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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).

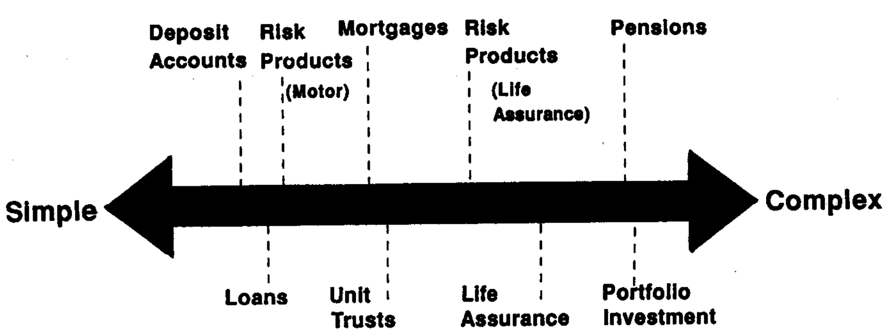


Figure 2.1 The Product complexity spectrum.

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).

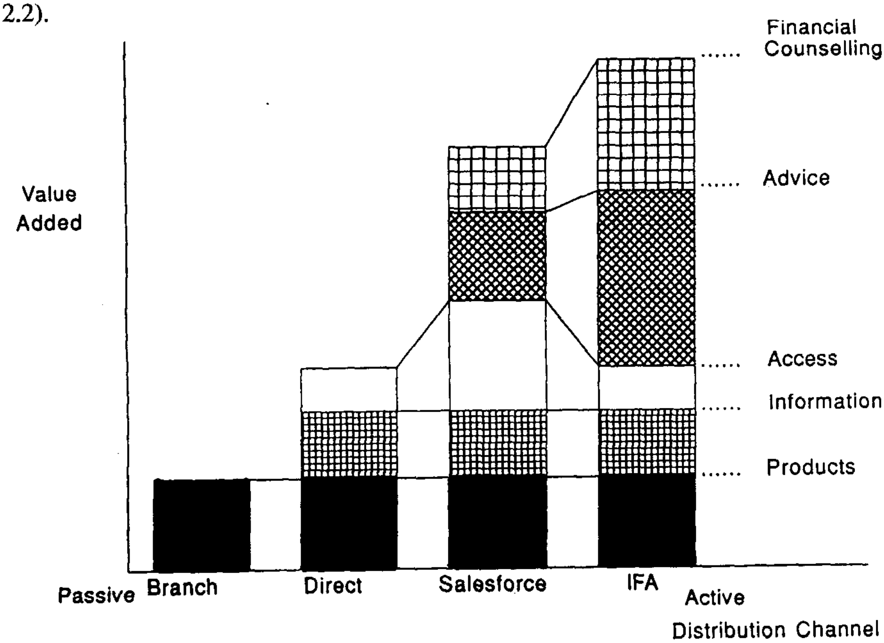


Figure 2.2 Value added by distribution system.

## 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).

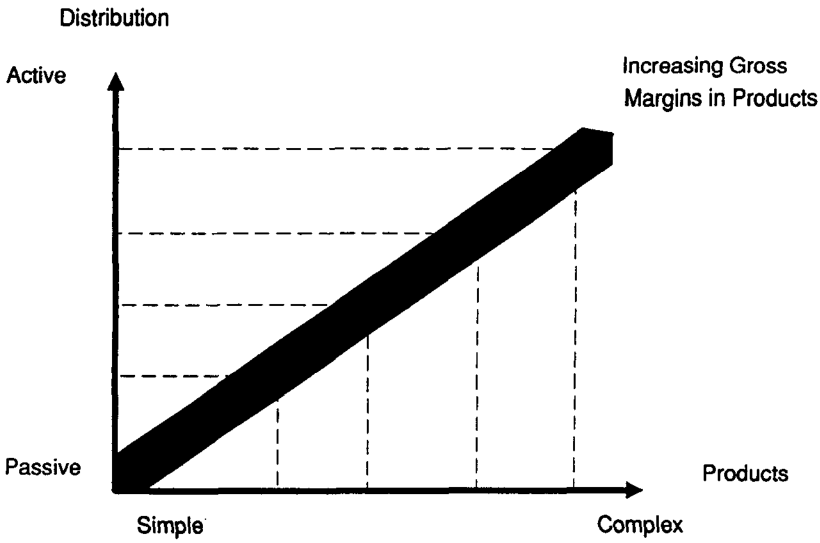


Figure 2.3 Matching products with distribution.

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):

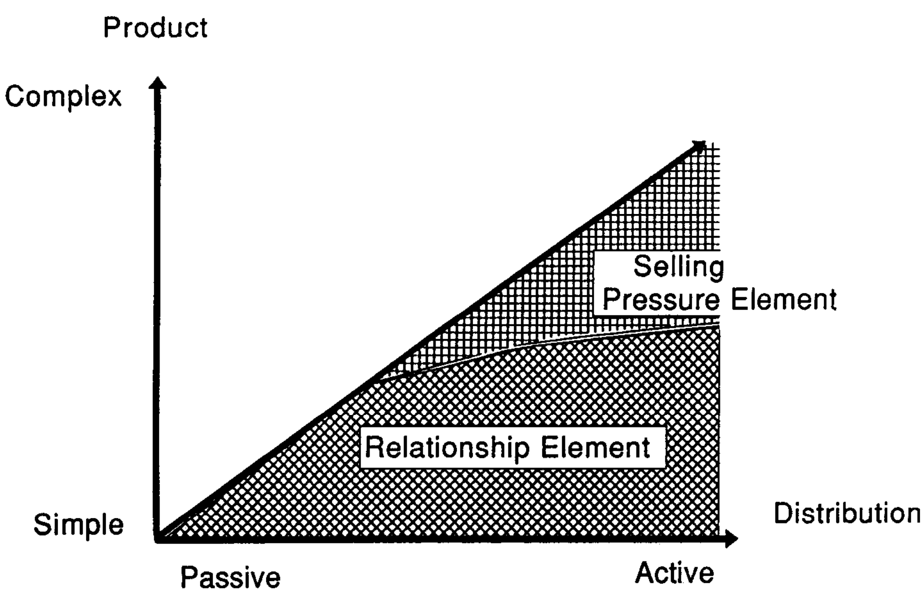


Figure 2.4 Relationship and selling element.

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 Accounts | high | low |
| Unit Trusts (commodity) | low | low |
| Unit Trusts (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:

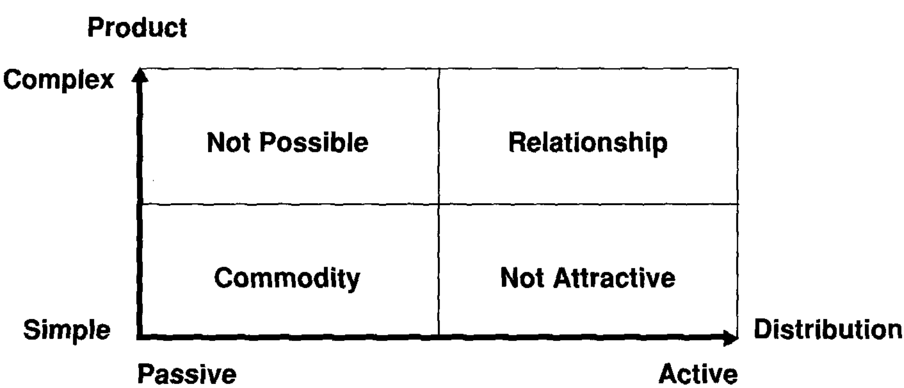


Figure 2.5

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:

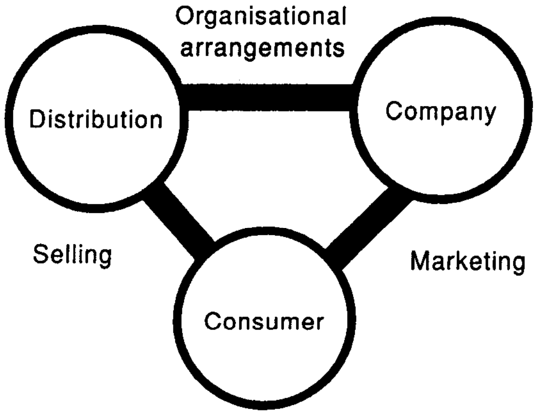


Figure 3.1

## 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/distributor/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 pre-determined 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.

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

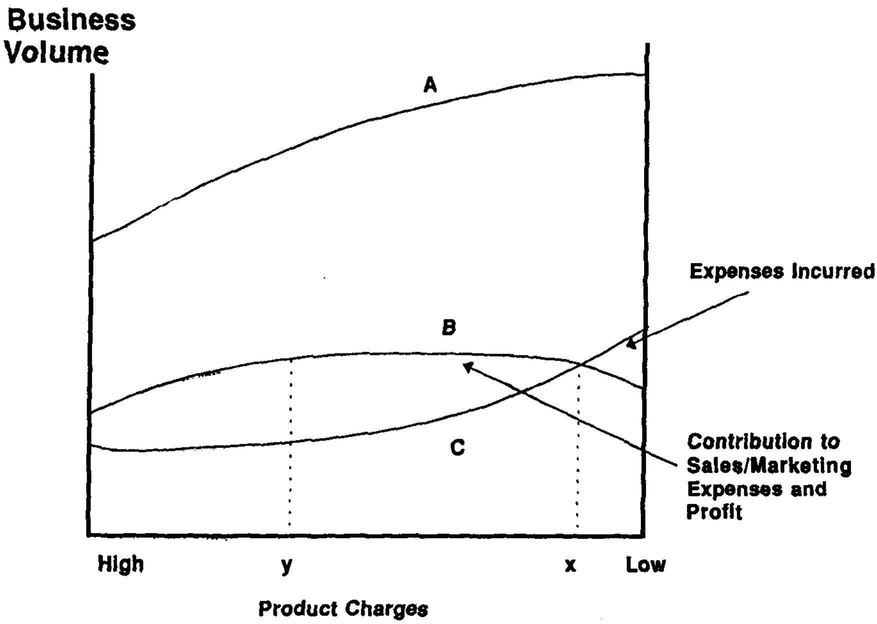


Figure 5.1 Analysis of the marketing strategy profitability.

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 5.2):

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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DISCUSSION

**Mr G. Westall, F.I.A., A.S.A.** introducing the paper said: Until Mr Gupta's recent elevation to Scotland, we were colleagues and worked together on many projects involving distribution. In undertaking these projects we found, quite naturally, that some things worked and others did not. It is this simple fact that led to the start of an analysis which in turn led to the current paper. The paper does, however, leave out a major factor in the success or failure of distribution, namely, the effectiveness of management. We left this out intentionally but it should be noted that this factor frequently makes analysis of other factors extremely problematic.

We have tried in the paper to set out a rational basis to explain why the distribution of financial products is as it is, and to try to make predictions for the future. If there is a central theme to the paper, it is that distribution cannot be considered in isolation. To be effective, three elements, i.e., of products, distribution and the customer, must all be considered as part of one entity. Indeed it is the need to match products and distribution which has been sometimes ignored in the past and has led to costly failures. The theory laid out in the paper is not capable of proof in the scientific sense and we do know of instances which appear to contravene some of our contentions. We do believe, however, that the theory is a powerful tool which can be used to assess alternative courses of action. Results should be treated with great caution not with blind faith. We have in fact used the usual actuarial approach of trying to distil the truth from experience and we are confident that we have the correct approach.

One of the factors we have used in developing the theory is to test if it explains the real world and then to use it as a predictor for the future. We have outlined examples in the paper where we believe that the theory does give explanations, most notably an explanation of the potential for success by the banks in the sales of life assurance. We have also risked some predictions by which the theory may be tested. In case anyone feels that we think the banks are a safe bet, we do think that they have problems as well as opportunities and existing life assurance companies do have the advantage of greater experience. We feel, however, that life companies will need to be more skilful to enable them to have continued success, and we are sure that many will succeed.

Products, distribution and customers should be considered as interdependent. It follows that product pricing and distribution should be considered together. Great strides have been made over the past thirty years in understanding the financial management of life companies and the role of product pricing. It is fair to say that in the U.K., profit testing is now accepted as the primary tool. Both Mr Gupta and I are firm supporters of profit testing but we now feel that there is a need to go further. The sales and marketing divisions must play an integral part in product pricing; pricing depends upon sales volumes and in particular the relationship between fixed costs and sales volumes. Generally volumes of individual product lines are not independent of volumes of others and effort expended in one direction cannot be expended in another. Thus the sensible approach to pricing is a portfolio approach we outline in Section 5. We would say that we think there is much interesting work remaining to be done in this area.

**Mr A. C. Buchanan**, opening the discussion, said: I am very much aware that it is both a privilege and a challenge to open the discussion on this evening's paper "Distribution of Financial Services". One of the privileges is to be the first to congratulate the authors – a privilege I take with pleasure, since they have produced a thought-provoking paper which is, I suspect, equally understandable and valuable to actuaries and non-actuaries alike.

The challenge – and no doubt this is a challenge similar to that faced by many other openers over the years – is to try to identify the key issues in what is a comprehensive review of one of the most complex aspects of the financial services industry. However, the paper provides me with some assistance by identifying on the first page certain "keywords" from the presentation. The first of these is "Marketing" and I, for one, certainly welcome the opportunity to discuss the, perhaps somewhat mysterious, interface between marketing art and actuarial science.

Iqbal's paper "Marketing of Retail Financial Services" may prove to have been something of a watershed in this respect. From it, this evening's paper has picked up and developed one of the classical "Ps" of the marketing mix – distribution. And before anyone gets too upset about my spelling, the classical "P" is, of course, Place – which really means market-place and the distribution channels for financial services and products to the market-place.

Philip Kotler in his book "Marketing Management" (which is included in the authors' "References", although not quoted directly in the paper) says that: "Marketing-channel decisions are among the most critical decisions facing management. The company's chosen channels intimately affect all the other marketing decisions. The company's pricing depends on whether it uses mass merchandisers or high-quality boutiques. The firm's sales force and advertising decisions depend on how much training and motivation the dealers need. In addition, the company's channel decisions involve relatively long-term commitments to other firms."

Kotler, of course, was not talking specifically about financial services, and the first edition of his book was published in 1967. Yet how appropriate and specific these remarks appear today for the businesses with which most of us are involved. Distribution is of *critical* importance.

Section 1.2 of the paper provides a useful background, "History of Distribution". However, I have to question whether the doubts expressed by the authors in section 1.2.2 (as to whether a major breakthrough in personal banking can be achieved without a branch network) are justified given the impressive development of First Direct.

Indeed Leiderman and Roncoroni, a leading firm of consultants on the strategic and operational use of the telephone, have suggested that the volume of banking transactions through branches is set to reduce from 61% (which was the figure for 1991) to 31% in the year 2001. They predict the use of telephones will rise from the current 8% to 41% over the same period with the usage of ATMs broadly unchanged at around 30%.

This may appear somewhat optimistic (as well as smacking of vested interest!) but the rapid development of direct writing for private motor insurance – which currently accounts for about 15% of the total market, with much of it using the telephone – suggests that the underlying trend may well be correctly identified, particularly if one considers demographic change as a potential driver. Experience in the United States can also be used to support this argument.

Looking specifically at the life assurance industry, the authors suggest in section 1.3.7 that life offices have no clients. I find this point particularly interesting, since one of the advantages of running a direct sales force has been perceived as being the fact that the life company actually "owned" the client, which was denied to offices using IFA distribution. I happen to agree very much with the point the authors are making, which is that the key issue is whether the office is in direct contact with the end client (as it would be with any "direct response" channel of distribution) or there is an intermediary involved (be they independent, tied or a direct salesman).

However, I also believe that with an increasing focus on customer service, and on relationship selling (a focus which will, in my view, continue throughout the 1990s), life offices will view their relationship with intermediaries much more as a "partnership" with shared access to their mutual clients. This is not to understate the sensitivity of the issues (particularly with IFAs) but I cannot see how it is possible to deliver good quality customer service where the basic principle is that "there is no customer".

I would also take the authors slightly to task over their suggestion, in section 1.3.9, that "most companies will not be able to be competitive on *all* of the indices chosen as important by the independent intermediaries". My emphasis on the word "all" indicates that I doubt if *any* company will be genuinely competitive on *all* these indices and certainly not over a period of time. It is not just for this reason that I think the authors are probably understating their conclusion that the IFA market "must be high risk for all but a few life assurance companies".

In section 2 of the paper the authors develop a theoretical framework, starting with the interface between "Marketing and Selling". This is really fairly fundamental to any discussion on distribution although the authors seem to feel that distribution is a function of marketing – at least they list it under the functions that many companies allocate to their marketing departments.

I personally have a very simplistic view of this. "Marketing" is responsible for planning and "Sales" are responsible for implementation. As such, the distribution system is primarily a responsibility of Sales to operate, provided it fits within the parameters of the marketing plan.

The distribution system is properly viewed as a key external resource. This was recorded by Davidson, Bates and Bass in the Harvard Business Review in respect of a drug manufacturer:

"Normally it takes years to build (a distribution system) and it is not easily changed. It ranks in importance with key internal resources such as manufacturing, research, engineering, and field sales personnel and facilities. It represents a significant corporate commitment to large numbers of independent companies whose business is distribution– and to the particular markets they serve. It represents, as well, a commitment to a set of policies and practices that constitute the basic fabric on which is woven an extensive set of long-term relationships."

Once again, I think it is noteworthy how closely this description of distribution in a different industry relates to IFA distribution of financial services.

The "long-termism" of the commitment, and the time taken to build up distribution channels, means that a key management challenge is to identify and develop channels which will be appropriate to *future* market needs (needs which may well differ significantly from today's market needs).

The authors rightly identify product complexity as being a key characteristic in determining distribution requirements – though I'll be very interested to see whether subsequent speakers take issue with the ranking of Unit Trusts as being less complex than "pure risk" life assurance products. Certainly, I think recent press comment about the increasing complexity and obscurity of some practices in pricing Unit Trusts leaves the suggested ranking open to some dispute.

I also had some difficulty in understanding Figure 2.2 which demonstrated the "value added" by different distribution channels. For example, why should a sales force provide much greater access to the end customer than IFAs? Are IFAs really a more active distribution channel than a sales force?

Moving on now to section 2.6.4, I rather suspect that many salesmen would view the life assurance industry as being "actuarially led". So perhaps it is an example of neat symmetry to have a paper to the Faculty and Institute identifying the industry as "sales led"!

The first two "keywords" on page one were "Marketing" and "Distribution" and I will return to these shortly. But I would like to briefly comment on the third keyword, "Pricing". In section 2.7.4, the authors note that "the distribution system" (this is the distribution system that life offices generally use) "will resist moves to lower margin products or the introduction of other distribution methods". If this is so (and I have to say that the arguments advanced by the authors are reasonably persuasive) then it clearly has significant implications for the life assurance industry. For example, LAUTRO Rules Bulletin 53 – with or without extension by the Office of Fair Trading – is clearly going to further raise the profile of life office charges. And one only needs to look at some of the recent comments made in the quality press – never mind the tabloids – to begin to understand that the life assurance industry does not enjoy a particularly positive public perception. And, realistically, I just can't see this improving with increased disclosure and the steady advance of a more consumerist environment.

So what has been the reaction in the marketplace of the distribution channels? Well, amongst appointed representatives and the direct sales-forces, there has been quite a shake out according to recent analysis – and it has to be expected that this will continue, and quite possibly accelerate, with the implementation of the LAUTRO Training and Competence requirements. Yet the basic structures and approach seem to be changing very slowly, if at all.

Equally, there is little evidence, as yet, in the IFA market-place that the distributors are prepared to accept lower levels of commission in order to allow more attractive products to be developed.

All this seems to support the authors' contention about distribution systems resisting change, although I suppose there may be some hope that the market will move towards products which spread expenses (most notably commissions) over a much longer period than at present. At least in that way we should be able to move away from the current situation, which is really an investigative journalist's dream, of "huge commissions and surrender value rip-offs".

Clearly, in all of this there is a very important role for the actuarial profession to play alongside the marketing and sales functions. Pricing will, I suspect, be an area where a great deal of joint work will need to be done in the coming years (although I don't think we have "years" in which to begin this process).

For me, one of the most important sections of the paper is also one of the most interesting. Section 4.2 deals with the implications of the changing environment, including increasing consumerism and greater regulation. The impact of this on the product/distribution mix is considered in section 4.2.3 and really this whole question is likely to be of critical importance for the future success of life assurance companies. I don't think it is over-dramatising the position to say that failure to react correctly to the changes which are currently under way could effectively mean the difference between "life and death" for certain offices.

One "hope" is that we will eventually achieve some form of level playing field in relation to competition from banks, building societies, National Savings and the like. Certainly, if we are looking at medium and longer term savings products, the actual effect of expenses is not dramatically different for a variety of products, for example Unit Trusts, building society deposit accounts and life assurance contracts. This was clearly indicated by figures produced by the ABI as an Appendix to one of their submissions on Expenses Disclosure.

However, having this information is one thing – getting either the media or the general public to understand and believe it is quite another. But it is a challenge that we must accept – both actuarially, in explaining the concepts, and from a marketing and sales perspective.

In many ways section 5 is an extension of the "Implications" in section 4.2 – moving on, as it does, to consider pricing and profitability issues. Again, there must be considerable potential for developing the actuarial and marketing/sales interface in this respect. The authors highlight this in section 5.1.6 – contrasting the slightly more advanced understanding of product profitability within the life assurance industry with the position within banks and building societies. I think it is probably fair to emphasise the word "slightly" since I suspect much work remains to be done within many life companies on product pricing and profitability and even more work could be done on the profitability of distribution channels (or even segments of distribution channels).

Section 5.3, and particularly figure 5.1, sets out a model which the authors suggest can be used to determine Sales and Marketing profitability. However, I tend to feel the interaction between the various elements is rather more complex than they have admitted in the paper.

Line A in the figure shows the situation you would expect in most "reasonable" market-places, that you sell more business if the price of your product reduces. Line B is also perfectly "believable", the contribution to expenses and profit will depend on a combination of changes and volume. However, when it comes to line C, we perceive the perennial problems for the marketing manager. Certainly, in the sort of imperfect market that we have for many financial services, it is very difficult to state with any degree of confidence how much marketing and sales expenditure is necessary to achieve a particular volume of business at a fixed price.

In this particular market, it is very difficult (if not impossible) to set out a relationship between promotional activity (or any other element of the marketing mix), and new business. One also has to consider the extent to which new business is affected by marketing and sales activity by competitors.

I therefore have some doubts as to whether the outputs from the sort of model proposed would ever achieve much credibility, given the uncertainty (and perhaps arbitrary approach required) in relation to line C.

In many ways, this would be a great pity. Even if one does not follow the approach suggested by the authors, there must be considerable value – both in a financial and in a management context – in having a better understanding of the financial dynamics of sales and marketing strategies. But the caveats in section 5.4 are necessary. It would be very dangerous to equate profitability with efficiency. The authors clearly demonstrate that a good understanding is essential of the way in which the different distribution channels – and indeed different segments of individual channels – actually operate. This enables one to gain a much better understanding of the effectiveness of the channel.

In concluding these opening remarks, I would like to paraphrase a quotation from John Frazer-Robinson's book "Total Quality Marketing":

"The objective of a distribution channel is *not* to make money. The objective of a distribution channel is to serve its market-place, effectively and efficiently.

"The *result* is to make money."

The authors have highlighted many issues with which everyone involved with the distribution of Financial Services – whether from an actuarial, a marketing or a sales perspective – has to come to terms. I would thank the authors most warmly for dealing with a complex subject in such an effective *and* profitable manner.

**Professor M. Baker** said: I appreciate very much this invitation to join you tonight and to listen to this paper. Much of it has not been presented although we have enjoyed a very thorough critique by Mr Buchanan. For me it is more the symbolism of this topic which is important as my department celebrates its 21st birthday. Perhaps marketing is really coming of age in Scotland.

Having said that I have some problems with both the paper and with the criticisms. One of the interesting opening comments was about the marriage, or rather the early stages of courtship, between actuarial science and the art of marketing. It is a courtship which I hope is going to proceed with great speed and come to some sort of fruitful outcome. The problem I have detected, however, is the common one during a transfer of concepts from one discipline into another. It is that people get bogged down in the detail of the relevance of another discipline and start looking at trees instead of the whole wood. They therefore get the wrong impression.

Most people starting to teach marketing would say you have to differentiate immediately between marketing as a philosophy, which is a state of mind which can be shared by all members of an organisation which have goods and services to sell, and the function of marketing, which is a skilled practice for which we can train people and for which there are a lot of techniques and procedures which help you in practice. A great deal of the content of the paper was in fact concerned with improving efficiency and effectiveness through improving a particular element of the marketing mix within the context of financial services. So I welcome the paper but, on the other hand, it does detract from something which is probably of much greater importance. You must take a conceptual leap and move away from being production orientated towards being marketing orientated. There was one hopeful sentence in this paper which never actually achieved its potential, that was on page 17, paragraph 4.2.2. It says: "the consumer is buying a comfortable retirement, not a pension plan." That is really the difference between the philosophy which is based on consumer need as opposed upon your ability to generate exciting and sophisticated financial packages which none of us, as consumers, can understand.

My favourite marketing guru – a man called Ted Levitt – summed this up particularly well when he said: "A man goes in to a hardware shop to buy a quarter inch twist drill, he needs a quarter inch hole." Charles Revson who is the owner of the Revlon cosmetic company put it another way when he said: "In the factory we make cosmetics and in the drugstore we sell hope." There is quite a lot of difference between the attributes of products and the benefits which they deliver. One must begin to think in terms of the needs of those customers and stop treating them as if they are only a homogeneous, statistical unit. I appreciate this helps to tell you the likelihoods of any given risk and its occurrence, and that it is the foundation of being able to write attractive financial instruments or policies for people in different risk bearing situations. However you have to segment the market and I am afraid that neither the paper nor the critique recognised that those people out there, the customers, are not just some sort of unlevened lump which can all be addressed in the same way through the same mechanism. Wherever there is elasticity of demand it follows that the salience of that product varies according to the customer's needs, and will need to be reflected in your marketing tactics.

What you really need to do if you have only got limited resources, is concentrate them on those people who are prepared to pay the highest margin for the differentiated financial product as opposed to the concept of a market out there which we have to sell to because they have not yet understood fully what benefits we have to offer them.

Naturally I have got a lot of definitions of marketing, I have jotted down three to remind myself:

- Marketing is the difference between trying to sell what you can make and making what you can sell.
- It is selling goods that don't come back to people who do.
- Mutually satisfying exchange relationships when both parties to the exchange perceive that they are getting value from it.

I would agree and endorse totally the first comment that was made by the speaker. Nowhere in the paper do the authors refer to the effectiveness of management and yet by implication they were saying that this is the most important thing of all. Colleagues of mine and myself have done quite a lot of work in recent years on the contribution of marketing to competitive success and we have done it across a whole range of industrial sectors. There is no magic panacea, people tend to thrash around and when times get difficult look for something new. People examine these other kinds of organisations to try to explain why they are more successful in an increasingly competitive market-place. The answer tends to come back that they have got something called "marketing", and then the order goes out, let's have some marketing. But you cannot simply stick on marketing as if it were elastoplast. You have to have commitment to it.

What we found from very extensive research is that marketing is a necessary condition for competitive success, it is not sufficient. The thing that ultimately differentiates between success in the market-place is the quality of management and their judgement and their ability to implement that judgement.

**Mr R. M. Paul** said: I was a little disappointed that the authors did not incorporate one of the topical aspects which will undoubtedly impact on the distribution of Financial Services, namely the current pressure for more expense disclosure. In particular it seems more than likely that the OFT will wish that the LAUTRO proposals are amended to demand more commission disclosure. If that is the outcome, and it only relates to Independent Financial Advisers, then the SIB will look for ways to level the playing field between IFAs, tied agents and direct sales forces.

As outlined in the paper the front end load developed naturally as a consequence of the manner in which complex life products were sold. Regardless of the merits or otherwise of potential hard disclosure, the result, in my opinion, will be to ensure the consumer is absolutely clear as to the direct impact of commission in particular on the early lapse or surrender value. That is likely to put significant pressure on the front end load system itself. The connection between low values and the amount of commission will therefore become too obvious to be missed and the front end load approach may have to change.

What I am about to outline now is neither novel nor new but I believe worth re-stating. Under the current system, theoretically, individuals receive their correct asset share in that expenses including commission are deducted from premiums before accumulation. Hence the surrender values in the early years are low. That is why it is so important to stress the long term nature of the contract during the selling process. Under a more open regime involving hard disclosure there will be pressure to increase surrender values to provide something akin to a return of premiums. Assuming no change to the expense and commission structure then somebody else must pay for the losses which will be incurred by these early surrenders. If such losses are debited to the policyholders in general, the result must clearly be a reduction in the long term return for those policyholders who maintain their policies in force throughout the duration of the contract. In other words, these policyholders will not receive their asset shares. I am assuming here that the approach will be the same both for with-profit and unit-linked contracts in that the remaining policyholders' assets will be reduced accordingly.

Under the scenario where the policyholders no longer receive their asset shares I wonder whether such a position is equitable. I also wonder whether the consumer lobby really consider such a position as reflecting the wishes of a customer who takes out a long term contract. For a proprietary company, without any change to the current practice of front end loading, it is possible that such losses may be borne by the shareholders. Whenever that is the case then the shareholders are faced with the option of either increasing the loading on all premiums, in order to maintain their required profit target, or alternatively must lower their profit target. The minimum reduction will of course be the level at which the shareholder deems an acceptable return on capital is provided, otherwise a withdrawal from the market could result.

To the extent that the shareholder is not prepared to absorb the cost, the effect will be a fall in the return to long term policyholders. If neither the policyholders nor the shareholder is to carry the cost, then it must be borne by the salesman, whether IFA, tied agent or direct. Even if it is possible to bridge the gap in changing the salesman's remuneration basis from front end to an average percentage of premium, the salesman must in the long run receive less to compensate for the higher surrender values on early termination. He may therefore require to be compensated by some increase in the level of commission. In these cases I am, of course, considering the present value for the future commission streams under either method.

If the salesman is not prepared to absorb the cost then to an extent there is a shortfall for which the policyholder must pay in the long term. Thus, whatever happens, if surrender values are increased at short durations someone must pay for that increase or the long term policyholder will experience a reduction in return. Is this not likely to have as major an impact on the current method of distribution of financial services as that change anticipated by the authors? It would therefore be interesting to know first how the authors believe this problem will be resolved and second how their conclusion on the future distribution of Financial Services would vary under each of the above scenarios which I have outlined?

In other words do they think there will be different winners and losers?

**Mr D. A. Berridge** said: I would like to make a few general remarks, firstly about the effect of competitive forces in our industry. Such forces are particularly difficult to predict in a fragmented industry which uses a variety of distribution methods and distributes an opaque, intangible product. It has become particularly difficult because of the stone thrown into the water by the Financial Services Act and by other pressures such as de-regulation of the banks and building societies which has led them to come into our market-place. Essentially what was always a very unpredictable state of affairs has been made that bit more unpredictable.

The authors quite rightly mention the effect of the mismatch which has occurred in many companies business' strategies between their product strategy and their distribution strategy. That is unfortunate but is hardly surprising given the difficulties of analysing what the effect of competitive forces would be. The important point is that the consequences of such a mismatch are potentially very severe. A simple no-new-business-for-a-time consequence immediately springs to mind. But other consequences are now being seen in that some companies respond to the mismatch not by a dramatic realignment of their strategies but by trying to force a fit between two irreconcilables. Even worse, they may ignore the financial numbers that are emerging. Some recent examples of such responses are the bidding up of commission rates, etc., to compete on recruitment, the introduction of what I call funny products and the pressure on charges and bonuses which in other times might not happen.

The job of a marketing actuary in this scenario is partly to remember he is an actuary and to work hard at improving the techniques that he has available to help him analyse the profitability implications of various business strategies. However, even although marketing actuaries are actuaries first, they are also marketing men. I was struck by Professor Baker's remarks, and suspect that there is a lot of segmentation of the U.K. Life Market. There is also a much more complicated distribution and product match than it has been possible for the authors to deal with in the paper. Leaving that aside, one of the consequences of all this competitive activity has been development of practices harmful to the industry as a whole. We are beginning to reach the stage where we are putting at risk the thoughts in customers' minds that they are buying comfortable requirements, or comfortable security from their policies, from us. That is the major thing which we have to address as an industry. So, marketing actuaries, stand up and be counted both on the actuarial side, by fighting to produce better numbers, and on the marketing side, by reminding whichever of yourselves, your companies and the industry is appropriate, that some practices might be "short-term" and damaging to the long-term health of the industry.

**Mr P. J. F. Taylor** said: At the risk of falling into the trap mentioned by Professor Baker of not seeing the marketing wood for the actuarial trees, I thought I might say a few words about actuarial aspects of general insurance which have an important bearing on the way one markets and hence distributes general insurance.

On Page 6, figure 2.1 the authors present a simple diagram showing what they called the spectrum of product complexity. I have to say that I do not really find this way of looking at products very helpful. The authors say that one of the driving forces to complexity is low perceived demand by the customer. I suggest that this lack of demand is in fact *the* driving force and the others mentioned in the paper are either incidental or are manifestations of the complexity rather than its cause.

The authors apply classical marketing theory and draw conclusions about the attractiveness of various means of distribution. These are summarised in Table 2.5. General insurance in particular, and financial services in general, exhibit the phenomenon of selection against the insurer, which does not fit in with classical marketing theory. Selection against the insurer is highly correlated with the perceived need by the customer. Sometimes this anti-selection is obvious but at other times it can be more subtle. Either way the effect on the bottom line can be quite profound.

I expect that there are some segments of the market where life insurance is bought because the customer perceives a high need for it. The authors say in paragraph 1.2.4 "the life insurance industry has expanded beyond satisfying that segment." It now sells its products to people who are not actively shopping in the market-place. This move was driven not just by the desire to expand the business but also, I suggest, by the need for underwriters to get a spread of risks which would accord with the law of averages. This way the occasional selection against the underwriter would be submerged in a balanced portfolio.

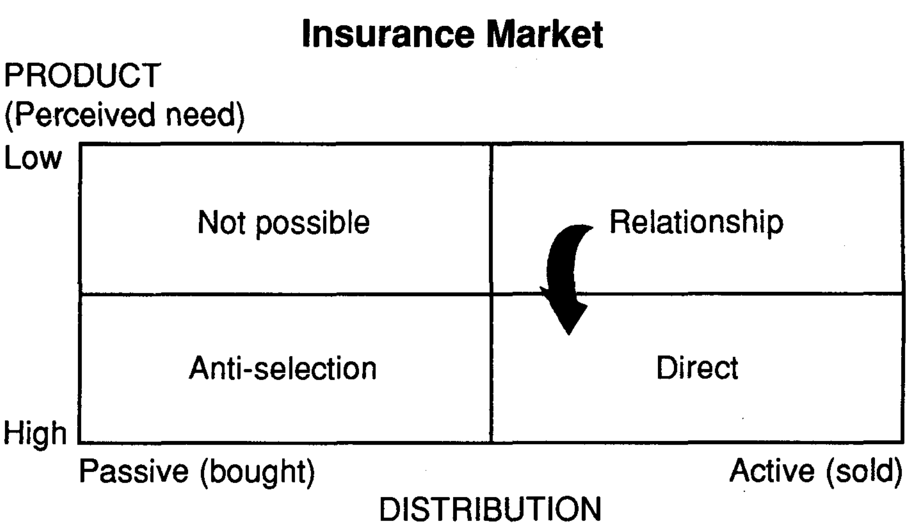
General insurance, however, has remained much more closely with satisfying perceived needs. Private car insurance is a good example. Most drivers recognise the need for private car insurance, indeed it is forced on them by statute. But I have not yet heard of insurance companies marketing private car policies to people who don't have a car! Anti-selection in the mass private car market manifests itself especially in the distribution channel where intermediaries use computerised quotation systems to select the cheapest insurer for the individual client.

Unfortunately for the private car underwriter there are large numbers of rating factors in use to determine private car premiums. Many of these factors have large numbers of possibilities. For example, there are thousands of possible postcodes to describe where the vehicle is kept. There are perhaps 50 possible driver ages, and so on. This leads to more cells for statistical analysis than there are cars on the road. Although wonderful things can now be done with computers and modern statistic analysis packages, at the end of the day the underwriters have to do the practical thing. They group some of these factors. Thus, for example, postcodes may be grouped into ten rating areas. Driver ages may be grouped quinquennially above age 25, and so on. This grouping leads to averaging of the experience within the group. Averaging means that some risks are under-costed and other risks are over-costed.

Different insurers employ different groupings. Put together these different groupings, all the rating factors and all the insurers in the private car market and you find that for any given risk or particular driver profile there is a range of premiums quoted in the market-place. You often see this commented upon in the newspapers. The mean of this distribution is probably about right for that risk. Unfortunately the computerised quotation systems result in the business tending to go to the company that has unwittingly under-priced. They get none of the risks where they have unwittingly overpriced. Computer quotation systems select against all insurance companies which participate in that particular segment of the market by denying the companies' underwriters the balanced or average portfolios which they need. There is therefore a tendency for business sold on price through this distribution channel to be unprofitable.

How are the insurance companies dealing with this problem? Interestingly enough they are following the path trodden by the life insurers in that they are now also trying to sell outside the market-place. Instead of having their products *bought* within the market-place, we have seen a growth in companies selling directly to the public. By this means they hope that their quotation will be compared with perhaps one or two others instead of with every insurer in the market. Thus they will get much better balance to their portfolio.

How does this move of general insurance between distribution channels fit in with the models in the paper? In figure 2.5 distribution through price driven quotation systems would seem to be in the bottom left hand quadrant. The authors have labelled this "commodity". It is possible to make money selling physical commodities if your costs of production are lower than other producers. The argument I have developed above suggests that with an insurance commodity, selection against you is going to mean losses are easier to make than profits. The move to direct marketing is arguably a move into the bottom right hand quadrant which interestingly enough the authors have labelled as "not attractive". I do not think Direct Line would agree with that label! My feeling is that this is an example where perhaps a peculiarity of insurance, namely the phenomenon of adverse selection, leads to some sort of modification of the classical theory. I would like to suggest a modification of the matrix.



On the vertical axis, instead of using product complexity I have used perceived need. I have allocated a scale along the distribution axis which recognises my interpretation of whether policies are bought or sold. High need combined with active distribution results in the direct selling which I was describing. The arrow between relationship selling and direct selling demonstrates another trend: general insurers are building relationships with intermediaries. These are aimed at heightening the intermediary's desire to trade with the particular insurer so that they provide the insurer with a more balanced portfolio. This results in a further complexity in understanding the market.

The authors have presented a stimulating paper which has given us a good start in understanding the distribution theory of financial services. The ideas have now got to be developed a little further, perhaps especially in general insurance.

**Mr D. M. Pike** said: Right away I would like to say that I am in broad agreement with the implications the authors draw from their theories but not necessarily from following the same reasoning.

A brief comment on 2.2: I do not understand how low perceived need by the consumer, and for that matter large premiums, necessarily imply complex products. The examples in the diagram do not help me either because risk products (life assurance) is shown as much more complex than risk products (motor). I do not see level term assurance as being more complex than comprehensive motor insurance, with protected no claims bonus, excesses, exclusions, etc.

Mr Buchanan commented on the diagram in section 2.3. I also do not understand how IFAs are necessarily more active than direct salesmen, although perhaps it is the choice of terminology that is misleading me. Active has connotations of hard selling. There is a reference to higher added value which makes more sense to me since IFAs are also advising on the choice of companies, but even so I do not think it is a clear cut division, e.g., to my mind there are up-market salaried salesmen giving higher added value, especially on pensions contracts, than are the majority of IFAs.

Perhaps as a result of the foregoing, I have trouble with the diagram in Section 2.4: I do not necessarily associate active distribution, at least in the sense that double glazing salesmen are active, with complexity of product. Even taking active in the sense of higher added value, if the main difference between IFAs and direct salesmen is in advising on the choice of companies, it does not necessarily imply complexity of products. The examples in this section do not help. The failure of U.S. banks to distribute life assurance through bank branches is a legal restriction and more to do with the political lobbying power of insurance agents in the U.S. than with marketing. Also, on the example of direct marketing, I would point out that in Sweden direct marketing is perceived as much more up-market.

Passing over the next two diagrams to the diagram in section 3.1.3, the arrangement of life assurance distribution is not always such a neat triangle and the company to consumer link can be weak or almost non-existent. The authors do not actually say this but I think it is implied in the last sentence of 3.3.2 which is about the marketing relationship being mainly between the company and the distribution.

In section 4.1.6 it is stated that the use of IT has not resulted in any major marketing success. There is one example in the Netherlands where a company has leased 200 teletext pages and you can watch their advertisement on TV, telephone them up, give them your details and then over the telephone be directed to a certain teletext page to see an illustration.

Section 4.2 is the heart of the paper. I agree with the main conclusion that the effect of regulation will lead to lower margins, simpler products and distribution that gives less advice and financial counselling to the consumer, at least for the majority of consumers. If, as now seems increasingly likely, attempts to establish the PIA fail and life offices withdraw from the Investors Compensation Scheme, the costs borne by IFAs will increase and accelerate this process.

Finally, there is a point in 4.2.4 about mortgage endowments being simple demand type products. I agree with this only up to the point when the bonus rates have fallen far enough for the consumer to appreciate the danger that mortgages may not be paid. At this point I think the consumers' perception of the product will certainly change.

**Dr D. C. M. Dickson** said: I do not share previous speakers' enthusiasm for this paper. Perhaps it is due to my lack of experience, and indeed knowledge, in the area of marketing. It is my habit when presented with a new paper to start by reading the abstract to determine if I wish to proceed further. Having read the abstract of this paper I wondered what was actuarial about the paper. I then looked at the list of references. Of the ten works referenced, only four are of an actuarial nature. Curiosity rather than real interest prompted me to read the entire paper. After reading it my initial question remains unanswered.

To be fair, I did find one aspect of the paper interesting, namely the description in section 1 of the changes in the financial services industry. However, the remainder of the paper left me confused, amused and insulted.

Section 2 told me things I already knew, but in business school jargon that I did not know. There was a tendency to state the obvious in this section. I am sure that nobody in this hall needs to be told that you get more out of an Independent Financial Adviser than from a machine in a wall.

At the start of section 4 the authors state that they have "developed a theoretical framework with which to analyse the distributions of products" and later state in section 4.2 that they will "now apply the theory". At this stage in the paper I was amused – with myself – for I realised that I did not know what this theory was. I returned to the previous sections but found it impossible to find any real theory in amongst the facts and jargon. It would have been helpful to have the key elements of the theory summarised in the final section.

At times I found the paper patronising and insulting. For example, we are told at the start of section 5.2 that "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". Even though I have never worked in a life office, this statement did not surprise me.

In their conclusions the authors state that it is a pity that the subject of distribution has not been discussed often at Staple Inn. I could not disagree more. This paper is an example of the trend away from technical actuarial papers at Institute sessional meetings. Indeed some actuaries nowadays seem to pride themselves in their lack of technical ability. It is my sincere hope that this trend will not be followed north of the Border. In their paper the authors refer to added value. As actuaries, we should be aiming to provide added value by using our expertise. I would like to ask the authors whether they think that the distribution side of a company could be improved by the use of actuarial techniques or simply by having actuaries run it? Where is the evidence to support their belief that insurance companies would be more effective if actuaries paid more attention to distribution?

**Mr A. C. Martin** said: I am a consulting actuary involved in pensions I therefore have no direct involvement with marketing or selling life assurance. I hope, however, that a slightly detached view will enable me to very firmly look at the wood rather than the trees.

Tonight we have a paper highlighting that banks and building societies are very significant competitors for life assurance companies. I however believe that life offices can solve that particular problem with a stroke, a master stroke, it is perhaps even a universal panacea. The solution is quite simply to do away with front end loaded commission.

In section 1.2.4 the authors refer to the master stroke of discounting commission and paying high front end commission. It applies whether it is paid to IFAs, direct sales forces or tied agents. It has obviously been very successful but I think we now have to address the possibility of change. I do not think that life offices should be dictated to by their tied agents or their IFAs. They should go directly to the public.

The removal of front end commission is necessary I believe to compete with banks and building societies. Such a move will become much more likely because of pressure from commission disclosure. I think a move to a much greater emphasis on single premium commission levels would be appropriate. I also think a greater emphasis on shorter term contracts would be more appropriate. The sales of life assurance products did not really dip with the removal of life assurance premium relief in 1984. Unfortunately there is too great an incentive to sell something irrespective of the tax advantages, with sales driven by the term of the contract. I think it is more appropriate to be able to sell nothing rather than something that pays the bills.

I would urge life offices to develop products along those lines. If that is done, the distribution problem will, I feel, disappear. We will then be able to move from the very nice adverts concentrating on name awareness towards direct highlighting of specific guarantees and simplicity. At the end of the day if the products can be simplified, I think that would benefit the whole life assurance industry.

**Dr G. Kaye, F.I.A.,** said: I had not intended speaking this evening unless I felt provoked. The speaker before last did just that! He asked for evidence that actuaries would help in distribution. It is my firm belief that wherever a combination of common sense and mathematical ability is required then actuaries can add value. I did not expect to have to defend such a statement in this esteemed hall.

**Mr I. J. Thomson,** closing the discussion, said: Firstly I would like to join with (at least most of) the other speakers tonight in congratulating Mr Gupta and Mr Westall for producing such a readable and thought provoking paper. As Mr Buchanan pointed out the topic of the paper and the treatment of the topic make the paper of as much relevance to all the many non-actuaries who are involved in the distribution of financial services as to their actuarial colleagues. Indeed this fact indirectly caused me some concern when preparing my thoughts for closing this discussion.

At first sight, many actuaries not directly involved in marketing might feel that this paper had little to do with them and so, conceivably, the discussion tonight might have been very limited. Conversely there are so many aspects to the paper and the topic of distribution that there might have been little pattern to the discussion and so few of the topics I prepared to summarise may have actually been mentioned. Fortunately I think we have all just witnessed a lively discussion and some of it I did accurately anticipate being covered. In my mind this merely confirms how distribution strategy is one of the key issues in financial services today. The crucial difference that a successful distribution channel makes to the fortunes of life companies means that this topic must be fully considered by all actuaries involved in the management of life companies, not just those directly involved in sales or marketing.

As the paper points out, a suitable distribution method for each financial services product has not arrived by chance. Each developed as a result of collective wisdom and experience. The process was one of evolution to the most efficient basis for the particular product at that particular time. However, in this modern day of increased competition and dramatic, sudden changes, it is no longer good enough to trust slow evolution. Management must have a total understanding of distribution channels so that appropriate responses can be made to changes in regulation or other legislation. Hopefully some of the expensive mistakes which were made by companies as they frantically chased tied agents can be avoided in future shake-ups and in this way, as Mr Berridge pointed out, mismatches of product and distribution might be avoided. Much of the paper and the discussion tonight has centred round the topics of marketing and selling. The paper and Professor Baker have given us various definitions of these activities and every course on marketing adds several more. I must say that I think we can get too hung up on the precise dividing line between the two: sales and marketing are two crucial aspects of the distribution of financial services and both must work in harmony with the other to prove effective in the market-place.

I did feel that the concepts discussed by the authors in section 2 and 3 of their paper form a good starting point for understanding the dynamics of financial services distribution and would hope that the consumer lobby are prepared to listen to the points made and accept the inevitable conclusions. I am probably being rather optimistic but, as Mr Buchanan indicated, this is a challenge the profession must take up.

Individuals, including Mr Pike, certainly have differing views on where products lie in the product complexity spectrum. This is likely to be because, as the authors point out, the same legal contract can have very different uses or applications. However it seems to me unquestionable that a complex product which provides consumers with long term advantages, but which consumers will only acquire if resource is expended to identify and explain the relevance of the product to them, must have higher margins than straight forward demand products. As Professor Baker stressed, it is important to sell benefits. If higher margins are prevented the products will cease to be available and it is the consumer who will lose out. I, for one, do not see spreading of up front commission as the whole answer. If commission is spread salesmen cannot afford to live unless they are otherwise subsidised in their early years of operation. This subsidy would have to somehow be fed back into the product pricing meaning higher up front charges. Fees are an alternative although they are actually the ultimate front end loading, leaving the products themselves untouched by sales costs. How ready consumers are to pay fees is however highly questionable. Mr Paul reminded us all of the difficulties involved in finding a workable alternative.

The life industry has had to explain and defend the high relationship element and the high level of selling pressure involved in its products at many stages of the development of the Financial Services Act. Fortunately, to date we have been able to convince the decision makers of the value of our arguments, but it is still far from certain that this will always be the case. The authors' paper is useful in reminding us of the fundamental points at stake. Having said that I do, however, question the inevitability of the authors' assertion in section 2.7.3. While totally accepting that the banks have significant strengths I question how easy they will find it to move from selling passive products up the slope to more complex products with more active distribution. This will not be easy for banks since they must themselves change culturally to accept the different disciplines involved. The banks' traditional products are themselves now attracting increasing attention from consumerists and their attempts to move into life assurance products must be managed very carefully if they are to succeed, That said, I agree that this should prove easier than persuading life salesmen to live off the low margins allowed for from the sale of traditional bank products.

As I said earlier, I believe the main value of the paper is helping us all understand distribution to help us cope with increased rate of change. Section 4 of the paper is therefore crucial as it underlines the extent of variety of changes we face. Regulation certainly remains the area from where most dramatic change can come. Our industry will have to face the outcome of the development of the PIA. Whether it materialises at all or is replaced by some form of direct Government supervision is in question. The impact of the final outcome on distribution channels must be quickly assessed by management as must the final outcome of the retail review. A reversal of the decisions on commission disclosure or own charge illustrations could again alter the balance between the channels.

However the driver for change which I feel holds out the largest potential benefit to our industry must be improved technology, although as Mr Taylor pointed out improved technology can also have threats to insurers. No matter what the distribution channel the potential advantages which we can achieve from fully understanding the dynamics of the channels and harnessing technology to deliver improvements must be huge. Indeed technology must be the key to producing what should be the eventual outcome – distribution channels selling a range of products with similar distribution characteristics. This does however leave me feeling more optimistic than the authors for the future of IFAs. If a range of providers develop a range of products with significantly improved sales and service support both the IFA and the probably few companies that provide that support will continue to flourish – if, of course, the consumerists allow that to happen.

I must say that I found section 5 of the paper somewhat disappointing. The impact of distribution on pricing and profitability is clearly the area of most direct interest to the actuarial profession. Yet I fear we are still far from understanding all the aspects and therefore are not able to anticipate the financial aspects of changes in distribution experience. The fact that organisations other than life assurers employ relatively few, if any, actuaries should give life companies an advantage in that they should be in a position to use our professional expertise to predict outcomes more accurately. However this is clearly not currently the case and I fear that the authors offer only the starting point for a lot more work. Many of the main parameters which influence the equation have been identified but we are nowhere near determining how exactly parameters, such as price, influence volume and hence profitability. Actuaries have developed models for investment markets and for sales forces but I fear that the complexity and subjectivity involved in distribution will make it very difficult to develop effective models in this area.

In summary I would therefore repeat my congratulations to the authors on producing this paper which I believe gives a very useful outline of the main factors influencing distribution in financial services, but still leaves the profession far from being able to use our professional training to advantage in that we cannot yet use our skills to predict the financial effects of strategy to help our employers face the threats from other competitors in financial services. Companies must meanwhile continue to rely on their considerable practical knowledge of how their chosen distribution channels operate, directing resource to areas such as IFA support or salesmen's training where they are known to make maximum impact on the overall success of the channel. Pricing actuaries must monitor experience and ensure that steps are taken so that overall profitability meets company objectives.

Whilst there are currently many threats to our industry there are companies that have proved that clearly identifying strategic advantages and determining clear distribution goals can result in a very healthy business. The challenge for actuaries in every other company is to use the lessons of this paper to ensure that their companies are counted amongst the successes.

**Mr A. K. Gupta,** replying, said: Thank you very much for all your comments. Mr Westall and I greatly appreciated the discussion tonight and it has really made us feel the effort has been worthwhile.

I would particularly like to address the issue of customer needs illustrated by the example of where unit trusts lie on this product complexity graph. A unit trust is a difficult product to place on the graph, as it is hard to say whether you are buying a solution to a complex tax problem, a solution to a complex investment problem or a simple investment. In fact you could be buying any of these. When you buy a mortgage endowment what is the product bought? My own view is that you are probably buying the house you desire.

We would certainly agree with Professor Baker's view that customers are not clones and we would not want to underestimate or understate their importance. But who are the customers of a life office? If we take an office operating in the IFA market, I would question whether they are in the retail market or in the wholesale market. I would argue that IFA companies are in the wholesale market and therefore the market you need to segment is the IFA market. I would also argue that in this situation that the true consumers are actually the customers of the IFA or of the salesmen. Moreover direct sales force companies, with one notable exception, also reflect this position.

So life companies have to address the question "who is our customer or who is our client?" Is it the IFA, is it the salesman or is it the consumer? The answer to this is derived from an analysis of the distribution chain.

Moving onto macro-pricing, we certainly would not want to understate the difficulty of developing macro-pricing models, but as a profession, we have to become more sophisticated and use techniques adopted by other industries. After all macro-pricing techniques are not new, they are only new to the life insurance industry. We agree strongly with Mr Berridge's comments in this respect and we think that actuaries in marketing departments have to introduce more rigour in their analyses and better disciplines. For example one company I have come across used a technique called Conjoint Analysis in developing its marketing strategies. I have used this myself and found it to be quite useful.

I must respond to Dr Dickson's comments. We may be stating the obvious, and I accept that in some places we are definitely stating the obvious, but this begs the question as to why have so many insurance companies lost so much money in doing things which are so obviously wrong? When Dr Dickson asks how actuaries can add value through the analysis of distribution, does he consider that sales management are already sufficiently financially sophisticated? If this is the case life companies would be more than adequately profitable. Actuaries should be concerned with all financial aspects of life office management and to say that they cannot add value to the distribution is perhaps viewing their abilities too narrowly.

Moving on to short term surrender values, and wondering whether the industry's approach to early surrender values will change, I have to say that my personal view is that they will not. But I think, however, that life companies will have to justify their position more by reference to the value that their products add. Different companies will evolve different solutions to this issue and ultimately we will end up with a market solution. I think that any solution imposed by regulation is highly unlikely to be satisfactory because if it was easy to eliminate front end loads insurance companies would have done it already.

So far as consumerism is concerned, the industry has a challenge and we believe that the profession is well positioned to address it. We do not think that banks have an easy task to exploit their opportunity in the life assurance market successfully, given their experience of moving into new businesses.

**Mr A. K. Gupta** and **Mr G. Westall**, replying in writing to some points raised in the discussion, said: It was not possible to deal with all of the points raised in the discussion. However, we would like to comment on a few of them.

Mr Buchanan raised the issue of First Direct and the doubt expressed in the paper that a major breakthrough could be made in personal banking without a branch network. Although First Direct's growth has been impressive it still has under 5% of U.K. bank accounts. The fact that it has achieved this position is a testament to the differences between people – there are sufficient people who do not like existing banks, or are attracted by technology, or 24 hour banking, to make the operation viable. The interesting point will be to see how large a market share can be grown, and the effects of any other banks using this distribution have on this.

We found Professor Baker's comments most helpful, but still have a nagging suspicion that marketing experts do not give enough emphasis to the low perceived need associated with many financial products. Examples quoted of marketing concepts are of people wanting something, e.g., a hole not a drill. We believe that there is a stage before this for some products – the individual does not know that he needs a hole, and it is a complex process to give him the insight needed.

The same line of reasoning affects the approach to market segmentation. Complex products currently involve a distribution system which insulates the company from the customer, and hence market segmentation will be done at best indirectly. Segmentation is done by choice of the intermediary who will deal with a particular segment.

Mr Pike raised the question of whether salesmen of IFAs were more active. We would agree that there is considerable overlap, and that in many cases they act in the same way. However some of Mr Pike's comments were a result of considering the product to be the actual contract or the physical entity, and not the totality of the service. Double glazing is a good example of a physical entity which can occupy more than one place on the complexity scale. On one basis, it is a commodity – this is how the authors treat it. On another, the benefits need to be drawn to the attention of the customer and the process made painless, i.e., there is a high service element.

We realised that the failure of American banks was partly affected by the regulatory environment. The point that we were making was that their attempts were failures – the reason for choosing the basis was immaterial. We like to think that if they had read our paper that they would not even have tried on this basis.