DCG Corporation DeHayes Consulting Group

Evolution, Earthquakes, Hurricanes & Mirages

by Philip H. Dutter

While the best possible foresight can not realistically predict every development in an industry's future, it is critical for executives who must manage in a rapidly changing environment.

Fourteen years ago my former colleagues, Tom Peters and Bob Waterman, wrote a best-selling business book entitled *In Search of Excellence.* One of the keys to excellent corporate performance, their research indicated, was to "stick to your knitting."

Undoubtedly the pace of change has quickened in the last fourteen years. Today there is very little in the business press about "sticking to your knitting" and a great deal about change. The January 1996 Life/Health edition of *Best's Review* proclaims on its cover, "Business as usual won't cut it." Life insurance executives are admonished that standing pat ranks high on the list of management sins.

While some may feel threatened by a world in flux, Gary Hamel and G. K. Prahalbad are not. In their 1994 book, *Competing for the Future,* they write glowingly of the potential of "industry foresight": "Industry foresight allows a company to control the evolution of its industry and, thereby, its own destiny." A tall order indeed.

Viewed either as a requirement for survival or as a key to new pinnacles of success, the idea of preparing for a future that is different from the past makes sense. We know change in the marketplace is inevitable. We know that changing an organization's capabilities generally takes several years. Before embarking on a program of change, however, it is

Unpublished work © 1996

vital to know what kinds of changes are likely to take place and how rapidly they are likely to occur. To what extent is accurate industry foresight possible?

To help answer these questions let's look at the changes that have taken place in the life insurance industry over the past three decades.

Business as usual won't cut it – standing pat ranks high on the list of management sins.

As I reflected on these changes it seemed to me that some have been reasonably predictable since they were driven by long-term demographic, social, and economic trends. These might be characterized as evolutionary changes. Other major changes were almost completely unexpected, yet dramatic in their impact. These I refer to as earthquakes. Other changes have taken longer than the "earthquakes" to develop real force but have had dramatic effects. I call these hurricanes. Still others have been predicted by various prognosticators over the past 20 to 30 years but have yet to take place. I call these mirages. Perhaps reviewing these four types of changes and the forces driving or retarding them will provide a useful perspective on the problem of developing industry foresight that will be helpful in shaping effective company plans.

Evolutionary Trends

One of the most persistent and predictable trends over the past 30 years has been the increasing proportion of sales to high-income, high-wealth individuals, particularly business owners and professionals. This trend was just beginning in the 50s and 60s and has accelerated sharply over the past 15 years.

There are several fundamental forces driving this trend. One is the increasing concentration of income and wealth among the 10 percent of families with the highest incomes. Another is that the tax advantages of cash value life insurance and annuities are more valuable to people with high income. A third is that life insurance agents are more likely to earn the commissions required for long-term success if they acquire the knowledge and skill to develop these affluent clients.

Related to this increasing concentration on high-income markets has been a long-term decline in the number of policies sold and, since the early 1980s, in the number of life insurance agents. In the early 1980s it was generally estimated that there were around 250,000 life insurance agents (including home service and multiline agents). LIMRA's 1993 Census of Life Insurance Sales Personnel found just under 220,000. The number of career ordinary agents appointed each year has declined from a peak of more than 50,000 in 1975 to less than 25,000 in 1994, suggesting the total number of agents will continue to decline in the years ahead.

As the number of life insurance agents decreases and the proportion concentrating on high-income markets increases, the emphasis on advanced training (in the uses of life insurance for business owners and for estate planning) and the need for technical and technological sales support have escalated. Sophisticated sales approaches used by only a few

Unpublished work © 1996

companies and agents 30 years ago have become commonplace today.

The increased focus on the high-income, high-wealth buyer has also had an impact on product and price competition. A higher proportion of buyers and their advisers expect to see cost/value comparisons among several companies. Agents, in turn, have become more cost/value conscious.

The increased interest in product cost/value comparisons has contributed to a growing proportion of agents who are independent, members of producer groups, or less committed to a single primary company. While "agent loyalty" is extremely difficult to measure, it is a rare ordinary agent today who does not sell the products of more than one company.

With the advent of universal life in the early 1980s there has been a rapid expansion in the types of life insurance products offered: fixed premium interest-sensitive life, variable life, variable universal life, and survivorship life to name a few.

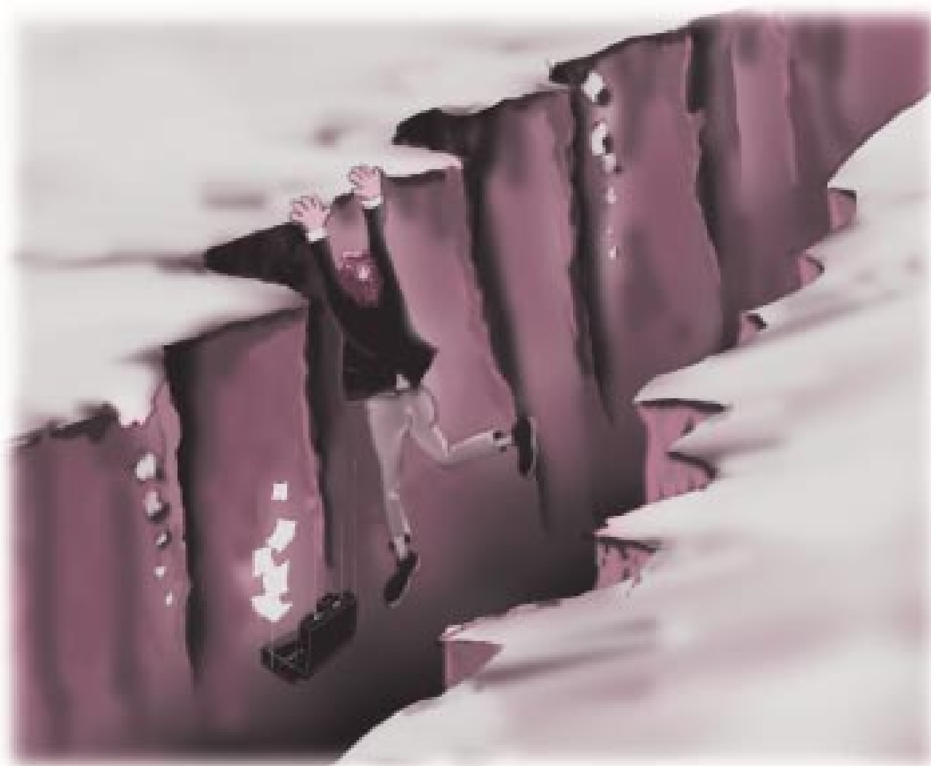
Even more significant than the wider array of life insurance products has been the rapid growth of annuity sales. From 1974 to 1994, while life insurance sales were growing at a 5 percent annual rate, individual annuity sales were increasing at a 20 percent rate. Today the life insurance industry receives nearly 60 percent of its premium income from annuities.

Some of the factors spurring the growth of annuity sales are fundamental and likely to persist. First, there is the aging population. Two-thirds of annuities are sold to people over 50, a demographic segment that has been growing more than three times as fast as the overall population and will grow even faster as the post-World War II baby boomers enter their fifties. Second, there is growing concern about the future of social security and the extent to which people can rely on company-funded pension plans. On the other hand, one key factor spurring annuity growth – the tax deferred build-up of annuity investment earnings and the tax deductibility of contributions to qualified retirement plans – is subject to legislative changes that may either help or hurt future annuity sales.

Increasing price competition and the shift in product mix to annuities and variable products have squeezed profit margins. During the 50s, 60s, and early 70s, life insurance companies had a free profitability ride on whole life insurance, particularly the non-participating variety, as interest rates slowly rose and mortality improved. For most companies, profits grew faster than premiums. Those days are gone forever.

Earthquakes

Overlaying these evolutionary trends and influencing some of them are three developments that occurred in the last 15 years. I call these earthquakes because they were so unexpected and dramatic in their impact.



The life insurance industry was "shooting itself in the foot" in its efforts to provide appealing products

1. Interest sensitive products. In the late 1970s Paul Volcker, then head of the Federal Reserve, launched an effort to tame runaway inflation by raising short-term interest rates to unprecedented double-digit levels. With money-market funds paying 10-20 percent interest rates, whole life insurance, particularly non-participating life, appeared to be a very bad buy and sales of whole life were suffering. The life insurance industry's answer was to create a new type of product, called universal life, where the interest rate used in calculating reserves and cash values could be varied periodically.

When this product was introduced with interest crediting rates around 12 percent, sales shot up, but it soon became apparent that a high percentage of these sales were replacements of existing policies. The wave of replacement selling gave rise to the observation that the life insurance industry was "shooting itself in the foot" in its efforts to provide appealing products.

Efforts have been launched to help companies and agents avoid the kinds of market conduct problems that have been plaguing the industry

The advent of universal life ushered in a longer-term era of much greater emphasis on product costs and values and, unfortunately, "illustration selling," which led many prospective buyers to attach more credibility to projections of policy values than such projections deserved.

Increased product competition accelerated the tendency of agents serving the higher income market to develop relationships with several companies to reduce the chances of losing sales in competitive situations. Although the dominant role of universal life as the "hottest product on the street" faded as interest rates declined in the 1990s, the product's impact on price competition and agent/company relationships appears to be a lasting one.

2. Financial failures of major companies. In the late 1980s and early 1990s we began to see the effect of the collapse of the commercial real estate and junk bond markets. Notable failures among sizable companies were Executive Life, Mutual Benefit Life, and Confederation Life. Investment decisions that now appear to be foolhardy probably were driven, to a large extent, by a desire to offer highly competitive products in the interest-sensitive and GIC markets.

As a consequence of these failures, company financial solidity has become a big factor in marketing life insurance and annuities. As never before, agents and buyers attach great importance to company credit ratings provided by the various financial rating agencies. This, in turn has contributed to several mergers and acquisitions among major companies – Phoenix and Home Life, Mass Mutual and Connecticut Mutual, Metropolitan and New England Life. Concern about ratings also played a role in the decisions by Equitable and State Mutual to demutualize.

3. Market conduct problems. Three years ago the two largest companies in the industry – Prudential and Metropolitan – were charged with using misleading sales material and replacing policies improperly. Both incurred substantial fines and spent millions reimbursing policyholders. More recently, New York Life and Crown Life were charged with leading policyholders to believe that premiums were guaranteed to "vanish" based on the interest crediting rates used in sales illustrations 5 to 10 years ago. As interest rates have declined, the premiums have stubbornly refused to vanish. New York Life agreed to a $65 million out-of-court settlement, but could pay substantially more depending on policyholder choices.

In response to the adverse publicity generated by these cases, insurance company executives and state

Unpublished work © 1996

insurance regulators have responded vigorously. Company executives are exercising much tighter control over sales literature and illustrations, agent training, and investigation of complaints. Regulators, through the NAIC, have developed model regulations for sales illustrations and are developing an approach to multi-state market conduct examinations. The ACLI, LUTC, NALU, LIMRA and The American College have all launched efforts to help companies and agents avoid the kinds of market conduct problems that have been plaguing the industry. The negative effect of adverse publicity and the elevated public concern about life insurers' market conduct may ultimately be translated into clearer standards, better enforcement, and greater trust. In the meantime, like the advent of universal life in the early '80s and the major company failures in the early '90s, market conduct concerns are having a major impact on the way life insurance companies do business.

Hurricanes

While the "earthquakes" just cited were largely unexpected and hit suddenly, two "hurricanes" that have had a significant impact on many life insurance companies were not unexpected but have surprised many with the gale force they have developed in the last few years.

One of these hurricanes is the growing role of managed care in providing medical insurance. Medical insurance has long been subject to severe profitability cycles, with rising medical costs substantially outpacing the overall rate of inflation. As more and more HMOs have demonstrated that they can restrain medical cost inflation and provide satisfactory service, their market share has grown. They have now become a major force in most markets and a dominant force in some. Apparently bowing to this force, such large, well-established group health carriers as Metropolitan, Provident Life and Accident, and Massachusetts Mutual have recently sold their group health businesses to HMO organizations.

The second hurricane has been the increasingly severe profitability problems in the individual disability income line of business. Competition that developed in the mid-80s with liberal product provisions, loose underwriting and low rates, combined with growing occupational pressures on physicians and lawyers, have caused huge losses. Many companies have exited this line of business and several others have changed their approach to it dramatically. It is still unclear whether a way can be found to provide disability income protection at a satisfactory level of profitability.

Unpublished work © 1996

Mirages

In contrast to the three "earthquakes," which were unexpected and unpredicted, there are several major developments that have been widely predicted over the last 30 years that seem as far over the horizon today as they did 20 or 30 years ago.

1. More efficient methods of distributing life insurance. For years, many industry observers have referred to the sale of life insurance by agents earning 40-60 percent first-year commissions as "expensive" or "inefficient", particularly when the cost of financing and training new recruits is included. Alternatives that various companies have pursued have been: sale by direct response to mailings or media advertising, work-site selling by enrollers in connection with payroll deduction plans, and salaried or low-commission specialists located in bank lobbies or retail stores. When universal life with double digit interest crediting rates was introduced, these approaches were pursued more vigorously by more companies with the belief that little selling effort would be required. Although a few companies, such as USAA with a loyal clientele base, were successful with their direct response efforts, most of these initiatives have turned out to be frustratingly disappointing. Over 90 percent of life insurance sales are still made one-on-one by commissioned agents – the preponderance by agents whose primary product is life insurance.*

2. The Financial Supermarket. The second mirage has been the idea that financial supermarkets – selling life, health, auto and homeowners insurance, stocks, bonds, mutual funds, loans and savings accounts – were just around the corner. After Sears bought Dean Witter, they placed Dean Witter representatives in Sears stores alongside Allstate agents, but that didn't last long. Training and motivating people to sell even a limited array of products has generally been more difficult than anticipated. With a broad array of products it is virtually impossible.

Cross-selling seems particularly difficult when life insurance (rarely a demand product) is the secondary product as multiline companies, such as State Farm and Allstate, can attest. For example, even though banks have had considerable success selling annuities, experiments in selling life insurance in cooperation with banks have rarely been successful.

Whether the financial supermarket and a more efficient distribution system will ever become widespread realities is difficult to say, but the experience of the last 30 years suggests that it will not be by the year 2000.

* In the early 1980s James Anderson, then head of Tillinghast, gave speeches predicting that the number of agents would decline from 250,000 to 50,000 in 10 years. Andrew Tobias made the same prediction in a 1982 book entitled *The Invisible Bankers.* Since the current agent count is over 200,000, they were off by more than 150,000.

Unpublished work © 1996

So What?

This review of changes that have taken place and those that have not materialized over the past 30 years suggests that 20/20 industry foresight is hard to come by. This doesn't mean that efforts to anticipate future trends and developments are a waste of time. While the earthquakes and hurricanes that have shaken the industry over the last 15 years were surprises, there are some trends and conditions that are unlikely to change over the next 5 years.

- A decline in the number of life insurance agents and increasing concentration in high income markets.
- Continuing intense product price/value competition and narrow profit margin.
- Growth in the sale of annuities that substantially outpaces growth in the sale of life insurance.
- Increasing competition in the retirement savings market from mutual fund organizations, securities dealers, and banks.
- Increasing dominance of the medical insurance business by managed care organizations.
- An expanding role for technology in customer service, sales support, and marketing.
- Continuing heightened concern about companies' financial condition and market conduct.

What is far less certain is whether some of the mirages of the past will become realities for more insurance companies in the future.

- Will more companies find ways to penetrate the middle-income market efficiently using direct response or work-site selling without alienating existing agency relationships?
- Will more companies find effective ways of broadening the array of products sold through their existing distribution systems?
- Will significant amounts of life insurance be sold through banks and securities broker/dealers?

What is even less certain are the new earthquakes that might strike the industry. Possible new earthquakes to worry about involve potential tax legislation and commission regulation:

- The tax-favored treatment of annuities or cash-value life insurance could be impaired in various ways and by various degrees.
- A flat tax or drastically reduced capital gains tax could reduce the tax advantages of cash value life insurance and annuities.
- Limits on first-year commissions could increase the difficulty of attracting and keeping new agents.
- Commission disclosure requirements could have a negative effect on sales.

In addition, there is always the threat of a dramatic change in the economy, particularly a new surge of inflation and a spike in interest rates. Such unwelcome developments would at first glance seem unlikely to occur in the next five years, but they are possible and could have enormous impact.

Over 90 percent of life insurance sales are still made one-on-one by commissioned agents

While the best possible industry foresight will not realistically enable a company to "control the evolution of the industry", it can give management better control over a company's destiny than it would have otherwise. It can help management determine which lines of business and methods of distribution to emphasize, which strengths to build and weaknesses to overcome, and what new initiatives, if any, to launch.

Since capability-building is a multi-year process, frequently involving extensive training and systems development, it makes sense to focus those efforts on a carefully considered vision of how management expects to compete and grow over the next 5 to 10 years. At the same time, it is critical to develop and maintain financial strength to withstand possible future earthquakes and hurricanes, something that several major companies unfortunately neglected to do in recent years. ■

Philip Dutter is an independent consultant for the insurance industry and a Member of the Advisory Board for DCG Corporation/DeHayes Consulting Group. For over 25 years, Mr. Dutter was with McKinsey & Company management consultants. He served as Director for 16 years and managed major consulting projects for 27 of the 50 largest insurance companies in the US.

Unpublished work © 1996

Management Consultants to the Financial Services Industry

DeHayes Consulting Group

3300 Douglas Boulevard
Roseville, California 95661
916.782.8321 • Fax 916.782.8325