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INTEGRATION AND DEREGULATION OF FINANCIAL SERVICES

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MR. R. LARRY WARNOCK: The complete topic description for our panel discussion is "Integration and Deregulation of Financial Services." That was the particular title selected, but we could have selected from a large repertoire of buzz words. We could have called this session:

- Revolution in financial services,
- Diversification in financial services,
- Between the dairycase and the meats: Insurance sales in supermarkets,
- Why the banks really wish Continental Illinois had never happened,
- The case for the non-level playing field,
- Fraternizing with the enemy: Joint ventures with banks and insurers, or
- One stop shopping: The American Bankers dream.

We will likely see this topic a lot in future meetings and perhaps it will receive a more glamorous name.

Let me tell you a little about our panelists. Mike Ross is an economist by background, and profession. He has participated in the recent Society seminars on "Diversification in Financial Services," so is well equipped to deal with our topic. I have asked Mike to concentrate on the Canadian scene.

Harold Ingraham, Jr., has become very interested and active in the financial services scene and most of you have probably seen one of his articles this year, or maybe you were fortunate enough to hear him speak on the subject. Harold has prepared some fairly extensive remarks on the U.S. scene in financial services, which I believe you will find informative. If you have not been closely following developments this year, a lot has happened in the U.S. in 1984.

Our topic is Integration and Deregulation of Financial Services. Some of you may believe this means only "Banks Selling Insurance." That is a big part of it ... but the topic is actually much wider. There are many players in the "financial services" industry. They include commercial banks, thrift institutions, securities firms, finance companies, financial conglomerates (Shearson/American Express), and insurance companies. Historically, each type of institution dealt in its own little sector of the financial services industry. But in the past decade, various firms have expanded outside their traditional bounds, by expanding their product lines and by making acquisitions outside of their industry.

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This has been the result of deregulation and aggressive management pushing just to the edge of their boundaries, and sometimes beyond the edge. So what we see now is this:

(1) Thrift institutions now offer checking accounts, previously reserved for banks,
(2) Insurance sold in the lobbies of banks ... and in supermarkets,
(3) Banks offering discount stock brokerage services, and
(4) Retailers, such as Sears, after financial services

That is what we mean by Integration of Financial Services. Now, to tell you about the Financial Services grab box, I give you Harold Ingraham.

MR. HAROLD INGRAHAM: Today, as never before, the insurance marketplace finds itself besieged by potential new competitors, many of which are financial institutions such as banks and investment houses. While many in both banking and insurance would argue that these financial disciplines are distinctly different, it must be recognized that the segregation of financial services is a relatively recent phenomenon - dating in the U.S. to the reaction to the Depression in the mid-1930's.

But throughout the world, and particularly within the U.S., changing financial demands are reshaping the financial services industry. The rapid rise of consumerism, increased buyer sophistication - both personal and commercial - and governmental deregulation are all increasing the competitive challenge as banks, investment houses, insurance companies, retailers and others seek to insulate and protect their own business while at the same time aggressively trying to enter other financial areas.

With respect to the life insurance industry:

- A number of the large companies have already positioned themselves to provide comprehensive financial services.
- Other companies will concentrate only on selected financial services.
- Still others may evolve into specialized life insurers focusing their efforts and resources on specialty products or market segments. In other words, nit-picking.

In any event, the trend away from segmented financial institutions and toward diversification seems firmly established. And even if the pace of acquisitions declines, product modifications will continue to carry this trend forward.

NEED FOR DIVERSIFICATION

Why should an insurance company diversify? Because diversification presents an opportunity to:

- Enhance corporate profitability,
- Penetrate target markets,
- Reduce the risk that any one product line will lose its viability,
- Meet competitive threats not only from traditional products, but from new products as well,

- Retain the strengths of the career agent distribution system by providing the career agents with more income sources and client control,
- Improve economies of scale so as to operate more efficiently and effectively, and
- Maximize the use of existing management talent.

These factors provide the push toward diversification. The pull is provided through technological innovation, deregulatory initiatives, and market entry mechanisms such as joint ventures and acquisitions.

It is worth spending a minute more on this technological innovation point. Data processing and transmission have become so economical and sophisticated that a wide range of new services is now feasible. Complex customer accounts can be produced monthly for even small depositors at very low cost. Such accounting now permits the interaction between checking accounts and savings accounts, and can also handle "sweep accounts" which send excess money into money market funds to maximize investment yields. Many experts believe that this new technology will overwhelm the existing regulatory process. They believe that technology will bypass current regulatory limits and make such limits pointless. Then, laws and regulations will have to be altered or removed to reflect existing technology, as may happen soon with respect to geographical boundaries.

The life insurance industry at the present time possesses certain competitive advantages which can help support both diversification beyond traditional bounds and also defend against attack from other financial service providers, such as:

- The unique "inside tax-free build up",
- Being alone in being able to offer consumers guaranteed income, along with reinvestment of earned income,
- Existing national marketing networks. On the other hand, branch laws at present limit many banks and thrifts to regional marketing, and
- Investment capabilities - valuable resource in an environment where the consumer is demanding flexible investment-oriented products and services which provide maximum liquidity,

and, our career agent distribution system which:

- Fosters personal contact with clients,
- Supplements company-oriented support services, and
- Allows agents to serve clients in an expanded client consulting role.

However, as Jim Anderson has pointed out in a recent NATIONAL UNDERWRITER article entitled, "Metamorphosis in Financial Services," the individual life insurance industry has become practically everyone's favorite target in the move toward diversification. This industry is perceived as competitively "soft" because:

- Its high cost, inefficient distribution system is well-known and viewed as an opportunity by many outsiders,

- Its products historically have provided high margins for expenses and profits, largely because price competition has been blunted by a complex product not easily compared,
- The industry is perceived to be a captive of its own distribution system and, therefore, poorly positioned to compete through alternative distribution systems, and
- The industry is vulnerable to a raid on its existing business in force because it seeks to recover from existing policyholders - whose cash values are demand deposits - the large unrealized losses on its investment portfolio.

Anderson goes on to state that with increased price competition from alternative products and alternative distribution systems, the traditional high cost distribution driven strategy of the industry is in trouble. He argues that that strategy must be replaced by a customer-driven strategy, emphasizing better value products and more efficient distribution systems.

INSURANCE BUSINESS ATTRACTIONS FOR BANKS

It should be noted that, despite existing regulatory barriers, the insurance business is not entirely alien to banks. Many, in fact, have already had some experience, albeit limited, in the insurance business and are now seeking only to expand their activities.

As of 1983, about 1000 banks were licensed to sell insurance according to Insurance Research Services of Philadelphia. Most of the banks are limited to offering credit life insurance which only covers the amount of the loan. Since 1971, banks also have been permitted to underwrite credit coverage. Today, about 250 banks own captive credit insurers. And the percentage returns on the capital needed to invest in these credit-life operations are substantially higher than those banks can normally generate in their traditional lines of business, ranging between 20-30% of invested capital.

A number of other banks are permitted to sell life insurance because of exemptions in federal laws. Banks located in areas with populations not exceeding 5,000 and institutions with assets under $50 million can enter the business.

One year ago, the Federal Reserve Board approved an application submitted by Whitewater Bancorp, Whitewater, Wisconsin - authorizing the $45 million-asset bank holding company to conduct insurance activities through its subsidiary, First Citizens State Bank of Whitewater, a community with a population just over 12,000. This was the first time that the federal regulator approved an application under a provision in the Garn-St. Germain Depository Institutions Act which allows bank holding companies with total assets under $50 million to engage in insurance activities.

Why do banks want to enter the insurance business? Some of the reasons are:

- Profits from insurance distribution,
- Synergy for existing bank products and services from the addition of a new insurance product line,
- Greater client control by providing more of the products and services the client wants and needs - the "full service bank,"

- For defensive purposes, and
- National presence. To the extent that the major national banks would be able to participate in the insurance system, especially by owning a national insurance company, they could both achieve a national presence and find significantly more ways to push against the present interstate activity limits.

In a 1983 study produced for the American Bankers Association entitled, "Assessment of Business Expansion Opportunities for Banking", one conclusion reached was that for banks of any size, insurance distribution is one of the most attractive areas while insurance underwriting is clearly the least inviting.

I take this conclusion, however, with more than a few grains of salt. The study lumped together property/casualty with life insurance, and many of the factors considered might have come out differently for each category of insurance.

How are banks likely to enter the insurance business? In analyzing this question, we should look at the present restraints on banks, current efforts to ease or break them, and some potential options with or without legislation.

- Legal Restraints. Most of the major banking institutions are nationally chartered commercial banks. National banks and their holding companies are presently limited to certain insurance sales activities - and, in most cases, further limited to small population centers and to small institutions. Federal S & L's have similar but somewhat less restrictive limitations. However, a single S & L holding company is virtually unrestricted in its other activities. And recent proposed legislation would have removed insurance activities in whole or in part from the list of prohibited activities for bank holding companies.

On the state level, there are varied laws both permitting and restricting the activities of state chartered banks and their holding companies. The South Dakota "Citicorp" law has been the subject of considerable interpretation and litigation. It would grant insurance powers to a special type of bank - bank with a single South Dakota banking office created or acquired by an out-of-state bank. Similar legislation is being considered in other states.

Reregulation. There are many forms which the proposed reregulation of bank activities can take. One is total deregulation. That could be deregulation of holding companies only, or of the bank themselves. At the other end of the spectrum is the South Dakota type legislation which appears to authorize a specific plan of operation. This would arguably allow Citicorp, and any others who wish to take this specific approach, the opportunity to do so. Considerable resistance to this approach can be expected.

Another approach would be an effort to allow either the bank or the bank holding company to freely enter the insurance distribution business only.

As opposed to total deregulation, it may:

- draw less fire from opponents,
- be less of a threat to the soundness and safety of banks,
- be seen as less of a step toward interstate activity,
- help more than hurt those insurance companies distributing through the brokerage system, and
- pose considerable less threat to smaller banks.

However, as has been demonstrated in the credit insurance business, it does not take long before some banks decide that they want the "whole pie" and seek to take over the underwriting as well.

Bank Options. Even without legislation, banks have ways of moving into the insurance business or availing themselves of the insurance distribution system to accomplish their goals. One way is through joint ventures - or networking, which I will discuss in more detail in a few minutes.

One example is Bank One of Columbus, Ohio, which has been creative in obtaining certain benefits of the securities business - and, thereby, in a small way of the insurance business - in its relationship with the Merrill Lynch Cash Management Account. Without moving itself into any business that it was not already doing, the bank found a way to increase the volume of its existing business by significant multiples. It is interesting that Bank One has also opened its facilities to Nationwide Insurance for walk-in or store-front marketing. The potential of these creative solutions to sharing the financial services playing field instead of knocking each other out of it is worthy of thoughtful consideration, no matter what course the regulation of financial services takes.

It appears that banks will move toward the insurance business in one or more of the following ways:

- Individual banks will make innovative arrangements, i.e., Nationwide-type sales desks, insurance available by credit cards, or insurance counseling in home computers.
- Banks will continue to chip away on state laws authorizing entry into insurance - e.g., the South Dakota initiative, and the DeWind Commission in New York.
- The banking industry will attempt to have insurance brokerage and underwriting permitted by regulation or legislation at the national level.
- Major banks will push for bank holding company freedom to acquire insurance companies.

A good guess is that the only one of these initiatives is likely to be pushed by the banking industry as a unified force is the opportunity to go into the insurance brokerage business. The other options are more likely to be undertaken on an individual basis or by a subgroup of institutions.

Impact on the Life Insurance Industry. Here, the most significant factor determining the degree of that impact probably will be whether or not the banks achieve the freedom to own and operate insurance companies. If the banks obtain brokerage rights only, the major impact will be on the distribution system. It raises interesting issues such as:

- Whether insurance will continue to be "sold, not bought".
- Whether the career agency distribution system can once again adapt to and withstand the challenge.
- Whether product simplification and/or computerized analysis and selection will assist in selling and make it more efficient than personal distribution.
- Whether bank brokerage will force the total split of insurance production from distribution.

Another question of major significance would be whether bank entry would generate greater pressure to split the savings from the insurance element of life insurance.

What makes the banking and insurance industries so attractive to each other? As mentioned earlier, the characteristics of the life insurance business that are especially appealing are:

- Favored tax treatment of the inside build-up,
- Personal contact distribution system,
- Major asset accumulations, and
- National scale of doing business with relative ease.

In the case of banks, the most attractive characteristics would appear to be:

- Government insurance,
- Efficient transaction systems,
- Favorable tax and leveraging positions, and
- Image with very high client confidence and loyalty.

Two fundamental questions here need to be addressed. First, are the advantages of either owning or acting like a bank worth having a bank owning or acting like an insurance company? Second, is it possible to compete effectively in the financial services business in ways other than by obtaining the right to have access to banks' powers and privileges?

In this regard, an ACLI task force recently concluded that on balance the insurance companies have more to lose than to gain, and that they will be able to compete better by preserving the separation of the two industries. That conclusion was based on the perception that the insurance industry's relative gain/loss position is poor and on the conviction that the public and the economy stand to lose as well if banks obtain freedom to enter the insurance business.

What do Consumers think of Banks Getting into the Insurance Business?

According to a recent nationwide survey conducted by Payment Systems, Inc. (PSI) of consumer views of financial services, about 20% of those surveyed said that, given the option, they would be interested in purchasing life insurance through either a commercial bank or thrift.

On the other hand, affluent consumers said they were less likely to purchase insurance services directly from a financial institution. In a study of the upscale market - individuals with more than $50,000 in income and more than $200,000 in net worth - PSI found that only 9.6% would prefer receiving insurance services from a bank or thrift institution. By contrast, a traditional insurance agent would be preferred by 76%.

More in-depth findings were produced by an ACLI-sponsored strategic research survey on bank entry date into life insurance. This survey involved 1001 adults between the ages of 25 and 54, with annual family incomes of at least $20,000. The survey focused on the image of banks and life insurance companies and specifically how the respondents compared the capabilities of these two industries in selling life insurance.

Here is a summary of their findings.

(1) Image of Banks and Life Insurance Companies

- Life insurance companies and banks both have positive public images.

- When asked, "when thinking about banks, what is the first thing that comes to mind," two-thirds of the respondents said something about a product-savings, checking, loans, or just money.

- When asked, "when thinking about life insurance companies," what is the first thing that comes to mind," 20% said something negative and for an additional 1 in 12, the thought of death was most immediately associated with life insurance companies.

- Despite the very favorable image of banks in general, consumers do not appear loyal to a particular bank. Only 28% of the respondents have all their accounts and loans at the same bank.

(2) Consumer Preferences

According to the survey, the public is not demanding changes in the distribution systems for life insurance or in traditional bank services. Consumers are not pushing for either bank expansion or for the establishment of one-stop financial institutions. 58% of the respondents say they prefer a bank that sticks to such traditional services as checking/savings accounts and making loans, while only 19% would like a bank that adds such new financial services as selling life insurance or acting as a stockholder.

(3) Life Insurance Company Strengths

- Life Insurance is perceived to be a complex product. Most people feel they need help in selecting which policy to buy and must have their coverage reviewed on a regular basis. Life insurance companies are also viewed more favorably than banks on providing services to all customers, not just those with large accounts or policies.

- They strongly felt need for the help of agents in the purchase of life insurance products.

- Two-thirds of the respondents prefer to buy their life insurance from a company that specializes in life insurance, and not from a company that handles many financial services in addition to life insurance.

- If banks sold life insurance, most respondents think that banks should arrange to have life insurance agents have an office at the bank, as opposed to having banks hire life insurance agents as their employees. Most also felt that a variety of life insurance policies sold by a number of life insurance companies should be made available and that life insurance agents should not be restricted to recommending the life insurance policies offered by the bank.

- Life insurance companies outscore banks very strongly with respect to servicing customer needs related to large, complex policies. Expectations are that life insurance companies would do a better job than banks in meeting the needs of people (i) who want a lot of counseling, (ii) who want to buy large policies, and (iii) who have health problems. Conversely, banks do their best with (i) people who are price conscious, knowing what kind of policy they want and are simply looking for the best price, and (ii) older people.

(4) Bank Strengths

- Overall, banks are perceived as highly qualified to sell a variety of financial products, while the qualifications of life insurance companies are more narrowly confined to life insurance products. Examples of such financial products are cash management accounts, financial planning, and stockbroker services.

- Banks greatly benefit from generalized beliefs concerning their ability to handle a person's complete financial portfolio.

- The public believes that banks use tie-in sales practices. This gives the banks a considerable advantage in the financial marketplace.

- A strong administrative image is another important bank strength. Banks are perceived as doing a better job of administrative backup and support than life insurance companies.

- Even though the life insurance business is perceived as financially stable, more policyholders think they would be unprotected if a life insurance company were to fail than if a bank were to fail.

CURRENT DEVELOPMENTS

Trade Groups' Statements to Congress

This past March, three financial service industries - life insurance, securities, and mutual funds - called on Congress to promptly enact a moratorium on bank entry into other businesses, to lay the groundwork for comprehensive reform legislation. This unprecedented joint statement by the ACLI, the Investment Company Institute, and the Securities Industry Association, urged Congress to prevent the concentration of power in large banks.

In their Statement of Policy on the Separation of Banking and Commerce, the ACLI, ICI and SIA said that the separation has:

- "Prevented concentration of economic power in large, centralized banking institutions and holding companies,

- "Helped allocate credit efficiently and impartially to meet the diverse needs of business and individuals, as determined by a free marketplace,

- "Promoted stability and the public reputation of depository institutions by preventing conflicts of interest, tie-in arrangements, and other unsound practices which arise when they or their affiliates assume the risks of commerce and engage in speculative activities, and

- "Prevented unfair competition between banks, which enjoy special legal, economic and commercial advantages, and non-banking firms who do not possess these "advantages".

The three groups also said they would oppose legislative efforts to weaken or repeal federal and state laws to permit depository institutions and their holding companies to expand into other businesses.

Representative Wirth's (D-Colo.) Study Plan

In May, Representative Wirth introduced legislation to establish a commission on capital markets. Speaking on behalf of Representative Wirth's plan, John Creeden, Metropolitan's president and CEO, made the following points:

- "Congress must act to discourage states like South Dakota and New York from enacting ill-conceived, parochial legislation to integrate the banking and insurance industries.

- "Congress should reinforce the doctrine of separation of banking from other lines of commerce by plugging the loopholes which permit ownership of nonbanks and which permit the states to include, with the definition of banking, insurance activities and other traditionally nonbanking functions.

- "It is anomalous that to deal with the woes of the banking industry (referring to the Continental Illinois situation and numerous recent bank failures), the major prescription proposed is for the banks to move into the insurance business, where, on the property and casualty side, we have had a third consecutive year of extreme underwriting losses, and on the life insurance side, we face the largest bankruptcy ever in the $4.5 billion Baldwin-United group of life insurance companies.

Mr. Creedon's remarks were particularly pointed on the subject of credit tie-ins. He stated:

- "Of particular concern is the possible undue influence that might be exerted on a prospective borrower - whether individual or business - to purchase insurance through the lending institution. Although it may be possible to develop legislation to mitigate the occurrence or effect of coercive sales practices, such laws would be largely unenforceable. Credit leverage is inherent in banking operations and is effective when merely subtle or implied.

- "Credit life insurance is usally sold on a group basis, with the bank deemed to be the policyholder and entitled to receive any dividend based on favorable experience. The higher the premium which is charged by the bank to the borrower, the higher the dividend from the insurance company, which is pocketed by the bank. This causes reverse competition, whereby the bank profits from finding the highest cost insurance."

Banking Bills

The refusal of Representative St. Germain (D-R.I.), to compromise on a bill which would have expanded bank powers into securities has apparently dashed hopes this year for federal legislation clarifying prohibitions against banks entering insurance.

The House Banking Committee, which Representative St. Germain chairs, in late June approved a bill to prohibit any state-chartered bank or bank holding company from offering insurance services not permitted under Title VI of the 1982 Garn-St. Germain Depository Institutions Act. The insurance industry had lobbied hard for this language to close the so-called South Dakota loophole, through which bank holding companies have attempted to enter insurance at the state level.

Meanwhile, the full Senate in early September passed a bill sponsored by Senator Garn (R-Utah). This bill contained language similar to that in the House proposal to close the South Dakota loophole. However, it also would grant bank holding companies expanded nonbanking powers - specifically, the authority to underwrite mortgage-backed securities and municipal revenue bonds. The Garn bill also would have authorized the conduct of limited interstate banking (such as those in force in several New England states, which allow banks to cross state lines in reciprocal agreements, but which are under Supreme Court challenge).

Representative St. Germain opposes any further expansion of bank authority. But rather than having to accept the part of the Garn bill that opened the securities door to banks, he decided to abandon his effort to obtain any banking legislation this year.

Interestingly, according to the September 10 NEW YORK TIMES, an intense grassroots lobbying effort was mounted against the House bill by Sears, Roebuck & Co. - which owns both Sears Savings bank, a 93-branch California savings and loan association, and Dean Witter Reynolds, Inc., a securities brokerage house. If the bill had been enacted in its present form, Sears would have been forced to sell one of those units.

NAIC

At their recent Omaha meeting, a split developed over whether or not insurance holding companies should be permitted to own banks. By an 8-5 vote, an industry advisory committee has recommended that the NAIC permit the practice.

At issue was an exposure draft submitted by the committee, recommending amendments to two NAIC model acts, to deal with the regulation of integrated financial services. The amendment in question stated:

- "Any domestic insurer, either by itself or in cooperation with one or more persons, may organize or acquire one or more subsidiaries. Such subsidiaries may conduct any kind of business in which they may lawfully engage."

The five dissenters urged that the section to be changed to permit activity in any lawful business - except banking. They suggested that it is inconsistent and politically dangerous to oppose bank entry into insurance and yet permit the reverse.

All of the advisory committee's recommendations will be considered at NAIC's December meeting in Washington.

CITICORP

No discussion of financial services integration would be complete without brief mention of Citicorp's recent activities and public pronouncements. Citicorp, in its own words, plans to "become a factor in the insurance business worldwide."

Walter Wriston, Citicorp's chairman, made the following points in a speech last March to the Bank and Financial Analysts Association.

- "Insurance services account for fully 40% of all financial services today. You cannot be a truly effective financial services enterprise without offering this product.

- "Insurance is a natural adjunct to our consumer business, particularly when one considers the current outmoded and expensive agency method of distribution that permeates the industry. Citicorp is already a major factor in credit insurance and we intend to become a factor in the insurance business worldwide.

- "Citicorp's overseas expansion is made possible by a recent Federal Reserve Board ruling enabling us to establish a fully competitive insurance operation in the U.K. In the Federal release, which announced the approval to enter this business, the Board concluded:

  'The general activity of underwriting life insurance in the U.K. can be considered usual in connection with banking or other financial operations in the U.K.'

- "It is Citicorp's stance that underwriting life insurance is consistent with the general activity of financial operations in the U.S. as well, particularly when you boil the insurance product down to its essence, which is the judgment of risk and the time value of money."

Citicorp currently underwrites life and disability credit insurance and has $1.5 billion in in-force coverage, the majority of which is against a $2.5 billion second mortgage portfolio. About one-third of their second mortgage customers buy their credit life insurance.

Although the 1982 Garn-St. Germain Act outlaws new property and casualty insurance opportunities for bank holding companies, Citicorp has a grandfathered homeowners P & C business operation and has achieved a 40% insurance penetration rate.

In his aforementioned speech, Mr. Wriston really laid it on the line when he made the following statements:

- "*We will engage in all forms of life underwriting,* as well as *offer* the more conservative end of the property and casualty spectrum. We basically intend to utilize pure actuarial techniques here similar to the way we price and score our credit business on the consumer side.

- "We will initially engage in a strategy of commercial insurance distribution, as opposed to underwriting, as the legal barriers fall in the U.S. We will ultimately become an underwriter for target markets focusing on financial guarantees and the funds flow side of the business, which is growing at a 20-40% rate."

In August, Citicorp withdrew an application filed with the Fed in June seeking to engage, as broker or agent, in the sale of life insurance related to IRA's offered by Citicorp subsidiairies. Citicorp had claimed in its application that the proposed activities are excepted from the prohibitions on bank holding company insurance activities set forth in Title VI of the 1982 Garn-St. Germain Act. The proposed insurance would have guaranteed to the insured's beneficiary, at a target retirement age, payment equal to that amount which would have been accumulated at the retirement date as a result of a periodic IRA purchase program if the insured had not died.

The ACLI objected, contending that the Fed did not have authority to grant the Citicorp request. The ACLI pointed out that the exception relied on by Citicorp is solely applicable to credit insurance and would not apply to the proposed "IRA completion insurance." The ACLI also disputed the Citicorp claim that the proposed insurance would be functionally equivalent to insurance the Board has permitted bank holding companies to sell in the past.

Finally, Citicorp has begun "networking", e.g., offering insurance services to consumers though arrangements with American International Life Assurance Company of New York. Facilities have been leased at two Citicorp locations in New York City and the "Personal Insurance Center" which the bank is now promoting offers whole life, term and universal life products - with AI life personnel in absolute control of the operation.

In 1985, American International Group plans to introduce automobile and homeowners lines as well, and to have the eight additional centers operating at "high traffic" bank branches within the New York City Metropolitan area.

AI Life regards this as another distribution channel for the sale of insurance. This company is following a multi-faceted marketing approach - distributing products through agents, brokers, direct mail, and personal insurance centers.

In return for the use of its space, Citicorp will receive a flat rate, or a percent of AI Life's sales, whichever is higher.

NETWORKING - BANKS AND INSURANCE COMPANIES

It has been said that no one will ever win the battle of the sexes because there is too much fraternizing with the enemy.

The same can be said of the battle for insurance sales between the insurance and banking industries. One form of such fraternization now taking place between the two is the joint venture between independent agents and banks. In other cases where a bank and an insurance company are owned by the same holding company, it is not so much a joint venture as cross-selling.

Some agents and their insurance companies see the joint venture as a way to "join them" if they can't "beat them." Others, including the two major P&C agents' associations, IIAA and PIA, see it as a threat to independent agents.

For an agent, a joint venture with a bank can be an extremely attractive proposition - while the bank stands to gain as well. The agent can achieve efficient customer access by setting up shop in a high traffic area - and the people making up the traffic have money on their minds.

For the bank, its a way to offer insurance service to their customers and make some money too without taking any risk. The risk to the agent is that the bank may later decide to run its insurance business without the agent.

Another kind of joint venture takes the form of an insurance company, or agent leasing the customer list of a bank for a direct mail campaign.

Safeco, for example, leases the customer list of the First Interstate Bank, a multi-state bank holding company. Safeco contacts the persons on the list through mail or telemarketing to buy personal lines of P & C insurance.

The usual joint venture is a contract between an agent/agency and a bank with space leased from a bank contiguous to the banking offices - and with the agent agreeing to sell the products of just one company. One question that has been raised in Massachusetts is whether a percentage lease, one based on production, is illegal commission-splitting.

Another joint venture variation involves adding a life insurance company's product line to the P & C products and services being brokered by the bank's insurance brokerage subsidiaries. In this scenario, no life insurance agent will be present in the bank offices. Existing bank personnel will be licensed as life agents and marketing the life products.

Yet another version involves bank referral of its customers to the local insurance company agency office. The bank might also include that company's promotional material as statement stuffers and/or make its client list available to the agency. The bank would receive a finder's fee for each referral that results in a sale of one of the life insurance company's products. Once again - would a finder's fee, either flat or percentage of sale, be considered illegal commission-splitting?

Finally, financial centers, physically separate from the bank offices, could be established to offer a full range of financial services and products to bank customers and others. The financial centers would be franchised by the life insurance company to the bank, and would be managed as turnkey operations by sales managers of the company. The centers would be stafffed by life agents and financial planners, bank trust and loan officers, and perhaps other outside financial service providers, such as P & C insurance agents.

With respect to these joint ventures, a number of distribution questions come to mind such as:

- What bank skills will be added value to the agent/broker?
- What role, if any, does the agent have in ATM, credit-card, and other bank-based mass marketing insurance sales?
- What management structures will best facilitate bank/agent-broker operations? And what factors are important in considering whether to develop a shared ownership facility with a bank?

Additional product and marketing questions that should be addressed are:

- What are the emerging needs and preferences of bank customers for life/health products? How do these needs and preferences enhance or compete with noninsurance products and service of banks, e.g., universal life vs. a money-market account plus term insurance?
- What current or newly developed bank products, services, and marketing approaches provide cross-selling opportunities?
- Must investmment-oriented life products, such as universal life and variable life, be sold face-to-face, or can these products be ass-marketed by banks?

- What are the key factors for success in mass-marketing to high affinity groups, such as employees of commercial accounts - as compared with marketing to low affinity groups, such as credit card customers?

- How can bank technology further enhance opportunities for marketing life/health insurance products?

A recent survey of 136 U.S. depository institutions revealed that more than 75% of them have formal plans for entering insurance.

The survey, which represents more than 20% of such institutions with assets over $1 billion was conducted by Vantage Computer Systems on behalf of the Inter-Financial Association, a multi-industry trade association representing banking, securities, insurance, investment management, and financial planning firms.

Here is a summary of the findings:

- Respondents rated insurance higher than discount brokerage or several other new retail banking services for contribution to long-term profit.

- Two-thirds prefer to tap banking relationships to sell insurance profitably, rather than to use insurance to building banking volume.

- The same proportion prefer that their insurance offerings carry the name of a well-known insurer.

- Expansion of insurance agency activity is a primary focus of current planning, especially among commercial banks.

- New Product planning focuses on investment-related insurance and other investment services. Products highlighted were universal life, tax-sheltered annuities and IRA completion insurance, asset management accounts, and personal banking services.

A number of innovative bank and insurance company affiliations have been put together in recent months. I have summarized a few of them.

<u>Metropolitan Life and Mercantile Bancorporation</u>

In September 1984, METROPOLITAN LIFE announced a joint venture with MERCANTILE BANCORPORATION of St. Louis, Missouri which owns 44 banks in Missouri. They will market all types of insurance - including life, health, automobile, and homeowners. The bank will get something above the fixed rental if business is good. Metropolitan will refrain from selling certain annuity products which could be viewed as competitive with bank products.

Metropolitan was careful to downplay the new marketing effort as merely an extension of its usual distribution. It was noted that the bank customer won't pay any less for the coverage than if he had bought it through a commissioned agent.

John Hancock and American National Bank

In July 1984, JOHN HANCOCK MUTUAL LIFE announced an agreement with American National Bank of Bakersfield, California. The bank has 29 offices. John Hancock will initially be selling a full line of insurance products in three branches. Eventually, they expect to expand sales into seven additional high traffic branches. John Hancock plans to sell a comprehensive line of personal and business products, including property and casualty insurance, as well as financial services, leasing programs and mutual funds. They are banned from selling I.R.A.'s - lucrative area for bank-sponsored products - and transaction accounts. The fee arrangement is based on a fixed cost plus 40% of commission income.

Aetna and First Tennessee Bank

AETNA LIFE AND CASUALTY announced in June 1984 a joint venture with First Tennessee Bank, through an independent insurance agency. The bank has 135 branches and serves 400,000 households. Products will include life, homeowners, and auto insurance. Aetna's policies are available to the bank's customers at lower cost that if they bought the same policies elsewhere.

Subsequent to Aetna's announcement, the Tennessee Insurance Commissioner, John Neff, challenged the lease arrangement, contending that state law barred licensed insurance agents from paying commissions to persons not licensed to sell insurance. He asked the state attorney general for an opinion. The attorney general subsequently upheld the agreement but set down some strict rules for how marketing should be done. Further hearings were held today, October 16, 1984.

Bank of America and Capital Holding

CAPITAL HOLDING's target market through Kroger and Bank of America ventures has been recently defined as middle income households with annual incomes in the $18,000 to $35,000 range. Bank of America is counting on an image of stability, consumer confidence, and a personal sales approach to attract insurance customers to their branchs.

The Bank of America/Capital Holding arrangement will feature an insurance operation center with sales desk, special telephone lines, and computer equipment. These facilities are to be staffed by licensed agents, employed and trained by Capital Venture. Other branches will be satellite facilities, with a display area for insurance literature and direct telephone lines to allow customers easy access to insurance information and rates. A telephone marketing unit will also be a part of the operation as a back-up system outside normal working hours.

Capital will offer auto insurance, homeowners insurance, and a range of life insurance products including term, whole life, and an interest sensitive universal life product.

Bank of America will make it easy to pay for insurance with bank credit cards, automated teller machines, and automatic debit procedures.

Prudential-Bache and Six Banks

Under a brokerage alliance arrangement, Prudential-Bache (PBS) has established a separate station for a fully-qualified account executive of the firm in the bank's lobby. The idea is to provide bank customers with a full range of brokerage services. PBS pays rent to the bank, plus the bank receives its 25% of the gross commission on all products upon which PBS can legally pay commissions. The exclusions are basically public underwritings which includes normal underwritings, including syndicate items, open end mutual funds, and public direct investments (i.e., any SEC registered product requiring a prospectus). Insurance product payments would depend on whether the bank or savings institution could actually participate under federal and state law and its charter. To date, however, there has been no insurance sold through any of these arrangements.

In addition, specific product exclusions may be agreed to at the request of the participating bank. For instance, PBS will not offer its Command Account if the bank has a sweep program of its own. Also, PBS agrees not to actively solicit competing products such as money market deposit accounts/money market funds, certificates of deposit, real estate mortgages, in addition to the Command Account. They ask the bank to give them their CD rates daily so that they can quote their rates to the mutual clients. If specifically asked whether they have available a CD with a better rate, they, of course, must respond professionally.

CONCLUSION

Jim Anderson states in his "Metamorphosis in Financial Services" article that the key to success in the broad retail market for financial services in the 1990's will most likely be efficient customer access. I agree. I also believe that competition will dictate the market of the future. There is simply no way to hold it back.

Competition will revolve around:

- Competition for investor confidence via the providing of products and services of high quality.

- Competition on the basis of efficiency in terms of pricing the products and services and the convenience by which they can be delivered to the customer.

- Competition through innovative use of technology.

- Competition via the rendering of personal services.

Even in this heavily competitive arena, there are those who believe that a place remains for the smaller, highly-focused specialty firm. In this regard, note the ironic counter-trends of, on the one hand, consolidation of financial services through a single organization - and, on the other, increasing specialization and market segmentation. There is no doubt that, in our open economy, there will be opportunity for "boutiques" and similar specialty organizations focused on a narrow market niche.

In any discussion of financial services integration, one senses an element of inevitability. Consumer needs and sophistication, rapidly changing information technology, increased variability in economic conditions, and a willingness of our new consumer-oriented society to take immediate advantage of cost efficiencies, convenience and preceived quality in financial services have all created a momentum which is drawing formerly separate financial institutions together. The issues remain important, and inequalities will continue, but it appears inevitable that the barriers of the past will fall away.

And well they should. As John McGillicuddy, Chairman of Manufacturers Hanover Corporation has stated, "insurance and banking must avoid getting into a competition in imprudence, because that fragile but essential commodity we know as public confidence cannot be taken for granted."

For the real threats to banks and insurance companies are not themselves, but rather such companies as American Express, Sears Roebuck, Kroger, and Merrill Lynch.

MR. MIKE ROSS: Larry has asked me to focus on the Canadian aspects of these issues. I thought that it would be useful to begin by giving a brief overview of some of the differences between the financial services scene in Canada and the United States.

Four Pillars

It is customary in Canada to speak of the "four pillars" of the financial services sector. This categorization, which in earlier years may have been primarily descriptive, is now being used more and more as a normative framework for thinking about financial services. The four pillars in Canada are:

- the banks, whose core functions are deposit taking and commercial lending,
- the trust companies, whose core function is the fiduciary business (but who are also heavily into retail banking),
- the life and P&C insurers, whose core function is insurance, and
- the investment dealer/stockbrokers, whose core function is the underwriting of securities and associated brokerage activities.

This categorization leaves out the credit union movement, which is a major force in retail banking in certain parts of the country.

The Banks

The most striking difference between Canada and the U.S. relates to the banking sector. In Canada, the big five banks have an 85% market share; in the U.S., the 35 largest banks have less that half of the market. In large measure this reflects the existence of national branch banking; the big Canadian banks are major banks by international standards, and each have in the order of 1,000-1,500 branches across the country.

Trust Companies

Banks are not permitted fiduciary powers in Canada; these reside with the trust companies. Since the second World War, the trust companies have grown dramatically, not primarily through fiduciary services, but by rampant expansion in retail deposit taking and mortgage lending. In this respect, they resemble the thrifts in the United States.

Insurers

The life insurers are predominantly Canadian owned, and have a strong international flavour. Many of the big Canadian life companies have less than half of their business in Canada. Unlike the chartered banks, which also rely heavily on international earnings, Canadian life insurers have significant retail distribution systems outside Canada. Many of the property and casualty companies are affiliates of international P&C insurers.

Investment Dealers

The investment industry is focused on the Canadian market, and on the distribution of Canadian securities to international markets. It is protected from foreign control, with the exception of a few "grandfathered" presences.

The Role of the Banks

The most distinctive difference between the Canadian and U.S. situation is the extent to which five large banks dominate the financial services landscape. The situation has been described by saying that "we do not really have four pillars of the financial system in Canada, we have one pillar - the chartered banks - and three very fragile samplings which run the risk of disappearing altogether if the powers of the banks are allowed to expand at the expense of the other intermediaries". This concern about the power of the banks dominates the regulatory agenda, and also dominates the strategic thinking of non-bank financial services providers as they line up to do battle in the remainder of the century.

THE REGULATORY ENVIRONMENT

Canada - U.S. Perspective

We have not seen the same pace of regulatory change in Canada as has occurred in the States in the last few years. In part, this reflects more thoughtful regulatory updates in prior years. In Canada, we have long ago gotten rid of:

- prohibitions on paying interest on checking accounts,
- interest ceilings on savings accounts,
- limitations on branch banking, and
- long term fixed rate residential mortgages.

As a consequence, we have also not seen:

- massive growth of money market funds,
- dramatic financial instability due to the regulated mismatch of funds, such as has occurred with the thrifts in the U.S., and
- products designed to exploit the prohibitions on interest ceilings and branch banking, such as CMA accounts.

Regulatory Calendar

Perhaps as a consequence, neither the regulatory changes or the radical restructuring of financial services which are taking place in the United States have been followed in Canada at the same pace. In fact, in Canada many financial institutions operate under antiquated legislation. While there have been a number of initiatives and discussion papers:

- federally incorporated insurance companies operate under laws which have not been seriously revised since 1932,
- Ontario trust companies have not had their legislation revised since 1949, although proposals are now on the table,
- although discussion papers and draft legislation have been provided, Federal Trust and Loan Companies are still operating under 1913 legislation, and
- the Bank Act is updated by statute every 10 years, although the ink had hardly dried on the last Bank Act revision before it was suggested that significant changes were required.

It has become clear that there is no concensus on the future direction for regulation in the financial services sector. The Federal Government effectively put a stop to further legislative change, and set up a committee under the Honourable Roy MacLaren, the Minister of State for Finance to study the issues. While this committee was expected to report this Fall, the change in government has led to considerable uncertainty as to both timetable and output.

Provincial Roles

One of the features of the Canadian regulatory environment is that both the Federal and Provincial governments have a role to play. For example, based on their method of incorporation, life insurers can be regulated either federally or provincially. The Province of Ontario has not made much more progress than the federal government in updating its regulatory environment. In Ontario, too, a study group is reviewing options. Some proposed changes to trust company legislation have been made; these primarily reflect concerns surrounding the circumstances which led to the recent government takeover of three Ontario-based trust companies.

The Government of Quebec has been the joker in the deck. The current Minister of Finance in Quebec headed a task force in the early 1970's, which developed a blueprint for regulatory change of financial services in the Province. With the motivation of developing some provincial counterbalance to the federally chartered banks, Quebec is systematically updating the legislation governing the various provincially regulated financial institutions, broadening the powers of each and consequently blurring the boundaries as well. Of particular note are provisions permitting mutual life insurance companies to raise funds by issuing non-voting preferred shares, thus providing one path to capital markets and a possible solution to some of the concerns motivating demutualization studies in the United States.

THE MOTIVIATIONS FOR INTEGRATION

Diversification and Integration

At this point, it might be appropriate to distinguish between diversification and integration; I am not sure the words are always used carefully:

- I use the word diversification to cover any attempt to broaden the base of products and/or customers served. Typically, diversification in financial services means the products which are different from the existing product base. Particularly in life insurance, there is considerable discussion about diversification with respect to distribution channels. Thirdly, one can diversify with respect to the market segments targeted; this sometimes goes hand in hand with the distribution channels.

- By integration I mean the bringing together under a single vendor of financial products or services which were formerly provided by distinct vendors. This is frequently linked to the diversification motive with respect to products, although particularly in Canada, a good deal of integration is aimed at attempts to:

  - maximize the value of existing distribution systems, and

  - maximize the value of existing clients.

Forces for Integration

Most of the basic motives underlying integration of financial services in Canada are similar to those in the States. In particular, there is a sense that circumstances have created a situation in which tremendous competitive advantage accrues to suppliers who can supply a spectrum of financial services, combining easy access and personalized service.

The situation flows from:

- better educated and more affluent consumers;

- the historical volatility of interest and inflation, which has broken down some of the comfortable preconceptions around earlier product groupings;

- in my mind, the most important factor is the revolution in technology. This has made possible the creation and accessing of information which can break down the specialized knowledge bases which underlie a good deal of the former compartmentalization of financial services.

Technology

Three important implications of the technological revolution are:

- There are significant scale economies developing in product development and system support. The financial services require larger such costs.

- It is now possible to provide the convenience of easy access, to customer-based information, and therefore competition is leading to its provision.

- It is feasible to support multi-line low-cost distribution, i.e., one can integrate additional financial service products into an existing product/distribution system in a way that was difficult to do previously.

WHAT IS HAPPENING IN CANADA

Banks and Insurance

When Larry gave me the outline, he asked me to spend some time looking at the integration of banking and insurance services. In this case, the situations in Canada and the U.S. are quite distinct. In particular, we see very little overt cooperation or networking between banks and the insurance industry in Canada. Banks have for many years provided credit life-type products in support of their consumer and mortgage loans, and banks have, along with trust companies, essentially taken away the RRSP (Americans read as IRA) market from life insurance companies. On the other hand, life insurers have been providing more and more bank-like products, particularly short-term annuity products at competitive rates. However, I am not aware of any circumstances in Canada in which banks and insurance companies are cooperating in the provision of, for example, life insurance products through a bank distribution system.

This perhaps reflects a "non-venturing" mentality on the part of banks as much as anything else.

Trust Companies and Insurers

I think it is clear that where we will find the integration of finanical services occurring first, from life companies' perspective, is with trust companies. This is true for several reasons:

- First, the basic growth engine of the trust company industry, residential mortgage lending, is sputtering, and the industry is looking for new ventures that underpin future growth.

- Secondly, many of the major Canadian trust companies are affiliated with life insurers. The integration of Royal Trust and London Life under the umbrella of Trilon is the most notable; but we should not forget Montreal Trust, which is affiliated through upstream holdings with Great West Life; as well as the new National/Victoria and Grey Trust Company, which is held within the same corporate umbrella as Empire Life. Canada Trust, which shares the industry lead with Royal Trust, is held between 25% and 30% by Manufacturers Life, one of the biggest Canadian insurers.

It is from the Trilon (Royal Trust/London Life) link that the clearest statements of philosophy have emerged with respect to "big trust companies". In this case, the rationale seems to be to facilitate a cross-selling network which will result in the delivery of products by both distribution systems, while preserving the core "manufacturing" capabilities in the trust company and the life insurer. Trilon also seems to be interested in the life cycle marketing potential of integrating life insurance and trust company services. While a number of experiments have been underway, the outside world has not yet seen much real integration of financial services in the Trilon case. I would guess that the first manifestations of such integration might be the obvious ones, such as the sale of simpler life annuities in a trust company context.

It should be noted that the credit unions, both in Quebec and elsewhere, have structured themselves for some years in a way which permits some integration of financial services. The major credit union movements have created both insurance and trust company groups, and have had some success in marketing non-banking services through the credit union retail network.

Some Other Examples

Some other recent examples of actual or potential integration in Canada have emerged recently, and are commented on below:

- In a move which prompted a good deal of regulatory concern, one of the large Canadian banks (TD Bank) has entered the discount brokerage business. In fact, their Green Line Services provide discount brokerage services in the eye of the retail customers; the execution is left to existing brokerage firms. Discount brokerage is certainly not the success story of 1984, and the near term concern has subsided. However, the Green Line experiment is interesting because it makes manifest all of the concerns about the big banks in Canada; here is the strongest financial sector impinging directly on the turf of what may be the weakest sector (certainly in terms of capitalization), and it is feared in some quarters that this may just be the thin edge of the wedge.

- The Canadian arm of AETNA Life and Casualty has formed a new venture with midland Doherty, one of the larger retail-oriented stock brokers in Canada. The motivation here appears to be to develop products which can be supplied through both sets of distribution systems.

- Crown Life, one of the larger stock companies, has been taking itself through a significant transformation which is expected to lead to considerable integration of financial services. Bringing in a non-life CEO, Crown has attempted to slim itself down considerably, has purchased a small trust company, and has just recently acquired a 40% interest in a major investment counselor.

Crown is clearly seeking to find opportunities to provide a wider range of financial services.

- Mutual Life, the most "money-oriented" insurance company in the country, has just entered the mutual fund business. The Company is not the first life insurer into mutual funds, but as one of the country's largest annuity writers, they clearly feel that they can expand the product mix of the existing agents and managers with another category of investment vehicle.

- An example from Quebec serves to round out the list. The Laurentian Group is centered around a mutual life insurance company in Quebec. To some extent anticipaing the legislative changes which have occurred, the Company has put itself in the position of having a significant interest in life insurance, in retail banking (through the Montreal City and District Savings Bank, the only institution of its kind in Canada), and through trust companies, through its holding of Credit Foncier. In addition, Laurential has P&C affiliates, as well as a number of U.S. financial services holdings. Laurentian appears not to have done a good deal of integration as yet. Current indications are that they favour the one stop shopping approach to integration, rather than the financial supermarket. In other words, their approach may be to put branches of the major financial services affiliates side by side in the same location, but to keep the companies and their distribution systems distinct.

OVERVIEW

What does all this mean? The examples I have provided highlight what I think are the important points to be made with respect to integration of financial services in Canada at present.

- Some of the key areas of interest in the United States do not seem to have counterparts in Canada, i.e., networking with banks and insurance companies.

- There has been a good deal of positioning, particularly vis-a-vis trust companies and life insurance companies, but we have seen little actual integration of the services or distribution systems.

- Those first off the mark appear to be having some difficulty moving new concepts through the regulatory maze. It should be noted that cross-licensing difficulties provide one of the most stringent restraints on integration of financial services in Canada.

- There is a lot of excess capacity in financial services in Canada, and there is therefore a reluctance to build from scratch.

- While Canadians feel themselves pulled along by the U.S. example, some of the recent fiascos in the United States have pointed out the wisdom of not being dragged along too closely on American coattails.

MR. FRANK LONGO: I have a comment regarding bank activities and a question regarding life insurance activities.

The survey of banks which was conducted by Vantage Computer Systems on behalf of the Inter-Financial Association reported that a very high percentage of respondents have plans to enter the insurance business. However, the survey had a low response rate, and Vantage admits that the survey is likely to be biased in that banks with those plans were more likely to response than those without.

Prominent articles in the last few months — I'm thinking particularly of the Wall Street Journal and Business Week -- have concentrated on the "indigestion" which many companies that have diversified are supposedly experiencing. (Some of these companies have been involved in financial services and some have not). One of the main reasons given for this is the difficulty companies have encountered in managing businesses which differ in basic character from the company's primary business. As financial services integration proceeds, what qualities will life insurance companies need to exhibit in order to be successful in managing their diversification activities?"

MR. ROSS: I think it is clear that any industry when it embarks on a diversification thrust tends to overestimate the benefits to be obtained, particularly through acquisition. Acquisition looks like the easy way to diversify and I am not sure it is always the easy way. That is not a comment that is restrictive to financial services. Part of the problem is just understanding the nature of the business that you have acquired. I am not sure there is any easy solution. Part of the problem is trying to put yourself in the other persons shoes. If I were to focus on a characteristic of life insurance that may be particularly relevant, it is that life insurance executives are not good at putting themselves in the shoes of non-life insurance people. I think it's a business that people grow up in much more than other businesses and perhaps even much more than other types of financial services. The challenge is to find a way to change your own thinking so that you can respond appropriately to the requirements and the culture in a different type of financial institution. That's a statement at the level of generality that does not leave you to much implementable action, but I think it is harder for life insurance companies to make that shift in perspective perhaps than it is for other types of acquiring corporations.