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Résumé de l'article

À l’heure de la déréglementation des marchés, du décloisonnement des services financiers et de l’émergence de nouveaux réseaux de distribution, le courtage, comme mode de distribution des produits d’assurance, représente un défi. Après avoir mis en lumière le contexte économique dans lequel évolue les courriers, madame Mollenhauer, qui dirige un service de mise en marché en matière d’assurances commerciales dans une société d’assurance, commente quelques unes des nouvelles réalités qui sont au coeur des grands changements dans cette industrie. Parmi celles-ci, mentionnons les nouvelles attentes du consommateur, la montée des services personnalisés, les approches stratégiques des assureurs et des courtiers pour cibler la clientèle et l’informatisation des dossiers.

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Marketing through Brokers

The New Realities of Insurance*

by

Gail Mollenhauer**

À l'heure de la déréglementation des marchés, du décloisonnement des services financiers et de l'émergence de nouveaux réseaux de distribution, le courtage, comme mode de distribution des produits d'assurance, représente un défi.

Après avoir mis en lumière le contexte économique dans lequel évolue les courtiers, madame Mollenhauer, qui dirige un service de mise en marché en matière d'assurances commerciales dans une société d'assurance, commente quelques unes des nouvelles réalités qui sont au coeur des grands changements dans cette industrie. Parmi celles-ci, mentionnons les nouvelles attentes du consommateur, la montée des services personnalisés, les approches stratégiques des assureurs et des courtiers pour cibler la clientèle et l'informatisation des dossiers.

In our business we are poised on the brink of a new competitive environment that will give us all the challenges we can ever want. Financial services de-regulations, the threat of new distribution channels, economic recession, the consolidation process underway within company and broker ranks... The list is lengthy.

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* Allocution prononcée dans le cadre d'une conférence organisée par l'Institut Canadien, les 13 et 14 juin 1994, à Toronto. Le thème de cette conférence était intitulé comme suit: *Promoting and Marketing insurance*.

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We've got a tough job ahead of us. The writing is on the wall. We've got to be more professional; we've got to reduce the expense component; we've got to manage losses better. All of this means we need our business partners, the brokers, to work hand in hand with us. There is no way we can do it all ourselves. Some of the pain has to come from the broker channel but we firmly believe that out of pain come opportunities for both of us.

I'd like to begin by giving you a capsule picture of Canada's property-casualty insurance business, so we can apply some statistical scale of measurement against other businesses and industries.

Ours is a $15 1/2 billion dollar business which has averaged a 10 percent annual growth rate over the past 20 years but closer to a 4.5 percent growth rate over the past 5 years. 22 percent of this 15 1/2 billion is controlled by direct-writing insurers like Allstate and the Co-operators. Over the past 20-30 years there has been very little change in the ratio of direct to indirect writing with the exception of Quebec where the Desjardins entry into personal lines enhanced the proportion of direct. Canada's experience is unlike the U.S. where broker dominance is much less, particularly in personal lines. In fact, the ratios would be almost reversed.

I have not mentioned the government-run insurance operations in Saskatchewan, Manitoba, British Columbia and Quebec but they would represent an additional $5b in premiums.

Looking at the broker force, the overall number of brokerages in Canada has declined: from 8,650 in 1987 to 6,950 in 1992—an almost 20 percent decrease. During this same period however, the overall number of individually licensed brokers has risen by about 7.6 percent from 30,400 to 32,700.

From a historical perspective, our industry performance compares favourably with that of the banks. However, over the past decade or so, there has been a long term decline. Cycles are shorter and more pronounced.

Traditional relationship has had the broker as the customer of insurance companies. The insurer introduced products and marketing aids to the broker and the broker brought the products to market. Insurer service was not focused on the relationship with the customer and this kept the insured a good distance away. Hence, it is not surprising that the majority of insurer data bases were policy number oriented - not customer oriented. The reality was and still is, to a large extent, that we don't know a lot about our customers.

Insurers pay for the broker distribution channel in two ways:

- Standard commissions at point of sale. These commissions vary by product but the variance in commission rates between insurers tends to be small.
- Bonus commissions - traditionally, overrides and contingent profit programmes with some form of stop loss have been available to brokers to encourage them to give insurers more of their business. They are an expected bonus amongst brokers. One of our regional marketing managers was remarking that in the past eight years he has been giving contingent cheques, he has only received one thank you from a broker. Coupled with this, the insurer still takes the hit on large losses, while the broker continues to receive contingent profit.

Until fairly recent years, orthodoxy ruled the financial services' industry, with the "four pillars"—banks, insurance, trust and securities companies—moving ahead in procession but separated by legislation, marketing strategy, management focus, and of course, tradition.

All that changed in December of 1986 when the federal government unveiled its long-awaited changes to Canada's financial services' legislation. This blueprint report essentially broke down the barriers that previously separated the four pillars and allowed the participants to explore each others' turf. The new reality in the financial services' market became the

"supermarketing" of financial products. Its proponents pointed to the natural synergism that would see a consumer buy a home, negotiate a loan for the mortgage, insure the family home plus the lives of the buyer and his or her family, and amass a stock portfolio all from one single source.

When the government minister involved tabled the amending legislation he inadvertently gave the property/casualty insurance industry its collective top laugh of-the-year when he solemnly announced that the increased de-regulation would quote "bring greater competition to the insurance business"! Of course this was just what we needed—a little more competition. After all, there are only 250 of us fighting it out right now.

The new reality of our business is not a single issue like the arrival on the scene of the banks as competitors. Rather, the new reality is: we're in a tougher battle for survival because a whole range of events and circumstances have descended on us at the same time.

Let's look at them.

Number one: the economy is still trying to pull itself out of recession. Lower levels of economic activity mean fewer new businesses, less factory and office expansion. By the same token this means a tapering off in demand for insurance and what demand there is is heavily price-conscious.

Allied to recession is the other dark cloud it brings with it: a rise in arson, and insurance fraud, in break-and-enter crime... all of which have left their negative imprint on insurers' results and continue to do so. Many companies—and Royal is one of them—have added special investigation units to meet the challenge of arson and fraud head-on. In our case we have gone from zero to a 7-person S.I.U. staff in less than two years and in its six months of operation our S.I.U. investigated 600 claims and saved Royal an estimated $4 million dollars. Recessionary times bring another problem: a falling-off in maintenance levels in both the automobile and property-casualty classes of business, and this has a cumulative effect on insured losses.

Number two: the decline in investment income. This, of course, is the offspring of economic recession, but for our business it has become an integral and crucial element of successful operation. It is an irony of our industry that the significance of investment yields to ensure profitability gets a lot less attention than underwriting results. And yet in 1992 our industry posted a loss of $1.4 billion on its insurance activities, a loss which was offset by investment income of $2.4 billion. Quite obviously, investment income is critically important to us. It is as significant a factor in determining profitability as earned loss ratios.

To put it another way: the impact on return on equity of a one point improvement in investment yields is two to three times the impact of a one point improvement in loss ratio. In addition to this, the undeniable fact of our persistent—and fully expected—underwriting losses is that our business considers prospective investment income in pricing its products, so the ability to obtain above-average investment yields also means the ability to price more competitively.

Another factor in the heightened awareness and importance of investment income is the entry of the banks—or at least some of them—into our business—but I will touch on this in a moment.

In previous decades, property-casualty insurers were able to factor in a reasonably predictable return on investments, to counterbalance losses suffered on the underwriting side. That hasn't been the case in recent time and in the foreseeable future it seems clear that the bumper investment yields of the 1970's and 1980's will be only a fond memory. The prospects are that over the short to medium term, industry profitability will be restrained for several reasons:

- governments are putting stronger pressure on insurers to assure responsibility for pollution damage, to pay for environmental clean-ups caused by pollution. And these costs are estimated in the billions, rather than millions.

- our legal fraternity has fought its way back into the automobile accident claims picture despite the arrival of no-fault in Ontario and Nova Scotia and its potential arrival in New Brunswick and Alberta. In Ontario, automobile loss costs are expected to rise by around 10 percent as a result of this.
- the incidence of arson and fraud already referred to.
- the negative impact of legislated tax changes on companies' balance sheets.

Having mentioned the "t" word brings me to issue number three in those factors which have all conspired to arrive on our industry's doorstep at roughly the same time: let's call it tax and regulatory changes.

The federal government has announced plans to tax unrealized capital gains on the securities held by financial institutions. This tax would be assessed at full income tax rates, as opposed to current levels of 75 percent on capital gains, and would be based on year-end valuations of the worth of a stock portfolio, even if the shares have not been sold and no capital gain has yet been realized. Only pension funds would be left as tax-free holders of common shares among financial institutions.

Apart from the potential for insurers and other financial institutions to back away from the long-term equity market—where realized gains in the past have helped offset one-year shock losses for many p/c insurers—there exists the potential for further diminishment of overall investment income and the consequent lack of competitive pricing flexibility that comes with that. With the likelihood of increasing competition from the banks for the mass market coverages like home and car insurance, this has serious implications for our business.

In addition, the move to full discounting of loss reserves for tax purposes will exacerbate this problem.

Issue number four that now assumes a much larger role in our operations: the question of expenses... the cost of doing

business. Because it is tied closely to my issue number five—the entry of Canada's chartered banks into the property-casualty insurance business—they could almost be rolled in together as one issue. However, the bank issue is such a large one that I'd prefer to look at them separately and lead off with the bank question.

As we all know well, insurance is the one remaining sector of the Canadian financial services' industry in which the chartered banks are not major players. They nearly all now own mortgage subsidiaries, trust firms, investment deals and leasing companies. Bank customers have access to practically any financial product or service: stocks, mortgages, loans, credit cards, mutual funds, trust services and, of course, a broad range of bank accounts. Until recently, the only missing piece in the financial picture was insurance.

This transformation of the financial services industry has certainly not been confined to Canada, or to North America. In Europe the barriers separating financial services have disappeared quickly in the past decade. There, banks are major players in insurance, particularly in life and personal lines of property-casualty, but also in straightforward commercial lines' products.

Germanys Deutsche Bank launched itself into the life insurance business in 1987 using its wholly-owned subsidiary Db Leben. Three years later this company had insurance in force of $5.4 billion. There's an even more impressive story out of Great Britain where the Royal Bank of Scotland set up an insurance subsidiary nine years ago known as Direct Line, where sales of auto insurance were made over the telephone. It now insures one and a quarter million, or about 10 percent of the United Kingdom's 12 million standard risk drivers, and confidently predicts it will have 2 million drivers insured by this September. It enjoys an enviable renewal rate of 85 percent. Earlier this year, Direct Line launched itself on the U.K. homeowners' insurance market and it is projecting half a million home insurance policies on its books by the end of 1994. Its

success story has not been lost on its competitors: four Direct Line-style programs, or, "direct response" organizations as they are generally known, have been launched in the U.K. by major British insurers, one of which is Royal.

This is a major change from bank policy of say, thirty years ago. As recently as the sixties Canada's chartered banks were constrained from doing anything other than their regular stock-in-trade: offering bank accounts and making loans to individuals and to business. They didn't even offer mortgages. But in the intervening years whole ranks of regulatory barriers have been dissolved between the four pillars, allowing banks to offer a very complete range of financial products and services.

C.I.B.C. is the first Canadian bank to get off the mark in operating insurance subsidiaries and doing its own underwriting. Their goal is simply to become a provider of the fullest possible range of financial services and to have a significant market share by 1998.

Although other banks' strategies are not so obvious, who would bet against most if not all the chartered banks moving in to get their share of the insurance business. For example, the Royal Bank has already entered an arrangement to offer insurance to all Royal Bank employees: a customer base of some 50,000. We understand the first offer was taken up by about 10 percent of the bank's staff, a pretty fair beginning, and it's interesting to speculate on their next logical step. The sole remaining restrictions are that Canada's banks are not permitted to market most types of insurance through their branch network, nor can they use their customer data bases. However, the reality is that these remaining restrictions are likely to be swept away as part of the next bank act.

If for no other reason alone, the sheer financial might of Canada's major banks make them an enormously powerful adversary. With $9 1/2 billion in capital the Royal Bank alone has almost as much capital as the whole of the Canadian property-casualty insurance business: $11.1 billion. Our banking system has vast and very detailed customer lists, a coast-to-coast

branch office and ATM network, plus sophisticated on-line electronic systems that link virtually every one of their offices throughout the country.

In assessing the banks as competitors, three principal factors come into play:

- distribution capability
- underwriting skill, and
- investment management

Starting with the last of these—investment management—already referred to the fact that investment income is an integral component in the pricing mechanism. The banks probably have an advantage here since they have long been accustomed to making a profit on the spread between their cost of funds and the yield on their assets. Their international exposure may provide advantageous access to overseas investment opportunities, and they have been managing foreign exchange exposures for a lot longer than insurers. And Canada's banking industry has had substantially more experience in the use of derivatives to manage risk and to enhance investment yields.

It's interesting to note that in a recent survey of property-casualty insurance company investment, only 20 percent of those polled used derivatives and only 50 percent considered the tax implications in assessing investment decisions... there's no doubt at all that both these initiatives would be in general use within banking.

On underwriting expertise, the traditional insurers have a sizeable head start. They have a wealth of historical information from which to extract statistical data to aid them in assessing and pricing risks. However, that head start can shrink pretty rapidly by either acquiring competing p/c companies, or the specialists who decipher and analyze the information.

It is the factor of distribution capability that is most critical, and there is no doubt that in this the banks could have a distinct advantage. They have well-established relationships with the vast majority of potential insurance customers. And not just

business relationships: the banks own detailed client information which can provide the perfect marketing matrix for cross-selling. The bank which holds a customer's mortgage knows precisely what the client's credit rating is, the location of his home plus its current value, and probably even the name of the client's present insurance company.

The fact is that about half the information required for a mortgage application is identical to that needed on a homeowners' insurance application, so the sales effort in arranging insurance coverage at the time a bank customer goes about obtaining a mortgage is minimal... more like checking off a series of boxes on a simple form. As many of you will have seen recently, one bank is offering $1,000 in cash to customers who transfer their mortgage from another institution... which leads one to consider that—since the average homeowner's insurance policy costs substantially less than $1,000 the banks could simply offer one year's free home insurance. Provided a $200,000 fire loss doesn't follow the giveaway it's an inexpensive way for the bank to attract insurance business.

Of course, in looking at the various options open to the banks in acquiring insurance market share, the focus falls directly on the most critical element: the use of independent brokers to distribute the product. Over 70 percent of property-casualty insurance in Canada is sold by companies using independent brokers, and while the system has amply demonstrated its strength and capabilities down through the years the banks' entry will put it to a severe test.

If we look at the impact that the lower cost structure of the banks and direct response organizations would have on our business, the realities are very sobering. The advantage of lower cost players will put downward pressure on rates and force insurers who fail to reduce expenses out of the market.

Most independent brokers are closely linked to their communities. They have developed secure links with local business; they provide a level of personal service, customer awareness, and added value that banks—even local branches in

the community—are unlikely to match. This is particularly true in rural settings. In urban areas however, like Metropolitan Toronto, or other large Canadian cities of population, these close ties are less well developed and the large mobile populations are a prime target for the mass market appeal the banks are likely to generate.

Recent surveys indicate that up to 20 percent of consumers would consider the banks for their insurance needs.

How can broker companies combat this vulnerability? Obviously the first step will be to strengthen the ability of independent brokers to compete with the banks: improving their service levels with improved technology like interlinks to the company computer and information systems; giving them discretionary claims-handling powers; providing marketing support and expertise. A second step might be a down-sizing process with insurers paring down their brokers to those who have the professional abilities plus the drive and determination to compete with the banks for the available business.

Virtually all property-casualty insurers now categorize their independent broker force, with the most professional and capable ones being admitted to preferred groups with special commission arrangements, concessions on financing and assistance in acquiring other brokers, and so on. With the arrival of the banks as competitors this trend will continue to expand; many smaller brokers will simply throw in their hand with larger, better financed and more sophisticated operations.

And now, since time is moving on, let me move ahead and suggest to look briefly at some of the structural changes that have appeared, are probably going to happen, and others which are either on the table or are likely to be in the near future.

- **Technology is changing how customers buy financial products**

The unmistakable trend is to "transaction selling" of commodity coverages like home and car insurance. In other

words, information can be keyed in direct to the company system at the time of consumer contact with the broker, and one transaction generates policy, payment schedule and any other necessary information: it is automation at its most effective. Frankly, we're still searching for that elusive "single strike data entry" but it's obvious that the electronic links between brokers' and insurers' automation systems must become more interactive.

- **The demand for personal relationship service is growing, not receding**

Consumers have let it be known that as insurance prospects they want to be considered as unique, individual risks, not part of a generic mass. So, there will be more tailoring of insurance products to suit individual needs.

- **Niche marketing will involve company and broker**

Niche marketing is a going and usually profitable segment of our property-casualty insurance business. There are good opportunities in developing products and programs for profitable industry groups working hand-in-hand with the independent broker. For success, niche marketing depends on knowing the targeted business: the risk exposures, the financial hazards, the key indicators for success or failure. As insurers, we must be able to talk intelligently about all aspects of risk management, so we can help the broker both capture and retain good business. By its very nature niche marketing demands an ability to research a potential market thoroughly, to quickly develop a viable insurance product at a fair price, and bring it to the market in a cost-efficient way... and we must be able to exit the market if necessary when, or if, circumstances change.

- **Automation must expand more rapidly to the commercial insurance classes**

Personal lines insurance—home and auto—is already highly automated, but too many insurers are dragging their feet in extending the cost-efficiencies of automation to commercial

business. Automatic renewal is certainly a start, but companies can go much farther in converting commercial transaction oriented business to automation; when this happens it opens up the cost-saving option of being transacted at either the company or the broker end.

- **Restructuring of broker commissions**

Commission structures have remained fairly constant: the new reality of the competitive squeeze on insurers is that it will require all elements of the product delivery system to be overhauled and cost-economies realized. The time allowed to pay agency accounts, and current profit-sharing plans will both face restructuring. Brokers will probably have to be prepared for a re-examination of full commission for renewal of straight-forward accounts. They may have to get used to the idea of quoting for business on a net or negotiated basis. Commission structures may increasingly be based on the overall profitability of products or individual territories.

Another option open to traditional p/c insurers is to set up an alternative distribution system or channel in order to compete more effectively with the direct channel used by the banks. As I mentioned earlier this has been the experience in Europe where many major p/c insurers have actively developed alternative channels of distribution while still maintaining and relying strongly on their independent insurance broker network.

It is this last issue which is likely to generate the greatest heat in the months and years to come. It is the cutting edge of the fight for market share and the battle between independent broker companies and the direct sales approach of the banks. It's not at all surprising that independent brokers are deeply concerned over any moves in this direction; by the same token most can understand quite well that the survival of a strong and stable independent insurance market is essential to their own survival.

As I said earlier, the broker channel, that is, brokers and insurers in partnership, should be able to compete against the banks but direct response entrants would pose a more formidable

threat. Our task is quite clear. We must be more professional. We must manage losses more efficiently. We have to reduce our expense component. And that in turn means we need our business partners—independent insurance brokers—to work hand-in-hand with us. We will need their full support in our quest to get closer to our customers.

The reality of our business is that to be able to compete effectively and to achieve acceptable returns on investment in the future, we will have to post operating ratios much closer to 100%. How many of us have managed operating profits in recent times? The industry average for the major market players in the first quarter of 1994 was more like 117%.

There is no doubt at all that the lower cost structure of the banks and the direct response insurers is going to put even more severe pressure on independent broker profits. Smaller brokers are probably the most vulnerable group since they have a high percentage of personal lines' and small commercial business accounts. It's forecast that the independent broker's share of the total insurance market in Canada will drop by about 10 percent by the end of this century, but commission re-structuring is forecast to reduce their income level by some 20 percent. In other countries similar competitive trends have resulted in a fairly rapid consolidation of the broker force: some moved toward greater independence from insurance companies—others moved toward greater dependence.

Down the road, to address the expense element of our business, we will probably see the development of the service centre concept: here, the insurer handles most, or all, of the transactions after the sale of business. We may also see—to reduce the cost component of the claims process—the provision of a 1 - 800 phone number by insurers for insured customers' use, bypassing the need to involve the broker.

Of necessity, this has been a fairly abbreviated visit with the new realities of our business. And if I might make one parting observation, it would be to say that although much of the emphasis has been on the problems that face our industry's

delivery mechanism in general, and the future role of independent brokers in particular, I think we have all learned over the years that Canada's independent insurance brokers are both resilient and resourceful. Critics have been sounding the death knell of the broker system for years—but it not only survives, it flourishes. Its underlying strength comes from brokers' willingness to adapt to change, to form strong and mutually beneficial partnerships with companies, and to find new ways to meet the needs of the customers we both serve.