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DISTRIBUTION SYSTEMS FOR INVESTMENT-ORIENTED PRODUCTS

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- What are the new distribution systems for investment-oriented products?
- How are investment-oriented products influencing traditional life insurance distribution systems?
- Which products will succeed with which distribution systems?
- What does the future hold for both distribution systems and products?

MR. CHARLES CARROLL: We have a very interesting panel to speak today, both of whom are from outside of the profession and are professional marketing people. Most of the previous sessions in this special topic meeting of the Society have been concerned with three major themes: investment strategies, measuring investment performance, and new types of investments. To a very large degree, interest in these topics is a result of the fact that many of the new products being sold by life insurance companies are investment-oriented. For example, interest in financial futures is largely a result of the growth in popularity of the single premium deferred annuity product. The companies which have pioneered the use of financial futures are by and large companies with a large amount of single premium deferred annuity business.

Similarly, the popularity of large guaranteed investment contracts in the pension field has made portfolio immunization and asset/liability matching necessary strategies for companies selling such products. The unique features of these contracts -- the combination of a fixed maturity value and absence of a guaranteed value before maturity -- make the matching both necessary and feasible.

These facts lead me to an important observation: investment operations of insurance companies must be driven by the characteristics of the products being sold.

When we delve into the origins of the new investment-oriented products we find that they were developed in response to radically different sets of needs occasioned by a vast change in the environment. These needs have defined a whole new market for insurance products, a market composed both of new customers and new distribution systems.

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This second set of facts leads me to another basic observation: the new customers and new distribution systems are to a large extent controlling the design of new products. If we put these two observations together, we can conclude that it is important to understand the market for and the marketing of investment-oriented products, since these elements influence or even control the choice of the correct investment strategy for the insurance company. This is the rationale for a marketing session within the context of a meeting on investment management.

MR. RICHARD D. JAMEISON: How many people have heard of Monarch Resources as a company? (a few hands are raised) How about Monarch Life Insurance Company? (more hands) In fact, people tend to think of us as Monarch Life Insurance Company and not Monarch Resources, although we are definitely a different company.

Let me begin by saying that I grew up in two very big life insurance companies, first the Metropolitan and then, for the better part of my career, in the Prudential. Two years ago, I left Prudential and went into what I thought was a similar job. The difference in selling a product that is more of a security than a life insurance contract has opened my eyes to many things which I was not aware of before, such as licensing problems, or SEC, NASD and life insurance regulation. The product has become much more complex than the relatively simple life insurance contract that I grew up with for 12 or 13 years.

Let me give you a little background on Monarch Resources to show you why we are different. We are a wholly-owned subsidiary of Monarch Capital, which owns a number of insurance companies, including Monarch Life. This company sells primarily disability insurance and didn't sell life insurance until it began marketing variable life. Monarch Capital also owns Fidelity Bankers and First Variable Life, which does not sell variable life. It sells primarily variable annuities.

Monarch Resources is not a life insurance company; it is a manufacturer. We manufacture variable life products and we distribute them without a captive sales force. We are affiliated with Monarch Life, but its 400 disability agents had as great a transition selling life, much less variable life, as did the brokers with whom I deal. We have a number of other affiliations including a few with mutual companies. But our primary business is to manufacture variable life insurance and distribute it through broker-dealers and through their agents' brokers.

How many of you in the audience work for traditional life insurance companies? (most hands are raised) How many are with consulting actuaries? (a few hands) So it's almost all the former. Of those of you who are with traditional life insurance companies, how many market a variable life contract? (a few hands) A few Equitable people, I would assume. How many market a universal life product? (more hands) How many people market both? (fewer hands) So some of you will know a lot about what I'm going to say. But work at Monarch Resources has been a major transition for me from what I grew up with in a traditional life company. I now work with brokers and most of my business is done through a major brokerage house. The product I sell is much different. Variable life may be the same in premium structure, it may also have guaranteed death benefits, but the non-guaranteed cash value changes the whole situation because the insurance person is used to selling guarantees.

My presentation is titled "Challenges for the '80s" because there has been an unbelievable amount of challenging change in products and markets since I came into the business 15 years ago.

The markets for traditional insurance and for investments and securities were separate to begin with, but have since grown together. Traditional life insurance agents and the products which they sold have been around for years. Investments and securities, until recently, have been sold in the regional wire houses, the regional broker-dealers, or the big national wire houses such as Merrill or Shearson, the two that have been traditionally selling a single product line. The change that has occurred is a mingling of the two markets, and there are now insurance people selling equities and equity people selling life insurance. And of course you have to add banks as the third element in the market. If you look at a Merrill Lynch or a Prudential, you will see that it is a bank, an insurance company, and an investment house. The distinctions between the players in the game have blurred.

The distribution networks include insurance companies, national and regional wire houses, and a third one which was new to me, regional broker-dealers. They are also called hat racks because they're a place for someone to hang an NASD license. They may provide traditional life products, traditional or variable annuities, Nuveen bonds, or stocks. The difference between insurance companies, wire houses, and broker-dealers is that the first two are career-oriented, for the most part, or involve an employer/employee relationship. The third one is only a supplier of various products.

Let's look at selling styles, first for the traditional insurance market. First, it's basically a need sale. The agent sits down with the client, develops a need, and sells a life insurance product to fill that need. When I first came into the business we used to sell income endowments at 65 or 18 as savings products, and that is basically the way the universal or variable products are sold today. Second, insurance is sold by the numbers. All of us in our careers have probably been involved in the development of the numbers which wind up on an illustration that an agent uses to sell. Third, agents are used to selling a guaranteed product. I know that in illustrations for participating insurance the caveat says that dividends are not guaranteed for the future, but every agent I have known that has sold a life insurance product sells a dividend as if it were a guarantee. And then, of course, the death benefit is guaranteed. Finally, life insurance agents sell face to face. They sit down across the table and they sell the product one-on-one.

The selling style for an investment broker is much different, almost the opposite of the insurance style. First, there's the old question, what's the difference between insurance agents and investment brokers? One sells needs and one sells greed. They sell much different products and you'll see that it is a different sale for the same product if it's a broker rather than an insurance agent or rep who is selling it. Second, brokers talk about concepts. They do not sell by the numbers, but talk about a rate of return for an amount of time and the advantages of buying a product. Third, brokers sell potential, the ability to have a certain amount of money in the future. They sell securities which have some potential for growth. Fourth, brokers sell by phone calls, not face to face. The two things that I have found which make insurance agents unsuccessful are that they think the telephone is a monster and that they hate asking for money. They have a great deal of difficulty calling someone on the phone, and dealing with that individual hanging up, saying something nasty or just saying no. And they have trouble asking how much the individual makes, and asking for the premium. You'll see later on that the difference in average premiums of policies sold by brokers and by agents is unbelievable.

Another contrast between brokers and insurance agents is in mind-sets. First, one of the key things that differentiates a broker and an insurance agent is underwriting. Insurance agents are used to requirements for urine specimens, but I have had more complaints from brokers about the little bottle that goes along with selling life insurance than you would believe. It is a totally different world. In dealing with a brokerage marketplace we have underwritten policies almost on a guaranteed issue basis. For example, in a single premium contract for up to 100 thousand dollars, if you can say that you haven't been in the hospital or actually seen a doctor within the past six months, we will guarantee issue of that contract. On the other hand, life insurance agents are used to taking an application and having it go up to underwriting, from where it may or may not come down. Second, agents are used to having commissions paid at some point in the future, but when brokers write tickets for investment transactions, they receive their commissions and have production credit immediately. The more you can make a life insurance product look like what brokers are used to selling and give them the same benefits that they get from selling investment products, the better off you are. Immediate pay out of commissions was not what made our product fly within the traditional agent marketplace; what helped was our guarantee of fast turn-around. When the application comes in, we guarantee to have the policy back within 72 hours. It was an advantage that we were able to work for both sides. A third difference in mind-set is the dollar amount involved in transactions. At Prudential the average premium is about $400 or $500, but the average broker is used to dealing in much larger numbers. In fact some of the policies that we have written have been for a couple million dollars of premium, which is a big ticket no matter how much money you have. Brokers are not scared to ask for the big ticket, so they're much more oriented to selling dollars than the life insurance agent. Part of the difference is because you have a demand product in the case of the broker, and a non-demand product in the case of the insurance agent. And the last difference is that while life insurance is not simple, conceptually it's a lot simpler than selling tax shelters or some of the other things that the broker gets involved in. In fact, when you mention life insurance in a presentation to brokers, you usually see some people go out the door and others climb onto the chair, because it is not the kind of thing that they are used to selling to their clients.

Next, I would like to talk about licensing. We're all used to the traditional life product license which requires a test within your state which if you pass gives you the opportunity to sell insurance. In New York State it's tough, but relatively speaking it's a simple test. Brokers, on the other hand, have to take the NASD exam and depending upon what other equity products they sell, there could be 4, 5, or 6 different tests that they wind up taking. Whether you sell a variable annuity or a variable life contract, you have to take the insurance rep exam, an NASD exam and on top of that, in many states, you have to take a variable annuity or a variable contract test. In some states such as Texas and Georgia, you have to take, in addition to the variable annuity test, a specific variable life test. So now what you've done is take a product that looks different from what either agents or brokers have sold and told them not only should they sell this product, but they have to take another test to do it. That's tough, especially for the traditional insurance agent who says, "Who needs it," or the broker who says, "There's no way I want to sell life insurance." Licensing is the first problem because you have to be licensed to sell the product. So the first important step is that people have to take the additional exams and become licensed to sell the new products.

Who sells what? This is where the transition in this business has come to pass. You could use any combination of products for this illustration, but you'll see what I'm trying to do is build to something that has a common ground for all. We've talked about agents and brokers, and the third group I include is planners. All who are not in life insurance companies and not in brokerage houses tend to call themselves financial planners. They take investment products and insurance products and put them together. Their membership is growing, but I don't know whether their quality is. Some of the products these three groups sell begin to overlap, but the major transition has been that single pay deferred annuities is probably the first product that each of the distribution systems got involved in selling. They also all sold variable annuities and wrap-around annuities a couple of years ago, but these products ran into some problems.

The development effort for variable products is different. First, the product is positioned differently depending upon the marketplace. Second, the training is also different because what you would develop in a training material for somebody who is a broker is different from what would be done for the traditional insurance agent. Third, and this is perhaps the key, is the software system, in other words immediate access to numbers. The insurance sale of the past was something that took place over a number of visits or over a couple of hours. The new products are not sold that way. Some are sold on the phone, some by having the policies brought into the office for an analysis and a replacement sale. It's a much quicker environment than what I grew up in. The broker makes $70 or $75 on an average ticket and does it in 60 seconds as compared to the insurance agent who takes a number of hours or a number of days. It is an immediate world. Therefore, the numbers used to make the sale must be immediately available from your system.

The experience that I have falls into two extremes. The one is Monarch Life and the other is Merrill Lynch which is our biggest distributor. In Monarch, they made very few life sales since the agents were disability agents. They're used to tough underwriting, and the percentage of policies that Monarch will not underwrite is high. The agents tended to sell life insurance as a by-product. On the other hand, Merrill Lynch brokers do not tend to sell annual premium life insurance. They would sell term but it was almost as a reaction to client requests, not as the product that was promoted. They now sell universal life as a replacer. Brokers can be trained, if that's the word, to get the policies in for some type of an analysis, and a universal life contract is a perfect replacement product because it gives you the flexibility within the product to mix and match the amount of investment going in and the amount of life insurance. I know that Frank will talk more about this later. Finally, the idea of "security" in the sense used in traditional life sales is not how brokers sell insurance. They tend to sell it as the cheapest product in the case of term insurance, or as a better deal in the case of a replacement product.

The positioning of the product is important. With life insurance agents, as I mentioned early on, variable life can be positioned as an alternative to whole life insurance with a better rate of return, but it is definitely a cash accumulation type of product. In comparison, a broker sells the life insurance in the product as secondary, while the life insurance tax shelter is primary. Qualification as a life insurance contract does three things which are used to sell the product. It is sold on the basis of tax-free accumulation, tax-free withdrawal through loans, and an income tax-free death benefit substantially greater than the amount that's invested in the contract. The life insurance is almost incidental to the product, although it can be substantial. But the key features are tax-free accumulation and income tax-free death benefits.

Monarch Resources came out first with an annual premium variable life contract with a death benefit that for the first ten years was level and doubled afterward. There were similar contracts from Prudential and Metropolitan. Brokers were able to sell the concept because it was cash accumulation. However, in the traditional marketplace the contract had a lower commission than other permanent insurance products. What agents wanted was something that looked a lot more like a whole life contract and paid a whole life commission. So we developed a second product which was a level contract. Then the traditional insurance agent said, "I can't minimum deposit this. It really doesn't look like something that I'm used to selling." The answer on our product was to add a variable loan rate. Thus, we ended up with the entire accumulation structure of a variable life contract in a contract that can be minimum deposited.

In the case of the single premium product, we started out with an 8% front-end load. The product sold, but slowly because it was like the old mutual funds with an 8% front-end load. It's a lot easier to sell a product that has 100% of your money accumulating than it is a product that has 92%. The change that we made was to go to a spread load, by taking the 8% front-end load, dividing it by 10, and spreading it out over 10 years. Sales tripled. Brokers were obviously more comfortable saying day-1, 100% of your money goes in than saying day-1, 92% goes in, because the average customer thinks that the other 8% is going in the broker's pocket. The second change we made was to increase the amount of insurance. This is going to change, since right now in Washington they're discussing the relation between insurance and investment amounts for a qualified insurance contract. The more insurance that goes into the single premium product the more it becomes an insurance product, and the less an investment, but I'm not sure what will happen.

Brokers sell the single premium product and the annual premium product still today tends to be sold by insurance agents. In the case of a Monarch life agent, who never sold life insurance, the average premium on an annual premium contract is over $1800, which amazes me. But they are dealing in the right market, and the average premium that we sell through other distributors is even higher. But the number that will always astound me is the size of the average single premium contract written within the Merrill Lynch organization, which is $50,000.

There are three changes I see coming in the future for universal or variable products. First, I expect to see flexible premium contracts, and second, more investment options. We had five options when we started, and we still do. One of the first questions I was asked in a presentation two years ago was "It's nice to have five options and flexibility, but where do I put my money?" A managed fund or one fund with the opportunity to invest in a number of different alternatives is a lot more salable to the average person than you might think. Investment flexibility is fine, but the average number of moves that we have with five funds is about one and a half per year, so people just tend to put their money in and leave it. The third and last change is adjustable coverage, similar to a universal life policy where you can mix and match both the amount going in and the face amount. But flexibility is the key. We are all going to have to change products, the time frame is going to be different, and the ability to react is going to be key to succeeding in the '80s.

MR. FRANK SIENI: Good afternoon. For those of you who question why I left Merrill Lynch after they made me a Vice President, a vice presidency at Merrill Lynch means that you get paid once a month as opposed to twice a month. I'm sure that's true with some large life insurance companies, and I know it's true at a lot of banks.

Let's take a look at what's happened since about 1974 or 1975, when the Variable Annuity Life Insurance Company (VALIC) brought to the marketplace what has become the single premium deferred annuity of today. The amazing thing is that the deferred annuity has been around for hundreds of years and I don't think it's received more press during that time than it has in the past two. Some of the press has been good, some not so good.

Speaking of the security side first, the introduction to the sales force of single premium deferred annuities came at a time that was extremely opportune. It came in 1974 through 1976, and those of you who follow the stock market will know that those were some very dismal times for account executives and registered representatives.

The first single premium deferred annuity contracts to come along were hybrids of the contract that insurance companies had issued for a hundred years, except that they were modified to bring them in line with current interest rates. Someone was smart enough to take the sales charge and do away with it by changing it to a surrender charge. Rich had alluded to that before. A security salesman is not used to selling a product where there is no sales charge. So when you now brought him a product and said there's no sales charge but there's a 4% commission credit, that was a surprisingly pleasant thing for him to hear. He could say to his customer, "100% of your money is going to work." And, of course, the customer would say, "How do you get paid?" And he would reply, "You pay me just like you pay the teller at the bank. The insurance company works on a spread and I get a piece of the spread but it doesn't cost you anything." It was ideal for the security salesman.

The second generation product that came along in 1976 or 1977 had a unique feature, a disappearing surrender charge. If you stayed in the contract for a certain minimum period of time, you could get out without losing any money. It was truly a no-load product if you lived up to your end of the bargain.

The third generation contract had not only a disappearing surrender charge but also a bail-out provision. Security salesmen are basically skeptical people, much more so than life insurance agents. The question that you got most often when you did a security seminar on annuities was, "Yes, you pay me 10% this year but the contract says that in the second year you can drop me to 3 1/2%. How do I know you won't do that? If you do it, my customer's locked in with the surrender charge." The bail-out provision in annuity contracts was introduced to do away with that fear. So you now had a contract with a 4% commission, no sales charge, a disappearing surrender charge, and a provision that said if the credited interest rate drops below a certain level, you can take all your money out without losing anything. And on top of that, you had the guarantees of the legal reserve life insurance system. What more could you ask for?

The market acceptance of this product was tremendous. It took some training, starting in the late part of 1975 and 1976. And in 1980 through 1982 the brokerage industry geared up and probably sold on average between 8 and 9 billion dollars in single premium deferred annuities per year. It's pretty amazing that an industry which never effectively sold a life insurance product in a period of three years could get to the point where it could sell 9 billion dollars per year in premium.

The product also brought with it a word that the security salesman was forbidden to use in all of his classes and in all of his tests. It's a word that life insurance companies use all the time: "guarantee." There is no product that a security salesman sells which he can describe using the word "guarantee," whether it be mutual fund, tax shelter, stock, bond, even a government security. When you buy the security, you are not guaranteed to get your money back, because if you sell it in a secondary market you can get less back than you originally put in. So the annuity opened for the salesman whole new sources of money, because he now had the ability to use that word. Today, the use of the word "guarantee" is somewhat in question. In 1980 or 1981, it was a given that an SPDA was a life insurance product and that no legal reserve company had ever failed. As a matter of fact, in the New York State Consumers' Guide to Life Insurance, there's a very clear statement in there from the Insurance Commission that says no legal domicile life insurance company in the State of New York has ever forfeited on any of its promises and no policyholder has ever lost a nickel. Unfortunately, Arkansas and Indiana never made those statements. So what we have today on Wall Street is a situation where the broker now questions the guarantee of not so much the product as the company. The broker today is probably more skeptical than he was in 1976 and 1977.

I'm sure that a lot of you have read in the Wall Street Journal that what sold the single premium deferred annuity was interest rate. In my opinion, that's a fallacy. What sold the single premium deferred annuity was the ability to go after money that you never could go after before and to use the word "guarantee." In conjunction with the benefits to the customer of tax deferral, competitive interest rates and so forth, this ability is what sold the product. I'm sure that many of you here think that if you bring a deferred annuity today to the market you're going to have to bring it at 12%. But Metropolitan Life could bring a deferred annuity today at 11% with Metropolitan Life's guarantee, and could sell that product today, given that it has the other competitive features. Interest rate is not the primary consideration.

It amazes me to see who's coming into the business. At the height of the business in 1981 and 1982, there were many companies that stood on the sidelines and said, "This is a bet-your-company product. This is the savings bank business where we could buy 30 year mortgages and sell the customer nothing more than a passbook with a guarantee that he can walk in at any time and leave with with 100 cents on the dollar." That's scary to a lot of life insurance companies, and it should be. However, even after the Baldwin situation and the Charter situation, if you pick up an AM Best Book you'll notice that New York Life has entered the annuity business. Manufacturers Life, Travelers, Provident Mutual, GEICO and so on, have all entered the business. I questioned the wisdom of entering now, and I got the answer from the chief actuary of Manufacturers Life of Canada. The answer is that you need investment money for an insurance company to survive, and life insurance no longer gives you investable assets. The insurance business is changing dramatically. If you have a truly competitive, whole life participating contract like Manufacturers does, your agents sell it on a minimum deposit basis, so your second year's premium is the first year's cash value. Nothing is left for the insurance company to invest. It costs you $1.75 to get a dollar's worth of premium. If your agents do enough of that business for you, they'll drive you out of business faster. You have to have a product that gives you investment money, whether it be variable whole life, universal life, single premium deferred annuities, or single premium whole life. That's why I think many of these companies are entering the SPDA market today. I think the fact that they're coming in is a benefit, because every big company that comes in lends credibility to the marketplace. That's pretty much where we've come to today. Now the question is where do we go from here and how do we get there?

Where do we go from here as far as products are concerned? I think in the next thirty to sixty days you're going to see a single premium deferred annuity product with a multiple year interest guarantee and no surrender charge. Now that's a fairly dramatic statement, the same as if in 1977 I had made the statement that in thirty days you'd see a single premium deferred annuity with a bail-out provision and a disappearing surrender charge. But I know that the product I just described to you is coming and will be here in thirty to sixty days. It's going to be in effect a tax deferred savings account. The reason it's coming is the competition. For the past 150 years the life insurance industry has not been a competitive business, but is just now starting to heat up. There is a tremendous amount of disintermediation that's taking place within life insurance companies, and they must combat it. They have to turn it around and get cash flow back into a positive position. The competitive forces of banks, brokerage houses, and smaller insurance companies with more aggressive products are going to force the insurance industry to change. I think that many more insurance companies will bring variable annuity products to the market. They have their problems, without a doubt, especially if you're dealing with a field force which is not NASD registered. I think if I were running a life insurance company today that had a captive field force I'd be breaking my back to get those people variable licensed today because I believe that in the variable market we have only seen the tip of the iceberg. And if Congress enacts the legislation that they're talking about enacting, the variable annuity will become a much more salable product for more different types of investments.

When you talk about new life products, you have to consider what segment of the marketplace you want to deal with. If you're going to deal with stock brokerage firms, you are not going to be able to bring that product into a brokerage firm as a life insurance product, because the language of life insurance is totally foreign to stock brokers. They don't want to learn about ADB's or APS's. They want to see how to sell it to customers in the span of 15 minutes. And there's a reason for that. Merrill Lynch used to have an advertisement that said that there were 28 ways for Merrill Lynch to invest your money. If they ran that advertisement today, the number would be 63. A broker at Merrill has 63 different retail areas where he can invest the customers' money, and it is impossible for someone to master them all. You have to get the customer's attention in three minutes and show him in 10 minutes how he can make more money without giving up any more time.

One of the problems that exists in the brokerage world is that for me to sell a $100,000 term insurance policy to my customer for a $300 premium could take me an hour and a half. Of the $300 premium, let's assume that Merrill Lynch is paid a 100% first year's commission. The most that I can be paid at Merrill is 40% of that $300, which means that I worked an hour and a half for $120. If I write two tickets in General Motors, which would take me all of three minutes, I make $170. The broker who takes the time to sell insurance will take it for the tax aspects of the product, for the ability to get at money that he can't get at, or thirdly, for the ability to do something that shows the customer the benefit of dealing with whatever firm he is with. If I can take your annual premium policy that you're paying $3,000 a year for, cut that to $1,500, give you basically the same type of contract you have, and give you greater cash value, I'll do that because I look better in your eyes. But I don't have the time to make a straight insurance sale based upon your needs and spending an hour and a half on needs analysis.

And I think as time goes on, it becomes more evident that companies have to change. If you look at what's happened to life insurance companies in the past five or even the past two years, you see companies that were built on whole life insurance running ads saying they've scrapped their whole life portfolio because universal life is best. That's a dramatic change for an insurance company, and there are more dramatic changes coming.

I think we will see several large mutual life insurance companies, right here in New York, become stock companies. I don't know if they know what that means, but it's going to happen. Taking those mutual companies and making them stock companies is going to have tremendous impact on the marketplace. It's going to give them the ability to become more aggressive. And as the man I used to work for, Ross Kinsey, who's now the Chairman of the Board of Goldome Bank and who was Executive Vice President of Marketing at Merrill, used to say, "It takes a lot longer to turn an aircraft carrier around than it does a PT boat. But once it turns, it's got a hell of a lot more firepower." I think big companies have got to change.

I don't believe that anybody today truly has a captive field force, because the captive insurance agent is constantly being asked to do more for less money. And the reason he's being asked to do that is because the consumer is smarter, the competition is greater, and therefore, the New York Life, the Met or the Pru agent, whoever he may be, runs up against people from Merrill, Paine Webber, Executive Life, or Jackson National. And in 8 out of 10 times he will lose the case. If he's put in that position for the second time, he'll be licensed with those four companies because he's not going to lose a case again. That's not disloyalty, that's survival. It's almost impossible to keep a captive sales force today with the competitive pressures that are coming to bear on the life insurance industry. I don't believe you can afford that system any longer, and more importantly, if you do have that system, those who do not have it take advantage of it by giving your agents products that you don't offer or giving him products in a competitive situation that he's forced to sell because somebody else is trying to sell similar ones.

Competition in the insurance industry will be coming from banks, and I know for a fact that once the New York State Law is passed Citibank will come into the business. They will be in New York, full-fledged in the insurance business the day that law is passed, since they are already putting the mechanism together.

Stock brokerage firms have not yet been a factor in the sale of traditional life insurance. I think that there are many reasons why that hasn't happened yet. Some of them are things that the insurance companies and some that the stock brokerage firms are going to have to change if they truly are going to make an effort to sell traditional or conventional death benefit type products through the stock broker.

If you make the decision to change and develop a new product line you have to decide where you market the product line. First and foremost, it is imperative that the product that you bring to the market be competitive if you're going to bring it to the stock brokerage community. The stock broker has 63 different products to sell, while the insurance agent basically has one -- insurance. If the stock broker doesn't like what he sees in insurance he moves over to mutual funds, tax shelters, stocks and bonds, zero coupon bonds, options, strips, straddles, calls -- he's got a myriad lines of products that he can pick and choose from. So you're going to have to bring a product that appeals to him, because if it doesn't appeal to him the customer will never see it. And there's no reason for him to bring it to his customer if he doesn't believe that it is competitive and he can sell it to his customer.

Two. Now that you've made the choice to build a competitive product, what do you do with it? Who do you bring it to? You walk over to Kidder Peabody and you go up to the seventh floor and you sit down and Kidder says, "We'll sell this." You drop off 10,000 pieces of sales literature, and then what? Who takes it from there? We all have a conception initially that the New York offices of brokerage firms control their branch offices. That's the greatest misapprehension in the world. When I came into the home office of Merrill in New York I discovered that it has no control over its field force. Instead, the field force tells New York what to do. If somebody in the home office doesn't make an effort to put your product into the branch office, you can have the best product in the world but nothing will happen. There are several companies which I'm sure are represented here which have variable annuity products and agreements with brokerage firms. How much business are those brokerage firms doing for you? As opposed to the business they do for Mass Financial Services (MFS), Sun Life, or Kemper? I'll bet if you look at your numbers versus theirs, the brokers are doing significantly less for you, because the first two that I mentioned have dedicated representation.

There are people from MFS and Sun Life in brokerage offices every day of the week. The home office of a national wire house cannot get your product sold. The best that they can do is put out a letter that says, "We endorse the sale of this product," which will come into the stockbroker's in-basket along with 76 other letters. He will quickly empty that in-basket into a garbage pail.

I'll give you a perfect example. GEICO's product is a relatively new one that we market. We mailed two convention statements to an individual at a brokerage firm -- one for GEICO, one for Garden State Life. They were thrown away without ever being opened. I was then called ten days later and asked, "Where are the convention statements you promised me?" That's what goes on. The field force tells the brokerage house what it will do, not vice versa. You have to have some form of dedicated representation within a brokerage firm.

Is anybody here familiar with Capital Life Insurance Company of Denver? No? Or Old Republic Life here in New York? Nobody's ever heard of that either. Capital Life last year wrote 900 million dollars of single premium deferred annuity business and did it predominantly with the weakest product in the industry. They did it because they have 67 people who don't do anything but sit in brokerage offices and make presentations for Capital Life. Dedicated representation. Life insurance and annuities are not sold based on which is best, but by having agents. If price were the key, every major mutual company in the Northeast would be out of business. Similarly, it's not price that sells products at a brokerage firm, because if it were Merrill Lynch, Paine Webber, Kidder Peabody and all the rest of those firms couldn't exist alongside the discount brokerage business. The way to get products sold is to have somebody in the field beating people up to sell it. Out of sight, out of mind is very true in a brokerage firm.

Third, the independent agent market is critical. We have found at MSM that our single largest "firm" in our computer, other than the Paine Webbers, the Kidder Peabodys, the E.F. Huttons, is the independent agent market for single premium deferred annuities. Last year our independent "firm" which constitutes about 3,900 independent agents out-produced every brokerage firm that we do business with. Those 3,900 agents out-produced Paine Webber, Prudential Bache, and Kidder Peabody, because life insurance agents sell life insurance for a living. If the stock broker falls across a single premium deferred annuity sales opportunity he'll take it, but the life insurance agent is actively looking to sell single premium deferred annuities. It's more of a bread and butter thing to him, whereas to the broker it could be an ancillary sale.

We have found that the independent agent market is adrift with no direction. Nobody had ever attempted to gather the independent agents, but if you could, you would probably wind up with a general agency that's got 15 to 20 thousand good producers. And if you think about the average general agency, you're dealing with monster numbers. That's one of the areas in which we are concentrating our recruiting efforts.

My final topic in how and where to market new products is brokerage firms. We've already discussed national brokerage firms, but let's talk about the regional firm. My definition of a regional firm is a little bit different. For example, A.G. Edwards & Sons is probably the leader in the brokerage industry in dollars of insurance premium per agent. If you assume that the average premium per Merrill Lynch account executive was $1,000, you'd find that that number is probably $4,000 to $5,000 at A.G. Edwards. A.G. Edwards and firms like it concentrate more on selling like life insurance agents, not like the big wire houses. Their offices are in out-lying areas, very seldom in major cities. Their account executives are trained to go and visit the customer, which is uncommon in the Merrill Lynch office where business is done by telephone. It's very difficult to make conceptual sales such as tax shelters, single premium deferred annuities, or life insurance over the phone. It's a much more complicated sale than "Buy 100 shares of GM, I think the stock's going up." There are many regional firms that fall within that category: the Edward D. Joneses of the world, the First Michigans. These second line firms are tremendous opportunities if you bring them the right product. A.G. Edwards right now is doing a heck of a job for several life insurance companies selling their single premium deferred annuity.

So we see the regional brokerage firms becoming more and more a part of the marketplace. But why would you want to go after a regional brokerage firm when you can deal with somebody who's got 6 or 7 thousand account executives like Prudential Bache or Dean Witter? One of the problems in marketing to Dean Witter, Prudential Bache, Shearson/American Express is that there is a tremendous amount of vertical integration taking place in those firms. It is difficult for me to believe that at some point in the future, Prudential is not going to look at the Bache sales force and say, "We ought to give these guys something to sell." Similarly, Fireman's Fund will give the Shearson/American Express account executives a product to sell. Now, if I were Sandy Weill and I were running Shearson for American Express, I would much rather keep the profits in house. If I can get the profits into Fireman's Fund as well as the sales compensation into Shearson, that's a lot better than putting money into Executive Life, New York Life or Metropolitan Life when all I get is the sales compensation. So I think you're going to see more and more vertical integration take place on Wall Street. And five years from now, I think you're going to see every major brokerage firm owned by an insurance company or you're going to see absolutely the reverse: there will be no brokerage firms owned by insurance companies.

Vertical integration will only work if you bring competitive products to the broker. If you don't bring competitive products, the broker doesn't have to sell them since he's got the other alternatives.

The Hartford recently bought 24% of Thomson MacKinnon with the idea that it would market products through Thomson MacKinnon; it has in registration with the SEC a fixed annuity product. You can no longer today sell any other deferred annuity product at Thomson MacKinnon until the Hartford product is approved, which is vertical integration at its strictest. There have been no single premium deferred annuity sales at Thomson MacKinnon in the last 4 to 5 months. I think you're going to see more and more of that take place on Wall Street as the companies who have acquired brokerage firms become more comfortable with the firms.

There has always been a dichotomy between the insurance industry and the brokerage industry. They come from different sides of the street. One was selling guarantees and the others were selling potential, what Rich referred to as need versus greeds. The broker sells not only greed, but fear. Those are basically the two sales made by stock brokers: to get you to buy it's a greed sale, and to get you to sell it's a fear sell based on the fear that what you made will shrink.

The products, as they become more sophisticated like variable life or variable annuities, can do away with fear and greed sales and bring the broker closer to an objective sale, although probably never a needs sale. Stock brokers are doing a hell of a job selling CDs today. So I think when you sit down to design a product, the conventional has to go out the window.

When I look at universal life contracts around, one of the things that distresses me is that if you take the company name off the policy, it's impossible to tell which one belongs to whom, with the exception of three or four companies. I don't believe that you can copy a product and expect it to be as good or expect it to allow you entry into a marketplace, at least not into the marketplace that we're talking about. If you're going to bring out a variable annuity product, you're going to have to do things different from MFS, Sun Life, or Chemical. Your product has to make a stock broker put down the application that he's used to writing and pick up the new one. If you don't give him a reason to do that, he won't, and he'll continue to sell what he's comfortable with. That's also true of financial planners. You can't just follow conventional wisdom any longer: if you look at some of the companies that have been highly successful, you see that they've been highly unconventional, and the industry has followed. I think that some of the bigger companies in the industry have got to stop following, and start leading again. The insurance business is again becoming a risk business.

I think the days of paying 4 to 6% interest on life policy funds are over because the consumer is too smart. Traditional whole life is something that a stock broker will never sell. He works with interest rates all day long, and he can't get somebody to buy a contract paying 6% because it doesn't make sense.

What are the opportunities that we face?

One: if you can put together competitive product, you can broaden the premium base. You can get higher premium flows into the insurance companies.

Two: if you bring out variable products, you've taken the risk away from the insurance company and what you're working for is predominantly fee income, which is something that insurance companies have not been used to. But I think it's something that you're going to work more for in the future because fee income can be substantial.

Three: you can stop the disintermediation that's taking place within companies today, which is probably the number one problem of most companies.

Four: you can grow or make your sales force larger and that's the key. Without a sales force, nothing can get sold. If you can increase your sales force by Paine Webber's 4,500 agents, that's a big increase. If only 10% of those salesmen sold your product seriously, that would be a tremendous increase in premium revenue.

Five: the new variable products will give you access to money not available before. As Richard said, the insurance agent is used to dealing with small sums of money. That's changing, largely because of the single premium deferred annuity. The ability to get to money that is not earmarked as insurance money but as investment savings money is of paramount importance to insurance companies. Insurance companies can not exist on three and four hundred dollar premiums any longer. The average single premium deferred annuity ticket that we write is $24,000 or $25,000 and the average single premium whole life contract that we currently write is about $75,000 of premium. It's a lot cheaper to process one $75,000 premium than it is a hundred $750s.

So, if I had to leave you with a word, I think the word is "unconventional," because I think the unconventional will succeed, and the conventional will wither. There are tremendous changes taking place in this industry; they are going to continue to take place in this industry and they are going to be brought about by the competition of newer companies which don't have the problem of older portfolios. The changes will be brought about by banks and by brokerage firms with parents which are or which own insurance companies like Dean Witter which is owned by Sears and which also owns Allstate. I think all of those forces are going to make this a more competitive and aggressive industry for the rest of the 1980s.

MR. GENE GALE: We are contemplating marketing a variable life product, and I wonder if you might say something about the extent to which home office personnel would have to be licensed within the NASD.

MR. JAMEISON: When I was at Metropolitan in 1968 I was involved in the development of a variable annuity. At that time, the feeling was that everyone connected to variable products had to be licensed. It's our view within Monarch Resources that anyone who relates directly to the field, in a sales situation, should be licensed at least to the level of NASD series 6.

MR. GALE: What about policy owner service? Should anyone who fields questions be licensed?

MR. JAMEISON: If you were to call into our office with a question on our toll-free number, you would be answered by a rep, and we try to get them all licensed. We're a relatively small firm, only about 90 people who are mostly for administration, but a large percentage are licensed with the NASD. We have encouraged licensing throughout our company, just as life insurer home offices encourage employees to become CLUs.

MR. SELIG EHRLICH: I have a question on the new SPDA that's coming with no surrender charge. Will it continue to have a 4% commission or some sort of commission and if it will, can you tell me where I can apply for an NASD license?

MR. SIENI: First of all you don't need an NASD license for the SPDA. The answer to your question is that the commission payment on the contract will be spread over a 4 year period, and the payment in the first year is larger than it is in the latter years. Ultimately it will pay a 5% commission, compared to the 4% that the SPDA does today.

MR. JACK MCKEE: How common is it for a regional brokerage salesman to have in his sales portfolio more than one company's single premium deferred annuity and, assuming he has more than one available, what motivates him to select a particular contract at any particular date?

MR. SIENI: I think that there are several answers to that question. First you will find that the broker in a regional office or brokerage firm will have more than one contract in his bag because the plain vanilla SPDA that existed in 1980 through 1982, with a one-year interest bail-out guarantee provision and disappearing surrender charge, is not the norm any longer although it still exists. Today you have multiple year contracts and indexed products, and there's a contract issued by Executive Life with a 15-year guarantee which is also an income product. So I think the broker does have those things in his bag, because when he sits with a customer the first time and talks about SPDA generically and gets the customer's feeling of where he wants to go, he's got to have the ability of the old mutual fund salesman to pull out the growth fund, the income fund, the balance fund and so forth.

MR. MCKEE: It sounds like features in these different contracts are critical, as opposed to who was the latest salesman or regional man in there pushing his product.

MR. SIENI: Let me answer you this way. I assume from your question that we're dealing with someone who can discern the difference among products.

MR. MCKEE: Yes.

MR. SIENI: If that's the parameter of your question, then I would agree. But if we're dealing with someone who has seen the product perhaps two months ago who cannot truly discern the differences, then I would say that the wholesaler who sees him the most will get his business. I don't believe right now that as much as 15% of the entire stock brokerage community can recognize the differences among products.

MR. BOB CARVER: One quick comment on your statement about Metropolitan Life. You would have a very interesting discussion with our sales force about 11% SPDAs.

MR. SIENI: Give me your 11% product with the other competitive features, don't give it to your sales force.

MR. CARVER: Maybe that's what we should try. I also have a question concerning the SPDA with no surrender charge. Do you see any problems with the possibility of the IRS coming down on the constructive receipt issue? I've heard there's a possibility that they will apply that principle or have a law passed about the tax-deferred annuity market. Do you have any thoughts on that?

MR. SIENI: Let me take you full circle. In 1976, the legal department of Merrill Lynch said that Merrill Lynch would never sell an SPDA that had a disappearing surrender charge because when the surrender charge disappeared, it was their opinion that you were in constructive receipt of the funds. But when the Carter Administration considered SPDAs for the first time, there was no distinction made between the product that had a surrender charge that lasted forever or a surrender charge with a disappearing feature. After looking at the Administration's attack and reading the laws again, the Merrill Lynch legal department relented and let us sell SPDAs with disappearing surrender charges. If the IRS came along at some point in the future and said of a nonqualified contract, "If you have an SPDA with a disappearing surrender charge, you're in constructive receipt," I think that the chances are that they would probably grandfather existing contracts. If they didn't, then that means that if I bought an SPDA in 1977 and still had it, I'd be in constructive receipt of the money, and I think that's a tough position for the government to take.

MR. JIM TILLEY: I'm really rather intrigued by this new product that's coming out. I'd like to be at the front of the line to buy one. I presume that, since you say that rate is not at the top of the list of things that are important in selling this product and it obviously has many other attractive features, the rate will be less than 11%?

MR. SIENI: I can't answer your question yet. I don't know the answer.

MR. TILLEY: In your opinion, is this product fairly risky for the insurance companies issuing it?

MR. SIENI: Well, I think you have to look at the scenario that's taken place from 1977 forward. The risk in the single premium deferred annuity contract is the risk of taking your money and putting it into a place where it is not liquid, and then having rates go against you. I.e., you buy 20-year paper in 1977, the prime rate goes to 21-1/2 in 1979-1980, and the same field force that gave you two billion dollars now sees you offering an SPDA at 16 versus the one that they sold at 11. Guess what? You're going to get that money again. Is there a risk involved? Absolutely. You can't buy bonds and lock them up for 20 years as the Savings & Loans did. They found that when rates went up and when other investments became more attractive, there were more people at the front door than they had liquid reserves.

Now, I believe the second part of your question deals with the surrender charge. If we look at the traditional SPDA that exists today, you'll see a surrender charge that normally starts at about 6% and gradually goes down, for example 6, 5, 4, 3, 2, 1, or 6, 6, 5, 4, 3, 2, 1. If long term bonds were to go from 10 to 14%, that 6% is not going to help you if you're in 20 year bonds.

MR. TILLEY: No, of course not, but it's sure better than zero.

MR. SIENI: Well, is it?

MR. TILLEY: Yes, of course it is.

MR. SIENI: The key is you can't buy 20 year bonds.

MR. TILLEY: Oh I agree with you but any time someone would give me $6 on leaving rather than nothing I'll take it.

MR. SIENI: However, if there's a bail-out provision in the contract you might not get the $6.

MR. TILLEY: Is it a fixed rate product?

MR. SIENI: Yes.

MR. TILLEY: Do you foresee a possible scenario in which the company could find itself in a predicament that makes what happened to Baldwin or potentially to Charter just pale by comparison?

MR. SIENI: I think that predicament exists for any life insurance company whether in the SPDA business or the life insurance business. It depends upon where investments are made. Baldwin was a life insurance or an investment problem, not an insurance company problem. Charter was a parent company problem, not an insurance company problem. So I think the view that Charter Life or Baldwin Life took their parents under is backwards. The parents took the life companies under.

MR. ED HIGHTOWER: My remarks are directed primarily toward the presentation made by Mr. Frank Sieni. While it definitely should be very thought-provoking, and may accurately characterize the type of strategy that some companies have used and are using to market interest-sensitive products in large quantities today, I offer the following criticisms, first, of the content of Mr. Sieni's remarks, and second, of certain of the design characteristics of interest-sensitive products espoused.

First, it seemed to me that there were some contradictions in Mr. Sieni's remarks. On one hand, he seems to be saying that interest rates and product features are not of primary importance in the marketing success hat a product enjoys; rather, "dedicated representation" is paramount. On the other hand, he suggests that life insurance comapnies should watch for the expected appearance of an annuity product which has neither front loads nor surrender charges.

Second, it seems that the whole notion of letting the distribution system, whatever its characteristics are, not only have input to the process, but really dictate to the companies both design and pricing features of products seems to me to be inconsistent with sound business practices. It is a repudiation of principles that have been discussed during the earlier parts of this meeting. While life insurance companies are risk-taking enterprises, and Mr. Sieni argues that we should take greater risks, I do not believe that we should jeopardize the soundness, safety, and solvency of policyholder funds in the quest for greater "market share" as the primary motivation of business decisions in this dangerous area of interest-sensitive products.

MR. SIENI: Everyone is entitled to his opinion. I think if I had done this session in 1977, the first year that Executive Life brought out the Irreplaceable Life contract with an 8% guaranteed cash value, your comments at that time would have been very similar to what they are today. Not only did it have an 8% cash value but it was truly a no-load life insurance product: 100% of the money went into cash value. Irreplaceable Life now pays 11-1/4% which is somewhat low in comparison to some Universal Life contracts that are being offered by the industry today. However, last year we sold just a shade under 200 million dollars of Irreplaceable Life first year premium, and people who bought the contract at 8% this year were also credited with 11-1/4%. I think the industry has moved more towards us than we towards them.

MR. CARROLL: I'd like to say something in defense of Frank although I'm not sure he feels he needs any defending. As somebody who is more familiar with the company side of the issue, I would say I am disturbed by some of the scenarios that Frank has mentioned, but we cannot deny that such scenarios exist, whether or not the product he mentioned does come into the market. As someone involved in the market from a supply side I would be fairly concerned about the appearance of a product like that. However, the product would appear regardless of my concern about it. I think we all have to find some way of dealing with that situation, whether by walking away from the market or by designing some defensive product in response to it. We have to develop those strategies, but decrying the fact that a competitive marketplace exists doesn't make it go away, and similarly decrying the fact that some companies will make decisions which will bet their company on a market also doesn't make that fact disappear. I would like to see at some point a synthesis of the marketing side and the company side which transcended those difficulties, but I'm not sure it would ever be possible. It's interesting to hear what actually exists, whether or not it's sound practice from anyone's point of view.