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Competitors to the Life Insurance Industry

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Panelists: JOHN C. R. HELE
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Summary: This panel of speakers represents the banking industry, stockbrokers, and mutual fund companies and focuses on life insurance company's competitors and their role in the life insurance industry of the future. This session addresses the following issues as they relate to each speaker's industry:

- *The nature of customer contact*
- *Methods of distribution*
- *The need for a level playing field (tax policy, regulatory, capital, and similar issues)*
- *Investment management capabilities*
- *Potential cross-breeding of various industries.*

Mr. John M. Fenton: We have put together a panel of well-known and respected speakers, who will address the issue at hand from various viewpoints. As many of you know, life insurance companies and the traditional agent distribution channels that have been used in the past are under significant competitive pressure. The number of individual life insurance policies sold has generally been decreasing over the past several years with a corresponding increase in distribution costs. Much of the annuity business that we sell is really sold by channels outside the traditional

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†Mr. Rasmussen, not a member of the sponsoring organizations, is Vice President of Product and Operations for the First Union Bank Insurance Division in Charlotte, NC.

insurance agent channels. This includes banks, stockbrokers, independent broker/dealer firms, and, to a lesser extent, direct marketing and fee-based financial planners.

We are going to hear from three speakers who have worked with nontraditional channels, and they will tell us their perspective on their role in the life insurance industry. I think going forward, insurance companies will have some key decisions to make about where they want to play in the future in the financial services business. Are they willing to embrace some of the outside channels as partners? Or do they want to stick with the agents who brought them to the dance so far? I think a key issue going forward is as an industry, we need to get closer to our customer; I think that the customer is the underlying consumer, not the agent. As an industry, I think, we need to work on this.

Our first speaker will be John Hele. John is director at Merrill Lynch Investment Banking Financial Institutions Group. John has 16 years of actuarial and life insurance senior management experience, and his responsibilities include counseling life insurance companies in the areas of mergers, acquisitions and divestitures. Previously, he was with Merrill Lynch as the senior vice president and director of manufacturing for the Merrill Lynch Insurance Group. John also served as that group's chief marketing officer.

Our second speaker will be Rich Murphy. Rich is the senior vice president of Fidelity Investment Life Insurance Company in Boston. His principal responsibilities are in the actuarial and financial areas. Rich joined Fidelity in 1995, after 30 years of experience in the insurance industry, including roles in administration, marketing, field management, product development, as well as actuarial and financial reporting.

Our third speaker is Marty Rasmussen. Marty is currently vice president of products and operations for First Union Bank Insurance Division. Until one month ago, he was vice president of product development and new business at Norwest Corporation in Minneapolis. Marty started in the insurance business in 1983, and has been in the bank distribution of insurance for the past five years.

Mr. John C. R. Hele: My talk will cover three core areas. First I'd like to try to draw the competitive landscape that shapes the entire financial services business. This is a very important step in determining just what you're fighting for.

Second, I plan to cover stockbrokers, something that I have a great deal of familiarity with. Just like the insurance business, the stock brokerage business has been undergoing a huge transformation over the past 20 years. Just how big a competitor are stockbrokers today and will they be in the future?

Third, I'm going to give you some personal visions of the future, not tied to any particular year. I don't want to get put on record for a certain year, but certainly, before I retire in the year 2023, I think that we'll see many of these changes happen.

What are competitors competing for in the financial services business? I have a list here of several items, and I would highly recommend the article from which I took these. It's in the March/April 1996 *Harvard Business Review*, called "Form Follows Function, The Transformation of Banking." It is one of the most insightful articles on the financial services business that I've seen in recent years. We also use this a great deal in our investment banking group, because we are in what is called the financial institutions group, which includes insurance companies, banks, thrifts, and investment managers on a global basis. We have been using this at some of our own internal discussions.

Financial services, in general, satisfy a list of consumer needs. The first one is a method of making payments, such as checks, money orders, credit cards, and so forth. Financial services also can have mechanisms to pool resources. These would be intermediaries such as insurance companies, a bank, a mutual fund, and other firms, such as a brokerage firm. Financial services also provide ways to transfer economic resources from one group to another, such as lending, from banks or insurance companies in investing; on the other side is stocks, bonds, and buying a policy. You have a two-way forum of ways to transfer economic resources from one group to another.

Financial services provide ways to manage risk, such as through insurance contracts, either life or property and casualty (P&C), derivatives, calls, puts, or swaps. These are all ways to manage risk. Financial services also provide ways to price information, such as interest rates, currencies, and securities. And last, financial services provide ways to handle incentive problems, deferred compensation, stock options, employee benefits, convertible securities. These are all ways to provide incentives to act in terms of certain behavior in a financial way.

Every country in the world has a set of regulations that define what organizations and what types of institutions can provide for a subset of these services. Our laws in the U.S. separate banking, securities, and insurance. These laws date back to about the turn of the century when banking, securities, and insurance were in their formative stages.

I have listed here several, but by no means all of the services insurance companies have provided to meet consumer needs. I think it's important to recognize that insurance companies in this century have been the second-largest intermediary in the private markets, second to banks. Just a few years ago, mutual funds passed the insurance industry in the U.S. in total assets. With the growth rates of mutual funds, they are projected, sometime after the turn of the century, to pass banks in the U.S.

Securities firms, in particular, have been taking assets away from banks. Merrill Lynch, for example, on our retail side, has \$770 billion of clients' assets under management. In many cities, it has more assets under management than most of the leading banks. What is really happening when you speak about competition is there is a combination of different players such as: security firms, mutual fund companies, and banks that have started to replace traditional functions that have been performed by the three core intermediaries.

I contend the biggest competitor of this century's insurance business has been the government. Social Security, the pooling and economic transfer of Medicare, and the tax advantage of securities of states and governments act as competitors to private insurance companies, and actually influence consumer behavior away from traditional financial services. The good news is on a global basis the trend of less government is really on a roll. In fact, I think in Chile or Argentina, they have now privatized the social security system, and a new report that is coming out is going to recommend ways to start privatizing our own Social Security system.

There are many different players. I'd like to spend a few minutes speaking about some of the future competitors. As the world deregulates financial services, and this is a coming trend all over the world, globalization will bring foreign competitors. Even in our own investment banking business at Merrill Lynch, we have major new competitors on our landscape. Deutsche Bank and UBS are trying to build major investment banking franchises by recruiting away some of our best people. Foreign insurers, who up to now have pretty much let U.S. subsidiaries run independently, will increasingly merge into global organizations. I have a recent example of this. The former chief financial officer (CFO) of the Equitable is now working for their major investor, really their parent company, AXA, and is now CFO for them. He still lives in New York, commutes to Paris one or two days a week, and is rapidly learning French. The global age is really here!

Exchanges are beginning to make inroads, as opposed to the use of traditional reinsurers for a certain P&C catastrophe risk. Securities firms and exchanges are developing new techniques to segment, package, and pool risk. Specialty firms are being developed, serving one function, or a couple of functions of insurance risk,

such as a bond insurer or an off-shore captive reinsurer. These specialty companies handle risks that used to be handled by a broad insurance company.

Never underestimate the power of technology. Although not common today, the ability to measure, pool, and communicate will increase exponentially over time with new technologies. Take for example the securities business, where the fourth market is growing at an extremely rapid rate. The market has no people involved since it is a direct technology network between buyers and sellers of securities. You don't see it today because every night they have to report their trades to the New York Stock Exchange, so you see it in the total volume of the stock exchange, but it's not really being traded there. So for pension managers, they can trade directly with one another through a variety of services, the leading one being provided by Reuters called Instinet. Technology is really making big inroads in many financial services.

I think it's very informative to study some other industries, to see what can happen to the insurance business. Nowhere has this happened better than in banking in the U.S. Banks used to accept local deposits and make local loans to individuals and businesses. That was their franchise. That franchise today is gone. Of the \$4 trillion of new mortgages originated in the U.S. from 1990 to 1994, 60% were used as collateral for mortgage-backed securities. This was unheard of 20 years ago. Mortgage servicing, the administration of mortgages, is now done for 21% of the market, again unheard of 20 years ago. What is more important is banks, many years ago, used to define themselves as having the ability to administer mortgages. That was their core competency. Now you are seeing new specialty firms come in and do administration.

The traditional function of a bank and its unique franchise has been making change. It is also under attack. In the U.K., the post office now provides teller services, in other words, making change, for a variety of banks. Traditional bank functions are now supplied by other competitors. Mutual fund companies, such as Fidelity, provide checking; AT&T offers credit cards; securities firms and financing companies make small business loans; and traditional teller functions have been replaced by automated teller machines (ATMs). I have not thought about whether there are more ATMs in the U.S. than there are tellers, but I think it would be interesting to take a look at it.

What about insurance? We see the life insurance industry evolving toward segmentation and specialization. The wave of mergers and acquisitions is only a by-product of this evolution. The traditional multiline insurer is evolving to become larger in selected business, better at managing the fundamental concepts, and creating unique products for specific market segments. Against this backdrop the

traditional life insurance industry has not really performed that well. Distribution is generally inefficient when compared to other competitors.

Many financial services companies view distribution as a profit center, not as a cost center. And the sales problems that are currently happening at major life insurance companies are really just the beginning, because the loss of trust has a very long-term impact on new business.

Alternative distribution is really in its infancy. A very interesting note is, what happens when you decide to do nothing? No decision is a strategic decision. Doing the things that you've always done the same way is a very conscious act. Human nature makes it feel like it's safer, but in reality it's not. You can pick many different industries where new competitors have come on board and really changed the whole landscape. What typically happens is the market leaders underestimate the new person's capabilities. They are usually surprised in one of two ways. The first way is what's called *unseen strategic intent*. It's a very long management consulting word, but what it really means is you have not really figured out what they are up to until it's too late. Probably the best example of this is the Japanese auto manufacturers. When the Japanese auto manufacturers came into the market and started selling small cars, the big three automakers didn't really think it was that important. Little did they know that the whole plan was to establish a beachhead in small cars, and then work their way up the curve.

The other way is by using nontraditional entry tactics, such as direct sales of mutual funds or direct sales of life insurance. What happens is there is usually a partial response, trying to do it part way by the main competitor. Eventually they tend to keep losing, when the company finally says it never really liked that business anyway. And they end up selling, exiting, or merging out of the business. I think you can pick many examples—insurance, banking, auto, high tech, you name it—where this is happening. This is happening for many people in the insurance business.

So what is there to do about it? How do you win? We see there are core competencies and core functions that life insurance companies provide. Underwriting and claims management, distribution, marketing, product design, administration, and asset management. Winners tomorrow will decide on which of the above they're going to be good at and be best in class, and create relationships with other people to provide the other functions so that they can be best in class. They probably will not try to be all of these functions at once. The best example that I've seen of this in any industry is Sun Microsystems. Most people think that their job is to make workstations, however, they actually do not manufacture workstations. They define their core competencies as being marketing, product design, and managing manu-

facturers. They do not build workstations, they manage others who build workstations. I think in the insurance business, I would say the M Group is almost at the Sun Microsystem level in that they manage their relationships with outside carriers and focus on marketing and distribution.

That is the landscape overview. I will now spend time on stockbrokers. Are they capable of being insurance agents in suspenders and black shoes? The answer is no. But can they sell insurance? The answer is yes. In 1995, the top 20 member firms sold \$15 billion worth of premiums, mainly in annuities, but I think what's surprising is there was \$500 million of life insurance sales. The majority of it was annual premium life insurance. When you look at the growth of what happened in 1995 versus 1994, clearly annuity sales were down in 1995. It was a very rough year in 1994, and it took a long time to recover in 1995, but life insurance sales were up 25%. So what was viewed as a very difficult task is now coming to the forefront.

The advantages of selling through full-service stockbrokers is actually quite obvious. They have a marginal transaction cost; they have additional service that builds a better relationship with your client, and better trust. Most companies bring in a life specialist who works at the firm to handle the sale. It doesn't take that much time from the core stockbroker, and it adds additional revenues, very sizable revenues. At most stock brokerage firms, the single largest transactions that are happening are life insurance transactions; number two is generally annuities. There's a great deal of motivation to begin to learn these products.

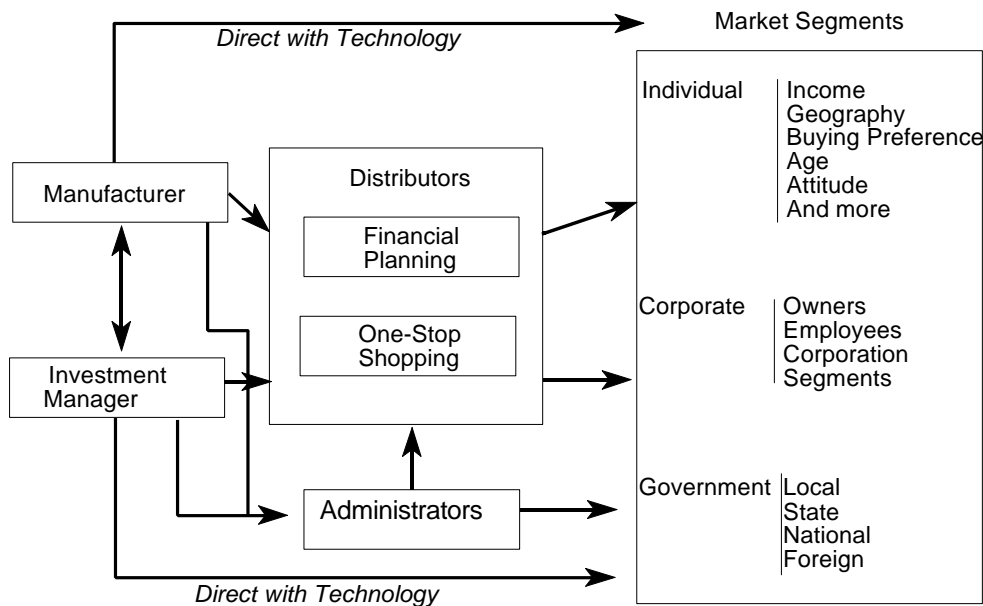
Brokerage firms generally hold themselves out to be independent, and to be brokers, and shop several firms. The strong equity markets have been very good for stockbrokers in selling other products. Clients are very happy. Their portfolios are up 20% or 30%, and it is now a good time to call and see whether there are services you can provide to those clients. Stockbrokers generally operate under fuller disclosure than the traditional life insurance business, because of the securities laws.

Stockbroker distribution has not grown as quickly as expected because of their culture. Remember, early in the stockbroker's career, they made the conscious decision to not be a life insurance agent. This takes a long time to overcome. Also, the length of time of the life insurance transaction is a real disincentive. It takes a long time to sell life insurance; stockbrokers are used to instant gratification. Stockbrokers are not generally trained in the nuances of insurance. They do not want to appear to be dumb to a client, and not know the answer. They see themselves to be a knowledgeable and trusted advisor. They also tend to worry about products. Stockbrokers have had a great deal of trouble with insurance and other

products that they're not that familiar with, such as Baldwin United, Executive Life, so they are a little worried about anything new. The strong equity markets also act as a negative because stockbrokers are making a good income. They may decide it's not worth their time to spend a little extra effort and expand their product line. Also, full disclosure makes it harder to sell these products in the stock brokerage environment sometimes.

Now for my own personal view about the future. What I and a few others see happening is an open market (Chart 1). A global open market in scope, with local segment-related regulations and oversight. This will be a highly competitive market. You may be a manufacturer, a large manufacturer, or a boutique manufacturer. Manufacturing will probably be separate from investment management. You will have insurance administrators. That function will be broken away to be processed much more efficiently. And I probably see two major forms of full-service distribution: financial planning and one-stop shopping. But there will be a great deal of direct access to investment managers and manufacturers. In fact, I think Fidelity has just announced that you can get 401(k) plans online and that is just the beginning.

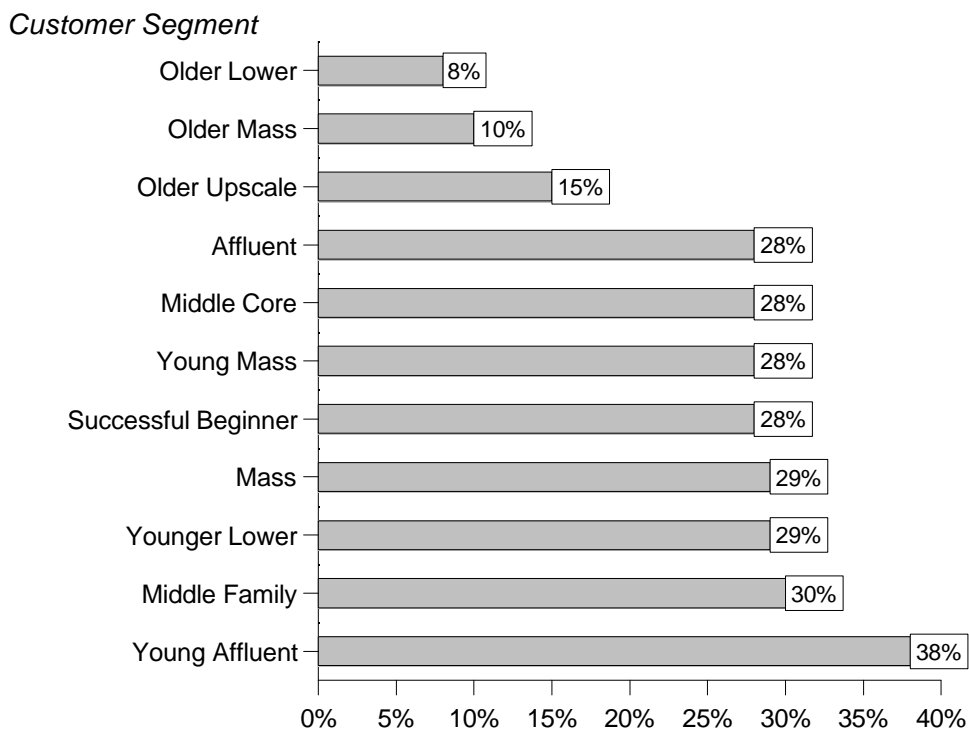
CHART 1
THE FUTURE: AN OPEN MARKET



The left-hand side of the chart is very important. Market segmentation and creating products for each individual market segment will really be the future trend. There are many opportunities.

Actuaries have been taught to look at the past to predict tomorrow; history is a good guide. Chart 2 is a historical study taken in 1995. What's surprising is that the general consensus is that people do not want to buy insurance direct. However, 38% of younger, affluent people are willing to buy direct. If you look down at the bottom, 15% of older, affluent people are willing to buy it direct. Who today are the major telemarketing term insurance writers? Are they the top leading companies in the insurance business in total sales? I don't really think they are. Remember what I said earlier about unconventional entry tactics as things evolve.

CHART 2
 ALTERNATE DELIVERY: THE PAST IS NO INDICATION PERCENTAGE OF RESPONDENTS WILLING TO PURCHASE INSURANCE VIA TELEPHONE, BY SEGMENT, 1995

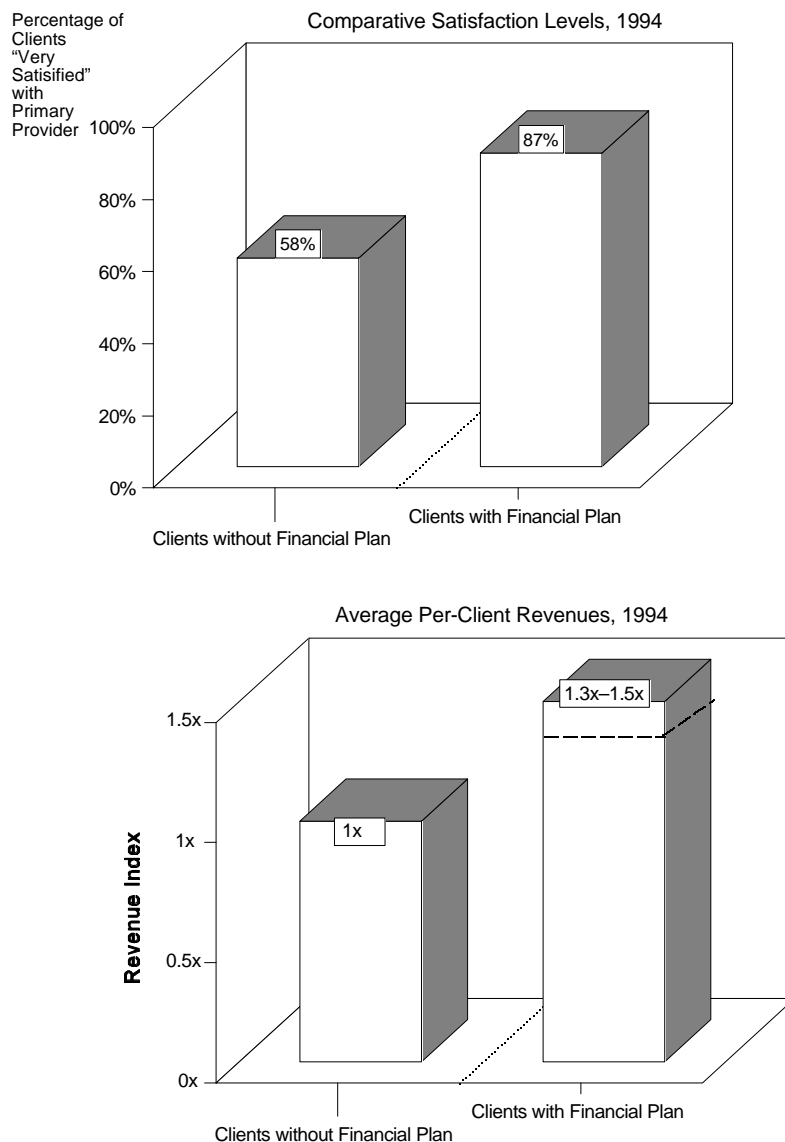


With regard to full service, we see two models happening in the future. One is having a relationship manager handling all the clients' needs and bringing in specialists to serve specific situations. This is actually the model that we used in the investment bank to handle client needs. It's also the model that we're using at Merrill Lynch Retail for our financial consultants, that we use to handle individual clients. Clients like dealing with one institution.

The other core model is financial planning. Financial planning can justify the fees needed to pay for full-service distribution.

A study showed consumers are much more satisfied when they've had a financial plan done, because they then do more business (Chart 3). I mean, it just doesn't get any better than this: satisfied clients do more business. Remember to never underestimate the power of technology. The growth in sales of home PCs will forever change the financial intermediary landscape. I know myself, having a new home PC, that insurance services online are just getting going. But more services will be coming, and you are going to have to be able to communicate and work with people through their home.

CHART 3
FINANCIAL PLANNING IS VALUE ADDED



In summary, we see the winners are those who can study other industries to see what life is like when it is really competitive, and to be prepared for it today in a

global business. That consolidation is not the total solution; it is a necessity to be successful. But you must become the best in the class in your selected core competencies. New ways do evolve. These trends take a long time, but corporate change can take just as long. We encourage people to start now. As actuaries we hold a very powerful and unique competency to communicate the financial outcomes of risk and strategic courses. I encourage you to spend a great deal of effort working with your management or clients to tell them the new world is here, and to be prepared for it today. In the end, the customers want it all. They want the best value at the cheapest price, and I really hope we can all get there together.

Mr. Fenton: Our next speaker is Rich Murphy of Fidelity Investments Life Insurance Company.

Mr. Richard Charles Murphy: This is going to fit very well with John's presentation. John discussed the public's comfort level at buying direct. Let me just take a quick survey. How many of you have bought individual term insurance ever in your lives? How many of you would have been willing to make that term insurance purchase on the phone if you knew you could save 15%? Now you understand Fidelity's advantage and direction.

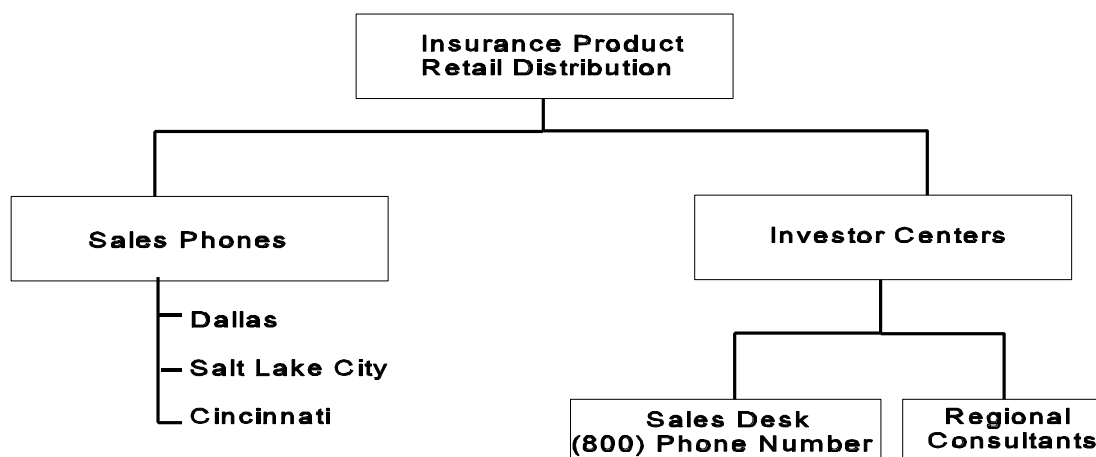
Fidelity Investments is a difficult organization to understand. The organization consists of 40–50 semiautonomous business units; their strategy and their budgets are changing quarterly. I'm going to talk about the insurance functions of Fidelity Investments. I will look at three of them: Fidelity as a manufacturer of insurance products, as a distributor of other companies' insurance products (not everything Fidelity sells is manufactured there), and, finally, as the investment manager of insurance funds.

The retail distribution organization at Fidelity is oriented towards individuals. The Fidelity Investment, Insurance, & Annuity Group consists of two insurance companies, one non-New York and the other New York only, and an insurance agency that will distribute the products of other insurance companies. On the institutional side of the house, it caters to other insurance companies, to banks, to wholesalers with the variable insurance products funds. These are funds used to fund the insurance products, and they are clean funds for those of you who are familiar with variable products.

How has it done? Well, the retail distribution side has been in business for about five years. As a manufacturer in 1995, it sold \$900 million of variable annuities, and as an administrator and distributor, it has sold \$100 million of non-Fidelity premiums. On the institutional side, it collected \$3.5 billion of new investments in these funds.

Let's first address direct manufacturing and distribution of Fidelity Investments Life Insurance products. The National Association of Variable Annuities does an annual survey of distribution costs and administrative costs. According to that survey, the distribution costs at Fidelity are about 50% of those of the more standard distribution systems for variable annuities. Now the annuities we sell are pretty plain vanilla, and the process is pretty simple. What we hope is to exploit this distribution efficiency in the introduction of term insurance products in the next 12 months. We are very excited about the advantage that we have in entering the market, and that advantage is primarily in the cost of distribution.

CHART 4
INSURANCE PRODUCT/SERVICES DISTRIBUTION



Note: No outbound cold calls; no investment advice

Let me explain how the products are distributed for the insurance company (Chart 4). The sales phones are in Dallas, Salt Lake City, and Cincinnati. Investor centers are located throughout the country, and there are 81 of them. They are supported by a centralized 800 phone number, staffed by insurance professionals. On a monthly basis, retail consultants will visit each one of the investor centers. I want you to note that there are no outbound cold calls, so no dinners get interrupted, and no potential clients become annoyed. Also, the second thing I would like to point out is the difference with Fidelity is that there is no investment advice. No cold calls and no investment advice, that becomes important as we proceed with this discussion. We develop product interest through advertising, direct mail, educational pieces, and word of mouth. These phones are located in three locations. They are staffed by 30 sales representatives, about 10 in each 1 of the 3 locations. They are licensed in 50 states, and so they can take, and do take, applications from every part of the country. In the investor centers there are 350 locally licensed

insurance professionals. Of course, they are selling other products at the same time. And 150 associates do not handle sales, but handle service only.

As John suggested, we likewise are looking at our customers. Customer focus is the driving force at Fidelity. It's not the product; it is not the distribution; it is the customer. The distribution approaches are interchangeable. Individuals might choose to call us on the phone, or they might choose to enter an investor center. As we look at this, and if we think about annuities for a moment, 36% of our manufactured annuities come from a demanding active segment. This segment has an income of over \$125,000 annually. Another 20% comes from senior asset managers. These are individuals who control over \$250,000 of assets. And another 15% come from the young and involved segment, much like many of you in the audience. Now this is the segment that is the key to Fidelity's future and to all of our futures in the insurance industry. This is the area that new products will be directed to, such as term insurance.

Fifty-two percent of our manufactured products are today sold to Fidelity customers. There are three million households in Fidelity's customer base. Fifty-two percent of our insurance customers will come out of those three million households. But do you know what that says? It says that 48% of the people who are buying Fidelity's insurance products are calling Fidelity because of the offering of our insurance products, and not because they are related necessarily to the Fidelity Mutual Fund family.

Not all products are sold the same way, and I want to spend a little time on that. Sixty percent of our deferred annuity products come from the investor centers, 27% come from the phones, and 13% involve both the phone and trips to the investor center, but not all products are sold alike. If we look at the immediate variable annuity, which we've been offering now for two years, only 8% of those sales are coming through the phone systems. That product is a life-long commitment, and a commitment of a significant piece of retirement assets. While 27% of the people might be able to make that decision by phone when dealing with the deferred variable annuity, only 8% are comfortable dealing only by phone for the immediate variable annuity. So far, at least, all of our life insurance sales have been estate planning sales. Those estate planning sales are really related to very high-income individuals, and 100% of those sales have involved visits to the investor center.

So far we've talked about Fidelity Investment as the manufacturer, but part of our organization is also Fidelity Insurance Agency, a distributor of other companies products. Yes, we do distribute quite a few of other companies' products, and we make a conscious decision of whether we're going to manufacture or whether we're going to distribute somebody else's product. We first look at what the Fidelity

customer demands in the way of product services. Is it something that we have already on the shelf, or something that we need to go out and buy from a manufacturer? What would the representative and customer reactions be to another name, besides Fidelity, being associated with that product? Does it help us control a larger amount of the wallet of the individual client? If it does, then it has a strategic benefit even though there might not be much profit.

We've had a few bad experiences with offering other companies' products. One was with Confederation Life. When you begin to sell somebody else's immediate annuity, they better have a good reputation and be financially strong; otherwise, your reputation is going to be tarnished by association.

In choosing to offer someone else's product, we also look at the numbers. In fact, we'd like to receive adequate commissions when we sell products from other companies. But we also look at the product risk profile. If we manufacture the product, how would our earnings vary? What kind of risk profile is there? Do we have the internal expertise? Do we have the actuaries or the marketing people to develop that kind of product? What would our rating agencies say about incorporating that product into our portfolio? Finally, how much do we expect to sell? Do we have the surplus to support it? How much can we earn in that process?

We currently offer the products of six to ten other companies. Looking at the names of these companies may help you understand how we have reached our decisions about what products to offer. On the non-Fidelity insurance side, we offer fixed deferred, fixed immediate, and life insurance. That ought to tell you something about our willingness to absorb risk; it is not very great. Fixed products are something we would rather place with somebody else than incorporate in our portfolio.

A quick example of why we offer the products of others is found in Funds Network. Through Funds Network, we sell the mutual fund families of other groups.

In Funds Network, we're collecting \$10–12 million per day. Twenty percent of those people are new households. We've accumulated \$5 billion for other fund families. This program does not break even. We're still losing money, but every Fidelity representative office is going to tell you that this program is a key to success. It allows us to control an increased share of the wallet. But we need to deliver all the products and become the "one-stop" shop that John described.

I talked to you about manufacturing and distribution. What about investment management? As an investment manager, our products are sold through the institutional side of the house. Our VIP mutual funds for insurance products are used to fund the investment obligations of variable annuities, variable universal life

(UL), group variable UL, and group annuity. You can't be successful alone; you need a partner. As an investment manager without distribution, we partner with banks, insurance companies, and others. A partner might be two people dancing together, or it might be a spouse or mate. In fact, some of the negotiations look like two people dancing together for a long time. But finally, when they do come together, it's people who are playing on the same team; it's an ally.

When we get into that institutional arrangement, everybody has certain responsibilities. We expect the partner to have customer control, deliver value. We expect the customer to respect the partner as delivering value. The partner needs to deliver the advice and counsel to the customers and bring a number of customers. Fidelity will provide the investment management, the education, and information about its products. Fidelity will recognize the partner as the customer, not his or her clients. Finally, we will bring the Fidelity brand name.

You must wonder, how can we both sell on the direct side and then offer a similar product through another insurance company, and not end up with a great deal of conflict? Fidelity Direct will attract and sell to self-motivated investors, self-managing their investments. What we are suggesting on the institutional side, is that we will develop a relationship with an institution, as long as they deliver value. As long as the advice and counsel that they provide to the customer is valued by the customer, paid for by the customer, then we want to deal with that partner and have them offer our investment services.

Our retail products manufactured by us are generally cheaper than the products offered by our institutional partners. In fact, they're cheaper by almost 30% if you measure the mortality and expense on the variable annuity. Yet, we don't have all the customers in the world, because there are more people who need advice and counsel of stockbrokers or financial planners. However, the self-motivated, self-managed part of this world is growing, and I suspect many of you are in that segment. And as that segment begins to grow, as people become more comfortable dealing with the Internet and 800 phone numbers to conduct all these financial transactions, Fidelity Direct will be there.

On the institutional side, we also will continue to provide support by providing a marketing consulting team and marketing support materials. We even provide a sales desk where the investment manager will outline his investment strategy over the recent past or the future, and that will be available to clients of the partner as well as the use of the Fidelity logo. Not all businesses are sought for this institutional relationship. We don't want to subdivide the market and have 15 different companies offering Fidelity products. What we try to do is restrict the availability of Fidelity's funds to only certain insurance carriers. We look at their creditworthiness

and we look at their cultural fit. But probably most of all, we look at the discipline of their distribution channel and the compliance problems that we might run into and share in the event that we become their partner.

Exclusives are also not required. We currently are offering our funds with Putnam, Twentieth Century, and Dreyfus. All of those are offered in some combination with Fidelity.

When you look at us as a manufacturer, a distributor, and an investment manager, there are common themes that are going to emerge. One, the customer is going to decide how they want to be marketed to. Whether it's through an advisor, directly on the phone, or through a PC. We're going to be present in all of those roles. Our success requires the understanding of a market, institutional and retail, and institutional and retail are very different markets. But in all of the markets in which we deal, we will be relying on providing convenience, extensive and actionable information, wide choice of products, and value in our pricing.

Fidelity is very sensitive to its competition. When you read in the paper about Schwab or about Merrill Lynch, I suspect that Fidelity will either be examining those same options or will have already examined them. We're also very sensitive to the public's education and their capacity, ability, and willingness to act directly. Who would have thought we would have done so many things with 800 numbers 15 years ago? Life insurance without an agent—what happened to the theme that life insurance is sold not bought? We're looking at a very broad array of financial management products and financial advice. And as we provide those products we will do it directly and with partners. Ten years from now, I think it's likely that you'll see us not only offering annuity and term insurance products, but I think you'll also see us entering into the fixed products and into the casualty markets. Therefore, we can provide an even broader spectrum of financial management opportunities for Fidelity and convenience for our clients.

Mr. Martin Rasmussen: I'm going to be speaking in terms of distribution and touching a little on investment management. I think both John and Rich did a fine job of laying out some general ideas about how all of this is going to fit together. Another comment about the competition of the industries is that if you think about it, it is not just the three of us competing against the insurance industry. From my point of view, many insurance companies have owned banks and mortgage companies for a number of years. So we're really competing together. That will hopefully bring us all to a higher level going forward.

If you see me flipping into comments between Norwest and First Union both in my notes and in my talk, bear with me; as John pointed out, about three weeks ago I

was with Norwest for five years. I certainly don't claim to have all the answers, and in fact, what we have tried to do is put together a number of different approaches, and see which one will work the best in terms of distribution. Again, this is both between Norwest and First Union. It speaks more to my previous experience in both the insurance business as well as the bancassurance business.

First, my legal department wants me to point out that, of course, these are my views, not necessarily the views of the corporation, especially after being in the business with First Union for a mere three weeks. Second, the crystal ball: most of this is based on my experiences, as I mentioned, and my belief in where this new and emerging industry is headed. However, my crystal ball is a little foggy. I do not think anyone knows exactly where the insurance business is going to be in five years, but I'm convinced that it's going to be substantially different than it is today. I think it's an exciting time for all of us to be a part of it.

There are more ruts on the road today in the bank and insurance industry than there are success stories. There have certainly been a number of banks that have been trying it, but we haven't found the best form of alternative distribution in the bank marketplace. We are going to continue to try multiple forms of distribution to help with that.

The topics I'd like to discuss are first banks, insurance, and an overview of what they means to us, and second, current experiences, both in forms of distribution models and the types of products. I also would like to discuss some outsourcing of administration functions and show you some of the things that we try to do to help our people do what they do best, and that is sell. Third, I'll discuss alternative forms of distribution in general, and fourth, where I think the business is headed in the future. I'll then wrap up with a brief summary.

Banks being in the insurance industry is really nothing new. It has been happening for a number of years, particularly on the credit-related side of things. It has been a huge part of fee income for most banks in the past several decades. Banks also have been in the P&C business—particularly those in small towns, which have been providing P&C insurance to their customers as a value-added service.

Fixed and variable annuities today are viewed more as a savings or investment tool, but they are obviously very much an insurance product. On the regulatory landscape, regarding Glass/Steagall reform, I have a couple of questions. One, will it happen? It's looking more and more like it may. Two, what does it really mean if it does happen, both to us as a bank in the insurance business as well as insurance companies assisting banks getting into that business? Some say it's a matter of time, but I think one of the things we have to do is consider the vast differences between

our two industries. Banks need to set aside their need for control and what I consider a bit of arrogance. We think we can do everything better than anybody else.

The other thing we have to do is be willing to take a look at the numbers. If you look at the insurance companies, they have been targeting a return on equity (ROE) of 12–15%, while what we look at from a bank perspective, and this is true of both Norwest as well as First Union, are ROEs that have been consistently around 21–23% annually for the past number of years. We have to ask ourselves whether we want to own an insurance company that will produce anywhere from 25–40% less in ROE to our bottom line? Certainly this is a big question. But I think first we have to recognize that a big share of the difference in those ROEs is due to the cost of distribution. Those cost shifts could shift to the banks, which would certainly help the insurance company ROEs. My question there is, what will it do to the banks' ROEs?

Looking towards the future again, I see a shifting of expenses from the insurance companies to the banks, mainly in the form of distribution. I also combine best practices and outsourcing, and really identifying who does what better. A few things such as investment management, administration, technology functions, marketing—I think they are things that banks do really well. They market themselves and their needs extremely well, but banks do not know how to sell. One of the biggest strengths that insurance companies bring to the table is the ability to sell and provide a product to the consumer at a level that they can understand. Finally, who owns the customers? The banks, of course, have a very large customer base, and we feel that they're all ours. We also have the distribution, the bank personnel, the bricks and mortar. When you combine that with insurance, it seems to be a good partnership.

Joint ventures and strategical alliances versus insurance company ownership are an alternative, particularly with the regulatory landscape changing the future. If regulations do change, again do the economics make sense for our two industries to become more closely aligned? In the meantime, I think there's a great deal to do. Banks need to understand the insurance business much better. There are huge differences in terms of understanding pricing, marketing, and sales aspects as I have mentioned. I think that the insurance salespeople are some of the best salespeople in the world. Banks need to do a better job of integrating sales into their systems, and understanding the major cultural differences between our two industries. Knowing more about these will not only prepare the banks for ownership, but also help us answer the question of whether we want ownership.

In looking at current experiences, we can get an overview of what things have happened in the past. I am going to try and build from the oldest area of insurance in the bank marketplace to the newest. For the most part, many banks have been in the P&C business since the 1920s, as a value-added service to their customers. Today, a large number of banks are getting back into that business. We had done that in a very large way; however, we found it difficult to make money.

The second area is credit insurance, including sales at the bank level, as well as underwriting profits or reinsurance through captive companies that many banks own. Fixed annuities then came into the marketplace in the bank lobby back in 1985. Banks have been a big player. Right now it comes to about 32% of fixed annuity sales. Variable annuities arrived in the early 1990s and have been very successful, even though a lot of them were introduced in 1993 and 1994. The year 1994, in particular, exhibited a down market. The timing might seem bad, but it sure helped to propel some of their success. Today, proprietary variable annuities as well as proprietary fixed annuities are being discussed more commonly. Life insurance is a big topic of conversation in the banking industry. Can we do it, and can we do it more efficiently and effectively than the insurance industry in general?

In terms of life products, as I mentioned, we have credit-related insurance. Sales are really driven there by the bank, though it is not a true sale. If you just took out a car loan for x number of dollars, you should protect that with credit life insurance. So it's not really a true sale, like the life insurance that is sold by most of your agents. But it does require senior management's support, to keep reminding them that they should be presenting this to their customers. To the banking industry, it is very, very profitable, both in terms of the front-end commission as well as underwriting profits that it receives. The average penetration in the bank today runs anywhere from 35% to 45% of all qualified loans, so they do penetrate a great deal of that.

Single premium life (SPL) is really the next logical step from fixed annuities—actually from annuities, whether it's a SPL in a traditional form or in a variable form. I think SPL will help as our population's goals start to change from more than a retirement orientation (putting money aside for the future and really recognizing that they have done a fairly good job in savings of 401(k) plans), to one where they are more concerned about providing for their heirs (doing some of the estate planning), and trying to transfer money in a more efficient manner (paying less taxes).

With regards to term insurance, in both of my recent positions, we sold a credit life-like type of insurance that has been designed to do a couple of things. First of all, the minimum premiums or minimum base amounts are set above the credit life maximums in an effort to protect the profitability of the credit insurance piece. What we are finding is that term insurance is not a big driver of profitability for us.

Also, we are finding that it is doing a couple of other things. One, it is getting our bankers more comfortable with selling a more typical type of life insurance, and two, it also allows us to gain that customer as a customer first, and then educate them about other products that are available later on.

In 1978, the insurance industry unbundled a typical whole life and developed UL, in an effort to disclose more to the consumer and also to combat the buy term and invest the difference. This made understanding UL such that, unfortunately, you almost had to be an actuary to try and understand it as a consumer. I think in 1996, one of the goals that I have of new products is to rebundle some of that. Still disclose the key elements, such as cost of insurance, but rebundle some of the expenses and other things to keep it simpler and a little bit more customer friendly, for the bank marketplace.

On a proprietary side, the purpose here is really several things, but assets under management and fee income are just the name of the game from banks today. Fee income from investment management is a big part of it, too. Being able to earn money over the weekend is a big topic of conversation. One of the marketing aspects is that bank customers really like the affinity and the trust that they have with their banks. They will continue to come, according to studies, to us for other advice, such as insurance purchases. We also feel it will give us a little bit better control over product design, so that we can better fit it to our different customer levels, whether they are the average person on the street coming into our branches, or the more affluent coming into our private banking or trust areas. We can also gear for those different forms of distribution as well.

I have three questions about pricing: (1) Can it be priced cheaper due to leveraging our existing forms of distribution? (2) Does affinity alone really make the difference that we think it will? (3) Should the product look any different tomorrow than it does today?

I think this explains better how the products are sold by the various forms of distribution that we have. A platform banker is the average banker that writes a loan or a certificate of deposit as you walk in the door. We feel that we will be able to add more insurance products to their form of distribution over the next three to five years, as their level of knowledge and learning curve increases. They target primarily mass market sales to middle-income America. This is really the area that the European bancassurance model reaches—those levels of customers that many insurance companies and agents don't feel that they can afford to reach. The products here include annuities, SPL, term, that simple form of UL that I mentioned, and eventually long-term care.

P&C agents offer a real opportunity for business-related insurance. They are calling in commercial customers every day presenting risk management types of programs to them. We feel that we can leverage that with their commercial customers selling personal and commercial lines, disability income, long-term care, traditional life, as well as individual group health insurance. The Series 7 investment consultants really are primarily marketing these products to their existing book of business. Their target is middle- to upper-income, investment-oriented consumers. The products include anything from variable annuities to term insurance, much to our surprise; there's also traditional and variable UL, long-term care, and disability income on a small level. There are some advanced sales opportunities here, but it's really more of an "oh, by the way," kind of sale as opposed to the sales of typical million dollar round-table type producers.

The dedicated life representatives present a fair amount of opportunity for the banks. The target market here is private banking and trust customers in the major markets around the country. The average net worth of each of these people in a private banking area is generally a quarter of a million dollars excluding their homes, and a quarter of a million dollars of annual income. The trust customers have an average net worth of at least \$2 million and in some international markets, several tens of millions of dollars. Here the focus is on the need for advanced estate planning. Their product lines include everything from term insurance to variable second to die. Right now with the programs that I have helped to start, and those that I have been involved with, we are seeing an average premium of about \$50,000, and neither one of the programs is at full capacity right now. It appears to be a good way of reaching those customers. Our expectations for these producers is at a top of the table in the annual renewable term (ART) production of about \$355,000 a year of annual commissions.

If you look at the top four categories—the platform bankers, the P&C agents, the Series 7 representatives and the dedicated life representatives—in the program that I'm currently in, that represents nearly 3,000 agents able to distribute different insurance products. It's a fairly good number when you compare that to some of the other insurance companies that may only have 1,500 or 2,000 agents out there selling. I think we have a fair opportunity to get into the marketplace. As for independent contractors, there are a couple of intentions. One, we are trying to figure out if there's a market for the specialty or niche areas. Some examples of that would be working with our mortgage customers, deferred compensation, the corporate-owned life insurance market, group-and employer-sponsored plans, and the more complicated types of things. We feel that there's a market to offer those types of products to our customers. But we don't want to put the financial commitment behind it until we have proven it. The questions we have are, one, is there enough business? Two, do we like the representative, and should we hire that

individual? Does he or she fit into the company or the organization culturally? It helps us to get immediate wrap-up time in those product areas without the large investment that I mentioned earlier.

The key here with independent contractors—that is, utilizing insurance agents from any of your companies that might already be working with some of our customers, or some of our bankers in a different area—is establishing relationships. But a number of cases involved introducing agents from an insurance company that are truly an agent of XYZ company, and suggesting that they go out on joint calls with our employee benefit people, or 401(k) people, or whatever the case might be. What we are finding is a real possessiveness of those bankers towards their customers, and they are very cautious as to what reps they will allow to do joint calls with them. I think one of the key things is integrating those relationships as well as we can.

For these to really take hold, we need more awareness by the bank and by the consumer. I think that insurance is available through the banks themselves. Looking toward the future in terms of compensation, I guess what I'd like to do is just compare it to the movie "Field of Dreams." They said, "If you build it, they will come." If we use the WalMart theory, and combine that with the utilization of existing bank distribution, we can reduce the compensation to reflect utilizing our existing infrastructure. Then can we make the product more competitive through lower prices and then make up the profit on greater volume? Again, the WalMart theory.

When it comes to low load examples, I guess I wonder myself what truly is customer value? Do we need to look at insurance company cash flow versus customer perceptions of what is value to them? An example of that might be today we have no-load and low-load UL policies available in a fair number. However, the commission savings is generally contributed to or added to the cash value of the policy and having them increase more quickly than a fully loaded product. But what is more important at the end of the month from the consumer's point of view: a greater increase in cash value in their policy, or having a lower premium, thereby allowing it to fit into their budget more affordably? The question is what to do with the commission savings. It's certainly the question we're looking at and we're trying to build some product designs for our distribution.

I'm not sure if any of you are familiar with the phrase "best practices." The best way I could describe it now is, one of my areas that reports to me has six people in it. They all do the same thing everyday, and each person does the same thing as the other one. Best practices is looking at six different sets of eyes, personalities, and forms of gifts and talents. If one of those six people can say, If we do this differ-

ently, we can either (1) do it cheaper, (2) do it faster, or (3) increase revenue. Can we apply that best practice to the other five people and gain greater efficiencies and make more money?

If we take that same best practices approach and apply it to the insurance industry, in fact, I think the insurance industry is already starting to recognize it. One example would be IUS. What we found is that some of the insurance companies have been able to outsource the teleunderwriting services because (1) they don't want to build it in-house; (2) they find that it's cheaper to have it outsourced; or (3) they want to see if it works for themselves. Another example would be the Underwriters Group in Harrisburg, Pennsylvania. I'm not sure if any of you are familiar with them. They have taken on a great deal of the "back room" functions and new business processing between the agent and the insurance company. This has given the insurance companies an opportunity to speed up the delivery policies and gain greater efficiency.

A third example is Western National. Western National is a little more unique in terms of their investment management, as you probably are all well aware of. They were owned by CONSECO for a number of years before they were spun off and bought ultimately by American General. CONSECO was doing all their investment management, as they still do today. In a situation like that, Western National felt that CONSECO could do a better job than they could in investment management, in terms of volume and buying opportunities and so forth. We may see more of these types of examples going forward.

Distribution expenses, as I mentioned earlier, will shift. The big platform here consists of the following concepts: utilizing existing resources, the current bank personnel, and the current bricks and mortar sitting on many corners in most communities. It gives us an opportunity to dilute the expense of product delivery over a multitude of products: credit cards, car loans, home equity loans, ATM cash cards, certificates of deposit, and a whole host of products, each in an effort to reduce the cost of delivery of each of those products. As far as the dedicated agents go, this is really Marty's crystal ball looking forward, I think many dedicated or independent agents are still going to be out there in the world of tomorrow. But I think they are going to function just a little bit differently, in terms of how they get their customers and what logo is on their business card. I think you will see a large number of independent agents or dedicated agents working for banks with the bank logo on their business card. I have hired a number of them myself. Those that do not are in the smaller towns. Smaller community banks will find themselves aligning more closely with banks to prospect into their customer base and take advantage of the affinity that I mentioned earlier. I think we almost recognize banks

as the profitable source of distribution for insurance companies. In my mind, it is more of an opportunity than it is competition.

I will finish up on subject of the best practices. Does ownership for banks make sense? Whether it does or doesn't at this point in time, we have much to learn about each others' industries. Once we understand each other better, we can collectively be able to reduce redundancies, become more efficient, and ultimately, more profitable. To do that we'll have to prepare for the possible Glass-Steagall reform. Also, we'll have to work on educating and cross-training each other integrating into the different cultures. That, I think is the most crucial piece. There are huge differences between the insurance culture and the banking culture.

I will turn to distribution channels. This has really been talked about a lot among the three presentations. Certainly, there are banks, broker/dealers (Charles Schwab getting into the business just a few weeks ago in big way), wirehouses, and so forth. Direct marketing—what you're looking at is not great penetration, but certainly lower costs and more profitability on first-sale basis.

Concerning fee-only and fee-based financial planners, one of the things that's very interesting about that is that the consumer views them as being an objective expert—somebody that isn't just looking out for their own personal pocketbook. If that person says they need a million dollars of whole life insurance coverage, the consumer is more apt to buy it. Employers too are another form of distribution of which we need to be aware. Many of these employers are making products such as group life, and group UL, and group variable UL available to their employees. They make it look like a benefit, although it's voluntary. Long-term care is another one that a lot of companies have been adding.

Although unproven, I think the Internet has a lot of potential for the insurance industry. These forms of distribution bring increased competitive pressures to all of us. Hopefully, they will help us become more profitable and eventually more consumer oriented.

Regarding future trends, one would be willingness to change and think "outside the box." I hear that phrase a little bit too often and I'm guilty of using it myself. I think what we have to do is throw the box away and put our heads together to collectively try to develop what this industry is going to look like going forward. Strategic alliances and a joint venture are more likely, but I think banks need to make that happen. Banks are going to need to put their arrogance and need for control aside, and be able to work hand in hand with the insurance industry. I also believe that variable and investment-related products will continue their appeal, particularly to the younger customers between the ages of 25 and 50. One of the things, I think,

that will be important in the banking industry is looking at the financial planning consultant, the consultative type of sales approach. Much like the relationship type of selling that the insurance industry has been involved with for a number of years.

In summary, I guess what I mentioned has really been a shift in distribution. I think that some of the associated expenses along with that distribution will call for outsourcing or a best practices approach. I think we'll all figure out who does what better than the other, and take advantage of that going forward. Private-label, proprietary products are going to become more and more common. Reduced cost due to the leverage of bank distribution will have an impact on the change in the pricing of products going forward. Joint ventures and strategic alliances may be more likely than actual ownership or acquisitions going forward. As a final statement, I would say that we need to look beyond our bottom lines today, and look at what we can contribute to our society collectively. If we put our heads together, we can certainly provide a lot more benefit to the average customer going forward if we do it together.

From the Floor: What kind of financial and medical underwriting can be done over the phone?

Mr. Murphy: We are now in the process of further developing this. It gets very involved. The process is primarily to sell the plan and sell the amount of insurance. The individual could complete an underwriting application while on the phone. Alternatively, we could send out the application and wait for it to come back. Fidelity is really a distributor and a marketer, and we can also manufacture products. One of the things we will not be doing initially, and I suspect we might not be doing forever, is medically underwriting this business. We will be working with a reinsurer who will give us the best reinsurance rates they can, and will do the medical underwriting at their facility. Don't ever underestimate technology. The technology of communications is critical in this process. The use of phones, the linkage into expert systems, the notification back for the issue process occurs by means of linked communication vehicles.

From the Floor: I wonder if you could give us a comment or two on the compensation of the sales representative. What I'm interested in is whether or not they can see a direct link between sales, and whether the phone representative gets some kind of incentive compensation.

Mr. Murphy: There are two different kinds of compensation plans. One is for the investor centers and the other is for the phone representatives. In both cases, the base compensation is salary. But in both cases, there is an incentive. With the phone representatives, the incentive is really related not only to sales, although

that's a big element. Compensation may also be related to the number of customers that they made contact with, and other kinds of measures of effectiveness and customer service. It's similar in the investor center. And so there is a pass-on of initial premium basis points in the way of a commission. When I say "basis points," I want to specify it's not asset based. It's one time only, based upon sales. The amount of money that they get is not measured in whole percentages. It's measured in relatively few basis points.

From the Floor: Will the representative have to take half of his or her total compensation as variable?

Mr. Murphy: Remember, at the investor center, that representative is not only selling insurance products but also selling many other things as well. Saying half of his compensation is variable is probably a reasonable thing to say. He will be measured on many different things, not just completed sales. He will be measured on customers served, quality of interactions, and so on.

Mr. Roy Goldman: My question deals with products like variable UL and variable annuities. Do you see those as products that will be sold without face-to-face contact?

Mr. Murphy: I think right now there are a few in our company who believe that variable UL could be sold without a face-to-face contact. It is just too complex a product. But let me describe a scenario that might emerge. When we start selling term insurance on the phone, people are going to become very familiar with that term insurance product, both our company representatives and our customers. Allow me to add a couple of mutual funds to that product. Put a different wrapper on the combination and call it variable UL. Have I simplified the process enough to get somebody to do it over the phone? I know they'll do term insurance over the phone. I know they do a lot of mutual funds over the phone, but can they put the two together? Right now there are a few in our company who could be convinced that would work, but it could be a different story in two years.