RECORD OF SOCIETY OF ACTUARIES
1993 VOL. 19 NO. 4A

BLURRING OF LINES OF FINANCIAL SERVICE BUSINESS

Moderator:	MICHAEL WINTERFIELD
Panelists:	GORDON C. BORONOW
	JEROME R. CORSI*
	JOHN M. FENTON
Recorder:	MICHAEL WINTERFIELD

- Who's selling what these days?
- Variable products
- Financial institution sales

MR. MICHAEL R. WINTERFIELD: Our first speaker will be Dr. Jerry Corsi. Dr. Corsi serves as executive vice president of MDS Bankmark, which is based in Morris Plains, New Jersey. Jerry is also president of MDS Bankmark's broker dealer, MDS Securities, Inc. MDS Bankmark specializes in developing securities and insurance investment sales programs for financial institutions. MDS Bankmark is a subsidiary of Conseco, an insurance holding company in Carmel, Indiana.

Our second speaker will be John Fenton. John is a principal of Tillinghast, the Towers Perrin Company. John was recently named co-manager of the New York business unit for Tillinghast. John has been with Tillinghast since 1985. His primary consulting areas are product development for variable products and annuities, New York state issues, agent compensation, and actuarial appraisals for mergers and acquisitions.

Our third speaker and fellow alumnus from my Equitable Life days is Gordon Boronow. Gordon is the president and chief operating officer of American Skandia Life. Gordon played a key role in developing the product and marketing strategy for American Skandia from its early days through 1991. Gordon also serves on the Board of Directors for American Skandia and is a trustee for its sponsored series trust, American Skandia Trust.

I'm a consulting actuary and director with Arthur Andersen in New York.

MR. JEROME R. CORSI: The topic I want to address deals with the growth of fixed annuities as sold predominantly through banks and thrifts, but also through stockbrokers and nontraditional sources of distribution, in an effort that began in the mid-1980s. The growth has been dramatic. In 1992, distribution in banks reached $12 billion. It has been a dramatically growing field. When I joined MDS Bankmark in 1990, it was writing $150 million in fixed annuities. This year we'll write just under $1 billion in fixed annuities as well as another $250 million in mutual funds through the broker dealers, all written through MDS Bankmark in banks and thrifts.

The point of the analysis is to look at why this has happened. What has been the growth of fixed annuities? What markets have fixed annuities addressed? What

* Mr. Corsi, not a member of the Society, is Executive Vice President of MDS Bankmark in Morris Plains, New Jersey.

impact has this development had on the insurance industry as a whole? And what future does it bring to bear on the industry as it goes forward? A large part of my discussions will be aimed directly at the actuarial field, as I'm going to make a solid argument that fixed-annuity marketing has truly been a revolution within the life insurance industry and, as such, has fundamentally changed the nature of the life insurance business from a business that has traditionally dealt with mortality risk to an industry that increasingly deals with investment and retirement risk. We want to see where the future of this distribution is going, in terms of new-product creation, the impact on traditional agency systems, and an overall blurring of the lines that used to very clearly delineate the life insurance industry from a financial institution market and from a brokerage market.

Three major waves of change led to annuity marketing. The first wave really came with the passage of the Garn-St. Germaine Act in 1982, when both savings and loans and commercial banks were bidding for the power to be able to pay competitively on deposits to compete with what then was seen as competition from money market mutual funds and the drawing off or disintermediation of funds that had been kept traditionally in savings vehicles. This price competition was really not foreseen in all of its ramifications. A clear impact was that many banks and thrifts entered into competitive pricing of liabilities with no prior experience at all in pricing such liabilities. As such, all too often the chief pricing strategy was to look in the newspaper and see what competitors were doing, or simply to price to attract deposits under the assumption that quality assets could be found when the deposits came forward. The pressure this put on the insurance industry was reflected in the early days in the development of universal life policies, which had been pioneered by James Anderson at Tillinghast, a movement that led even the mutual companies to reevaluate their dividend policies and to reconfigure them for more flexibility and for greater yield.

When all these developments began in the early 1980s, almost unnoticed, a series of entrepreneurs began approaching banks and thrifts, asking if annuities could be sold as an alternative either to the money market accounts or to the bank's own higher yielding CDs to generate income for the bank. The argument was that the annuity provided tax deferral on the appreciated accumulation, and in 1985 and 1986, when annuities were being marketed, there was about a 150-basis-point advantage for annuity yields versus CD yields. That, plus the tax-deferred rate of appreciation, made annuities very attractive. Mostly thrifts, but to some extent commercial banks, seized on the opportunity and began offering annuities for fee income, even though annuities had largely been ignored by the traditional life insurance agent who saw annuities as a very low-commission product. An annuity might pay a 4% or 5% commission traditionally, while a life agent was looking at 85% or more of the first-year premium as a commission on an ordinary or universal life product. So began the initial wave of marketing annuities.

A second major wave of change came in 1986, with the passage of the Tax Reform Act. You might recall that was counted at the time as tax simplification, the last major tax bill we were to see in our generation. I think virtually every year since we've had a revised version of the tax law amending the code, including this year. The 1986 Tax Reform Act had a component that was retributive on any tax-advantaged product, largely going after the tax-sheltered or the tax-advantaged limited partnerships in real estate. They were largely wiped out, and their investors were not even given grandfathering on the policies they held. With the 1986 tax law, the only investments left that preserved tax advantages were municipal bonds, which continued to have a market risk, and annuities. Annuities won almost by default, as a tax-deferred opportunity for those who had resources that they wanted to appreciate in a tax-advantaged form. With that, and also with the elimination of the universal IRA by the 1986 Tax Act, banks and thrifts moved toward annuities, both as part of their overall IRA marketing and to access the CD market, which included mostly over-50-year-old, retired individuals seeking to live on fixed incomes and minimize taxes.

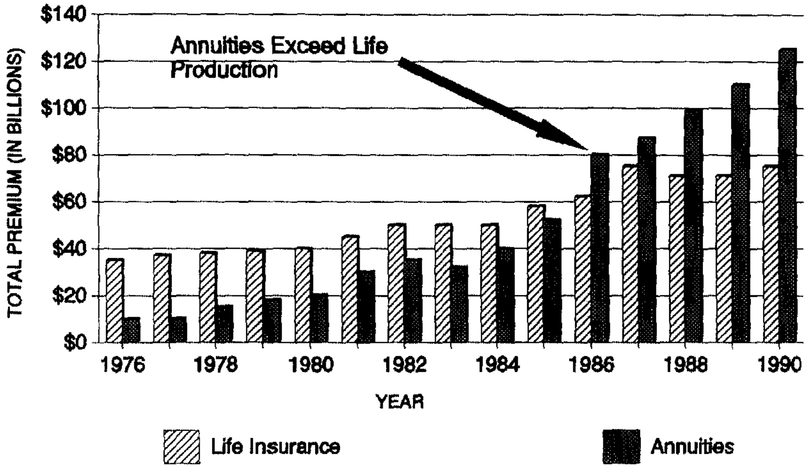
The urge for fee income also gained momentum after 1986 because of the collapse of the limited partnership market, the resulting depression in real estate throughout the United States after the Tax Act, and the elimination of many favorable commercial tax hedges that had been part of the previous legislation. Annuities and the fee income that could be derived from them became increasingly important to the financial institutions that were selling annuities, and the product began to become accepted. Also in the mid-1980s, the stockbrokers in the traditional major houses, the Merrill Lynches and the PaineWebbers of the world, were actively selling annuities along with mutual funds, but again there was a focus on the annuity as an investment product in the retirement market.

The third wave came from yet another direction. With the October 1987 stock market crash, you began to realize a series of problems. All investment-based instruments, including mutual funds, were now perceived by the investor as subject to market risk, and, as such, a safety factor was underlined for the annuity, along with the CD. Even municipal bonds, through the period right after the 1987 crash, were perceived by the retirement market as having more fluctuation and more risk than they were willing to tolerate. For these reasons, annuities began to modify into forms that were designed to directly address the retirement market, being configured to look almost exactly like a CD with back-end penalties, even having a 1% bonus rate. The commissions became very attractive, typically as high as 6-7%, of which a bank could net anywhere between 2.5% and 3%. In many cases, this was greater than the spread income they were anticipating. In the period after the crash in 1987, many thrifts across the United States were earning negative spread income, and their fee income was their only source of revenue.

Chart 1 shows some of the figures that we've derived from A.M. Best's. If we look at the period from 1976 to 1990, in 1986, for the first time, annuity assets surpassed assets gained in the life insurance industry through the sale of ordinary life products. That trend has continued. The life insurance industry, which previously was looked at as protecting against mortality risk and helping savings within ordinary life products, was now being reconfigured so that the garnering of investment assets was really its primary driving force.

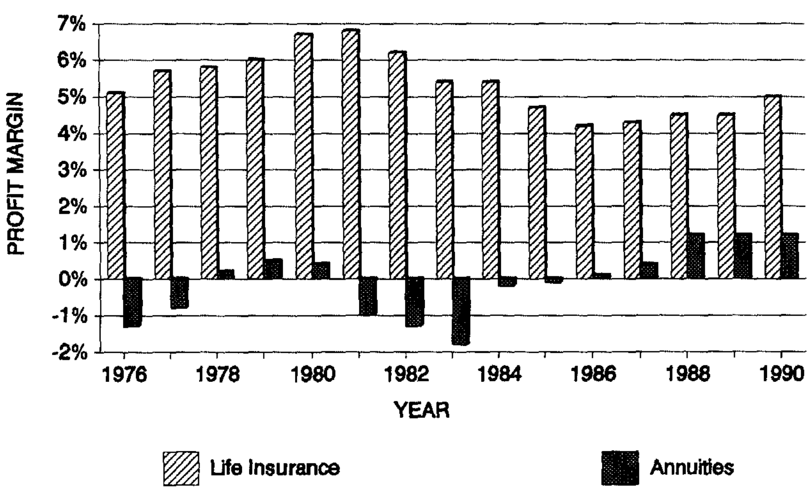
Chart 2 shows that annuities are a much less profitable product. If you look at the after-tax profit margins that are realized on annuities, and again these figures come from A.M. Best's insolvency studies, you can see that through the years 1982-83, annuities were not generating a profit. Annuities have a long-term profit curve. It was not until 1988-90 that annuities became profitable.

CHART 1
Total Premium
All Life Insurance and All Annuities



Source: A.M. Best Company: Special Report, Insolvency Study, Life/Health Insurers, 1976-1991.

CHART 2
Total After-Tax Profit Margin
All Life Insurance and All Annuities



Source: A.M. Best Company: Special Report, insolvency study, Life/Health Insurers, 1976-1991.

You can see the difference between the overall profitability levels of ordinary life insurance and annuities. And so you can see that the industry is garnering assets in an area in which the after-tax profit margins have to be anticipated as being slimmer.

At the same time, as we study the 125 largest companies (Table 1), we see that 66 companies have no mention of any chief investment officer or any investment officer. Only 50 have chief investment officers who appear to report to an executive officer, and nine companies have lower-level vice presidents reporting to nonexecutives. You rarely see an extensive investment department that you would typically expect to see at a mutual fund investment company or a major wire house that underwrites mutual funds.

TABLE 1
Insurance Company Officer Distribution
125 Largest Companies

•	Total number of officers	2,606
•	Total assets ($000)	$1,308,897,458
•	Total number of companies	125
•	66 companies have no mention of chief investment officer or any investment officer	
•	Only 50 have chief investment officers who appear to report to an executive officer	
•	Nine companies have lower-level vice presidents reporting to nonexecutives	

Source: A.M. Best, *Best's Insurance Reports, Life/Health Edition*, 1991

The companies writing in this business are primarily taking on bond assets. The flight to quality and the due diligence required by banks have resulted in high-risk bonds and real estate, including commercial real estate, no longer being in the portfolios. And yet managing a $100 million or more bond portfolio is an extremely difficult business when you get toward the issues of asset-liability matching, duration, and the underlying investment risk in the bond market when we've just gone through a strong bond market cycle. Should interest rates turn, the future for many of these companies will conceivably be very squeezed.

Annuities have become a specialty market for the major underwriters (Table 2). In the ordinary life business, many warlords (companies that have the largest agency forces, the best products, and the national presence) garnered the majority of market share. Those same companies are not represented on a list like this. On this list you see specialty annuity carriers: Aegon, which has been a leader redeploying Dutch assets to underwrite annuity liabilities in the United States; Great Northern Annuity (GNA), owned by General Electric (GE) Capital, formed in the early 1980s in Washington state as an underwriter of annuities; and Conseco, our parent company, formed with the primary business purpose to establish underwriting in financial institution marketplaces for annuities. Look at some of the others: Ford Life, writing in conjunction with Conseco; Hartford, a major player in the annuity business, despite its strong agency force; Keyport, owned by Liberty Mutual; and USLife, which wrote some

$300 million in annuity assets last year. USLife is a traditional life player that has not bypassed the opportunity in annuities.

TABLE 2
Underwriters with Largest Fixed Annuity Distribution
Through Banks and Thrifts
Ranked by 1992 Financial Institution Fixed Annuity Premium (Premium $ in Millions)

Company	1992	1991	1990	1989	1988
Aegon	1,300	1,228	990	650	700
Great Northern Annuity	875	900	815	825	682
Conesco	775	1,120	875	430	250
Ford Life	700	39	0	0	0
Hartford	645	350	91	N/A	N/A
Keyport	640	541	437	475	228
Financial Horizons	630	648	500	115	N/A
Lincoln National	600	400	200	175	N/A
USLife	550	279	N/A	0	0
American Enterprise	520	210	125	100	N/A
AIG	500	300	150	85	175
American General	275	59	N/A	0	0
Alexander Hamilton	260	275	246	235	320
Safeco	260	150	125	85	N/A
Kemper Investors	260	250	255	190	N/A
Jackson National	250	200	200	130	N/A
Central National	220	110	77	12	0

Source: Kenneth Kehrer Associates, Inc., Princeton, N.J., *1992 Annuity Underwriters Survey*.

I will conclude these comments with one or two observations. First, from the point of view of the actuarial discipline, actuaries have largely controlled and dominated life insurance companies where profit was a matter of proper pricing. Proper pricing is not enough. It's additionally necessary to have strong investments, and the investment risk must be considered in the construction of the product. Second, when we look at this curve on fixed annuities, we feel as a marketing company in this business that the time is ripe for product innovation -- for a reconceptualization of what the fixed annuity is, perhaps one that could move it toward market-value adjustments, but not fully into a variable annuity. Anticipating John's presentation, we think variable annuities are a strong market and one that must be pursued if assets of this strength can be collected in life insurance products. We think the future for the actuarial discipline may also consider a re-examination of life policies, again to re-emphasize the investment aspect rather than the strict mortality aspect, and of variable life within the same context.

In conclusion, we're seeing a market that has developed in response to an opportunity. I think you will read increasingly over the next few years that Americans, especially the baby-boomers, are not saving for their retirements, and pensions could not be less secure. From the point of view of public policy, the life insurance industry should come to the forefront to assist average Americans – not the wealthy, but the average American – with an opportunity to invest for his or her own retirement in a secure fashion. Our average annuity is less than $20,000, sold to a person over age 65 who has an average liquid net worth of about $55-75,000. These are not wealthy individuals. These are individuals who have retired with values in homes, with pensions, and with accumulated lifetime savings. The market there is strong, even if the distribution is nontraditional, and the companies that will succeed with it are those companies that see the opportunity and configure themselves appropriately to take advantage of the opportunity.

MR. JOHN M. FENTON: I'd like to talk about the variable products in the financial services business. First, what is the current role of variable products in the financial services business? And by that I mean both variable life and variable annuities. Second, I will focus in more depth on variable annuity product considerations and then finally take a look at the future. What does the future hold for variable products in financial services?

First, what are they doing currently? My definition of the financial services business primarily focuses on two channels: the stock brokerage channel as well as banks and savings and loans. We will have some discussion of direct response, but the first two channels will be my primary discussion points. Insurance products already play a large role in the financial services business. Jerry has talked about this. Fixed annuities are a big player, with total sales of about $12 billion for the banks last year. Stockbrokers are probably selling just as much. At the banks, annuities are an attractive alternative to CDs for the customers. Essentially this is moving the customers up the yield curve to tag into longer rates. On the bank side, they also provide fee income, which is desirable and gets them off the asset/liability risk.
Variable annuities are sold primarily in the nonqualified market as a tax-deferred mutual fund with guarantees. The fixed account and guaranteed minimum death benefit make them very attractive in that particular market. Of course, variable products as a whole are benefiting from the low-interest-rate environment that we have in which consumer monies are moving en masse away from low-yielding investments and toward mutual-fund-type products: variable annuities and mutual funds. So we see a lot going on there.

Single-premium variable life was a major seller through 1988, with many sales for the stock-brokerage community, but this was killed by the tax law. Now there is flexible-premium variable universal life (VUL). I'd say that sales are limited, but they do have potential for expansion. There are customers in these particular markets who have insurance needs.

We see that banks, as Jerry mentioned, are an emerging player in the variable annuity marketplace. Bank annuity sales are switching from fixed to variable. In 1992, about 10% of all bank sales were in variable products. Does that sound about right, Jerry?

MR. CORSI: Yes, that's right.

MR. FENTON: And this year, I don't have a specific figure, but I imagine it's significantly higher than that. Bank customers are looking for an alternative to the returns that they have at 3-5%. The reason a variable annuity is appropriate for bank customers is that if you take a look, a typical customer might be age 60, for example. That's probably even a little high, but even at age 60, the life expectancy there is almost 20 years. I would argue that the greatest risk that annuitants have is not that they're going to invade principal. It's not that their investments are going to lose principal over time. The greatest risk they have is that they're not going to keep pace with inflation. This point, if it can be effectively communicated to the customers, is going to help drive variable annuity sales even farther.

Another attractive alternative from the bank's point of view is that the variable annuities enable them to capture a share of the investment-management profit. Right now it's been the distribution profits that are in there, but more and more banks are looking to wrap their funds around a product and capture the investment-management profit, and that's very important. Of course, when they look at this, the break-even size is a critical issue, and I think Gordon's going to talk about this a little. But the key point is how much money is needed to make money on your funds. Break-even sizes probably vary from as low as $15 million up to $100 million or more per fund. So you need to have a significant amount of money in your funds for a bank to make money on them. A big part of the break-even side depends on whether you have existing fund-management capabilities inhouse and whether you can leverage that into variable annuities.

Table 3 shows the variable annuity sales during the past few years. It's no surprise that variable annuity sales have increased over time, starting at about $3.6 billion in 1987 and rising to $24.5 billion through 1992. This was about a 50% increase over 1991, and for the first six months of this year, total sales are $17 billion. On an annualized basis, that's about a 40% increase over 1992. Again, the market is continuing to move ahead quite rapidly. What we're talking about here in terms of sales is total premiums: first year and renewal premiums. It includes the fixed account and qualified money, which accounts for more than half.

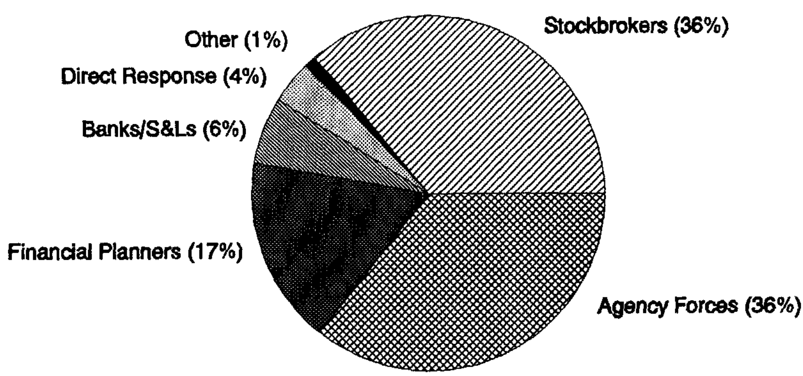
TABLE 3
Variable Annuity Sales Have Increased

Year	Variable Annuity Sales (Billions)	Estimated Market Share
1987	$3.6	11%
1988	6.5	14
1989	8.5	17
1990	12.5	23
1991	16.0	31
1992	24.5	44
1993 first six months	17.0	N/A

Source: Tillinghast VALUE Survey, American Council of Life Insurance (ACLI)

The estimated market-share figures (Chart 3) are difficult to obtain. These are estimates and they may overstate the variable a little bit in the later years, but I think it's near 40%. The interesting thing is that variable annuity sales are not coming only from insurance agents. We did a survey for the first six months of 1992, and it shows that stockbrokers and agency forces were both leading, in terms of total sales, each with 36%. The stockbrokers are selling most of the nonqualified business. Agency forces would include qualified business: tax-sheltered annuity (TSA), 401(k), etc. We see financial planners at 17% and the banks and savings and loans at 6% for six months of 1992. My guess is that's probably up in the 8-10% range right now, and we see direct response at 4%. So banks and savings and loans are 8-10% and have significant potential.

CHART 3
Variable Products in the Financial Services Business
Variable Annuity Sales Are Not from Insurance Agents Only



Source: Tillinghast survey, fist six months of 1992

Table 4 shows the history of variable life sales during the past six years. We see the tremendous amount of sales in 1987 spurred by single-premium variable life, but as the tax law changed, that dropped down quite a bit. Annual premium sales have muddled along. For 1989-91, it's somewhere under $1 billion, but starting in 1992, they really took off, with about a 50% increase to almost $1.4 billion. We see an increase on an annualized basis for the first six months of this year. It's not nearly the success story that we see in variable annuities, but individual companies in the market have had significant increases, and we do expect to see more companies come on line. I think this market's going to keep moving up. The market share has risen from 12% in 1992 to 14% in 1993.

Who's selling variable life? Right now it's primarily sold by agency forces. We would say that career-agent distribution has led the way, and for several companies, variable life accounts were more than 50% of the market share of their products. Variable life is a major player at several companies, and I'd say that this is being spurred by emphasis from senior management. Several larger companies have effectively decided that their agents are going to be selling variable life, thereby reducing the attractiveness of the universal life products. Senior management is pushing that along.

TABLE 4
Variable Life Sales Have Also Increased

Year	Sales (Millions)			Estimated Market Share
	Annual* Premiums	Single Premiums	Total Premiums	
1987	$1,225	$2,600	$3,825	10%
1988	1,225	525	1,750	8
1989	750	100	850	7
1990	950	100	1,050	7
1991	885	15	900	8
1992	1,320	30	1,350	12
1993 first six months	730	20	750	14

* Includes dump-ins.
Source: Tillinghast Value Survey

The other point is that there is a lot of attention in the independent-agent, personal producing general agent (PPGA), and independent-broker-dealer markets right now. As you know, agents can only be directly affiliated with one broker-dealer. There's a race to sign up independent broker-dealers and independent agents, and many independents may be driven to some of the large marketing firms, perhaps on a regional basis. These firms will enter into relationships with multiple companies; that's one possibility for the market. Overall, these two distribution channels account for 95%+ of the variable life sales.

Right now variable life is not being sold tremendously by the stockbrokers or banks or savings and loans. The banks and savings and loans are selling hardly any business. Direct response is very small, and I guess there are two reasons for this. First, it's not a big-ticket sale. Underwriting is involved. Typically, brokers and bank employees are not comfortable discussing the health of their applicants. Second, the insurance element reduces the investment return. On a pure investment basis, variable life is not going to provide a better after-tax return than a variable annuity, despite the advantages from the access to liquidity. There are other reasons for sales in these particular markets, but so far the focus has been on these two reasons, and I think that's why we have not seen the sales to date in the financial services market.

I want to switch gears a little bit right now and talk about variable annuity product considerations. First, we've seen several, recent, variable annuity product enhancements, and Gordon's going to talk about some more of these. Probably one of the most important is the enhanced, guaranteed minimum death benefit. The first type is premiums growing with interest, typically ranging from 3% to 7% per year. The other is the reset feature, in which a new floor is established every five to seven years. The reset feature is probably more common overall, although many of the new products have been adding premiums growing with interest. There seems to be more interest there.

Obviously, cost is a major issue for these particular products. We have done some preliminary work in this area, and we found that the cost does vary significantly depending on several factors. The first is product features. Those products with premiums growing with interest compounded at 5% and higher are going to be much more expensive. The reset feature is not quite as expensive and is more in line with the 3% accumulation. Cost would also depend on whether you cap your benefit (for example, after 10-20 years or at two times premium). Another very important component of the cost is the investment scenarios that you run it under. If you look at the cost in a marketplace in which we may be coming from an overvalued stock market (also, the bond market really doesn't have anywhere to go but down in terms of the returns), the cost is going to be significantly higher than in a more normal type of scenario, maybe by a factor of two to three times. The other consideration is the issue age. We found that issue-age 70 roughly costs about 10 times as much as issue-age 45. You see a considerable range in terms of the volatility. Another important factor is how long the business is going to be around. If you have all your business going off the books after seven years, the cost may be somewhat less.

Cost is obviously the major issue and is what you need to look at. A new trend is to have a separate load. Anchor National has come out with a justification that it needs a higher mortality and expense (M&E) charge because it offers a feature. One or two other companies have filed as well. That gets us over the 1.25% charge that has been, until recently, the stated maximum.

A few unique designs have emerged in the market, including no-load products from Vanguard and the Fleet products. Also, Capital Holding has brought out an A-versus-B unit, in which A is front-end loaded with a lower mortality and expense (M&E) charge, and B is back-end loaded with a higher M&E charge, or vice versa. This is paralleling a trend that we see in the mutual fund community, in which companies have A, B, C, and D shares. We may see more parallels to the mutual fund industry over time. Right now the sales of that product are relatively low, but that may be something to look for in the future.

Investment programs are important. Many of the new products have dollar cost averaging, in which monies are moved periodically out of the fixed account or money market account into other funds, and asset allocation, in which on say a quarterly basis you move back to a preset mix. Both of these investment programs are very important to help investors overcome concerns when there is the inevitable market correction. If a lot of consumers get into these particular programs, it'll reduce the flight out at that particular time. There's also been some activity in the market-value adjustment on a fixed option. It seems to be a desirable feature. It's one way to protect the risk, but there are some regulatory issues. Only a limited number of states allow it to be sold as an individual contract for a full monthly benefit amount (MBA), and the SEC also has said a nonunitized separate account may have to be registered under the 1940 Act.

I just want to briefly go through some of the considerations that we've seen when selling a variable annuity in the national warehouse stock-brokerage community. You need to offer a choice of compensation, and that may even vary by producer and by policy. You have a choice of all up front (a portion might be deferred as a trailer commission) or all deferred (of course, this would not be applicable in New York state). Or you might offer a competitive product in which, to attract distributors' attention, you offer an enhanced, guaranteed, minimum-death benefit. The next considerations would be a cumulative free-out provision (10% for each year) and a higher maturity age so that there's less chance that it's going to annuitize. Other considerations are to not impose any commission chargebacks and direct-premium tax loads up-front (but rather, charge them on annuitization or surrender) and, finally, to waive administrative charges at higher face amounts.

You probably can't afford to put all these into your product, but these are some of the things that buyers like to see. It's also important to have access to some of the top producers at regional or national meetings, and there may be a cost to get this. The final consideration is that you need to pay appointment fees for the brokers who are selling your product, and at $30-40 per agent this can be significant.

Finally, we turn to service issues. Agents like to see the fund balance on the quarterly client statement, and they like to see instant policy issue and commissions paid on a net basis. The key issue with these features is that there's going to be a higher administrative cost, and you need to reflect that in your pricing.

Regarding the future of variable annuities in the financial services marketplace, I'd say that going forward, stockbrokers will continue to be major distributors of variable annuities. If you look at stockbrokers' typical clients, a variable annuity product is going to be an ingredient in their portfolio. With a variable annuity sale at $30,000-$40,000, many of their clients can afford it. In terms of stockbrokers, a variable annuity offers a better after-tax return than a mutual fund. There's still a lot of market out there. I was talking to one major fund family. They indicated that they're on target to sell roughly $6 billion in mutual funds this year, and only $1 billion or so is going into variable annuities. There is a lot of potential. Also, as we talked about, banks offer a significant new market. Variable is a small portion right now. It's roughly 10%, maybe a little bit higher, of a $12 billion market. So there's a lot of potential there for annuity sales to move over from fixed to variable. An important caveat, though, is that I do see consumers as being more risk averse, and this could be an issue when there is a market correction down the road.

In terms of variable life, it's not clear whether it is going to become an important seller in these particular channels. Unless we have some new thinking, brokers are not going to sell it unless it provides a better after-tax return. We have to overcome the underwriting issues. I think that there is a market, though, because there are individuals out there who do have needs for insurance going forward, and that's something you need to pay attention to.

In terms of the future role of variable products, it's going to be driven by several factors. First is the low-interest-rate environment. Right now, variable looks very favorable, but what happens if there is an increase in interest rates in the future? If there is a 200- to 300-basis-point increase in interest rates during the next year or so, two things are going to happen. Fixed products are going to become much more attractive, although perhaps at the expense of the client's existing portfolios. Also, the stock and bond markets, in reaction to an increase in interest rates, will be driven downward, and variable products will be impacted by that. So I think that is something that we definitely have to pay attention to. Another thing that's going to help variable products is their lower target surplus requirement. It's a big issue for the industry. Senior management's going to pay a lot of attention to that in the future. And, finally, there is always the possibility for a tax law change on annuities. There are no immediate prospects for that, but it is always a threat. I would say overall, though, that variable products definitely have a strong role in the financial services business. They are going to be a major player in annuities through stockbrokers. Banks must continue to grow, and there's potential for variable life in the future.

MR. GORDON C. BORONOW: Let me say first that there is a war out there: a war between the mutual funds and a war between banks, insurance companies, and stock-brokerage firms. It's a war for the hearts and minds but, most importantly, the wallets of the consumer. I'm going to start by showing what some banks have done in the way of blurring the lines. Mutual funds and stock-brokerage firms and even direct-marketing firms like Charles Schwab are thinking along the same lines.

Now, the idea of blurring the lines is not a new subject, and this is a quote from a well-known industry person, Alan Blank, taken from the October 22, 1990 issue of the *National Underwriter*. "Due to deregulation, industry observers predict more depository institutions will seek to become full service financial centers and will succumb to market pressures and offer their customers access to mutual funds, residential real estate sales and, more importantly, insurance products. . . . Several critical factors when designing products for the financial community . . . consumer oriented, product quality, customer service and support." This is from three years ago, and it couldn't be more relevant.

Let's take a look at some of the products that banks and other financial institutions are offering. Proprietary products are in banks and are in stock-brokerage firms, etc. We have to look beyond the borders of the traditional life insurance industry when we talk about the blurring of lines. The blurring of lines cuts across the whole range of financial services; banks and stockbrokers and others are offering proprietary mutual funds. These are some 6/30/93 statistics of retail bank mutual fund sales:

- $88.3 Billion Managed by 94 Banks
- $16.8 Billion in Equities
- $14.5 Billion in Fixed Income
- $ 7.8 Billion in Munis
- $49.2 Billion in Money Market

You can see that they're heavily weighted to money market funds, which is not surprising, given the nonsales ethos of banks. However, banks are a sleeping giant. They're waking up, and we're going to see much more rapid growth in proprietary bank mutual funds outside of the money market arena. According to the Investment Company Institute, during the next five years, the sale of bank funds could increase to between 35% and 50% of total mutual fund sales.

Another product offered among the financial-service providers is a wrapped-fee account. If you're not familiar with wrapped-fee accounts, I urge you to read up on them. They are a growing factor. They're fairly new. The historians will trace it back to the 1970s, but the real surge in popularity is still only about three or four years old. They have already surpassed variable annuities in the volume of assets going into wrapped-fee accounts. The banks have offered proprietary wrapped-fee accounts. Chase has a consultant program. Liberty Financial has its Counselor-preferred product. It's an excellent product for the bank and for its trust department as a way of managing money, and it can be packaged nicely. It allows the banks to compete with stock-brokerage firms, such as the Shearson track program and Merrill Lynch Consults, but even the smaller firms are now, through the use of technology, able to offer a sophisticated wrapped-fee program.

Life insurance is also being offered through the banks. It has not been terribly successful, but banks are working on ways to change that. Stockbrokers are not far behind and might be somewhat ahead, particularly in the financial-planning segment of the broker-dealer networks. A very interesting development just this year has been an American General program in which it is actually doing underwriting by using a saliva test. This greatly simplified the selection-of-risks process.

And, of course, variable annuities are a major battlefield among banks, mutual funds, insurance companies, and stock-brokerage firms. We've already heard from John about the growth of variable annuities. What's happening now is that banks no longer want to just sell the product and earn a commission. They want to be part of the manufacturing process and earn ongoing fees. Remember, the battle here is for the client's capital. They don't want to give up their customer to the insurance company or to the mutual fund. They're trying to build products to retain the customer, and so banks have been developing proprietary variable annuity products. Four that have just come out this year are Great Western's Sierra-American General; First American's with Security Benefit Life; Signet with Holden Group; and our own product, the Fleet Galaxy product. We expect that there will be significant additional activity in this area in the next year-and-a-half to two years.

John mentioned that one of the hurdles to overcome is the volume of assets that you have to get into a fund to offer variable annuities. I have a hypothetical example of how much money you need to generate to sustain a fund. Assuming that you can charge a full 1.25% as total expenses charged to the fund, with an advisory fee of about 75 basis points and other expenses of 50 basis points, you would need about $37 million in the fund, and that's if you're running quite a lean shop. You typically can't offer a product with a single fund. You must have a variety of funds. For example, four funds would mean that you'd need to produce $150 million of assets to cover your expenses. If you're looking just to break even, you can do it at a much lower level, but not many executives are willing to go into business just to spin their wheels. The other trend that's occurring is that the marketplace gets more sophisticated each year, and it's really questionable how long you'd be able to stay competitive with fund expenses totaling 1.25%.

Finally, I have a quote that might seem frightening if you're engaged in war. It's about bankassurance, which is what Europeans call this combination of banks and insurance. "Bankassurance has resulted . . . in price squeezing and marketplace crowding . . . . Banks are pursuing a low-cost, price-competition strategy . . . . They have been able to realize an 80% reduction in commission rates because agents are selling seven times as much business." This refers to the experience in Europe, particularly in France and the U.K. You may be aware that American Skandia has launched a proprietary variable annuity with Fleet Bank in the Northeast, and Fleet is pursuing this strategy of driving down the acquisition costs and building for volume. Other banks will follow that in the future. They don't need to spend the high commission to go out and find the customers. They've already got the customers. They need to be able to deliver product and make a profit.

I have a few other prepared remarks that are not specifically on the subject of blurring of lines, but are more on the subject of how to compete and how to adjust to prepare for this new world order, if you will. I'd like to step out of this day-to-day world of funds and products and performance and look at the culture behind the world that we work in. I'd like to look specifically at one aspect of the culture that we use that affects our strategy to compete in the financial services market. Perhaps this aside will spark an idea that you can take with you.

The topic is one of innovation. Part of our core corporate business strategy is to capture market share. Skandia is a Swedish company that has operating companies, such as American Skandia, in eight countries around the world. We know from our experience that for a foreign-owned company to enter into a market, innovation is a much better strategy with which to win a significant market share. Innovation will breed a grudging respect from your competitors, and it expands the market opportunity for everyone. In fact, in Japan, where we're currently engaged in obtaining a license, the only way that we would be able to win a license is through an innovative approach or product. In the U.S., we chose to introduce multimanager variable annuities in 1988 and to follow that up with regular innovations.

But what exactly is innovation? According to Peter Drucker, "Innovation is the specific tool of entrepreneurs, the means by which they exploit change as an opportunity for a different business or a different service."

This is just an example of some of the ways that we've focused on trying to bring an innovation out each year.

Innovations at American Skandia:

- Multimanager variable annuities, 1988
- Market-value-adjusted fixed annuities, 1989
- Best-rate guarantee, 1989
- Use of insulated separate accounts, 1990
- Exchange credit program, 1990
- Breakpoint pricing, 1990
- Adjustable immediate annuity, 1990
- 5% compound-growth death benefit, 1992
- Market-timing program, 1992
- Consulting fee/investor's edge, 1993

I'd like to emphasize that innovation is not just an idea. It's the act of implementing the idea. An example would be that Charles Babbage had the idea of a calculating machine, but the computer had to wait another 80 years before the idea became an innovation. Most innovations, particularly the most successful ones, do not involve a flash of brilliance based on a new invention. Instead, innovation is often just recognition that existing things or existing ideas can be rearranged to a better solution.

Some examples of that are, drawing from the world of sports, the designated hitter, the three-point shot in basketball, and the instant-replay camera in football. You may or may not like some of these innovations. How did these innovations come to be? Did Pete Rozelle just wake up one day and decide to introduce an instant-replay official? No, of course not. Innovation is motivated by some need. So what I want to do is look at some of the ways that innovation can be inspired. The need in front of us is to compete in this battle for the customer's wallet.

Drucker identifies seven sources of innovation, seven ways to motivate the energy required to make an innovation out of an idea. Let's look at these and see if anything relates to our session. The first innovation, a very likely source of a successful innovation, is the analysis of the unexpected result. This can be an unexpected success or an unexpected failure. What was behind the success or the failure? What was the reason? How does that create an opportunity? What are some of the successes or failures in our business? Do you know what they are? You have to look at them and analyze them to find the reason behind them and then see if innovation results.

One example comes from the auto industry. In the 1950s, Ford introduced the Edsel, which was one of the all-time failures in the history of motor cars. Ford analyzed the unexpected failure of the Edsel, and it learned something that led to the very successful development of the Thunderbird and the Mustang. So, if you have a failure or you recognize a failure in the industry, learn something from it and, as they say, turn a lemon into lemonade. At Skandia, we've analyzed the failure of the variable annuity to fulfill its initial mission, which is to be an inflation-beating income product. Why are so few contracts annuitized on a variable basis? As we analyzed that, we came up with what we think are some important lessons, and we have a product in development for introduction in 1994 based on that analysis.

Another source of innovation is to analyze incongruities around us. Drucker gives an example of cargo ships in which companies focused on trying to make the ship travel and operate more quickly and more economically. They got very good at it, but losses still increased because the ports became congested. Ships were lying idle and pilferage increased. Finally, somebody had the innovation that led to the container cargo ship with roll-off and roll-on cargo containers. There was a tremendous increase in productivity. One of the incongruities in our business is one-year interest rates with seven-year surrender charges. This can lead (I'm sure it doesn't in your company) to bait-and-switch-type renewal rates. These customers are locked in; they need a roll-on/roll-off annuity. In 1990, we introduced an exchange credit program to help the customer roll on and roll off, which resulted in a tremendous increase in customer satisfaction.

The third source of innovation is really the most common, and that is necessity. We all know that necessity is the mother of invention, and numerous examples of necessity-driven innovations exist. Many of you are now faced with a necessity that's driven by risk-based capital ratios, and that's driving many new companies to compete in the variable products arena.

The fourth source that Drucker identifies is a change in market structure. This is a very dangerous source of innovation, because it's so easy to overlook. Look at the way that MCI and Sprint have been able to take advantage of the change in the long-distance telephone market structure. In our business, a change taking place before our eyes is the shift to fee-based products. Banks, mutual funds, broker-dealers, and insurance companies now all offer no-load products for fee-based consumers.

The fifth source is demographics, and this is a very fertile field for innovation. Drucker cites Club Med as an innovation that was driven by demographics. American Skandia exists because of demographics. Our mission, our raison d'etre, is to ride the age wave for the next 30 years as people increase their savings and look forward to retirement. However, we just recently completed an exercise within Skandia world-wide in which we looked at the needs and value systems of the next generation, which sometimes is referred to as Generation X. These people were born after 1968, and we found some very interesting shifts taking place in the demographics of the generation following the baby boomers. There are some clear demographic differences in our business that differentiate and segment the market, and you can see them in services such as automated teller machines, Prodigy, CompuServe, etc.

Another interesting source is a change in fashion or perception. The Edsel led to a change in fashion. Prior to the Edsel, the auto market was segmented based on income. Chevy drivers had lower incomes, Buick drivers had middle incomes; and Cadillac drivers had higher incomes. That shifted from income-based to lifestyle-based segmentation, which still exists today. In our business, the variable products are now gaining favor because of a shift in fashion. Is this a fad that will fade away at the first bear market? What other innovations are going to come out of this fashion? I don't believe it will fade. Obviously, our whole company is geared to variable products. However, that is the underlying risk that we face.

Finally, the source of innovation that comes to mind when you think of innovation is the brilliant idea that's based on new knowledge, which, of course, happens much less frequently than you would think. In the securities business, wrapped-fee programs and asset-allocation programs are new knowledge innovations. The Charles Schwab One-Source program on the mutual fund side is an example of a new idea. Maybe it's not that new, but it's innovation. It's packaging the technology with the concept and introducing the idea, and Schwab is going to extend that idea from mutual funds to variable annuities. You'll soon see advertisements for the One-Source variable annuity on your television screen.

I have some practical ideas about going beyond the idea of an innovation to the practice of innovation. Are there any rules or guidelines to follow? There are. They're not very profound. They're basically just common sense. And, fortunately for this talk, Drucker has already laid them out. The first rule is to analyze the opportunities. You've got to work at this. Have meetings with your staff on a regular basis and specifically go through the forces that I mentioned earlier that drive the innovation. Look at your competitors, whether it's another bank, Charles Schwab, or Shearson. Even look at what other life companies are doing. Get out and talk to your customers and talk to your front-line employees. For our most recent product, which is coming on the market later this year, a small team went and visited the broker dealers. They sat down with brokers in their offices and listened to the way the products were being sold. How do they develop the story? Get out there and find out what the customer is thinking.

Obviously, you need to keep the innovation simple. Keep it focused. Keep it obvious. The best innovations are so obvious they achieve instant receptivity. The three-point shot in basketball is my favorite example. Sometimes something clicks, and you say, "Why didn't I think of that before?" You know right away you're onto what's very likely to be a successful innovation.

Be sure to start on a small scale. Everything you do has a learning curve. If you start small, you can learn the lessons and make changes quickly, and you don't waste very much. If you start on a grandiose scale, you'll have great difficulty trying to make later modifications, and a competitor will steal the benefits of your innovation. This spring we introduced a program for our brokers called Investor's Edge. It was a fairly small innovation, but even before we introduced the Investor's Edge, we already knew where we were taking it. We wanted to get out there, get on the learning curve, and get some feedback on pieces that were missing before we invested heavily in concrete to pour around our feet.

Drucker's last rule is to aim for leadership. If you don't aim for leadership, your innovation simply becomes a vehicle for somebody else aiming for leadership. And so our goal is to become leaders in packaging investment products for long-time investors. There are also some rules for what not to do. Don't try to be too clever. As we've said earlier, keeping it simple is the order of the day. I could go into some of our failures, and we've had a few, but basically you can trace them back to trying to be too clever or not keeping it simple. Don't splinter your development effort. Innovation involves changing something, and change requires a lot of energy. If you diffuse your energy by developing an innovation in too many directions, you'll surely fail.

A final rule is to not innovate for the future. Innovate for the present. I'm not advocating short-term thinking. Innovation is focused on solving a present need, not a need in the year 2003. Long-term needs spur research, not innovation. Innovation takes existing technologies and solves existing needs.

Finally, I'd like to mention some enemies of innovation. The most important enemy of innovation is regulation and laws. You can't regulate innovation into existence, but you can sure regulate it out of existence. Our business is one of the worst industries in which to innovate because of the layers of regulation. As an example, our newest product will introduce a new feature that has never appeared in an annuity before, and we had to find our way through a thicket of laws and regulations involving the IRS, the SEC, and the various state insurance departments to get the product approved for sale. Anything new is viewed with suspicion by a regulator at the state or federal level, and I'm not knocking regulators. They should look at changes with suspicion, because if they don't, there are likely to be some problems. The good news is that things are so difficult for creating innovation that it leaves many opportunities still available for innovation as a strategy.

The second enemy of innovation is self-inflicted, and that is company policies. Policies exist to stamp out innovation; there are layers of approval and 15 ways to say no to innovation. Perhaps you have experienced the NIH syndrome, which stands for "not invented here." This is an unwritten corporate policy in some places, and it's an enemy of innovation. I'm proud to say that we're not too proud to copy a good idea.

Now, Drucker lists taxes as an enemy of innovation, and what he's getting at is that the tax structure locks capital into old industries that are really not going anywhere as opposed to freeing it up for newer, up-and-coming companies. However, taxes in our business are often a source of innovation as well as an obstacle.

The last enemy of innovation is success. It's simply human nature not to rock the boat if it's sailing along smoothly, but that's just what is needed, a mover and a shaker when we think we have reached success. Success will lull you to sleep, then the hard work of innovation stops and somebody else takes the leadership.

Well, I've tried to share some of our learning from an innovation-based strategy at American Skandia. We've pursued this strategy from the very beginning, which is only four years now, and I can tell you it's been a very fruitful strategy. It can be pursued according to a pattern. Look at the seven sources of innovation, follow the do's and don'ts, and especially fight off the enemies of innovation, particularly those that are self-imposed. At the end of the day, you'll find that your work becomes significantly more enjoyable and rewarding.

FROM THE FLOOR: To what extent have you discussed the idea that tax deferral may be bad on two theories? First, the tax rate will be higher in the future, and second, if you're a good guy and provide for your retirement, you're not going to get your Social Security. The last tax changes made that clear for people in a certain bracket in which 85% is now taxed. Tsongas and Rudman are saying the way out of this is to means-test Social Security. So the die is cast. Everybody's thinking means-test. Being a good guy, you buy a variable annuity, take it when you retire, you get a higher tax, and you lose your Social Security. Now to what extent is that an issue?

MR. BORONOW: I don't know what the alternatives are. One of our people said poverty is the alternative. My job involves motivating employees. We exist as a company to help people solve their needs in the future, and it's a very positive force to think that you are helping people set money aside in a tax-deferred way to provide for their future. It reinforces traditional values of thrift and self-reliance. So it's really foreign to our thinking that you're undermining some personal gain by saving for the future because the government's going to take away promised benefits. Whatever the government's going to do, it is going to do it whether you save or not, and so we offer that vehicle and try to reinforce traditional values.

One other enemy of tax deferral is the unfair advantage that mutual fund companies now have over variable annuities. They have such a huge tax advantage that I'm surprised Congress doesn't shut them down. The advantage is that the capital gains tax is now below the ordinary income tax rate. All of the gains inside a variable annuity, when they are distributed, are taxed at the ordinary income tax rate. That creates an opportunity for someone who's looking for long-term capital gains to actually outperform the variable annuity by investing in a high-growth investment and having it taxed at a lower ultimate rate. That's theoretically correct, but I think in the practical, real world it never works out that way.

MR. WINTERFIELD: Paul, another important matter in dealing with your question is that many different groups are buying the annuities. Your question certainly is very pertinent for the upscale buyer with a $250,000-a-year income; there the specter of higher taxes could be very real. Jerry Corsi also talked about the smaller bank buyers with the less-than-$20,000 purchases. They would be less vulnerable to the increases in tax rates. That's a good question.

How will insurance companies be able to make money offering variable annuities, fixed annuities, and other products through alternative distribution channels? Certainly there has been a lot of pressure regarding commission rates. Gordon discussed the nice possibility with the Fleet group to, in fact, drive commissions down, but certainly there have been many upward pressures on rates. Along the same lines, many actuaries found that it was very disheartening to read about lapse rates after surrender-charge periods for single-premium deferred-annuity contracts. In that particular study, we saw that lapse rates increased a lot when surrender charges were up for career agents, and they increased by much more in the cases of banks and stockbrokers. Are there any comments on profitability and dealing with the post-surrender-charge risk?

MR. CORSI: Let me take a first stab at that. I think you'll see that the persistency rates are probably lower among stockbrokers than among banks. At least in our experience, the stockbrokers have been known to call and tell people their annuities have matured. Major commercial banks entering the arena are more interested in thinking about partnership and long-term results. By comparison, the thrifts that were dominating the market through 1990 were desperate for fee income, and commission pressure was intense. I think the next wave of products that will be looked at among major commercial banks will be a combination of variable annuities, in which the bank is interested in managing some or all of the assets, and even fixed-annuity structures, in which the bank is interested in reinsurance and other longer-term remuneration, which might tie the bank into persistency rewards.

MR. BORONOW: It's a trend in the industry to move away from the front-end-loaded commission structure to more of a level commission structure that encourages the seller to make its profits at the same time we make our profits, and that trend will continue. It may go faster or it may go slower than we think it will. But at the end of the surrender-charge period, you've got the sleeping dogs and you've got the rest of your business, and the only profitable portion of your business is the "sleeping dogs." Everything else is, at best, a wash. So we're spending a lot of money to acquire a lot of business, and we hope that 30-40% of that business represents the sleeping-dog population. But I think the real long-term key is to tie in the seller, that alternative channel. Tie the seller's profitability to the profitability of the block of business itself.

MR. WINTERFIELD: One other technique is to look at having some bonus features for the policyholders after the surrender-charge period is up: in the case of fixed contracts, perhaps somewhat higher interest rates; in the case of variable products, some reduction in the M&E charge (for example, the 1.25% charge that was alluded to earlier).