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DISTRIBUTION OF FINANCIAL SERVICES

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ABSTRACT

The historic barriers between the different companies which comprise the financial services industry are breaking down. In order that organisations may prosper in the new environment the relationships between products, distribution and clients need to be understood. A theory is developed to explain the historic position and the dynamics of the current environment and indicate future trends. The conclusion is that successful organisations will be those which fully understand and specialise in a limited number of sectors, and those who start with a clientbase and a distribution system which will not inhibit the introduction of other distribution methods so that they can become multi-product and multi-distribution organisations. Finally, the paper explores the relationships between pricing policy and distribution by means of distribution chains to determine the point and degree of price sensitivity.

KEYWORDS

Marketing; Distribution; Pricing; Financial Services

1. INTRODUCTION

1.1 *Historical Position*

1.1.1 In the United Kingdom, as elsewhere, the historical position in personal financial services was that products were characterised by the legal constitution of the organisation which offered them. Each sector of the financial services used its own particular distribution method:

Industry	Distribution Method
Banking products	the branch banking system
Stockbroking	person to person (stockbrokers)
Life assurance	person to person (brokers and salesmen)
Unit trusts	advertising
General assurance	brokers

1.1.2 Until the 1960s each sector of the broader industry offered products with a defined character, a definite purpose, and each was recognisable as a product of that particular sector. There was, for example, no danger of confusing a banking product with a life assurance product.

1.1.3 It is our contention that the distribution method for each industry (product) did not arise by chance. We believe that each developed as a result of collective wisdom and experience. The process was one of evolution to the most efficient basis for the particular products at that particular time.

1.1.4 The exact date at which the rigid lines started to break down is not easy to determine. What is certain is that there were tentative moves in the 1960s, developments in the 1970s and radical changes in the 1980s.

1.2 *History of Distribution*

1.2.1 The financial services industry can only grow if a significant proportion of the population has a significant amount of free net disposable income. Financial services will only develop when the economy is strong—generally the richer the country, the stronger the financial services. In the U.K., where financial services developed rapidly in the eighteenth and nineteenth century, the companies developed to service a significant, but small section of the population.

1.2.2 Banks developed from goldsmiths and other merchants. It was natural, therefore, that the distribution would be at their place of business. The development of more extensive banking services did not alter the position to any extent, because of the need for security and to be at centres of commerce or wealth. The bank branch system is the natural outcome—at the present time we doubt whether a major breakthrough in personal banking can be achieved without a branch network.

1.2.3 Stockbroking, which is selling mixed with some advice, developed from the selling environment which was person to person contact in coffee houses. The development of stockbrokers and the Stock Exchange did not change this. The private client departments of stockbrokers continued to operate as salesmen selling to clients—hoping to build up a relationship for repeat business.

1.2.4 Life assurance started as a demand product—potential policyholders applied to the company, and considerable trouble was taken before they were accepted. This situation gradually changed as companies wished to expand, and to do so they needed to appoint agents in distant towns, or even distant countries. The development of the agency system, and the masterstroke of discounting commissions to pay a high front-end rate with reduced renewal commission, led to the wide adoption of the person-to-person selling we have today.

1.2.5 Unit trusts were developed with low margins, and legislation which constrained their marketing/selling efforts. The initial distribution was by way of newspaper advertisements—subsequently IFAs have been utilised.

1.2.6 General insurance encompasses commodity-type products through to solutions to highly technical problems. The efficient way to deal with this array is to be a wholesaler, and to have retailers to deal with the public. This has been the situation with brokers filling the retailers' role. There have been occasions when tied salesforces have been used for distribution, principally by industrial insurance companies; commodity products, such as car insurance, have at times been sold off the page and recently by television advertising.

1.3 *Life Assurance*

1.3.1 In the U.K. the distribution of life assurance was historically subject to light regulation. The overwhelming majority of policies was sold by individuals on a person-to-person basis, but the sales persons were a diverse group.

1.3.2 By the 1950s the diverse groups had settled to:

—full-time independent intermediaries,
—part-time independent intermediaries,
—industrial insurance agency forces, and
—branches of Australian and Canadian companies with direct salesforces.

1.3.3 The majority of the business underwritten by ordinary branch companies was sold by independent intermediaries, both full-time and part-time. Because no authorisation was required, a large number of part-timers were enabled to sell.

1.3.4 The two major changes which occurred in the 1960s were the banks' decision to forbid their managers to have agencies with insurance companies on a personal basis—this was to lead to a major move by the banks into the industry later—and the development by U.K. companies of their own direct salesforces. At first the companies which developed a salesforce tended to be new unit-linked companies, but these were followed by the composites and eventually some traditional specialist life companies.

1.3.5 The 1980s saw the rapid rise in insurances related to both loan repayment and loan protection, so that building societies became major producers. They also witnessed the increasing importance of the banks in the distribution of all products.

1.3.6 The major recent factor which affected the distribution of life assurance was undoubtedly the Financial Services Act 1986. This piece of legislation took the U.K. from being one of the least regulated to one of the most (possibly the most) regulated distribution environments. It has resulted in a shrinkage of the independent sector, an increase in commission rates and an increase in expenses—all in the name of consumer protection. It has also been the catalyst for organisations with client bases, such as banks and building societies, to form their own life assurance companies. As we shall argue later, we think that this just hastened an inevitable trend, but it is an important consideration for non-bank insurance companies.

1.3.7 The life assurance industry has traditionally been in a weak position because, with few exceptions, companies had no control over distribution and no clients (the clients were clients of the distribution system, whether this was independent or a direct salesforce). The industry was, therefore, not in a strong position to cope with the consequences of the Financial Services Act. We expect the consequences of the Financial Services Act on the distribution of life assurance to be far reaching, and to be the major factor in changing the industry in the 1990s.

1.3.8 The most obvious consequence is that companies have become concerned to secure distribution. The two most popular ways are by linking with a major distributor, or establishing a direct salesforce. The favoured major distributors are banks and building societies, and relationships are:

—tied agent relationships,
—joint ventures, and
—acquisition (by the distributor).

1.3.9 The life assurance industry, the industry of major concern to actuaries, is now at a point of crisis with respect to distribution, with four basic distribution options open to companies:

—Secure tied agency relationships with large distributors such as banks, building societies or estate agencies. Except in the few cases where the life company owns the distributor, the life company is generally the weaker partner in the relationship. The move will be for the distributor to extract more of the profits, as the distributor has the relationship with the client and is the key link in the distribution chain.
—Secure tied agency relationships with an array of small previously independent intermediaries. The financial consequences of this course of action have not proved to be happy in a considerable number of cases. Companies have offered inducements such as loans (more appropriately called gifts in many instances) and high rates of commissions to secure ties. However, they had no experience of managing agents for whom they had total responsibility. The results, in many cases, have been large losses, disappointing production and considerable compliance problems. A reappraisal of this distribution channel is under way—most companies are facing up to the need for a more interventionist relationship.
—The independent intermediary sector has shrunk, but still produces approximately 30% of all new business. By its nature it has always been competitive, but it has become more discriminating because of 'best advice' or 'appropriate advice', which is required by the Financial Services Act. This market must be high risk for all but a few life assurance companies. Most companies will not be able to be competitive on all of the indices chosen as important by the independent intermediaries—new business will, therefore, be unstable.
—There has been a marked increase in the number of direct salesforces as the solution to the problem, because a salesforce does give some degree of control over distribution. Thus far, a limited number of these have proved to be a financial success, although it may be too early to say for how many.

1.4 We use this brief historical and current perspective as a background to develop a theory of distribution. This theory will indicate the possible areas for success or otherwise, and provide warnings for many traditional life assurers.

2. Theoretical Framework

2.1 *Marketing and Selling*

2.1.1 Marketing has been defined in a variety of ways, but perhaps the one which might receive most agreement is that approved by the America Marketing Association in 1985:

"Marketing (management) is the process of planning and executing the conception, pricing, promotion and distribution of ideas, goods and services to create exchanges that satisfy individual and organisational objectives".

This definition indicates that marketing covers a wide range of activities including distribution.

2.1.2 This definition is consistent with the way in which many companies organise their marketing departments to undertake:

—planning and strategy,
—market research,
—product development,
—promotion, and
—distribution.

It will be seen that the emphasis placed upon each of these is significantly different between different parts of the financial services industry, for example banks concentrate more on market research than life assurance companies, whereas life assurance companies are stronger on distribution.

2.1.3 Iqbal, in his paper to the Institute of Actuaries[1], quoted Drucker:

"There will always, one can assume, be a need for some selling. But the aim of marketing is to make selling superfluous. The aim of marketing is to know and understand the customer so well that the product or service fits him and sells itself. Ideally, marketing should result in a customer who is ready to buy. All that should be needed then is to make the product or service available...",

which seeks to explain the relationship between marketing and selling. We have considerable difficulty with this proposition for the current stage of development of financial services. It does not explain the current marketing/selling relationship.

2.1.4 Typical definitions of selling[2] are:

"Selling is a straightforward concept which involves persuading a customer to buy a product",

or

"Salesmanship is the skill or art of presentation of goods so as to convert neutral or even negative attitudes towards them into positive ones or demand",

neither of which are subtle enough to explain the real world of financial services, in which the salesman needs to build a relationship and raise the level of perceived need for the product.

2.1.5 In order to explain the relationship between marketing and selling in financial services, we will need to introduce some additional concepts:

—the product complexity spectrum,
—distribution added value,
—the product distribution relationship,

—relationship and selling pressure, and
—marketing and selling *inter* relationship.

2.2 *Product Complexity Spectrum*

2.2.1 Product complexity is a controlling factor in the distribution method of financial services. It is our contention that the intangible nature of many, if not all, products leads to a different situation from other industries. In this discussion we define the products to be the totality of the service and the legal contract.

2.2.2 What is product complexity? We find it easier to describe some characteristics which lead to complexity:

—low perceived need by the consumer,
—long-term commitment,
—large premiums or investments,
—tax and legal complications, and
—product obscurity.

It is implicit in this that complexity is defined by reference to the consumer, and that 'demand' products such as motor insurance are non complex.

2.2.3 If products are arranged from the simplest to the most complex we have the product complexity spectrum (Figure 2.1).

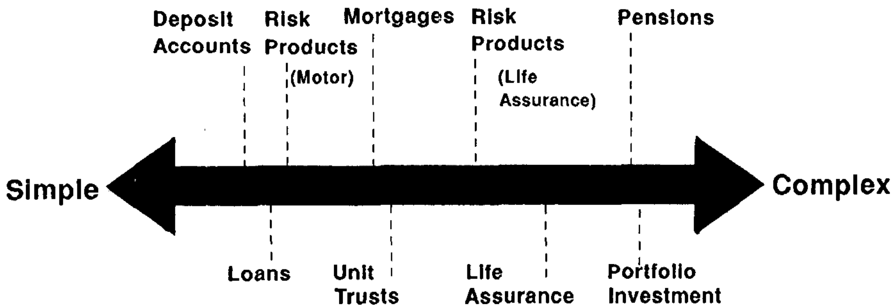

Figure 2.1 The product complexity spectrum.

2.2.4 Some observations on the complexity spectrum are that:

—the same legal contract can occupy different places on the spectrum, depending upon its use,
—the products offered by each legal entity may be dispersed along the spectrum, and
—generally more complex products have higher gross margins for distribution and profit.

2.3 *Distribution Added Value*

2.3.1 The distribution channels, that is the way in which a 'manufacturer' reaches the customer, open to financial services are:

—bricks and mortar (High Street branches),
—automatic machines,
—advertising,
—direct mail,
—telesales,
—tied agents, and
—independent agents.

These range from 'passive' (bricks and mortar, automatic machines, advertising) through 'medium' (advertising, telesales) to 'active' (tied and independent agents).

2.3.2 The value added by the distribution system will depend upon the degree of activity. Passive methods add little value, active methods are high added value (Figure 2.2).

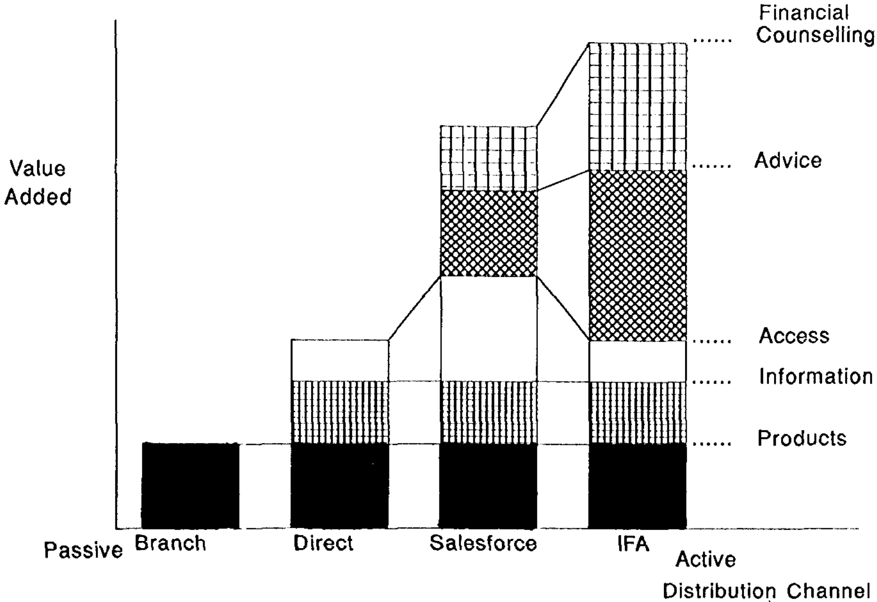

Figure 2.2 Value added by distribution system.

2.4 *The Product Distribution Relationship*

2.4.1 A fundamentally important factor of financial services is that products and distribution must be matched. Simple products can be distributed by passive methods, whereas complex products require active distribution. This can be represented diagrammatically (Figure 2.3).

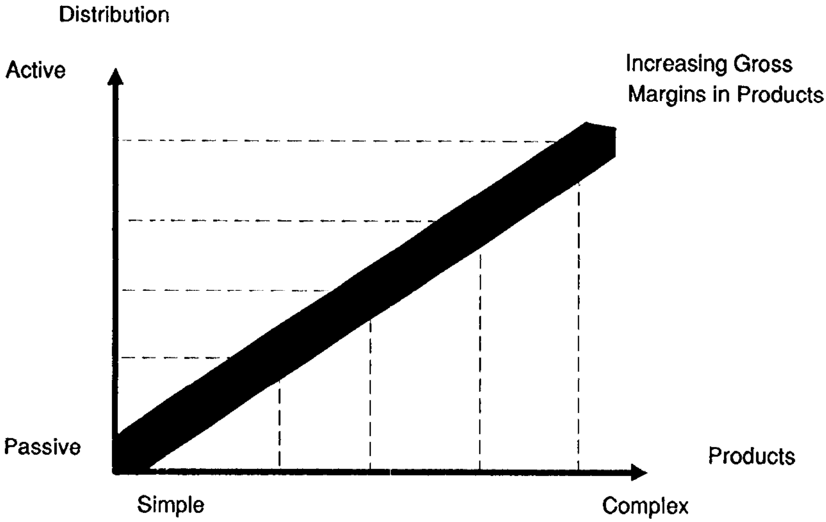

Figure 2.3 Matching products with distribution.

2.4.2 Failure to understand the product/distribution relationship has been responsible for some major mistakes in the past, for example:

—the continual failure of U.S. banks to distribute life assurance through bank branches,
—the failure of the distribution of a bank account through a salesforce, and
—the inability to use direct marketing of complex products to a cold client base.

An interesting case study in the product/distribution relationship is the history of universal life in the U.S.A. The product was originally introduced as a simpler product than conventional whole life which would have more consumer appeal, and hence be easier to sell. In terms of the above diagram it was mid way on the scale of product complexity. Because it was easier to sell, margins and commissions were lower, but there was no attempt to change the distribution from that used for more complex conventional life assurance. Thus there was a mismatch between the product and distribution, and the product was not a success. After some time of non-success the product was withdrawn, and a new more complex version with higher margins and commission was introduced.

Thus the product and distribution were matched and the product became a success.

2.5 *Relationship and Selling Pressure*

2.5.1 In the sale of any product the selling process will encompass two elements:

—the establishing and building of a relationship between the organisation or salesman and the customer, and
—the degree of sales expertise which is required—we call this the selling pressure.

2.5.2 We believe that these non product features hold good for all industries. For example, Marks & Spencer have a strong relationship and low selling pressure for a retailer. Specialist collectable products (vintage cars, for example) often have a medium relationship and medium selling pressure. Complex financial services products require a strong relationship and high selling pressure.

2.5.3 The product/distribution relationship diagram can be extended to the following (Figure 2.4):

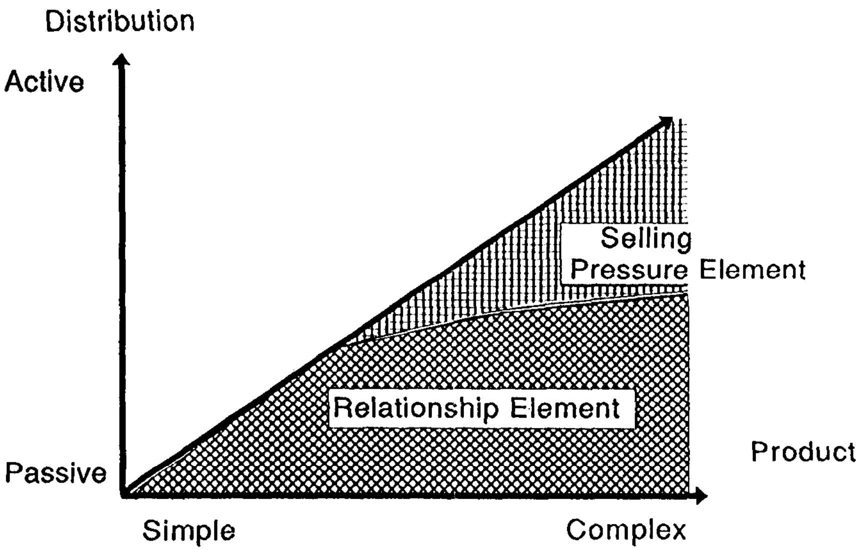

Figure 2.4 Relationship and selling element.

2.5.4 Typically, the distribution of life assurance requires a high relationship element and a high level of selling pressure. Also traditionally, both of these elements have been provided by the salesman, whether IFA, tied agent or direct salesman. If we look at the various sectors of the financial services industry we find:

Product	Relationship	Selling Pressure
Bank Account	high	low
Unit Trust (commodity)	low	low
Unit Trust (intermediary sales)	high	high
Stockbroker	high	generally medium
General Insurance	variable	medium
Life Assurance	high	high

2.5.5 The exact nature of the non-product sales features has an important bearing upon the ability to move from one product to another. It is easy to move from a high relationship to a low relationship product, but, by definition, the relationship needs to be established if the move is from low to high.

2.5.6 Another feature of life assurance is that, because both relationships and selling pressure are generally accomplished by the intermediary, the intermediary is said to have a high level of 'prominence' (see below). This high degree of prominence will inhibit a move away from the current product lines, especially to those which require low selling pressure.

2.6 *Marketing and Selling Inter-Relationship*

2.6.1 Because of the lack of a clear definition of marketing, we have decided to offer our own, so that some analysis can be undertaken. We will define marketing as:

"the raising of awareness of the company's product, the generation of demand or the delivery of the product on a corporate basis".

Implicit in this definition is that the relationship is with the corporation, and that the distribution is tightly controlled by the corporation. In a marketing-led operation, selling is a part of the marketing function, and controlled by marketing.

2.6.2 Most organisations are marketing led. In financial services, all but life assurance, some general insurance and stockbroking, are in the marketing-led group.

2.6.3 The marketing and selling mix can, in theory, range from 100%/0 to 0/100%. The prominence of the salesman—a term used by John Moynahan in his book *Designing an Effective Compensation Program*(3) is useful in this analysis. The prominence of the salesman is an indication of the value added by the salesman. A greater selling content in the marketing/selling mix indicates the greater prominence of the salesman.

2.6.4 Life assurance, because of the historical development, is almost always sales led. In this case an attempt by the company to do anything directly with the client may well be detrimental to the distribution effort. Marketing effort in a sales-led company will be most effective if it is in the form of sales support, or if it is used to promote the salesman.

2.6.5 The inter-relationship between sales and marketing is the cause of many problems, and in some ways may be at the centre of the problems of culture between life assurance operations and other financial services. The problems are most clearly seen when a life assurance company is part of a wider group, so that some companies in the group are marketing led and the life company is sales led.

2.7 *The Dynamics of Moving from One Sector to Another*

2.7.1 The recent years have been called the financial services revolution. This 'revolution' has been the move of one part of the financial services industry into others. In many countries this has been accompanied by considerable deregulation. In the U.K., with one or two exceptions, this has not been the case—in some ways regulation (The Financial Services Act) has been a promoter of the revolution.

2.7.2 For some years both life assurance companies and banks have owned unit trust companies, banks and building societies have been distributors of life and general insurance, and banks and unit trust companies have owned life assurance companies. The change in recent years has been more one of attitude rather than just changes in ownership. The desire is now to extend the definition of 'core business' (i.e. to have more 'core businesses') or to leverage on existing strengths.

2.7.3 In order to explain why the banks and building societies are in the best position to make the transition, and to be the most likely to become dominant providers of generalised financial services, we return to Figures 2.3 and 2.4. Figure 2.3 can be modified to:

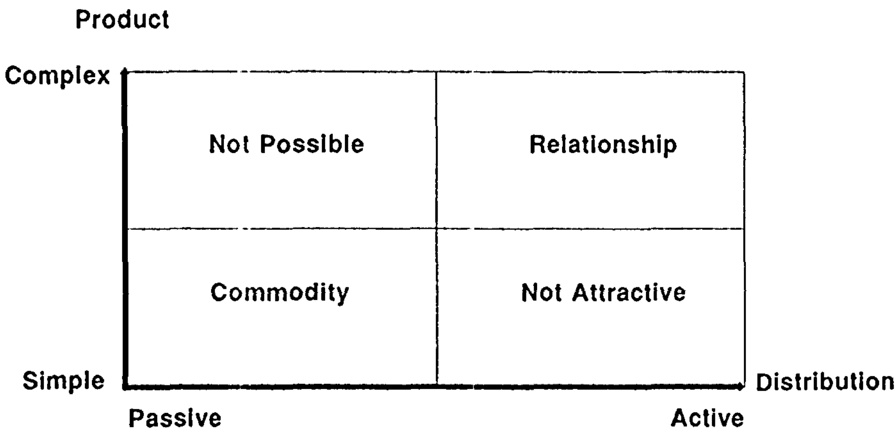

Figure 2.5

In this diagram the banks occupy the bottom left corner and the life assurance companies the top right corner. Characteristics of the bottom left corner are:

—the relationship is between the corporate entity and the customer,
—products tend to be low gross margin commodity type products, and
—the distribution system is passive, and there may be little resistance to moving up the slope to more complex products with more active distribution.

In addition the banks and building societies have two further important advantages: the branches, a distribution method which is difficult, if not impossible, for others to create from scratch, and a strong relationship with their customers. There will be saving in cost, because there is no need to find the customer, so that distribution costs will be significantly lower for all more active distribution systems and complex products, if they are built upon an existing simple product, passive distribution position.

2.7.4 The position of banks and building societies may be contrasted with that of the life assurance companies. Life companies generally have active distribution systems which involve:

—high gross margin products, so that any change will be to lower margin products,
—the relationship with the customer is strongly with the distribution outlet and only weakly, if at all, with the life company,
—there is limited control over the distribution system, and
—the distribution system will resist moves to lower margin products or the introduction of other distribution methods.

2.7.5 An extension of this argument can be used to analyse the position of other financial institutions. The result is that, potentially, the banks and building societies are in the strongest position to become important in all sectors.

3. Elements of Financial Services

3.1 *Elements of Financial Services*

3.1.1 In the distribution of financial services there are three principal elements:

—the manufacturer (company),
—the distribution channel, and
—the ultimate consumer.

The relationships between each pair of these three elements determine the distribution strategy.

3.1.2 We characterise the three relationships as:

—between manufacturer and distribution is the organisational relationship,
—between distribution and consumer is the sales approach, and
—between manufacturer and consumer is the marketing strategy.

Although the three relationships are inter-dependent, it is only by considering the elements and relationships in a coherent way that a successful distribution strategy can be developed.

3.1.3 Diagrammatically we can express this as:

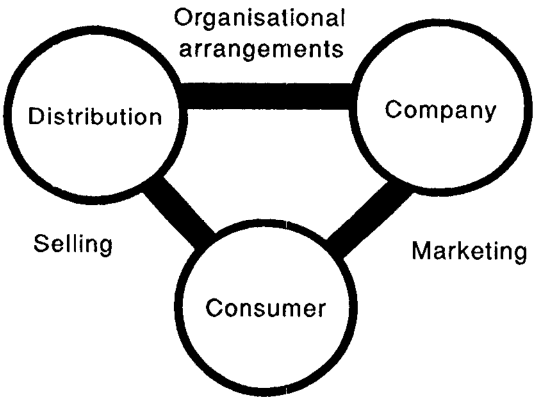

Figure 3.1

3.2 *The Manufacturer/Distributor Relationship*

3.2.1 The manufacturer/distributor relationship varies from total integration and identity (a retail bank and its branches, for example) to total independence (a life assurance company and an IFA).

3.2.2 It would be expected that a totally integrated position would give greater control and a more stable financial position. It is difficult to assess whether a totally integrated relationship produces higher profits (or better value for the consumer), because the position is usually dictated by the particular sector of the financial services industry. However, in the limited number of cases which are available higher profits do result.

3.2.3 The manufacturer/distributor relationship also encompasses the degree of control which the manufacturer has over the distributor. The degree of control is generally determined by the type of distribution channel. Branch distribution tends to be more tightly controlled than salesforces, but this is not universal.

3.2.4 Control can be exerted in a variety of ways:

—management,
—remuneration,
—structure, and
—technology.

Of these, the strongest two are management and remuneration. The theory of management and remuneration in distribution is covered by Moynahan. This may be summarised by:

High Incentivisation	Low Incentivisation
Independent	Tightly controlled
High added value	Low added value
Frequent sales	Infrequent sales

It should be noted that the difference is not between well managed and the reverse, it is possible to manage an independent distribution outlet well. The contrast is between directly managed and indirectly managed. The way in which distribution systems are managed and rewarded in financial services traditionally has fitted in with this framework.

3.3 *The Manufacturer/Customer Relationship*

3.3.1 The manufacturer/customer relationship is dominated by the marketing policy of the organisation. The different types of organisation with balance between selling and marketing has been covered in Section 2.

3.3.2 One important effect of marketing is the degree to which the customer has a relationship of trust which will pre-dispose him, or her, to purchase again from the organisation. Empirical evidence strongly suggests that banks and building societies are in the position to sell further products and a greater range—because of their past marketing. Life assurance companies, on the other hand, are not in this position—the relationship is with the sales outlet, and life companies have tended to put their marketing effort behind the distribution system to promote it to the ultimate consumer.

3.4 *The Distributor/Customer Relationship*

3.4.1 The distributor/customer relationship is characterised by the sales approach. This in turn determines the degree of activity or passivity of the distribution system.

3.4.2 The distribution/customer relationship will affect whether the ultimate consumer will seek out an individual or representative of the manufacturer. It will also be dependent on the service and advice content of the product. In active sales methods there will be a high level of advice of a financial planning nature, and the financial instrument is incidental to the sale. As the service and advice content reduces the products move to commodities, and the distribution method becomes more passive.

4. The Changing Position

4.1 *Drivers for Change*

4.1.1 In Sections 1, 2 and 3 we described the historical position, and developed a theoretical framework with which to analyse the distribution of products. This section considers the changes which are affecting the industry at the current time.

It is not part of our analysis that the position of products in the simple/complex range is fixed for all time, nor that all active distribution systems are the same. Many of the changes taking place are affecting these two features.

4.1.2 We identify the main drivers for change to be:

—deregulation,
—regulation,
—consumerism,
—improved technology,
—marketing and branding, and
—management and financial reporting.

Others, such as availability of capital and changed economic conditions, may be about to have an impact.

4.1.3 The U.K. has traditionally been a lightly regulated environment. The impact of deregulation, therefore, has been limited. The major changes have been:

—The Building Societies Act 1986, which enabled building societies to enter other financial services and become publicly quoted companies. This has an impact on all other areas, because potentially large distributors of all financial services have been created.
—The Financial Services Act placed unit trusts on the same basis as life assurance—this resulted in a more liberal approach to distribution for unit trusts, but a more restrictive environment for life assurance.
—The advent of the European Community has encouraged foreign financial institutions to enter the U.K. Because the U.K. has been relatively an open market in the past, this has been less important than for other countries.

The effect of deregulation has been to produce a more competitive marketplace, although the full effects have not yet been fully realised.

4.1.4 Regulation has had a major impact, overwhelmingly as a result of the Financial Services Act. All of the changes have not worked their way through, but the results have included:

—Fierce competition by life assurance companies for distribution. This has resulted in a significant increase in the cost of distribution.
—A radical reduction in the number of IFAs and an increase in tied agents, with several new entrants to the field of company salesforces.
—Banks have, in general, decided to distribute in-house products, with a minority of their production being placed through their IFA operations.
—Increased product disclosure, which has led to increased costs, and a potential threat of commission disclosure to the IFAs, which will ultimately affect the size of the whole industry.

4.1.5 Consumerism is the reason put forward for the introduction of, and scope of, the Financial Services Act. Generally consumerism encompasses:

—the consumer movement's belief that there must always be someone (other than the consumer) who is to blame, who should meet any losses by the consumer,
—regulation rather than existing law is preferable,
—the consumer always wants the maximum information, and
—if all else fails, there must be a compensation scheme.

The results of this are predictable. From the point of view of distribution they are:

—greater controls over distribution and ultimately less competition, by raising the barriers to entry,
—increased costs, and
—greater difficulty in the sales process, because of the greater amount of information which it is required to give.

Consumerism has little ultimate effect on the distribution of demand products. By their nature they are 'essential', and the consumer will pay what is necessary—volumes will be little changed, even though costs will increase. However, there is a greater threat to relationship products—increased costs, increased difficulty and information overload may lead to a decrease in business volumes as distribution outlets disappear.

4.1.6 Technology has been used successfully in recent years to improve productivity of distribution, e.g. through the use of lap tops at the point of sale, and to cement relationships of IFAs to particular companies through the use of networks. It has also been used successfully by banks for cash transmission. To date, the use of IT in distribution has largely been to improve the company/distributor relationship or to back-up the distributor, but it has not resulted in any major marketing successes.

4.1.7 Marketing and branding can be used to strengthen consumer relationships and create better awareness of the company. It is difficult to determine the extent to which increased marketing has increased the overall size of the market or merely increased costs. To date, branding has not been used particularly successfully in selling the more complex financial services—perhaps the exception to this being BUPA, which has dominated the medical expenses market.

4.1.8 More sophisticated management techniques include the following:

—improved decision making,
—better information for management,
—improved financial control, and
—new accounting techniques.

The last mentioned, 'new accounting techniques', has been used by banks to overcome the problems associated with demonstrating that an adequate return is being obtained on new life insurance ventures, and this enables them to enter the life insurance market. Management techniques have improved in the other three areas, but considerable scope still exists in these areas for improving the economics of distribution of life insurance products.

4.2 *Implications*

4.2.1 In many respects we expect the effect of the drivers for change to be less dire than might be imagined. There is a strong tendency for the regulated to capture the regulators, and for the industry to absorb consumer led and other changes in such ways as to produce advantages for itself. However, there are some implications which can be drawn from the theoretical framework which may be more far reaching.

4.2.2 Part of the objectives of the consumer movement is to make the product more intelligible to the consumer. As such it will make the personal contact, person-to-person distribution method less important. We would maintain that in this objective there is often confusion on the nature of the product—the consumer is buying a comfortable retirement, not a pension plan, for example—and the totality of the service being offered by the salesman is much greater than the individual policy. Nevertheless, regulating the policy information will lead to an interference with the provision of the service. At the same time margins will come under pressure, because of greater disclosure. This pincer movement will have a greater impact on the traditional life assurance company distribution methods.

4.2.3 From the earlier analysis, lower margins must result in simpler products which require less active distribution, or alternatively to losses from complex products and active distribution. However, the active distribution will resist the move to simpler, lower margin, less active distribution products. In this case, the relationship is between the distribution and consumer, rather than the company and the consumer, so that resistance to the move will be effective. However, effective resistance will lead to losses for the life assurance company—this is not a sustainable position. Thus, it can be expected under current trends and regulations, that the distribution of traditional life assurance products through traditional distribution methods will diminish.

4.2.4 Mortgage endowments produce the same commission as endowments sold for long-term savings. The products, however, lie at very different points in the simple/complex product range. Mortgage endowments (which are mortgage repayment vehicles) are simple demand type products, most other endowments are relationship type products.

4.2.5 Mortgage endowment commissions do one of two things:

—inflate the mortgagee's profits, or
—subsidise the other costs of house purchase.

In either of these cases, unless the tax or investment benefits are sufficient, the position of mortgage endowments is at risk. Above 'normal' profits are not sustainable in a competitive market. If profits are reduced, then other repayment vehicles may become as attractive (or more attractive) to the distributor. If the commissions are being used to subsidise costs, then only mortgage providers who also sell the endowment will be economically viable. This will cause the elimination of some distributors, and retaliation from mortgagors who do not sell endowments to demonstrate any lack of attraction of the endowment. Longer term we are not optimistic for mortgage endowments in their conventional form.

4.2.6 Organisations which have not been strong in distribution in the past will see opportunities. Because they do not have an active distribution system, they have greater flexibility. The group includes unit trust management companies and merchant banks. There are already signs that these organisations are moving from their core businesses and we expect this to continue.

4.2.7 The most dramatic of all implications is already well under way—the move of the banks into other financial services. They have for some time been producers or distributors, including:

—owning life assurance companies,
—owning unit trust management companies,
—being IFAs,
—being general insurance brokers,
—providing mortgages,
—operating housing trustee departments,
—owning stockbrokers, and
—owning investment banks.

The major difference has been the move to distribute these products vigorously. We now apply the theory to try to establish the likely outcome.

4.3 *Outcome*

4.3.1 As a greater understanding of the product/distributer/customer emerges, products will be grouped together according to their similarity rather than the legal nature of the company which offers them. Products will then be matched with distribution more suitably.

4.3.2 We expect the outcome to be a major realignment in the U.K. financial services—although this may take some time because of the effective resistance of vested interests. If the theory is correct, then the trends are inevitable.

4.3.3 A major cost in the provision and distribution is finding the customer. Any organisation which can find a way of reducing this will have a major competitive advantage. Banks moving into other areas are in this position. In the absence of regulation or gross mismanagement, banks (and building societies) are in the position to become generalised low-cost (but profitable) financial services providers, with the complete range of products and distribution systems.

4.3.4 The dynamics are in favour of this happening, because for banks and building societies:

—the move is from passive to active distribution,
—the move is from low margin to high margin products,

—the relationship is with the organisation not the distribution channel, and
—the banks are best placed to have all distribution channels.

4.3.5 To survive and flourish, other financial services must understand where they have a competitive advantage, which must lie in one or more of:

—product,
—distribution, or
—customer.

The primary means of success will be by understanding the product/distribution relationship because, by definition, there is a weak relationship with the customer. To illustrate this we give two examples.

4.3.6 The first example may be confused as a product only strategy. There will be a few products which are manifestly superior—examples are high-performing unit trusts and with-profits endowments (both based upon investment expertise)—and these will, therefore, become demand products. The products could then become low margin, low distribution cost (passive distribution and bulk market), or high margin (active distribution and large investment by the client) successes. By definition, only a few can succeed at this.

4.3.7 The other example is that of high added value distribution. Specialist companies are emerging, and will be successful, who use an active distribution system selling high margin products which have a high service/advice content. This satisfies the top right corner of Figure 2.5:

—complex product,
—high margin,
—active distribution,
—high relationship content, and
—high selling pressure.

5. Pricing and Profitability Implications

5.1 *Pricing of Financial Services*

5.1.1 Historically, two approaches have been adopted by financial services institutions in determining the price at which to sell their products. The two approaches can be termed 'cost plus pricing' and 'market driven pricing'.

5.1.2 Cost plus pricing requires an organisation to identify its costs, based upon anticipated product experience, identify its required profit criteria and fix its prices at a level sufficient to provide for the identified costs and profits. The competitive positioning of the product is then a consequence of the pricing process. This approach anticipates a non-competitive sale. It has been used historically by life insurance companies selling through a direct salesforce or by direct mail, i.e., typically organisations which are sales driven.

5.1.3 Market driven pricing requires a company to fix the price of a product by comparison with prices adopted by its competitors, so as to achieve a predetermined market positioning. After allowing for the costs of the company's operations and anticipated product experience, the resultant profit is measured, and if inadequate, the price adjusted to the extent that price/demand elasticity permits. This approach implicitly assumes a competitive sale, and has been used historically by banks and building societies and life companies operating in what they perceive to be competitive markets, i.e. typically organisations which are marketing driven.

5.1.4 The approach to pricing can, and often does, vary within an organisation, depending upon its various products and distribution channels. The markets for various products and for various distribution outlets differ substantially in their price sensitivity. Market-driven pricing is more commonly used for simpler demand products, whereas cost plus pricing is used for more complex products. It is debatable whether true market-driven pricing can be used rigorously for more complex products, since it is rarely possible to compare all competitive aspects of such products. Typically, only the maturity values of complex life insurance products are compared, thus permitting organisations to be less competitive on other aspects of the product, e.g. surrender values, and to incorporate a degree of cost plus pricing into their market-driven pricing. It is equally difficult for an organisation to adhere strictly to cost plus pricing. Few organisations, if any, can ignore the prices charged by their competitors, and most now alter their profit criteria according to product and/or distribution channel.

5.1.5 The method companies use to incorporate expenses into their product pricing has helped further to confuse the issue. The approach generally adopted is for an organisation to calculate expense allowances, and build these into its product pricing and expense monitoring. The excess of actual expenses over expense allowances generated in a period is termed an expense overrun. The approach is described in Goford's paper, 'The Control Cycle'[(4)]. Whilst this approach may be appropriate historically, within many institutions there is considerable uncertainty as to what is actually an overrun and what is the *true* level of expense allowances. This uncertainty has enabled organisations to adopt a flexible attitude to expenses in their product pricing.

5.1.6 The end result is that, because of the lack of a coherent pricing philosophy and a flexible approach to product expense allowances, many life companies have a less than rigorous approach to their product pricing and towards measuring the profitability of their products. Many of those organisations without actuaries, i.e. banks and building societies, are even less aware of the profitability of their products. For reasons discussed in the remainder of this section, we consider it inappropriate to measure product profitability without a clear understanding of the role of products within the distribution and marketing strategy of the organisation.

5.2 *Insurance Company Expenses*

5.2.1 The approach most commonly used to determine acquisition and maintenance expense allowances is to separate the current year's expenses into those which relate to acquisition activities and those which relate to maintenance activities; each is then divided by the relevant volumes of business to determine per policy allowances. If the expense allowances derived are considered atypical, either because the company is in a developing state or because significant one-off expenses have been incurred in the year concerned, adjustments are made to the current year's expenses to derive more acceptable allowances. Thereafter, deviations are treated as aberrations and do not normally impact the allowances. Since the allowances are calculated on a per unit basis, and then are used independently of the volumes of business, the implicit assumption underlying this approach is that all expenses are variable.

5.2.2 The reality is that Life Office expenses are a mixture of fixed expenses and variable expenses. In his paper entitled 'Pricing for Reward and Risk'[(5)], Shuttleworth divided expenses into three categories:

(a) marginal per unit expenses such as medical fees and stamp duty,
(b) marginal per project expenses such as computer system modifications for a new product line, and
(c) fixed overhead expenses such as office rent.

Although this approach has advantages compared to the approach described in § 5.2.1, in practice very few expenses are totally fixed or are totally variable; the key difference between the various types of expenses is the rate of change of each type of expense in relation to business volumes and the way in which these rates of change vary, e.g. do they occur gradually or are they stepped? Typically, for a fixed change in business volumes, per unit sales and marketing expenses can vary significantly, per unit acquisition administration charges will vary by a lesser amount and per unit maintenance administration expenses will vary very little, unless a threshold is breached in which case the maintenance expense can change significantly.

5.2.3 Since life office administration expenses can only be varied slowly with time, they can be predicted with a fair degree of accuracy. This is less true of sales and marketing expenses. Moreover, administration expenses are a function of the product, whereas sales and marketing expenses are a function of the sales and marketing strategy. Indeed, the product itself is also a function of the sales and marketing strategy.

5.2.4 Our preference is, therefore, to determine per unit administration expenses and incorporate these into the product profit testing. The profit test can then be used to derive for each product, the contribution to sales, marketing expenses and profit. The profitability of the sales and marketing strategy can then be determined as described below.

5.3 *Analysis of Sales and Marketing Profitability*

5.3.1 The key elements relevant to determining the profitability of any sales and marketing strategy are:

—the products sold and their prices,
—volumes of business anticipated,
—costs of the sales and marketing strategy, and
—risk.

In his paper, Shuttleworth outlined an approach to pricing which he termed 'macro pricing'. The approach described below is based on his paper, but has been adapted to reflect our differing approach to the treatment of expenses and risk.

5.3.2 Our approach to determining the profitability of a sales and marketing strategy entails the following steps:

(1) Estimate the business volumes that can be obtained of a particular product for difference product charges (i.e. different product prices)—line *A* in Figure 5.1.
(2) Using the approach described in § 5.2.4, determine the contribution to sales expenses, marketing expenses and profit—line *B* in Figure 5.1.
(3) Estimate the expenses required to produce the differing level of business volumes—line *C* in Figure 5.1.
(4) The contribution to sales and marketing expenses and profit can then be compared to the expenses (lines *B* and *C*), to identify the profit associated with different sets of charges, business volumes and expenses, i.e. different marketing strategies.
(5) Identify the risks associated with each strategy.

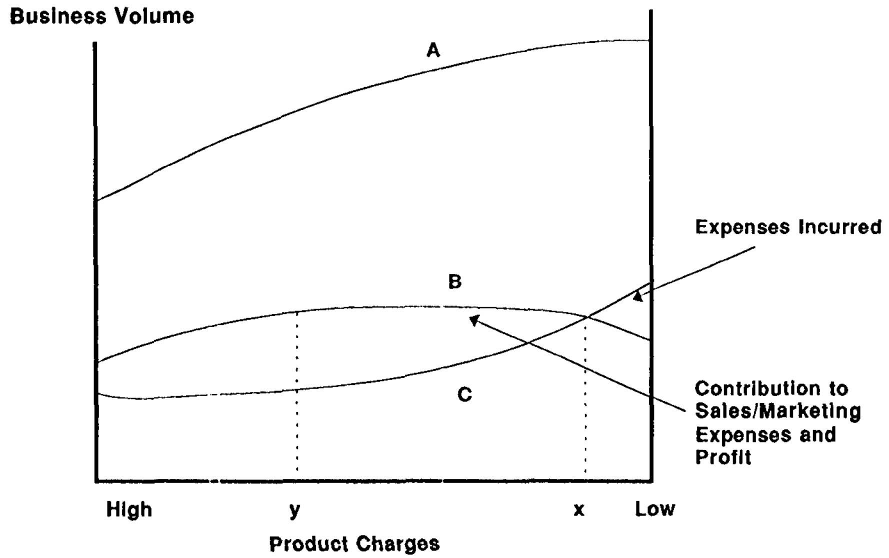

Figure 5.1 Analysis of the marketing strategy profitability.

5.3.3 This approach enables an informed discussion to take place regarding the potential profit associated with various marketing strategies in the light of the risks associated with each strategy. For example, an organisation would be unlikely to adopt a strategy to the right of X in Figure 5.1. Although theoretically point Y would generate the maximum profit, the risks associated with a marketing strategy in between X and Y might make a strategy different from Y preferable.

5.3.4 The description above has incorporated the simplified assumption that volumes are directly related to product charges. In practice, whilst business volumes are likely to fluctuate in line with product charges, product charges are unlikely to be the only factor influencing business volumes, and changes to one product may affect production from that one and from others.

5.4 *Management of the Distribution Channel*

5.4.1 Whilst the above approach to determining sales and marketing profitability is desirable, analysis of the profitability of a sales and marketing strategy is in itself insufficient to determine which parts of the distribution channel are operating most efficiently or to identify how to improve the efficiency of a particular marketing strategy. The efficiency of a distribution channel is best understood through an analysis of the various relationships which exist.

5.4.2 Consider the example of an IFA distribution channel which comprises the following chain of relationships (Table 5.1):

Table 5.2. IFA Distribution Channel Chain

Company—	Branch manager
Branch manager—	Sales consultant
Sales consultant—	IFA
IFA—	Consumer

Depending upon the way in which a distribution channel is constructed, the strength of each relationship will differ. From the viewpoint of a life assurance company, various elements essential to any relationship can be identified:

—value added,
—costs,
—basis of operation,
—support requirements,
—management style/culture, and
—risks.

The operation of the entire chain and its efficiency will be determined by each of these relationships and the way in which they interact.

5.4.3 Ultimately the expenses of the whole distribution chain must be borne by the products sold. However, in the above example the expenses of the company, branch manager and sales consultant must all be borne by the company whether or not the product is sold, whereas profits are only generated for the company if a product is sold.

5.4.4 The fourth relationship, i.e. between the IFA and the consumer, is ultimately the most important. If the economics of this relationship are unstable, the whole chain becomes unstable. However, in the above example, this relationship is outside the control of the life insurance company, and its actions are limited to determining whether or not to carry out business with and influencing the IFA. From the perspective of the company, the third link is the vital one, since it determines whether or not it receives the products sold by the IFA. It is, therefore, necessary to consider the economics of the entire chain, not just that part of the chain under the control of the life insurance company. It is necessary for the life assurance company to consider the economics of the entire chain, not just that part of the chain under its control; however, in understanding the effectiveness of the distribution channel it is appropriate for it to focus upon the effectiveness of the third link.

5.4.5 In the limited history of tied agents, most life insurance companies have used the same distribution channel to service both IFAs and appointed representatives. More recently, many companies have appreciated that separate structures or separate distribution chains are needed for appointed representatives and IFAs, and separate channels have been set up by many companies to address the different needs of these different agent types. This analysis also helps to explain why some IFA life insurance offices have set up different distribution chains to support national agency brokerages and to support other IFAs. National agency brokerages may require head office to head office contacts, as an extra link in the chain. This extra link may decrease the effectiveness of the distribution channel; furthermore the links that do exist in the chain also need to alter to reflect the removal of other links—thus a new chain is developed.

5.4.6 Taken to its conclusion, this analysis suggests a segmentation of the IFA market into homogeneous segments, and the setting up of differently structured distribution chains for each segment, each segment most likely having different profitability.

5.4.7 This model can be extended to other distribution channels. Table 5.3 considers a distribution chain for a Sales Force.

Table 5.3. Sales Force Distribution Chain

Company—	Area sales manager
Area sales manager—	Branch manager
Branch manager—	Consultant
Consultant—	Consumer

Whilst the same distribution chain would apply for both a prospecting sales force and a bank owned sales force, the value added by each link in the chain is different for each type of organisation. For the prospecting sales force the value added by the consultant and the recruiter of the consultants is high, whereas the value added by the company is low. For the bank owned direct sales force the value added by the company is high, whereas the value added by the branch manager consultant is considerably lower. Clearly different remuneration, control and cultural considerations follow from this.

6. Summary and Conclusions

6.1 Distribution is not a subject which has been discussed often at Staple Inn Hall—this is a pity, because we believe that many life assurance companies would be more effective if actuaries had paid greater attention to this part of the operation. We hope that this paper will provide some added impetus to a move in this direction, which has already started.

6.2 The relationships between the three parties:

—manufacturer (product),
—distributor, and
—customer

have not been well understood, and practice has been ahead of theory, by relying on trial and error to reach a solution. Although the theory is still in broad outline, we believe that its application may help to reduce the number of both trials and errors.

6.3 The way to a successful operation depends upon understanding the relationships, the dynamics and what is possible within the financial constraints. It is generally possible to deliver any product to any group of customers by any method, provided cost is not an issue. In the real world costs and financial constraints are of great importance, and will become more important. It is, therefore, necessary to be efficient, and this paper has been concerned with greater efficiency through greater understanding.

Acknowledgements

We would like to thank our colleagues who helped develop and refine our ideas over several years. In particular we are indebted to Patricia Rawlins for her creative criticism and her help in making the paper more intelligible. Finally, the paper would not have been possible without the patience and tolerance of Julia Pearce, who, together with her word processor, coped admirably with both the text and diagrams.

Whilst we have discussed many of the ideas in detail with colleagues and friends, the views expressed are those of the authors.

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ABSTRACT OF THE DISCUSSION

Mr A. K. Gupta, F.F.A. (introducing the paper): Over the past decade Mr Westall and I have been invited into a large number of financial services institutions, both in the United Kingdom and overseas, and have been trusted with much information regarding the success and failure of these companies' marketing, sales and product strategies. During this time we have formulated various hypotheses as to why some products and distribution strategies work and others do not. We believe that today's financial institutions and their current marketing strategies exist because, through a continual process of evolutionary trial and error, the companies and their strategies have been found to be successful for consumers, intermediaries and companies; and a rationale exists as to why this is the case.

This paper attempts to pull together and develop a theoretical framework for considering and analysing the marketing and distribution of financial services. We hope that it will help to explain why some strategies work and others do not, that it will help in formulating future strategies and that it will contribute to the on-going analysis of the economics of distribution by actuaries.

In his original paper on profit testing written in 1959 ('Growth Premium Calculations and Profit Measurement for Non-Participating Insurance', *T.S.A.* **11**, 357), J. C. H. Anderson formulated an approach whereby actuaries could price insurance products such that they achieved a profitability criterion expressed as a percentage of commission. In this way they could align the interests of the salesman and the company, and, to a large extent, make the profitability of life assurance products proportional to the volume sold. Actuaries could focus mainly on sales and expenses, and did not need to get too involved in the marketing and sales strategies of their organisations. This paper was highly influential in developing the thinking of many actuaries. However, we now believe that it has encouraged actuaries to concentrate on the pricing of insurance products without regard to the marketing and sales strategies of the company.

Whilst this approach may have been appropriate in past decades, we believe that competition has now developed to such an extent that it is no longer valid. Actuaries can no longer consider the profitability of life assurance products in isolation, but must consider the profitability of the overall marketing strategy, and its viability. In a similar way, the sales management can no longer leave the financial implications of the strategy to the actuary. They now need to get involved in the financial implications of the overall marketing strategy. This requires sales and financial management to work together as a team, and to understand each other's business. We believe that this is essential if actuaries are to succeed in improving the financial efficiency of life assurance products.

Mr M. R. Kipling (opening the discussion): The authors open with a shrewdly observed history of the development of financial services distribution in the U.K. As they observe in § 1.2.4, life insurance has moved from being primarily a demand product to being primarily a product which has to be sold. One might add, "or which has to be sold to keep a large number of participants profitably active in the market".

At the beginning of Section 2 the authors state their intention of explaining the relationship between marketing and selling. Unfortunately, I was unable to identify by when in the paper they thought they had actually achieved this. Nevertheless, they developed a number of very interesting propositions on the way regarding product complexity, distribution added value and the relationship/selling mix; all of which are very helpful semi-objective ways of analysing the distribution process.

In Section 2.7 the various strands are pulled together. I suspect that there are few who would disagree with the paper's conclusion that banks and building societies are in a strong position to increase their life assurance market share. However, I am not convinced that this position is fully explained by distribution dynamics alone. Indeed, I find it difficult to identify where the authors have proved that it is easier for a 'commodity' product distributor to become a 'relationship' product distributor rather than the other way around. That a theory fits the facts in one particular scenario does not make it right.

It would have been interesting if the paper had examined how well the theory fitted financial services distribution in other countries or even in this country at other times. Japan, for instance, has a financial services market dominated by a small number of massive life assurers with tightly controlled sales forces and branch networks. I would be surprised if they could not more easily distribute a modern telephone banking service than traditional banks could break into life assurance.

Section 3 highlights one relationship between marketing and selling, although I would contend that 'marketing' embraces the whole of the triangular process of Figure 3.1. The nature of the manufacturer/customer relationship might, in fact, more correctly be termed 'public relations'. I think that the life industry is aware of this relationship, and is trying to strengthen it and build customer bases. The industry is also much more concerned with the distributor/customer relationship, not only for compliance purposes, but also to ensure that it reinforces the key manufacturer/customer relationship.

In Section 4 the authors consider what they term the 'drivers for change'. The section gives a topical summary of current influences on the financial services market, and perhaps says more about why the banks and building societies have an advantage than does Section 2. However, I believe that the banks and building societies have only a temporary lead. Currently they have advantages in terms of a core of mortgage endowment business, a complex product sold by disguising it as a simple product, and 'warm' leads on which to cut the teeth of an embryo sales force. However, the mortgage endowment business may well fade, either for the reasons given in the paper or because of a loss of belief in investment performance. Moreover, direct sales forces require skilled management to grow successfully, and not all banks and building societies will succeed. At the same time, those life assurers who wish to be survivors will be building their client bases and targeting their advertising on building up the same level of customer relationship that the banks and building societies currently enjoy. Moreover, banks' and building societies' customer relationships may already be weakening, because of the diminution in personal contact. For example, 70–80% of customer transactions are apparently now automated. Furthermore, diversification brings its own pitfalls. Sir Mark Weinberg, addressing the Harrogate Convention in September 1992, warned of the over-confidence often exhibited by specialists in one field when attempting to enter another; and M. Black, in the discussion on the paper by M. Iqbal ('Marketing of Retail Financial Services', *J.I.A.* **115**, 405), warned of the severe management problems to which large-scale cross-selling can give rise.

Section 5.3 contains what I think is the most interesting part of the paper. Macro pricing is an approach to pricing which considers life office profit targets in aggregate, rather than policy-by-policy. The authors have adapted the concept ingeniously to the world of marketing and distribution. The price of simplicity, however, has been a lack of an explanation of how the contributions from, and interaction of, different product lines are to be handled. I wonder, though, how easy macro-pricing would be to put into practice. It is by no means an easy matter to estimate what new business volumes will emerge at different price levels. For a few simple life insurance products, for example compulsory purchase annuities, it is fairly easy for an office to vary the price at short notice and to experiment with the impact on new business volumes. However, for many other products there is a considerable capital overhead in terms of systems and literature, so price changes can be made only infrequently. The volume/price relationship is, therefore, largely a matter of conjecture. Quite how much further one should then pursue a scientific analysis is open to question. Indeed, for some products there may be relatively little relationship between product charges and business volume. As was pointed out in the discussion in Sydney on the paper by D. Shuttleworth ('Pricing for Reward and Risk' (1988) Institute of Actuaries of Australia), this will clearly apply to tied distribution channels where the volume/price line might be fairly flat over a large range of feasible product charge levels, perhaps rising sharply towards the lower end as highly competitive products become key features in attracting new agents, and vice versa at the higher end.

Even with independent intermediaries, where it might be expected that there is a more typical price to volume relationship, there are, as the authors admit in § 5.3.4, many other factors that influence business volumes. Perhaps the key one of these is the amount of money spent on supporting the distribution channel, whether this takes the form of name awareness advertising, higher commission rates, better servicing or competitive underwriting. A low pricing strategy might render it impossible to provide this support, and, particularly for the more complex products, this could lead to lower rather than higher business volumes. However, this could be allowed for. It would first be necessary to estimate how the level of expenditure on each of these factors would impact upon business volumes. To do this, the actuary could have recourse to a theory from the field of psychometrics called 'conjoint measurement'. This enables the price equivalence of the utility of higher or lower levels of various attributes of service levels to be determined.

If we consider just one support function, say advertising, it should be possible to extend Figure 5.1 into three dimensions, with the z-axis representing the level of advertising support. With each advertising level, using the results of the conjoint measurement, a positive or negative adjustment to the price can be associated, depending upon the perceived price equivalent of that level of advertising support relative to the norm. A series of surfaces rather than lines will then result. It is then just a matter of finding the marketing strategy which maximises the vertical distance between the 'cost surface' and the 'generated loadings' surface. If mathematical formulae can be associated with the various relationships, the analysis can even be extended into more than three dimensions.

I suspect that the relationship between price and business volume actually differs little between offices. On the other hand, the cost of delivery of a given level of support varies very much according to the efficiency of the office. It would be interesting to hear if any studies have yet been carried out into the perceived value of intermediary support, and the implications of this for pricing and profitability.

Even with a more complex model, however, I wonder if the definition of profit is wide enough. Perhaps it is for independent intermediary sales, but for tied sales it can rightly be expected that it is possible to place some real value on the acquisition of a client over and above that resulting from the sale of the first policy to him or her. Precisely what repeat sale multiplier to use will depend upon past experience and future expectations, but to ignore it entirely is to risk mispricing the products most relevant to those channels.

This paper cries out to be seized by those actuaries responsible for distribution management, planning or pricing functions. Its techniques will help them to analyse their own distributor and client relationships more objectively, and also will assist them in pricing products correctly for different distribution channels. If they do so, perhaps their offices will be the survivors of the 1990s.

Mr C. Clark: Like many actuaries, I have worked in a range of areas within the life assurance industry, including in a direct selling company. With the increasing attention of the regulators to the sale of life assurance and pensions, and the problems that this has publicised, I have, for some years, questioned the basis of the industry's operation that I, as well as others, have accepted as secure for so many years. There is a grave danger that the internal momentum of the industry will prevent it recognising and adjusting to the changing circumstances around it.

The paper identifies some of the changes that have occurred over the years, but I believe that there are 5 further important factors which have had a significant influence on where we find ourselves today:

(1) In the 1970s there was considerable debate on the prudence of offering maturity guarantees. This was followed by solvency margin regulations which discouraged the offering of all guarantees, and, as a result, we all took pride in how little we had to guarantee and how little effect this had on our sales. The industry merely guaranteed to invest the accruing monies, whereas the client had to guarantee to continue his or her contributions throughout the term.

(2) In 1984 tax relief on contributions to life assurance was withdrawn, a feature which had been enjoyed by the industry for many years. This seemed at the time to have little effect on the industry's ability to distribute its business. Our selling techniques had already developed to such an extent that the methods adopted by the industry overcame any lack of competitive edge. The industry was driven forward by the distributors', or sales persons', need to maintain their income.

(3) In my view, the Financial Services Act had a further indirect effect not mentioned in the paper. There is no disputing that various changes in the 1980s encouraged the banks and building societies to establish their own life insurance operations, but I believe a catalyst to this was the reaction of the established companies to the feared reduction in market share. We saw a rush for connections with banks and building societies, who, quite rightly, were seen as excellent avenues for business, particularly in a mortgage boom. It is hardly surprising that the banks and building

societies, to whom considerable sums of money were being offered, did not fail to recognise that the business they gave to the life companies contained considerable profit over and above the commission they received. It is only a short step from there to questioning why they needed the established life companies at all. These new entrants also have a considerable advantage in having a direct link with the customer, something which the established companies have not generally achieved. Standing behind intermediaries, whether they be independent or tied in some form, is unlikely to achieve this important relationship.

(4) Concerning investment return, as inflation, equity and property returns have been reduced, comparisons with building societies have become increasingly unfavourable. The costs of the industry are also drawn into focus, and if one compares the management expense ratio, including commission, on funds under management of the major life insurers with the major building societies, the relationship is 4 to 1.

(5) The most important factor affecting the market has been the development, through the regulatory structure, of a requirement to provide best, or appropriate, advice. Whilst I am sure that the industry would quite naturally claim to have done this for years, there was no policing, and the commission system encouraged longer-term products. Whatever spokesman for the industry might say, we were interested in selling products, and profitability was generally linked to commission or term. We were happy to accept longer-term policies, if we were told by the intermediary, independent or otherwise, that this was the requirement.

To operate any form of distribution, it is first essential to identify the objective which is to be achieved. In the past this has been simply company profitability, which, traditionally, has been in line with length of term and commission. However, already, and even more so in the future, the industry is forced to take as the most important objective, best or appropriate advice for the consumer. This, in my view, is not compatible with the profit objectives of the industry, nor with the commission system, and consequently, until this problem is addressed, LAUTRO will continue to expose problems. I am sure that the industry would rather LAUTRO were not there, but having reached this point, I do not believe that there is any going back.

The only possibility, in order to diminish the attention of the regulators, is for the financial incentives for both the seller and the company to be clearly unbiased, and for the companies to absorb the initial costs if the consumer, for whatever reason, is persuaded not to continue with the policy. However, in order to allow movement in this direction, there needs to be the possibility for companies to test-market different products through different outlets, without having to offer all products to all outlets. This is something the rules do not easily allow. If the regulators wish to see improvements, then they have to provide a framework within which transition can be encouraged.

Whilst I have made no reference to the pensions area, I feel that, despite its tax advantages, there is inevitably the same bias, resulting from profitability and commission, to advise later retirement ages, and consequently the regulators will, I suspect, turn their attention to this when they have time. The solution must lie in finding the distribution method, and its unbiased method of reward or remuneration, such that the companies can ensure that correct advice is given, and the success of this objective determines whether both the seller and the company benefit.

I am disappointed that so much time appears to be spent on discussing reasonable expectations, when we cannot satisfy ourselves that the advice to our policyholders is unbiased, and therefore likely to fulfil its reasonable expectations. With the advent of best advice, the link with reasonable expectations is clear, and I believe that the Institute needs to be in the forefront of finding a solution to the industry's problems.

Actuaries are in a unique position in this industry, since they alone can relate all the areas, from the consumer, the product and the sales incentive, through to the profitability of the company.

Mr M. J. Pickard: I speak from the perspective of someone who has spent the whole of his career with an insurance company whose sole outlet for life business continues to be through the home service network. This distribution channel only received a passing reference in the paper. Lest it be thought that this is yesterday's approach, the latest figures from the ABI indicate that the home service offices still transact more annual premium assurance, annuity and personal pensions new business than the direct and IFA business of the banks, building societies and estate agents put together.

The question all companies must be addressing is whether their business can hold its market share in the light of the developments described and anticipated by the authors. In §4.2.7 they rightly indicate that a major influence in recent years has been the decision of the banks to distribute financial services' products more vigorously. This has been accompanied by the decision of all the major banks to become manufacturers too, with two of them due to come on-stream in 1993. I am concerned that, in the immediate future, there is not the market for this increased capacity. The position might have been different only a short while ago, because, in the last few years, we have had two very strong periods for regular premium new business: in endowment business during the mortgage boom; and in personal pensions following the introduction of individual contracting out of SERPS.

The question is: which type of manufacturer and/or distributor is more likely to suffer from these increased pressures? The consumerists, many life offices and some authorities, notably the Office of Fair Trading, hope it is not to be the IFA market. "Do not rely on just one company, but 'shop around', and carefully compare all the mass of information you are now receiving before committing yourself", is their advice. However, it has to be recognised—and I believe that this is fundamental—that many members of the public do not feel comfortable in considering financial services matters. They like to be guided in making their decisions by intermediaries they can trust, who they know will be well trained, and who will give them good advice and service. As the opener has indicated, building up customer relationships is the key, so I disagree with the authors when they say in §4.2.2 that the person-to-person distribution method will become less important.

I am concerned that the extra capacity, allied to pressures from market conditions, from consumerists and from the regulators, should not lead to corporate casualties. This would lead to the whole industry being tainted, to no one's benefit, not least our policyholders. One solution canvassed is realignment through mergers or takeovers, which, of course, is much easier said than done; but it must be a strong possibility.

Mr A. S. Cherkas: The alignment of products, distribution and customers may seem, at first sight, to be a critical concept for use in a comprehensive review of a company's strategic position, and indeed it is. However, opportunities for this kind of analysis do not arise frequently. How then can we apply the concept in a practical sense to benefit our businesses in everyday management? To answer this, I offer one real life example from overseas.

A company had a problem with a product development initiative. Responding to a chorus of complaints from the field force, the new head of the individual life insurance division had promised the field force a complete 'revamp' of its product line to make it more up-to-date, marketable and competitive. However, there was a log jam in the product development committee; the parties to the discussion could not agree on the right combinations of, and trade-offs between, product features, competitiveness and profitability. The beleaguered actuary naturally insisted that they could not afford everything. The problem was that the views being brought to the table differed, because they were formed from individual selective exposures to various segments of the field force which, as they had not appreciated, served different types of customers with naturally varying requirements for product features competitiveness. Marketing and sales management considered that they had one homogeneous field force with a generally up-market client base, and managed it accordingly with a one-size-fits-all approach. Subsequent on-the-ground research showed that they had, in reality, two (but probably more) distinct field forces, with different sales approaches, client demographic profiles, product preferences and—crucially—price elasticities: first, a truly up-market segment serving high net worth individuals, where head-to-head competition was a big problem; and second, a middle-income segment, where the sales approach utilised financial planning tools, and which was not price sensitive.

No wonder, then, that the one-size-fits-all approach was going nowhere. Different products and sales support activities had to be developed for each segment. In the U.K. you might have wanted two marketing groups. The implication of this example, for the practical application of the concept, is that it can be used to explain and overcome problems and dysfunctions within an organisation, and make marketing and sales management materially more effective. If skilfully applied internally, it can be used to reverse into some larger strategic questions that have to be addressed. For a developing company, applying the concept has clear implications, for example, for the care required in the selection and recruitment of salespeople and the adoption of various sales approaches.

Macro pricing approaches can bring important benefits to the ongoing refinement and development of marketing and sales strategy. There are a number of macro pricing approaches: the one proposed here; the approach suggested by Shuttleworth in Australia[5]; and Chalke in the United States of America[6]. All three benefit from a requirement that, during the planning and product design processes, marketing and sales management provide sales volume estimates under varying scenarios. In all companies, of course, sales volume estimates are required each year, and we must all be aware of the difficulty in placing reliance on them. However, in these approaches there is a crucial departure from traditional practice, with two clear benefits: one immediate, and one more long term, but fundamental.

The crucial departure is that the sales projections assume an elevated and pivotal role in the decision-making process. The immediate benefit is that this pivotal position should result in sales estimates that are more cogent, reliable and realistic than is often the case, because they will have to undergo additional scrutiny and will require defensible explanations. However, sales projections will always be educated guesswork and involve a high level of uncertainty. Is this additional scrutiny of much value? It is of value, I believe, because the way to handle uncertainty—in sales projections or otherwise—is to examine and address the critical assumptions that give rise to the uncertainty. It is the scrutiny of these critical assumptions underlying the sales projections that can be a very productive exercise, if managed well. The long-term benefit is that this scrutiny and discussion will normally throw any problems in field force productivity—or even marketing and selling strategy—into sharp relief sooner rather than later, and will, it is to be hoped, prompt sharp attention to them. In addition, if managed tactfully, there will be benefits in promoting more effective co-operation between actuarial and marketing disciplines, and in reducing the propensity for adversarial interactions to occur.

Sir Mark Weinberg (a visitor): The paper describes with great thoroughness the highly complex market in this country, and analyses with great perception the changes that have taken place, and are still taking place, in this market. It is a significant contribution to have succeeded in breaking down the many disparate things that make up the market into the various elements presented in the model set out in the paper.

I support the comment in §4.3.2 which says that "a major realignment in the U.K. financial services . . . may take some time because of the effective resistance of vested interests." However, I think the reasons for this timing delay are by no means restricted to vested interests, but arise out of fundamental differences in the way in which different institutions operate. For example, the paper draws attention to the major competitive advantage that banks and building societies have as they move into other areas, but I think that the operative words there are 'in the long run'. In the short to medium term, what might best be described as friction is going to slow down the process, and, indeed, I suspect, is going to prevent quite a number of these new life offices reaching viability at all.

A customer base is undoubtedly a significant advantage for a new life office; but equally undoubtedly, it is by no means by itself a sufficient condition for the establishment of a viable operation.

In §4.3.4 the authors say that, where banks and building societies move into life assurance, one of the reasons why they are at an advantage is because they are moving from passive to active distribution—but therein lies the rub, or perhaps I should say the potential friction. The banks and building societies are used to passive distribution—and to deal with a point raised earlier by the opener, I feel that this makes it difficult for them to switch to become active distributors. You cannot simply convert someone who became a customer through passively distributed products into a customer for actively promoted products without the intervention of a salesman, and building up the sort of sales force that is going to work for this purpose is not easy for a bank or building society. The culture of the bank or building society is against it; customers are delicate blossoms that may fall off the bough if actively approached for life assurance. Employees engaged in promoting services for the bank or building society are salaried people, used to promotion on the basis of seniority, and the idea of having people out there who need to be paid, at least partly, by results in order to motivate them to undertake the active role that they have to do in order to fulfil this particular function, is alien to the culture of the bank or building society, and is perceived as resulting in divisive remuneration structures between the employees of the core business and the new life assurance off-shoot. A sales force will not work without an experienced sales management team, and the sort of people who run banks and building societies are very different from the people who run the marketing side of life assurance companies. This makes it difficult for them to recruit the right type of sales management; or if they do succeed in recruiting them, to give them the freedom to operate in a way that is very different from the way the core business operates.

This is why I suspect that quite a number of these new life companies are going to find it difficult to establish a viable entity—or at least more difficult than they had expected—and certainly the concept of bancassurance or Allfinanz, that was all the rage on the Continent a few years ago, is no longer spoken of with such enthusiasm there.

There is an additional hurdle in this country in the current environment. The companies that have recently been established, or are in the course of being established, are largely an outgrowth of the success of selling endowment mortgages at a time when house buyers were themselves actively looking for houses and were quite happy to take out an endowment as part of the package of getting a mortgage. Now, far fewer people are buying houses, and for those that do the endowment mortgage is no longer the automatic choice. Of critical importance is that the sort of person who can perfectly adequately market an endowment to a customer for a mortgage is not necessarily equipped by training, or very likely by personality, to get involved in the active marketing which is required for selling the broader range of life assurance products. So, while Allfinanz will undoubtedly play an increasingly important role in this country over the years, I suspect that many of the new players are going to have to fight as hard as the rest of us for their place in the sun.

Mr M. Iqbal: In § 2.6.4 the authors state that, because life assurance is almost always sales led, any "attempt by the company to do anything directly with the client may well be detrimental to the distribution effort." I question this statement. There is much that the company can do directly that will reinforce the distribution, by enhancing the company's image in the client's eyes, or even as initial prospecting for the salesman. Sales of simple products can often be set up in this way.

The relationship set out if § 3.1.2 is from the point of view of the manufacturer. From the perspective of the retailer, there can be a marketing input into his relationship with the consumer.

In § 3.3.2 the authors suggest that "Empirical evidence strongly suggests that banks and building societies are in the position to sell further products and a greater range—because of their past marketing." Where is the evidence? Banks and building societies have high name awareness, but also have an image of not caring for their customers. Past marketing of banking services did not materially increase demand.

Life assurance salesmen have acquired a bad name in recent years. Many suggest that the Financial Services Act has simply highlighted bad selling practices that have existed for years. While that might be true, I do not think that it is the whole truth. What has happened is that the greed culture of the Thatcher revolution has led to over-selling in many sectors. We in life assurance have problems in our core businesses in terms of over-selling, but so have banks and building societies with theirs. You have only to look at their bad loan portfolio to realise that the root cause is the same underlying economic problem. I can see banks dominating low margin commodity markets such as term assurance, but their penetration across the diagonal in Figure 2.3 will, I think, be increasingly slow rather than slowly increasing. The opener and Sir Mark Weinberg appear to be making the same point.

In § 4.1.5 the authors state that consumerism has little ultimate effect on the distribution of demand products. I assume that they mean the sales of demand products rather than how they are distributed, but what about cigarettes or fuel emission? I suspect that the authors are using the term 'consumerism' in a very narrow sense.

In § 4.1.7 it is stated that "It is difficult to determine the extent to which increased marketing has increased the overall size of the market or merely increased costs." There are plenty of examples outside the financial services industry to demonstrate this. In our own case, the Dover Plan of the 1960s was an outstanding example of successful word-of-mouth marketing.

In §4.2.3 it is stated that "lower margins must result in simpler products which require less active distribution," and that "active distribution will resist the move to simpler, lower margin, less active distribution products." I query this. People always react to change by adapting their habits. What is likely to happen is that the method of operation of the typical direct salesman could change to a mixture of the active and the passive. In some ways he has to do this in order to survive, and the role of the life company is to help him in this process. In part, this will be by providing him with a new range of simple and complex products, and in part by better sales training and sales management.

Of course, not everyone will succeed in this. This leads to an inevitable corollary that is not explicitly stated by the authors. After 10 years only 2 categories of pure life companies will flourish:

(1) large firms with strong brands and high consumer name awareness and captive distributions, and
(2) medium-sized firms offering high added value products direct or through IFAs.

I share the authors' pessimism on the future of low-cost endowments in their present form. That is not to say that a survivor in some other form will not emerge. It is a challenge for the industry as a whole.

The authors' use of the term 'market driven pricing' suggests to me the approach to pricing of commodities and is, perhaps, too narrow. I prefer the expression, 'what the market will bear'. Going back to the Dover Plan and the associated term assurance that was sold with it, it was the most expensive life assurance savings plan I have ever known, but there was little competition.

I support the expense allocation basis suggested in § 5.2.4, which I call contribution accounting. It is the only way to see which product lines are making marginal contributions to overheads and which are not.

The graph shown in Figure 5.1 is very seductive, but, in practice, very difficult to plot reliably. Some years ago I tried to plot the relationship between price and volume on a simple commodity product (annuities) by means of regression analysis, but failed to establish a reliable pattern. What chance do we have with complex products? Currently I have difficulty getting reliable sales forecasts from sales channels on a single price, so what chance does such analysis have?

Mr R. J. Squires: It is important that actuaries are involved in the strategic decisions relating to distribution, where we should be able to make a more valuable contribution than can more generally based management consultants.

I agree with other speakers that, at present, the bancassurance operations look as though they are going to be in a winning position, although they will not necessarily have an easy ride. For example, some may be tempted to move too quickly towards multiple distribution arrangements, and will find that organising these in a coherent and effective manner will be a major challenge; or a tougher attitude by the regulators towards the requirement to demonstrate best advice might have a significant effect on their sales, particularly in the mortgage endowment market. However, as the authors have noted, their current pricing posture leaves them with margins in hand, and they will be well placed to deal with any such difficulties.

If we can identify those that are likely to be the winners, we can guess that the going will get very difficult for some of the others, because it is unlikely that the whole market will expand significantly. Again, distribution appears to be the key aspect. Some independent companies have distribution strengths and will be well placed to survive; some do not. For the smaller proprietary companies, the day will surely come when their shareholders decide that there is no point in struggling on alone. The more interesting question is the future of the smaller mutual companies. Some of these will secure their distribution by finding partners, even if the price is demutualisation. Some will not wish to do that, or if they do, may not be able to find suitable partners. They will then be faced with a choice between closing to new business or struggling on, writing inadequate volumes of business at the expense of the return to their policyholders. Is there another alternative? For the past 25 years, I suggest, the winning strategy has been to spend more than your competitors on distribution; but with increased awareness of the effect of this on early surrender values. Perhaps the end of that road has been reached. A strategy of drastically reducing distribution costs, perhaps through the use of developing technology, would mean taking a risk, and would undoubtedly mean lower volumes of new business in the short term, but for a mutual company especially, that must be better than no new business at all.

Ms E. Corley (a visitor): The authors suggest that the effective management of distribution in the future will improve the prospects of success for life companies; is this really enough? Who will succeed in the life assurance market in the future? In the past we were in the happy situation where demand exceeded supply, and the profit fell naturally to the manufacturers. Success was associated with good product management. Potential demand is one thing; but accessibility and understanding of the products is another. As we have had consumers who did not understand the products and found them inaccessible, there was a happy alliance with our distribution media.

For many years it has been possible for both manufacturers and distributors to make much money in a mutual arrangement. We have now to consider whether supply exceeds demand, and whether that demand is becoming more discerning. I believe that we are in a position where supply does exceed demand, where the happy relationship between manufacturer and distributor is actually being disturbed, and where servicing the consumer demands in the future will be as important as sales.

It is useful to consider a parallel with other organisations and other markets where supply exceeds demand. Success does not just come with profitable product management and pricing, nor with profitable distribution and pricing, but also with a very keen understanding of what the consumers are prepared to pay for. In future, in addition to the successful management of distribution, there has to be a very clear understanding of the consumers' needs. What is the product they are buying from you? Is it a product? Is it best advice? At the moment they get excellent advice, which is actually free until the point at which they buy a product.

Mr M. H. Field, C.B.E.: In § 1.3.2 the authors refer to independent intermediaries being extant in the 1950s, and in § 1.3.6 to the shrinkage of the independent sector after the Financial Services Act. In my experience, in the 1950s, in the 1960s and even in the 1970s there was not much independence among the brokers we dealt with. I believe that the concept of independence was established by the Financial Services Act, and that is one of the good things it did.

In Section 2 the authors consider selling pressure in the context of the degree of sales expertise required. It is a pity to use the word 'pressure' in that context, because, in the jargon of selling, pressure is usually regarded as a bad feature.

As regards deregulation, the passage of events was that the banks went into the mortgage business, the building societies went into cash transmission; the building societies began to offer interest on their current accounts, the banks responded. As a consequence, the banks saw the prospect of a rapid reduction in the profit they were making from non-interest-bearing current accounts. They needed some extra income, so they looked to life assurance. It was not just opportunism; they needed the money.

The authors state that the banks are best placed to have all the distribution channels. I agree, because, whereas life assurance and units trusts are bought, they are not bought very frequently; they are occasional products. Banking is frequent and regular, and therefore the much needed relationship is so much more easily built up.

In §4.3.6 the authors say that the with-profits endowment could become a low margin, low distribution cost product. I have gone on record in suggesting that it was time that the insurance industry got back to insuring something, and I was thinking of the with-profits system. I think it has a future; not in the way it is presented now, but rather as a low premium, high basic sum assured, low bonus product. I still believe that that is a very suitable product for the banks. I suggest that the profession might lead the industry in that direction.

I agree with the authors, in Section 5.3, where they refer to informed discussion on potential profits associated with various marketing strategies. As the industry, or parts of it, wind down, or perhaps shed the extraneous bulk put on in the last 2 decades or so, actuaries will have to learn how to manage decline. That is a job that we have not had to do since the 1930s.

Mr M. J. Wadsworth: In § 1.2.1 the paper deals with the relationship of financial services activity with net disposable income. I suggest that current financial services activity has at least as much, or more, to do with the rearrangement of personal financial assets, and this is significant for the sales process. In § 1.2.6 the paper deals with the sale of commodity products, such as car insurance, by television advertising. However advertising—particularly advertising by large financial institutions—may have an increasingly powerful effect on the distribution chain and on the relationship of the consumer with the financial institution—indeed on the speed with which that relationship is built up. A good example of the effect of advertising was when, for example, a certain bank went into the personal pensions market and built up a high profile very rapidly.

In Sections 4 and 5 there are the ingredients for a price war driven by successful bancassurance and other efficient distributors. I suggest that a price war may well occur when the comparatively easy initial expansion of bancassurance sales slows, but, nonetheless, bancassurance still enjoys very large distribution and manufacturing cost advantages.

There is little in the paper about the impact of developments in information technology. Improvements therein appear to offer the prospect of high quality, high speed, but low cost advice, so that high quality advice need not necessarily mean high margin products. Labour intensive selling methods invariably mean low quality advice and high margins.

Mr P. A. Crowley: Financial services organisations have traditionally sold products relating to relatively simple consumer requirements. However, the structure of some of these products has often been peculiarly complex; life assurance being one of the prime examples of this. The need for suppliers to minimise capital requirements and hide initial charges from consumers have been major drivers in this complexity. Obviously, these drivers have led to change for the benefit of the supplier rather than of the consumer, and have then been packaged and promoted with the consumers' need being a secondary requirement. The lack of consumer understanding of long-term contracts and the ease of hiding charges (until the deregulation of the 1980s and the removal of traditional entry barriers), has meant that customers' non-basic needs were often disregarded. The insurance industry is not alone in this, as has been manifested in capricious and often punitive customer charging in banking, cartel operation and restrictive customer selection by building societies—not to mention wide variation in consumer charges by insurance companies. These organisations were not marketing driven, and even now have changed only because of fear of loss of market share or regulatory enforcement.

The authors' definition of marketing excludes the process of analysing customer needs and developing products accordingly. Because of protective distribution, most new product development is on a 'me-too' basis. Increased market segmentation and targeting may make this a dangerous practice to rely on. Financial service providers, and especially insurance companies, need to satisfy their customers to a greater extent if they are to keep them. The high attrition rates suffered by consumers are calling industry practices into question.

Consumerism cannot simply be dismissed as pandering to the unreasonable whims of certain individuals. The U.K. is following the U.S.A. in this field, as in many others, in greater consumer protection. Self-regulation allows the industry a greater degree of control in its conduct than legislative bonds, but few companies' selling practices are passing muster. We need to heed the warnings of growing customer dissatisfaction with our industry, and raise our distribution standards to provide the true level of customer care. Life assurance was once demand driven. Can we help it to return to that status?

Mr B. H. Shaw: I agree with the authors when they state in the Abstract, "The conclusion is that successful organisations will be those which fully understand and specialise in a limited number of sectors", but I think that the next part, "and those who start with a client base and a distribution system which will not inhibit the introduction of other distribution methods so that they can become multi-product and multi-distribution organisations", is much more difficult than it might seem.

Bancassurance is an untried and yet-to-be-proven system. Bank customers will not necessarily welcome being sold insurance products by the banks. It appears that there is an attempt by the banks to get their existing employees involved in the selling of insurance. I think that they will find that difficult to do, for reasons apart from the regulatory and training requirements.

In these times of difficulty in managing an effective distribution system, and to ensure the future well being of one's company, we would do well to concentrate on making more effective and doing better the things we are doing, rather than necessarily thinking that solutions lie in rushing down other channels.

We need to be aware, when looking at the distribution of financial services, of the needs of the customer. I prefer the word 'customer' to 'consumer'. Mr Clark drew attention to the difficulties of the customer's interest and best advice. There is much work to be done in the area of remuneration in the distribution system. In particular, there are a number of weaknesses of the current system, and we need to look at the shape of remuneration packages for staff. For example, it may be that cover periods are not long enough. Should the intermediary or the salesman receive any remuneration if a product does not last 12 months? Should he be refunding all his fees, and should we be able to improve surrender values thereby? Do we remunerate our field staff and the intermediary sufficiently for selling life assurance protection products *vis-à-vis* endowments?

I also believe that fees and remuneration increase too much with term, and probably too much with the size of the policy. One example of this lies in the writing of personal pensions to transfer preserved benefits. When the salesman becomes involved in the transaction he has no idea how much the transfer value is to be, and has no control over it whatsoever. So why is his remuneration linked to it? You could argue much more that he should be paid a flat fee for that work.

Mr C. G. Lewin: Speaking partly in my capacity as a past Chairman of the National Federation of Consumer Groups, I was a little depressed by the definition of consumerism in the paper, if it was intended to be all-encompassing. There are more aspects of consumerism in the sense of the needs of the consumer.

It is helpful to consider what is the ideal from the consumer's point of view. We know that we can seldom approach the ideal, but it is a starting point. What does the consumer himself or herself want from us? These are:

(1) Flexibility. What do I, as a consumer, actually need? I may have certain perceptions as to what I need. There may be certain things which I need which I do not perceive, and should be told about. Either way, I hope that the industry will be able to provide at least a good approximation to my needs, and, in particular, will not sell me something which I do not need.
(2) Honesty. So much in the life assurance industry in the past has been dishonest, particularly through non-disclosure of commissions, and the fact that I will not get much of my money back if I discontinue in the near future. Nowadays, society itself has changed. So much in the past was kept secret or not talked about in many fields. Now everything is much more open. Consumers are increasingly coming to expect a good level of honesty.
(3) Elimination of risk to the consumers. There are so many risks in life: getting run over unexpectedly; catching an illness; etc. Cutting down the number of risks in life is something which insurance can help to provide, and it is one of our greatest strengths.
(4) A good financial return. Can we necessarily provide that more than other people? It is one of our strengths, but it is not necessarily a strength which we have uniquely. So how can we put over an honest picture to the consumer about financial returns?
(5) A simple solution as far as is possible. The consumer does not want to get involved in too much complexity if he or she can help it.
(6) A generally pleasant experience in the whole transaction. Good after-sales service is also very important.

The fundamental dilemma with distribution is, given a mixture of specific ideal requirements from the individual consumer's viewpoint, how can the industry present a product which, by its nature, must have a degree of inflexibility built into it? The paper discusses various ways of doing that, from the simple product meeting the simple need, to the complex product meeting the complex need.

The companies which will be most successful will be those which concentrate on the consumers' ideals, and aim to produce products which meet as many as possible of those ideals for the particular sector of the market that they are considering.

Mr W. A. Daniel: I have a question regarding mortgage endowments. In §2.5.4 the authors look at various sectors of the financial services industry, and categorise relationship (which is between the organisation or salesman and the customer) and selling pressure (which is the degree of sales expertise required). Banks, unit trusts, stockbrokers, general insurance and life assurance are listed. I should like to consider two more: building societies and estate agencies. I would categorise building societies similarly to banks—that is: relationship, high; selling pressure, low. I would categorise estate agents as: relationship, low; selling pressure, variable.

In § 4.2.4 the authors state that "Mortgage endowments . . . are simple demand type products, most other endowments are relationship type products." I should like to ask the authors why estate agencies were not a very successful distribution channel for a number of life offices, given that they could match the relationship required for mortgage endowments? Is it, perhaps, that life offices invested money in estate agencies on the assumption of sales of more complex life products, which required a more highly developed relationship, and which, in the event, did not materialise?

Mr J. M. MacLeod: The paper refers, in § 4.2.5, to the likely decline of mortgage endowments through the removal of tax relief. What is not sufficiently realised is that an endowment mortgage is really two products: a repayment mortgage, in which the borrower makes repayments; and a further transaction, in which the lender lends back those repayments, which are then applied to an endowment policy. Both loads attract tax relief, and so tax relief could be removed by the government in one of two ways: either all mortgages (endowment and repayment) could no longer be subject to tax relief; or tax relief could be granted only to repayment mortgages. The latter approach would be far more cost effective for the Inland Revenue than the present system, since its cost would diminish as each loan was progressively repaid, but both are almost equally beneficial so far as the consumer is concerned, since the choice between an endowment and a repayment mortgage is currently marginal.

Mr M. G. Clarke: The nature of the insurance products that we sell means that a viable and productive distribution system is crucial to success. Furthermore, an organisation of any scale, as many insurers are currently discovering, is not easy or cheap to establish. The skills necessary to manage a direct sales force, for example, are not the same as those required to direct a broker office. The cultural differences between the manufacturer and the retailer are significant, even though the product range is very similar.

Much is made in the paper of the effect of regulation as an influence of change in distribution strategy. There is a danger that this influence could be overstated. A number of major insurers have operated an unchanged distribution strategy over the last few years when regulation has been an issue. Where change has occurred, factors such as the changing pattern of demand for financial services, the growth in the housing market in the 1980s, the development of customer base and other technologies have had as much impact. Where regulation has entered the equation is in helping management to identify weak areas, and in providing a motivation to take prompt action. Good compliance practice is associated with good business practice, and the penalty for failure is being appreciated—at some cost in many cases.

Distribution cannot now be bought simply. It needs a product and customer base to provide support; and it needs skilled and experienced management to impose the rigorous control to achieve financial and quality targets. The main distribution issue for the future is productivity; how this can be maintained or improved in a difficult market in the middle of a recession, when much of the driving forces behind the growth over the past decade are becoming worn out. All the elements of distribution management, from recruitment and training through to marketing support, need to be addressed, but even this may not be enough to sustain the numbers presently engaged in insurance sales. We may find that we are in the position of having the prospect of well-managed and well-resourced distribution channels looking for new directions in terms of product support.

Mr E. B. O. Sherlock C.B.E. (closing the discussion): When I first read the paper I noted particularly two sentences. In § 1.3.9 it says "The life assurance industry, the industry of major concern to actuaries, is now at a point of crisis with respect to distribution", and in § 6.1, "we believe that many life assurance companies would be more effective if actuaries had paid greater attention to this part of the operation". The authors hope their paper will add impetus to a move in this direction which has already started, but in a recent article in *The Actuary* (2, 11, 20) Eric Short wrote that, in his experience, the sales intermediary was the one-eyed leading the blind.

One implication of the authors' challenge is that actuaries working or advising in this field should be concerned about quality. I have devoted the whole of my working life to life assurance, an industry which has been of immense value to the nation and to individuals. It pains me, therefore, when it is criticised, but criticism, whether fully justified or not, is best accepted and used as a basis for going forward.

I believe that the industry badly needs input from the profession to help it regain its rightful standing in the community. As a regulator, I am more aware of the things which are still not right than those which were never wrong in the first place, but I am, nevertheless, confident that the tide is turning. Actuaries are playing their part, and I believe it to be very important that they continue to do so. The quality, and hence the reputation, of the industry is in the hands of management, helped by their advisers, not in the hands of the regulators, although I believe that they have a positive role to play.

The public believes that actuaries are looking after its interests. It is vital for our profession that the belief is justified. As actuaries we are not the decision makers; but many, in different roles, are. Those who are purely advisory must, in my opinion, beware of taking a narrow view of their role. I do not believe that all was good in the past and has become bad. The reality is that the standards required are rising, and actuaries should be in the forefront, helping, goading their companies whether as employees or advisers, to match those standards.

In the article by Eric Short, to which I referred earlier, he wrote about the profession's high standards of training for its recruits. Surely, the same principles should apply in the context of this discussion to those who sell for life assurance companies.

These days, actuaries are involved in all sorts of specialist activities, and that is all to the good, provided that they retain that basic, almost moral, sense of responsibility which should be the hallmark of any professional person. However, as in the past, when admittedly many of our companies were much smaller, it does not require an actuary to be involved in every sphere for a business to achieve that standard. What is needed is a powerful lead which the actuary can, and should, give, and which then permeates the company. This lead needs to demonstrate that low standards are bad for business to be convincing. That truth, I believe, is becoming increasingly obvious, both from within and from external criticism. Higher standards at the sharp end have many implications. We should be thinking these through and anticipating the outcome. After all, forecasting is one of our skills. Are all the forms of distribution covered in this paper equally viable if one demands higher standards? What effect will higher standards have on product design? As the paper demonstrates, these issues are linked.

Sadly, we all, I hope, accept that at present too many members of the public make unsuitable investments. That means relatively high discontinuance rates, and these are built into pricing formulae. Indeed, surrender penalties may be an essential element in the viability of a contract. The President's predecessor, H. H. Scurfield, had much to say on the subject, and Mr Squires posed just the sort of question that should be answered.

Should we, as a profession, be prepared to price a product on the assumption that, for a significant percentage of purchasers—who look to us as their guardians—the product will yield a poor return? If we are successful in helping to enhance the standard of selling, there will be fewer discontinuances. How does our pricing look then? Will the flow of new business be maintained? If not, is that good or bad?

The authors have some comments about endowments sold to repay mortgages. They describe their position as 'at risk'. Actuaries should be, and no doubt are, thinking whether the interests of the public who, I repeat, look to us as their guardians, are sufficiently close to the forefront of our minds. I leave that as a question, but the authors seem to me to be very clear what their answer is. If so, as they say, it has a powerful follow-through effect, which again we should be helping life assurance companies to anticipate.

I believe that the selling of life assurance is an honourable role, that it requires well-trained, well-supervised and devoted people, and that it is extremely difficult for a company to prosper long term without such sales people. This, if it is true, means a contraction of numbers, and a reduction in what is, for some, part-time activity. It may appear to mean less growth, but how do we measure growth? It used to be by sums assured—that is, an increase in liabilities was a good thing. People in other industries found that very strange. It is now new premium income, regardless of discontinuances. Would it not be better if the profession could identify a more sensible definition of size? If we try, we must be very clear that it will affect behaviour, and therefore be sure that the behaviour change is desirable—for companies and the public alike.

The paper has led me, as it did the opener, to conclude that the profession has a real opportunity to help the life assurance industry to regain its standing, and I hope that it will rise to the challenge.

The President (Mr L. J. Martin): This paper has been timely and topical. The world of life assurance is forever changing and developing. As it does so, the work of actuaries in life assurance also changes, develops and broadens, and we continue to help, advise and, I hope, to lead—thinking, as actuaries, on a broad front, well into the future.

This paper has outlined past developments, described the current scene and given pointers to the possible future, which must be examined by all of us in the years ahead. Some papers presented to the Institute are intensely theoretical, and some are fundamentally practical. Each kind of paper is needed, and each acts as a stepping stone for the others. This paper is a practical one, and we are greatly indebted to the authors for writing it and bringing it to us for discussion.

Mr G. Westall (replying): To respond to why we think it is easy to go from commodity to complex products, in the discussion the claim was made that this was just an assertion. In §2.4.1 you will find that the reason is that, if the product is complex, there will be an active distribution system. As many people who operate active distribution systems will know, they can be obstructive, and will prevent a move into simpler products with passive distribution methods. Generally speaking, passive distribution systems are not obstructive.

The claim has been made that life assurance companies can develop relationships with clients, and will do so, thereby making them as powerful as banks. Our assertion would be that, because of the nature of the distribution system, life assurance companies, with a few exceptions, (for example the industrial insurance companies), do not have a relationship with clients. It is the distribution system which has the relationship. This feature is one of the inherent weaknesses of the life assurance industry.

Some misgivings were expressed about macro pricing. This is probably used by all industries, so there need to be good reasons not to consider it for life assurance. Some speakers said that it is very difficult, because you cannot trust the sales force. This seems to show that you do need to approach pricing in the way we suggest. If we have an industry where an important, if not the most important, functionaries of the company cannot be trusted to know the financial mechanics of the company, then there is something fundamentally wrong. Macro pricing is a good way to start corrective action.

I am sorry that the paper did not give more attention to industrial insurance. This is one of the strongly performing areas of the industry. It is because there is a high service element that there is a relationship between the company and the client. This is why they are potentially well placed.

Some worry was expressed that, with all the banks and building societies entering life assurance with, perhaps, even new companies, there was a danger of excess capacity. It was said that it was not known whether there was a need for the increased capacity. This seems to be the wrong way round. By definition, excess capacity can exist for only a limited time, and while it exists there will be more competition. One of the points that we are trying to make is a consequence of this, in that increased competition will mean that some companies will have to do things differently, or perhaps not do anything at all.

Regarding the regulations, there is a theory that ultimately the regulated capture the regulators. In the initial stages, when the regulators are filled with zeal, they may well have the upper hand. However, all the evidence seems to show that soon the regulated become very comfortable. Probably legislation is more benign than self-regulation, because the regulated learn to operate it so well that they become very powerful under it. Regulations cannot change quickly, so the regulated become increasingly adept at exploiting them. The U.S.A. gives us a situation where this can be seen.

We have put forward the not-so-surprising thesis that the banks will be amongst the winners. There are strong arguments against this, notably the ones put forward by Sir Mark Weinberg, which are basically the claim that banks do not have the right culture, and that it will be difficult for them to tolerate salesmen, because they are not selling organisations. I agree with the description of the bank culture. We tried to express this as being a marketing-led organisation rather than a sales-led organisation. Many of the problems that the banks have arise because of this. I also agree on the great difficulty of starting, managing and operating a sales force. I would say that the advantages of a bank will make success slightly easier than for a non-bank. There are many life assurance operations which are trying to establish different distribution systems from the ones they have had traditionally. I cannot see that it is going to be easy for them either. It will be even more difficult than for the banks.

There was a spirited defence put forward of the position of the life assurance salesman, and also the power of the company in helping the salesman distribute the products—that the company could do quite a lot directly with the consumer. As we said in the paper, our contention is that, if you have an active distribution system, there is a likelihood that the marketing effort will get in the way. The argument that marketing can do much to help the salesman sell simpler products raises the question: if products are simple, why is there a need for a salesman? We believe that there will be problems in a sales-led organisation if there is an active marketing policy.

Despite what Mr Lewin said, we do think that the consumer is important. We tried to put this over by saying that distribution cannot exist on its own, and we feel that there are three elements: the customer, the distribution and the product. It is only by considering all of them in concert that you can have an effective distribution strategy. Whether the consumer is able to determine price in many of the financial services products, especially the complex products, is an issue which concerns us, and generally we think that, unfortunately, the answer is no. We were admonished for not considering the role of IT in distribution. I would not say we have not considered it, but at the moment we do not think it is particularly important. One of the problems with complex products is that much of the complexity is in the role of the salesman in raising the level of awareness. It is no good believing that wonderful advice can be delivered by IT if the potential customer does not realise that he needs the advice.

I agree with Mr Shaw's problem with multi-distribution channels. This difficulty should not be under-estimated. While we believe that the banks and building societies are in the best position to be successful, we do not actually claim that they will. The banks' history in managing anything other than core business does not lead one to have much confidence in them. However, they are best placed to do it. They have considerable resources and higher profitability from life assurance than non-bank owned companies, and so it would be expected that they would come to the conclusion that they should buy in the expertise that they need. However, it is not going to happen overnight. Even when banks do get things right, we are not suggesting that they will have 100% market penetration. Many people do not like the banks. Far from wanting all their financial services products eggs in one basket, there are many people who would like their financial products with different institutions.

Consumerism means to us the consumer movement. We think that, in the paper, we summarise a fair reflection of the position. We believe that it has some things fundamentally wrong. It is trying to remove customers from the situation where they can lose through bad luck. There is a belief that there is always someone to blame, who should compensate for loss. Generally, it is deep pocketed companies which are held to be to blame. We believe that this is a dangerous and inefficient tendency.

We have an answer to Mr Daniel's question, as to why estate agents did not sell endowment mortgages—although, in fact, some of them did. The ones that did realised that one of the problems with salesmen is that most of them can sell only one product. The estate agent negotiators were primarily interested in selling houses, and were not interested in selling endowments. In fact, they would have been worried about doing anything that might interfere with the sale of a house. It was not until organisations put financial services consultants—that is, mortgage endowment salesmen—alongside the negotiators, that success was achieved.

I agree entirely with the closer that, whatever we do, we must have an accent on quality. It may sound trite, but we firmly believe that good quality distribution is better than bad; and ultimately, good quality distribution will win.