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Distribution Channels and their Economic Role in the Insurance Business

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Outline

- What does distribution do?
- Multiplicity of channels
- Economic explanations for existence of multiple channels: demand versus supply
- Relevance of role of independent distributors
- Do independent distributors earn their fees?
Empirical evidence
- Conclusions

What does distribution do?

- Create value for customers and companies by helping the former to understand their financial needs and communicating such needs to the latter
- The role of distribution is particularly important in the financial sector: in other sectors people know their needs better
- In finance people often do not know their needs because of
 - low financial education (e.g. do not know which risks can be covered)
 - behavioral biases (e.g. underestimation of specific risks)

The importance of distribution

- Recent evidence on the financial crisis has highlighted the centrality of distribution in the business model
- For example the banking sector has increasingly relied upon an originate-to-distribute model whereby risks are created by lending but then immediately passed to other investors through financial markets
- It follows that distribution and production of financial products are deeply connected
- Insurance have also used this model but have retained a larger share of risks in their books
- The Summer crisis calls into question the effectiveness of the distribution channels to sell the right risks to the right investors

The various channels

- Direct employees at insurance companies
- Captive agents: work exclusively for one insurance company
- Independent agents (brokers): represent several companies and match insurance policies for their clients with the company that offers the best rate and coverage
- Bancassurance: a bank may distribute insurance policies originated in only one or more insurance companies

Evidence in the insurance market

- Wide differences between life and non-life and across countries
 - Dominance of bancassurance in life business
 - Dominance of agents in Italy in non-life
 - Balance among three channels in France and Spain in non-life

	DISTRIBUTION CHANNELS (LIFE)							
	INSURANCE COMPANY EMPLOYEES		AGENTS		BROKERS		BANCASSURANCE	
	1999	2005	1999	2005	1999	2005	1999	2005
SPAIN		0%		12.10%		11%		66.70%
FRANCE	17%	16%	9%	7%	9%	13%	60%	62%
ITALY	9.20%	12.40%	27.20%	18.20%	1.20%	1.10%	62.30%	68.30%

	DISTRIBUTION CHANNELS (NON-LIFE)							
	INSURANCE COMPANY EMPLOYEES		AGENTS		BROKERS		BANCASSURANCE	
	1999	2005	1999	2005	1999	2005	1999	2005
SPAIN		24%		39.70%		29%		6.80%
FRANCE	37%	35%	35%	35%	17%	18%	8%	9%
ITALY	3.80%	6.30%	88.50%	84.40%	7.20%	7.70%	0.50%	1.60%

Source: European insurance in figures, CEA Statistics, August 2007

Motivations

- Why do multiple channels persist in the long run?
 - Demand: varying complexity of products and of customers characteristics (young vs. old, retail customers vs. institutional clients, sophisticated vs. naive clients, clients with different risks to hedge) may be better served by different distribution channels
 - Supply: different choices of vertical integration on the part of insurance companies (independent agency versus exclusive dealing)

Demand

- Demand for insurance products is determined by:
 - amount of existing risks which are not covered by the public sector (e.g. health risks, pension risks)
 - level of financial literacy which may help people to better understand risks and appreciate the importance of hedging and of understanding the characteristics of the available products
 - evolution of financial needs, e.g. increasing interest in financial/insurance products for private pensions
- Various channels may be differently effective in trying to help people to understand risks and the best ways to hedge them

Demand

- Technology has affected the relationship: simple products can be directly purchased through direct telephone or Internet
- Complex products need understading and explanation on the part of experts, but there are issues regarding the level of trusts in the salesperson
- Young investors may be better skilled at looking for information on their own but there are crucial issues about the credibility of the information sources

Supply

- The crucial decision is whether the distribution channel should be independent or whether there should be an exclusive dealing arrangement
- Independent agency distribution has higher costs but may offer higher benefits as well
- Organizational forms (from the extreme of spot markets to the other extreme of vertical integration) are an attempt to minimize the sum of production and transaction costs (TC)
- TC are a function of the complexity and uncertainty of the transaction and the presence of relationship-specific investments

Example: investments in IT and advertising

- Investment in IT at points of sale is likely to be higher for exclusive dealing as the company is likely to repay the investment sooner than what would happen under independent agents
- Investment in brand to attract customers is more likely to be conducted under vertical integration as independent agents could shift the customer to a competitor
- Brand investment may reassure the distributor about the quality of the product because the insurance company cares more about reputation effects

Example: risk assessment

- Independent agents have advantages in autonomous valuations of risks
 - They can address the customers to various insurance companies therefore having an incentive to spend more resources for a better effort
 - They can capture a larger share of the profits from a correct decision which also promotes long-term relations between distributors and companies
- The more complex the decision to take the higher the value of an independent agent system

Example: risk bearing

- Higher uncertainty is better dealt with by an independent distribution system because:
 - Independent agents can diversify risk across insurers and products
 - Insurance companies may share risk with agents more than what they can do with an exclusive dealing system

The choice

- Which channels need to be used for what products?
- Independent agents may have advantages when:
 - Need to share business risks between producers and distributors
 - Credibility may be in doubt when there are incentives to sell particular financial assets that are produced in-house
 - Dynamic financial innovation competition requires salespeople to continuously update the supply of available products and one single company may have problems in keeping up with the competition

Benefits of independent channels

- But...do costly distribution channels deserve their fees?
- Recent literature looks at effectiveness of mutual fund distribution channels in the US
- The US involves several channels usually associated with various classes of mutual fund shares (direct channel, supermarket channel, consultants, A and B shares...)

New distribution channels

- At first the system seems to be efficient: ICI data show that distribution costs decreased 60% between 1980 and today due to
 - unitary decrease in costs
 - development of low-cost distribution channels, substituting expensive channels
- However, some research suggests that decreasing distribution costs have been associated with decreasing quality and that independent and high-value distribution channels have not performed according to expectations

Interplay between distribution and fund management

- Nanda, Wang and Zheng (2005) show that the introduction of multiple classes has attracted more investors: the increase in cash inflow in the first year after adopting a multiple-class structure is about 12%
- The new investors are often characterized by short investment horizons (they prefer classes that are more convenient to short term investors)
- This forces mutual fund managers to absorb more frequent liquidity shocks with negative effects on performance that can be quantified between 1.2 and 1.7% per annum
- The reduction in performance negatively affects net inflows (about -3% per annum)
- The final result is a partial crowding of long term investors by short term investors

Effectiveness of distribution

- Bergstresser, Chalmers and Tufano (2006) estimate that mutual fund investors paid \$3.6bn in front load fees, \$2.8bn in back end loads, \$8.8bn in 12b-1 fees and \$23.8 bn in management fees and other operational expenses in 2002
- This cost was too large as:
 - mutual funds sold through consulting channels cost the same as mutual funds sold through other channels but have risk-adjusted performances smaller than those of funds sold through other channels
 - in aggregate terms, the return of the asset allocation implicitly obtained through consulting is not different from that associated with direct choices of investors
 - consultants sell mainly funds that pay kickbacks: there is a link between the size of the kickback (through 12b-1 and front end loads) and sales on the part of consultants. A 0.25% increase in 12b-1 is associated with a 9% increase in sales
 - expense ratio is negatively related to sales in the direct channel while there is no link in the consulting channel

Effectiveness of distribution

- Christoffersen, Evans and Musto (2004) study the difference between independent consultants (unaffiliated brokers) and captive brokers. It is found that:
 - investors pay larger costs for the service of the former
 - the clients of both types of brokers are more sensitive to bad fund performance than the clients who directly buy funds
 - in case of divestment captive brokers tend to sell to their clients mutual funds belonging to the same family

Implications

- Independent distribution channels may not be so effective as they seem; hidden costs may negatively affect their effort in maximizing welfare of clients
- Where is true creation of value for the final investor? If financial markets are efficient then financial planning seems to be of great importance in assigning the right portfolios
- What are the implications for insurance companies and distribution channels for insurance products?
 - they should mainly focus on financial engineering and in the production/distribution of products for hedging well specified needs
 - the increasing relevance of credibility should be a primary concern in designing an effective distribution system with a careful thought given to incentives to maximize the welfare of customers