



Unique Aspects of Direct Marketing of Insurance Services

Kumar Kautilya

As insurers move to direct distribution and database marketing, new approaches to the business, integrating the marketing, underwriting and pricing activity will be increasingly important. Many insurers today are adopting increasingly sophisticated approaches to direct marketing, especially for automobile insurance. Large, sophisticated customer databases and sophisticated analytic approaches are used to direct marketing efforts. The underwriting, pricing and marketing roles at these companies are evolving but are still largely segregated. Each area functions in a highly specialized area, linked to the others but still compartmentalized. Marketing analyzes customers and customer lists to predict response rates and thus profitability of the marketing activity. Actuarial analyzes experience data to estimate loss costs by type of insured. This is often done with special actuarial databases, making little use of more extensive customer databases.

To achieve optimal results, more integration of these three roles is needed. The actuary will need to have active hands on involvement in the marketing process, helping the marketers move beyond response prediction, to analysis of loss costs as well.

Direct Marketing is increasing in importance in business in general, and in the insurance business in particular. Direct marketing is gaining share in the insurance business worldwide, with spectacular success in some areas such as U.K. auto. Database marketing techniques are increasing in sophistication, driven in part by increases in available computer power. Other Financial Services companies such as banks use these techniques well, and will bring them to the insurance markets, forcing insurers to adopt them to keep pace.

To maximize value from these techniques, they should not be viewed as simply a change in how insurance is marketed. They should be used in a way that has a broad impact on the entire operation, integrating marketing with pricing and underwriting. Direct marketers use very sophisticated analytic techniques, developed over many years of marketing a wide variety of products. Insurance is a unique product for these techniques in many respects. One very important respect is that the cost of goods sold is a function of who buys the product. For other products, direct marketing techniques are used to manage the volume of sales and the cost of selling, with the cost of the products sold taken as a fixed assumption in the analysis.

Managing the cost of goods sold is, in a sense, the focus of traditional actuarial pricing work. The actuary determines rates that will produce the targeted unit profits. The primary focus of the work is loss costs, which represent the bulk of the cost of goods

sold for most types of insurance. Marketing unit costs are typically taken as an input assumption.

By integrating database marketing techniques with traditional actuarial approaches, the total profits from the business sold can be managed more effectively. Management of loss costs and marketing costs will be integrated into a single process. This integration of marketing and pricing will impact the actuary's job tremendously. Traditionally, the pricing actuary has focused on rate analysis, typically reviewing each set of rates once or twice a year. The process for doing those reviews has not changed much for many years. That work has been coordinated with other areas of the company, but not closely integrated with them on a day-to-day basis.

In a database marketing environment, actuaries will have much larger data sets to analyze, updated much more frequently. Decisions concerning rate levels will be made frequently, not just for changing filed rates, but also for managing the marketing process.

First, there is a brief description of current processes in a nonintegrated approach. Then, direct marketing approaches in general use for all industries are described, including emerging database marketing techniques.

The goal of an integrated approach is to maximize this new objective function per dollar invested in marketing. The following sections go on to discuss how the marketing, pricing and underwriting functions should operate to accomplish that. Most of the principles discussed here generally apply to any line of business, in any country. Examples used here to illustrate these principles generally are based on Indian private passenger automobile insurance.

Traditional Approaches to Pricing, Underwriting and Marketing

Pricing

Traditionally, actuarial pricing activity has focused on the need to review and update the rates charged. Overall rate levels are reviewed every 6 to 12 months. Indicated changes in rates are filed with state regulators and implemented when approved. The process is entirely a cost-based analysis in form, but in practice there is usually some ;recognition of the market (e.g., competitor prices) reflected in the final rate decisions.

Underwriting

The underwriting activity involves a review of individual risk applications that are received. Rating data is verified, using tools such as motor vehicle reports. Risks are evaluated based on factors not in the rating plan - e.g., credit history, interactions of unusual variables. The underwriting process results in a decision whether to accept or reject the risk. It is frequently used to make judgmental adjustment to rates - e.g., assigning auto risks to one of several tiers: select, standard or nonstandard. This evaluation process is increasingly being done using expert systems.

Some underwriting decision rules are based on analysis of loss experience data, but many are not. Often they reflect the seasoned judgment of experienced insurance professionals as to what constitutes a good risk.

Marketing

The objective in traditional direct marketing is to maximize sales per dollar of investment in acquiring customers. This traditional approach assumes that the cost of goods sold per unit is fixed and known. That is the case for many products commonly sold through direct marketing. But not for insurance, where the cost of goods sold is a random variable, and the expected value of that random variable is a function of who the buyer is.

Direct marketers have developed very sophisticated analytic tools for maximizing the sales generated per dollar of marketing costs. The marketing databases to which those tools are applied are increasingly large and powerful. These will be discussed in some detail in the next section. Applied to managing marketing costs alone, these techniques impact only 10-20% of the premium dollar. If they can also be applied to manage loss costs, representing 70-80% of the premium dollar, the potential payoff is much greater.

Direct Marketing Techniques

Direct marketing techniques have been well developed over many years, for many different types of products. They have increased in sophistication as computing power has become cheaper, and as increasing amounts of consumer data have become available. For those readers not familiar with the field, there are many popular books describing it. Two good examples are listed in the Appendix. The brief description below is a very high level overview, intended as background for the following sections.

In most applications, the goal of direct marketing is to maximize the return per dollar invested in marketing - e.g., in creating and mailing a direct mail campaign. The return is typically measured in terms of numbers of sales or dollar volume of sales. Tools to manage that return include selecting who to mail to and design of marketing materials for direct mail. For other media, tools include advertising design, and choice of advertisement placement for print and radio and television.

In some cases, price is also a tool. By testing different prices, the company can select which combination of price (profit margin) and response rates (sales volume) will maximize total gross margins. Past results are the basis for analysis using those tools. For example, results of past direct mail campaigns can be used to select the best prospects for a new mailing. The results of the past campaign are analyzed to determine the key characteristics of people who bought - e.g., demographics, psychographics, prior buying behavior for similar products. There are many mailing lists that can be rented to identify new prospects. This data can be added to the company's house list (the database of its own customers' past behavior). Mathematical analyses identify prospects promising the best return per marketing dollar in the new campaign.

Similarly, results on past print, radio and television campaigns are analyzed for planning future advertisement placement. The impact of variations in advertising copy is reviewed as part of that process.

Marketing database tools have increased in size and power over the years. Successful direct marketers continually enrich their databases. Knowledge about customers and their buying behavior is a key competitive advantage. Marketing databases are constantly enriched through external data sources, through customer feedback and surveys, and through customer interaction with the call center. Sophisticated mathematical tools are used to analyze this data, to spot buying behaviour patterns that can help manage the marketing process more effectively. These tools are often based on linear regression models, enhanced by special techniques for examining interactions among variables. Sometimes advanced techniques such as Artificial Neural Networks are used.

In summary, direct marketing applies sophisticated mathematical techniques to large data sets, to manage the marketing process to maximize response rates or revenue generated. Much of this approach is valid for insurance as well, but the objective function - the item being maximized - should change.

References

- Gupta, A.S., "Executive Development in India: A futuristic Practice", Journal of Management , Vol. XI, No. 4, 1977.
- www.wikipedia.org.
- Rae P. Subba, "Essentials of Human Resource Management and Industrial Relations: Text Cases and Games", Delhi: Himalaya second revised and enlarged edition, 2003.
- Media Reports, Press Releases, Press Information Bureau.