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THE FINANCIAL SERVICES INDUSTRY AND ITS RESPONSES TO INFLATION AND DEREGULATION

Moderator: PAUL MILGROM. Panelists: JOHN M. LENSER, MA ROSARIO RODOLFO, ROBERT D. SHAPIRO

1. Industry reconfiguration--relative competitiveness of various segments of the industry.
   a. Which products and markets form the financial services industry?
   b. What are the competitive strengths of the key segments of the financial services industry: banks, insurance companies, securities brokers, and integrated financial conglomerates?
   c. What are the viable strategic alternatives and what is required to implement them effectively?
   d. What strategies are being followed by the industry leaders?
   e. How will the pattern and timing of deregulations of financial services companies affect the ultimate structure of the industry?

2. New products and technological advance.
   a. What products are being developed to cope with inflationary conditions and soaring interest rates?
   b. Will advances in electronics, such as home information systems, have any significant impact on the financial services industry?

3. Impacts on the life insurance industry.
   a. Will life insurance be successfully marketed by banks? By department stores? By securities brokers? By the sellers of travel/entertainment cards? At what cost?
   b. Will investment products and banking services be successfully marketed by life insurers?

c. Are there really any cost or marketing advantages to selling packages of financial services, or are specialized companies more efficient than integrated firms?

MR. PAUL MILGROM: Our purpose here today is to discuss the remarkable changes that are taking place in the financial services industry in the United States. Now is a time of turmoil, not only for the insurance companies that employ most of you in the audience, but also for banks, securities brokers, financial planners, and everyone else who provides financial services to the consuming public. The turmoil I speak of includes not only the things commented on by the speakers earlier, the combination of inflation and recession that's undermining the financial security of American households, but also regulatory, institutional and technological change.

In just the last few years, we have seen money market mutual funds, starting almost from scratch, accumulate over $190 billion in assets. We have seen Congress liberalize the contribution limits on Keogh plans and IRA's and pass the Depository Institutions Deregulation and Monetary Control Act of 1980. We have witnessed a whole series of major acquisitions: Bache Halsey Stuart Shields by Prudential; Shearson Loeb Rhoades by American Express; and Dean Witter and Coldwell Banker by Sears.

There has also been a surge of major new product introductions. Merrill Lynch broke new ground with its Cash Management Account, and other brokerage houses have been scrambling to introduce their own versions of that product. Insurance companies, trying hard to retain their historical share of consumer savings, have introduced their own new products, like universal life, to compete with the mutual funds and brokerage houses. Banks and thrifts have issued an endless parade of new products of their own.

So far, my remarks have been limited to the changes that are taking place <u>within</u> the financial services industry, but there are other changes taking place in the general environment that may prove to be even more important for the future of the industry. The plummeting public confidence in the Social Security system and the high real rates of interest may, if they persist, lead to drastic increases in the rate of personal saving over the next decade. The growth opportunities that could present should be obvious. On the technological front, the explosive growth of two-way cable systems promises to open an important new avenue for reaching consumers in their homes. You can be sure that some innovative marketers will find ways to exploit the new opportunities that the home information systems offer.

A question that is certainly on many of your minds is: Who will succeed and who will fail in this new environment? Economic theory predicts that in an intensely competitive market, the successful firms will consist of two groups: those that offer a hard-to-copy product that is uniquely well suited for some important market segment, and those that control costs well enough to earn a good return on standard products. That simple recipe needs considerable elaboration before it becomes a workable basis for a corporate plan. Companies like Sears that plan to create a financial supermarket apparently believe that their approach delivers the most value to consumers at the least cost. Companies that continue to specialize in insurance or banking or securities brokerage are betting that specialization will enable them to reduce selling or administrative costs or to field more knowledgeable sales forces to set their products apart from the competition. Our distinguished panelists will offer their own opinions and they will tell us about the strategies adopted by some of the industry's leading firms.

Our three panelists today are Robert Shapiro, Director of National Life Insurance Consulting for TPF&C, Rosario Rodolfo, Vice President of Fireman's Fund American Life, and John Lenser, a consulting actuary with Milliman & Robertson who has been actively involved in planning for clients in the financial services industry.

MS. MA. ROSARIO RODOLFO: In his latest book, The Third Wave, Alvin Toffler makes the following observation about this strange new civilization we find ourselves in:

> "...as we explore the many new relationships springing up...we suddenly discover that many of the very same conditions that produce today's greatest perils also open fascinating new potentials."

So it is with the strange new financial services industry.

The principal forces that have brought about change in the industry have been discussed in many forums. To summarize:

1. Since the mid-70's we have seen the inflation rate remain at or near double digit, the prime rate move from about 6% to over 20%, fluctuating wildly in the process, and threatened or real recession. And today, when we have almost learned to accept continuing high inflation, we are beginning to read that we may face deflation instead, at least in the near term.

2. Largely as a result of the economic environment, today's consumer is more demanding and more sophisticated.

3. Partially in response to its inability to control the economic environment, government has supported deregulation of several industries, including the financial services industry.

4. And finally, advances in technology have opened up new opportunities for financial institutions, both big and small, to offer a broader and more flexible range of products and services and to realize significant improvements in operating efficiency.

Today, financial institutions operate under new rules. Its customers have new behavior patterns. And the traditional boundaries distinguishing the various competitors within the industry have blurred.

Paul asked the question: Who will succeed in this new environment? Who will succumb to the perils and who will seize on the new potentials?

Companies can succeed following one of two viable strategic alternatives: diversify or specialize.

It is clear that American Express has chosen the former. It has elected to develop a diversified, full-line financial services capability--what Paul refers to as a financial supermarket.

A recent Stanford Research Institute study counted a dizzying array of financial service outlets: 45,000 bank branches, 15,000 savings and loan offices, 25,000 finance companies, 35,000 credit unions, 500,000 insurance agents, and 100,000 stockbrokers.

The typical affluent American now deals with 20 different vendors, and purchases close to 40 different products and services from the financial community.

American Express believes that a large percentage of these customers will push for a much-needed streamlining and consolidation within the financial services industry, and eventual one-stop shopping.

In the words of chairman Jim Robinson:

> "It is my guess that the pressed-for-time consumer will want a more integrated set of financial services, a multiplicity of choice to manage his or her assets, the use of sophisticated access and transfer mechanisms for routine transactions, and more personalized service for crucial financial decisions."

Tactically American Express is positioning itself to offer consumers a variety of products and services: travelers' checks, credit card authorization and processing, point-of-sale terminals, debit and credit cards, insurance, annuities, securities, money market funds, financial planning, and tax-sheltered investments.

These products and services will be delivered to consumers through a variety of distribution systems: American Express' sales force, Shearson's brokers, Fireman's Fund's agents and field offices, the travel offices, direct mail, and in the future, interactive cable television.

Each of the corporations within the family will manufacture and distribute its own products and services; make these own products and services available for distributions by the other corporations within the family; and provide a distribution avenue for the other corporations' products and services.

American Express will reach consumers in cooperation with the banking community, whenever possible, and in competition with that community, when necessary.

While the strategy has been defined and articulated, effecting it is a difficult task. It requires bringing together in a common effort, three sizable organizations with very different characteristics: American Express, Shearson, and Fireman's Fund. That task is far from completed.

Life insurance companies in general have had particular difficulty adjusting to the changing financial services environment, because of our long history of success. For many years we sold essentially the same product, in the same way to very loyal customers. Profits were assured by declining mortality rates and interest margins on substantial policyholders' reserves.

In view of this success, there was generally little need to pay much attention to strategic planning; maximizing investment performance on the tremendous assets we had under management;

the hiring, training and retention of superior personnel; and marketing innovation and flexibility.

We ignored the consumer's message as we watched the proportion of disposable income spent on individual life insurance decline from 2.6% in 1968 to 1.8% in 1980, and sales of our traditional product decline from 57% of total individual sales in 1972 to less than 43% in 1980.

Without a change in our method of doing business, the life insurance agent would have to increase his productivity 800% in the next 10 years to have an income in 1992 equivalent to his income in 1982.

Within the diversified American Express financial services umbrella, Fireman's Fund American Life intends to play a specialized role. We will address two market segments: the affluent $50,000-and-over market and the middle income market of $25,000 to $50,000 income.

We are positioning ourselves in the affluent market to provide a targeted set of products responding to that market's demand for flexible, high-return, tax-favored options. These products will be manufactured within the Life Company or will be available through other American Express companies in the family, as well as through contract arrangements with other vendors.

In the affluent market, as well as for American Express as a diversified group of companies, a key to success will be our ability to develop and nurture customer relationships. Our goal in Fireman's Fund Life is to put in place a structure that will allow us to give personalized service to the affluent market for its more complex financial transactions.

We would like to be able to do this through a national network of financial planners who will act as a focal point for our affluent customers as they go through the process of making their financial decisions.

The problem, however, is to find a way for the financial planner to make a living, while maintaining his objectivity.

Although we are not targeting the affluent market, we believe that future success lies in effectively targeting the middle-income market. We are reaching the middle-income market with simple products distributed through streamlined cost-efficient mass marketing methods. Tactically more and more of our efforts are directed toward developing a superior capability in the market.

These are our plans. Obviously we think they will allow us to be winners. Time will tell how right--or how wrong--we are.

MR. ROBERT D. SHAPIRO: The turmoil in the industry today is obvious and, as companies come out of the stupor of the 60's and 70's where things worked almost in spite of what we did and recognize we are not going to be bailed out anymore by being able to maintain excess interest or constantly decreasing mortality, I think all of us have to look at our long-term strategies and refocus, getting away from the year-to-year kind of planning that worked no matter what we did ten years ago. I am going to start this presentation the wrong way. Our industry has always been too product-focused and I'm going to start by talking a little bit about what all the potential financial products and services are. That seems to be the way we most easily relate to where we are having to go over the next ten years. Then we will branch away from that into a process.

The financial products and services can be thought of perhaps in these six categories (and everybody has their own list).

a. Moneyhandling. Savings and checking are the obvious ones. The cash management accounts are another way of getting somebody's money.

b. Investments. Stocks, bonds, mutual funds, tax shelters, gems, whatever. Doing something with that money once you're handling it.

c. Insurance. We tend to think of life, health and annuities. Obviously, there is property and casualty insurance and financial guarantee insurance is sold, for example, by mortgage guarantee companies.

d. Real estate. Mortgage guarantee insurance is a real estate mortgage guarantee. Real estate brokerage, just a handling of mortgages.

e. Other financial services. Some of the things that American Express and Sears, for example, have done in financial counseling, travel, car rental, and so on. And something that doesn't always appear on the list but should once we get market focused are other non-financial products and services, because once we have gone away from starting with product and we start with market, there are other things that aren't financial that support our overall marketing strategies and shouldn't be forgotten.

So now that I've started on the wrong foot, the same way we've always done it, let's talk about a process of how we might get to a long-term corporate strategy that is often diversification oriented in the life industry today, particularly in the larger companies. Inflation is one of several key variables. Although inflation is in the title of this panel, it is awfully tough to separate inflation from the other factors, so I apologize for perhaps being a little more general than inflation in some of these comments.

As each of us in our life insurance companies attempt to identify right objectives and strategies for us, I think we tend to begin once we get over the product fixation with analyzing what we do well, our strengths, what opportunities exist for us, and how that relates to what we have in terms of resources and structures in our companies. But a very important thing for a life insurance company to do is not to lose focus on what it does uniquely. When it is competing with banks and stockbrokers and other financial institutions, not to forget that the life insurance company uniquely can insure life and health contingencies, uniquely can provide life insurance and annuities and health insurance, and uniquely has a product that develops from the level premium funding of long-term risks that has a tax favored status in terms of internal buildup. To forget these things at the start of the planning process tends to create a long-term plan that doesn't take advantage of some of the differentiated features of our industry. That is opinion.

If we start with these factors, and then step back and keep these in mind for the rest of the process and start looking at strengths and weaknesses of the company, I thought it might be helpful to look at two slides. One, a list of some of the strengths and opportunities that we often see in this part of the planning process. Some or all of which, rarely all of which, are found in some companies. Each company has its own mix and match. But the things that many life insurance companies have in part is something they should build from. Many of us have a large existing customer base, where the customers already have one of our company products. As a result of that, we have a continuous image because of No. 5 on my list, the established periodic contact. We are billing and collecting routinely, periodically, with these people, so they are not only a large base, but they are a base that we are close to.

We have a large existing distribution system, much of it in terms of our agency companies, and most of these agents have produced something for us in the recent past. So again, there is a positive, recent image contact. Strong financial resources. I think that is arguable. It certainly is company by company. But many companies do feel that they have strong capital surplus bases, warranted that there is some concern about the book value/market value cash flow problems.

We, as an industry, generally have excellent administrative systems. They are proven, and they are efficient; they have grown up over many years of doing roughly the same things. They should be proven and efficient. That is also a weakness, as we'll see, because the imposition of those systems on an organization that is changing dramatically, considerably constrains that organization. The established periodic contact we talked about and the strong image of security of the industry in general, that feeling of trust, is something that can be built on.

Then there are special skills within each company, they vary obviously from company to company, but agency management may be a skill in one company, direct response marketing, investment management, and so on. Again, I am going through a process and perhaps we can in conversation talk about the application to some specifics.

When we get to the weakness side, these are the kind of things we often hear in different forms and different patterns from company to company. Although we have a large existing customer bases, we have limited control and that is particularly true where that customer is really related to the company through an agent. It is really the agent's customer base, not ours. We have limited control of our distribution system in many companies, particularly when we're operating through independent brokers. We have a number of what I call constraining sacred cows where we have things embedded in our corporate structures that constrain developing new things in a mode that isn't consistent with the way we have administered the trust in the last 20 or 30 years.

Things that are really good in an organization that is in a maintenance mode, quality control procedures, checks and double checks, completely stifle the development of new business in that those same things are applied to the new business development process. Non-creative management. As a result of some of these constraints, we tend to be either frustrated in our creativity or not attract creative people, we tend to get people who do maintain things well and don't take risks, we don't have many failures in terms of things that don't work and sometimes don't recognize that the continuation of what we are doing is failure. Our existing contracts, although they are there, are vulnerable because of many of the things that the other panelists will talk about and that I think are pretty well known. There is always the adverse press and the limiting regulation as we expand our financial services and get involved more and more with things that cross into the interest of the FCC, IRS, FTC. We are also looking at a lot more federal regulation that must be dealt with.

Each company will come up with its own list and I think that each company will have certain obvious strengths, certain obvious weaknesses, and in my opinion, they should always keep in mind the industry's unique strengths and unique features.

How does inflation enter into all this? What is inflation's impact? All the things that inflation impacts are listed in every one of these presentations. Obviously, we have high interest rates - they are also volatile. I don't think there is a simple economic theory that explains everything anymore. And the implication there includes having to spend more time doing variance analysis, alternative scenario analysis, to stop building in risk implicitly, but explicity to build in all the different things that can happen. We tend to say if an assumption is conservative, that accounts for the risk, but I don't think that is any longer a good way to run the life insurance business. We obviously have intense expense pressures, increased lapses, loans, and replacements, and reduced assets values. Those things squeeze our financial statement so that people are aware that those things are happening to us.

The inflation has also reduced confidence not only at the buyer level but within some of our companies. Obviously, the fixed income products like traditional ordinary life are under pressure. The management problems are exposed. Back in the 60's and 70's, the life insurance industry was often talked about as an industry progressing along this kind of growth and profit pattern. The variance between companies is obviously wide and will continue to widen and, instead of everybody going along nice and smoothly, we will have winners and losers and very obvious winners and losers five or ten years from now.

The increased consumer awareness is something that is talked about. Rather than get bogged down in this list, just recognize that this is where inflation does impact the process and we have to think about it much like we keep in mind the industry uniqueness. But the consolidated bottom line is that we are going to have companies that are not the same from company to company. Wide differences in performance and a critical need for management that is sophisticated in terms of current management techniques and has long-term vision not just in terms of how to maintain what we have had for another ten years, but long-term visions that will produce something that will be on the books ten years from now other than just a remnant of what's there to date.

Where do we start? I have this trite thing that I play with my kids all the time by putting a glass on the table that's half full of water and say describe that. Of course, a couple of them will say half empty and a couple of them will say half full and I will give them the lecture that you always look at it as half full. I think that trite example may be one way to approach what's going on out there. In many ways, although lots of problems have been created today, much of what we are doing is probably what we should have done ten years ago. So, the environment is forcing us to do something that even had it not done what it has done to us, we would have had to do sooner or later, and we are being forced to do it under duress, but it probably is good for us.

One approach to starting to define what we should become ten years from now is to identify the key perceiver groups that we need to be concerned with ten years from now - those groups that we want to perceive us a certain way - then try to list two or three sentences very carefully as to what we would like them to be saying about us if we do, in fact, achieve what we want to be.

I think it is important to classify these things broadly enough to allow for a change from what we are today, but identify what you would like the distributors of your products to be saying about you if you succeed. And by going through this process you start to get a feel for what the difference between what you would like them to be saying and what they are saying is, and you can start to use that difference as a foundation for building a strategy. Once this process has gone through, this is not a step-by-step thing - a lot of this is a continuous and related process - the next thing we need to do is look at the key to diversification issues.

If my next slide looks like a strategic planning list, it probably is, but obviously, diversification is just a subset of a strategic plan. There is nothing magic about a company diversifying - diversification is always going on. It can be done through internal development, acquisition, what have you, but diversification in the broad sense is the expansion in one's business and to grow one has to expand his business either building on what he has or developing something else. The key question is, what business are we in? - and that will be defined by the previous slide - what we want people to be saying about us. That will define business in the broad sense that we will be in.

What is our market? It sounds obvious, but that isn't the way we usually start our planning in this industry. By asking what is our market - that is not what the top 100 agents think our market is, it is what is our market given that definition of business. How many companies interpret the marketplace through their top 100 agents, forgetting about the next 100 and the next 100 and the 100 that left because they didn't make it when, in fact, there is a lot broader market than the one seen through the honor group of agents. We don't start with market, we start with product and we too often look at distributor and interpret market through distributor. So it's first, what is our business? Then, what is our market? Then, what products and services do we need to properly serve that define market or those markets.

Given that, what is the best way to distribute the products? This is the logical marketing approach to diversification strategy. Once you have answered those three marketing questions after what business we are in, there are three fundamental structural questions, the things that have to be aligned right so that the marketing strategy works. How do we manage our capital - the crux of that is how do we trade off short-term results for long-term performance? How do we get over the hump of having this pressure to get next year's earnings at a certain level when what we really need to do is somehow sacrifice that to do the right things long-term. How do we organize flexibly? How do we both administer what we have well, and allow for the new developments that are required in any kind of diversification particularly when we are going away from life insurance that what we know and things that we don't know and requires a different kind of knowledge and different kind of manager. And last, how do we attract and retain compatible management. Management that can fulfill those things we're not used to doing.

The next slide sort of simplifies the process that you might then go through once you define your environment goals, opportunities and strategy. Once we define all of those things in terms of the self-analysis that has been gone through, it is very helpful to list the five or six what I would call critical success factors, the things that you have to do well to achieve the strategy, and once you've listed those things to go inside your organization, identify the resources you have, the culture of the organization, the systems, the policies, the structure. All those determine what might be called distinctive compentencies - the things that you now do well. When we first list the critical success factors, things we have to do well, and match them against the distinctive competencies, things we now do well will never find a match.

The process of optimizing the chance of getting a strategy developed is one of making sure that the things you do well are the things you have to do well, and it's a simple schematic that, I think, displays that process. Too often, we go into our companies and reorganize without the total picture in mind. We'll develop a strategy and forget that the culture doesn't allow us to do the new things we need to do. There has to be a matching of what we do well, what we need to do well, and some give and take in that process. Cherri is the only one up here that really represents one of the big five financial services companies that's always in the press - so it isn't fair to do this, but it might be fun to talk about how those companies go through this kind of process. Since we are unencumbered by facts, we can attribute anything to them.

There are a lot of different sub-strategies that can be talked about between a speciality company and a full financial services company. Some companies are trying to enhance their current agents, or steal agents, or target certain markets or target certain distributor groups; those are all between specialization and full financial services. When we look at the characteristics of a winner in 1990 because there will be an obvious list of winners and losers, these are the things that I believe you'll find in the companies that succeed and many of those companies will not be those companies we find in the top 20 or 30 in our listings today. First they'll have a clear image of what they want to be in the future and everybody will live that image and the strategy comes out of that image.

Strategy won't be something that's developed by some external consultant and thrown in a drawer with everybody feeling comfortable. This involves a lot of communication and other things that many of us don't find in our organization - but companies that succeed need to have this common feeling, common sense of where they are going and tie into the overriding strategy. The companies will maintain a market sensitivity. Getting back to the first step and the classical marketing strategy development is what is our market. When the company starts there, they then know the group that they have to understand in terms of wants and needs and characteristics and those companies that have a well-developed market research - market attitude capability will succeed. Those that don't - those that continue to read those markets through third parties will probably not succeed. Dealing from strengths, that's obvious, fosters innovativeness; that doesn't mean a whole lot. What it really means is to make sure that the new business operations are organized and staffed in a way that they can succeed. It is very difficult to take a traditional life insurance company and throw in a very esoteric new financial service that may very well be appropriate for the markets to find and extrapolate personnel and procedures and everything else from the existing company and expect it to work. I think operating efficiently follows developing an organization to facilitate the development of the strategy.

MR. JOHN LENSER: The broad topic of this panel is the financial services industry and its response to inflation and deregulation. My own topic is much more narrow in focus. My remarks are entitled, "The Impact of the Insurance Product Line and Expanding the Wall Street Securities Firms into Broad Scale Financial Services Firms." What I would like to do today is describe some of the things I have seen happening in recent years. I don't claim to be able to predict where this particular segment of the financial services industry will go, but based on what I've seen and my own personal individual perceptions of how the financial services industry can efficiently serve me, I would like to say why I believe that such an industry can work. Whether it will work depends, of course, on the perceptions of millions of other consumers on the presence or absence of key individuals in the industry, of the will to make it work, and on a multitude of other unpredictable and, in some cases, unknown factors in the general environment. With that caution as to the limited basis for my remarks, let me begin.

What I am going to do is take fifteen minutes or so to talk about the Wall Street brokerage houses, the securities firms, and the position that they have established already in the financial services industry. I have spent much of the past six or seven years working with several of the brokerage firms and with many small and medium-sized insurance companies who have been providing insurance and annuity products to those securities firms. During those years, I have seen the insurance and annuity activities of those firms grow from almost their very beginnings and develop into firmly established operations that make a substantial contribution to the total revenue of those brokerage firms. A strong and competitive insurance and annuity marketing that competes alongside the existing life insurance agency network, and the direct marketing distribution that works, has been created by these people.

My perspective and attitude then are those of someone who has seen a segment of the financial services industry actually working, expanding and establishing itself. I believe that there is a place for it and it will work and I believe that I can see some of the ways in which the distribution system already works as an efficient mechanism for providing valuable financial services to consumers. The securities firms have already established a position. In my remarks today I want to focus on the way in which the brokerage community has been and will be a factor in creating, shaping and generally being a part of that financial services industry that is emerging; then I would like to speculate a little bit on how it will continue to take shape, expand and grow.

First, let me take a little time to recite what has happened over the past six or eight years.

In October of 1980, I made a presentation at the annual meeting of the Actuaries' Club of New York concerning the financial services industry. At that time, I described some of the activity that had already taken place. First, in the area of mergers and acquisitions involving insurance companies and securities firms. Second, I also commented on the growth and the volume of sales and the variety of insurance and annuity products marketed by the securities firms. And, third, I commented on the internal structural changes that were occurring that would tend to entrench insurance and annuity operations within various individual securities firms.

In the eighteen months since I made those remarks in New York, the pace of activity in all of these areas has increased dramatically. The most visible changes that have taken place are probably in the area of mergers and acquisitions. The least visible, but perhaps the most significant, have been the changes that have occurred internally. In the middle lie various changes in marketing, changes in product mix and the volume of business they are doing, the marketing arrangements, etc. Let me talk about these recent developments as well as the activities that proceeded them.

In the area of mergers and acquisitions during the middle and late 70's, there was some activity involving insurance companies and securities firms. Merrill Lynch had a quiet family life background in 1974, E. F. Hutton acquired Life of California back in the late 70's, renaming it E. F. Hutton Life in 1980, Dean Witter acquired Surety Life in that period and, going the other way, the Bache Group has acquired several insurance marketing organizations.

The really heavy activity involving the big guns has occurred in the last year and a half, however. In that period, as you know, Prudential acquired Bache (in this case, the acquirer becamed the acquired) and, subsequently, Prudential, I believe, divested itself of the Bache Insurance Services operation that Bache had put together earlier. Sears acquired Dean Witter, American Express acquired Shearson, Loebe Rhoades, and several other acquisitions of smaller regional securities firms by insurance companies have also been in the news recently.

Moving away from mergers and acquisitions, let's take a look at some of the products that these securities firms have been marketing in the past. Since 1974 or 1975, and, in some cases earlier than that, the Wall Street securities firms have been heavily involved in marketing the various insurance products, particularly, as most of you know, the single premium deferred annuities. During the years from about 1975 to 1980, single premium deferred annuity sales of close to $3 billion were written in half a dozen insurance companies whose total annuity reserves at the beginning of 1975 were less than $50 million. The great bulk of that business was written by the brokerage firms.

Capital Life and Anchor National each had annuity reserves in excess of $1 billion. More recently, in 1981, National Investors Life Insurance Company and its affiliates developed more than $1 billion of single premium deferred annuity business in one year. Also in 1981, I believe at least a couple of the major securities firms individually wrote more than $1 billion of annuity premiums on a combination of both fixed and variable annuities. In mid-1980, the securities firms began to get heavily involved with the variable annuity, but in a form quite different from that annuity which had been marketed in the early 70's by the insurance companies. We began to see names like Rainbow, Galaxy, Spectrum and others. They were on products which provided a variable annuity with a variety of funds backing the annuity.

The sales of this variable annuity built up during 1980 and through much of 1981 until the adverse revenue ruling 81-225 appeared late in 1981. Before the ruling appeared, however, a number of insurance companies had developed similar annuity products that they were marketing through the brokerage firms or through life insurance agents or both. Also, Massachusetts Financial Services, a mutual fund operator, was supplying the backup funds, the mutual funds, for a couple of annuities for Nationwide Spectrum and another marketed on an agent basis by, I believe, Northwestern National.

Other companies that began to put together variable annuities for the brokerage firms were Kemper Financial Services through

Kemper Investors Life Insurance Company; Keystone Provident, I believe had a variable annuity and Merrill Lynch's insurance subsidiary, Family Life, introduced its own variable annuity in the middle of 1981 for marketing by Merrill Lynch account executives. In the early part of 1981, Monarch Insurance Company introduced a variable life insurance product backed by, again, a variety of mutual funds managed by Merrill Lynch Asset Management. That product was initially sold by Monarch agents and then following that was sold on a test basis by Merrill Lynch's account executives. More recently, it has been sold on a nationwide basis to the extent that it has been approved by Merrill Lynch's account executives.

Interestingly enough, at the same time in the area of variable life insurance, John Hancock introduced its product and the Equitable also introduced its product - which has been on the market for many years. They have modified their product and backed it with a small variety of funds, more in line with what was being done with the product being marketed through the brokerage firms. Both variable life and variable annuity are products that in their initial form and in the initial attempts to bring them to the market have encountered at best, I think, a limited success when they were being marketed primarily through life insurance agents.

As you can see, the securities firms have been writing a wide variety of insurance and annuity products and, as far as the variable products are concerned, they seem to have enhanced the ability of the insurance companies to market them. Perhaps it was easier and more efficient to introduce products such as these by marketing them through account executives and adding a few enhancements to the products and allowing sales to expand through such a sales force than to start them with a life insurance agency marketing network whose market may have generally been not quite as well suited to the product as that of the account executives of the securities firms.

Finally, in late 1981 and the early part of 1982, we have seen the brokerage firms add to their portfolio the universal life products that were popularized by E. F. Hutton and, more recently, by the Occidental. I think the securities firms have had a considerable impact on product design in the few years they have been involved in marketing the products. Particularly with respect to products like variable life insurance, variable annuities, also single premium deferred annuities and, to a lesser degree, universal life. They have had a dramatic impact on certain insurance companies where they have written large volumes of business and I think they are beginning to have some impact on the structure of the compensation scales.

The third area in which changes have taken place was internal. There has been a substantial penetration with regard to the portion of account executives who are licensed to sell insurance, annuities and variable annuities. In some of the larger firms, 75% to 85% of the account executives are licensed to sell insurance. The portion who actually sell such contracts is somewhat smaller because of various reasons, such as turnover of account executives and the fact that many of them specialize in certain products. This is to be expected, and there is some feeling that the real maximum for this figure might be 50%-60%; but there has been a substantial growth in this area, too. Today, perhaps 45% or more of the account executives in some larger brokerage firms will sell one or more annuities this year compared to approximately 5%-15% six or seven years ago.

The internal growth in these organizations has obviously taken place in areas such as sales administration where they have had to increase staffing because of sales volumes and such, but in addition to that, in other internal areas they are becoming stronger and more capable of handling an insurance annuity operation. The impact of insurance and annuity-related income on the earnings of the security firms is much more significant now than it was a few years ago. Consequently, firms are devoting more attention to the sources of such earnings.

The insurance companies are working with the marketing methods, etc., and are devoting more attention to stabilizing and increasing these earnings. This, therefore, means more internal staffing to deal with the problems related with that. In addition, the products that they are marketing have become more complex and the uncertainty associated particularly with the regulatory activities surrounding these products has increased. This has been particularly true with variable annuities and also with universal life and variable life. Consequently, more time, effort and manpower are being expended in what's referred to as their due diligence activity related to those products and that develops a greater expertise within the company in those areas as well as developing a stronger position with respect to those products.

The internal changes that I've seen - as well as the marketing and merger activity - create a momentum and I think that the ball is rolling for the securities firms that have moved into the financial services industry by way of these life insurance annuity products. The mere fact of that momentum, I think, will make it more difficult to hold back something like the financial services industry.

That gives you a brief sketch of what I have observed. As to continued expansion of this segment of the financial services industry, I believe that the marketing of insurance and annuity products by the securities firms will continue to expand just as their product base grew from a small volume of single premium deferred annuities in the early 1970's to an enormous production of single premium deferred annuity income in 1980 and 1981. I also believe that the current small base of income from products such as variable annuities, variable life insurance, universal life, single premium whole life and other such products will increase greatly during the 1980's.

In terms of product mix, the firms have been selling single premium deferred annuity in a variety of forms and will continue to do so. Variable life insurance has been sold, as well as traditional whole life and term products, variable annuities backed by a variety of funds, selling IRA's and ILR and single-premium life insurance. And I think they will continue to sell these products heavily through insurance companies that are not associated with the securities firms as well as those that are subsidiaries of the firms.

What about the future with respect to the need for a financial services industry? I said I think they're well enough established, they can continue to grow, that they have an internal base, and they have developed products that they can sell. Is there need for a financial services industry? As I said, I believe the elements are there--the elements that are prerequisites, the growth of a financial services industry out of the securities firms - they're already in place and they have been to varying degrees for at least several years.

Is there a need? Well, I think that there is. I conducted a small marketing survey. One person. Myself. I asked myself whether I felt that such an industry would be of value to me and whether I would avail myself of the services of a financial services industry if it existed and my answer was yes. I believe this is the first marketing survey ever where respondents expressed unanimous approval of a proposal.

Why did I say yes? Well, here's what I see a financial services industry doing for me. I think that such an industry could, and based on its brief record to date, would provide me, the consumer, with services on a more efficient basis and, therefore, at a potentially lower cost and that I would have more convenient access to those services. First, I would have all or many financial services in one stop. That I guess is probably the most commonly cited reason for development of such an industry. When I say one stop, not necessarily one life insurance agent or one account executive, but one phone number, one location or one source in which I have confidence, is the key to it. It's that confidence I think which is the key to the efficiency of the financial services industry. When I find an account executive or an insurance agent who provides me with the products that I need, handles my policyholder's service and claim problem as well, and generally makes me confident of his abilities, honesty and integrity, I want him to handle other financial matters for me because I have confidence in him and his company. Once they have gained that confidence, they can sell me a variety of services--in fact, I think that they're inefficient and they're letting my confidence in them be wasted if they don't do that.

I may listen when E. F. Hutton talks and I may listen but with a little more strain when the quiet company talks. And if the Merrill Lynch bull winding its way through the maze of the securities industry or a china shop can sell me securities, then I think it can also sell me insurance and annuities and a variety of other financial services. In fact, it is again, I think, wasteful and inefficient if that financial company, and its agent or account executive in whom I have confidence, doesn't use that relationship, image and trust to sell me a variety of services.

My personal objective in dealing with a life insurance company, securities firm, property/casualty insurance company or any other such financial organization, is to obtain some sort of financial security. I trust the companies that I turn to for those services.

Financial companies that use that trust to sell me and other consumers a full range of financial services are using that trust and that relationship to provide services more efficiently and to let me obtain those services more conveniently. It seems to me that these are good reasons for the existence of the financial services industry and I look forward to the continuing development of such an industry. Thank you.

MR. MILGROM: Well, thank you, John, and thank you all of our panelists. I would like to open a question and answer and discussion section and I'd like to open it by asking the first question myself--taking advantage of my privilege as the moderator. I think the gauntlet has been thrown down by a lot of companies, by the panelists in their discussion, and the companies that are trying to offer integrated financial services providing insurance and brokerage services. Sears is trying to provide everything, and I think that perhaps at this juncture it is useful to look to other industries and see whether something can be learned from their experiences. This is not the first time that Sears has offered a wide range of services under one roof. They offer a wide range of retailing services right now and they have found themselves competing with speciality stores. Sears has not done that well financially on their retailing end. In fact, companies which have been more narrowly specialized, such as Toys-R-Us competing with Sears in selling toys, have done significantly better. So what occurs to me as the natural question to ask is: why should we think, in the context of financial services, that integrating services and selling many under one roof is likely to be successful, when Sears has had less success in doing the same thing in retailing? That's a question I'd like to pose to all three of the panelists.

MR. LENSER: I'll try one shot at it. This goes back to a remark that I made just a minute ago. I don't care all that much who I buy my toys from, whether it's Toys-R-Us or some other store, Sears or someone else. The essence or the critical element of the relationship that I have where financial security is involved is trust and that means trust in a particular company and trust in a particular agent or account executive or whoever provides that service. I think that they can use, as I said before, that trust and confidence I have in them to sell me a variety of services and I think they can do it more efficiently if they are selling life insurance to me and they also have available securities and they have available money market funds and other things. The mailing lists and such that they have from this, from the list of life insurance clients gives them ready access to people to whom they can sell a variety of other services.

MR. SHAPIRO: I think John is right that trust is important. But when the life insurance industry talked full financial services in the 60's, "one stop selling," that quickly died. I think the problem was that synergy is tough to do at the point of sale and the problems that we've seen are that the individual who has the relationship with the customer doesn't have the capability of selling expanded products and services. Hence you can give them those products and services, or six months later they're back selling what they were before. Or, you take the tact that says, we'll develop that relationship with other experts and then the individual who has the primary contact doesn't trust somebody else coming into that relationship so there's a whole lot of breaking down that has to be done at the point of sale to synergize all these financial services. That doesn't happen if you start with market instead of starting with distribution system, but many companies can't do that.

MS. RODOLFO: I think the answer to your question is different depending on the company and I think the answer may be seen probably by looking at the process Bob described. It's a listing of what you need in order to succeed in that strategy and what you have. I don't know the answer to the specific question of Sears verus Toys-R-Us, but I do think there is another way of looking at it which is different. You viewed Toys-R-Us as a speciality company. On the other hand, couldn't we view it as a diversified toy company relative to Sears because when you went to Toys-R-Us you had a wide array of toys to choose from and when you went to Sears you had a very specialized, lower income type specialized toy variety to choose from. So I guess I don't know the answer, but the process that one would go through is what Bob had described.

MR. LENSER: I think I'd add two comments that relate to what Bob said. I would agree that certainly one of the critical problems is that an individual account executive or life insurance agent probably can't and probably doesn't himself want to sell a really wide variety of products, and that's a key problem that has to be dealt with and solved. That doesn't mean that the firm can't offer all of those things, but I would agree that's a problem. As to the 1960's versus today and the relative probability of success of such an industry, I think several of the things that Cherri Rudolfo pointed out have a bearing here. One is that there probably is a more sophisticated consumer that we're dealing with here today. Deregulation may make it easier, and more than anything she mentioned, changes in technology. I think that may make it more feasible today than it was twenty years ago.

MR. WILFRED A. KRAEGEL: I would like to ask the panel what they thought about an article by Stewart Gainsley a few weeks ago, I think it was in the National Underwriter. He suggested that consumers do not want to buy all their financial services from one source because they feel uneasy about having somebody having information about all their financial transactions.

MR. LENSER: I believe that. When Cherri mentioned earlier the variety of vendors of financial services and the numbers of people from whom we buy our financial services, the numbers were big. In fact, I think she said twenty might be the average number of people from whom we buy financial services. And that means you don't have to narrow it down to one. I'm not interested in buying everything from one vendor either but it might mean that I get it down to two or three people and, responding for myself personally, it gets back to the convenience of dealing with one, two or three people in whom I have confidence, and I think that's worth a great deal.

MR. ROBIN B. LECKIE: I have a question for the panel. You have given us a very interesting outline of the changes we can expect in the next few years. Rather dynamic changes will take place in our industry in terms of financial services, obvious changes in your product and the structure. I wonder if you'd care to comment on those changes you expect to see in the role of the actuary and the future of the life insurance product.

MR. LENSER: There are two things that I think I see occurring. One is that it seems the rate of change of products has certainly speeded up over the last several years, probably during much of the late 70's, at least in the work I am involved in it as a consultant. It seems the pace of change of products is great and that is likely to continue. We're therefore likely to be as involved as we have been in the past but maybe more related to products such as variable annuity or variable life, security type products. In addition to that, I suppose that given the accumulation nature of some of the products and the problems we've seen with products - like single premium deferred annuity in particular and perhaps also with universal life products where funds may move from one carrier to another more frequently than they have in the past - I certainly would think that we will be much more involved with the questions of asset liability matching and cash flow generally and more involved in working with investment people in our insurance companies. Perhaps that's commonplace already in many larger companies but that's not so common in some smaller companies.

MR. SHAPIRO: I guess I'd add that the whole education process needs to be refocused to make us better businessmen, focus more on communication, decision making and things like that with less technical focus. All the things that seemed so right ten years ago in terms of projecting your best, your most expected results without a lot of additional business and sensitivity analysis, I don't think will work any more. And I think the education policy committee of the Society is wrestling with that and getting more of those things on the syllabus. I think we really have to push for more business orientation, more decision making kinds of things, otherwise we're going to be staff people and we're going to be out of all the action, and I think most of us want to be where the action is because that's where the fun is. And I don't think we can do it with a very narrow focus education.

MR. MILGROM: Let me ask a question of the panel, too, and also of the audience, for those of you who have some background in this. There have been a lot of rumors flying around about the difficulties that some of the conglomerates have had digesting their acquisitions; stories that Merrill Lynch has had trouble with their account executives not wanting to turn customers over to real estate salesmen; stories about the differing management styles between the American Express senior staff and the senior staff at Shearson. With those kinds of stories going around, let me ask Cherri in particular, who is with American Express: What's happening in terms of digesting these acquisitions? Are these groups really turning out to be compatible?

MS. RODOLFO: Well, I think it's true that there's a lot of indigestion going on right now, nd it will be a slow, difficult process. But it's a process that's got to be gone through if one takes the posture of getting these organizations working together. I think the only way it can be done is through very senior management doing it themselves and being very articulate and forceful in getting the word down. But it is difficult, as I said. That task for American Express is far from complete.

MR. MARTIN STAEHLIN: I want to respond to Mr. Leckie's question. I agree. It seems to me that the main thing that the actuaries contribute to this environment that's developing is as a forecaster and a marketer, not your traditional technical background as it relates to pricing and what the entrepreneur says about these products. Everybody says strategic planning is important and that long-term planning is important. And so you try to look forward and try to do some marketing and some projecting and there's so much uncertainty because of inflation. Even if you can demonstrate the best actuarial marketing, there's usually a short-term penalty. You can quantify that act and that gets to be your biggest focus--that short-term penalty and the fact that relative to the scenario that you were wrong last year about inflation, and you were wrong about cost shifting and Medicare. What's going on in inflation today is one of the causes of this degree of uncertainty and it sort of negates most of the strategic planning you're doing. Then what happens is like in the financial services industry, something that's expanding. The insurance company gets hit with people, brokers and other people coming up with these products, variable annuities and such, and how come you don't like this product? Well, we did tell you about this a few years ago, but there was a short-term penalty and then you scramble and you get the same answer. So I think the goal of the actuary is sort of to be uniquely positioned in that we start out as technicians, get involved in sharing it, and involved in marketing.

MR. J. ROSS HANSON: My question revolves around the notion that it seems as if we talk about the life insurance company as acquiring other services which it will offer in some basket of services. But when we talk about the financial services industry and the life insurance business, the reality is that the other financial services industries are miles ahead of us in their flexibility of systems, their sales compensation and a host of other things, and they are really acquiring us. In the last year or two we've seen the life insurance industry unbundle the investment aspect of its product from the insurance aspect, and we've seen the insurance press and the other press recommend this new thing very highly and say clearly, now the life insurance industry has invented the very best kind of life insurance policy. But what in fact I think we've done is divide our product into two financial services: the accumulation of money and the cost of paying for some life contingency, whether it's a fear for the cost of dying or the cost of living too long. I guess my ultimate question to the panel is, is there really going to be anything left of the life insurance business beyond annual renewable term insurance guaranteed to some age like 95? I mean, what is there left for us because we are being acquired. I don't think we are diversifying; we are being acquired.

MR. SHAPIRO: I guess that's all there will be left for some companies certainly if a life insurance company is acquried by somebody with all the other financial services. That corporate structure may be left with one-year term premiums, but I'm not so sure that the concepts of level premium funding for lots of reasons including convenience, expectations, especially in the middle and lower income groups, isn't valid, even in the upper income groups. Within a life insurance company today, I think there's been a lot of press for universal life. I think it was fairly slanted. I think you're seeing a lot of press on the balancing side and a fair number of changes going on in universal life types of products. That isn't the only way. It's the right way for some companies and the wrong way for others. My guess is some companies jumped into it when they shouldn't have and created a situation where they'll get only term insurance premiums, and they really can't manage the investment side of that kind of product. But I guess I would favor long-term. I have hoped that the concepts of level premium funding could involve a better reflection of current investment return in some way. It isn't dead.

MR. MILGROM: I would like to comment on that question, too. Level premium funding seems to make the most sense in an environment where prices are fairly stable so that the level premiums are level in some real sense when incomes are fairly level and when prices are fairly level. The insurance industry has always, in effect, been providing a combination of savings and insurance, and part of what determined the packaging was the environment in which we lived when prices were more stable, as were the costs of providing those services. A level premium format worked well in an era when everything was hand processed. It was much cheaper to run than any kind of more sophisticated format. I think that the change in technology has made it possible to be flexible, has made it cheaper to be flexible and the change in the economic environment has made it necessary to be flexible. Flexibility is what the consuming public is now demanding.

MR. SHAPIRO: I'd say flexibility is probably not as well understood by the lower and middle income markets as by the upper income markets.

MR. RONALD E. TIMPE: I have been interpreting the panel's comments as relating to the marketing of individual insurance purchased by individuals for their own sake. Would any of the panelists care to comment on the potential for specializing in the marketing of group insurance and whether or not specialization is more feasible in that area?

MR. LENSER: Take a firm such as one of those that I was describing, for example a company like Merrill Lynch that is now selling a variety of insurance products as well as securities, variable annuities, variable life insurance, retired life, and reserve products. Because of contacts that they have with small employers for various other reasons, they would market insurance products to their mother group. It's hard for me to pinpoint what some of them are, but they would market products related to pension plans, or to medical expense reimbursement trusts, so that in a sense they are a financial services company, an expanded financial services company offering not only individual products but some group products, at least on a smaller group basis.

MR. SHAPIRO: One way to look at a life insurance company is to divide it into components. Essentially there's a risk component, which I think is the uniqueness of the life company. There's also an administrative component, a marketing component and an investment component. If you look at those components in terms of the changes going on, I'd say our biggest strength is probably the risk component. The administrative component is a wash because we do a very good job administering what we have and probably don't quite know how to administer what we're going to have. The marketing components in many companies are negative and the investment components were a strong positive when we were investing so long in a different kind of environment. I'm not so sure we all understand the environment that is being created today. If you do that and then assess each particular company against that kind of grid, each company will come up with a different answer. If the investment components are negative, one strategy is to work with other financial institutions either by acquisition or joint venture, and essentially let them have the investment dollars and keep the production dollars.

MR. LOUIS GARFIN: The implications of what we're hearing, I think, are that the connection of the life insurance industry with the rest of the financial services industry may well be through merger, acquisition or affiliation in some manner. Accepting that, I wonder if anybody is willing to comment on the final item on the agenda which relates to the current situation and perhaps the outlook for banks in the insurance industry and possibly insurance companies in the banking industry.

MR. LENSER: I'm not responding specifically to the question as it pertains to the banking industry but to the last item on the list. Are there really any costs or marketing advantages to selling packages of financial services or are specialized companies more efficient that integrated firms? It seems to me that the efficiency of the financial services industry as opposed to a single market, or a market of a single financial product, is the access that they have to clientele and the confidence on which their relationship with them is built. It's that confidence and that access to them that I think provide the potential efficiency of a financial services industry as opposed to a market or of a single financial service.

MR. SHAPIRO: Let me try something on. Maybe this is hope, but I think the banks are in a tougher position than the insurance companies because they don't have anything unique. They can't offer insurance and they can't really compete in the same way that, say, the stockbrokers can. So I would be very disappointed if the life insurance industry gives away its uniqueness and loses to the banks. I would rather be in our industry than be in theirs right now.

MR. PAUL H. LEFEVRE: Our company is basically a manufacturer of products for the brokerage community right now and as we watch what's been happening in the last year, we see brokerage companies owning insurance companies, insurance companies owning brokerage houses, etc. I'd like to ask the panel to comment on the long-term survival of this type of company, the independent provider of products to that marketing force.

MR. LENSER: I guess I'd respond in two ways. One is, if you take a company like Merrill Lynch, which has had a life insurance company for quite a few years and has done some work with that company, it has, through all those years, managed to go to many other insurance companies to have them provide what it wanted. You can't always get everything you need from the company that's a part of your organization. That's one point. Second, I think they are very much inclined to want products that are current and those they think are extremely good products, even if they are being manufactured by an organization that's outside their company, as long as it's going to reimburse their marketing organization satisfactorily. Then I think they'll continue to go to that kind of an outside manufacturer of insurance products.

MR. MILGROM: There's been little enough dispute about what's happening in the financial services industry, so I will take a moment to express a contrary opinion. I hold it because I don't think it has been adequately represented in the discussion today. I don't think it's certain yet that offering an integrated package of financial service is necessarily the way the entire market is going to develop. It's clear that there are large segments of the market that have gone that way. I think that the analogy between Sears and Toys-R-Us was not altogether inappropriate. One of the reasons that Sears had trouble competing with Toys-R-Us is that when people go to buy toys, that's not necessarily the same day they want to buy a refrigerator. This story of going to a broker and thereby saving on costs presumes that the day that you want to buy insurance is also the day that you want to buy securities; or else it presumes the other possibility that there's a reputation effect, this trust effect that John described. I don't think that the growth of insurance under

Merrill Lynch is likely to make people trust Prudential less. I think that the names are well enough established that the trust of those companies won't be undermined.

Another thing that has not come up is the analysis has been almost entirely an industry-based analysis. That is, we've talked about the things that are going on within the industry. I mentioned in my opening remarks that there were things going on in the general environment that I think might be at least as important as what's going on in the industry. I think that what's happening with the declining public trust in the Social Security system, and the high real rates of interest might change savings patterns very significantly in the next decade. If that happens, it's important that the consequences be thought through.

I think, as mentioned earlier, that the evolution of home information systems is going to change not only the way these products are sold but also the nature of the product. In connection with financial services, one of the things we provide to consumers is planning. We provide them with information and there are going to be new means available to deliver that information. So I would like to amplify what has been said here before. There is a need for a broad perspective and perhaps not all aspects of that have come out completely during the course of the seminar.