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## DEREGULATION OF FINANCIAL INDUSTRIES

*Moderator: ALLAN D. AFFLECK. Panelists: LAWRENCE J. LATTO\*, JOHN J. MARCUS, LENORE A. MARDON\*\*. Recorder: ARTHUR LYLE GARRISON*

### Competition

- Current regulation
- Status of deregulation efforts
- Evaluation of distribution systems and costs
- Market evaluation
- Philosophy of other financial services industries toward underwriting insurance

### Effects on life insurance companies

- Product development
- Inforce products
- Distribution systems

### Possible cooperative efforts

MR. ALLAN D. AFFLECK:

My name is Allan Affleck. I am a consulting actuary with Milliman and Robertson, and I'll be your moderator this afternoon. Our panelists this afternoon have a varied background. We have an attorney, an actuary and a banker. The organizations they represent and the individual perspectives they bring cover wide backgrounds; it will be interesting to see the inter-action among them.

Larry Latto is a partner with the Washington D.C. Law Firm of Shea & Gardner. At one time, he was the Editor-in-chief of the Columbia Law Review. He has been extensively engaged in matters involving the application of federal and state securities laws to insurance companies, with particular emphasis on equity products and products utilizing separate accounts. He represents investment advisors, brokers, and banks, as well as insurance companies, and has acted in recent years as outside counsel to the American Academy of Actuaries.

John Marcus is Senior Vice President of Prudential, in charge of the Insurance Services department. He is also Chairman of Pruco Securities and Vice-Chairman of Pruco Life. In these capacities he is responsible for the development of Prudential's investment type products. At its inception, Mr. Marcus was a deputy on the American Council of Life Insurance (ACLI) Task Force on Financial Services Integration. As a member of its Blueprint Committee he was one of the authors of the ACLI's study of financial services in the 1980's.

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Lenore Mardon is a product development officer in the Consumer Marketing Department of First Interstate Corporation, one of the country's largest bank holding companies. Her responsibilities include research into potential insurance programs to be offered to their system wide customer base and coordination of their strategy in anticipation of deregulation. Prior to joining her present employer, she spent 7 years in the insurance industry, initially as an agent and then in various regional marketing capacities.

Our recorder this afternoon is Art Garrison who is an actuary with Beneficial Life here in Salt Lake City.

During this panel discussion we are going to try to cover most of the points that are outlined in the program description. We'll have an opening speaker on each of these. On some of them, one of the other panelists will follow up, while on other topics we will just move onto the next one.

The topic "Deregulation of Financial Industries" is so broad and there are so many people giving two day seminars, including our own Society, that I think these must be the cheap seats for those of us who want to learn it all in two hours. There is no way we will be able to cover the entire field in a two-hour presentation. I think the most that we can hope to do is to give you an overview, raise questions in your minds, and let you know how some people are viewing various aspects of these issues.

Deregulation of Financial Industries is certainly a hot topic in our industry and one that you can't help but notice as you pick up any of the trade press. My favorite news clipping is one that recently appeared in the National Underwriter, which had two interesting headings side-by-side. The major heading across the top was "Trade Groups Join Forces to Fight Bank Expansion in Three Financial Services Industries; Life Insurance, Securities, and Mutual Funds are Courting Congress to Promptly Enact a Moratorium on Bank Entry Into Other Businesses. We will work to defeat legislation which would intermingle banking and commerce," they said. The other heading was "Citicorp Official Describes Banks Insurance Aspirations. Citicorp has a ten year plan which includes the resolve to become a factor in the insurance business worldwide in both sales & underwriting." That seems to set the tone. You can read whatever you want these days on both sides of the issue, and we will try to give you some flavor of both sides this afternoon.

Our objective is to start out setting the stage by describing the current regulatory arena. Our attorney will then talk a little bit about the current status of deregulation efforts that may take place in the future. John, with his background in an insurance company that owns a stock brokerage firm, and Lenore, with her background in a bank that is awaiting deregulation, will address some of the market issues, distribution system, distribution cost issues, philosophy of underwriting insurance for non-insurance companies, and the impact that these steps may have on the insurance companies that are now in the marketplace.

With that introduction, I will ask Larry to start off by talking about the current regulatory environment.

Mr. Lawrence J. Latto: My charge is to provide the context of this discussion by describing briefly the relevant aspects of existing regulation and the current proposals for deregulation, possibly followed by predictions about the likelihood of adoption and probable impact. My focus will be primarily upon general regulation and the life insurance business.

There is, I know, a widely held belief that there has been a significant deregulation of financial institutions and that there is more to come and probably soon. But it may be useful, at the outset, to consider what kinds of deregulation have been occurring in this and other industries and then to verify whether this belief is correct or whether we are actually talking about something else. Deregulation may involve: (1) the removal of barriers to entry into a particular business; (2) the removal or lessening of the rate regulation that often accompanies those barriers; and (3) the removal of restrictions upon the manner in which a regulated business is conducted. The last of the three may or may not affect the competitive balance. Much of the deregulation of the radio and television business, for example, falls into this category. The elimination of regulations that forced you to run your business in a way that you thought foolish makes life easier. Some deregulation, like proposals to end all restrictions on multiple ownership, does have a more direct effect on other persons, and those other persons commonly are not very happy about it. Deregulation in the transportation industries includes changes that fall into the first two categories. What, then, has been happening in the financial services industry?

The main players are: the banks, the life and casualty insurance companies, the investment banking and securities brokers and dealers, the savings and loan institutions (the "thrifts"), real estate brokers and, possibly, the consumer marketing conglomerates ("Sears") who want to make money any way they can. If we put aside the banks and thrifts, for a moment, there hasn't been much change in the regulatory climate, at least that is relevant to this discussion. The insurance industry is, of course, supposedly regulated only by the states. As we all know, there are several major areas that are subject to federal regulation. One example is the equity products business of life insurance companies, where there is currently very stringent federal rate regulation over charges for distribution. The industry has not yet been able to get the deregulatory relief that they both need and deserve. Securities broker and dealers continue to be very closely regulated as to the manner in which they conduct their businesses, although there has been some lessening of restrictions (the freeing of constraints on the level of brokerage commissions is a major example, one that has led to the development of the significant industry segment of discount brokers). Persons who are willing to play by the rules, have the necessary capital, and have the ability to demonstrate the necessary qualifications, have never been barred from this business (banks aside). So, too, this has been true of the life insurance business, with respect to both issuance and sale of the products.

To be sure, many large insurance companies are engaged in activities that they were not remotely involved in 20 to 30 years ago. But this is not so much because they have taken advantage of the removal of bars as because they decided to do now, for what they consider good and sufficient reasons, what existing law has permitted all along. And the same explanation can be given for why Sears is now selling more than power mowers and sturdy work clothes. In the same way, many institutions are diversifying into other related - and not so related - businesses, some of them with an eye to becoming financial supermarkets offering one-stop shopping or at least trying to offer customers a variety of products. Merrill Lynch and Citicorp are probably the leaders of this movement. So to a considerable extent this panel may be talking about the growth, within the confines of existing law, of the financial supermarket, rather than the effects of deregulation.

The one respect in which we may be talking about deregulation may be summed up in two names, Glass and Steagall. In the early days of the Roosevelt New Deal, after a graphic demonstration of all the bad things that an unregulated banking industry could do, and had done, Congress decided that banking was too important a business to be carried on simultaneously with the investment banking business and complementary prohibitions were enacted. On the one hand, Glass-Steagall prohibited underwriting of or dealing in corporate securities. At the same time, investment bankers were not allowed to engage in the business of banking. For a while some escape from the restrictions of the Glass-Steagall Act was accomplished through the holding company route. The adoption and later strengthening of the Bank Holding Company Act made it impossible for a parent or sister corporation of a bank to engage in any business other than one "closely related to the business of banking." It is this restriction that impedes not only Citicorp but also Merrill Lynch, Sears and Prudential from free expansion into the businesses in which the others are engaged. Citicorp can't, either directly or through an affiliate, own an insurance company or acquire Dean Witter. Neither Merrill Lynch nor Prudential can establish or buy a bank (a "real" bank, that is; a non-bank bank is acceptable) because the transaction would make them subject to the Bank Holding Company Act and the concurrent engagement in both businesses is prohibited.

Before turning to the current legislative proposals it is necessary to observe how much can be and has been done without any change in the law. Merrill Lynch, as I said before, is showing the way to how much can be done. Starting from its large retail securities brokerage business, and without owning a bank, it created its innovative Cash Management Account, that has been so widely copied, one cornerstone of which is the working contractual arrangement with Bank One of Ohio. Incidentally, in the discussion this morning, I learned for the first time that Merrill Lynch is perhaps not as innovative as they thought. Merrill Lynch now perceives that by using a non-bank bank, it can establish a bank of its own which will perform all the functions that it needs. According to Lenore, it is well under way of doing so. Merrill Lynch has a nationwide real estate brokerage business. It sells insurance (perhaps John Marcus will tell you why this hasn't been a particularly profitable business for them). So you can now buy stocks, bonds, commodity futures and tax shelters, buy your home, obtain your mortgage, get your insurance and keep your checking account all with Merrill Lynch. Of course, as a technical legal matter, the checking account is with a bank, but the statement comes to you from Merrill Lynch. I think a small percentage of the customers fully understand the actual legal relationships that are involved. And to belabor the point just once more, all of this has been accomplished without significant change in the law.

Citicorp, our second good example, has not been idle, but its path has been harder. It has employed a small army of loophole-finding lawyers and lobbyists seeking first to expand the list of permissible activities by persuading sympathetic regulators, almost always over the vigorous objection of present and punitive competitors. Citicorp can do certain things now which they had not been doing in the past. Together with other expansion-minded banks, it has had both successes and failures. Efforts to obtain authority to sponsor and sell mutual funds have failed, but banks may act as investment advisors to mutual funds. And banks were empowered by Congress to offer what only pedants would deny are functional equivalents of money market funds, with federal insurance, to boot. Mutual fund distributors are just terrified at the thought of how convenient it would be to have a

bank that was able to sell inhouse both stock and bond mutual funds at the tellers windows as well as an alternative to their money market accounts in the form of money market funds.

Banks have successfully resisted a 10-year effort by the Investment Company Institute to establish that the collective investment of pension fund assets by banks is in violation of the Glass-Steagall Act, or at least that this aspect of the trust business should be subject to the federal securities laws and particularly to the Investment Company Act of 1940. Citicorp, using the authority in the 1982 Depository Institutions Act (not deregulatory legislation in the true sense) has acquired at least three failed thrift institutions. It has opened industrial banks in two states (probably more by now) and has opened new banks in Maine and Maryland because state laws were changed to permit entry by out-of-state banks on a limited basis. Banks have used innovative devices, such as consumer finance and loan production offices, helped by favorable interpretations, to establish presences in other states, in the face of laws that seemed at an earlier time to bar interstate banking. Almost every favorable interpretation that the banking industry has been able to obtain has been followed by legal action to overturn it. The Supreme Court, for example, has just heard arguments on whether BankAmerica's acquisition of Schwab was validly authorized, and there are scores of banks waiting anxiously for the decision. The nonbank-bank device, first used by other financial institutions, is now also being used by banks to establish presences in other states.

The most imaginative loophole, which was sought to be employed by BankAmerica and First Interstate Bankcorp as well as Citicorp, to acquire a South Dakota bank that was authorized to sell insurance in 49 states, was closed when insurance trade associations persuaded the Federal Reserve Board not to grant approval of the acquisition. Actually, the Board didn't deny the application. It suspended the proceeding, with the consent of the applicants, who preferred suspension to denial, to see what, if anything, the Congress would do. Note that the loophole was closed only to bank holding companies. A South Dakota bank, with the necessary resources, could engage in the insurance business. This brings us to the pending legislation.

Mr. Affleck: It strikes me as I listen to everything that has happened without essentially any change in regulation, that obviously there is an opportunity for a lot more to go on after changes and regulations take place. If you think about all the new products and the new structures that attorneys and actuaries are going to be dealing with, I think we have another full employment act. We know that changes are being proposed, that something will happen, and Larry is going to outline what he sees as the issues to be examined in the future and maybe give us a personal perspective on what directions he thinks future deregulation may take.

Mr. Latto: The Administration, primarily the Treasury Department, with the somewhat reluctant acquiescence and support of Paul Volcker has reached the conclusion that banks, or more precisely bank-holding companies, ought to be freed from the fetters to which they are now subject and should be permitted to engage in a wide variety of businesses that provide financial services. Both the proponents and the opponents of this proposal agree that banks are in the unique position of being the only type of financial institution that can create money and therefore require special and careful treatment. Other lenders make commercial loans but do not accept deposits; still other institutions, in fact if not in theory, accept deposits but do

not make commercial loans. In addition, banks (and thrifts also, of course) enjoy the benefit of federal insurance for their depositors. Their safety and soundness is essential, and cannot therefore be permitted to be compromised by direct engagement in any business other than banking.

At this point the agreement stops. The Treasury Department's position is that so long as other activities are conducted by affiliated corporations and the bank itself is limited only to the business of banking, adequate and close regulation will see to it that the bank's financial condition will not be affected by the businesses of its affiliated corporations. The pending bill proposes, therefore, to permit wider activity by banks in the field of underwriting of all types of municipal bonds, to confirm the existing Federal Reserve Board interpretation that banks may properly offer discount and other brokerage services, to permit the sponsorship and sale of mutual funds, to permit the conduct of a real estate brokerage business, and to permit both the writing of insurance and insurance brokerage.

The opponents of the bill, primarily from the securities, insurance and investment company industries, rely primarily, as might be expected, not upon the fact that they will face increased competition but upon high principle. The Administration is wrong, they say, that the corporate form will not successfully isolate the banks from their affiliated businesses. Even if a bank does not have a legal obligation to use the assets of the bank to support failing affiliates, it will find ways of doing so, if necessary, and this will undermine the stability and soundness of an institution that all agree must be protected. Reference is frequently made, in this connection, to the real estate investment trust experience, where many banks thought it prudent, to protect their good names, to lend support to financially strapped related companies. (The Treasury Department's response is that we will watch them more closely in the future, i.e., more rather than less regulation.) Opponents also argue that enabling bank holding companies to expand in this way will result in concentrations of economic power that will have serious adverse effect upon the nation and the economy. And they also point out that banks will have terribly unfair competitive advantages because of their ability to use the leverage that is available to them when people need to borrow money. Empirical evidence drawn from the experience with credit life insurance is mustered to support this argument.

A subsidiary argument made by mutual life insurance companies (which John may also wish to enlarge upon) is that one of the purported objectives of the legislation - to have things work both ways, that is, banks will be able to establish or buy insurance companies and insurance companies will be able to establish and buy banks - would work with stock companies but not with mutual companies. This is because there is no way to recapitalize a mutual company so as to end up with a corporate parent that could establish or acquire other corporations in other businesses. Mutual company affiliates can only be downstream subsidiaries, and a mutual company that acquired a bank would become a bank holding company, faced with intricate, conflicting, overlapping regulation. This is not an easy problem to solve but somewhere out there in this vast country of ours, there must be an ingenious lawyer who could come up with a solution. But we haven't found him yet.

There has not been any narrowing of the gap between the proponents and the opponents of this legislation. The proponents maintain, with religious fervor, that so long as a corporation, as such, engages only in the business of banking, it can be adequately regulated and its soundness insured. The

opponents maintain, with equal assurance, that legal fictions may sometimes serve useful purposes, but will be inadequate in this area if the Administration's bill is adopted. Banks will find a way, they insist, to use assets that should be dedicated to the banking business, to help affiliates that are in need. The analogous experience of Charter may be instructive here. The company maintains that its troubles do not affect the soundness of the insurance company affiliates. But the policyholders do not hear well, and there have been massive surrenders and redemptions.

It would be foolhardy, without having been intimately involved in the legislative effort, to venture any predictions as to what will happen and when. The Treasury Department continues to maintain a public stance of high optimism. There will be a bill, they continue to say in public, in the present Congress. The opponents insist that while there may be some narrow beneficial legislation, there will be no broad legislation by the current Congress expanding bank powers and that the results of the election will then play an important part. To the extent that a neutral observer can draw any conclusions from the tone and style in which these predictions are made, it is the opponents that appear to be correct. I don't think there will be any legislation this year.

Mr. Affleck: Thank you Larry. Before we leave this area of deregulation, John, do you have any comments you would like to add.

Mr. John J. Marcus: Well, Larry suggested that I say a little bit more about demutualization. Actually, so much can be said about the status of deregulatory efforts, that I'll only add two other comments, one on the so-called level playing field we have heard so much about and the other on state activity. There is a lot of state activity. Larry referred to the South Dakota activities, and of course there have been very important developments in other states, particularly in New York.

Now, as to demutualization, the disadvantages of the mutual form of organization in a deregulated environment are essentially the same as those currently existing in the regulated environment. The difference is one of degree more than kind. By loosening restrictions on competing financial services institutions, the competitive obstacles facing mutual life insurers would be magnified. The degree of damage would depend upon the form that deregulation takes. The current Treasury proposal for deregulation would be particularly damaging to mutual insurers. The proposal contemplates only an upstream holding company as the vehicle through which banks and insurers could co-exist under the same corporate umbrella. And because mutual companies cannot establish an up-stream holding company, mutual insurers would be effectively barred from affiliation with a bank while a stock insurer's upstream holding company could hold a bank. The banks themselves would have free access to the insurance business through bank holding company subsidiaries.

Most of the competitive problems faced by mutual insurers, in the changing marketplace, stem from this inability to form an upstream holding company and from investment restrictions placed on insurers and their downstream holding companies by the various states.

## PANEL DISCUSSION

To summarize, the disadvantages to the mutual form of organization in an increasingly competitive and deregulated marketplace fall into four broad categories.

1. Lesser flexibility in organizing and entering new businesses;
2. Diminished availability of capital - e.g., need for equity if purchase of a large bank were contemplated;
3. Taxes - Stark-Moore places an onerous "add-on-tax" on mutual companies;
4. Handicaps in competing for personnel - there may well be adequate surrogates for this category.

The current demutualization activity of the Union Mutual has been well publicized; and it seems clear that continuing activity in this area should be anticipated.

The level playing field-is this achievable? Larry referred to tie-in-sales, so I won't talk about those. I would like to talk about two other factors. Banks and insurance companies and their products are taxed in fundamentally different ways. Last year, the Department of Treasury's Office of Tax Analysis study concluded: "This complexity in the tax laws stands as a formidable barrier to the establishment of tax laws and rules that would provide for uniform treatment of similar types of income regardless of financial institution; this lack of uniformity in tax rules, in turn, frustrates the establishment of a level playing field across institutions."

Another point pertains to this level playing field concept; insurance is regulated at the state level. Under any of the current deregulation proposals, it is not clear how financial transactions between a bank holding company and its insurance subsidiary could be adequately regulated. If there is a crisis, will the state insurance regulators be able to protect the viability of the bank? Will the federal regulators be able to protect the viability of the insurance subsidiary? Just looking at these areas might lead one to conclude that like the Holy Grail, a level playing field is something to be sought after but possibly never achieved.

Referring to state activity, I want to discuss the New York situation very briefly. Following the 1982 commission's proposals for sweeping changes in the New York Insurance Law, the New York State Temporary Commission on Banking, Insurance and Financial Services, known as the Dewinn Commission after its chairman, recently released its report with the Governor's support. Very broad powers for banks, including their ability to enter the insurance business are recommended, and there are 38 major proposals. Here are just a couple of them. On January 1, 1985, banks could act as insurance agents and brokers and be able to lease space to agents. Effective 1986, they would be allowed to own and acquire life insurance companies. They could own property and casualty insurance companies after January 1, 1988, but the property and casualty member on the committee was instrumental in getting a little clause inserted, - "but only after further study."

Mutuals could own or control the stock of a banking subsidiary. Mutuals would be permitted to demutualize and there is much more. If enacted, competing in the financial services area could be a whole new ball game.

Mr. Affleck: We are going to move on from the regulatory environment now and look at some of the other topics. The first one is market evaluation. Lenore is going to talk about that from the perspective of a banking organization.

LENORE A. MARDON:

For the most part, banks and bankers have based their evaluation of the insurance marketplace on the potential for fulfilling fairly general market demands, rather than on the specific insurance skills needed to properly evaluate a particular risk. One reason for this approach is, of course, the current regulatory prohibitions regarding banks selling or underwriting insurance. Another equally important reason is the banker's appreciation for the high degree of skill necessary to profitably produce a marketable insurance product. Simply put - it takes years of training and experience to produce someone like you - a top-notch actuary - and a similar amount of time to produce fully credited underwriters, claims adjustors, systems analysts and so on.

Frankly, the world of banking is changing so quickly that most of our employees can barely keep up with their own products, let alone take on new ones from new industries.

So - rather than examining the change in mortality rates or claims statistics, banks have concentrated on our country's changing demographics and how these changes have affected consumer needs. Among the most notable of these changes is the role of the working wife.

In 1950, only 20% of American wives worked outside of the home; today that figure exceeds 50%. Correspondingly, the number of husbands who are sole providers of family income has decreased from 59% in 1958 to only 34% in 1981.

On the average, these dual-earners are members of the baby-boom generation who find that their two-profession lifestyle leaves little time for shopping - whether it is for groceries, household goods or financial services. More and more people are turning to the convenience of one-stop shopping for so many different items that it seems an almost natural progression to the so-called "one-stop financial services supermarket."

The average person owns approximately 15 different financial investment and insurance products. Often, he buys these from a dozen different people. The average consumer no longer feels he has the time or the patience to deal with 10 to 15 different individuals or institutions in order to transact these services. An increasing number want to consolidate these efforts and simplify their lives.

Certainly, we don't presume that these individuals want to buy all of these services from their friendly neighborhood banker. In fact, most people are not comfortable with the idea of putting all their financial "eggs" in one basket - and we agree. However, the ability to "package" a number of these financial services could substantially simplify their efforts by allowing them to contact perhaps as few as 3 different institutions in order to purchase the 15 different services they desire.

What banks hope to achieve with deregulation is the ability to compete - on equal footing - with the other financial service industries for the ability to package and distribute these products to the consumer.

Let me transgress a little bit here, referring to the level playing field and the types of regulations involved in them. First of all, banks are currently subject to both federal and state regulations. I think there are 7 different federal institutions alone that look over us continually. In the event that deregulation would allow us to own either brokerages or insurance companies, we certainly would expect that these institutions would be subject to the existing insurance laws, as much as any other subsidiaries we have been able to acquire. It seems that our list of non-bank affiliates is almost as long at First Interstate as our bank affiliates, and they are subject to the existing regulations for those enterprises. Insurance would fall into the same thing. Regarding the credit tie-in, the banking environment today is such that we are only loaning out 60% of our deposits. In order to do a business properly, we should be loaning 85% to 90%. I think its almost obvious that we are having a hard time getting loans out. For example, First Interstate is currently advertising 100% car loans, regardless of whether you want a prestige, elite, sportscar or a compact. They want to make more loans. They are not going to add additional codicils in getting a loan finalized, just in order to sell insurance. So I think there is another aspect on that issue. A few years back, the lines of demarcation between our industries was very clear. Banks provided loans, savings vehicles and trust services. Stock brokerages provided investment advice and handled stock purchases. Insurance companies afforded protection from catastrophic loss of either life or property. Retail stores sold clothing, appliances or hardware. Life was easy.

Today however, these lines of demarcation are becoming increasingly blurred. Retail stores such as Sears, J.C. Penney and Montgomery Ward now own insurance companies. Sears also owns a real estate firm, a stock brokerage and Allstate Savings and Loan - which, by the way, recently changed its name to Sears Savings Bank in order to better fit Sears' overall strategic planning goal of becoming a "major provider of financial services." Once the name bank is attached, it loses the identity of being a thrift, a different type of a savings & loan. It now is perceived to have the same type of financial basis and solidity that most people perceive of a commercial bank. To underscore that, let me share a conversation I recently overheard between two of my friends. When one asked the meaning of the initials F.S.B. which followed the name of a particular savings bank, the other quickly answered, "Oh, that's easy - 'Full Service Bank.'" The correct answer is, of course, "Federal Savings Bank," but you can see how the confusion continues to mount.

E.F. Hutton, which began as a stock brokerage, expanded first into life insurance and two weeks ago received approval to expand into banking (The so called non-bank bank). Prudential Insurance now owns both a stock brokerage and a bank which offers mutual funds as well as their newly announced Paperless Certificates of Deposits. American Express, of course, owns Fireman's Fund Insurance, along with Shearson for Investments; and recently announced a merger with Lehman Brothers, a major investment bank. These are some of the more obvious examples of the numerous crossovers occurring in our marketplace. We read of new ones nearly every day. We have seen what the lack of the ability to compete has done to our steel and automotive industries in this country. We cannot let this happen to our financial industries as well. In light of all this data, I think most reasonable people would agree that in order for our country's banks to remain viable, competitive financial institutions, they must be able to provide their customers with a full range of products and services from which the customer can freely choose.

We may all wish for the simple life of the 1950's when dad worked, mom was able to stay home and take care of the family, the local insurance agent came by to collect the weekly premiums and each of the financial service industries had its own part to play. But the clearly defined roles of "Ozzie and Harriet," "Leave it to Beaver" or "Father Knows Best" are a thing of the past. We can never go back. And if we are to continue to grow and prosper, both of our industries - insurance and banking - must remain responsive to the fast-paced and ever-changing demands of the world as it is today and will be tomorrow.

Mr. Affleck: Thank you Lenore. We are going to move on from that perspective of the market, to talk about distribution systems and costs associated with those distribution systems. First of all, we will hear from John Marcus and the perspective he brings.

Mr. Marcus: I would like to make some remarks complementing Lenore on distributions through banks. Also, I would like to make some comments on distribution through brokerage houses.

I don't know of any studies that would give us a handle on the relative distribution costs of commercial banks versus life insurance companies. In any event, since life insurance is not now distributed through commercial banks to any great extent, we would have very little data upon which to base a comparison. Nevertheless, it appears that banks believe cheaper distribution costs will constitute a major advantage for them. Earlier this year, a Security Pacific Executive Vice President. branded the agency system as a dinosaur and claimed that banks could trim 20 to 30% from the premiums for life insurance. Should banks be most successful at selling demand products and gravitate to term insurance where pricing is almost entirely a matter of expenses and persistency, the end result may be to make an already overly competitive field yet more competitive and worsen persistency. Also, Citicorp executives consistently make statements which imply that they wish to enter the insurance business in order to better serve the customer. They also say they could lower prices, yet in their banking business, they are hardly known for having the lowest fees and charges on services and loans. In fact, a Senior Vice President in the consumer group of CitiBank told stock analysts earlier this year "we don't compete on price - it's not profitable to do so."

Also, the history of bank involvement with credit insurance adds little substance to the argument that banks would pass on lower costs to the consumer. The greatest strength of both the banking and insurance industries is also the source of the greatest cost to each, so it's a matter of balance. Suffice it to say that both insurance companies and commercial banks are looking hard at ways to cut back costs and reduce overhead. On the other side of the equation, both are looking actively at ways to increase revenue on a profitable basis. Banks have an over supply of branches. In an era of regulated interest rates on deposits, non price competition replaced price competition. In response to the truism "all other things being equal, the consumer will choose to bank at the bank closest to his home", banks expanded their branches rapidly in order to provide the location and service convenience. Now, in a price competitive environment, there are too many branches. There are many examples of banks which have aggressively closed branches. By and large, however, the attempt to reap savings by replacing live tellers with ATMs has not yet lived up to its promise. There does not appear to have been a significant reduction in the number of

branch personnel. It is the people cost involved as much as rent which is being referred to when one hears of the high cost of "bricks and mortar".

I shall largely confine myself to an examination of the pluses and minuses of each system from the standpoint of the sale of life insurance, but it should be noted that bank inroads into insurance - should the regulatory barriers fall - may be more heavily in personal lines of insurance - property and casualty. It is here that the convenience tie-in is most prominent. Banks can make it convenient for homeowners insurance to be picked up in connection with mortgages or home improvement loans and for auto insurance to be sold in connection with new car loans. Consumers are also equally or more likely to bring their casualty policies into a bank for a comparison quote as they would be to bring them to a department store. As newcomers, however, they would have to guard against the low quality of risk walking in the door. How willing are banks going to be to turn away good customers who come to them for casualty insurance on the basis of risk quality?

In order to spread the cost of maintaining branches over a wider base, banks are looking for new products and services to sell their customers. The desire to cover or spread some overhead has given rise to the boom in discount brokerage availability through banks. It is also the primary reason they are looking into insurance. They would like to supplement the spread that they earn on money to keep their store-branches profitable. Thus, they are looking for fee or commission income.

One reason that they regard insurance as so attractive is that they have relatively high fixed cost and relatively low variable costs. Thus they stand to profit more by the spread of fixed cost. In the life insurance industry, attempts to lower variable costs by lowering commissions or over-rides have not met with much success. As with the banks, insurers are trying to move more product in order to spread the fixed cost overhead. My company's distribution systems have changed from a life-only to a multiple-product basis. We are attempting to support our agency distribution systems with property and casualty, health, pension, and investment products. On the cost-cutting side, the focal point for action has been on fixed costs. Many companies are moving towards larger sized agencies. There has been a dramatic increase in the role of brokerage.

About this time last year, Prudential completed an analysis of its primary strengths and identified several key characteristics which we believe differentiate us from our competitors and provide a base from which to expand our role of leadership in the dynamically changing financial services industry. A major strength is the largest full-time marketing force in the industry reaching out to a broad base of individual customers. To build on this and other strengths and to be more responsive to the competitive marketplace we anticipate in the future, a framework was developed for an organization which will streamline decision making through tightened lines of communication and facilitate the use of state-of-the-art technology. As an example, the number of our Regional Home Offices is being reduced from eight to four. While our major objective was not cost savings, we do anticipate a savings of \$50 million a year or more from this change in the future. This fits into the very strong position we've recently taken to concentrate on expense control, profitability and financial planning. From the pronouncements we've heard, we believe most insurance companies

are similarly engaged.

If deregulation permits banks to enter the insurance business, they are apt to do so in one of two ways: direct marketing or location selling. I'll limit my remarks primarily to location selling. Direct marketing to bank customers is nothing new. Rental of customer lists to direct marketers has been a source of fee income to banks for quite some time. Thus far, the products offered to bank customers through the mail have had little price advantage. To distribute life insurance through location selling so as to spread their branch costs, banks would have to buy, rent or develop direct marketing expertise.

Let's look at some of the theoretical and practical competitive advantages that commercial banks would enjoy if allowed to enter the insurance business. First, they would have a formidable distribution capability. As a principal source of commercial credit, banks have a retail distribution capability in place serving a massive existing customer base which could be used for individual insurance. Insurance could be easily made available in conjunction with credit and/or installment financial contracts.

To give some perspective on distribution capability, there are roughly 14,000 banks in this country with 45,000 branches. In addition, many larger banks already own captive credit insurers whose charters could be changed readily to underwrite other forms of insurance.

Second, banks would also seem to have an advantage because of their data processing capabilities. Banks have set up sophisticated back office processing facilities which can handle a large volume of transactions and integrate different products for account purposes and perhaps insurance processing could be added at relatively low cost.

Third, banks have become increasingly sophisticated in product design and marketing. They have proven their ability to plan for and design innovative products which appeal to customers. Their data bases are usually more advanced in their segmenting ability than those of insurance companies. This permits profiling of their customers for better target marketing.

Fourth, statements have been made that banks are more advanced than most insurance companies in cost accounting systems, allowing them to determine product profitability.

Fifth, banks would not have to suffer from the ill effects of old business. They would not have to worry about an old portfolio of low yielding assets nor about new products cannibalizing old ones.

Finally, and perhaps of greatest concern to the insurance industry, is the fact that banks have a better image than insurance companies and bankers have a better image than insurance agents. For the past several years in its Monitoring Attitudes of the Public (MAP) survey, the American Council of Life Insurance has found that banks are rated significantly higher than life insurance companies on virtually every dimension including (1) quality of service, (2) respect for individual privacy, (3) treating people as individuals, (4) reliability, (5) management, (6) trustworthiness, (7) importance to the national economy and (8) modern and progressive practices.

Most people have no strong opinions about life insurance companies. The attitudes which do exist are mixed. On the negative side of the ledger, people with opinions generally believe that life insurance companies make high profits, are too concerned with profits at the expense of policyholders, and often avoid paying claims because of technicalities.

While the MAP survey indicates quite a jump from prior years in the percentage of people who would prefer to buy insurance directly from a company rather than through an agent, the overwhelming majority (72%) still prefer to buy through an agent. On the other hand, there is no evidence that people's desire to purchase insurance at a bank or at a financial service center is increasing. In fact, the 1981 MAP survey showed less interest on the part of people in buying insurance this way than had existed in 1971. The most recent MAP survey shows that agents who come to the home or business are the overwhelming choice when it comes to enabling people to get the best policy for their needs, to making them feel more comfortable and relaxed, and to giving them more control over the type of policy that they get. Purchasing directly from the company either by mail or telephone is seen as less time consuming and less expensive than dealing through an agent. Agents in banks or other retail outlets fared very poorly on all dimensions. Fewer than one in ten respondents chose such a purchase system over others on any of the dimensions. Only 8% felt that purchasing insurance through an agent at a bank would be less expensive. Also damaging to bank marketing of insurance is the 1983 MAP survey finding that 82% find undesirable the mechanism of paying for insurance through automatic charges to a credit card. Still, the better overall image enjoyed by banks suggests that people may be receptive if and when banks get around to aggressively marketing products denied them in the past. What bankers must speculate upon is whether their image will suffer once they start to sell insurance. A major reason that people may rate bankers higher than they rate agents is that most banking transactions are not adversarial or confrontational in nature whereas many insurance dealings are.

There are at least four competitive disadvantages that banks face if deregulation permits their entry into insurance on a large scale basis. First, there is a lack of capital. Banks are typically very highly leveraged compared to insurance companies and the capital requirements for most insurance products tend to be high. Second, most banks do not have a name that is known outside of their currently permissible deposit-taking area. This would hinder expansion. The primary beneficiaries of bank entry into insurance would be those banks that have a national name and/or a national consumer finance system - e.g., the likes of CitiBank, BankAmerica, Chase, etc. If all the barriers to interstate banking were to crumble at the same time, many banks would be diverted from new ventures as they would be using capital to gobble up existing banks. Third, banks are at a disadvantage in risk management. They are not experts in taking in money and determining risks associated with future pay-outs. Rather they are expert at lending out money and determining risks associated with future pay-in. These risks may be significantly different. Finally, the lack of selling expertise is a disadvantage often mentioned for banks. Life insurance has to be sold. This favors insurance companies who provide knowledge and service through commissioned agents versus the type of relatively unsophisticated selling that banks have been accustomed to.

Aside from automobile and homeowners insurance, other sales by banks may be tied to their existing businesses. For example, life insurance through disability insurance may be sold in connection with home mortgages. Further, products associated heavily with the savings area such as annuities may also be a natural because of banks' expertise there.

The experience of banks and other financial institutions in the sale of life insurance is instructive. Savings banks in states where permitted to sell life insurance have not become the force that many people thought they might be. This is despite the fact that their rates are very competitive. However, we should be cautious of drawing too many conclusions from savings bank life insurance, because savings banks do not possess many of the strengths of commercial banks which I cited earlier. Location selling has never demonstrated the capacity for the sale of life insurance that it has for the sale of personal lines products. We have been told that Allstate does not sell a lot of life insurance directly at its booths. The hope is to get the casualty business first and then go back and get the life insurance.

Federally chartered savings and loans (S&L's) have been officially permitted to engage in the insurance agency business since 1971 when this activity was added to the list of permissible activities in service corporations. Prior to that time, many S&L's maintained relationships with insurance agencies and were able to bring these agencies into their service corporations once the regulations were changed to permit the activity officially. Despite this, a recent article by Henry Tillman in the Property & Casualty edition of Best's Review indicates that S&L's have captured only five tenths of one percent of the nationwide insurance market for personal lines. Further, the larger the service corporation, the smaller the amount of insurance activity as a percent of total activity according to this article. State banks and small bank holding companies empowered to operate insurance agencies in towns with populations of 5,000 or less have been much more successful in moving property and casualty coverage than they have in selling life insurance.

Travelers entered into a well-publicized relationship with the Hawkeye BanCorp. in late 1982 which permitted this Iowa bank holding company to market Travelers' auto, homeowner and small-business insurance policies. In August of last year, the Wall Street Journal reported that despite the fact that Hawkeye had insurance agents in 25 of its branches and was charging about 10% less than Travelers' own agents, it was selling only 100 new policies per week.

A Business Week article in June of 1983 reported on the Norwest Corporation of Minneapolis. This large bank holding company has been marketing insurance coverages since 1929. (This bank had been grandfathered under the Bank Holding Company Act.) It uses bank employees at over 60 branches to sell other insurance companies' casualty lines as well as some life insurance. Norwest receives the commissions from the insurers. The policies it sells are not any cheaper. In 1982, despite the longevity of this operation, the insurance line accounted for only 5% of its non-interest revenues.

Banks may not have as much to gain by being in the life insurance business as they might suspect. Few will find it feasible to organize and capitalize a brand new company large enough to have a substantial impact on their business unless they are willing to anticipate a strong negative impact on earnings for years. Nor will buying an established company prove very attractive. Good companies do not come cheap now. Banks entering into the

bidding will raise the prices still further. As I've said earlier, greater success may be realized in selling personal lines, particularly if a pricing advantage can be maintained, than in selling life insurance. We find little indication that the public has overcome its inertia and indecision or has stopped procrastinating in dealing with unpleasant topics such as death, disability and old age. Agents will continue to seek out prospects and convince them to take action in filling such needs.

The dangers which would result from bank entry into insurance may very well far outweigh the possible advantages. Still, entry into at least the sale of insurance is a top legislative priority for many of the larger banks. While they are not apt to get their way this year, they are also not apt to give up on the idea. In the meanwhile, we can expect the type of joint ventures such as those recently announced between BankAmerica and Capital Holding and between First Interstate and Safeco to expand. An active period of joint venture will be a healthy development. Results from such ventures should be constructive to banks and insurance carriers alike in pointing to the potential uses and abuses of bank marketing of insurance. Accordingly, it is not surprising to read about the flurry of activity in different insurance companies to investigate and negotiate joint venture possibilities with other financial institutions.

And now I will comment briefly on marketing insurance products through stock brokers. Just about three years ago, Prudential surprised the business community with its acquisition of the Bache Group, the parent company of one of the nation's largest brokerage firms, now known as Prudential-Bache Securities. This was followed by a series of mergers and acquisitions involving brokerage firms and other financial institutions. As a result, many in the industry began to scrutinize more closely the idea of stockbrokers as an additional distribution arm for insurance products.

First, I'd like to provide you with a capsule picture of the history of life insurance and annuity sales through stockbrokers. The New York Stock Exchange first allowed its member firms to sell life insurance in 1972. Most brokerage firms produced negligible amounts of insurance and annuity business until the mid-to-late 1970's. Since then, stockbrokers have sold tremendous amounts of annuities, primarily non-qualified fixed-dollar annuities with investment guarantees. Recently, the growth rate of annuity sales has done an abrupt turnabout, due mainly to the publicized difficulties of companies such as Baldwin-United and Charter.

Brokerage firms have not established themselves as adept movers of protection-oriented life insurance products. However, investment-oriented products, where death protection is not the major concern, have been more interesting to stockbrokers.

The major brokerage firms operate essentially as general agents for several insurance companies. Individual account executives (AEs) sell for a general agency (a captive of the stock brokerage firm) and commissions are paid to it, not to the AE. A portion of this commission is paid to the AE who made the sale and a portion is retained by the brokerage firms to cover the cost of its internal support organization.

Marketing support provided by insurance companies through distributors has been important to the sale of annuities through stockbrokers. It has been

rather common for distributor firms to have wholesalers visit stockbrokers' branch offices to provide on-site marketing support. Their responsibilities include training AEs in annuity concepts, product details and sales procedures, putting on seminars, helping with individual sales, and resolving problems. Generally, wholesalers are not provided to support the sale of death benefit products, such as one year term and universal life, but are provided for investment-oriented insurance products. Some brokerage firms provide intensive internal support for annuity sales; others rely almost exclusively on wholesalers.

Given this background, what are the advantages and disadvantages of marketing insurance and annuity products through stockbrokers?

On the plus side, stockbrokers have an affluent clientele which an insurance company might be able to tap for insurance and annuity sales, thus increasing its penetration in the upscale market. Also, stockbrokers represent a potential additional or alternative distribution system to a company's agency force, through a distribution system of advisors that is already in place. In particular, stockbrokers would be well-suited to the marketing of investment-oriented products.

However, there are also disadvantages in marketing insurance and annuity products through stockbrokers. Stockbrokers may be reluctant to sell insurance company products unless they are similar to, or can be tied in with, investments. Stockbrokers need a lot of training to properly market protection products with good persistency.

Rather than continuing this list of advantages and disadvantages, I'd like to ask whether stockbrokers have the potential to successfully market insurance company products. The answer, I believe, is that the jury is still out on this question. It is clear that stockbrokers can sell investment-type products. What is not clear is whether they can also sell true "insurance" products. Only as time passes will we discover the answer to this question.

Mr. Affleck: Thanks John. Lenore, do you have some comments you would like to add on distribution systems & costs?

Ms. Mardon: Today's consumers are not only more insistent upon effective use of their time, they are also much more knowledgeable of the ever increasing number of choices between financial products. As a result, they demand better value in their purchases, including money market rates and financial service products which are both integrated as well as flexible. Their demands don't stop there. They expect that all of these services will be provided conveniently, efficiently, and inexpensively.

Why shouldn't they expect all of this from their financial service industries as well? After all, more and more manufacturers and retailers are providing shopping malls for convenience, factory outlet shops for lower prices and product shows (such as boat and recreational vehicles) for the ease of comparison shopping.

In light of these changing consumer expectations, banks have determined that the financial supermarkets (with their multiple product capability) can offer the convenience and economic advantage that is needed. In fact, a recent survey by SRI, International, showed that 86% of U.S. households said that one-stop financial services shopping would be advantageous to them.

Now I'm no cost accountant, so I'm not going to pretend that I can stand up here and give you the exact dollars that would be saved by this supermarket approach. However, a number of studies have been done for banks which show that the average distribution costs would be reduced from 25 cents of every premium dollar to only 15 cents. This reduction would be brought about by the use of existing branch and office facilities, the increased application of technology, the leveraging of existing assets such as bank advertising and marketing departments and the broadening of available product lines.

The distribution systems themselves could be a combination of direct marketing and face-to-face sales. After all, it's not really a question of an 800 number or an agent in the branch, since people differ. Some only feel comfortable until they actually meet with an agent. In many ways, this should prove similar to what is now occurring between full-service and discount brokerages. Some people want all the "frills", while others are only interested in rock-bottom prices. The important thing is that the customer be given the opportunity to make his own choice.

Mr. Affleck: Thank you. Having looked at the market and distribution systems and costs, we want to go on and take a look at the philosophy of other financial services industries toward underwriting insurance. Lenore is going to lead us off in that area.

Ms. Mardon: Much of what you and I read today would lead us to believe that banks are nervously "chomping at the bit" in anticipation of full deregulation which would permit them to underwrite as well as sell insurance products. And I suppose that when the possibility was first presented, that may very well have been the case.

After all, at first glance, the life insurance industry has an enviable return on equity (ROE) ratio. In fact, a recent article by financial analyst James Embersit and Melanie Quinn, reported an average life insurance ROE of 26.9% while the same figure for commercial banks was 10.5%. Of the 11 financial service industries cited in this study, life insurance ranked second behind only real estate brokerages (33.4% ROE) while commercial banks ranked fifth. Add to this the simple premise that both banking and insurance are based upon the proper evaluation of risks and the ability to make knowledgeable (read-profitable) investments; and then add the growing number of research studies such as that reported by Ruder & Finn earlier this year. You could find an increasing number of customers who would be willing to purchase insurance from their bank and you have what appears to be the proverbial "Marriage made in Heaven."

Upon closer examination, however, the number of disadvantages to be found in insurance underwriting far outweigh the potential advantages which an average bank would hope to experience. A full report can be found in the Arthur Young & Company study entitled Assessment of Business Expansion Opportunities for Banking, which was prepared last year for the American Bankers Association.

In brief, this study found that (once the law permits) banks of all sizes could benefit from participating in the distribution of insurance products through owning an insurance brokerage. The same could not be said of insurance underwriting. The study reported that there was little basis for linkage between banking and underwriting since their product, customer, outlet and knowledge bases seemed to have very little in common. In addition,

the highly competitive and cyclical nature of insurance underwriting, when added to the fact that it is capital-intensive and skill-intensive, did not forecast a predictable, profitable expansion opportunity.

However, it should be remembered that anytime you deregulate a formerly regulated business, the tendency is to get into all kinds of different areas. I suppose it is a result of belief that the "grass is always greener" elsewhere. But, the fact remains, that in nearly every instance, it is harder to make a go of it than was originally expected.

I'm sure some banks will persist in their hopes of someday underwriting life insurance as well as property & casualty. Those who do, however, will not be foolhardy enough to attempt it on their own. It's silly to think that banks would ever have Fred, the commercial loan officer, doing underwriting, or Agnes, the new accounts representative, handling sales. Instead, you can be sure that banks will respect the varied and different skills necessary to write insurance profitably. They won't attempt to do it themselves, instead they will go out and hire experienced insurance people with the knowledge to do the job well. Rather than jeopardizing the jobs of insurance professionals, like yourselves, I believe that deregulation would actually increase your value in the marketplace. That certainly was my personal experience.

All in all, however, it is far more likely that (given the regulatory approval) banks will focus their expansion opportunities in the direction of insurance brokerages where they can best profit from their customer and product base transferability while minimizing overhead expenses. Actual underwriting will probably be undertaken by only a few of the over 14,000 commercial banks.

Mr. Latto: I find it noteworthy that two panelists, drawn from two different industries which in many ways are at loggerheads, have provided us with a not very aggressive analysis, but both of them reasonably objective.

John points out that banks have some very significant and competitive advantages if they enter this new area. At the same time, he warned the banks to watch their step, because they may find that they are biting off more than they can chew.

Lenore assures us that the banks understand full well that if they enter new businesses, they are going to be subject to the same regulation that those existing businesses are subject to. They are prepared, and they are taking heed. They are not going to become life insurers, for the most part, because they recognize the accuracy of what John has said. Returning to an earlier theme, the persons who are involved in one or more of the industries that are concerned with these developments would be greatly mistaken, I believe, if they conclude that if the kind of deregulation we have been talking about comes about, that they will have less regulation and greater freedom to run their businesses efficiently. One of the inevitable results of any deregulation is that practices soon develop which are found by one consumer segment or another to be undesirable. As the intensity and the extent of complaints increase, the legislators and regulators are motivated to do something about it and forget that the "abuses" may really be only the inevitable and perhaps acceptable price that must be paid for deregulation.

Let me cite a couple of current examples. Undoubtedly, many more could readily be cited. The Securities Exchange Act of 1934, defining the term "broker", says explicitly that the term "does not include a bank". But as brokerage activities of banks - something that they have been engaged in modestly at least since 1934 - expanded sharply, the Securities Exchange Commission (SEC) has been motivated to seek to interpret this exclusion as not preventing it from subjecting the division of the bank which conducts these activities to all the regulation to which conventional brokers are subject.

The lifting of interest rate ceilings has been accompanied by vigorous competition for deposits, and this has caused a strain on the profit margins of some banks with the result that there has been a proliferation of increased fees and charges and the closing down of some uneconomical branches (part of the justification now being offered for the pending federal legislation is the need to provide better regulation of these fees and charges). In other areas, there is a growing pressure for the establishment of "life-line banking", which would impose upon banks the obligation to provide at least minimum services to sectors of the community that cannot economically support them.

In another example, in a deregulated atmosphere, one might conclude that companies engaged in a legitimate business of helping investors to make deposits in federally insured banks and savings and loan institutions would be allowed, and that such companies, as long as they violate no laws and commit no frauds, could conduct their businesses subject to minimum and necessary regulatory control. But the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) recently moved with remarkable alacrity, in the face of strong Administration and Congressional opposition, to adopt regulations that would effectively put out of business companies engaged in deposit brokerage. The objective - that of preventing enormous drains on FDIC and FSLIC insurance created by failing banks and thrifts - is something that cannot be quarreled with, and there is a litigation pending which may determine whether these agencies had adequate legal and factual basis for choosing this particular remedy. But the decision to take regulatory action was made, I am sure, without reference to the fact that these agencies are part of an Administration that believes in deregulation.

A similar point can be made with respect to what is happening in some quarters with respect to the life insurance industry. In some important insurance states, notably in New York, efforts are being made to loosen some of the regulations to which the companies are now subject. But at the federal level the movement seems to be in the opposite direction, even though the Administration is committed to deregulation. The issuance and sale of equity products has been for a couple of decades subject to SEC regulation. General account products have essentially been free of such regulation. As a result of the Baldwin-United disaster, the SEC, on its own and under Congressional pressure, is intensely re-examining the decision that permitted single premium deferred annuities to be sold in enormous volume without SEC registration. That decision, it is fair to say, did not involve careful deliberation but rather represented a failure to act because of the press of other matters and a failure to perceive, shared by all, the risks that were being run. The SEC has looked at the question of whether universal life insurance policies might be regarded as securities that could be sold only if they are registered, but a small staff and the difficulty of

the issue has also resulted in inaction and, in consequence, this business has had a dramatic, rapid increase that it might not otherwise have had. It could be, although I doubt it, that the current review of the single premium deferred annuity question will spill over and will result in action with respect to universal life that the industry would consider adverse. I don't think this is likely to happen. In a related area, one issuer of an annuity contract with a market value adjustment provision treated it as a security that must be registered under the 1933 Act and other insurers are wondering whether to do otherwise with similar products is imprudent.

The situation is different with respect to what has been called Universal Life II or flexible premium variable life insurance. The industry has accepted the fact that the product is a security and must be registered and that the issuer must also be registered as an investment company under the Investment Company Act of 1940. This brings with it extensive regulation including, most significantly, rate regulation, with respect to distribution charges, of a kind that was designed for a wholly different product. This provision, if applied to this product in a mechanical and inflexible way, would effectively prevent its sale. A petition is pending with the SEC that seeks what is generally agreed to be necessary exemptive relief from the Act. However, the complexity of the issues and the fact that extensive relief is sought combine to make it difficult for this petition to be acted upon in anything like a reasonable time. If past experience is any guide, then this proceeding is likely to drag interminably, while many issuers wait impatiently on the sidelines hoping to offer what they regard as an innovative and attractive product. This hardly looks like deregulation.

One last example of increased regulation is the legislative proposal to mandate unisex rates. I find this kind of legislation particularly interesting because of its potential to result in still more regulation and increased enforcement machinery. Will it be necessary, for example, to prevent the issuers of automobile liability insurance from purchasing mailing lists from Seventeen and Mademoiselle unless they concurrently buy and use a Penthouse list?

Finally, the drive to get into new and unfamiliar businesses may bring with it new entrants that are not familiar with existing regulation who may find that compliance difficult. They may also engage in practices that will be regarded as undesirable with the end result that more of our business lives will be spent under the scrutiny of regulators and in the effort to adjust business practices so as to conform with regulatory requirements. Businesses that have been familiar with federal regulation may find compliance with state regulation difficult and onerous and vice versa. Businesses that have been subject only to one regulator may find it more than inconvenient when they encounter the traumas of dual regulation. As experience develops, it may well turn out that the objective of providing all the financial services in one place will be an attainable and successful path for some to follow. But there will still be room for those who choose to do only one or two things and to do them exceedingly well.

Mr. Affleck: Thank you Larry. We will bring our presentation to a close by dealing with one remaining issue. John Marcus is going to talk about how all this may impact life insurance companies.

Mr. Marcus: The product explosion in the life insurance industry has been startling in its dimensions. Deregulation of financial institutions, with all clamoring for clients' dollars, has made savers very aware of interest rates in particular, and investment yields in general, of alternate places to park their money. Of course, "buy term and invest the difference" was with us long before the current deregulation environment development. Deregulation has intensified the competition and heightened the demand for products having current interest rates readily visible.

I would be remiss if I did not hasten to say that there are many factors outside of deregulation that are spurring the product revolution on. The type of products being developed are also a function of economic conditions, lifestyles, attitudes and technology, e.g., the requirement that "unisex" policies be produced for certain markets, smoker/non-smoker policies, IRAs, low ball term, etc.

Those who loudly proclaim that whole life is dead and is no longer a viable consumer product are carried away by their newly acquired missionary zeal to make unfair and untrue statements that only 3% to 4% is being credited to those policyholders. Certainly, the mutual companies have been crediting the excess of portfolio or in many cases, new money rates over the guaranteed rates in their dividends and a similar situation prevailed for participating business of stock companies. Nevertheless, the shift toward so-called interest sensitive products has been phenomenal in the last 3 years. The list of these so-called non-traditional life and annuity products continues to grow. Their names have become household words, Universal Life, Variable Life, Excess Interest Whole Life, Excess Interest Single Premium Life, Single Premium Deferred Annuity, Single Premium Variable Annuity, Irreplaceable Life, Indeterminate Life, Variable Universal Life, and so forth.

This shift in interest sensitive products began with the Single Premium Deferred Annuities in the early to mid 1970's when the New York Stock Exchange firms and the financial planning community recognized the need for tax favored products to compete with bank and thrift institutions.

These interest sensitive products bring with them many challenges for life insurance companies. Companies are trying to develop new products and get them into the marketplace faster. In general, the "shelf" life of interest sensitive products will become shorter as companies capitalize on particular investment situations and current products fall out of favor. Compounding this shortened "shelf" life of products are tax oriented products which lose their attraction when tax loopholes are closed. Shortened "shelf" life obviously increases the cost of product development. There is a growing tendency for companies to manufacture their own specialty products for others to distribute.

The emphasis on investment oriented products further heightens "price" and "interest" competition. The complexity of Universal Life, Variable Universal Life and excess interest products will increase the battle for business via projections. This presages the use of hand-held computers, instead of rate books, in addition to more complex illustrations via terminals.

For some of these products, the need to get SEC clearances and to comply with the 1933, 1934 and 1940 Acts has added a level of complexity which many companies never experienced before. As part of the product development process, registration statements, prospectuses and conforming sales and

training material must be prepared. Since insurance products need state approval as well, it becomes a delicate balancing act to meet all regulatory demands. Likewise, complex administrative systems have to be developed in tandem with the approval process in a fashion that minimizes wasted efforts in the event regulatory requirements force changes. Some companies are developing or purchasing separate systems and others are integrating them with their traditional product line systems. In my company's case, we have purchased separate systems for some products, but have developed universal life, variable life and variable universal life ourselves and integrated these products with our traditional systems.

Obviously, the emphasis on investment-oriented products further heightens "price" and "interest" competition. We now see unfolding a battle of projections; double digit interest rates have been projected far out into the future, producing some very attractive results indeed. No longer is there any moderation exercised by showing projections with interest rates reduced to more normal levels. Part of the strategy of companies selling participating permanent insurance has been to rapidly move to new money rates in their dividend formulas and a few companies have managed to raise their portfolio rates to levels matching the new money rates of some companies and emphasizing "abbreviated payment period" selling. (Selling where after say 7 to 9 years, no further premiums need be paid if the dividend scale is continued). This method of selling has spawned another round of product development as companies tried to develop products tailored to abbreviate in shorter time spans. Thus, we have universal life policies with a so-called low target premium where excess interest earnings can carry the policy for the whole of life with the payment of that low premium. We have the other extreme where the premium is higher but through the use of dividends or excess interest earnings, premiums are paid for only a few years.

Life insurance companies' investment practices will also be tested. It appears that there may already be some mismatching of assets and liabilities under some universal life policies. There is pressure to invest long-term in an attempt to show higher returns. Hopefully, the temptations to which some annuity issuers succumbed will be avoided. Obviously, this is a dangerous situation under volatile economic conditions.

Adding to the product development explosion is the trend towards facilities to help clients manage all their financial problems. This and the need to spread overhead expenses are leading life insurance companies to provide an ever increasing array of non-life financial products such as tax shelters and mutual funds through their agency forces.

In the current environment, it is not surprising to see variations of cash management accounts being developed to enable companies to better hold on to clients' money. It is hoped that flexible policies that permit an individual's benefits and premiums to be modified as needed throughout his life cycle will also be used as a means to "lock-in" a client. Product development is being further stimulated by the transfer of the idea of backloading from the annuity area to life insurance. Investment-oriented products can be made to look more like certificates of deposit. Also, increasing attention will be given to developing products that lend themselves to automatic premium payments through bank accounts and payroll deduction methods.

The impact of increased competition with the proliferation of these new interest sensitive products is having the most severe impact on in force in the history of the life insurance business.

Replacements have continued to escalate. With high current interest rates, replacements very often are claimed to be in the policyholders' interest, and many agents have conveniently used this approach to increase their commissions.

As long as responsible business leaders subscribe without qualification to the viewpoint that the existence and continued sale of thousands and thousands of whole life policies creates a tremendous pool of policies for agents to replace, external replacements will continue to proliferate.

Some companies have chewed up their own in force paying and encouraging agents to replace their own in force with their universal life products. And, of course, the drop in capability, which is part of the flexible premium design, has added a new dimension to replacement techniques.

One of my colleagues, who held a policy in company X, received the following solicitation from the agency in which his policy was in force.

"The ordinary life policies you purchased years ago may have been right for the time. But times have changed. We at the (name of company deleted) have a simple professional program to exchange old outdated life insurance for new up-to-date life insurance at great savings.

...You owe it to yourself to see the benefit you could reap by replacing your outdated policies with our new interest and investment sensitive products. . . You will be participating in today's insurance revolution, hand in hand with an insurer that's known for integrity, innovation and consumer orientation."

While replacements have triggered higher lapses, sample surveys made by my company have shown that lapses and loans were initiated to purchase an increasing variety of alternate products.

Many companies have already or are now processing "policy update" programs in order to protect their in force and to protect themselves from policy loan disintermediation.

Since it is the in force that generates the funds to run the enterprise, disintermediation and loss of in force have caused significant modifications in operations - resulting in updates, increased conservation activity and attempts to anticipate loss of in force. There is increased attention by every company with which I am familiar to reduce and control expenses and to refine measures of profitability. As an extreme situation, Prudential found it to be cheaper to waive premiums on its old 25¢ per week policies, rather than to continue to collect premiums.

Mr. Latto: John, if I can interrupt you for just a moment, you will be glad to know that the SEC, on its own, without any goading, now requires on the cover page of every variable life and flexible premium variable life insurance policy, a legend that says it may not be in your best interests to surrender an existing policy in order to obtain the proceeds to buy this product.

Mr. Marcus: The final item is distribution systems. Deregulation will spur companies to find more cost effective ways of marketing. The tendency towards interest sensitive products with reduced margins will make this a necessity for many companies. Should other financial institutions, for example banks, find they can market to a broad spectrum of the public at lower costs than through traditional systems - as some claim they can - there will be increasing pressure to further reduce insurance company's marketing costs.

Traditional captive agency distribution systems are becoming increasingly expensive to maintain. Most of the new agents are being brought into the business by a handful of companies. At the same time, company loyalty is diminishing and "outplacement" of business has become commonplace.

Upon reading an article entitled "Piggyback" in the April 9, 1984 issue of Forbes Magazine, one may well conjecture as to how long this situation can continue. Just let me read a bit of the article to give you the flavor.

"Last year, Jackson National Life Insurance Company sold policies with a total face value of \$7.6 billion. But you won't find any Jackson agents listed in the phone book. 'Our agents are agents of New York Life, Prudential, Metropolitan, the companies that are paying their overhead' says A. J. (Tony) Pasant, Jackson's 65 year old founder and president. By piggybacking instead of maintaining a sales force of its own, Pasant says, Jackson can afford to sell competitively priced policies, pay attractive rates on its annuities and give agents 'slightly higher commissions' than competitors do."

To maintain large agency forces, some companies may choose to go multi-line, (expanding to property, casualty and health lines). This creates a strain as a result of the need to introduce a whole new level of expertise. Of course, others will confine themselves to a "boutique" life insurance operation. Others will attempt to convert their field forces to full financial planners. A recent article proclaimed: "The John Hancock Mutual Life Insurance Company plans to eventually become a financial services supermarket, according to the company's executive vice president of individual insurance services." Another large insurance company has stated: "As the distinctions blur between insurance, securities and banking, the future 'customer representative' will become a more broadly based Financial Services Account Executive (AE). Many AEs will specialize as they do now, but the view is that the majority will move toward a position of offering more products and services, particularly for the middle and upper-income market customer segments." It is clear that competitiveness will escalate, particularly in the upper-income market. Training problems will become more difficult as representatives must take more complicated licensing examinations, learn changing products in a time of rapid product development, and increasingly cope with more complicated selling methods in which they tailor-make their own illustrations.

Over the past year, a number of companies implemented or announced plans to implement changes relating to their traditional distribution systems. These changes will continue to escalate and will fall into the following broad non-exclusive categories.

- a. system structuring
- b. brokering
- c. networking
- d. financial center
- e. inter-company marketing agreement
- f. horizontal integration

Systems restructuring refers to moving from a branch office to a general agency system, moving from a general agency operation to a managerial system, moving from a debit operation to a general agency system, etc.

By brokering, I mean relying on the brokerage community to distribute products. Many companies are now placing less emphasis on developing their own field force, which is costly, and more emphasis on brokerage outlets.

Networking is where an insurer enters into an agreement with a non-insurance financial institution to distribute the insurer's products. The non-insurance financial institution has generally been a bank.

The leader among companies moving to full service financial centers is Sears. Sears plans to have financial centers in 280 of its retail outlets by the end of 1984. J.C. Penney is following Sears' lead, although on a smaller scale in terms of the number of centers as well as product offerings. Capital Holding is also expanding in this area by establishing centers in selected Kroger food stores.

Some of these full service financial centers are fee based. The best example of the full service fee based approach may be the CIGNA arrangement.

LIMRA has identified over 50 insurance companies which have intercompany agreements to distribute one company's products through the other company's sales force. A natural extension of the individual inter-company marketing agreement is the formation of a Corporate General Agency/Brokerage operation to make available to one's own sales force specialty products from any number of other insurers.

Horizontal integration is the merging of insurers with other non-insurance financial institutions to provide clients with a wide array of financial products and services. Following Prudential's lead, more than half a dozen other companies have purchased securities concerns. Fewer have followed our lead in purchasing a bank.

Beside insurance companies buying banks or brokerage houses, there are insurance companies acquiring other insurance companies - vertical integration - to expand their base of operations.

In addition to these changes in distribution systems, other experiments will continue in the future in areas such as direct response marketing, payroll deduction marketing through specialized marketing forces, electronic marketing, and further attention to group mechanisms.

Mr. Affleck: Our panelists have covered a broad territory this afternoon and we welcome any questions you would like to direct to them, or any comments or observations that anybody might have.

Mr. Allen D. Booth: I would like to direct some questions to Ms. Mardon. Assume that your bank is going to distribute life insurance products, setting aside any considerations of mass marketing. Referring to your feelings that distribution costs could be cut from 25% to 15% of the premium dollar, would you please expand a little more in specific terms, on what kind of person would be making the face-to-face sale? Would this person be a fully accredited life insurance agent, a branch manager with a life insurance license, or some other individual in the branch of the bank? What is the nature of training that might be required for that person before the sale? Please give a generalized scenario on how you might utilize modern computer technology to support that person who is lacking a Chartered Life Underwriter's stature in the life insurance industry.

Ms. Mardon: I don't think we can completely disregard the direct or mass marketing approach. Insurance companies and banks both need to streamline acquisition methods. One approach might be to have a joint agreement between the two institutions. Banks already have overhead expenses. Locating an agent in the banks may be less expensive than setting up an office someplace else. When it is possible, we would place licensed agents (perhaps through an agreement with an insurance company) into our branches. Obviously, we would not do the selling; our people have a hard enough time selling checking accounts and automatic teller machines at the same time. We would definitely use a life insurance agent. To date, we have already received well over 50 proposals to market insurance through the bank. These proposals have come from agents and brokers and directly from insurance companies. The most common proposal is a combination of direct marketing techniques (mail and telemarketing) and placing agents in select high traffic branches. Direct marketing efforts and activities similar to the support for our discount brokerage operations would be needed to provide the agent with access to people. However, names would not be passed directly. There would not be any credit tie-ins such as "before you get your loan, go see Joe Agent in the corner." Thus, a licensed agent would be available in the branch to handle the face-to-face sales of insurance products.

Now the compensation structure may undergo a radical change. Rather than 80% of the first year premium, the agent may be put on a salary plus incentive type of arrangement. Some insurance companies have suggested using a fully trained agent who may not be very good at prospecting. If the agent knew that part of the skepticism was diminished in the bank environment, he would have more confidence in his sales capabilities and would do an excellent job in closing the sales. We do not have an agreement right now with an insurance company, but we are looking at all of these proposals. We would leave the agent's training to the people with the know-how, the insurance company.

Computer technology has been utilized extensively in the insurance industry to provide illustrations for complex products. We could use these capabilities in a seminar selling approach. We would invite business-owners into the bank for luncheons and meetings. The agent would have access to groups of 20 or 30 prospects at a time. The agent could prepare, before and during the meeting, individual illustrations of the various products and their benefits.

Mr. Affleck: In reference to the seminar approach, there is a recently formed company in the state of Washington that has been quite successful in using seminar techniques. Through savings and loan institutions, they have been primarily marketing annuity products.

Ms. Mardon: Lastly, the computer could be used to demographically segment our customer lists by age, income level, etc. Mailings on specific products could be made to the specific people most likely to buy. So there are ways that insurance companies and banks could work together.

Mr. Marcus: I would like to make a comment, because some of these kinds of questions were addressed by the Dewinn Commission. Their position on agent training was as follows: If a bank was going to put an agent into their office, the agent must already have at least three years of experience in selling life insurance. By recruiting only agents with over three years of experience, the bank avoids training allowance compensation and may be able to sell insurance cheaper. The bank would also gain the long prospect list of agents with over three years experience. That requirement may solve the training problem, but too much will just kill the goose that laid the golden egg. There isn't any way that insurance companies can just turn out to be training groups for the banks to capitalize on.

Ms. Mardon: I agree that there is a definite problem with the cannibalization of agents by banks. In the talks between insurance companies and banks, we have noticed that both parties request business to be written exclusively through that company.

Mr. Paul A. Campbell: I would like to add just a couple of comments and questions. In this whole subject of deregulation and diversification, we have to be aware of the different kinds of markets served by both financial industries. There are dramatic differences in the needs and wants of the various markets, and these differences will influence the kinds of activities that will be taking place.

Only once in John's remarks was the whole subject of systems requirements and data base requirements mentioned. This subject appears to present a huge challenge to companies wanting to diversify in either direction. This challenge extends to covering the clientele and meeting their needs.

My first question is directed to Mr. Latto. In the discussion of the kinds of informal arrangements that are currently taking place between the banking community and the insurance industry, do you see any kinds of arrangements that are likely to raise concern on the part of the federal regulators, to the point of trying to close down the arrangement?

My second question is addressed to Ms. Mardon. Do you see any wide differences between the two general categories of large national banks and the small regional local banks as to the kinds of needs they see themselves wanting to meet in the whole subject of diversification of services?

Mr. Latto: I have not yet seen specific danger areas that are going to be a concern of the current regulation.

Ms. Mardon: Yes, there is a difference between the large national banks and the smaller regional banks in how they perceive their needs and possible future accomplishments. For the most part, smaller banks will be surely looking at distribution. They will still stick with the more traditional direct mail supplemental type of insurance policies. This is a very clean cut, tried and true distribution approach, and

people are used to it. The smaller banks do not have a large account base. It's very, very hard for them to attempt to underwrite insurance. The smaller banks do not have the people or the capital necessary. On the other hand, brokerage is not very capital intensive. Once it's allowed, the bank could purchase a brokerage operation. This acquisition could be quite profitable. The smaller banks could have trained brokers or agents working within the banks and able to offer a full range of services. The larger banks can approach the insurance business in a vastly different and more flexible manner. Some will insist on getting into underwriting, and they will want to do it full line with multiple products. Others will pick out market niches. Right now, Bank of America is working with Capital Holding and their own subsidiary, H.L. Capital, in addressing workman's compensation and in using offshore captives. Thus, the more that is allowed will enable banks to do more. From small product brokerage operations to full scale underwriting, the smaller banks and larger banks will be different.

