finally decrease near the end of the term as some VSCs expire based on mileage. It is impossible to track this pattern with any simple calculation. See the sidebar — Vehicle Service Contracts, Some Actuarial Techniques — for a deeper look at this calculation.

The use of simple earnings methods often masked serious pricing problems. Over the past 20 years, many companies have entered the VSC market because of low entry barriers and the lure of rich single premium cash flows. Many of these companies left the market because they unknowingly offered under-priced coverage (remember the unlimited mileage plans of the early 80's) and sold too many VSCs before the problem was apparent.

Knowing the track record of dealers and the general agent (if any) that "controls" their business is essential in this business. Unlike a life or disability agent, the dealer can directly influence claims in a number of ways. Some examples are:

- Reconditioning – selling a VSC on a used car that was not adequately maintained, checked and serviced prior to sale
- Service bay sales – selling a VSC under an extended eligibility option because the vehicle has already had a number of problems
- Betterment – diagnosing and performing "covered" repairs when a true breakdown (failure of a covered part) did not occur.

(continued on page 10)

Vehicle Service Contracts, Some Actuarial Techniques

For the VSC actuary, the most critical and most difficult task is to develop good estimates of the emergence of claims by coverage and term. This task is critical because pricing decisions are based on this estimate. It is difficult because the data may be inadequate, incomplete or biased. Nonetheless, the actuary must make an estimate, carefully study results, and adjust the estimate as the studies indicate. Following are some techniques that may help in this process.

The earnings factor for a given contract month is an estimate of the ratio of claims paid through that contract month to the ultimate claims paid by the end of the contract. This is the most common expression of the emergence of claims. Ultimate expected claims for a book of VSCs are estimated by dividing incurred claims as of the study date by an earnings factor.

There are a number of techniques for estimating earnings factors, most of which are based on claim triangles. The first step is grouping the contracts into relatively homogenous cells, such as by type of coverage, vehicle group (e.g. Asian / domestic / European), term and initial mileage. Within these cells, VSCs are grouped by effective calendar quarter. Then contract counts and claims are summed by contract quarter for each effective quarter in each cell. These sums are the claim triangle data required for the calculation. Two methods of calculating earnings factors from this triangle, the Periodic Cost Method and the Link Ratio Method, are described below.

In the Periodic Cost Method, average claims per VSC exposed are calculated for each contract quarter. These average costs are projected using trend so that they represent estimated averages for a VSC issued on the study date. The earnings factors as of the end of the quarter are calculated as the ratio of accumulated costs through the end of the quarter divided by total costs through the end of the VSC.

In the Link Ratio Method, the cumulative incurred claims as of each calendar quarter are calculated and the ratio of successive quarters is determined. These ratios are Link Ratios and are the building blocks for estimating earnings factors by this method. When the VSC is fully earned (usually at the end of the term), its earnings factor is 1.00. The earnings factor as of the previous quarter-end is estimated by dividing the final factor by the weighted-average link ratio for the final contract quarter. The earnings factor for each earlier quarter is estimated as the next earnings factor divided by the corresponding weighted-average link ratio.

Both of the above methods are subject to bias as a result of underlying changes in the programs. For example, if the mix of vehicles changes from vehicles with low maintenance costs to vehicles with high maintenance costs (or vice versa) during the study period, the Period Cost Method will overstate (understate) the portion of claims incurred in the early durations. This overstatement is a result of using average costs for the early durations based on the more recent high-cost vehicles and average costs for the later durations based on the lower-cost vehicles. The link ratio method is not subject to this bias if the underlying claims emergence pattern is the same over time, even if the mix changes. However, it is subject to bias if the underlying claims emergence pattern changes. Possible causes include parts and labor inflation and longer manufacturer powertrain warranties on newer models (up to 10 years / 100,000 miles on some makes). To the extent these biases are known and can be quantified, the earnings factors should be adjusted accordingly.

A typical problem in estimating earnings factors is lack of data. If the program is relatively new, it may be impossible to estimate earnings factors from the program data. In particular, at least 3 years of experience is required before the claim results of a new car program are credible, because early breakdowns are covered by the manufacturer's warranty. Even if the program is mature, there may be new coverages or terms without seasoned data and there may be several cells with statistically insignificant data. Furthermore, there is not an industry experience database for VSCs. As in life and health insurance, a partnership with a knowledgeable reinsurer is a prudent way to operate in the absence of sufficient experience data.

Managing Non-Life Insured Products Sold Through Auto Dealers Part I - Vehicle Service Contracts

from page 9

In addition, the dealer can influence claims indirectly through anti-selection. If the dealer has access to more than one VSC provider, the one offering the lowest rate for the desired make, model and term/coverage combination is selected for each VSC sold.

VSCs have been marketed for over 20 years and most dealers have experience that can and should be reviewed before setting them up on a program. Each new dealer should pass an underwriting screen that includes review of the following:

- Claim and Loss Ratio experience with prior carrier(s) for the past 5 – 7 years
- Number of contracts sold per month, with breakdown between new, used and extended eligibility
- Reason(s) for switching or adding carrier
- Number of programs currently offered

The dealer screen should be more stringent for high-volume dealers because they tend to be more sophisticated in dealing with insurers and there is more risk (i.e. greater potential profit or loss). Dealer participation in underwriting profits via experience commissions or reinsurance is a common method used to encourage high volume dealers to think of the insurer as a partner and increase program profitability for all.

Once a dealer is on a program, sales and claim results must be monitored regularly to detect the need for corrective action. Particular attention should be given to low volume or unusual concentration by term (anti-selection), excessive early claims on used cars, high average claim, high loss ratio and high frequency of claims. If the program has a flexible rate chart (most states that review rates allow a deviation up to +/– 30% for objective differences), rates may be adjusted. Other corrective actions include:

- Limiting extended eligibility to the sale date of the vehicle
- Limiting availability of longer term and/or exclusionary coverages
- Requiring used car inspections prior to coverage
- Imposing a 30 day (or longer) elimination/wait period before a claim can be made on a used car
- Limiting sales on non-franchise vehicles (e.g. used Fords sold by a GM dealer)

The ultimate corrective action is cancellation if all else fails or if the situation is so bad that the chance of sufficient improvement is low.

A well-designed administrative system facilitates the job of paying the right claims by verifying coverage, estimating costs for parts & labor, and providing easy access to claims information on the same vehicle or at the same shop.

However, it is easy for a repair shop to perform and provide documentation of a covered repair even if the repair was not needed, and it is much easier to pay a claim than to challenge one. Therefore, the claims personnel must be accountable for results because there is additional administrative cost to inspecting a vehicle with a questionable claim. Furthermore, the claims personnel must understand auto repairs in order to detect potential abuse in the first place. Use of an independent inspector and requiring pre-authorization approval will help avoid problems.

In summary, an insurer must develop appropriate expertise in underwriting, claims administration and actuarial in addition to marketing in order to build and manage a profitable book of VSC business.

Next installment: GAP

John H. Kerper, FSA, MAAA, is a consulting actuary at JHK Company in Birmingham, AL. He can be reached at jkerper@ bellsouth.net.

"The Internet - How Can The NTM Section Use It To Better Advantage?"

by Steve P. Cooperstein

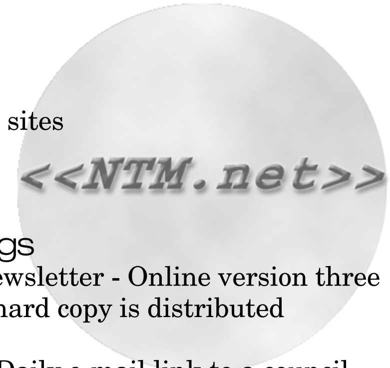
Seeking answers to this question is obviously in your best interest. Not only could the "answers" serve you directly, they might offer marketing opportunities that you may be able to cash in on. As with many opportunities, though, especially those involving the Net, benefits will likely be a function of your involvement. With that thought in mind, we would like to review possibilities with you here on NTM.net on an ongoing basis.

To begin, let's review the functions that have been made available to you online by the Society and the Section.

Society Offerings

- Portal
- News
- Calendar of seminars and events
- Education and examinations
- Academic relations
- International information
- Section information
- Committee listings
- Discussion board
- Electronic searches of Society literature
- Mortality manager
- Store
- Directory of members
- Blast e-mail
- Programs and continuing education information
- SOA staff roster

- Links to other sites
- Help



Section offerings

- *NewsDirect* newsletter - Online version three months after hard copy is distributed
- Q&A Link — Daily e-mail link to a council representative
- Product/Channel Directory — Online electronic sortable database
- Listserve — For e-mail discussion of matters of interest to NTM members.

The Society staff and the Sections have begun discussions of upgrading Section offerings based on what other Sections have done. This would include a more consistent set-up while maintaining Section "looks" (e.g., logos; colors, etc.); survey results; and the presentation of documents apart from those included in the newsletter. A quick click-through of the various Section offerings, as well as the whole *SOA.org* site, is suggested.

Which of these functions do you use, how, and how much? Why don't you use them more? How would you suggest we use them to better advantage? What other functions would you seek?

In exploring these questions, consider your use of functions elsewhere on the Internet, or tools that you see effectively used in marketing. Also, consider how Section members might utilize certain of the Society site's offerings on an exclusive basis.

Send me, or any other council member, your thoughts. We look forward to them.

Steve P. Cooperstein, FSA, MAAA, is NTM Section Webmaster, and president and actuary at Steve Cooperstein & Affiliates. He can be reached at *stevec360@compuserve.com.*

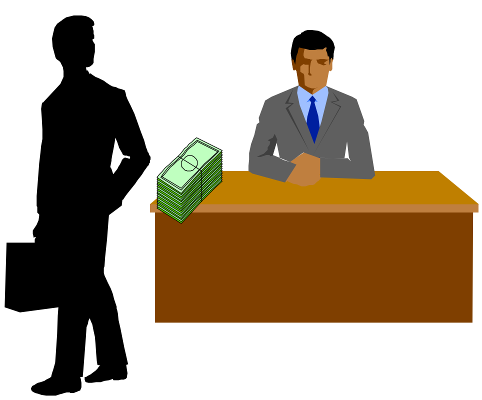
Product Development Considerations For The Bank Market

From the Seminar, "Successfully Selling Insurance In Banks — The Whole Picture"

Washington DC, February 8-9, 2001

by Maria N. Thomson

A well-rounded faculty assembled by the NTM Section discussed all aspects of developing successful bank insurance programs. Speakers included Maria Thomson, FSA, MAAA, and Alan Wade, CLU, both Principals of Thomson Management Solutions, Inc., a consulting firm that specializes in helping banks and insurers develop successful bank insurance operations; Steven Ostlund, FSA, MAAA, principal of Actuarial Consulting, a firm that specializes in credit insurance; Barnett Ovrut, a partner of Morisson, Mahoney and Miller, LLP, a law firm that specializes in insurance; and Les Webb, FCII, FLIA, FInstSMM, strategic marketing director with NMG Europe, a multinational actuarial/distribution consultancy.



In a day and a half, this group covered legal issues, sales models, bancassurance in England, relationship structures between banks and insurers, and product development issues. This article recaps the product development issues discussed.

Products for the Loan Market

According to Ostlund, credit products are a natural for banks, they are comfortable with this market and see credit insurance products as protection for themselves. In fact, before the Gramm Leach Bliley Act, banks had secured the right to "underwrite" their own version of credit insurance: debt cancellation or deferment coverage.

This coverage is considered to be a part of the loan agreement, rather than insurance. Some banks secure group insurance protection to cover their risk for this, which provides insurers a market opportunity. Features that can be included with such coverages are debt deferral for unemployment, marriage, divorce, childbirth, and family leave.

Credit insurance is very easy for banks to offer, Ostlund added. The coverage matches the loan amount, it is guaranteed issue, and the premium is included with the loan payment.

Products for the Affluent Market

These products are most alien to banks, since they are complex and require sophisticated advice. However, because these products are what most insurers are now selling through their agency forces, they are easiest for insurers to offer, other than credit insurance. These products fit with banks best in their private and corporate banking areas, which cater to the affluent market.

Products for the Mid-Market

As pointed out by Maria Thomson, the keys to this market are simple, cheap products that can be issued quickly. She reiterated the points discussed at the Annual Meeting in the "Products & Services for the Bancassurance Market" session, covered by this newsletter in the previous issue.

Pricing Products for the Mid-Market

Every aspect of pricing has to be reviewed for products designed for the mid-market.

If policies are issued in the field, then issue and underwriting functions in the home office are largely eliminated, which is a great costsaver. There will be some additional costs borne by the bank, such as increased time devoted to the sale, printing costs, and special software by the bank to enable field issue, if the bank is paying for this. This additional cost may have to be covered by paying additional compensation.

Issuance

If advanced technology such as electronic application transmission, workflow software, or expert underwriting systems is used to speed up the sale, then the cost of this will have to be amortized. If dramatic reductions in time-to-issue are achieved, then additional costs will be at least partially offset by much-reduced not-taken rates and reduced manpower costs to issue.

Underwriting

If underwriting standards are lowered to speed up issue, then mortality or morbidity rates will increase. In contrast, if using underwriting tools can lead to faster decisions, without lowering standards, then the underwriting expense assumption may have to be changed. In either case, a speedier underwriting process will lead to reduced manpower needed to process an application, which would lower the expense assumption.

Service

Banks do not want to devote much time to servicing the insurance products they have sold, so insurers should try to shift service to the home office as much as possible. This means additional staffing of customer service areas, more phones, a voice response system, and possibly Internet access and fax lines. Additionally, there should be a well-staffed sales support unit. These costs should be covered by reducing or eliminating renewal-service compensation.

"Banks don't want to devote much time to servicing insurance products they've sold, so insurers should try to shift service to the home office as much as possible. This means additional staffing of customer service areas, more phones and a voice response system..."

Mortality

There's insufficient information in the U.S. market to lead us to develop special mortality assumptions for bank insurance. In the U.K., Les Webb noted, bancassurance mortality is up to 15% less than traditional insurance mortality. The reason is not known for certain, but possibilities include:

- Less anti-selection
- Better application completion than in the traditional channel
- Less "hard sell"
- More frequent use of expert underwriting systems

Persistency

As in the U.S., the U.K. has experienced first-year lapses of 20% to 25% in the traditional channel. However, some U.K. bancassurers have first-year lapses less than 4%. Part of the reason may be that many sales are loan related, and there is a high propensity to sell single-premium products.

Distribution Costs and Productivity

Bank agencies have lower office maintenance costs and are more productive than traditional agencies. Overseas, it has been shown that up to eight sales per week are viable for a bank insurance agent, compared to two per week for a traditional agent.

The Bottom Line for Mid-Market Sales

Keep mid-market products simple and low cost. Get policies delivered quickly. These are the essential principles of product development for the mid-market, regardless of the distribution method.

Maria N. Thomson, FSA, MAAA, is Managing Principal at Thomson Management Solutions in Brimfield, MA. She can be reached at mthomson@tmsolutionsinc.com.

NTM Sponsored Sessions at Toronto SOA Meeting, June 20-22

CUSTOMER RELATIONSHIP MANAGEMENT (CRM) — A PRIMER (50 TS)

Moderator: W. Howell Pugh
Instructor: Scott Degraffenreid

This session addresses the techniques, methods, and processes that make the most efficient use of an insurer's investment in its client base. It also addresses how to maximize customer value.

Instructors define CRM and its necessary place in any modern marketing program. They discuss:

- Tools and techniques
- Approaches to maximize customer value to the firm
- Areas in which improvement in life insurance marketing can be made
- The importance of defining and focusing on the "customer"
- The effect of alternative distribution means (e.g., Internet) on customer relationships

At the conclusion of the session, attendees leave with a better understanding of what CRM is and why it's mastery is important in order to be a successful company.

*This session is designed for attendees who have **no experience** with the subject.*

Session
Coordinator: Tom Bakos

CUSTOMER RELATIONSHIP MANAGEMENT (CRM) — OPPORTUNITIES IN THE NEW ECONOMY (62 IF)

Moderator: David Florian
Panel: Eric Denham
Kevin McKenna
David Florian

Participants are introduced to new channels of distribution for insurance products: the Internet, banc assurance, in-house orphan management and customer retention. Direct contact with the customer is different from working through a traditional agent. A well-conceived CRM strategy is required. This session explores the opportunities a direct relationship with the consumer affords. They also address channel conflict risk.

At the conclusion of this session, participants understand new channels of distribution and how a well thought-out CRM model permeates all aspects of a new business strategy.

*This session is designed for attendees who have **no experience** with the subject.*

Session
Coordinator: David Florian

CUSTOMER RELATIONSHIP MANAGEMENT (CRM) — HOW DO YOU MODEL A CUSTOMER? (78 TS)

Instructors: Michael Shumrak
Paul Turner

Why does CRM matter?
Participants learn how CRM can leverage your company's distribution channel(s), increase sales volumes, and lead to greater customer persistency.

How do you model a customer?
Actuaries are accustomed to modeling products and policies. CRM requires modeling customer relationships, and actuaries need new tools and thinking in order to achieve a strong understanding of the financial value that current and potential customers represent to their company.

At the conclusion of this session, participants learn state of the art modeling techniques and which CRM strategies promise the highest return.

*This session is designed for attendees who have **no to moderate experience** with the subject.*

Session
Coordinator: Paul Turner

CUSTOMER RELATIONSHIP MANAGEMENT (CRM) — PRIVACY ISSUES (87 PD)

Panel: Mark Gorman

With the passage of the Graham/Leach/Bliley Act and other legislation affecting privacy, CRM must adjust to new challenges and requirements. This session considers:

- Updates on national and state-specific privacy legislation
- The impact of privacy concerns on direct marketing and other CRM models
- "Safe harbors" for CRM in the United States and Canada

Participants have the opportunity to share individual company approaches relating to privacy issues.

At the conclusion of this session, participants have enhanced knowledge on a timely and controversial topic and learn policies and process-es that can minimize a company's risk.

*This session is designed for attendees who have **moderate experience** with the subject.*

Session Coordinator: David Seidel

CUSTOMER RELATIONSHIP MANAGEMENT (CRM) — A CASE STUDY (105 CS)

Panel: William M. Korach

Case studies are presented on the way successful companies manage and leverage customer relationships to sell multiple products to their customers over time. The case studies emphasize what works today in CRM and current trends.

At the conclusion of this session, participants learn:

- Benefits of CRM
- Practical techniques for applying CRM
- The application of CRM in your environment

*This session is designed for attendees who have **moderate** experience with the subject.*

Session Coordinator: William M. Korach

IS THE NEXT GENERATION INSURANCE BUSINESS MODEL THE "VIRTUAL INSURANCE COMPANY?" (19 PD)

Moderator: Ed McKernan
Panel: Shane Chalke
Ihor Hron

Over the past several years, there has been an emergence of low cost insurance providers. Does this create a new playing field that becomes fertile ground for the virtual insurer? During this session, the panelists address:

- What is a virtual insurance company?
- Is it a more efficient means of manufacturing?
- Are functional costs truly variable? Does this mean low cost?
- Are time frames collapsed for the various insurance functions?
- Does delivery speed and convenience diminish branding?
- How does it affect the overall sales distribution strategy?
- Risk management
- "Security" and privacy concerns

The session challenges participants to consider the insurance landscape over the next five to ten years, and how existing business models need to evolve to meet the challenges facing the industry.

*This session is designed for attendees who have **no to moderate experience** with the subject.*

Session Coordinator: Ed McKernan

HOT TOPICS IN CREDIT INSURANCE (24 WS)

Facilitators: E. Perry Kupferman
Jean-Francois Poulin

Participants have the opportunity to discuss specific topics on items of critical interest including:

- Recent regulation
- Dynamics within the industry
- The newest thoughts on actuarial concerns
- Canadian vs. U.S. practices

Participants ask questions, raise issues, and gain a better understanding of current thinking among their peers. Please come prepared to contribute to this discussion.

This session is designed for attendees who have all levels of experience with the subject.

Session Coordinator: Steve Ostlund

BANCASSURANCE — NOTES FROM EUROPE (115 PD)

Moderator: Paul Nitsou
Panel: Toon Bullens

This session provides an overview of trends in the European bancassurance market and a case study of one successful Dutch company.

At the conclusion of this session, participants learn forces affecting bancassurance in a different market including the experiences of a successful bancassurer.

*This session is designed for attendees who have **no experience** with the subject.*

Session Coordinator: Paul Nitzou

Note: The Nontraditional Marketing Section is sponsoring a networking continental breakfast on Wednesday, June 20 from 7:30 a.m. - 8:30 a.m. This session will allow section members an opportunity to network with each other and to learn about the NTM sessions offered at the meeting.

NTM Sponsored Sessions at New Orleans SOA Meeting, Oct. 21-24

The Growing Senior Market (11 PD)

The senior market has been a niche target market for some years, but with the fast approaching baby boomers and growing ranks and phases owing to increased longevity, more major marketing initiatives are on everyone's target list. Yet, the market has unique qualities which have slowed development in certain quarters. This panel discussion addressed the forces influencing the direction of the growth in the senior market. Topics include:

- Forces driving market growth
- Recent innovations in the marketplace
- Product development opportunities
- Distribution difficulties

Panelists provide insight into current practices and areas for potential development.

At the conclusion of this session, participants gain a better understanding of the dynamics of the senior market and are better equipped to participate in its evolution.

*This session is designed for participants who have **moderate experience** with the subject.*

Internet Marketing and Underwriting (33 PD)

The proliferation of insurance sites on the Internet brings new challenges for marketing and underwriting. The variation in Web site design can require new methods of reaching customers. In assessing the risk of those customers, companies need to meet the demands of timeliness and accuracy.

The panel discussion addresses the sources that drive the direction of growth for Internet marketing and underwriting. Topics include:

- Distribution models on the Internet
- Underwriting innovations
- Product development opportunities

At the conclusion of the session, participants will have a better understanding of the new models created by Internet marketing and the underwriting challenges those models create.

Distribution Channel Management (101 PD)

How companies are managing multiple distribution channels and avoiding channel conflict. How do companies marshal their distribution channels to meet customer needs.

Learn how other companies view channel conflict. Details about differing pricing philosophies and coordin- ating products and distribution.

*This session is designed for participants who have **medium experience** with the subject.*

Financial Services Modernization — 1 Year On (78 PD)

The impact of Financial Services Modernization is unfolding one year after it has taken effect. Companies are finding new opportunities and new challenges.

The panel discussion will look at Financial Services Modernization from an insurance industry perspective. Key topics include:

- A look at the main issues faced by participants
- Reaction by players in the marketplace to the new opportunities
- What is the impact of privacy issues?

Experience Tables (134 PD)

The need for current experience is ever present for product developers and financial analysts. Regulators are increasing the pressure on actuaries to incorporate valid data and company experience into their work.

Using the recently released Credit Disability table as an example, the panelists will describe the process of having a table developed and adopted.

At the conclusion of the session, participants will have a better understanding of the dynamic of turning data into a published table.

Note: The Nontraditional Marketing Section is sponsoring a field trip to the LSU Molecular and Human Genetics Center on Tuesday, October 23 from 2:15 p.m. - 4:15 p.m. and a reception follows shortly after from 5:30 p.m. - 6:30 p.m.