Distribution: Adding Value to Clients Through Economic Insights

Actuaries' Club of the Southwest

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As Actuaries, why should we care about distribution economics?

- Management cites distribution as one of the most challenging issues that they currently face. There are many important questions that are being asked about distribution.
- The Market Situation presents many client challenges and opportunities.
- There are some analytic tools and perspectives to help management better understand distribution and make better decisions.

Client Questions

Clients pose a variety of questions as they seek to manage and realize value in distribution

- Competitive allowance?
- Alignment of interests and understandings?
- Investments?
- Investment/performance management?
- Implication of operating model economics?
- “Foreign” products?
- Trade-offs among production channels/segments?
- Compensation and rewards?

What competitive distribution allowance should I command from the product manufacturer?

- What is a stable, exclusive career system's production worth?
- Can I interpolate from practices in the independent market?
- What is the "market" for independent and non-exclusive arrangements?
- How to cost or value resources beyond straight GDC and allowances?
- What is the scope/definition of distribution functions and costs, versus those that the manufacturer should bear?

How to align interests and ensure understanding of distribution economics to improve performance?

Influence Centers:

- Home office distribution and field sales management
- Product management
- CFO
- LOB management
- Etc.?

Challenges:

- Alignment of metrics
- Shared accountabilities
- Collaborative approach to resolving tough issues
- Refine roles and responsibilities to meet the challenges
- Managing winners and losers under a new system

How should I think about investments?

- Cost invested this year for which the return is expected later — e.g., acquire an agency or build a new wholesaling channel for payback in three to five years
- Distinguish among:
  - Routine, current operating expenses
  - Routine, ongoing operating investments (hiring new producers, adding sales management)
  - Significant and discrete capital investments (acquiring a company or distribution system, buying an agency, building a new technology platform, opening a new market — which may be deferrable)
  - Others?
- Define and focus on incremental costs and benefits, and then track and manage results against expectations

How can I better improve my investment decisions, management and performance?

- Be disciplined — don’t rationalize overspending by capitalizing expenses/investments inappropriately
- Understand and consider constraints of various accounting approaches — GAAP, STAT, value-based
- Be practical: capitalize and subsequently amortize every “investment”?
- Project incremental costs and expected results (financial modeling) to enable cost-benefit and risk analysis
- Decision process aligned with accountabilities, rules of engagement, roles, scorecards and “budget discipline”
- Enable trade-offs among competing demands — e.g.,
  - Recruiting experienced vs. inexperienced producers
  - Extent of investment in sales management
  - Technology versus brand

What are my distribution business's economics, leverage points and performance requirements?

- Define "success" — short- and long-term
- What are my more significant performance gaps?
- What are the more important (and realistic) improvement opportunities and how can I best achieve them?
- What should be the performance standards — e.g., $40,000 FYC to provide benefits to producers; or payback multiple to justify the cost of acquiring an agency or significant producer?
- What are the consequences of changes in product mix or balance among proprietary and non-proprietary products?
- What role does/should scale play — e.g., should an office of housed producers managed by an OSJ generate at least $2.5 million in distribution revenue?
- Extent of leverage in a variable cost channel and implications for investment decisions?

How can I realize profitable growth by selling more through “foreign” distribution channels?

- E.g., life insurance sales through PC agent bank or securities broker; or VUL through term brokerage distribution channels
- Engineer the “customer experience” to satisfy interests, leverage capabilities and address economic reality
- Be effective at “business partnering”; understand constituent’s:
  - Interests
  - Capabilities — e.g., marketing, generating leads for, selling, closing, fulfilling, servicing and developing additional business
  - Economics
  - Strategies — e.g., priority and relationship of your product with their business and product focus

Where and how should I focus my distribution efforts across various sources of production?

- How can I segment current and prospective sources of production to understand differences in operating models, costs-to-serve, levers for performance improvement, and (ultimately) value creation
- Insights should guide distribution strategy, operating model, capability requirements and implementation — e.g.,
  - Organization of the wholesaling function (geographic, distributor/producer/sector type, product, hybrid)
  - Applicability of retail (POS) versus wholesale sales support

How can I align compensation with refined distribution metrics, roles and accountabilities?

- Another perspective on defining the operating model/customer experience
- Requires understanding of competitive practices, distribution strategy, sales management, economics and metrics, modeling, change management

Market Situation:
Client Challenges and Opportunities

Distribution is at the heart of the industry's challenges and opportunities

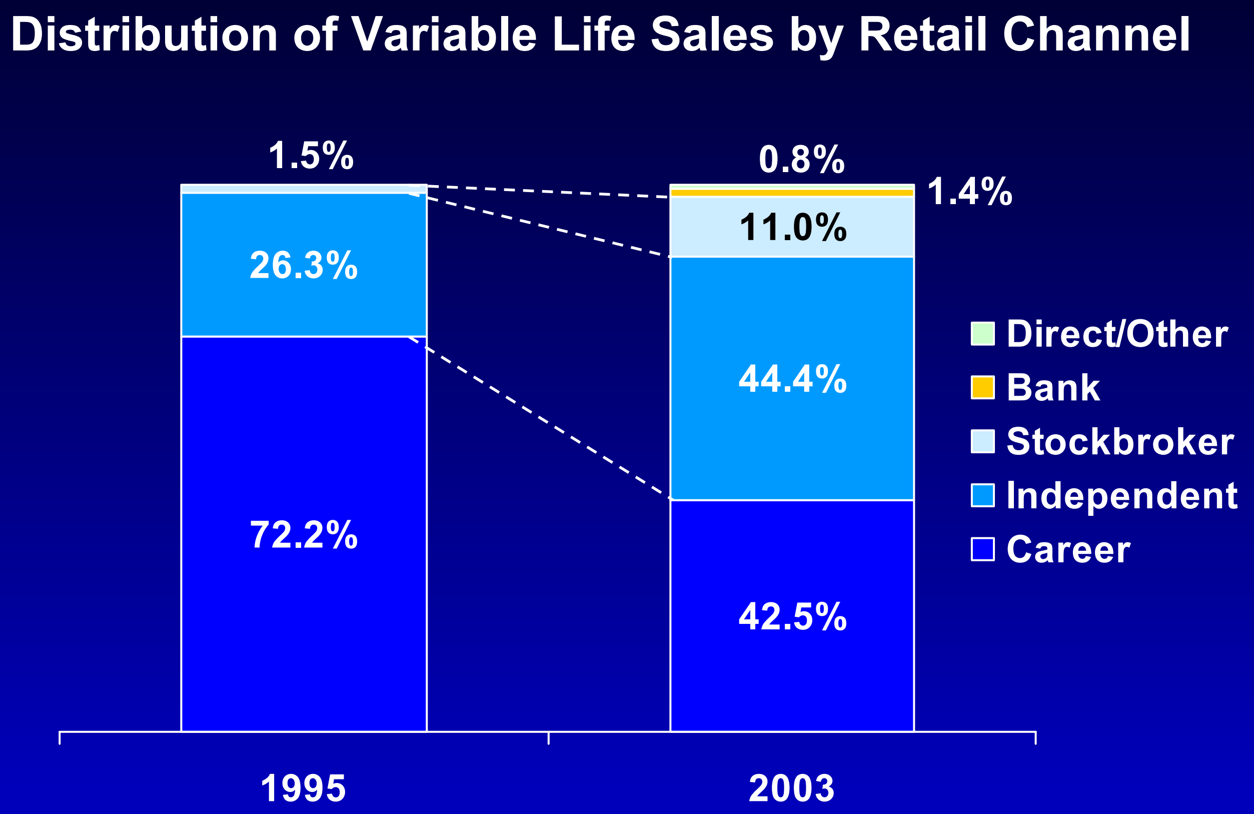
Opportunities	Challenges

■ Grow business profitably
■ Create and sustain competitive advantage in distribution:
  ■ Increase shelf space, share of wallet, producer loyalty, consumer loyalty, share of channel
  ■ Attract, develop and retain productive producers and profitable consumers
  ■ Integrate multiple channels/ media cost-effectively
■ Contribute to "value" — strong ratings, share price, acquisition potential
	■ "Distribution" is a business
	■ Product competitiveness can be critical
	■ Compensation is "needed to play"
	■ Complex and varied dynamics:
	  ■ Channels
	  ■ Proprietary and non-proprietary products
	  ■ Product mix
	■ Significant performance gaps:
	  ■ Cost versus pricing
	  ■ Growth
	  ■ Profitability of new business, producers and channels

The distribution landscape is changing in fundamental ways

- Shrinking and maturing market of professional agents
- Value of expert, consultative sales approach is clear for more sophisticated and complex needs/products
  - Cross-selling life insurance through “foreign” channels has been frustrating
  - Direct marketing has increasing influence with commodity products
- Unbundling manufacturing and distribution; increasing focus on distribution economics and performance management discipline
- Shift to “independent” channels (from career) with emphasis on traditional and “point of sale” wholesaling, and BGA/MGA intermediaries
  - Variations between fixed and variable product; some firm vs. producer conflicts of interest
- Scale becoming a factor: brand, technology, marketing, sales support infrastructure, compliance, others

Agents have shifted from career to independent; wholesalers are gaining influence



Results reflect retail channel as opposed to intermediary channel

Source: Tillinghast's VALUE Survey. Based on companies that provide distribution channel information. Premium sales in millions include target and dump-in premium at 100%, single premium at 10%. Reflects variable life, last survivor, and single premium product; excludes Group VUL and COLI/BOLI.

A variety of potential “ties” can add value, build loyalty and produce sales

Field sales manager/ Wholesaler/MGA/BGA

Firm/Agency

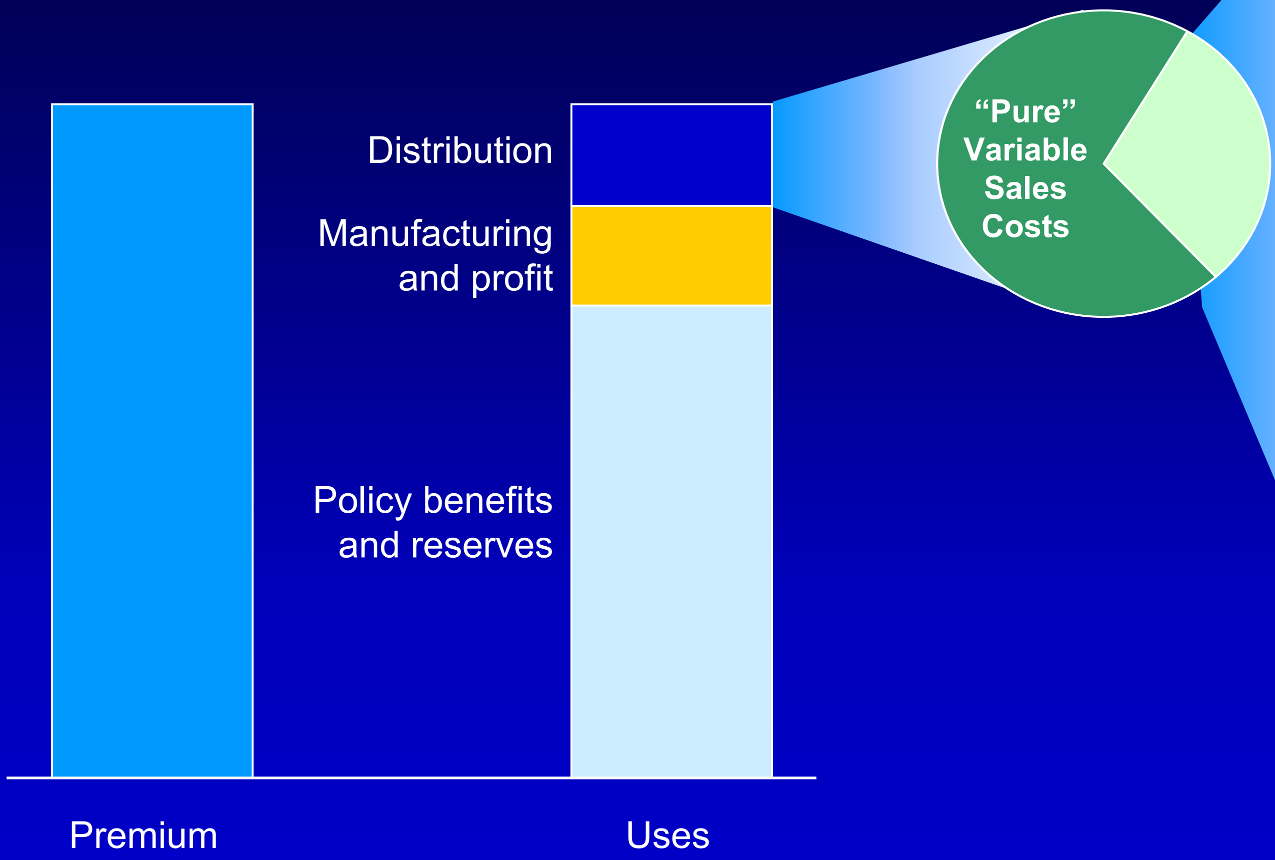
Producer

Manufacturer

Potential “ties” that ac value and build loyalt

- Compensation
- Product
- Housing
- Recognition
- Sales, practice, business support
  - Broker-Dealer
  - Management, mentoring, coaching
  - Training and development
  - Compliance
- Selling assistance
  - Leads
  - Processing
  - Expertise

The cost of the distribution infrastructure required to deliver the "ties" must align with the distribution revenue available to pay for it



Potential "ties" that add value and build loyalty

- Compensation
- Product
- Housing
- Recognition
- Sales, practice, business support
  - Broker-Dealer
  - Management, mentoring, coaching
  - Training and development
  - Compliance
- Selling assistance
  - Leads
  - Processing
  - Expertise

Most companies struggle with their distribution business and its performance

- Distribution costs exceed allowances for most, hence profit targets are not being met
- Sales growth is difficult, especially in life
- Few companies are recruiting *new* agents
- Producers are increasing their bargaining power…and using it to companies' detriment
- Regulatory/compliance pressures are increasing and expensive

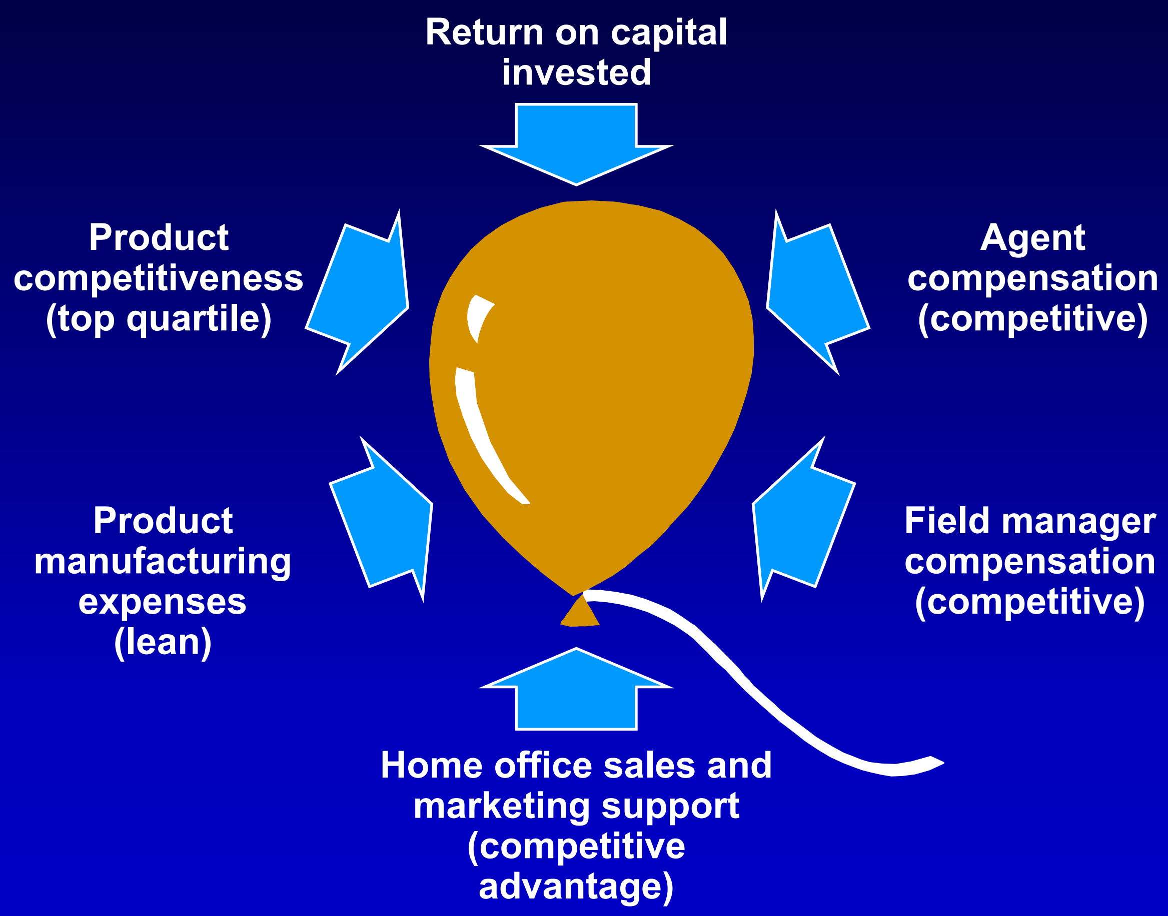
How We Help Clients Develop Answers

The economic framework and related financial models have helped management:

- Guide and support field and home office management in achieving aggressive, profitable growth
  - Help close the performance gap
  - Accommodate diverse field office operating needs
- Reflect industry/competitor practices
- Foster understanding of basic economics and performance characteristics to enable close, effective collaboration between field and home office management
- Support and align with management tools and processes — e.g.:
  - Performance measurement and management
  - Investment decisions
  - Field compensation

The economic framework reflects competitive constraints and business requirements

- Subject to increased productivity, it is a zero sum game



The economic framework and "P&Ls" capture the roles and economic perspectives of all major constituents

ILLUSTRATIVE

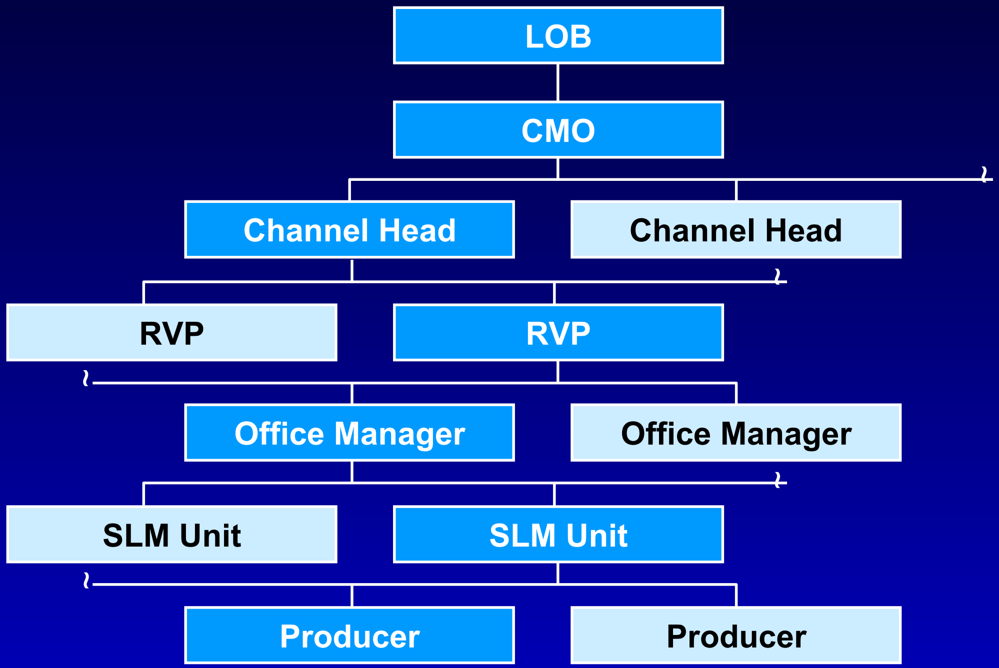
Product Manufacturer	Distribution Management	Field Office	Producer
+ Premium income ■ New ■ Renewals – Distribution costs (allowance) – Policy benefits/ reserves – Management, administration and service costs	+ Distribution "revenue" (allowance) – S&MS costs – Investments – Field distribution costs (allowance)	+ Field distribution "revenue" (allowance) – Operating expenses – Producer expenses, compensation and benefits	+ Compensation + Expense reimbursement – Housing – Benefits – Special support
"Profit"	**Breakeven**	**Profit/contribution**	**Net compensation**

The economic framework, P&L model, business planning and compensation program helped align and discipline management for the entire business

Past	Future
Growth	*Profitable* growth
Distribution costs exceed revenue	Distribution revenue and costs in appropriate balance
Focus on contractual expenses - Excludes some expenses from field	Full and complete expense picture; P&L of the whole
Ad hoc negotiated investments	Disciplined performance management
Management by exception	Goals, roles, compensation aligned

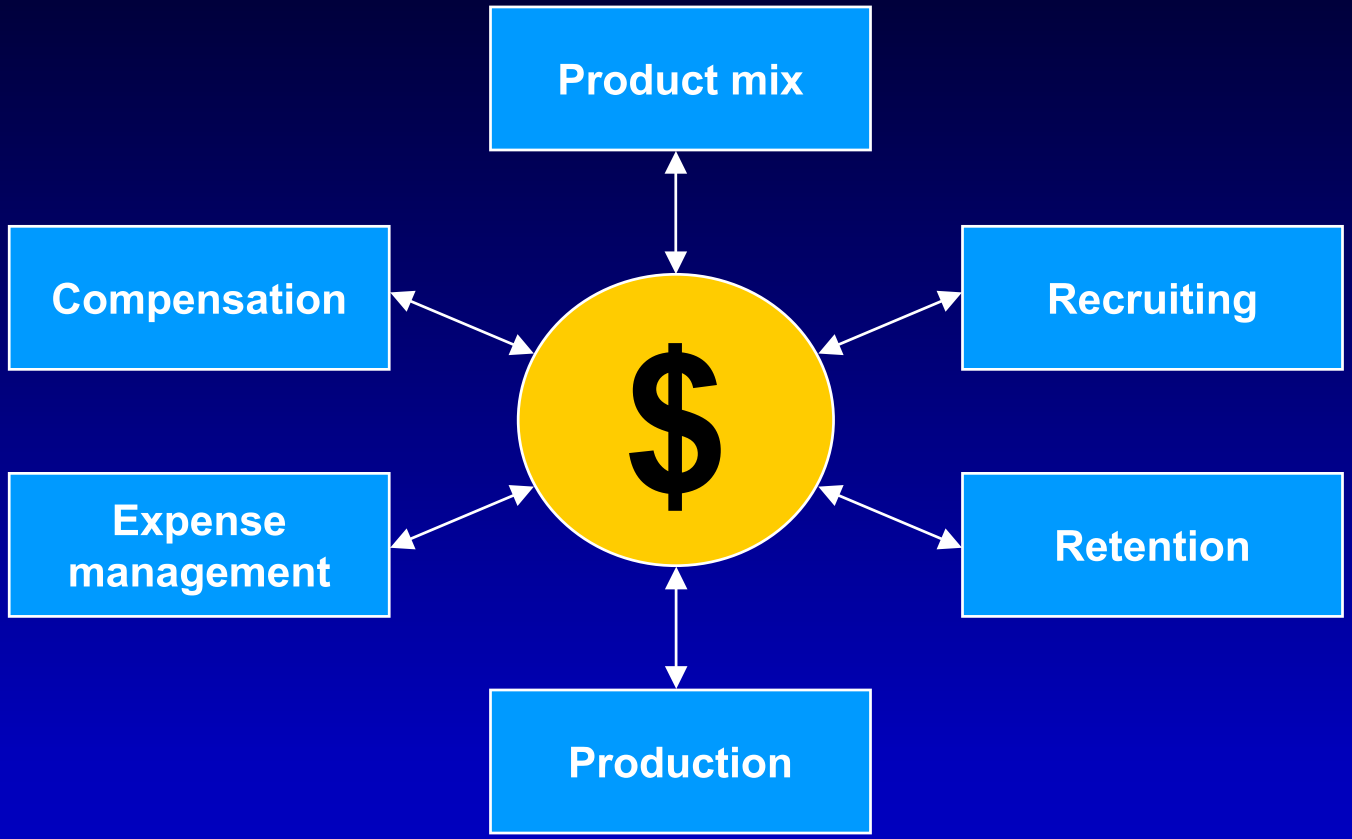
Our ability to understand, evaluate and communicate distribution economics is core

- Financial modeling of a distribution business



- Market knowledge and benchmarking capabilities, to inform and challenge assumptions
- Integrated into strategic planning, performance management, field compensation design, investment analysis, etc.

Distribution valuation shows the tradeoffs and economic implications of decisions affecting distribution profitability



Over the past five years, companies have moved to implement a distribution P&L

Revenue

- Distribution allowances
  - Negotiated between manufacturer/distributor
  - Generally tied to pricing
  - Product and possibly performance based
  - Typically higher than GDC paid to retail selling firms
  - Closer to full allowances paid to MGA/IMO
  - Still seeking its ultimate level

Expenses

- All field expenses
  - Agent compensation and benefits
  - Manager compensation and benefits
  - Agency expenses
- A portion of home office expenses
  - Sales and marketing support
  - Broker-dealer
  - Distribution management
- Allocated corporate expenses

Reflects distribution portion of business, not manufacturing

Considerations on Distribution P&L

Advantages	Disadvantages

■ Imposes financial rigor that did not otherwise exist
■ Becoming accepted in industry
  ■ Analysts can understand
  ■ Can benchmark against others
■ Can be applied at various levels of distribution organization
  ■ Agency
  ■ Agent
  ■ Type of contract
■ Allowances can reflect actual characteristics of underlying business (average size, persistency, etc.)
	■ Investments are expenses
	  ■ Does not provide a good basis to assess investments
	■ Very short-term focus
	  ■ Can look at future year projections
	■ Can create Us vs. Them environment for manufacturer vs. distributor
	  ■ Distributor not necessarily incented to sell proprietary products or help overall entity
	■ Distributors feel it does not fully reflect value of "loyal" distributors

P&L Example #1: Shift recruiting focus from inexperienced to experienced producers

Recruiting Assumptions

Office: NYC1

Projected Results

Baseline P&L

Revised P&L

	Baseline Projection ($000)					Office Plan ($000)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
Net Profit/(Loss)	($300)	($325)	($350)	($400)	($425)	($275)	($300)	($300)	($275)	($250)

New Recruit Types

Year	Housed Experienced			Detached Experienced			Inexperienced			Total
	High	Medium	Low	High	Medium	Low	High	Medium	Low	
1999 (actual)	0	0	3	0	1	0	1	1	3	9
2000 (actual)	0	0	1	1	0	0	1	2	1	6
2001 (actual)	0	0	1	0	0	0	0	1	1	3
2002 (Baseline)	0	1	0	0	1	0	1	2	1	6
2003 (Baseline)	0	1	0	0	1	0	1	2	1	6
2004 (Baseline)	0	1	0	0	1	0	1	2	1	6
2005 (Baseline)	0	1	0	0	1	0	1	2	1	6
2006 (Baseline)	0	1	0	0	1	0	1	2	1	6
2002 (Office Plan)	1	3	1	0	1	0	0	0	0	6
2003 (Office Plan)	1	3	1	0	1	0	0	0	0	6
2004 (Office Plan)	1	3	1	0	1	0	0	0	0	6
2005 (Office Plan)	1	3	1	0	1	0	0	0	0	6
2006 (Office Plan)	1	3	1	0	1	0	0	0	0	6

Revised assumptions

Baseline assumptions

P&L Example #2: Sales shift from variable to non-variable products, in addition to shift in recruiting

Business Mix

Office: NYC1

Projected Results

Baseline P&L

Revised P&L

	Baseline Projection ($000)					Office Plan ($000)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
Net Profit/(Loss)	($300)	($325)	($350)	($400)	($425)	($290)	($305)	($320)	($350)	($375)

Proprietary Life Weighted Premium

	Baseline Projection					Office Plan				
Year	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
VUL	80%	80%	80%	80%	80%	60%	40%	20%	0%	0%
FUL	10%	10%	10%	10%	10%	20%	30%	40%	60%	60%
WL	0%	0%	0%	0%	0%	5%	15%	25%	25%	25%
Term	10%	10%	10%	10%	10%	15%	15%	15%	15%	15%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Baseline assumptions

Revised assumptions

As Actuaries, why should we care about distribution economics?

- Management cites distribution as one of the most challenging issues that they currently face. There are many important questions that are being asked about distribution.
- The Market Situation presents many client challenges and opportunities.
- The Good News is that there are solutions to these distribution problems.

Questions??