MANAGEMENT'S APPROACH TO ALTERNATIVE METHODS OF INSURANCE DISTRIBUTION

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The pattern of insurance distribution is changing with increasing speed. All-line facilities are developing swiftly, with major property-liability insurance companies forming life affiliates and life companies forming non-life affiliates.

Company managements are finding also that their insurance marketing practices no longer fit reality. Their sales policies and programs, drawn up in terms of long-accepted principles, fail to produce good results. It is the purpose of this paper to show why these managements must look to new marketing patterns for policy guidance and also to suggest some of the directions these newer distribution concepts appear likely to take.

Insurance marketing still has many features which are peculiar to this business. Certain of these basic distinctions between insurance and other services must be preserved because of the inherently unique characteristics of the insurance contract. But, increasingly, the successful insurers are supplementing their sales programs with a wide variety of marketing techniques which have been applied effectively in other industries.

In general, these newer distribution methods are based upon careful studies of insurance consumption patterns. These studies have used rigorous tools for market analysis which, to a large extent, are derived from comprehensive economic theories of consumer demand, on the one hand, and cost and price concepts, on the other. Many of the modern refinements stem from the theories of imperfect competition which stress the influences of advertising, product differentiation, and price policy as they relate to management decisions. And for the future, the concept of "collective capitalism" suggested by Gardiner C. Means [1] appears to have great potential value for the marketing analyst, particularly as it seems to offer a more realistic description of the pricing policies of large-scale firms, including insurance companies.

Earlier Innovations in Insurance Marketing

Many current developments in insurance marketing find their

[1] G. C. Means, "Collective Capitalism and Economic Theory," *Science* (August 16, 1957), pp. 287-293.

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origins in the acute insights of earlier insurers. Some of the most conspicuously successful companies owe their rise to the technique of market segmentation. This generally took the form of finding and exploiting inequities in the accepted rating system.[2] Often, these insurers learned to rate successfully part of a group that was commonly considered an undesirable risk. At other times, they recognized what had previously been an unrecognized preferred group.

There are many cases, involving both stock and mutual insurers, which illustrate market segmentation. Zachariah Allen, for example, organized the first of the New England Factory Mutuals in 1835 to provide low-cost fire insurance for selected cotton mills at a time when all factories paid a uniformly high rate. Prior to the Factory Mutuals, the insurers had no inspection system and made no effort to recognize that one risk could be better than another.

In Sullivan County, New York, the cooperative mutuals have specialized in fire insurance on boarding houses in the Catskills. By strict inspection and close personal acquaintance they operate successfully with rates as much as one-third below those at which most companies lose money on this class of business.

During the early development of automobile insurance, several companies recognized that farmers were a preferred class. At the same time, they developed unique distribution techniques to serve that market, including a sponsorship relation with state Farm Bureau organizations, membership fees, continuous policies, six-month premium payment plans, as well as policy billing and collection by the companies.

More recently, another insurer has recognized a similar preferred class among government employees for automobile, fire, and life insurance. To reach this market it has developed a specialized distribution system. Much of its business is solicited by mail. A few special agents contact consumer groups directly in order to develop lists for mail solicitation.[3]

These random examples show how important it is for management to differentiate among differing groups of insurance buyers. They also demonstrate that different distribution methods have arisen in response to the service needs of these groups. To a large extent, the distinctive features of these alternative methods were created in order to serve more effectively those particular segments of the market.

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[2] The author is indebted to William A. Hyde, Assistant Casualty Actuary, Nationwide Insurance, for pointing out this significant factor in the history of many insurers.

[3] For a complete analysis of distribution methods, see John S. Bickley, *Trends and Problems in the Distribution of Property-Liability Insurance*, Research Monograph No. 91, (Columbus: The Ohio State University, 1956).

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Insurance Distribution Methods and Management's Social Responsibility

The insurance business now seems to have reached a crossroads in its development. This is particularly true of automobile insurance, where various related factors are causing difficulties. Legislative measures, for example, are forcing broader application of automobile insurance in more states. In many cases, the traditional rating formulas have not been adequate to keep pace with current losses and expenses. And, generally, higher claims and administrative costs are serving to aggravate existing competitive problems.

Under these vexing circumstances, it is particularly important that all automobile insurers support policies and programs within the industry which will win continued public acceptance. If managements are to act in the public interest, it appears that they should base their decisions on the following general propositions:

1. Private insurers must develop programs which provide adequate insurance services for *all* classes of motorists at reasonable premium costs.
2. Insurance laws and regulatory provisions must be flexible, assuring opportunities for new developments in rating plans, product design, and distribution methods.
3. The automobile insurance business can best serve the total market by using, not one, but several different distribution methods.

If the industry is to continue applying the basic concepts of free, competitive enterprise to insurance, the above statements appear self-evident. Unfortunately, there is considerable evidence that their validity is not universally accepted within the business. However, the insuring public is giving obvious support to insurers who place the welfare of policyholders foremost in their management decisions, despite the concerted efforts in some quarters to enforce orthodoxy and to curb the competitive inroads of dynamic independents.

In this regard, the late Professor Joseph A. Schumpeter, whose theory of economic development forms the core of present ideas on economic growth, often stated that innovation and change are the essence of effective competition. To him, the competition that counts is "the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest scale unit of control for instance)—competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and their outputs of the existing firms but at their foundations and their very lives." [4]

Schumpeter's kind of competition is needed in the automobile insurance business if private insurers are to meet the challenges of

[4] Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper and Brothers, 1947), pp. 84-85.

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universal coverage and rising costs. Above all, bold innovations in product design, rating plans, and distribution methods will be needed. Although the leadership must come initially from top managements of the automobile insurers, regulatory officials share an important responsibility. They must keep the regulatory provisions sufficiently flexible to permit new ways of doing things in the public interest. As Charles Kettering once remarked, we must try "to find out what we shall do when we no longer can do what we are doing now."

Serving the Automobile Insurance Market

There is mounting pressure to require all motorists to be financially responsible for accidents for which they have liability. As this trend develops, it will mean that liability coverages must be supplied to virtually all motorists. Insurers must decide, therefore, whether this protection is to be provided through an acceptable system of private insurance or, in default of private action, by the state. The answer seems clear on both economic and social grounds. Private insurers must develop programs which provide adequate insurance protection for all classes of motorists. And these programs must be broader than merely extending the scope and activities of assigned risk plans. Such a course would be an open invitation to the establishment of state funds.

Under the just-mentioned circumstances, the kind and character of private insurance programs are of crucial importance. There will be increased need for flexibility and experimentation if plans acceptable to the public are to be developed. In cases where motorists buy automobile coverages on an involuntary basis, price looms even larger in their considerations than it has in the past. Obviously, where coverage is mandatory, questions will be raised as to what functions are being performed by agents or brokers, and whether the compensation received is justified in terms of the services rendered. In answer to these questions, it can be shown clearly that the acquisition costs of insurers vary according to distribution methods used to secure business.

In general, the effective rates charged by companies employing the American Agency System have been higher than those levied by direct writers. Because price is a major factor motivating car owners in their choice of an insurer, stock companies using full bureau rates have had a decreasing share of automobile insurance in recent years.

The importance of price has been stressed in several studies.[5] The

[5] Cf., for example, Thomas C. Morrill, "Management Returns from Insurance Research," *Journal of the American Association of University Teachers of Insurance* (Fall, 1956), pp. 16, 17, 19; also *The National Underwriter*, "Auto Insurance Market Study is Outstanding Work" (August 22, 1957), pp. 1, 2, 4, 21-24.

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report of the National Bureau of Casualty Underwriters shows that not only are price considerations reported to be the major factor behind the growth of the low-rate companies, but they are the primary reason for past and anticipated future shifts between companies.[6] The other major reason cited for choosing a direct writer is recommendation by others. Even in this case, it can be assumed that in making the recommendation friends and neighbors stressed the price advantage. These findings are not necessarily inconsistent with other studies which conclude that price is not a significant factor in the demand for tangible commodities. In the case of an automobile, for example, its size, horsepower, and the brilliance of its chrome trim are symbols of status and prestige. The higher the price, the greater the personal satisfaction in many cases. An insurance policy is in a different category; it is an intangible, it cannot be seen, and there is little ego-involvement. If service features are acceptable, price becomes the dominant consideration.

The above appears to be the case with automobile insurance because lower price does not seem to connote lower quality to policyholders of direct-writing companies. More than 90 per cent of those policyholders who recognize service differences believe their own automobile insurer offers the best service possible. They explain their insurer's ability to charge lower rates in terms of volume, efficiency, and other operating policies.[7] Moreover, in the area of claim settlement, which, after all, is the most important service an insurer can render, some direct writers maintain that they render better service than the agency companies. They point out that their adjusters can settle claims on the spot, whereas the old-line agents lack full authority to settle claims.

Price has not been the only reason for the rapid growth of the direct writers. The National Bureau study has shown that agencies under the American Agency System deal generally with upper middle and higher income clients. Agents for the direct writers, on the other hand, work primarily with middle and lower income groups.[8] When it is considered that some 70 per cent of car owners have incomes below $6,000 annually, the ability of the direct writers to serve a broader market comes sharply into focus.

The direct writers can look forward to increasing their share of the market on other grounds, if the National Bureau study is valid. It points out that ". . . about 43 per cent of the insureds reported that, to their knowledge, all companies charged about the same

[6] *The National Underwriter*, *op. cit.*, pp. 2, 4.

[7] *Ibid.*, pp. 2, 4.

[8] Nationwide Insurance Companies, Research Department, *Insurance Consumption Patterns* (September, 1955), p. 39; and Simon Dinitz, *Insurance and Socio-Economic Status* (Columbus: Ohio State University Research Foundation, 1954), p. B-4.

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rates. Those insured in companies using manual rates appeared to be less informed on rate differences than insureds with other companies. Further evidence that insureds with member companies are not knowingly paying more is the finding that 7 out of 10 of this group think they are paying the lowest rates possible. It may be assumed that as the advertising and the considerable word of mouth communications that seems to be operating in favor of the low-rate companies penetrates further, car owners now insured with member companies will begin to question why they are paying greater rates."[9] A comparably high percentage of insureds in the State Farm study also failed to recognize that there is a difference in rates charged by different companies.[10]

In view of the foregoing factors, the outlook for companies charging standard rates is not bright unless they can successfully develop new marketing techniques. Some experiments have already been undertaken. Safeco, for example, adopted certain features of the direct writers, such as continuous policies, six-month premium payment plans, and premium billing and collection by the home office. The agent is allowed to retain his right to renewals and may represent more than one company. On the other hand, the agent's commission scale is lower because of the increased responsibilities of the home office. Other companies are experimenting with similar distribution plans in an effort to curb the inroads of the direct writers.

However, neither the agency companies nor the direct writers can meet the long-term needs of policyholders for automobile insurance at acceptable rates if they rely upon distribution methods as they are presently constituted. It does not take extensive long-range planning to demonstrate that the distribution of individual automobile policies by individual agents is a luxury which the "high-pressure" economy of 1970 cannot afford. As Peter Drucker has pointed out, ". . . *increased productivity* will be the paramount need of the American economy in the decades ahead. . . . A company that intends to maintain its competitive position in its own industry will have to be able, ten years from now, to produce two-fifths more than it does today without much, if any, increase in its hours worked."[11] And, he might have added, these goods and services must be distributed under the same conditions. It seems clear that productivity in the merchandising of automobile insurance must be increased significantly to keep rates at socially-acceptable levels. This increase may come in a variety of ways: by increased use of mail solicitation, by expanded use of insurance

[9] *The National Underwriter, op. cit.*, p. 4.

[10] Morrill, *op. cit.*, p. 17.

[11] Peter F. Drucker, *America's Next Twenty Years* (New York: Harper and Brothers, 1957), pp. 10-11.

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counters in department stores and shopping centers, by payroll deduction plans, or by group insurance techniques. The best distribution methods have probably not yet been tried. In the future the social performance of auto insurers will be measured largely in terms of their solution to the distribution problems which loom ahead.

Criteria for Management's Approach to Insurance Distribution

Thus far, attention has been given to distribution methods as they affect automobile insurers generally. The acid test, however, comes in the management performance of individual insurers. In this section, consideration will be given to the four steps in making executive decisions which are necessary to achieve satisfactory distribution and earnings objectives for individual automobile insurers. These steps are:

1. Setting specific long-term goals for company growth and earnings.
2. Determining the potential markets for automobile insurance which the company will serve.
3. Estimating the premium volume which the insurer can write in the different market segments, using alternative distribution methods, rating plans, and product designs.
4. Selecting the optimum combination of distribution methods, rating plans, and product designs which will achieve the growth and earnings objectives of the insurer.

Some insurers may question the sequence of the above steps. It seems clear, however, that a decision on long-term goals is the first order of business. Every organization has a dominant management philosophy, whether implicitly or explicitly stated. Some want to be the largest insurers of automobiles in the country. Others may want to maximize their earnings. At some point, top management must stop and analyze what objectives motivate its actions and whether they are in the long-range interests of the company. This is not always an easy assignment. Every large corporation is a "going concern" with its own internal driving forces, its own momentum, and its internal clashes of personality and ambitions, as well as conflicts of principle. The top management of every large insurer is often the focus of conflicting, as well as common, interests in other respects. It is the arbiter between policyholders, employees, investors (in the case of stock companies), and the general public. Increasingly, top management is accepting this role of social responsibility as a necessary step toward higher status in the community and, indeed, to long-run survival.

Setting long-range goals is not only a matter of harmonizing management philosophies and reconciling divergent goals. These are internal matters. There is also the need for careful, precise, long-

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range planning by qualified personnel. In no other way can the aspirations of management be translated into specific goals that take into account the economic, financial, and social trends upon which effective programming must rest.

Long-range planning is a necessary tool also in determining the potential markets which the insurer will serve. In the first place, the insurer must determine the characteristics of the automobile insurance markets that will exist in the future. This involves a study of automobile registration trends, classified by such factors as: geographical location; use of vehicles; age of vehicles; age, income, education, occupation of insureds; and other background variables.

A next step will be to assess the resources of the insurer, to determine which markets it is best equipped to serve in terms of management experience, present distribution methods, capacity to handle new business, and underwriting experience. An insurer whose management and agency force have specialized in one segment of the market with a particular distribution method is likely to get better results from a concentrated drive to expand business in that market than from experimenting with different distribution methods in other markets.

Obviously, in cases where rates are no longer competitive and distribution methods are obsolete, efforts to penetrate more intensively into existing markets are not feasible. On the other hand, the use of different distribution methods by the same insurer may be self-defeating. If the agents believe that new distribution methods introduced by an insurer threaten their future security, the company may not gain any advantage from the new marketing pattern.

When it comes to estimating premium volume which the insurer can write in the different market segments, using alternative distribution methods, rating plans, and product designs, the core of demand analysis has been reached. Ideally, management should be able to get concrete answers from its researchers on the following question: "What will be our premium income and our underwriting gain if we use rating plan (*w*), product design (*x*), distribution method (*y*), underwriting program (*z*), with promotional and advertising expenditures of, say $500,00 in markets (a, b, and c)? These are the major variables determining premium income and underwriting gain. Practically, because every insurer is a going concern, the analyst starts with present programs and estimates the effect on premiums and operating gain of small changes in each one of the variables to see whether such modifications will have a favorable effect on final results. This type of partial-analysis technique permits the firm to move toward the optimum combination of programs in terms of the growth and earnings objectives of the insurer.

But what about cost analysis? Hasn't this factor largely been

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neglected, except for promotional expenses? It appears fairly certain that automobile insurance is a decreasing cost industry in that expenses are a declining function of production. On the other hand, preliminary research indicates that the loss ratio is an increasing function of production. On balance, taking losses and expenses together, the combined ratio probably does not vary significantly with relatively small changes in production if the underwriting program remains constant.

It also is fairly certain that the demand for automobile insurance is relatively inelastic in terms of price. This means that when an insurer reduces its rates there will be only a relatively small increase in policies in force.[12] In fact, the premium income of the insurer will actually decline because the increase in coverages will not offset the loss of income on existing business due to the rate reduction. This fact is relatively easy to understand. If the new production of an insurer annually runs about 20 per cent of policies in force, it would be necessary to raise new production by one-fourth in order to secure a 5 per cent net increase in total policies in force, neglecting influences on persistency. In a market as competitive as automobile insurance, it would undoubtedly take more than a 5 per cent rate decrease to achieve such an increase in new production, other factors remaining constant.

Conclusions

What do the foregoing observations mean to top management from a policy viewpoint? If the insurer uses low-cost distribution methods which permit vigorous competition, rate-wise, it might consider expanding significantly its sales promotion and advertising program. Production depends, in part, upon how much money is spent on advertising. So long as 43 per cent of the insureds do not realize that there are rate differences between companies, it would seem possible to "shift" demands substantially to the lower-rate companies by expanding advertising budgets. Obviously, several large direct writers are pursuing this policy vigorously. The National Bureau study noted strong consumer awareness of automobile insurance advertising by direct writers. Specifically, 40 per cent of the insureds in the survey recalled seeing advertising for low-rate companies. This was about four times as many insureds as those who recalled advertising from a non-stock company (10 per cent) and eight times as many as those who recalled seeing advertising for a manual rate company (5 per cent).[13]

For those insurers who use distribution methods which do not permit rate competition, the best policy would appear to be sig-

[12] Rigorously defined, price elasticity of demand is equal to the ratio of the percentage increase in quantity to the percentage reduction in price.

[13] *The National Underwriter, op. cit.*, p. 22.

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nificant product differentiation, including improved service on claim settlement and other features. In this manner, the insurers' contract might be distinguished from others in terms of consumer acceptance and might help them develop more non-price competition. Moreover, it would give these insurers some leeway in operating with adverse price differentials and might tend to stabilize their share of the automobile insurance market.

It does not appear that changes in distribution methods are a short-term solution to an insurer's competitive problems. For the long run, however, all insurers, whatever their present distribution methods, must find ways to increase the productivity of their merchandising methods. On the one hand, emerging economic and social forces require automobile insurers, in the interests of self-preservation, to develop innovations in marketing. On the other hand, the trend toward universal, mandatory coverage means that they must return to policyholders a larger share of the premium dollar. Far-sighted leadership by company executives and insurance department officials is called for to help develop sound distribution methods which will advance the welfare of both policyholders and the insurance business itself.

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