

## Distribution and Consumer Value Issues

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The distribution conundrum continues to perplex most insurers around the world. In many markets consumers continue to feel uncomfortable with the high pressure tactics engendered by insurance sales forces that are compensated largely on upfront commission. Regulators are questioning whether distributors are acting in the best interests of customers. At its most extreme form this has been reflected in the Spitzer enquiries into brokerage commissions. You would have thought with this consumer and regulatory backlash that distributors were coining in money – but they aren't. Many distributors are not profitable or are facing a strong profit squeeze as commissions get reduced by insurers under their own economic pressures.

What might change this picture? A host of potential solutions seem to beckon. These mainly revolve around:

- Consumers being more in charge of their insurance product purchases so eliminating the potential for mis-selling by distributors
- Distributors and consumers interests becoming aligned through wrap or annual fees, where the incentives are for distributors to maintain not churn business
- Distributors focusing more on consumer value added than earning the quick buck

This paper explores these solutions and illustrates with case studies drawn from the UK and Japan. The failure of the UK stakeholder initiative, involving a 1% price cap, is contrasted with Aflac's successful entry and development in the Japanese insurance market.

*Consumers taking charge*

Market forces continue to push towards more transparent, more efficient distribution. Consumers are increasingly willing to buy direct for certain products

- Growing share of direct distribution for simple financial products (e.g. auto, mutual funds, term). In the UK 40% of personal lines sales are direct vs. 17% five years ago. In France its 33%.
- Growing penetration of internet sales across all retailing that extend over broad customer segments rather than just the young or technology savvy. Internet purchases now account for almost 10% of retail sales in some countries.
- Increasing use of information searches across all financial products, especially products like mortgages

This hunt for simplified and cheaper distribution is being encouraged by regulators' actions. This runs from Spitzer type programs to reduce commission bias/steering to regulators' actions to promote savings e.g. demanding more product transparency, putting price caps on products, mandating introduction of simplified product features.

In addition, insurance providers have a vested interest in encouraging direct distribution selectively. High cost distribution does not work when customer needs are simple or margins are slim. As a result, insurers have moved towards lower cost distribution approaches for simpler needs (e.g. mass market, commodity products), self service by consumers and consumer guided revenue enhancing tools e.g. asset allocation, financial planning

However, expecting consumers to take total control of insurance decisions is a pipedream even in countries with highly developed markets. Significant barriers still exist to achieving the simple, internet oriented distribution model at one time predicted to dominate insurance

- Consumers lack knowledge and motivation to buy insurance. This means a "push" sales approach will still be required. For example, limited evidence exists of direct buying of complex products e.g. pensions. While consumers will research these products online they continue to seek advice around purchase. In addition, consumers just don't enjoy buying financial products. Several surveys have shown that consumers will spend a longer time researching the purchase of a washing machine than a pension.
- Products characteristics in many insurance products- large value, long term commitment, infrequent transactions, multiple features, tax implications- make them inherently more difficult to sell via non-human methods of distribution.
- Product economics militate against the manufacturers' and distributors' interests being aligned; upfront commissions encourage churn, while lower value policies offer insufficient incentives to sell
- Commission oriented distributors have a lock on the customer. In many insurance markets all providers would benefit from lower commissions but none want to move first in reducing commissions for fear of losing business.

This is especially true in segments like commercial insurance where brokers account for over 90% of insurance sales.

Despite these issues, there are some notable examples of successes in consumers buying direct. In the U.S. 401k market, consumers have not needed to use commission based sales people. The key characteristics that drove the ability for consumers to go direct included tax and employer incentives to invest, a simple but broad product range, easy access to investing via payroll deduction, ease of switching if a customer doesn't like their initial investment choice, and some lucky timing (401k exploded during the 1980s and 90s, a time of booming financial markets). Australia's superannuation funds had many of the same characteristics, turbocharged by compulsion. In contrast, initiatives to set up exchanges around annuities, mortgages and other more complex products have generally met modest success.

### *Distributors and consumers interests aligned*

Academic papers and think tanks around the world have highlighted the benefit of fee based models of distributing many insurance products. They point out the likelihood that consumers will receive the best unbiased advice, distributors can focus on client needs not just concluding a sale, and overall costs are likely to be lower. But in very few markets, except in the high net worth segment or large corporate sector, has fee based distribution achieved any presence. While fee remuneration may grow in prominence in the corporate insurance market (as reflected by the response of the largest insurance brokers to criticisms around contingency commission payments), it seems unlikely fee based arrangements will take hold in the retail or small business markets. When consumers are surveyed around levels of fee they would pay, the results are such low levels that they would not adequately compensate distributors. Also, consumers do not seem to object to sales people being reimbursed by commission as long as the payment of commission and its level is transparent.

The answer to aligning consumer and distributor interests seems to be moving to a sales incentive structure where less emphasis is placed on upfront commission payment. While aligning consumer and distributor interests, it would also reduce new business strain and risks of mis-selling. Alternative structures include wrap charges, asset trails or levelised commissions. Wraps in particular have enjoyed strong success in Australia and the U.S.A.

Obviously, there are lots of barriers to achieving levelised compensation, including ensuring sufficient focus on new business sales rather than just farming existing business, providing sufficient compensation to new sales people who do not have a big book of existing clients, and ensuring compensation is sufficient to attract distributors. However, change is possible as reflected by U.S retail securities brokers successful transition from compensation "by ticket" to wrap fees. Change is also necessary to avoid regulatory wrath. For example, indirectly UK regulators have put pressure on traditional commission arrangements by placing price caps on pension charges and placing heavy fines on providers when mis-selling has occurred.

## *Distributors adding more value*

Distribution will get increasingly sophisticated, especially around its responsiveness to evolving customer behavior. Greater segmentation is likely to occur with closer alignment of distribution approaches to customers needs. For example, traditional advice orientation will remain at the top of market. Needs of these customers are complex and bespoke, requiring a tailored solution. Also these customers have sufficient asset or premium flow to be able to compensate a sales person for their efforts. In contrast, in the mass market there will be a movement to simple packaged products that can be bought directly or as part of a simplified, basic advice sales process. Needs in the mass market are simpler and standardized and does not require great sophistication in solution design. The role of the distributor is often around encouraging saving or insurance coverage.

While bancassurance has had various degrees of success around the world to date, increasingly banks see insurance as an untapped growth potential, particularly in the small to medium sized corporate market. While many banks have merely been distributors in the past, remunerated by commission, they may increasingly strive to earn their insurance profits in future from underwriting and investment profits.

This more segmented approach to aligning distribution with consumers will clearly be aided by:

- Product simplicity; appealing to mass market and part of mass affluent segment with products that don't need lots of selling
- Regulatory encouragement of simple savings and transparency across all financial products. Even more assistance to "pull" type distribution will be achieved if there are tax (&/or employer) incentives for consumers to use the vehicles
- Business simplicity; reducing insurance process complexity so consumers can undertake more self service, product selection and only need to access advice where required
- Technology enablement that assists in auto-underwriting, straight through processing, auto claims adjudication and other items that allow more streamlined distribution

## Summary

The "push" nature of most insurance product distribution and the regulatory and fiscal restrictions have got in the way of simplification of product distribution. In a push environment it has been difficult to get close alignment between consumer and distributor interests. Yet the situation is changing. Consumers are becoming more comfortable with direct purchase of many retail products. Regulators are trying to enhance product transparency and thus reduce complexity. Providers are seeking product and business simplicity to increase operational efficiency and reduce risks of operational risks.

Insurance providers can gain advantage by being in the forefront of the distribution evolution. But, “be careful what you wish for”. Simple businesses become commodity businesses and create the potential for huge amount of economic value to be transferred to consumers from distributors and manufacturers.

## CASE STUDIES

### **Case Study I: The Failure Of The UK Stakeholder Pension Initiative**

#### **The Perceived Problem**

The United Kingdom has a long history of state and private pension provision. In the 1980s many commentators regarded the UK system as world’s best practice. The comprehensive state arrangements with contracting out and a strong occupational system based mainly on defined benefit arrangements provided a satisfactory safety net and good coverage for a sizeable segment of the population. However, many believed that in spite of the valuable tax concessions, the extent of coverage was insufficient. The perceived problem was that not all employees had access to good occupational pension plans. The secondary concern was that personal pensions that had been marketed, largely to the self-employed, were too expensive.

In common with other countries the UK had suffered from mis-selling problems in previous years. In particular there was a wave of mis-selling associated with government sponsored encouragement of employees to contract-out of their occupational plans, take a government rebate and apply it with their own contributions to personal pension arrangements. Many of these personal pension plans were structured as relatively high charge, high commission products. It was common for initial commission as a percentage of the first year’s regular premium to be of the order of 75%.

#### **The Suggested Solution**

The government published a consultation paper in December 1998 entitled “Partnership in Pensions”. This outlined proposals for a new stakeholder pension regime that was meant to be consumer friendly. The new arrangements were aimed at full time workers earning between £9,000 and £18,500 per annum. This corresponded approximately to between 50% and 100% of average earnings.

The government released six further discussion papers in 1999 dealing with issues such as minimum standards, employer access, clearing arrangements, regulation of advice, information, governance and the tax regime.

All employers with more than five employees were required to offer a low cost flexible and secure arrangement to their employees. The stakeholder plans would be on a defined contribution basis with compulsory minimum standards.

A key feature of the plans was the imposition of a rigid price cap. Charges were limited to a maximum of 1% per annum of the accumulating funds under management.

There were to be no up front charges, no exit charges, no member charges, no cross subsidies and no charges on transfers. The minimum payment was set at £20.00 per month.

This whole experiment was based on the rather naïve assumption that if you make the product cheap enough the customer will buy it.

The government issued regulations in May 2000 and the new stakeholder system was open for business in April 2001.

### **The Contagion Effect**

As the shape of the new products became apparent, product providers brought the design of other pension arrangements broadly into line with the new stakeholder regime. These were known as “stakeholder friendly” pensions. Pensions were established with a single annual management charge rather than the multiple charge basis that was common previously and it was standard for there to be no early termination penalties for all new pension arrangements.

The predecessor of the current regulator, the Personal Investment Authority issued Regulatory Update 64 (RU64) in March 1999 which attempted to prevent Financial Advisers selling higher charge pensions in the two years running up to the launch of the stakeholder system. This stated that the planned introduction of stakeholder pensions must be taken into account when an Adviser recommended a pension. This meant that pensions with early termination penalties were no longer suitable.

### **Initial Success**

When the doors opened for business in April 2001 there were 50 stakeholder providers. All employers with greater than five employees were required to have a stakeholder framework in place by October 2001. Initial sales figures were very encouraging but were massively inflated by some providers converting existing pensions into stakeholder pensions. For example, the Building and Civil Engineering Insurance converted over 100,000 personal pensions to stakeholder in the first few weeks.

### **Life Company Reaction**

There was considerable concern expressed by industry participants about the ability to provide the new products at a satisfactory profit. Life companies reacted to the new regime by reducing the rates of initial commission paid on pensions business. The typical reduction was from 75% of the first year’s premium to approximately 25% of the first year’s premium for regular premium products. This seemed like a large reduction at the time however even after this change the economics of the business were questionable. Some life offices went even further and reduced the charges on their in-force block of business so that they were broadly in line with the new stakeholder regime with an annual management charge of approximately 1%. The logic of this change was to remove any justification for Advisers recommending a move of existing plans to stakeholder.

Non-stakeholder pensions were significantly impacted by these changes. Most of these arrangements were changed to a single charge basis in line with the stakeholder products. Some of them offered the option of a higher annual management charge - of the order of 1.3% to 1.4% per annum to allow for the payment of commission. Advisers however were still confused as to whether including the cost of advice was a legitimate reason to discount the offering of stakeholder in favour of a personal pension (RU64). The regulator failed deliberately to clarify this issue. Part of the justification for offering a non-stakeholder plan was that originally these plans offered a wider range of investment choice. However, the nature of competition meant that the original basic stakeholder product offerings were significantly enhanced in the early days of the regime.

## Results

The take up of the stakeholder arrangements has been very disappointing. By October 2001 over 80% of the stakeholder schemes were “empty boxes”. This means that the stakeholder plan was in place but there were no employer or employee contributions. The following table shows the number of new regular premium stakeholder sales made in the years 2001 to 2004.

Number of New Regular Contribution Stakeholder Pension Contracts  
(Figures in ‘000s)

	Individual Stakeholder Plans	Employer Sponsored Stakeholder Plans	Total Regular Premium Stakeholder New Plans
2001*	215	334	549
2002	276	239	515
2003	200	254	454
2004	183	223	406

\*From 6th April 2001 to 31st December 2001

Source: Association of British Insurers

The writing of stakeholder business also had a significant impact on the financial position of providers and distributors. A product which offers 25% of the first year’s regular premium as commission and relies on a charge of only 1% per annum of funds under management clearly needs a long period of years before it pays back the initial financing let alone produces a satisfactory return on capital. This business was very capital intensive and potentially unprofitable.

There was a flow-on effect to distributors who were effectively prevented from charging fees because the stakeholder arrangement appeared to offer value to employers and their employees which was too good to be true.

During 2002 and 2003 the fall in stock markets had a further adverse impact on this business. Advisors naturally turned their attention to more profitable product lines

and so this resulted in “financial exclusion” of the original target market. It was notable that the Government also attempted to distance itself by redefining the target market as above average earners. The number of stakeholder schemes open to new business fell to around 35. Another indirect impact was a surge in protection business and an increase in the rates of commission on protection business. In the UK at the present time the average rate of initial commission on regular premium term insurance is of the order of 160% to 180% of the first year’s premium. This contrasts with levels approximately half that amount in the US, Canada, Australia and other countries. So not only is the pension business problematic but there are also very significant capital strains in writing protection business.

During 2004 a new sense of reality dawned on the UK market. The leading product providers all took steps to reduce significantly the rates of initial commission on individual pensions regular premium business from approximately 25% of the first year’s premium to around 8%. This is a much more sensible level; however, it is still difficult to make money in this line of business.

Product providers have also focussed on other more sophisticated pension products suitable for high value customers. Sales of Self-Invested Personal Pensions have increased. These products can be described as pension wraps. They provide the opportunity for the individual to invest in a range of different vehicles including a bank account, shares, mutual funds and other selected investment vehicles, commercial property and, under changes in legislation which will come in to place in April 2006, residential property. These products typically are low charge but the charging basis is transparent and more in tune with the underlying dynamics of the expenses of operating the business compared to the 1% single charge.

### **The Way Ahead**

It is interesting to compare the experience in the UK with its mandatory 1% price cap with events in Australia. The introduction of compulsory pensions in that country also prompted a significant reduction in charges on pension products. The personal pension products, for example, that were paying initial commission of 75% of the first year’s regular premium effectively disappeared overnight. Market forces operated and the charging basis for the new compulsory pension arrangements quickly settled at a level that was equivalent to approximately \$1 per person per week (40 pence) plus a wholesale investment management charge. This has worked out at approximately 1.35% of funds under management. The Australian system now provides almost complete coverage, relatively good value for members and it is operated on an economic basis as far as providers are concerned. Advisors now do not get involved in helping people or encouraging people to join pension plans. They do, however, provide a very valuable role in advising members when they move from one employer to another, when they retire, and after retirement. The system appears to be working well.

It is now recognised in the UK that the stakeholder experiment has failed. This is yet another example of well-intentioned policy going wrong because of the imposition of a price cap. The way ahead in the UK will become clearer after the Turner Commission submits its recommendations later in 2006 but it will almost certainly

involve the proliferation of more wrap type products where the interests of the client, the advisor and the provider are more naturally aligned.

## **Case Study II: Secret of Aflac's Japanese Success**

In 2003, Aflac became the largest insurer in Japan in terms of individual policies in force. In the industry where visible successes by foreign companies are not so common, a small insurance company from Columbus, Georgia, that started operation nearly 30 years ago has never stopped growing despite the fact the its Japanese counterparts are struggling in the recent years. What sets Aflac apart from the rest? What is its secret formula? While there is more than just one single success factor, its "distribution" system is clearly one of the most significant.

### **Corporate Agent System**

Aflac's distribution system is unique. In contrast to other large Japanese life companies, which sell almost exclusively through salaried sales staff (commonly called "Insurance Ladies"), Aflac sells through fully commissioned agents. The agency distribution system allowed Aflac to grow quickly in the formative years. Had Aflac followed the traditional Japanese distribution method of "Insurance Ladies," it would have had to hire a large number of sales people to reach a critical mass. This would have been a tremendous burden, both from the financial and the human resource perspectives, for a fledging company just starting out. On the other hand, starting with a small number of sales people would have grossly limited its growth. For Aflac, the "Insurance Ladies" way was never in their plan as its US home office had always sold through agencies.

However, selling through agents was nothing new or unique in Japan. In fact, non-life companies had always sold through agents. So, what was so unique about Aflac's agent system? Aflac developed its agencies by working with large corporations. The corporations would establish new subsidiaries and have them become Aflac agencies. These agencies were often staffed with retired employees. This approach allowed corporations to offer continued employment to their key employees after their retirement. And since Aflac would pay commissions on the new policies sold, the agency subsidiaries became profit centres rather than cost centres. Also, the employees of these corporations found it much easier to talk with and purchase policies from familiar faces who had worked with them for many years.

Aflac did not stop there and went one step further. It worked with the human resource departments of these companies so it could distribute sales leaflets to employees as a part of their employee benefit plans. The leaflets would be personalized reflecting the individual employee information. When the employees wanted to purchase policies, all they had to do was to sign and send them back to HR. The method was so successful that Aflac obtained a patent for this process.

## **Refining the System**

But you would be surprised to find that a larger portion of Aflac sales today comes not from the Corporate Agent System but from another distribution channel. As far back as 10 years ago, Aflac began to shift its emphasis from the Corporate Agency System to individual agencies. This is because Aflac realized that the preference and needs of consumers were changing. Our market research today shows that only about one out of five people want to purchase insurance policies at the work site. Many people want to discuss details of their insurance needs at home or agency offices away from the office.

Aflac was also changing. From the one-product company, it was transitioning to become a diversified product company. From the initial Cancer Life Insurance, it added Care, Accident and Medical and other products. The Cancer Life itself was also upgraded to include a wide range of benefits. Distributing sales leaflets to employees at the office described above was no longer adequate for the type of distribution system the products required and the customer wanted.

## **Looking Ahead**

Aflac continues to refine its distribution system. It had started a subsidiary that markets through the Internet. It is enhancing call centre operation so more people can contact Aflac in response to TV commercials and other mass media ads. To respond to one out of three customers who want to discuss insurance outside of their homes, Aflac is building a network of “Insurance Service Shops” where customers can walk in to discuss with sales agents. Aflac Japan “imported” the highly successful, award-winning SmartApp from the US Headquarters and modified it for the Japanese market. The SmartApp, or e-App as it is called in Japan, brings automation to the process of writing business and reduces errors at the same time. And there are much more. Aflac is continuously refining its distribution system to meet the changing market and changing customer needs.

During the session we will cover:

- Overview of the Distribution and Consumer Value Issues A. Power
- The failure of the UK stakeholder initiative T. Matthews
- The secrets of Aflac’s Japanese success A. O’Bryant
- The changing role of the insurance broker B. Fung