RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 1

INDIVIDUAL INSURANCE PRODUCTS -- BANKS/STOCKBROKERS

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The panel will discuss issues related to products marketed through the financial services industry.

- What is the future of insurance through these financial services organizations?
- What products are sold?
- How are products distributed?
- Are banks and stockbrokers a "growth" market?
- What are the risks/returns to insurance companies?

MR. JOHN C. R. HELE: I am currently chief marketing officer for the Merrill Lynch Insurance Group, a subsidiary of Merrill Lynch and Co. Starting off will be Rick Kolsky who is a principal in management consulting with KPMG Peat Marwick. Rick specializes in market-driven strategies, especially for banks and insurance companies. Prior to joining Peat Marwick, he was with the Mac Group for 10 years and has worked with quite a few insurance companies, including CIGNA, IDS, American Express, and Allstate. Rick has a Ph.D. in economics from Yale. He also served at the White House in the late 1970s in energy policy. Rick will give us a basic strategic overview of the marketplace and provide us with a unique insight into the distribution channels of banks and stockbrokers and the selling of products through such channels.

Tim Pfeifer is a consultant with Milliman & Robertson, Inc. He's been a consultant for about four and a half years. Prior to that he was with Allstate. Tim has written articles on no-load insurance products, variable products and individual pricing for *Best's* and is also the editor of *Product Development News*. Tim will be speaking from the bank perspective.

I'm going to follow Tim and speak from a stock brokerage perspective as to how we view insurance. Just to give you a little bit of background, the Merrill Lynch Insurance Group has over $12 billion in assets. We are a major profit center of Merrill Lynch, selling almost $2 billion of products a year. The Merrill Lynch Insurance Group includes three life insurance subsidiaries, as well as Merrill Lynch Life Agency, which is the brokerage for all insurance products to the 10,000 licensed stockbrokers it has across the United States.

Following all of us will be Noel Abkemeier. Noel is senior actuary and director in the Dean Witter Profit Center for Allstate Life Insurance Company. Noel is

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responsible for the development and entry of Allstate into the bank distribution channel. He has a great deal of experience with the stock brokerage side being at Allstate. Noel recently spent five years in Japan where he tells me that almost three-quarters of the premiums come through banks.

MR. RICK KOLSKY: Banks and brokerages are going to play a key role in what I think is going to be an enormous growth in life and health products over the next few decades. But we are never going to tap the enormous opportunity that's out there for us over the next few decades unless we fundamentally rethink the way we do business and that's what I want to talk about.

Instead of being in a mature market, we are the victims of 30 years worth of mature markets. And what's even more interesting, despite the potential and what looked like tremendous inroads that some of the banks and brokerages have made in selling products, we have not changed our marketing response to a more mature market. We've picked another channel to do it the same old way and that's what we have to change. If you compare us, for example, to Japan, U.S. households are terribly underinsured and undersaved. (See Charts 1 and 2.) This translates into an untapped opportunity of about $89 billion in annual premium.

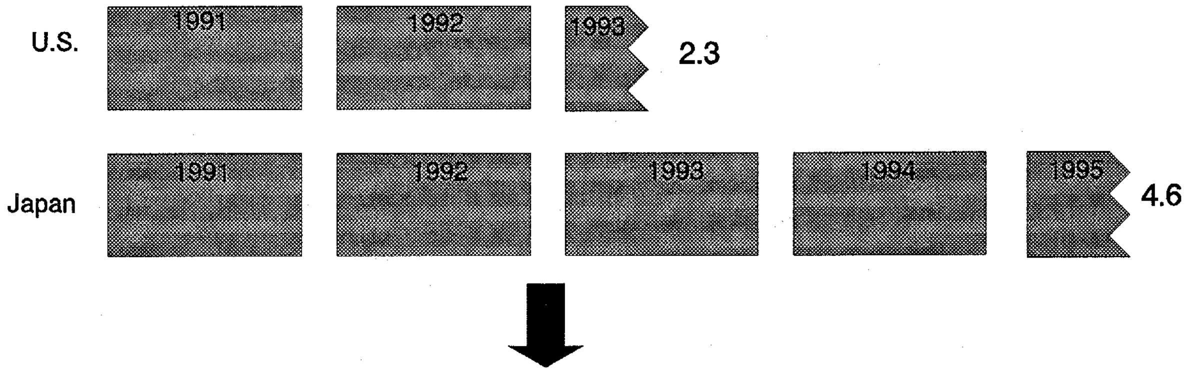
This is why I say there is a tremendous opportunity for life and health insurance. And the time for that is now, because if you look at the demographics, you find that the 50+ population is only 21% of the population. That 21% controls 51% of the discretionary income and 75% of the assets. Twenty years from now when the baby boomers are over 50, this segment will grow to 33% of the total population with control of 80-85% of the assets. How well positioned are we with the folks who represent this growth? How prepared is the insurance industry to deal with the needs of the baby boomers? There is a tremendous protection and investment opportunity within this group.

These boomers are starting to think about sending their children to college, keeping themselves healthy and planning for retirement. They're becoming increasingly conscious of these things. For the already retired folks they have to make sure there's enough there to have a little place they can go to in the summertime. They have to make sure that when one of them dies the other one can survive. Now there are some big needs out there and I will tell you right now for most, especially in the middle market, these needs are terribly underserved. The typical baby boomers are absolutely unprepared.

We've got this tremendous opportunity. Why can't we have it? Why is there still $89 billion out there that we should be getting that we're not getting? Maybe the answer lies in our presentation and in our timing. We've taken a bunch of products to try and sell but nobody can understand them. We've asked somebody who nobody trusts to explain it to them. We rarely approach clients when they're ready; rather we approach them when we're ready. And when we do approach them the standard agent's answer to any problem is invariably "you need insurance." We will even go so far as to have them fill out some financial needs analysis, but then we always tell them at the end of the day -- "insurance will meet your needs." We don't even really push anything else.

CHART 1

Average Years of Disposable Income Covered by Life Insurance In-Force (1988)



Untapped Opportunity: $89 billion annual premium

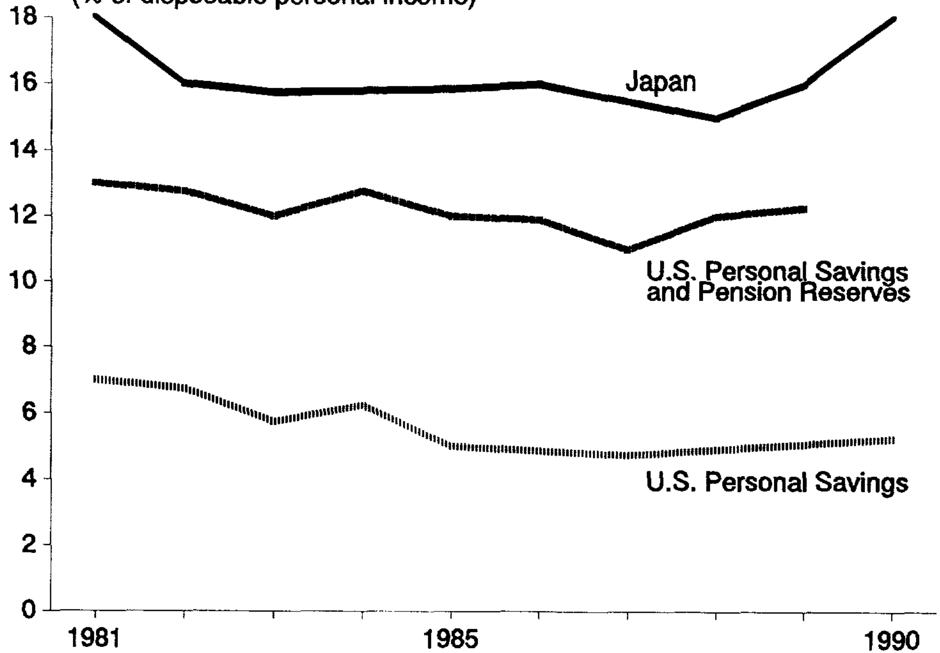
Source: Data from *1989 Life Insurance Fact Book Update*, American Council of Life Insurance Washington, D.C.

PANEL DISCUSSION

CHART 2

U.S. Household's Savings

(% of disposable personal income)



Source: Data from *Life Insurance Fact Book*, American Council of Life Insurance, Washington, D.C.

Contrast this apparent lack of credibility with a bank. What is it that banks and brokers offer to the client that our agent cannot? Two things come immediately to mind, trust and availability. Citibank's able to generate $50 million per month. Cal Fed is doing $300 million per month. And the reason that they're able to get it is they have tremendous trust. The fact of the matter is a lot of products have been going through banks. Are they better priced than the ones that go through insurance companies? I doubt it. All right, yet people for some reason, whether it's the pillars on the building or whatever, trust the bank in ways that they don't trust the insurance company. Similarly, clients trust that the broker is smarter than they are when it comes to investing money.

Second, banks and brokers tend to be present or at least readily available when people are making key financial decisions. If you look at a mortgage, think not only of the wealth of information that's in a mortgage application, but the timing. Someone has just moved. Someone has undertaken a tremendous responsibility. The perfect opportunity for a life insurance/savings plan is when people are thinking about doing financial planning. How many of us here are trying to work through mortgage brokers to sell our insurance products? How about brokerages? When people get big bonus checks do they call their insurance agents? Do they call their bankers? No, typically, they'll call their brokers. Bankers and brokers are there at the right time getting the information needed to make a great sale. They have the trust of the consumer that the insurance agents don't have.

Yet bankers have not been that successful in selling life insurance. Why? Basically, they haven't changed the way they behave. All they're doing is replacing one bit of money from your money market fund or your CD with an annuity. How about the stockbrokers? Have they really fundamentally changed this? In a few cases, yes, but most of the time it's the same thing. What they're doing is shuffling money in and out. They're saying to get that money out of the bank and put it in an annuity. It's tax-advantaged. And they also don't change the behavior of trust because they're driven by the concept of velocity.

Have we really, then, attacked the underlying cause of the fact that people are underinsured and undersaved? No. People are underinsured and undersaved because they don't know about insurance or annuities. They don't know they're available. They don't have access to someone they trust at the right time to make the decision. There's tremendous inertia. Insurance agents are asking me to save more and nobody is making a convincing case for me to save more and pushing me to do it. If we want to be successful in tapping the $89 billion opportunity, we have to be market-driven. Our motto must be 'The Customer is King.'

Let's look at the actual customer. A good example is the yuppie. These yuppies are starting to accumulate some capital. What kind of opportunities do they have to invest that capital? Who are they going to go to? Do they want to put their fortunes in the hands of a 55-year-old stockbroker? How about the insurance agent? How about a banker? Suppose I'm a guy with an MBA from Harvard. My wife also has an MBA. We each work 80 hours a week. We pull in a lot of money. We want to put that money to work for us. What's my projection of the average IQ of a banker? Probably fairly low. There's no real place for me to go. Is this really a mature market where this fairly big and growing group can't do what they want? Another group is middle America. What happened in the early 1980s? Hyperinflation, deregulation, money market funds, all kinds of stuff. Were they confused? Were they anxious? Were they worried that they'd never be able to send their children to school? Does this sound like a mature market? They say the same thing today about life insurance. Sales are sluggish and margins are under pressure, but if you actually look at the various needs of specific segments you find enormous opportunities and there are some people who really make a killing because they've totally changed the context of the business.

Fidelity, for example, saw those young affluents in a hurry and did everything possible to serve them. The first thing it did was allow free transfers among 150 funds. Why did it do that? Imagine yourself as a young affluent in a hurry. You want to be able to move the money around freely and not have to deal with 16 different companies. You don't have time. Furthermore, if you have 150 funds, what's the likelihood you're going to have one in the top 10? Reasonably high. With 150 funds to pick from, are you going to blame Fidelity if you pick a loser? No. Your response will be, ah, geez, am I a dummy. What else did Fidelity do? It recognized that these people want to be affiliated with somebody innovative because that's the way they think of themselves. They want to be affiliated with someone who they can trust with their money. They made a god out of a guy named Peter Lynch.

Fidelity was the first to advertise rates of return because these people wanted to get big rates of return. It was the first to give them convenience of check cashing with money market funds. Everything was centered around the customer. Most importantly is what it did with service and distribution. It totally and fundamentally changed the context of telemarketing. These customers want their money, when they need it and they want great service. They don't want an airhead on the other end of the phone. What did Fidelity do? It hired all college graduates, and put them all through three months' training.

In terms of distribution, it's got to be any time, any place. Everything it did was tailored to the customer. Was selling mutual funds through direct marketing new? Was it a new channel? No, but it totally changed the way it worked and what we're talking about is what's really required if we want to make the banks, brokerages, and insurance work.

You can contrast that with IDS who took the entirely opposite approach. IDS looked at this group and asked, What do they need? They're confused. They need financial planning assistants. They need this sophisticated financial planning software behind them. They need someone to totally change the context of the sale instead of talking about products that will ultimately confuse them. Does IDS sell products when it speaks to its customers? No, it sells goals. IDS plans for children going to college and how much you want at retirement. That's the reason IDS was the most rapidly growing, large insurance company in the U.S. in the 1980s.

Now what does this mean for insurance? What are the things that we have to do? The first is to make sure we're building these programs. We're not just saying to go deal with the banks because they can sell a lot of this stuff. Start by identifying specific target markets. Where is that $89 billion? What kind of people are these? What's the problem? What's their problem? Why are they saving or not saving?

Why are they protecting or not protecting? Figure out what the gaps are. Figure out what it takes to gain their trust. The problem is they don't trust the people who are trying to peddle it. Figure out what those great marketing moments are that we can tap into. Figure out how we can do that and still actually make a buck. But, again, do it segment by segment, just like IDS and Fidelity.

The second thing is to build everything we do around that target segment. A key piece of that offering is on the distribution side and it's not just who the partner is, but it really is the partnership. What are they going to do? How are they actually going to behave differently so that we gain the trust at the marketing moment and fill the gap and somehow convince them to do things which for years they haven't been doing even though they should have.

Where are most people's financial assets these days? Increasingly in their pension fund. It went from 13% of financial assets in 1970, to 27% in 1989, to a projected 39% by the turn of the century. For the typical middle income retiree and baby boomer, 66-70% of their financial assets at the point of retirement are going to come from their pension funds. That is a tremendous market. There's an enormous gap in the marketplace right now for people to actually be linked in to their pension plans with some sort of supplemental program. Right now our retirement plans are not retirement plans, they're just pension plans. In retirement you've got to worry about not whether you're going to live too long.

If you look ahead, the one place that somebody is going to make a killing, and people like Fidelity are already starting to figure this out, is in the pension markets. Seeing the trust that people have in their employer, we are being far too narrow given the various marketing moments we have during the enrollment process. We've got to get these people to supplement their savings and actually protect for their long-term retirement, not just their long-term pension. Who should do the enrollment? Is it going to be a broker? Is it going to be a banker? I'm not sure. Is there any reason why it can't be an insurance agent?

Consider the typical mortgage process. Would you ever buy anything else from the guy who was your mortgage loan officer? People wonder why anybody would want to try to sell more stuff through that channel. Is it a bad channel? It doesn't have to be. We can fundamentally change the way we do that mortgage. I can turn a mortgage into a financial plan. It's the absolute perfect time. A certified financial planner (CFP) can be my mortgage loan officer. His job would be to make sure I open the deposit accounts, have a supplemental savings plan, and make sure I have a homeowners policy, all in a streamlined way. This is an extremely vulnerable and anxious moment for people and a prime opportunity for somebody who is really there to help as opposed to being adversarial and making a bundle. Those people who have all that money with Fidelity and Vanguard don't have a lot of life insurance, disability, or long-term care. We have to find a way, given the way these folks behave and the kinds of things they look at, of getting them back. And it may mean finding partnerships with people at Vanguard and Fidelity and working it out. This is a tremendous untapped opportunity.

Has anybody heard about American Express in the long-term care business? It picked a target segment and a mature market, which was felt to be terribly underprotected.

It tried selling it through direct mail, realized it didn't work, then changed to face-to face selling through the use of a cadre. Who do you think is its most productive agent type for selling long-term care? It is the retired housewife. This isn't necessarily a recommendation as much as it is a way to think about tapping into that tremendous gold mine that we're sitting on.

Pick the target, know the segments, figure out why they're so underprotected and undersaved, ask yourself how to gain their trust, what are the right marketing moments, find a partner. Get a partnership that delivers exactly what that particular segment needs. Let's not start with the product to find a channel; leave it up to the channel to find the customer.

MR. TIMOTHY C. PFEIFER: We've done a lot of work recently with financial institutions and I'm going to be speaking from the perspective of a banker. By banker, I also mean a S&L executive. I'm going to offer comments from the perspective that the banks and thrifts we're talking about are in the mode of marketing insurance products as an agent rather than acting as an underwriter, although I will make a few comments about underwriting a bit later.

According to many bank surveys, insurance is the most popular product among bankers right now. Whether you believe that or not, I think it's safe to say that insurance has certainly attracted the attention of bank executives and is a product line that is gaining a lot of attention as a potential way to retain customers and generate fee income.

BANKING INDUSTRY TRENDS

Let's try to set the stage by talking about some of the trends in the banking industry that have led to the consideration of insurance as a viable concept. First, the financial institution marketplace is seeing increased competition, not only from other banks and thrifts, but also from financial supermarkets, insurance companies and many others. As we all know, there have been financial difficulties in the financial institution industry due to third-world loans and real estate problems, that have led to a search for alternative income sources by the banking industry. As with the insurance industry, there has been a certain amount of consolidation taking place.

Banks have sought out more products to be offered to their customer base. We've seen a steady evolution in the banking market since the 1960s, of increased products and services being offered to bank customers.

In the search for new income sources, operating as an insurance agency is one avenue. There have been many others, including investment services and trust services, that institutions have taken on.

Domestic banks look overseas and see expanded powers among foreign banks in England and Germany and in other European countries.

Finally, another major trend that is by no means the least important is on the consumer's side -- namely, heightened fears from consumers regarding the stability of the banking industry. However, despite this last point, I think a lot of consumer confidence is still there. This is the issue of trust that Rick raised earlier. The FDIC guarantee still means quite a bit and the confidence factor is still there.

A survey was done by *The Wall Street Journal* within the last year, asking individuals to respond to the question of which industry they were most confident or least confident in. The banking industry appears on both lists. There is a segment of the population that is quite concerned about the banking industry, yet there's a very solid core that is still comfortable about the structure and the stability of this industry. (Unfortunately, insurance is next to last in the "least confidence" column in this particular survey.)

ADVANTAGES TO BANKS IN INSURANCE

Given that there is this core of loyal customers, let's talk about what a banker sees as some of the advantages of selling insurance products through the institution. First is the issue of strengthening customer retention. It's not just retention, however, it's actually expansion in many cases. Studies that banks have conducted indicate that if they are able to provide four or more products or services to an individual, the chances that an individual will stay with the bank in any given year is over 90%. A product or service would include an ATM machine, a checking account, or some type of loan. Providing an insurance alternative is another way to solidify that relationship.

Another advantage of marketing insurance is that it represents a source of commission income. The amount of that income, obviously, varies depending upon the type of products that are being sold. Commissions are usually 4-5% of the premium in the case of deferred annuities and may be as high as 80% for some traditional life policies. The bank's compensation usually falls somewhere between 20-40% of the premium for credit and mortgage coverages.

Commission income provides several benefits to an institution. It can improve some of its financial ratios, such as net worth to asset ratios. Based upon some recent accounting rulings imposed on financial institutions, banks are looking for additional income to help improve their financial situation. (Accounting decisions include rulings that banks must amortize loan fees over the life of a loan.)

In general, some of the large banks realize over 40% of their earnings from non-interest spread income. The commission income from the sale of insurance products could account for as much as 10% of the bottom line for some larger institutions and this enables these institutions to spread some of their fixed costs. Commission income is definitely important.

Lower distribution costs are something that Rick alluded to earlier. At least in theory, the distribution costs from a bank-originated sale should be lower than an insurance company agent sale because a bank sale is often a direct mail sale or because the prospect has walked into the institution, so prospecting costs should be lower. In practice, commissions on most products have been quite similar to those that a traditional agent would receive. Accordingly, there is potential for more competitive products on the bank side.

Convenience is a major issue. Certainly, the fact that much of the bank insurance business is walk-in business and a customer can conceivably open a checking account and buy an annuity policy at the same time provides a lot of convenience from the customer's perspective. Due to the nature of the institution and its working with the client on existing accounts, there are opportunities for improved service. For example, establishing payroll deduction or check draft systems for particular insurance products can be handled efficiently for sales through institutions.

A few other advantages include items such as cross-sell opportunities for the institution. Maybe a final major advantage is the fact that an institution can enhance its image relative to its customers by appearing to be a forward thinking institution that offers enhanced services.

RISKS TO BANKS IN INSURANCE

However, there are risks from the bank's perspective in selling insurance products. One that is frequently mentioned is the disintermediation or cannibalism risk. In the situation where the institution is acting as an agent, there is the danger that money deposited into annuities or insurance will come from existing assets under management by the institution. Many banks have done their own studies on disintermediation experience. In fact, most banks regularly monitor experience to try to understand where their insurance premiums come from. Some institutions will encourage their sales team to bring in money from other sources by paying a higher commission on money coming from the outside. So far, most of the results seem to indicate that disintermediation has not been a major problem for institutions.

The second major danger is the loss of customers. Why would a bank or institution lose customers due to starting an insurance program? There are several reasons. First, the insurance products may be uncompetitive or perceived as being uncompetitive. An annuity that starts off crediting 10% could drop its rate to 8%. Customers tend to view the institution (not the insurance company) as the entity who issued the contract. Therefore, if customers become disenchanted, they tend to blame the institution. Perhaps the customer is unhappy because the right product was not sold. Poor customer service could drive other customers away. Poor training of the institution's sales force could lead to misunderstandings. So there is a very clear risk from the institution's perspective that the customer could become disenchanted for many reasons and the blame likely would be placed on the bank.

Another risk to an institution is potentially inadequate commission income. The institution could have worked with other insurance companies that would have paid a more attractive commissión, so there's a real opportunity cost there. A poor commission may stifle the motivation of sales staff to sell to the degree the bank would like.

Another risk is cultural. Banks have been order-takers in the past. Now, they're being asked to develop more of a sales culture and that's a very difficult thing for many institutions to do. Despite the help from insurance companies and third-party marketers in training and licensing bank personnel, many banks have found it impossible to create an aggressive sales culture. Some insurance companies have tried to plant agents within bank premises to try to encourage sales. This hasn't worked, by and large.

Finally, if an institution is actually underwriting insurance, as in the case of a few institutions, it faces all of the risks that an insurance company faces with respect to mortality and morbidity risks, investment management, capital needs, etc.

One other thing that's very critical is the point brought up earlier of FDIC guarantees. Clearly, there's a disclosure issue that customers must understand that insurance products do not have FDIC guarantees. This can lead to major risks if individuals believe that there are implicit guarantees, but then find out they don't have the level of guarantees they thought.

PRODUCTS SOLD IN A BANK MARKET

What products does a bank sell? Some of the products that have been sold most often in the bank market by loan originators primarily include life insurance products such as credit, mortgage term, AD&D, universal life, single premium and term. Health insurance includes credit, mortgage disability, AD&D, long-term and major medical. Also included are deferred and immediate annuities.

We're probably all familiar with the controversial issue of coercion and the fear that there could be tie-in sales that force people to buy credit insurance. From the banker's perspective, I do not believe that this is an issue. Insurance sales are generally handled by an entirely different bank department than loan origination. I haven't seen any broad data to imply that the coercion fear has been substantial.

Mortgage term and AD&D are often sold through direct mail. However, the direct mail outlet has had some difficulties in recent years due to increased costs associated with rising postage rates as well as list fatigue.

Universal life and single premium life have been sold with some success in banks, although, single premium life is not so popular anymore. A few years ago there were some substantial bank sales made using single premium life. Universal life accounts for some business through banks, but not very much. Part of the reason for this is that it is a difficult product to sell. The concepts of cost of insurance (COI) charges, expense loads, etc. really require a more savvy distribution outlet than currently exists in most institutions.

About 15% of large financial institutions sell some sort of term insurance. Premium rates generally are far less competitive than what you would see in the brokerage market.

On the health insurance side, a good number of health products are sold through direct mail outlets. The one that I would like to focus on is long-term care (LTC). There seems to be a genuine opportunity to sell LTC through banks and thrifts. To date, only about 8% of institutions are selling LTC and the results are mixed. Some insurance companies and institutions have tried to package a single premium immediate annuity policy with LTC coverage, where the benefits paid from the annuity are channeled as premium into a LTC contract.

The demographics for LTC seem to be in our favor. However, with all the legislative activity in the LTC arena, and the complications of a product that's not easy to understand, LTC sales, at least so far, have been disappointing; but clearly the potential is there in the future.

The major product in recent years has been the deferred annuity. Annuity sales in 1987 through banks and thrifts totaled about $4 billion. They climbed to $6 billion in 1988, $7 billion in 1989, and almost $10 billion in 1990. Most of these sales are fixed deferred annuities, although there's more interest than ever in selling variable products. This may be a function of more banks getting into the insurance business as opposed to S&Ls where the typical bank client is a little bit younger and has a stronger risk tolerance. There are several companies that have made a big splash in the immediate annuity business, selling payout annuities to liquidate large savings built up by individuals. We believe that immediate annuities will be another growth area. I believe that annuities will eventually become core products for banks. We already are headed in that direction.

From a banker's perspective, how does one determine what products to sell or what products would be appealing? Commission income, customer needs, product simplicity and cultural fit are important.

Commission income is important as certainly, a bank wants adequate commission income. But in most cases, this is not the driving force.

Based on work we've done with institutions, the customers' needs are more important. Banks view insurance as no different than any other product sold to their client base. They want to make sure that it's not a "make-work" product, that it is meeting a customer need. Different insurers will often be used by one institution based on the strengths of the company. For example, it's not unusual for an institution to use one set of companies for fixed deferred annuities, another set for immediate annuities, and maybe a third set for variable annuities. Companies that seem to meet clients' needs with their products are the companies that banks will choose.

Products need to be simple. There is a limited amount of time in which to discuss a product with a bank customer and, therefore, the concepts need to be explained quickly. The products either need to be marketed simply or they need to actually be simple products in order to be successful in this market.

Lastly, a bank should address the cultural fit, which is very important. As insurance companies approach banks with joint venture proposals, insurers need to be very sensitive to the fact that institutions have their own culture in terms of how risk averse they are and many institutions will shy away from very competitive products because they do not feel comfortable with the risk posture of the insurance company or because in general their philosophies do not seem to mesh.

DUE DILIGENCE CRITERIA FOR INSURERS

Due diligence will become even more important given the events of the last few weeks. Institutions carry out due diligence in several ways. They may have an internal committee or team that performs this function. Second, they may go to outside firms that specialize in due diligence work, and there are several of those that have been established. Third, they may hire outside actuarial firms.

Institutions look at a number of things. Large institutions tend to be more demanding than smaller ones. Most institutions go through a multiphased approach in their due diligence of carriers where they use publicly available information to weed out companies not meeting basic criteria. Then, they go to a second level where they may visit companies to learn about internal procedures and financial measures. If you're considering this market or are already in it, don't be surprised if bank executives come into your policyholder service area and plant themselves in there to watch your operations to gain an idea of your service.

Institutions, in some cases, take up to two years to conduct due diligence of insurance carriers. That's probably an extreme amount of time, but it certainly not unheard of for banks to take that long. If a bank would approve a loan to the particular insurance company, it would probably like to work on an insurance program with that company.

Some institutions have minimum size requirements. They won't consider companies with less than a certain level of assets. Some institutions look for name recognition, regardless of whether the insurance company is presently in the bank market. Ownership structure is important to institutions with respect to the questions: Is the insurance company a key part of its overall organization? Are there major distribution sources that the bank would be competing against such as captive agencies? What experience does the insurance company have not only in the bank market but in annuities in general?

Financial stability in terms of surplus ratios and other leverage measures are important. Investment performance and examination of the company's asset/liability management and the nature of its portfolio in terms of quality and diversification are closely reviewed. What has been the financial performance of the insurance company using GAAP reporting, statutory reporting, and internal reporting measures? Finally, ratings from the professional rating agencies are examined early in the process. These are just a few of the criteria and within each of these you can expand it quite substantially.

In terms of the due diligence of products, banks currently feel this is less important than the financial stability of insurers, although the level of guarantees is important. For example, on annuities a return of principal guarantee is a prerequisite these days. Another key product factor is flexibility. The product should be able to adjust to a customer's changing lifestyle. As we mentioned before, products need to be fairly simple. Multiple options such as allowing different guarantee periods on a deferred annuity are attractive. Competitiveness is important, but only reasonably competitive products are needed. A product doesn't have to be in the top 10% of credited rates, accumulated values, and paid commissions. The main consideration is that products fit a need and that they be consumer-oriented.

What about due diligence of service? Service is a key area but how does one really measure the quality of a company's service? A company needs to show a commitment to service. It needs to take pride in the quality of its service. Advanced technology is really not a critical point; we've talked with institutions that work with insurers that have state-of-the-art processing equipment, but the commitment to service is not there and the bank views the administrative function as a black hole for them.

The company needs to have a track record and some experience in terms of servicing. Timeliness is, obviously, a key issue. Specific service capabilities that are attractive are field issue and net remittance programs. These are nice extras, but most bankers will tell you that the key is just a definite commitment to service. It's in this area where banks tend to pay personal visits to the company and really take a hard look at how well staffed you are, how you answer phones, and how quickly you respond to customer inquiries.

CONCLUSION

The KISS principle has probably never been so important as it is in this market. The keep it simple approach is critical. You work with clients who will probably walk into the institution not expecting to walk out with a life insurance policy. You have a short amount of time to present it and you want to make it simple. Another critical point to remember is that it's the bank's customer, or at least the bank views it that way. Banks certainly want to offer a product that's fair and competitive, but they believe that any problems that arise will be traced back to them. They certainly don't want insurance companies destroying customer relationships because the biggest assets that banks have are customer relationships and trust.

I thought I'd also mention *Sleeping with the Enemy*. That refers to the fact that I think we should all remember that the relationships insurers establish with banks today may be far different from the relationships 5-10 years from now when these same institutions are competitors, at least in certain product lines. Finally, the underlying message that I've gotten from working with institutions is to be fair. Banks have a client they want to protect and serve, and the insurance companies that honor that customer will succeed.

MR. HELE: You have to understand, first and foremost, that a stockbroker makes his money transacting. The average gross commission to the firm on most transactions the stockbroker does is around $300. In most firms the stockbrokers are paid between 30-60% of that. It's $100 for every transaction that they do. You've got to do a lot of transactions to get to the nice six-figure income that all stockbrokers aspire to. The average insurance commission, on the other hand, is about $1,600; a dramatic difference to the stockbroker. In looking at any distribution channel, you have to understand what the market is thinking and doing when you design and price products. And when I say the market it's not just the market of the end client, but the market of the distribution channel of the salesperson who is selling that product. What are the most important things to the person selling the product? You have to ensure that you design your products appropriately.

To a stockbroker the most important aspect for long-term success is trust. At Merrill Lynch, our motto is a Tradition of Trust. The clients that you're golfing with and you go to church with have entrusted large sums of money to you for investment purposes which requires that you maintain the trust with those clients. As a stockbroker you have to also maintain the trust with the firm. You have to be able to trust that the product you're selling has appropriate due diligence and won't come back to bite you.

The second most important aspect to a stockbroker, as well as to a client, is liquidity. I think this is very important in thinking about product design. The average client, in terms of assets, at most firms is approximately age 67. One of our largest markets is Florida. It is little old ladies coming in with bags of money who are very concerned about liquidity. They're concerned because of health reasons, because of long-term care, and because they aren't sure what may happen. So liquidity is very important to the clients and it's very important to the stockbrokers. This is also at odds with a lot of insurance products where because of paying up-front commissions and with the many risks inherent in these insurance products, you need to tie up the money.

The key word and the key measure for profit traditionally in stockbrokerage firms has been a measure of velocity. Velocity is the measure of how much assets turn over within the firm. Velocity during the 1980s was extremely high and stockbrokerage firms were extremely profitable. In a relative sense, the 1990s will not see that anymore. The 1990s will probably be the era of boredom for stockbrokers. The velocity is down dramatically because there's a huge fundamental shift happening in the stockbrokerage world right now. Stockbrokers are moving away from being stock pickers to being money managers. In essence, they're actually a money manager in many situations, helping clients pick through a wide array of very complex products and picking the right one for them. The velocity is very important. If the money's liquid they can move it.

Also important is product credibility. You've got to have a good story in your product and it's got to be easy for the salesperson to understand so he can quickly answer the questions of the clients. He's got to do a lot of transactions. He's not making a very large commission on each transaction in a relative sense. It is not the 60% commission, long typical of an insurance sale; therefore, credibility is extremely important.

Let me give you an example of probably one of the most successful investment products in the past few years. It's an issue that we sold at Merrill Lynch. It's called a liquid yield option note (LYON). Now if anybody thinks insurance is complex, the prospectus is quite thick but it has a lot of credibility. It has a minimum guaranteed rate of return. It's like a zero-coupon bond that can be convertible to stock; therefore, you can get the upside with a minimum guarantee. It's still very complex. One LYON that Merrill Lynch underwrote, and was sold through Merrill Lynch and other broker-dealers last year, was called the Disney LYON. The Disney LYON was actually to help fund the Euro Disney park, and it was convertible to French francs and was extremely complex. The issue was sold out in one morning, because what Disney had was credibility. The brokers understood it. In fact, the top brokers, one from every office, were flown down to the Disney park, given little Mickey Mouse ears, and they walked through the details of the product.

But the pitch on the phone was, how would you have liked to have bought Disney stock 20 years ago with a minimum guarantee of 5 or 6%? Sold. Because the clients trust Disney. They trust the broker who's selling them the product and the brokers trusted the product that was being created. And I think the insurance industry really has to take this into account very carefully when it thinks about products. Going in with the highest interest rate and lowering it later on does not gain you credibility in the long haul.

All stockbrokers think about return. They love numbers. They think about the rate of return on everything. On every product they are selling what the rate of return is until it becomes liquid again. Is there a seven-year surrender charge or a five-year surrender charge? The moment it's past the surrender charge the funds become available. If you have a product with a good story, money can be moved, but it's got to be moved when it is in the client's best interest. You're not going to move money around and lose your client's trust by continually rolling money and not giving the client a better deal. But if you have a client in a product where the surrender charge is over and the insurance company is investing long yet guaranteeing a one-year rate, and interest rates go up 300 basis points, (which they have done a few times), the stockbroker has a very good story to move the money. It's very easy to do. And you should think about that very carefully when you price.

If you think about what's been sold through stock brokerage firms, the market right now is about $12 billion. (See Chart 3.) In 1990, 75% of the volume was in fixed and single premium deferred annuities, 23% was in variable annuities, and the remaining 2% was in life insurance.

If you want to look at who was the most successful (see Chart 4), Shearson sold a lot. Eighty percent of their total volume was in fixed annuities, 19% in variable annuities, and 1% in life insurance. And that 1% is still $20 million which would rank it as a pretty large insurance brokerage firm. A lot of that was in an annual premium life insurance product. There are many companies that would love to sell $20 million of annual premium life insurance. Dean Witter was number two last year with about 85% in fixed annuities. At Merrill Lynch, we sell a bit more life insurance, but we have specialists throughout the United States who assist stockbrokers in selling life insurance and 11% of our sales were in life insurance. Prudential had about 86% in fixed annuities while Paine Webber had almost 30% in variable annuities, 68% in fixed and 2% in life insurance. In 1989 and 1988, Merrill Lynch was number one. We sold about $2.4 billion each year. We have seen a dramatic drop in our fixed annuity sales basically because rates are lower. When interest rates go up and when you've got an 8% or a 9% rate that you can talk to a client about, you can sell the business. When you're down around 6.5% it's not quite as exciting. So your volume will go up and down.

There's a huge trend going on in the industry where stockbrokerage firms are now asking why should we be disintermediating ourselves? Stockbrokerage firms have turned from moving money a lot on a small amount of assets to having a large amount of assets with a much lower velocity. They are gathering assets all the time. At Merrill Lynch we have over $360 billion of clients' money under management, $110 billion of which is in our own mutual funds. So I think you can see by the trends more is now propriety. There will always be a mix because clients do not want to put all their money in one firm, so I think that brokerage firms will always have a variety of products to sell. There is opportunity if you have a good, solid product.

At Merrill Lynch, we're selling just about as much as we did 10 years ago (adjusted for inflation). (See Chart 5.) I picked 1981 because I had the numbers handy for 1981. The mix is roughly the same. The volume is the same. In fact, interest rates were higher in 1981, so there was a real story to sell.

HISTORICAL SALES
Top NYSE Firms

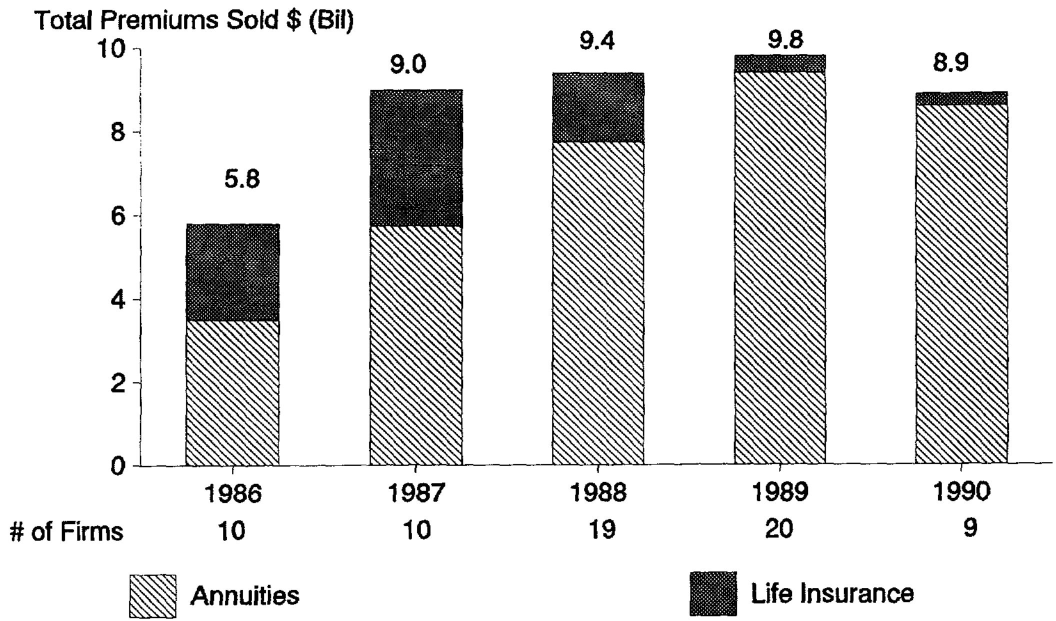


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CHART 4

1990 SALES

Top Five NYSE Firms

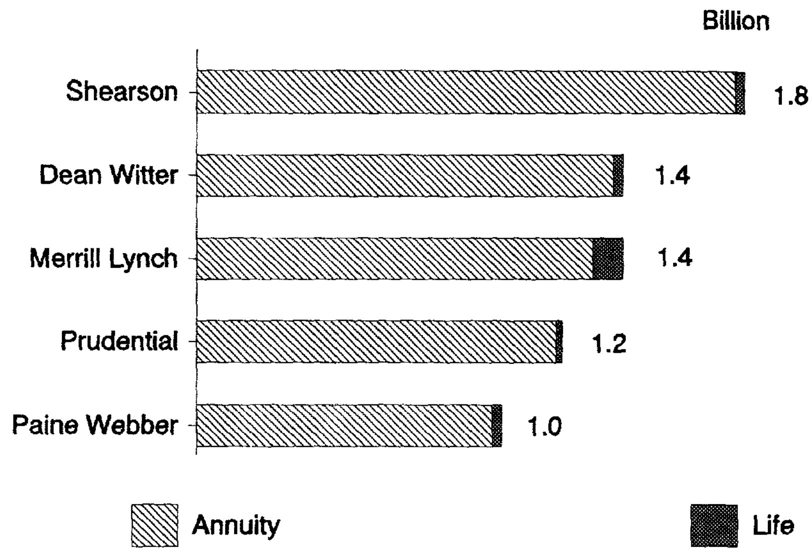
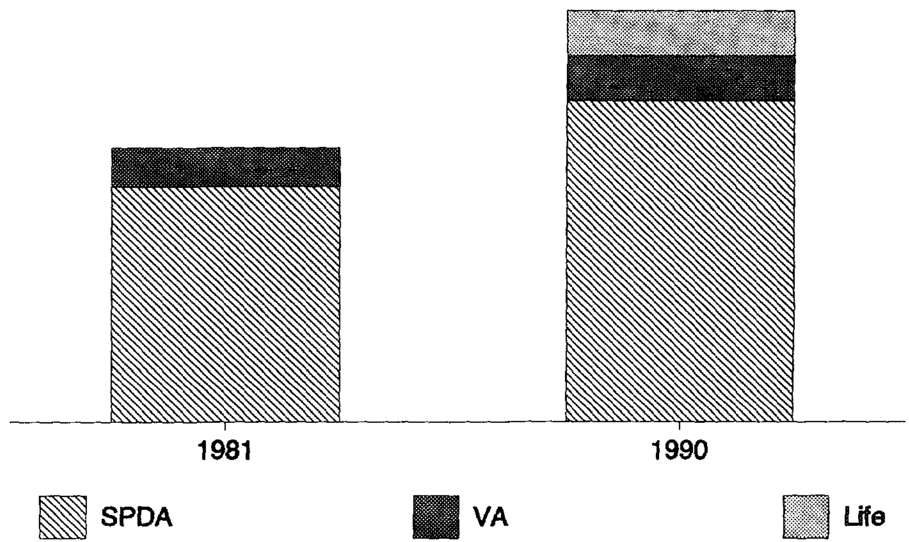


CHART 5

MERRILL LYNCH SALES

A DECADE APART



But I think you've got to look at the companies. We no longer carry most of the companies we had in 1981 and some aren't even around anymore. This has not been a long-term business for insurance companies. There are examples of 70% of a block of business being rolled within a year. So you've got to be very careful. Know the risks you're taking. I think one of the reasons why firms are going to propriety is because it is hard to continue like this. The credibility of insurance companies is not very good among the stockbrokerage community and with the recent example of Executive it's not going to get any better.

Think about the future and what may lie ahead. The over-55 segment will continue to grow in importance to the stockbrokerage firms. The challenge will be for full-service stockbrokerage firms to capture that market. But the economy, hopefully, should be okay. The 1990s may be the growth of equities, the recapitalization of America, a great story. Rates may go down, that's great. Rates may stay the same or interest rates may spike. We have all three scenarios. I would not bet the farm that rates are just going to go down, though many insurance companies are.

You have to be very careful when you sell through stockbrokers and don't forget even though you're selling through other distribution channels there's a lot of competition out there for consumers' dollars. Basically, I think stock brokerage firms are going to be more and more into the manufacturing of insurance products. There's no reason to disintermediate the client's money from management. But there is an opportunity for joint ventures. Stock brokerage firms do not want to be experts in absolutely everything. There is tremendous opportunity for firms to join together to provide expertise especially in the underwriting of insurance as opposed to money management. Insurance is a big investment. If you speak to anybody in insurance who deals with stockbrokerage firms, the relationship really takes a great deal of investment just to get going. If you can't get a joint venture you should think about persistency rewards to the firms.

This is my personal prediction, but I think that basic single premium deferred annuities (SPDAs) will be moving less and less unless we get a large interest rate spike. It's going to be harder and harder with capital constraints for firms to keep selling the large amount of volumes that are required. I think there's a tremendous opportunity if it's packaged right and if it can fit the values of stockbrokers to sell life insurance. Long-term care, interestingly enough, has been very well received by many stockbrokerage firms. In fact, we really love it because it draws in clients and then the stockbrokers can sell zero-coupon bonds, along with some long-term care. So I think the most important thing is to step back, understand your distribution channel, and think about the values that are going on and make sure your products fit it.

MR. NOEL J. ABKEMEIER: Tim has talked a lot about the bank's perspective and John an awful lot about the brokerage perspective. The insurer's perspective is basically a response to what you've heard.

I want to first look at the attractiveness of the market to both the brokerage and in the bank community and afterwards the requirements imposed on the insurers. First of all, in the brokerage distribution of the annuities, there is the market where brokers are currently distributing a bit over 20% of what's being sold. As we look in the future there are a couple influences that are going to affect it. First of all is the flight to quality that has been mentioned concerning the solvency of companies, the appearance of companies. This is going to lead to a redistribution of market shares among companies. Those who are in the business and who are perceived as strong can strengthen their shares. If you cannot project an image of strength you may see your segment shrinking and, also, of course, if you're thinking of entering the market don't consider doing it unless you can get yourself ranked in the top tier of companies on quality standards.

The second factor is the baby boom that Rick referred to. This cohort of people board between 1946 and 1964, are just reaching age 45 and getting into the prime ages for annuity purchases. As we look over the next 20 years as this wave moves forward, the population in the annuity purchaser segment will increase by 45%. The question is -- when they're in this segment how are they going to view the annuity market?

Are they going to continue to be the spenders that they have been characterized as or are they going to conform to the characteristics that we've seen in the past? The second one is their attitude toward old age. Do they see old age coming as early as our predecessors and perhaps we do or are they going to see old age as a longer process and, therefore, you start saving later? So depending on how they view the market and how they act, the market could grow very quickly or it could grown much slower than the 45% mentioned. Or it could be a deferred growth if they simply are going to act at a later stage. Also, within the market there are always factors beyond control. In the selling through the brokerage market, if you're selling in a strong equities market you find that the interest of the stockbroker goes toward the equities and this is a damper on your fixed annuity sales. Another circumstance is inverted yield curves insofar as insurers tend to invest long and take the advantage of the yield curve in developing the SPDA products. When you have an inverted yield curve that advantage is not there and it's hard to differentiate yourself. So there are certain influences outside of your control which can affect your results.

The profitability in this market is attractive if you do things right. There is no reason why if you're properly pricing your product and properly investing that, in the brokerage market, you could not achieve a 15% aureole or up to a 1% return on invested assets under management. Now this does require good investment approaches. Of course, in the last decade there was a high dependence on high-yield bonds, which had gone sour. We have to look at new investments in the future, but with the proper investments you can maintain such a profit profile.

Of course, the practices of the business are such that the investment climate when the money is received determines an initial interest rate. However, there's a need to be responsive to changes in market rates, so your renewal crediting rate is somewhere between where you started off and where the market is currently. So if the market is drifting downward you have the opportunity to widen your margins. If market rates are going up you may have to shrink your margins. But the bottom line is that the profitability I mentioned may or may not be there depending on how the market treats you.

Finally, persistency is an unknown factor. In recent years we lived through some favorable circumstances. Interest rates have been drifting down which causes your customers to be more satisfied and less likely to leave through the yield-induced lapses. Also, surrender charges are a great exit penalty. People will view the surrender charge as one of the costs for switching. Most of the business is still in the surrender charge period; therefore, we have not seen heavy surrenders. The question is, What will happen if you do have a rate rise in the future after a large number of surrender charge periods have expired? We don't know what will happen.

Next, within the brokerage market there is a distribution of life insurance. The culture is such that the brokers are selling risk investment and there's always been a conflict between risk and security and is not changing very quickly. As has been mentioned, long-term care can be an attractive product as the people who've accumulated money view the long-term care product as a way to keep their hard earned savings from slipping through their fingers in the future. So I see it as a product which not only will be talked about and used as a door opener, but actually will be a purchased product later on. After developing annuity and long-term care sales skills, the possibility of then transferring these techniques into life insurance is there, although it's just a moderate possibility.

Next, I would like to comment on the attractiveness of the bank distribution of annuities. This is a market where over the last five years the compounded annual growth rate has been 33%, so it's a very attractive market. As you look forward there's a possibility and probability of more and more banks entering the business with the result that the market may triple what it is today by 1995. That could be a $25-30 billion market. Also speeding up the growth not only the entrance of new banks, but the development of sales cultures as has been mentioned previously.

A variable coming into the picture is the deregulation. As you know, the administration proposed possible liberalization for banks in the way of sales and underwriting of insurance. If this comes to fruition, which will take a while, still the sales aspect can be made more attractive for the banks. Currently, national banks cannot have their own sales structure, but rather must have some indirect approach to do the selling of the insurance products. The proposal is that they be treated just as state chartered banks, which currently may be licensed in 14 states. With deregulation the banks can then bring the whole sales process more into the fabric of their operation, build an identity with it, and have a greater growth potential than has been in the past.

In the area of underwriting insurance there are enough restrictions and fire walls being imposed that it is my feeling that only the largest banks would get into the underwriting of insurance. Most of them would still depend on traditional insurers. Another variable is industry consolidation. Currently, there are 12,000 banks in the United States. The projection is by 1995, this may shrink to 5,000 banks, so only 40% of the current level. An even more pessimistic observation is that there may be as few as 1,000 banks in the long run. The bottom line is that you must be selective in the affiliations that you form with the banks so that you can grow through acquisition of banks as opposed to shrinking through consolidation of banks.

Once a product is properly positioned its profit picture is similar to what I mentioned on sales annuities through the brokerage channel. Up to now the interest crediting on annuities sold through banks has not been as demanding as in the brokerage business, but I think you'll see a convergence over the future to bring it close so that the pictures will be similar. The lapse rate in the bank market has been about half that in the stockbrokerage market, but it is still a very immature business. The surrender charges are high. It has had a decreasing interest rate environment during its short lifetime. The sales culture in the bank is still weak, therefore, you don't have the pressure for churning of business. The competition among banks themselves has not been very heavy. But as the future evolves each of these factors may change. I see a more competitive situation, and less attractiveness in surrenders; however, I still see it being a bit better than what you see in the brokerage business because of the conservative nature of the customer.

In distributing life insurance through banks, this is the franchise that's been untapped, as Rick has mentioned. Just as in the brokerage business, this becomes a very ideal market for long-term care. People have their funds accumulated and it is good to protect them from evaporating through adverse circumstances. The customer in the bank is more security conscious than the brokerage customer and the banker is more trustworthy than the broker in the customer's eyes. Both of these lead to a stronger long-term care market than in the brokerage business. Once this practice of selling long-term care is developed as a second stage after the selling of annuities, I see as part of the sales culture evolution into selling traditional life insurance products. The bankers have to be conditioned to approach the market, but once they're conditioned the potential is there for being true insurance salespeople.

Within the bank environment there's the opportunity for having very economic sales. Experiments or actual cases in Europe have shown that the unit costs of selling insurance through banks can be half of or even a third of what they are through agent channels. If banks here choose to do that they can distribute that low unit cost with still good income for the people doing the selling. They will be able to deliver products very attractively and can perhaps roll into other lines of business, property casualty business and the like. It's been mentioned that the sales culture is slowly evolving. Banks are using third-party marketers for their selling but some are moving inside using their own people, their own control. Ultimately, it will be woven just totally into the fabric of the bank which then can be a very effective sales environment.

The question is, what does the insurer have to do to succeed? Basically, it's respond to the various points that have been described by Tim and John. The first one is to have the appearance of corporate quality. Tim indicated nine different items that are critical for due diligence evaluation. I'd like to point out that in the banking industry third-party marketers are emphasizing this very strongly. One of them does its own due diligence of 400 insurers to help the bank select who it should be willing to do business with. Another utilizes a consultant on a retainer basis to actually review companies it is considering representing and narrowing it down to those who meet its standards. Also, there are publications in the market, such as bankers' guide to insurance companies, that help the banker through the due diligence process. The point is that the insurer must make sure it is conveying the strong picture to these various intermediaries and to the banks themselves as to how strong it really is. Another quality characteristic is the predictability of underwriting capacity. Neither a third-party marketer who is representing you nor a bank who ultimately wants to have the products wants to see the capacity dry up. So you as an insurer better have a predictable source of capital so that you can grow with your customers.

The crediting rates must be very attractive and it presents a challenge to the insurer. The markets in which we're selling demand crediting rates that are better than certificates of deposit that provide profitability for the bank, profitability for the insurer and some commissions for the sales channel. So this all points to the need to have a very strong investment program to support the annuities.

The incentives for selling must be on an equal footing with what's common in the culture. If you're selling through a brokerage house the salesperson must view your annuity product as something similar to the mutual fund that he's selling. Your compensation must be of the same form and similar level. If you're in the bank environment, you must be providing incentives to customer service representatives to refer annuity business with the same attitude as selling certificates of deposit. So the incentives they receive, whether's it's some bonus or some kind of credit, must put the annuity on the same par with the certificate of deposit. In the home office there must be a good adaptation to the culture. This starts with the product design where you must recognize that the products for an agent's sales force, and then for a broker's, and then for banks, each must be different in increasing simplicity, because the number of areas that each of these people are required to have expertise is increasing. Therefore, what you are presenting must be made simpler. Also, the method of servicing the customer must be in tune to the bank market. As Tim mentioned, banks may come to your insurance company and look around your service area and see how you operate. You clearly must convey that you are geared to that market and you have in a sense a small company within your company dedicated solely to that market.

Finally, the banks view their customers as theirs, as very much theirs and they like to be co-developers of products and activities. As a result, they are interested in things such as having proprietary products that are designed specifically for them. They would like to have private labeling where their name gets prominence. They would like to have the opportunity to invest some of the funds. This is very easy in mutual funds and it is possible also for a single premium annuities or fixed annuities where they may want to manage the general account assets.

We look specifically at the brokerage channel, we're dealing with a market which is characterized as an upper middle-aged investor and the key term there is that he is an "investor." To respond to that, we need not only SPDAs and flexible premium deferred annuities (FPDAs), but things such as CD annuities to help the customer park his money at times. Variable annuities to build on the mutual fund expertise. Market-value-adjusted annuities allow you to present to the customer products that reflect the positive yield curve. This product is very feasible in the brokerage market because the risk that the customer must assume is quite similar to many of the risks he faces through other brokerage purchases. The product should have features suggested of mutual funds. The load charges would fit into that category.

Rate crediting is an interesting area because it is viewed in three different ways by the customer, the intermediary, and the insurer. When the customer looks at a one-year guaranteed product, he feels that it's a one-year investment. The intermediary, such as a broker, views it as an investment having the maturity equal to the surrender charge period. The insurer considers it a long-term contract. So, as a result, the investment program and the philosophy must be sensitive to the new money market rates to satisfy the customer needs, but must also present attractive crediting after the guarantee period or some compensation to combat the surrenders that could be induced by activity and the self-interest of the broker. At the same time, you have to invest sufficiently for a sufficiently long period to satisfy the insurer's needs.

Another item is the need to have some shelf space. You must get visibility to your clientele, so that must be done either through a third-party marketer who can strongly present you or your development of your own active wholesaling force. In order to be in the market some procedures must be developed that you're consistent with the brokerage house culture. We have found, for example, that we issue policies without applications because the broker is accustomed to selling a product on the word of the customer without anything in writing.

Finally, through the bank channel we're dealing with elderly savers, as distinguished from the broker who had elderly investors. The bank market basically requires an SPDA, but it may also be good to be prepared to have products and service to address the minimum distribution requirements under IRAs at age 70 1/2. Insurers have not gotten heavily into that, but there is an avalanche of this business waiting to come and we should be prepared to jump into it. The late crediting in the bank channel had been less demanding than in the brokerage channel as much as 50 basis points lower. That's narrowed to about 25 as compensation structures have come down. As we look into the future, we must be ready to address the same issues for the bank channel as we do for the brokerage channel in their crediting area.

As you're entering the bank annuity business you must recognize that there are various choices as to how you are going to enter the market. You can enter it through the utilization of third-party marketers who will develop the bank clientele and actually market the business for you. A little lower degree of third-party marketer involvement is using them as your wholesaler. You may develop your own third-party marketing capabilities or, finally, you may wholesale directly on your own. Your choice of approach is going to determine your speed of entry into the market and your entry cost. Using some outside help will get you in quickly. The flipside of the coin is it is felt over the long run third-party marketers are going to fade from the scene and the more that you have brought them into the picture pushes you as an insurer further into the background and will influence a degree to which you can influence the bank's activities in the future. You have to weigh those two against each other. Finally, on the administration within the bank environment the common feature now is on-site issue. The customer can walk out of the bank carrying an insurance policy or an insurance certificate in much the same way he would if he were buying a CD.

In summary, the bank and brokerage channels give you an opportunity to diversify away from your basic agent's channel. There is profitability with some uncertainty in it, but it is doable if you adapt to the culture.