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CHALLENGES AND OPPORTUNITIES IN THE MARKETING OF INSURANCE PRODUCTS THROUGH FINANCIAL INSTITUTIONS

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- This session will examine the distribution of insurance products by and through financial institutions, products, distribution options, etc. The marketing opportunity will be addressed from several viewpoints -- insurance company, marketing organization and financial institution.

MR. EDWARD B. MARTIN: I have been involved in the insurance industry for close to 20 years, and even when I first started, the issue of banks in the insurance business was a hot topic. Many people view it as inevitable that banks will become more and more involved in our business. It is natural to view this as a threat, and it probably is, to some extent. But more and more companies seem to be looking at the opportunity side of it, and that is the theme that I hope this session takes.

Factors in both the insurance and banking industries have led, over time, to more and more joint activities between insurance companies and banks. On the insurance company side, we are all looking for more distribution opportunities, areas where we can generate growth. A lot is happening in the banking industry that is causing banks to reevaluate their strategic positioning and to look more seriously at insurance options. Many of the largest banks in the country are now involved in insurance marketing programs.

Our objective is to explore this market. Our panelists represent a cross-section of experiences and viewpoints. We have a representative of a consulting firm that has done a lot of work with financial institutions and marketing companies, helping them evaluate insurance organizations. We have the head of sales and marketing for an insurance company that is heavily involved in the financial institution marketplace, and a chief actuary for another company that also focuses on this market. Each brings a different perspective, and my hope is that we can add just a knowledge base, whether you are already involved in this market or if it is something you are considering.

Our first speaker is Cheryl Krueger. Cheryl is a consultant with Tillinghast in its Chicago office. Tillinghast has been involved in assisting financial institutions and marketing companies to evaluate insurance opportunities and to evaluate potential carriers. Cheryl has performed financial reviews of life insurance companies on behalf of financial institutions. She has also been involved in the development of excess interest whole life, term, and market value adjustment annuity products. Prior to

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Tillinghast, she supervised product development and implementation at Great Northern Insured Annuities (GNA) in Seattle. Cheryl, a graduate of the University of Nebraska and a Fellow of the Society of Actuaries, will give us an overview of the market in general, and then she will talk about how financial institutions look at insurance companies.

MS. CHERYL A. KRUEGER: I will attempt to talk from a financial institution perspective about this market and the opportunities as they see it, even through I am not a financial institution person. The real growth in this industry has occurred in the last few years. There are Life Insurance Marketing and Research Association (LIMRA) statistics on what the growth of the annuity market has been in financial institutions in the last five years. In 1987, approximately $4 billion of annuity sales were through financial institutions. Last year this figure was about $9 billion, even with some slowdown in sales toward the end of the year because of the interest rate environment. Things are picking up again now, and LIMRA is projecting that in the mid-1990s, we'll see $40 billion a year of annuity sales through financial institutions. So, there are some real opportunities on both sides, for insurance companies and for financial institutions.

There are multiple reasons why institutions have been slow to enter this market. One reason is, of course, regulatory issues. Another issue for some banks has been disintermediation – disintermediation in the sense that banks and thrift institutions are afraid that the deposits will be taken from their Certificate of Deposit (CDs) and put into the annuity products that they introduce to their customers.

About 50% of annuities that are sold through banks come from funds already on deposit with the banks. Some believe they would have lost much of this business anyway. So they do not mind collecting the fee income, rather than have the funds go to another bank or to an insurance company. So, the disintermediation issue is still there, but banks are getting more and more comfortable with it as time goes on.

I will now address a group of issues facing financial institutions entering the insurance market. The first one is the choice of an insurance company. Institutions look at a number of criteria when making their choices. One of the most obvious criteria is ratings. All the rating systems are used, including A.M. Best's, Moody's, Standard and Poor's, and Duff & Phelps. It is getting to the point where if you want to be very active in this market, you need to have not only a Best rating, but also one, and maybe two, of the claims-paying ratings of the other agencies. In terms of Best's ratings, A or A plus is basically a requirement, although some lower-rated companies do operate in this marketplace.

Another factor is stability and experience in the financial institution marketplace. In bank distribution, the culture is different than the individual agent culture. Is the insurance company committed to this marketplace? I am aware of one example where a financial institution did quite a bit of business through a very small insurance company. With little notice, the insurance company decided it could not handle the strain, and it pulled the plug on the institution. Fortunately, the institution had other outlets. But the bank was very concerned about its customers and doing business with an insurance company that was not committed to the bank insurance market.

Insurance companies that want to be successful with financial institutions are helped by demonstrated stability and experience in the marketplace.

With respect to due diligence, much of a financial institution's focus in evaluating insurance companies is financial. And their interests are not too much different than those of other distributors. In the asset portfolio, of course, we have the junk bond concern, and the real estate concern, and the liquidity concerns that go along with these types of assets. Financial institutions are really focusing on credit risk.

We are going to see more focus on the asset/liability management risks. There has been concentration on the C-1 risk, there will be increasing concern with the C-3 risk. Prepayment risk is part of that, and banks want to make sure that insurance companies with large Collateralized Mortgage Obligation (CMO) portfolios understand the cash flows associated with these assets and the possible mismatch with their liabilities.

Capital and surplus position is a key indicator for a lot of banks. For example, surplus as a percentage of assets is a number that can be looked at to determine capacity to write more business in the future.

Asset/liability management is something on which banks will become more educated. They know about asset/liability mismatch, so, as they focus in on this for insurance companies, it will be a bigger issue.

Another area that banks will focus on as they become more educated is the impact of the Asset Valuation Reserve (AVR) and Interest Maintenance Reserve (IMR). What impact will these have on earnings? What is the affect on surplus issues? The AVR-IMR is an example of what regulations for insurance companies can do to the way people look at earnings in the business.

All of these issues lead to an increased interest in due diligence with respect to insurance carriers. And if you are an insurer in the bank market, you have probably had quite a few requests for due diligence information either from the bank directly, from their third-party marketing organization -- they are very active in due diligence -- or from another party who is retained by either the third-party marketing organization or the financial institution.

I want to talk some about products. There was another panel at this meeting that focused on products, so I will just mention a few of the products that are popular in this market. The first one is, of course, fixed deferred annuities. A few features are fairly standard. One is a money-back guarantee. This is offered by virtually everyone in the market. Customers want to know that their principal is going to be there when they want it.

Bail-outs are also a very popular option. I wonder how much lower interest rates need to be before the minimum guaranteed rate is more important than the bail-out rate? Bail-out features have been used on an optional basis -- companies have offered a choice, with or without a bail-out.

The initial interest rate guarantee period on Single Premium Deferred Annuities (SPDAs) typically has been one year, but there are some companies that offer three- and five-year guarantees.

The use of surrender charge waivers has grown. First the 10% free withdrawal was offered by nearly everyone. Then we began to see 10% cumulative withdrawals where you could carry 10% from one year, and if you didn't take it the next year you could withdraw 20%, and so on, up to 50%. This feature is offered by a few companies.

Another method of offering surrender charge waivers is the nursing home-hospital confinement rider. These are very popular in the bank market because of the older average age of the customers.

Initial interest-rate bonuses are also popular. Typically, 1% additional interest is credited in the first year, usually accompanied by a commission reduction of 1%.

Another feature that is popular in the financial institution market is the monthly or quarterly payment of interest where, rather than take the 10% free withdrawal, the customer is sent a monthly or a quarterly check that represents the accumulated interest on the contract in the period.

The next product group is variable annuities. Projections are that variable annuity sales are going to double in the bank market this year. As the stock market has recovered from five years ago and as interest rates have gone down, variable annuities have taken off in popularity. Many banks have mutual fund distribution systems and could enter this market relatively easily.

Market value adjusted annuities are very popular outside of the bank market. Within it, there has been some success, but it has been limited.

The final product group is life and health products. Again, very successful outside of the bank market. A few insurance companies have tried to market universal life and/or long-term care products with little success. Many see the older average age clientele as an ideal market for these products. But it has not been a high-success area for most banks.

This leads into product due diligence. Banks are very concerned about offering the right products to their customers, and may request some product due diligence. This typically involves reviewing renewal interest rate history and reviewing minimum interest rates and how they compare to the competition. Competitive analysis is also done with respect to surrender charges.

For variable annuities, banks will look at the amount of funds under management, the funds behind the variable annuities, and how to make those funds available and not too expensive for the customer.

The next thing I want to talk about is compensation. The compensation issue for banks is a little different because of the number of parties receiving part of the commissions. The sales representative gets a portion, and the bank gets a portion. If there is a third-party marketer involved, a portion goes to the third-party marketer for marketing support. Some payment goes to the bank employee who did the referral of the customer to the insurance area. Compensation can get split quite a few different ways, and things are getting more creative in how that is done.

The final topic I want to address is relationships. First of all, how do insurers maintain their relationships with the financial institutions? As larger institutions have entered the market, as opposed to the small thrifts, production bonuses have been instituted. Banks sometimes manage the funds for the insurance company, and this can generate fee revenue. Bank participation in underwriting experience is sometimes discussed. Reinsurance is probably in the future, but there have been some arrangements where the financial institution receives a trail commission based on profitability of the business.

With respect to service from the insurance company, something that has been attractive to banks is issue at the point of sale, so that the customer does not have to wait a week to receive the contract. Financial institutions view the people who buy insurance products in their banks as their customers. Therefore, they are very concerned about the relationship between the customer and the insurance carrier. They do not want it to reflect poorly on the financial institution because of something negative on the insurance company side. Communication is very important. If there is something negative, like an expected downgrade in one of the claims-paying ratings, it needs to be communicated to the bank right away so they can communicate with their customers. Even though, legally, the customer is a customer of the insurance company, the perception is that the customer is first and foremost a customer of the bank.

MR. MARTIN: Our next speaker brings a different perspective. Tom Fitch is vice president of marketing for First Penn Pacific Life Insurance Company in Oak Brook, Illinois. First Penn is part of Lincoln National Life's family of companies and has been an innovative marketer of life insurance and annuity products since 1979. It specializes in distributing through financial planners, financial institutions, and stock brokerage firms. Tom also oversees the Financial Institution Product Division for Lincoln National Life, which specializes in customizing annuity products and services for bank distribution. Tom has been active in the insurance business for over 20 years, holding a variety of sales and management positions with Connecticut General and CNA Insurance Companies. He is a graduate of Wake Forest in Winston-Salem, North Carolina, and holds an MBA degree from Pepperdine University in Malibu, California.

MR. THOMAS W. FITCH: My portion will focus on financial institution marketing companies. My remarks will cover five areas: First, I will outline First Penn-Pacific's and Lincoln National's experience in this marketplace and in using financial institution marketing companies. Then I will cover the marketing company approaches, the function of marketing companies, and the opportunities they afford both life insurance companies and financial institutions. I will then discuss marketing company options, the various programs, and distribution choices available through marketing companies. Then I will give a brief overview of insurance products offered by marketing companies and, as best as we can determine, their success, and then summarize with some observations on marketing company trends.

As a quick history, First Penn-Pacific was formed in 1979 for the purpose of introducing universal life. When it became apparent that universal life would be a successful product line, First Penn was acquired by Lincoln National Life. As part of the Lincoln National family, we sought to compliment the other distribution systems by focusing on nontraditional producers. These are defined as financial planners, financial institutions, and more recently, stockbrokers. We have been successful in this marketplace because as primarily a product manufacturer, we are able to customize products and support services to meet the specific needs of these nontraditional distributors. We choose to market our products through marketing companies, and we define marketing companies as "companies that have an end buyer target market," such as a financial institution selling to their customers or a unique distribution system for reaching the general marketplace, which is closer to the stockbroker and financial planner markets.

Over the last eight years, our awareness of and participation in financial institution marketing has grown resulting in 1991 with First Penn-Pacific being given responsibility by Lincoln National Life to manage the Lincoln National Life Financial Institution Products Division, whose sole focus is providing customized products for the financial institution marketplace.

To give you a sense of the scope of this operation in terms of distribution, we distribute our product through eight financial institution marketing companies, six of which are within the top 12 leading marketing company producers of insurance products through financial institutions.

We also have direct relationships with six financial institutions. In terms of the balance between savings and loans and commercial banks, we work with 33 thrifts and savings and loans, and 23 commercial banks.

The products we offer are fixed annuities on Lincoln National Life paper, specially packaged universal life programs for mortgages, and a single-premium universal life plan with a convalescent care rider. We offer long-term care on First Penn paper, a stand-alone health plan, and will introduce, in the first quarter of 1993, a Lincoln National variable annuity wrapper for proprietary bank funds.

That is our background and experience to date. Let me begin now to talk about, in more general terms, the marketing company approach and the opportunities I see it provides. There are at last count about 127 marketing companies serving the financial institution marketplace. In terms of product, in 1991 these marketing companies produced about $9 billion of annuity premium. What is interesting to note is how few marketing companies accounted for the majority of the production. Four companies accounted for almost 40%, seven more than half, with 20 accounting for 81% of the $9 billion.

It has been difficult to accurately get a handle on how much life and health is sold through financial institutions. As a benchmark, the most recent study I could find was a 1990 survey completed by LIMRA and Ken Kehrer Associates which placed the amount at about $300 million, of which 76% was sold by financial institution marketing companies, with 19 companies accounting for that production. We will talk a little later about the life insurance products offered through financial institutions. Right now, I would like to move on to the marketing company approach.

One of the most important roles marketing companies play is actually identifying institutions and convincing them to offer an insurance program. This includes everything; recruiting, selecting, and convincing to contract. Overcoming all of the objections financial institutions have is a time-consuming and often costly function.

Due to state and federal regulations, alternative arrangements need to be made in order for institutions to market insurance products. In the case of commercial banks, a separate legal entity must be provided, and again, it is the marketing company that provides this resource.

There is not a financial institution that I am aware of entering this marketplace to sell insurance products that would not do a serious carrier due diligence review. Our marketing companies provide this important impartial function, often times contracting themselves as third-party reviewers to help establish the credibility and solvency of the carriers recommended.

Our marketing companies assist us greatly in selecting the insurance products and the design of those products to meet the needs of the institution and the market that they serve. If we are along side another insurance carrier's product in an institution, they ensure that our niche is determined, and that our product is specific for the market in which we want to operate. There is not a successful annuity program that I am aware of that does not have a successful lead generation program. Again, it is the responsibility of the marketing company to institute and indent that program to gain bank approval.

It is the marketing company which manages the process within the institution, managing everything from foreign funds and disintermediation to making sure that the new program fits in with the branch goals and that a relationship is built with this program within the branch.

The marketing company provides administrative systems, tracking sales, production by representative, cross-selling opportunities -- they recruit, select, and train sales people, also providing marketing materials on taxes and industry updates.

They provide ongoing training for existing products as well as introducing new products and services. They process applications and provide client service; I do not intend to infer that they act as a third-party administrator. Their functions are primarily to ensure accuracy and completeness, and answer basic questions on policy provisions and basic client information. This is a lot of marketing support that would otherwise fall to the product carrier or the institution. In working with marketing companies, we are able to focus on product and policy administration. They are able to focus and concentrate on what they do best -- marketing. We are able to utilize their expertise, talent, and resources across a variety of distribution approaches that would otherwise be difficult and costly to bring in-house. Essentially, we translate these functions into variable costs versus fixed expenses.

Let us continue on and look at some of the marketing company options. First, in working with a variety of marketing companies, we are able to have our product supported through various marketing company programs. Each program is suited to the specific needs of the institution and the customers they serve.

In turnkey programs the marketing company owns the sales agency. Producers are the employees of the marketing companies, not the institutions. The financial institution essentially rents the insurance operation from the marketing company. This used to be the way new institutions entered the marketplace, but it is needed particularly by commercial banks to meet certain state and federal laws prohibiting owning and operating insurance operations.

Full support programs are ones that include all of the activities and functions I talked about before with the difference being that they are in support of producers who are bank employees. Here the institution actually hires and has on payroll a distribution system.

The third kind of program -- limited -- refers to the choosing by the financial institution of selected services they need from the marketing company to support their own activities in marketing insurance products.

The trend we see is primarily one of turnkey -- getting commercial banks into the marketplace. The intent of the commercial banks is eventually, when allowed, to own their own distribution system. They will recognize the continuing need of marketing company support, and contract for that under the limited program menu approach.

In addition to the type of support program provided by the marketing company, "who" actually sells the product to the client has become a most important issue. I was at a meeting not too long ago when the head of retail sales indicated that all of the discussions regarding product, programs, and procedures were theory but what really determined whether you made money was the type of distribution system your institution employed.

There are three distribution options. First is the platform approach which utilizes existing employees of the institution. These are branch managers, customer service representatives, and new business representatives. These are usually salaried employees with a small -- and let me emphasize small -- bonus paid on any kind of insurance or annuity sales. The idea is to just add one more product to the list of products and services these platform people are already responsible for.

A second type, the dedicated approach, usually means hiring a new employee, one who has experience and expertise in selling annuities, mutual funds, or other insurance products. These employees are usually compensated on a commission or salary plus commission basis, and their only function is to market specific products.

The third type of distribution, which we are just beginning to see emerge, is a blend of both, where we have a dedicated sales person responsible for overseeing the activities of the platform group.

With a dedicated sales force, you have instant expertise and a capacity to add broader product portfolio. They also remain focused on sales results. The disadvantage, however, is that they usually come at a higher cost to the institution, and it is difficult to integrate a dedicated program within the bank culture.

A platform approach has a lower cost of sales, there are a lot more of them in financial institutions, and they have strong branch loyalty and customer relationships. It takes a much longer time to start up the operation, and maintaining ongoing training and licensing is becoming very costly, especially with the new continuing education requirements required by many states. The feeling also about this distribution system is that it has limited product capacity.

Let us look now at other insurance products marketed through financial institutions. The numbers here come again from a survey completed by LIMRA and Kehrer and provide really the first look at the kinds of insurance products marketed through financial institutions. Again, we are dealing with a $300 million total, and as a percent of that total, whole life – meaning single-premium whole life – accounted for 40%; universal life 33%; term 17%; long-term care 6%; and disability income 4%. The $300 million total appears disappointing, but it has almost doubled from a report that was done previously, which indicated about $157 million sold.

Marketing companies generated about three times of the universal life premium as insurer's direct institutions. The insurer direct activity – meaning those institutions that do not use a marketing company – accounted for two thirds of all the term and all of the disability income (DI). Marketing companies were responsible for all of the long-term care and single-premium whole life.

From our standpoint, annuities have been so easy to market that the need to focus attention on other insurance sales has not been felt. Further, with the emphasis on trying to activate the platform programs, introducing new insurance products requires additional resources which currently are not justified through performance.

Even though the commissions are higher than on the annuity products, emphasis on other product lines has taken a back seat. It is encouraging from our standpoint that four of our marketing companies have just recently allocated the resources in support of a major introduction of life products through their institutions, and we are hopeful at this time next year that the results will be greatly improved.

In summary, I would like to end by sharing some of the trends we see regarding marketing companies and financial institutions.

As I mentioned earlier, we provide product both to marketing companies and direct to the financial institutions. The pendulum that at one time seemed to be moving away from using marketing companies has swung back, and we are finding more and more the need for institutions to utilize the services of marketing companies. Clearly, commercial banks need to utilize their agency operations; however, even savings and loans that terminated relationships with marketing companies have seen their sales fall dramatically because the bank simply is not able to focus enough attention on those activities compared with their other responsibilities to generate the kind of fees they are looking for. Marketing companies are returning on a limited support basis, and we think this is a trend that will continue. Further, with our direct relationships, we believe they also are enhanced by the utilization of a marketing company, acting as interpreter for bank needs. Their activities focus on sales results and increase the performance of the institution. What has changed dramatically, and we do not see reversing, is the independence of financial institutions in demanding accountability for services from their marketing company as well as insisting on direct access to the insurance company. We see the future being a three-legged stool whereby the financial institution, the marketing company, and the insurance carrier all work together to support a successful program.

On the insurance specialist versus the bank generalists side, we see clearly a limit on the kinds and amount of products that a platform program can support. The trend here is to have dedicated specialists either responsible totally for the insurance sales, or certainly as a coach. It will be interesting to see as we move forward if this trend continues.

With respect to other insurance products, life insurance seems to be on the horizon as a product of choice, being introduced by a number of our marketing companies. A key product we are looking at is a variable annuity wrapper for bank proprietary funds.

MR. MARTIN: Our next speaker is Vic Moses. Vic Moses is the senior vice president and chief financial officer with Great Northern Insured Annuities (GNA), a competitor of First-Penn Pacific, and they work in a somewhat different way. First Penn makes very heavy use of the independent marketing company approach, whereas GNA employs more of a captive marketing company approach. Similar, but with some interesting differences. Vic is responsible for all actuarial and financial functions for GNA. He joined GNA in 1983. Prior to that, he was the actuary for Safeco Life Insurance Company. He managed the ordinary life actuarial functions for Safeco from 1976-81, and in 1980, was appointed actuary. Vic is a 1970 graduate of Seattle Pacific University and is a fellow of the Society of Actuaries.

MR. VICTOR C. MOSES: I will approach this topic from a little different perspective, focusing more on some of the whys of what is going on in the financial institution marketplace, and focusing more on the insurance company perspective. To do this, it helps to look at the background of GNA.

GNA is an insurance company that was formed in 1981 specifically to market insurance products through financial institutions. And so, when you look at the history of GNA, you see a microcosm of what has gone on in the bank business in general.

First, let us look at GNAs annuity sales. They have grown from virtually nothing in 1981, to about $886 million in 1991, and are estimated to be approximately $900 million in 1992. If you compare that 1991 number with an estimated total of $9 billion of annuity products sold through financial institutions, we have about a 10% market share. We have been generally stable at that level over the last four to five years.

GNA was founded on the premise that banks wanted to control the retail distribution of products through their financial institutions, and the company's structure was designed to support this. One of the things you'll notice is what appears to be a leveling off of the growth rates of the production of the product. There are a couple of reasons for this: one is GNA's management of the level of business it can reasonably support, and two is competition from other financial products.

One of the things that we do, in addition to selling insurance products through financial institutions, is also to sell securities products. By securities products, I am referring to packaged mutual funds. If you look at where the trend in money flow has been with respect to consumer savings dollars, both banks and insurance companies have been beaten badly by the mutual fund industry. There has been a tremendous outflow of dollars from banks, in particular, into mutual funds. The sales of mutual fund products through our distribution force has allowed us to participate in this trend.

Where have the annuity sales come from? At the individual annuity product update session of this meeting, one of the comments made was that the bank share of all annuity sales had been fairly flat over the last five years at about 14% of the market. My contention is that market share is going to grow. Initially, financial institution annuity sales were concentrated in the thrift industry. Thrift industry sales have declined significantly. Commercial bank sales have really started to pick up. That is where the majority of the business is coming from now. And commercial bank sales, we predict, will continue to grow. Thrift industry business will stabilize. And we believe that the bank or financial institution share of the overall investment product sales is going to increase.

GNA distributes insurance products both as a wholesaler to the bank, and as a manager of the bank's retail sales force. From 1981-87, 100% of our business was sold through the banks on a wholesale basis, primarily through platform personnel and primarily in thrift institutions. Beginning in 1988, we see emerging involvement of commercial banks. Commercial banks saw the success of the thrifts in selling the products and generating fee income, and decided that they wanted to get into the business. There were regulatory restrictions with regard to commercial banks being able to sell these products on their own, and so they required a legal entity as a vehicle for making the sales. This was a great opportunity for third-party marketing organizations. GNA's response to this was to develop our own third-party marketing organization. We have been willing to step in and manage the retail sales forces for commercial banks.

This has resulted in a shift from sales by platform personnel to dedicated personnel. If we are managing a sales force, the sales people are our employees, and not commercial bank employees. They are 100% dedicated to the sale of our products. So retail sales of product began with the transition to commercial banks.

These dedicated sales forces have a difficult time supporting themselves on the sales of insurance products alone. Consequently, because they are investment oriented, the next logical product for them to sell is mutual funds. Mutual fund sales also began to pick up at about the same time. The result is a dedicated sales force in the bank, not dissimilar from a brokerage wing of the bank, selling mutual fund products and selling investment-oriented insurance products.

An interesting point is the estimated decline in retail sales in 1992. This results from the first of the commercial banks beginning to take over the distribution of these products. This is a result of the Comptroller of the Currency's ruling that annuity products are investment products that can be sold by national banks. So in those states where the banks have the latitude to do it, we are seeing banks internalizing their programs. This is something that GNA actually supports. When we start out with a program, we work with the bank with the idea that we will set it up, we will build it, but that ultimately they are going to want to own that retail sales force. The goal is to come up with a retail sales force that is well integrated into the bank culture, so that the bank can step in and take over easily when the time comes. In our opinion, this is one of the trends you will see. The large banks, in particular, will want to control that sales force.

Next I will talk about the impact on product design of dealing with financial institutions. Banks look at a number of factors in evaluating products. They look at acquisition costs (costs of funds in their terminology). They look at investment spread, net of expenses. They look at a holding period for a particular investment product. And they look at the equity margins that are required to support these products. The terminology's a little bit different, but the business that they are in is no different than the business that we are in. In 1981, when GNA started selling products, our commission rate to financial institutions was 3%. That made the market very attractive from our point of view. Some of the additional margin was actually expended. We incurred additional acquisition costs for media advertising in various markets to inform people that these products were available through financial institutions. As the sophistication of the financial institutions in this increased, we have seen our cost of funds go up. Now, our total acquisition expenses are comparable to companies selling through general agency and career agency forces. There is really no difference. As we deal with bigger and bigger banks, their ability to negotiate commissions, when they can produce $50 million or more in business in a year, is substantial. Money that before was expended for media advertising is now going out in direct compensation to the financial institutions.

I have just a couple comments with respect to investment spread net of expenses. One of the key factors here is that your competition may not be directly other insurance products. The competition is very likely to be other bank products, in particular bank CDs. We actually had a situation this year where because of the very low rates on bank CDs, on one of our products we actually reduced initial crediting rates below what we thought would have been appropriate based on our target spreads simply because we were concerned about the margin between our products and bank CDs.

In the individual annuity product update session mentioned earlier, a comment was made that the average age of sales of insurance products or annuity products to financial institutions was about 63. Our average age sale has been even older than that. Our average purchaser is about 66 years of age. Our customers are generally individuals who have retired or are very near retirement. The funds that are going into the annuity are not funds that they expect to live on. These are emergency funds, so some liquidity is needed.

This has a couple of implications with regard to the holding period that you can expect with these products. The information we have been able to compile is very similar to that of a dedicated sales force, because of the knowledge of the sales people, is able to provide better performance with regard to persistency of the product, at least in the short term. That is, the number of not takens and the number of first-year surrenders, or surrenders within the commission chargeback period, are substantially lower with a dedicated sales force.

I do not think the experience is there yet to show whether platform or dedicated sales forces will produce substantially different long-term persistency results. However, our belief, based on the experience we do have, is that dedicated sales forces will produce lower persistency rates over time. These people are dedicated to what they do. They are paid on a 100% commission basis, and 10 years down the road, when that money is sitting there with no surrender charges, the dedicated sales staff will have the same tendency that a stock brokerage firm has. That is to look at that money and say, gee, how can we roll that money for a new commission? So, in planning for the long term and estimating your asset holding period, you need to take a look at how the business is sold, and consider a couple of factors. One is your relationship with the financial institution; and two is what you think your pricing practices are going to be at that point. Will you be willing to go back out and essentially resell product?

One of the things we have tried to do in our relationships with financial institutions is to use an evergreen nonchurn clause that specifies that even if the financial institution terminates its relationship with us, they have an obligation not to churn the policies. There is a question of enforceability with regard to this type of provision.

An example of the risk that we face can be seen with the Resolution Trust Corporation (RTC) and the liquidation of thrift institutions. We have seen the RTC look at our customer list and decide it had some value, and turn around and sell it to a local insurance agent. The agent will then go out and try to move the funds. So, there are some things that can happen to you in this business that you might not anticipate, which in turn can have a substantial effect on your holding period.

Another factor in dealing with the financial institutions is that you are going to have large concentrations of business in one agency. You must be well aware of the possible effects of contagion if your relationship with that institution changes.

The last thing I will cover is equity margins. I do not believe there is any difference in the equity margins that a company ought to hold for this business, whether it's sold through financial institutions or sold through a general agency force. But, those levels, those margins, really have not necessarily been determined by what risk analysis would indicate is the rational level, or what regulators have indicated is the rational level. They are basically determined by what the rating agencies have set as the criteria for investment-grade or high ratings. So, even though your risk analysis may show you ought to be able to hold target surplus at 4% of account values, you will be forced to hold a higher amount in order to maintain the necessary ratings.

The due diligence area is one that you will find a tremendous amount of focus on with financial institution. They understand the problems of the business, to a large extent, and they know the problems they have on their balance sheets. When they have trouble with the mortgages on their balance sheets, they will be concerned about the mortgages on your balance sheets. GNA actually publishes a quarterly due diligence manual for all of our institutions, which updates them on the status of our balance sheet, and just about everything else you can think of; rates we have set during the period, statutory and GAAP financial statements, etc. When we first did this, we looked at it as a lot of work. In the long run, it has actually saved us money, because institutions now get our due diligence information and they manage to use it. Before, we would get 30 or 40 different requests from different financial institutions in different formats for the same information.

I have a couple remarks in closing that have to do with where the opportunities in this business lie. I think the initial window of opportunity in the banking business is probably fast closing, as a result of consolidation. If you are a vendor of product through one of the large regional banks, your chances of being a vendor of product through another bank in that region is virtually nil. Pick a New York example. If you are selling a product through Chase Manhattan, as we do, your chances of being selected as a carrier for Citicorp, whether you are good or not, are very slim. So, given what has been happening in the banking industry, your company must decide where your focus is going to be. Are you going to go for those large financial institutions? And if you are, realize that your capability to penetrate the market in any geographic region is going to be limited. You will need to pick your partners, and pick them well.

I think the other survivors in the banking industry, long term, are the community banks. Community banks pose a whole different set of challenges for our industry. Personally, I believe there is a real opportunity there, but the opportunity is different. The opportunity is to manage a distribution system that can serve a number of small banks without being captive to any one of them. You need more flexibility and the long-term ability to offer your own products, mutual funds and annuities. The larger financial institutions will continue to put pressure on for proprietary products or for products tailored to their distribution system. If you want to do that, fine, commit to that kind of a product development effort. If you don't, you may want to focus on this community banking segment.

The potential pot of gold for companies is the ability to sell other insurance products. GNA has had very little success in doing this, either through our retail sales forces or through our direct sales forces. Not that we wouldn't like to. But the psychological perspective of someone coming into the bank with money to invest is that they are looking for consultative advice as to where to put that money. If someone who represents the bank directly or indirectly provides the advice to buy a CD or to buy an annuity product or to buy a mutual fund, people are willing to take that advice. They do not yet go into the bank looking to be sold on insurance. And so, our perspective is that sales of term insurance or long-term care insurance or disability income insurance is that it is still a long, long way off through the bank distribution system. And, in particular, for distribution systems where you do not have dedicated sales people, it is not economically efficient. They have to sell the products where they can make the sales quickly without a tremendous investment of time and training. And you simply cannot do that with the more complex insurance products.

MR. MARTIN: To start, I have a question for any of the panelists who would care to address it. And that is, how do you see the banks looking, long term, at this market? If they look five years down the road, what are their objectives? Are many of the banks that you work with thinking about becoming underwriters at some point, or is this primarily a marketing option for them?

MR. MOSES: I think, long term, the banks view themselves as investment managers. And for most of the products that we are selling today, we are the investment manager. And so, long term, they view us as competitors. Right now, the banking industry simply does not have the capital to maintain all of the account balances that could be attracted. So, they are willing to allow someone else to step in and sell products for which they can earn fee income. If they had the capital and the resources to retain the funds, they would just as well have them in their own CDs and be managing the investments themselves. So, if for some reason there were a tremendous influx of capital into the banking industry, which I do not foresee, the attitude of banks toward selling third-party products would probably diminish.

Do banks want to underwrite our products? My perspective is that they don't. One of the things that has helped is the due diligence efforts that have been conducted. Generally, when you look at somebody else's business, it looks better than yours. By exposing banks to the economics of the insurance business, to the capital requirements, to the risks, etc., they see that it is not necessarily a great deal different or better. I think what the banks really want to do is to be able to effectively use the huge distribution systems they already have in place. They don't want to retrench and cut back on those distribution systems. They are trying to cover the expenses of them while they recover from a capital standpoint, and then aggressively attempt to retain more assets.

MR. FITCH: I would share Vic's thoughts, but would like to add one other thing that comes to mind. I was at a meeting not too long ago, and they were asking the banks who their competitors were. Who is the competition? And the answer was, Sears and General Motors. It is these other corporations that are getting into credit cards, getting into different kind of services, all the stock brokerage houses with their cash management accounts. What banks were saying is that they're trying to move away from a branch thought process. A branch meaning only selling bank products. And what the banks wanted was to open these branches as true distribution centers. Centers where their bank customers can come in and not only get bank products, but get other kinds of investments. So one of the things I think we are seeing is the need for the institutions to try to build a sales culture, and get a handle on how you actually distribute other products and services and open up a broader base using their branch network for broader distribution outlets, not just promoting bank products.

MR. MOSES: Interestingly, there was a related article in *The Wall Street Journal* recently. Nations Bank, which is a large, mid-Atlantic bank, just formed an alliance with Dean Witter, with 400 combination Dean Witter-Nation's Bank representatives in the bank branches selling securities products.

MR. ROBERT OZENBAUGH: We have entered the bank market over the last couple of years, and one thing that anyone even considering it needs to be very aware of is that it requires you to do business a little differently than what you have in the past. Banks are not willing to wait quite as long. They do not want to wait a week to have a contract issued. They want to issue it instantly. They want to have contracts on site and be able to issue them on the spot. They want to net their compensation out of the money they send to you; they want to be compensated instantly. These things bring an element of risk. You have to isolate your bank operation outside of your normal processing, or you will really run into a lot of problems very quickly.

MR. FITCH: I can confirm that. That is how First Penn got into the annuity business. The marketing company went to our parent, Lincoln National, and asked them to build the annuity product. Lincoln did, and sales took off, and then they just stopped. Because, what we learned was that the kind of traditional support for the annuity product that you had in a large company, which are annual reports and a steady flow of predictable premiums, isn't the nature of the bank marketplace. You need instant issue. You need quick accounting. You need wire transfer of funds. And so, they asked First Penn to build a specialized administration system specifically for the bank marketplace. And after that was set in place, sales took off. There are dramatic differences in the transactional relationships between the financial institution and the insurance carrier and of the type of special services this business requires.

MR. MOSES: I can confirm Tom's comments. I tend to overlook this because financial institutions are GNA's only market. But, we do provide branch issue of our products. We do allow them to net commissions. Another thing we do is to maintain an account at each institution we work through. Customer money is deposited in our account on the day they make the purchase. We sweep those accounts daily or weekly depending on what the anticipated balances are and what we think the status of the financial institution is. The net result of that is that we have investable funds somewhat more quickly than you get through a traditional agency force.

There are some risks involved with the branch issue process and with the allowing of institutions to net commissions. But, as we generally deal with large and fairly reputable financial institutions, we have not had problems with commission charge-backs.

MR. OZENBAUGH: With interest rates where they are, we are all sensitive to the C-3 risk potential. In this marketplace, the buyers may not be a hot money kind of group. But given that you are dealing with a bank who is in the money business, how do you look at that from the C-3 risk perspective? Do you do anything differently with this business that you might not do with other kinds of business?

MR. FITCH: It is a critical issue, as we view it. We look at asset matching; we look at short durations of portfolios in the neighborhood of 5-7 years. We have pursued interest rate caps, and have those in place on certain interest spreads. We have also explored coinsurance arrangements, recognizing that there is only a certain amount of this kind of business that we believe can be responsibly underwritten. So we have actually sought partners on a coinsurance basis to help increase capacity to meet the needs of our marketing companies and the institutions we service, thereby reducing our exposure by spreading it over a number of quality companies.

MR. MOSES: Again, this is all of our business, so, do we do anything differently? The answer is no. But I think that our perspective is similar, especially with rates low, that there is a tremendous amount of risk. One of the things illustrated, or advocated, was what was called an option-adjusted duration calculation. The actual duration of our asset portfolio is about two years. We measure the duration of our liabilities using the same set of models at about 1.6 years in the aggregate. So, we have about a four-tenths of a year duration mismatch, which we think is acceptable. We try to stay within a half a year. This is an obvious concern, and I don't know what you can do other than to carefully take a look at the business and make sure that you have an investment portfolio that protects you. A 5-7 year maturity for these kind of assets is too long.

MS. KRUEGER: One other result of the low interest rates is an increase in the interest in variable annuity products by banks. Insurance companies have responded by offering more products to banks in the variable area and in that way are diversifying their C-3 risk.