THE REVOLUTION IN INSURANCE DISTRIBUTION CHANNELS IN HONG KONG

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Abstract

Distribution of insurance products in Hong Kong is characterized by the traditional Agency Distribution Model – Insurance Intermediary. Due to a changing landscape in the business operating environment and the evolution of information technology, significant changes in insurance distribution channels can be seen in recent years which include bancassurance, direct sales, internet sales, tele-marketing, cross-industry sales and other innovative form of distributions. Among various forms of alternative distribution, Bancassurance is dominant. Emergence of alternative distribution channels poses a threat to the traditional agency distribution system and disintermediation is an issue of concern among insurance intermediaries.

The purpose of this paper is to discuss the alternative distribution channels and their impact on the insurance intermediary profession. It provides an insight into the role played by bancassurance and its quality of service, and examines the views of agents, insurers and the public towards the changing patterns of insurance distribution.

INTRODUCTION

The insurance industry keeps on growing in Hong Kong, as Hong Kong offers a liberal regulatory environment for insurance business. As with other countries, the industry entered a period of consolidation in recent years – inter-industry mergers and acquisitions – in an attempt to boost growth.

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Provisional Statistics for 2002 showed that gross premiums for general insurance rose 19.8% to US$298.7 million. Office premiums for new long-term business rose 19.4% to about US$260.3 million according to a report from the Office of the Commissioner of Insurance. As at March 2003, the insurance industry comprised 197 insurers (209 in Year 2001) of which there were 49 life insurers, 19 composite insurers and 129 general insurers. Registered insurance agents were 30,656 of which 28,675 were individual agents and 1,981 were insurance agencies. Authorized insurance brokers were 447.

The implementation of the Mandatory Provident Fund Schemes (MPF) in December 2000 provided an excellent opportunity for banks and insurers to form corporate partnerships in the distribution of insurance and retirement products with the aim of capturing untapped potential markets. Ten local banks formed a consortium for the MPF business and six of them then formed a life insurance company in 2001, leveraging their infrastructures.

With the convergence of financial services, the traditional boundaries among insurance, investment, banking and securities have become increasingly blurred over the past few years and the channels through which financial products distributed to the public have been changed. Insurance companies, in recent years, started to develop products which are similar or identical to bank or investment products, such as investment-linked insurance schemes, short-term saving plans, with-profit bonds and investment funds. To operate within the insurance regulatory regime, all these products incorporate a risk factor.

The emergence and rapid adoption of alternative insurance distribution channels has triggered fear of dis-intermediation in the insurance intermediary profession. The market has evidenced massive change in insurance distribution management - from predominant agency distribution to a wide spectrum of other channels. Statistics showed that insurers who adopted multiple distribution channels ranked in the top ten insurers for new business in the last couple of years and their individual market shares have soared.

RESEARCH METHODOLOGY

Primary data were collected through a series of telephone calls and personal interviews conducted with insurance intermediaries and bank staff who are front-line people, and with customers and insurance executive responsible for the function of alternative distribution operation. The number of interviews exceeded 800 and in some cases group interviews were conducted. Secondary data were collected through government statistics and other research materials.

The result of the study was supplemented with mystery shopping exercises carried out by other parties.

AN OVERVIEW OF INSURANCE DISTRIVUTION CHANNELS

Social trends, information technology and changing patterns in consumer demands have resulted in changes in the traditional channels of insurance distribution in Hong Kong. Traditional insurers have developed new distribution strategies to cope with the consumers' demanding and sophisticated buying behavior.

Life insurance products are predominately distributed by tied agency forces, and personal line products are distributed through a wide spectrum of channels including multiple channels. Brokers or company direct sales force dominates commercial lines. Distribution of commercial lines products is mostly through insurance Intermediaries, and brokers still maintain a strong hold of commercial lines market but lose their market share on personal lines to the new distribution channels. Insurers in an attempt to handle channel conflicts tend to offer products made specific to different channels with price differentiation.

The development of the new distribution channels has been based on the following fundamental factors:-

Operational efficiency: a low cost structure when compared with an agency structure Customer relationship management: A multiple product policy, e.g. a bank has this advantage Sharing of distribution infrastructure: A ready portfolio of clients can be offered a varied range of products

Personal Distribution System

This includes channels such as insurance intermediaries, bancassurance and other forms of personal selling. The main advantage of this system is interactive but the main disadvantage is the expensive cost.

Direct Marketing/Direct Response Distribution System

This is an interactive system of marketing that utilizes various media, such as direct mail, e-mail, call center/tele-marketing or Internet to communicate directly with customers or solicit a direct response from defined or target prospects.

<u>Traditional Channels</u>

Tied Company agents - The traditional agency system constitutes the dominant form of distribution in the industry, predominately life insurance products. A tied company agent is an intermediary between a client and an insurer who is contractually bound to a specific insurer and remunerated mainly on a commission basis

Company sales force – a sales person directly employed by an insurer, remunerated on a salaried basis. Most of them operate in the personal line and commercial lines business.

Brokers - An authorized insurer broker, who is independent of any insurer, represents the best interest of the client in recommending appropriate insurance products and is remunerated on a commission basis.

Retail outlet: - Domestic helper agency as well as travel agency that sell standardized maid insurance and travel insurance scheme

<u>AlternativeDistribution Channels</u>

Bancassurance – The definition of bancassurance varies, and some of them are incorrect. In its simplest form, Bancassurance is "the distribution of insurance products by banks" (Sigma No. 7/2002 P.5) or "when banks engage in insurance business" (Dinenis and Nurullah, 1999).

Various Bancassurance models exist in Hong Kong, which include distribution agreement, fully integrated-own insurers, and strategic alliance. Among these models, the fully-integrated model is the most successful as two leading bancassurers established themselves in the top ten for new business in the past couple of years. Multiple distribution channels are the strategy in this channel, which have gained a foothold in the alternative forms of distribution channels marketing life and non-life personal insurance products. Market share represented 15% in life insurance premium and 17% in non-life insurance premium (Sigma 7/2002)

Advantages of this channel are the high credibility with the public, established brand name and possession of a ready customer base. This is also a lower cost channel for selling simple products. Insurers usually design simple and standardized products to fit the particular market segment

E-commerce: The growth of this channel has been slow, as a majority of customers still prefer personal contact. Complexity of product is one of the barriers. Personal contact is still preferred instead of communicating with a screen where no human response is available. Market share was less than 0.1% of total non-life insurance. (Sigma 7/2002)

Invisible insurer: Credit-card company, telecommunication companies or Public Utilities Company and the like, promote insurance cover with their own label as an add-on product, leveraging the brand of the retailers. Risk is underwritten by selected insurers, and products which have been distributed through this channel include credit card related insurance, and standardized products (e.g. household insurance, accident and health).

Electronic Machine: A recent innovation by a leading travel insurer: A touch screen machine is located in the platform of a train station, where cross-border travelers can buy low-benefit travel insurance plan with the stored valued travel-pass. The response is unfavorable and on average it generates approximate on average only 5 policies per day with premium ranging from US$1.5 to US$13 per policy. The Insurer when interviewed cited that this was a sort of advertisement; educating the public on insurance purchase and stimulating them to approach their office for additional insurance purchase.

Direct Insurer/Telemarketing: Insurers or banks selling direct by telephone offer a competitive premium. The penetration through the promotion of an accident and health insurance policy through this channel is on the increase which is perceived by customers as a convenient and low cost product. However, standardized products, which offer low benefit might not suit the needs of certain market segments.

Tele-marketing is making in-roads and is expected to gain market share in future. The low cost of the standardized products with minimum benefit appeals to customers. Products distributed through this channel include accident and health insurance, and home contents insurance.

Market share in this channel represented less than 1% of total life insurance premium and less than 1% of total non-life insurance premium.

Affinity Group: A tailor-made product is promoted to membership of a club, trade union or professional association. Cost saving can be achieved in serving a large group of customers with common needs. It offers an ideal market to develop cross-selling opportunities of other products beyond the specific affinity policy.

Driving Forces of Alternative Distribution Channels

Forces of Social and economic trends in the past decade have driven the adoption of innovative distribution channels. People are looking for alternative investment other than property and stocks. After the Asia financial crisis, people perceive insurance as a risk transfer mechanism to protect them against any financial loss as a result of catastrophe event, sickness or disability and property damage. An ageing population and shrinkage in social security also prompt people to look for insurance such as healthcare and retirement planning.

Customer Segmentation. Affluent people with education in finance, and greater sophistication in dealing with their own personal finance, tend not to employ intermediary services. To tackle this market, insurers simplify their products and sell them via direct channels.

Cost efficiency. Distribution costs, which means paying and supporting either tied or independent agents, are by far the largest expenses for most life insurance companies. Face to face dealing which is replaced by person to person selling by telephone which can result in reduction of middleman commission.

Increased Market share: This allows insurers to expand distribution and to increase market share by tapping into the market segments, which have not been or could not be captured by a traditional agency force. The sophisticating banking sector infrastructure can broaden an insurer's client base and achieve reduction in distribution costs.

Bancassurance. Banks enjoy the advantages of their huge customer base, and their established brand and reputation as a trustworthy financial institution. Innovative and tailor-made products to match specific clients' needs are advantageous to banks in tapping into new customer segments.

Banks are increasingly turning to insurance for new opportunities, as the days are gone when banks could earn easy profit from 'Mortgage and other types of loan'. Banks are keen to seek fee-based income to compensate for shrinking profit margins due to interest rate deregulation and a high level of non-performing loans.

FINDINGS OF THE STUDY

Quality of Bancassurance

Consumers throughout the world rate banks higher than insurance intermediaries in terms of such criteria as objectivity of advice and product knowledge (Kumar p.6). Mystery shopping exercises conducted by Tillinghast (August 2002), Benchmark (April 2004) and Hong Kong Consumer Council (December 2002) challenged this perception. In a majority of the cases: -

1. Insurance Products were mis-sold as bank saving accounts with free life insurance
2. Product recommendations were made with little or sometimes no knowledge of the client's protection and financial needs.
3. There was a strong theme of recommending funds and insurance saving plans regardless of individual needs.
4. Senior citizens were misled into buying an insurance wrapper, i.e. an investment fund with 101% death benefit of the amount invested as a normal deposit product.
5. 'Non-guaranteed return' life insurance plans were misrepresented as 'guaranteed return' insurance plans.

6. The long-term nature of the life insurance contract was not disclosed, and customers were not advised of the disadvantages in withdrawal.

Receptiveness of customers toward different forms of distribution channels

1. 29% of the respondents preferred to deal with banks for insurance but not any middleman.
2. 25% of the respondents who had experience with a bank in insurance sales had turned to an insurance intermediary and would never buy from a bank again due to poor quality of service, and a lack of knowledge and skills in insurance and financial planning.
3. 21% of the respondents had diverse views: they utilized multi-channels in their insurance purchase for standardized products – they bought on price irrespective of channel. For the purchase of complex products, which need advice (advice- based products) insurance intermediaries were still preferred, taking advantage of their skills and knowledge.
4. 22% of the respondents preferred to buy from insurance intermediaries due to convenience, personalized services and need-based assessment. However, the ethical standards of intermediaries is one of their major concerns.
5. 3% of the respondents had no preference and would utilize different channels for insurance purchase based on price and product features

Bank Staff Perspective: Role of Bank Staff in Insurance Business

Currently, the majority of the bank channels use bank staff to distribute the insurance product, and the new trend is to label this distribution as 'wealth management service' or 'personal financial planning service' and employ special staff.

The majority of bank staff gave this response in respect of their role played in insurance sales:

1. Their culture had been traditionally demand-driven with a reactive selling philosophy (unlike insurance salesmen who were usually need-driven and have an aggressive selling philosophy) as bank staff were not remunerated on a commission basis irrespective of performance.
2. They enjoyed an advantage in soliciting sales, as they possessed financial information of the clients' background and some of the clients perceived insurance products as complementary to bank services. There is homogeneity distinction between funds and life insurance can easily be substituted.

3. The potential for mis-selling by bank staff became the norm as they were mandated by the bank to sell specific products (product driven/sales driven). Sales were therefore not executed based on clients' needs or demand.
4. Due to product/service overload and mounted with multi-tasks, bank staff were not equipped with technical knowledge and skill in providing insurance services. They personally were not inclined to acquire this, even when insurance sales, which were not their jobs' original core function, became part of their daily function. Transaction of insurance products was based on information on promotional pamphlets, and the staff had no idea of the product or policy terms and conditions

Insurers' Perspective: Alternative Forms of Distribution

It is part of the Hong Kong culture that insurance is still a people business – people buy insurance based on personal relationship. With this distinct cultural and social ethos, some people would never buy any insurance without being convinced or persuaded by insurance intermediaries.

Insurance intermediaries still play a key role or form the major channels of distribution especially in life insurance and non-life personal line products while alternative distribution channels are complementary. Agency channels when compared with other channels exhibit differences in terms of quality of advice, recommendation of products, and after-sales service and claims settlement. With other channels, all after-sales services have to be supported by insurers' call-centers or customer service centers after the transaction is completed.

1. For the traditional agency channel, the major challenge to insurers is the increasing cost pressure, and insurers have to expand beyond the traditional channel. Expansion of alternative distribution channels is to increase new market share/new market opportunities rather than substitution of existing distribution channels.
2. Alternative distribution channels offered insurers cost saving in the long-term. Cost saving cannot be achieved at the initial stage in alternative distribution channels especially for non-life personal line products as an infrastructure has to be set up, e.g. call centers, customer service centers to serve these clients.
3. Alternative distribution channels pose risk to insurers due to instability of a business portfolio. Persistency of business, on average, is not favorable as lapsation/termination/surrender of policies is high compared with insurance intermediaries' business. To overcome the potential of mis-selling by other channels, insurers tend to design simple products. Also, distribution

agreements prove unstable when channels change to new insurers after expiry of an agreement, as the client base is their asset.

4. It is too early to address the issue of dis-intermediation as new and innovative channels keep on evolving, or to comment on the success of different new channels.

Intermediaries' Perspective: Alternative Forms of Distribution Channels

1. Fear of dis-intermediation with the emergence of alternative distribution channels.
2. Bancassurance poses the major threat to them as most of them claimed they were losing business to the other distribution channels, especially bank channels.
3. They were inclined to attend training courses so as to upgrade themselves in view of changes in products and client's needs in the financial services environment
4. Most of the agents engaged in competency upgrades and make inroads into transforming themselves into financial planners.

EFFECTIVENESS OF DIFFERENT FORMS OF DISTRIBUTION CHANNELS

Various forms of channels exhibit their different strengths and weaknesses. Their existence can complement each other in serving diverse market segments.

Bancassurance:

Banks have vast potential to generate an increasing volume of insurance business if proper management is in place to improve the quality of bank staff. Currently, banks are suitable for execution-only sales or commoditised products and for those customers who understand well what they buy.

The major drawback of this model lie in the hidden traps: the ownership of the client base, which remains the property/asset of the bank. The Bank has the choice to change corporate partners after termination of a distribution agreement if other insurers offer a better compensation system. Brand loyalty contributes to its success, but the quality of services provided to the customers is questionable. It still takes a long time for bank staff to adapt to the right attitude and approach in the provision of insurance services if bancassurance can be a success and can substitute for the existing distribution channels

Insurance intermediaries

Buyers who needs advice in choosing appropriate products will be better serviced by agents or brokers who are equipped with skills, knowledge and the adoption of a need-based approach in product recommendation. The complexity of products requires an agent to examine and recommend insurance products by going through a long application process with clients. According to the examination by Regan (1997) into the distribution channel preference from a transaction cost perspective, it was reported that intermediaries sell more complex products, whereas standardized products are sold by direct marketing.

While the domination of the agency channel is still pronounced in Hong Kong, this channel typically presents major problems often in the form of high expenses and low productivity. The expensiveness of the agency system is due to the overriding commission and incentives under its pyramid agency structure. The problem is further compounded by the continuous poaching of agents, causing increased cost to insurers due to high lapsation rate and recruitment costs. The industry so far has not been disciplined in these regards.

Harrision cited that the greater the human involvement, the greater the potential for variations in service quality (Harrision 2000). As far as insurance and financial service is concerned, the dominant customer preference is for face-to-face interaction or people-based activity. The Agency network remains as the dominant form of distribution. To compete with the direct sales operations and bancassurance, intermediaries must specialize and find a new position between these two competitive channels. Intermediaries must make use of their strengths in needs assessment and personalized service to have a competitive edge over these competitive channels to satisfy sophisticated customers. Agents have to target their market segments, sell different products and display high levels of performance.

Direct Marketing: Telemarketing distributes only standardized low benefit policies, and should therefore not pose a threat to existing intermediaries. Tailor-made products provide only limited forms of coverage.

E-Commerce: Insurance is a complex transaction requiring dialogue between insurers and customers over terms and condition of coverage. Communication is handicapped with a computer, by comparison with personal dealing with intermediaries either face to face or telephone dealing.

Most insurance products via these channels offer simple products with limited choice of coverage. Alternative distribution channels, although posing a threat to agents, can complement the insurance intermediary channel, as customers seeking for wider coverage must turn to agents for advice and purchase. There are still consumers who perceive that banks are largely for deposit and mortgages while insurers specialize in insurance.

Brand Loyalty

As a result of limited pre-purchase information available on financial services and the greater risk associated with the purchase, it might be expected that brand loyalty be prominent among financial services consumers. Bauer (1967) stated that brand loyalty is a "mean of economizing decision effort by substituting habit for repeated, deliberate decisions" which basically reduces the risks associated with the purchase.

THE FUTURE: INSURANCE INTERMEDIARIES

The emergence of new distribution channels triggers fear of dis-intermediation in the insurance intermediary profession. Dis-intermediation is defined "an economic term for dumping the middleman" (Maciag, 1996) or "squeezing out of agents from distribution channel" (Seasholtz 2000). While new distribution channels have created opportunities to bypass the traditional marketing channels, the impact on the intermediary profession is a major concern.

Credibility

Consumerism demands brand recognition, yet traditionally intermediaries have not relied on brand as a differentiating factor. Insurance intermediaries have to upgrade their ethical standards and establish credibility.

The Insurance-Buying Community in the New Information Age

Insurance is sold but not bought. The emergence and rapid adoption of Internet has changed the consumer's behavioral patterns. The impact of the Internet is gradually changing the profile of the sophisticated insurance buying community. Sophisticated customers shop for insurance instead of waiting to be sold. They search for information by looking into a number of resources although they will not buy over the Internet or other channels as they are cautious and prefer to approach experts to process information for them for product recommendation.

Competitiveness

To differentiate from the competitive channels, intermediaries have to rethink the way to upgrade their skill, developing into broad-based marketing professionals capable of utilizing customer profiles, and adopt flexibility in terms of customer approach so as to deliver added value to customers.

Many products that are sold directly to consumers today will more than likely continue to be sold directly through new channels. While agents may no longer sell some products within certain market segments, agents will leverage information technology channels to enhance the value of the products and services they provide. Being aware of internet developments, with technology getting easier to use and becoming more widespread, intermediaries have to 'informationalise' their business, improve the process, become more customer-focused in delivery services.

On-going Revolution

The role of insurance intermediaries in the future remains uncertain and is likely to vary within insurance and market segments. The success of insurance and financial service marketing depends on market segmentation and products and services offered based on their social and cultural needs.

Agency segmentation Studies (Connolly) revealed that the agency system still offers three key advantages, particularly in Asia where relationship rank as priority:

- Face to face contact or advice-based service is needed from intermediaries with an expanding array of new and complex insurance products
- Most customers' preference is an expectation of ongoing personal services; and
- Some customers makes insurance decision purchases with the encouragement or persuasion of insurance salesman

Recently, another survey by Milliman USA conducted among a group of life insurance company CEOs revealed that 87% of these leaders gave this indication: "an agent-based sales process will continue to dominate the distribution of insurance. Therefore, in the US, we believe worldwide, the agent channel in one form or another is here to stay. The challenge is to make this type of distribution as cost-effective and productive as possible".

A holistic approach in insurance and financial planning starts to emerge and the traditional way to retail different insurance products will diminish. Customer-focused, solution driven process and teaming up with specialists in other disciplines is important to intermediaries in the future – delivering value.

CONCLUSIONS

Distribution channels keep on evolving as a result of product developments and customer sophistication. Alternative or innovative forms of distribution channels remain the key competitive advantage, particular in the life insurance and non-life personal line sectors.

Bancassurance which remains dominant in future distribution among different forms of channels will be driven by the mutual interest of banks and insurance companies aiming for growth in the insurance sector.

It is widely accepted that the increasing level of insurance business sold through new channels, coupled with the domination of bancassurance, is an obstacle to insurance intermediaries. Intermediaries who can take advantage of modern information technology could open up new business opportunities, benefit from its growth potential and survive in the industry.

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