RECORD, Volume 23, No. 3*

Washington Annual Meeting
October 26–29, 1997

Session 79PD
Bank Alliance Niche for Insurers

Track: Smaller Insurance Company
Key words: Product Development, Marketing

Moderator: PAUL J. SULEK
Panelists: JOHN K. HILLMAN†
STEVEN M. LANDBERG‡
JULIE L. WILLIAMS§
Recorder: PAUL J. SULEK

Summary: This panel:

- *discusses the insurance product offerings of banks and identifies what an insurer can do to be selected as the preferred product provider,*
- *considers the advantages of a small-company niche focus,*
- *presents historical cases that attempt to explain why affinity marketing through retailers and large financial institutions has not always worked, and*
- *explains the implications of federal banking regulations on state-regulated insurers.*

Mr. Paul J. Sulek: The Bank Alliance Niche for Insurers is a title and concept that I am comfortable with. As a smaller company, we cannot successfully be all things to all people. We have to target those markets and relationships that will allow us to succeed. Although this session is sponsored by the Smaller Insurance Company Section and some of its content will to focus on smaller companies, if you have a large-company affiliation and perspective, we invite you to stay because much of what will be discussed will apply to you as well.

We have three panelists. Each speaker is a guest of the Society, and each brings a unique perspective to the bank alliance niche for companies. Julie Williams is the

†Mr. Hillman, not a member of the sponsoring organizations, is President of Philadelphia Financial Group in Blue Bell, PA.

‡Mr. Landberg, not a member of the sponsoring organizations, is a Principal at Sibson & Company in New York, NY.

§Ms. Williams, not a member of the sponsoring organizations, is Chief Counsel at the Office of the Comptroller of the Currency in Washington, DC.

chief counsel at the Office of the Comptroller of Currency (OCC). She will provide a brief, historical perspective and will tell us about the regulatory environment. Steve Landberg, who's with Sibson & Company, will give us the perspective of the banks. Finally, John Hillman, president of Philadelphia Financial Group, will tell us about the life company side of the relationship and will give us something of a case study along those lines.

As I mentioned, Julie Williams is the chief counsel at the OCC. Before being appointed to that position, she served as deputy chief counsel at the OCC, with responsibilities for legislation and regulatory matters. Since 1993, she has led the OCC's regulatory review program, a comprehensive review of all the regulations of the OCC. Julie is also responsible for the OCC's bank organization and structure division, which handles the corporate applications and licensing matters that are referred to OCC headquarters. Prior to joining the OCC in 1993, Julie was the senior deputy chief counsel at the Office of Thrift Supervision (OTS), with responsibilities for regulation and legislation, corporate and securities, and general law divisions of the OTS chief counsel's office. Prior to that, she held other positions with the OTS and its predecessor agency. Before her government service, she was an attorney with a law firm. She's the author of *Savings Institutions: Mergers, Acquisitions & Conversions*, a law journal, NY Law Publishers, 1988. She's also the author of numerous articles and conference materials on regulations for depository institutions, financial services, securities, and corporate law matters, and has lectured on these and related topics at conferences and law schools. As I mentioned, Julie will give us a historical background in the regulatory environment.

Ms. Julie L. Williams: I'm going to try to take a broad sweep and give you some context and background about the involvement of banks, with a focus on national banks, because that's the type of institution that my agency regulates, and their involvement in insurance activities. National banks today, asset-size at least, comprise close to 60% of the total assets of depository institutions in the U.S. The number of national banks relative to all depository institutions is about one-third, but they tend to be the larger institutions throughout the country.

The source of their authority to become involved in insurance activities traces to two sections in the National Bank Act, and in some respects, sometimes there is some misunderstanding about that fundamental starting point. These are very, very old sections in the National Bank Act. One section, which dates to the original National Bank Act—it was called the National Currency Act, I think—was enacted in 1863. It authorizes national banks to engage in "the business of banking and to exercise powers that are incidental thereto." Shortly after the turn of the century, a separate authority was enacted by Congress that specifically addresses insurance activities by national banks, and that is one that authorizes national banks that are located in places with a population of 5,000 or less to act as insurance agents for companies that are authorized to do business in the particular state in question. So, the historical backdrop of the source of bank insurance powers and ability to be involved in insurance activities are these two sections. The oldest one that I referred to is Section 24. The so-called place of 5,000 authority that I referred to is known as Section 92.

The types of insurance activities that have been authorized over the years for national banks, pursuant to the very general language that authorizes national banks to engage in the business of banking and activities incidental to banking, have evolved. The activity really began in the 1960s, it began to accelerate in the 1970s, and it continued to grow in the 1980s and in this decade as well. So this is not a new development or a new phenomenon. The OCC has authorized and in some cases where there have been challenges, courts have upheld, the ability of banks under their business-of-banking and incidental powers authority, to provide various types of credit life and credit disability insurance; other types of insurance designed to reduce the credit risk to a bank in connection with a borrower, not necessarily insurance that has to be insurance directly tied to collateral, however; municipal bond insurance, the ability to sell fixed and variable annuities, and a recent product development, acting as a reinsurer of mortgage insurance. All these activities, as I said, have been found to be within the scope of the ability of banks to engage in the business of banking and activities incidental to banking.

The key development in the sequence of authorizations of these types of activities was a decision by the Supreme Court in 1995 in the VALIC case. That case involved the sale of both fixed and variable annuities, and the question there was whether that was an activity that was permissible for a national bank, again, under this business-of-banking incidental to banking authority. The Supreme Court, in a nine-to-zero decision, upheld a decision of the Comptroller of the Currency, finding the activity to be permissible, and in the course of rendering that decision, announced some very important views about the flexibility and adaptability of the activities permissible for national banks under the business-of-banking incidental to banking authority. So, our view at the OCC as to the sort of flexibility available today for banks being involved in various types of insurance and insurance-related activities is that there remains some significant, yet untapped opportunities for national banks in this area, pursuant to that source of authority.

The other source of national bank authority to sell insurance, this is agency-only, is the specific authority that is contained in Section 92. This is a very short section, and for the few words in it has probably prompted more litigation per word, or per punctuation mark, than anything I've run across in a long time. It authorizes national banks that are located and doing business in places with a population of

5,000 or less inhabitants, as determined by the last census, to act as agent to basically sell any kind of insurance. Since the 1960s there has been a fairly steady development of interpretation, often accompanied by litigation, about the scope of that particular authority. One of the key developments actually occurred in the 1960s, when the OCC took the position that authority for a bank located in a place of 5,000 could be satisfied by a bank branch located in a place of 5,000. It didn't have to be the head office of the bank located in that small town or municipal unit.

There has been—and I wasn't joking when I said punctuation—litigation that went to the Supreme Court over whether this section actually was repealed inadvertently sometime in the late 1910s, because a congressional scrivener placed some punctuation marks in the wrong place in connection with amendments that were being made to some related provisions in the law. The court concluded that, in fact, the section had not been repealed accidentally, and that led to further litigation to try to define the scope of the authority.

Most recently, important developments with respect to this source of authority for banks to sell insurance have included a Supreme Court decision in 1996 that concluded that the specific authority granted national banks to sell insurance under that section preempted a Florida law that purported to restrict and prevent national banks from selling insurance in Florida. We at the OCC have also recently been dealing with a variety of questions about what can be done outside the place of 5,000 in terms of marketing. Can a bank have its insurance agents, if they're based in the place of 5,000, go outside the city limits (to take a simple example, call on customers)? To what extent can you use the telephone? To what extent can you use the mail? To what extent can you use the Internet? If you're doing mailings, do you have to put the mailings in the mailbox in the place of 5,000? You can conjure up a whole variety of scenarios. Our basic approach has been to say that the bank has to have its agency base in the place of 5,000, but we don't impose any geographical restrictions on the way the insurance can be marketed from that base. So if an insurance agent in a given state has the ability to roam around the state and meet with customers, we would say that the national-bank-associated agent has that same flexibility to go outside of city limits.

The active issues here in the context of banks' involvement in insurance activities are questions of, how is that involvement regulated, both by the OCC and by the states? There are two facets that are current topics. One is the question of federal preemption. To what extent does that authority that national banks have under federal law supersede restrictions that states might impose on the banks' ability to sell insurance? Then there is just the question of, very closely related to that, the role of the states in regulating what national banks and national bank subsidiaries do, relative to what the OCC does in connection with those activities.

Our position on the question of preemption, and also on the question of the OCC versus the state regulatory role, is that we do not want to be insurance regulators. The Controller has said that personally to everybody who will listen. We have a concern, which I think in the broader scheme of things is a relatively narrow concern, with certain types of state laws that may impose unique restrictions on the ability of banks to operate, and in our view, the ability of banks to exercise powers that they've been granted under federal law. We do not contest the ability of the states to regulate in the same way they would regulate anybody else, things such as licensing qualifications, continuing education, market conduct, and to the extent that national banks or national bank subsidiaries are involved in activities such as reserve requirements or solvency standards. Those, from our perspective, are not in dispute.

From the banking industry perspective, we will see going forward increased interest in furthering their own activities in the insurance area, getting into types of activities that are complementary to the more traditional banking activities that they conduct, and also a very increased interest in trying to figure out ways to partner with companies in the insurance business, so that the customer linkages and the retail outlet factors that the banks have today can be married with the product and marketing expertise that is available through participants in the insurance industry. So, I think this is an area where there has been a lot of activity and a great deal of evolution in the last few years. I would expect to see that continue going forward through the end of this decade.

Mr. Sulek: Steve Landberg will give the bank's perspective next. Steve is a partner heading the insurance practice for Sibson & Company, a leading business strategy and organizational effectiveness consulting firm. Steve has extensive experience consulting to major banks and insurers, where he focuses on enhancing their marketing, sales, and distribution channel effectiveness, as well as new product business development. He has been creating bank insurance businesses with his client as a business manager since 1983. Prior to joining Sibson, his corporate experience included running the insurance and investment businesses for Citibank through the Asia Pacific region, as well as having been senior vice president of business development and planning for Citicorp's global insurance group. He is formerly a manager of business development for G.E. Capital and a marketing director for Pepsi-Cola. Steve is a member of the Strategic Leadership Forum and is chairperson of its insurance strategy group. He has been a speaker at numerous insurance and banking industry association meeting in North America, Europe, and Asia. He has published several articles on bank insurance marketing in *Banks in Insurance Report and Bank Securities Monthly.* Steve was a contributing author to the book, *Integrated Direct Marketing*, by Graeme McCorkell, 1996, Kogan Page Chicago, Illinois.

Mr. Steven M. Landberg:. Having been both a bank insurance executive with Citibank and having consulted to both the insurers and the banks looking at this business, I believe there's a growing interest in the bank insurance channel, but there are really very limited, true success models out there for people to follow. In light of that, how many of you are currently selling annuities through banks? (Perhaps about half.) How many are actually selling life insurance products? (Perhaps 25%.) My presentation will focus on three aspects: profiling the U.S. bank insurance market, highlighting current life insurance opportunities, and discussing how to best take advantage of those opportunities.

To set the stage, we need to recognize that bank deposits have lost about half their share of households' discretionary financial assets during the last ten years, having gone from about 40% of households' financial assets in 1986 to approximately 23% in 1996. Individual equities and packaged investment products, such as mutual funds and annuities, have taken a significant share of the consumer's financial wallet. The life insurance reserves position on the consumer's balance sheet is relatively small, but it's been stable during this time period. Along with that shift, you've seen a broadening of the household ownership of equities and mutual funds, which have now become much more widespread. Today, about 40% of all households own equities, and about 30% own mutual funds. Consumers have clearly taken greater control over their own financial situation, and they have shifted their assets to higher risk and reward investment opportunities. Unfortunately, the trend has been for fewer households to own individual life insurance, declining from approximately 50% in 1989 to less than 40% today. There's clearly an opportunity to more efficiently reach the broader middle market with simpler life products, potentially through banks, to reverse this trend.

Along with the tremendous growth in financial assets, there has been a corresponding growth among financial advisers, who have grown approximately 30% during the last ten-year period. Approximately 35,000 bank investment representatives are now selling both insurance and investment products, up from virtually none ten years ago. About half those bank investment representatives work part-time, or work through third-party marketing firms. The number of retail security brokers and financial planners has been growing robustly during this time period. But corresponding to flat new life insurance sales growth, and the declining proportion of household ownership, the number of life agents has declined by more than 15% during the last ten years, as I'm sure you're all aware.

So why are banks pursuing insurance and investment business opportunities? We recently conducted a proprietary market research study of retail bank investment and insurance businesses, and we found that today they are primarily interested in building retail investment capabilities to maintain their share of customer relationships (86%), to grow new customer relationships (67%), and to increase their share of the consumers' financial assets (86%). Most banks have moved beyond the learning phase for bank insurance and bank investment opportunities, only 13% are responding to that today. You would have found that up on the 75% range approximately five or six years ago. But we found that only 25–40% are actually focusing on improving profitability. We believe that this will be important for banks to continue to focus on during the next five years. That's an opportunity, as you position your programs with banks, to differentiate and focus on the profitability of those programs, not just hold onto the customer relationships.

We also found that bank retail investment businesses tend to be relying on customers with assets of less than $200,000. Approximately 75% of bank retail investment business customers have less than $200,000 of discretionary financial assets. This is consistent with the overall U.S. population. However, those customers account for less than 20% of total household assets. Not surprising, we found that banks that primarily serve households with less than $100,000 of discretionary financial assets tend to be unprofitable. Clearly, more efficient distribution approaches are required if you want to pursue that kind of strategy. Larger banks tend to focus more on higher-net-worth households, but in general, U.S. banks need to increasingly focus on higher-net-worth segments to be profitable, in both the bank insurance and investment arena.

We also found that profitable retail investment businesses primarily sell third-party mutual funds, fixed, and then variable annuities. Unprofitable bank retail investment and insurance businesses primarily sell individual stocks and bonds, largely discount brokerage, and proprietary mutual funds. While low profitability from discount brokerage is understandable, it would seem that proprietary funds should be very profitable. Unfortunately, most bank proprietary funds have not reached sizes to achieve economies of scale by distributing solely through their own bank. I think some of the activity that you're seeing with banks buying brokerage operations are attempts to try to distribute beyond their own retail channels. This is also potentially true for the manufacturing of life insurance products where only a few of the largest banks have even tried to attempt it, but the economies of scale necessary to be efficient at doing this will be very hard for banks to achieve through their own retail distribution channels.

Banks, in terms of distribution, are primarily using either branch platform representatives or their own broker-dealers to distribute these kinds of products. Smaller banks are also using third-party marketing firms, like John, as well as Essex, Great Northern Annuity, Bankmark and a number of other players, to give them the expertise and leverage necessary to be successful in these businesses. We also found that unprofitable businesses relied upon discount brokerage and trust departments as distribution channels rather than products or services sold through other distribution channels. I hope that's clear.

Despite wanting to broaden their customer relationships and hold onto consumers' financial assets, banks today are primarily still distributing products—insurance products, investment products, bank products—to their customer base. Insurance bank product representatives and investment representatives are all calling on the same customer, trying to build their own relationships with little incentives or capabilities to cross-sell each other's products. More advanced banks, such as First Union with its cap account, or Citibank with its CitiGold relationship-oriented banking, are attempts to deliver the bank through relationship managers or coordinator roles, generally focusing on higher-net-worth households. As you approach banks, for you to be successful with them, clearly you should understand how they are trying to approach their customer bases in terms of trying to deliver either products or deliver relationship management.

The biggest issue that we find for bank insurance success is crossing the cultural boundaries between insurance and bank services. The life insurers' sales culture tends to be solutions-oriented, focused on growth, very proactive, and very results- and external customer-driven. That contrasts significantly with how the banks' culture exists today. It tends to be more procedural-oriented, focusing on customer satisfaction and responsiveness to their requests. Banks tend to have a lot of shared responsibility among teams and tend to be internally support-driven. This has resulted in banks having a higher degree of trust from their customers because they are, in fact, not sales-driven. However, to succeed with life insurance and investment products, banks are increasingly trying to build a sales culture within their environment, and that is a very difficult challenge for them to pursue at this time.

I'd now like to further discuss bank alliance niche opportunities for life insurers in this evolving landscape. Bank insurance opportunities fall into six major business opportunities, in terms of serving their existing customer bases. Each has very different risk, complexity, and return characteristics that need to be considered as you pursue these kinds of businesses. I will briefly touch on five of those segments and then focus the remaining time on the savings-oriented life insurance segment. Starting with the simplest business features first banks have utilized insurance as a benefit for selling bank products, such as giving away free travel accident insurance on credit cards, among other opportunities. Second, banks have evolved into credit-related insurance products, such as life insurance, and insurance that covers outstanding balances on mortgages or personal loans, but there are also opportunities for them to protect collateral, such as fire and automobile insurance protection as well, and you're seeing an increasing interest in that arena today. The third category is direct marketing programs. Usually five to six direct marketing programs are going against an existing customer base to be successful here. The most typical products are AD&D, hospital income, and term life, as I'm sure you're well aware. The fourth business segment, savings-oriented life insurance, is where I believe the best opportunities are for life insurers today. I actually believe that going against the retail consumer base as well as the small business base (fifth) for business life opportunities represent's the biggest opportunities. Clearly, bank success with annuities is in this segment. The last segment, the risk management segment, is one where really only the larger commercial banks are even attempting to look at. You're seeing the convergence of both financial and insurance risks, and the use of financial reinsurance. Surplus relief is one example of where banks can play in this arena.

So what are banks actually doing today? Almost 40% of banks are currently selling insurance. In general, more of the larger banks are involved, but 26% of the smaller banks are already participating in this business. Julie's already described the regulatory environment, but I'd like to point out that about 50% of banks and thrifts can already sell any kind of insurance. About another 22%, in 14 states, can also sell only annuities. So in terms of the percentage of banks that are offering different products today, the highest sell is fixed annuities (87%) with variable annuities following (75%). Some of the selected life products beyond credit and mortgage insurance include whole or term life (60%) and variable life (35%). While annuities are somewhat developed, there is a greater degree of interest today in starting to sell life insurance products. I would suggest that the stock market volatility may shift some of their focus away from mutual funds and back to more stable life insurance products. A very small proportion of banks offer commercial and personal property and casualty or health insurance, though you're starting to see some interest growing in this arena as well. But currently, approximately 90% of what banks sell are annuity products, and 75% of that is fixed annuities. Despite projected growth in life, health, property, and casualty, annuities are still projected to represent 80% of banks' insurance sales by the year 2000. Life insurance is projected to grow three to four times during that time period, with rising interest from both banks as well as life insurers in this segment.

Now, while banks have rapidly grown their annuity sales, their actual share of annuities has been flat since 1992. Banks have been focusing more of their energy, as we mentioned earlier, on selling mutual funds, which has diverted some of their attention from the annuity business. In addition, I think annuity writers have also been broadening their distribution channels, pursuing stock brokers, financial planners, and specialized general agents in addition to banks in their own career agency system. Despite banks' sales growth in both mutual funds and annuities, their ability to be profitable in these businesses is a growing concern. Banks plan to improve their profitability by primarily growing their businesses to economic size. This will largely be achieved through adding new insurance and investment products to their mix, working with additional bank departments beyond just getting referrals from their own branches—there's an incredible constraint within the bank itself—and then adding new distribution approaches for insurance products, such as direct marketing and PC banking electronic channels to also grow their businesses. This is also from the survey.

Life insurance CEOs also believe that banks offer attractive growth opportunities. Today, 65% of life CEOs believe that banks are the most effective channel for selling annuities, and 90% believe that they have the most attractive growth prospects. On the life insurance side, only 25% of life CEOs think that banks are currently the most effective channel, but 70% think that they have attractive growth prospects. More than half the largest life insurers today are already selling through banks, and clearly more and more will add to that trend.

So let’s talk about how you can potentially take advantage of these growing bank distribution opportunities. I think that you need to recognize that bank distribution of life insurance has fundamentally, or will continue to, shift into two different types of value propositions or delivery mechanisms. Both high-end solutions delivery and low-cost product providers are becoming the distribution winners, not only within banks, but outside banks as well, versus the traditional distributor providing a product, advice, and a relationship. Consumers are increasingly requiring a greater level of service and expertise, such as financial or estate planning, when buying life insurance, or are willing to purchase a competitively priced product through a more efficient distribution approach, such as direct marketing, bank distribution, or work site. This, therefore, generates some different opportunities for you to be pursuing within banks. Just putting an agent in a branch does not work. Some banks are beginning to utilize well-designed direct marketing programs for their convenience-oriented middle-market customers. Fleet Bank was my example of doing that, though it seems to have taken a different turn during the last several weeks. Others are offering more sophisticated services through representatives outside of branches to target the emerging and affluent consumer segments as well as the business life insurance segment. Chase would be a good example of a bank pursuing those kinds of opportunities.

We believe that these bank segments offer the greatest opportunities for life insurers going forward, but each approach requires very different capabilities and an aligned distribution strategy to succeed. It is not sufficient for a life insurer to just offer its standard life products for banks. Those products, as well as the marketing, selling, and servicing support must be tailored for the bank environment. As life insurers you need to understand the bank's organizational structure and its motivations. In general, you need to please both the insurance agency, which will act as your supplier's gatekeeper to the bank, as well as the bank's relationship and product management organizations, which actually own the customer bases. You're going to need to work with both of them to be successful. As I mentioned earlier, getting access to the various bank customer bases is one of the key challenges that came up in our survey.

In terms of having a successful program, we believe you need a long-term perspective to create an alliance, versus just being a supplier to the bank. It's critical at first to align your objectives, your philosophies, and your market positioning at the outset to initiate a promising alliance. The next phase of pursuing your life cycle of a bank alliance usually involves creating some initial beachhead wins to gain broader organizational support for actually pursuing insurance. We generally recommend that those first programs be simple and have a high and rapid impact for each of the bank alliance partners to continue your level of interest. The most challenging phase is the third phase, which is where you're often attempting to broaden the products, customers, and channels to achieve greater economies of scale. This is, in fact, where I believe most of the larger banks are actually struggling in order to be successful. Finally, the last phase of a bank alliance program is where you would pursue executional excellence, database mining, and become an integral part of the bank. Some European banks are actually in this phase, but I'm not sure that I know of a U.S. bank that I would actually put in this stage of development.

So for you to be successful in pursuing a bank insurance program, I suggest four key areas of your focus. First is to re-engineer your products, support, and procedures in terms of overall program to succeed. Products need to be simpler and easier to sell, and it's generally recommended that you start with savings versus pure risk life insurance products to be successful in a bank. Second, support must be fast and responsive for these large bank insurance agencies, and this requires strong training programs, quality information systems, and high service level standards. Third, sales and marketing processes versus your career agency system need to be designed to be very simple and efficient. Banks also generally require high commission levels and incentives and, in fact, are often looking for profit sharing as well. Fourth, it requires studying the bank environment and pursuing a proactive partnership to integrate insurance into the fabric of the bank.

From an insurance perspective, pursuing multiple channels requires careful orchestration. It's complex to pursue multiple channels. You need to overcome the fear of your career agency distribution channel, but rapidly the issue becomes, how will you orchestrate multiple distribution channels? As we look at life insurers, we see very complex organizational structures, conflicts, and inefficiencies when trying to actually pursue multiple channels. Therefore, we think that for you to actively pursue this kind of program, you will need to resolve a number of different issues, including your brand's positioning, your target market segment strategies, and what kind of pricing and commission structures you want to deal with. Among all these different distribution channels is manufacturing, marketing, or distribution and control of product design and customer service. These issues are now keeping life insurance CEOs awake at night. Which organizational levers need to be pulled to resolve these conflicts? Do I restructure the organization? Do I have to bring in new people and start training my organization to do very different things? How do I change my job design, my rewards, and my measurement systems to be successful here? How do I develop new business performance models and metrics? We find that each of these levers must be addressed to avoid channel conflicts and to pursue multiple channels through skilled organizational orchestration.

In summary, let me say that I believe that there are a number of very specific, attractive bank insurance opportunities for life insurers. We believe it's critical to have both focused strategies and an aligned organization to succeed in these bank insurance niches. Strategy must have very targeted market segments among the bank's customer bases to be successful. You need to really differentiate your value propositions in terms of how those life products will be delivered to those targets. You need a well-orchestrated approach among your various distribution channels to succeed strategically. From an organizational perspective, you need to become aligned with your bank alliance partner as well as with each of the bank's organizational entities. You will need to work to overcome the cultural barriers and integrate insurance selling into the bank as part of your responsibility in this program. Finally, you must pursue a dedicated organizational structure and reward system to pursue bank insurance opportunities, if you truly wish to succeed in this complex business.

Mr. Sulek: John Hillman is the president of Philadelphia Financial Group. He's been involved in the life insurance industry for 15 years. He spent eight years with Arthur Andersen and Company, a big-six accounting firm. At Arthur Andersen, he was a member of the national insurance practice group. He's held senior financial positions at Philadelphia Life Insurance Company and American Guardian Life Assurance Company. Mr. Hillman is a certified public accountant, a chartered life underwriter, a chartered financial consultant, and a fellow of the Life Management Institute. John will talk about the bank alliance niche for insurers, a case study, and perhaps he'll also tell us about the hazards of doing it too well, vis-à-vis possible acquisitions.

Mr. John K. Hillman: I'd like to tell you the story of what we've done over the past few years. This is a case study, and sometimes when you speak about case studies it seems a little frightening because most of the time a case study in the business school is either a complete failure that people want to learn from, or a tremendous success that people want to emulate. We're happy with our progress to date, and Paul is right, it has drawn some attraction from other parties and has caused our company to be acquired recently. But I don't stand in front of you and tell you that we have all the answers, this is a complex problem that we're dealing with. But I'd like to tell you a little bit about our company so that you have some perspective of where my comments are coming from, and then also share with you our experience over the last three years.

One of the unique things about our organization, Philadelphia Financial Group, is that we are a third-party marketer. But we focus exclusively on life insurance programs. We started our organization in 1995, and we really grew it out of a joint venture with a large, well-known third-party marketing organization that was selling annuity products across the country in a number of banks. We decided to focus on life insurance exclusively for a couple reasons. We were a late entry into the annuity game. We attempted, a number of years ago, to acquire a third-party marketer, and it did not work out. Right around 1995, we concluded that the annuity business, from the distribution side, had very tight margins, was very competitive, and was very mature. Many banks were internalizing their programs, and many carriers were acquiring those few third-party marketers that existed. We thought we were at the beginning of a new curve, and that was the sale of life insurance products. We thought it would be easier for us to make an impact in life insurance and get banks to talk to us. Because we were one of the few companies out there that had some life insurance expertise, most of our third-party marketing competitors grew out of the distribution of mutual funds and brokerage services. We were correct in that assumption.

One other assumption, before we started the company, was that we thought that the regulatory environment would remain vague enough so that we'd have at least perhaps five years—we didn't want much more than five years—where banks, both large and small, would be required to work with a company like ours, as opposed to have a number of options. Now, we were incorrect in that assumption. The regulatory climate has changed rapidly and continues to cause what I would view as inert bankers to be even more inert in moving forward on some of these initiatives.

As I said, we began our company in 1995. We became operational in 1996, and we wrote about $5 million in first-year life insurance premium in 1996. This year we are on target to write first-year premium of about $22 million at a number of banks. Even though I say we don't do annuities, we have done about $35 million of annuities just as our relationship develops. So we've been reasonably happy with that success, but it is nowhere near what's happening on the annuity side and what some of your companies, I'm sure, are doing on the annuity side.

We work with a number of different clients. We work with about 25 institutions, and they range from large money center banks, you're all familiar with their names, to banks that are as small as $1 billion in core deposits. We had, at that point in time, selected not to work with banks that had less than $1 billion dollars in deposits, because from the life insurance perspective, we thought the systems and the programs that we were introducing were not conducive to be efficient, and we couldn't make money at it. We also have an interesting breadth of programs. We work with bank platform personnel and customer service representatives, trying to license them and get them to sell types of life insurance products. We have featured a number of upscale programs where we introduce top-of-the-table producers into the private bank or the trust bank, and they go off and create business opportunities on their own. We've done some direct marketing, and we've also tried to leverage off of existing distribution systems. As I look back on the programs that we have done to date, I can tell you that the upscale market is the most difficult for organizations like ours, mainly because of the very high up-front cost to get a life insurance professional into the private bank, and then to get that culture to mesh well with a trust or a private bank client. Our average upscale producer will produce about $350,000 of first-year premium, which is a good level of production. However, we thought we would just walk in and be able to really control the client. Nine times out of ten, what would happen is that we would walk in, our representative would certainly run illustrations and propose to the client, but when it came time to actually putting a signature on an application, the local life insurance agent, or the golfing buddy, or whomever it was, came out of the woodwork, and we were in a very competitive situation. So our view right now, is that upscale programs are a lot more competitive and aren't really leveraging the inherent infrastructure that a bank has, because that market is well served. But we have done those upscale programs, and we continue to do them.

One of the challenges we faced was a small life insurance affiliated with us, so we had to create value. One lesson that most banks learned over the past, probably 15 years in the annuity business was the role of a third-party marketing organization. It has become increasingly difficult for a third-party marketer to add value and to extract something from the commission flow. It's very difficult to make a living splitting commissions if you don't deliver any services. So we have been reasonably creative when trying to package life insurance products and programs. We have created Internet tools, both for the distribution of life insurance vis-à-vis Quick Quote and those sort of things, and also Internet-related programs to manage the underwriting process and the tracking of business. Banks are not used to nontransactional-oriented life insurance sales. The sales cycle, to go from an application to actually a policy receipt, is long, much longer than the bank is used to. We have created some administrative systems and communication tools to get a bank comfortable with that. So, we have seen that as a requirement in the life insurance game.

I have a few pages of what I called market conditions, and rather than read them to you, I just want to really make a few additional observations. Again, if you went back to 1995 and as a third-party marketer you started calling on insurance companies to get product, to take product into financial institutions, it was very difficult. Many of insurers didn't want to talk to us. They were a little embarrassed; they were concerned about channel conflict with their existing distribution systems. We used to go in the back door a great deal. That has changed dramatically, and we get called on by a number of large, well-known insurance carriers. I think Steve's executive survey is right on. I have sat with some of the largest insurance companies' CEOs and chatted about why they want to be in the bank insurance game, and I think they do truly believe that it's real. So in the beginning, insurance companies didn't want to talk to us. That's bad news. In addition, in the beginning banks really wanted to talk to us, but all they wanted to do was talk. They didn't want to do anything, and that was also bad news.

Really one of the biggest challenges in this business, from a life insurance perspective, is identifying and defining life insurance at a bank. It can mean many things. If you open *American Banker* and you read about a success story at one bank, it's probably 40% accurate, but also it varies by bank. We have clients who believe a life insurance program is selling long-term care insurance to their 50-plus club. Some bank clients believe that featuring term insurance on their Internet site is selling life insurance. Others feel that offering it in their private bank, to their corporate customers, is a life insurance program. So a real challenge is trying to help a bank identify, for its institution, and it varies, by institution, what life insurance should be. After you define what it should be, then the idea is, well, how do we distribute it effectively and efficiently? So, a really critical point, at least that we've seen over time, is that people really don't know what life insurance is, and it varies a lot.

The other thing that people constantly talk about is alternative distribution. I think that's somewhat of a misnomer, the insurers that I have worked with in this vein, view alternative distribution as the distribution of the same products and the same services through an alternative means. That really is not what this is about. Insurers that take that approach, I believe, will ultimately be disappointed. This is an alternative distribution system, but it requires alternative products and alternative processes and services, and that's critical. So really, my major comments with respect to market conditions are that we need to help banks define insurance.

That's what we do; we spend a great deal of our time doing that. We also have to help our insurance manufacturers move forward with really recognizing this as a true alternative distribution system.

I have a comment here about traditional third-party marketers, and if you look at companies such as Essex, Bankmark, Laughlin, our own company, Philadelphia Financial, we have repositioned ourselves a number of times over the last few years, and we probably will continue. I think the good news for insurance carriers is that this really, ultimately, is a carrier game. Long term, insurance carriers make significant inroads with financial institutions. I don't think that banks, as they move forward and get more sophisticated, will have a need for organizations that don't manufacture products.

I don't want this to sound like pure doom and gloom, and with all due respect to what's happening on Wall Street, we're very bullish about the insurance market. I believe it is real. I believe that the mysterious middle market does exist somewhere within the financial institution marketplace. If you were involved with annuity programs, as a number of you were, in the mid-1980s most banks were concerned about disintermediation of their assets and were concerned that the annuity products were going to cannibalize all their CD lists. I think there's been a shift in thinking, and banks are very concerned with disintermediation of their customers. That really opened the door for us, as an industry, to help them retain their customer's with what I'll call needs-based products. But that is a dramatic challenge for both the banks and for us, to help them sell a needs-based product. They are used to executing transactions, and the sale of a life insurance product is not a transaction. They really do have extensive databases on their customers, and probably borrowing from their credit-card brethren, they are beginning to really understand buying patterns and life events and life cycles. As insurers we need to perhaps marry some products to those events and identify ways to piggyback on what the bank is doing in that regard.

From an actuarial perspective, again, not being an actuary, but it would seem to me that this is an exciting time. I do think that this is a different distribution system, and I think that with thoughtful design of some products, that, again, is married to life cycle events, (we are working with a number of carriers on this) that couples a number of needs, in nontraditional ways, you will have a real opportunity to do something unique.

Now, the challenge is, you need to have the resources and commitment to see it through to the other side. I don't think that this market will happen, inside of banks, that it'll happen tomorrow, but I think it is there. I think, though, the critical aspect for both the actuarial as well as the operations side of insurance companies is to change the process and the product. We have spent a number of years as insurance carriers trying to attract and retain agents. We have traditionally tried to deliver good service to them, but we've also really focused exclusively, in my mind, on product features, the best rates, the lowest cost of insurance the lowest loads, the best commissions, or whatever. We've done ourselves a disservice because if you talk about annuity products inside of banks, they want to know your rate, they want to know your bonus, they want to know whether you can net commissions and those sorts of things. As you move into life insurance, I think we have a sliver of an opportunity to get away from that, and not just constantly chat about features, but try to do a little bit of what the mutual fund industry has done, and try to get consumers to think about where they are in their lives, and what they need to do. Ultimately that may actually create the opportunity for increased profitability on products, and not just through the lowering of commissions, because somehow you feel that you have this captive audience. I don't think a bank market is a captive audience. The products are being marketed very heavily by mutual funds and other service providers, and the bank is worried about that.

The other thing that I believe is a great opportunity is that the banks are evolving. We have worked with a number of multimillion dollar banks that have really made great strides in understanding our business. As they understand more, they become better clients for us and also recognize better the opportunities for their customers. Finally, in terms of reinsurance opportunities, I'm sure a number of you over the years have tried to create agent captives. They, in my opinion, seem to be little more than a way to pay an agent even more commission. I believe with banks, and people used the phrase "partnering" before, a number of large banks are very actively waiting for the regulatory environment to change because they are interested in the underwriting side of this. Now, we have tried to educate them that the underwriting side is not just underwriting profits, but also underwriting losses and target surplus and the like. But I believe that, given the size of these distribution systems, I think that you do have the opportunity to create a real partnership with somebody who may actually be able to stand up and be a partner, and not just an absorber of yet more loads.

From the challenge side, we've talked to many carriers over the years, large and small, and I see some consistent issues. As I said earlier, I think that most carriers that we have chatted with really don't understand that this is a new distribution system and it requires different things. You cannot use last year's universal life product and simplify the application and hope that it works. You need to do some additional product tinkering, and we are working with carriers on that.

We have made a decision, as a marketing organization, with respect to selection of distribution channels inside the bank for life insurance. We've hired upscale agents and we've paid them a salary and then hoped to collect money on the back end while they generate new business. We've gone in and created a new distribution system. We have gone backward, and we have moved away from that. There is a reasonably large infrastructure of investment counselors and representatives inside banks. Rather than fight for referrals, rather than confuse the bank customer one more time, we have focused right now on trying to create products that make an easy transition for that investment counselor, from annuities and mutual funds into life insurance, and intensive training and wholesaling support around that, to get them comfortable with the move.

We have a bank client in Texas that is a good model for us. We have put through 35 investment counselors, and they're selling a single-premium whole life product, an annuity look-alike product, a replacement for the chronic annuity buyer who's been wandering in and out of the branch for years, who is being sold fixed annuities. We have now just recently hired about four insurance specialists to pyramid on top of that. Our investment counselors are all very comfortable selling that product, and that bank will sell quite a bit of that product for us this year. Now they are more comfortable with understanding and identifying a need, recognizing a long-term-care opportunity, recognizing a permanent insurance opportunity, and so we've seen a nice migration there. The challenge is to be patient enough to integrate with existing distribution channels; we think that's key. Obviously, I've said before that I think the focus is really on packaging, as opposed to features. The bank customer's are not being called upon by an insurance agent, they're not being handed 50 different illustrations and asking their certified public accountant to review them. They have a need, and they need to be convinced that they have that need, and be sold an appropriate product. I think how you sell the product to them is as important as what you sell, and that's from the investment counselor or the bank's perspective. They may believe in the product, they may say that this is the perfect product for us, but if it is hard to sell, and I would reference American General's experience with the lollipop, it just isn't going to happen. That was an efficient way to perhaps do some underwriting inside a branch, but it was not accepted by the distribution system.

I think that the other challenge that our industry isn't willing to recognize at the outset is that the compliance environment inside the four walls of a financial institution is very high. As an institution, it has a very high attention level to doing things properly. As we design products and marketing material and associated training, we need to pay attention to that. Again, finally, I think you need to define what insurance is.

Let's discuss things to do. First, I think you have to commit to the channel. Again, some insurance carriers that we work with view this alternative distribution as the elephant graveyard, and everybody whom we deal with is kind of one step out the door. I think that carriers need to really commit to this channel. They recognize it's a long-term prospect, it is going to deliver results, they have to be ready to invest in it. Second, I think you have to also be open to the changing bank marketplace. With the level of mergers & acquisitions that's going on out there, we don't know who our customers are, and they change regularly. But every time they change, they get bigger and become a more viable prospect for both partnering as well as distribution. But I do believe that you have to recognize that your bank client and your bank partner is actively in play almost every day of the week, no matter how large it is. I think we need to consider new products. I think using shelf products is a recipe for disaster.

When I talk about technology, and we have provided just technological services to some financial institutions, I don't think, from a carrier's perspective or from an actuary's perspective, that the concept of electronic underwriting, or some sort of Internet whizbang approach is really as important as understanding how banks use technology to view their customers. They are making great strides in this, in my opinion, focused on life cycle events and on buying patterns and the like. The more, as insurance carriers and product manufacturers, we understand the way banks view their customers and use technology to view and monitor their customers, our products will succeed. For the smaller carriers, I think you need to focus within the segment. Clearly, as Paul said at the outset, you cannot be everything to everyone. Again, with the exception of a recent development at Fleet Bank, where it has just kind of shut down the entire program and decided to do an exclusive deal with the Travelers on all fronts, I think those types of arrangements will be few and far between. I think you need to, as a carrier, identify your own strengths, and stay within that niche. Then finally, patience is a virtue, and it's also an absorber of resources. I think you need to balance those very carefully, and try to identify what you want to do, stick to it, and commit to it.

Mr. E. Perry Kupferman: In some of the markets that I travel in, all the automobile manufacturers have provided a three-year, 36,000-mile warranty; they've dabbled with it. Generally the information I have is that they've typically underpriced it. Now they've moved on and they offer an extra charge for the consumer on something called an extended warranty, which takes that three years out to five years, and they've typically underpriced it. But that's GM, Ford, and Chrysler and they have an infinite supply of funds, so it doesn't matter much. I went out and bought a computer recently. I forget if it was from Best Buy or Computer City, and for $15, I was offered a three-year extended service contract beyond the 90 days that the manufacturer provided. I wonder if, in fact, that $15 is enough to cover that exposure, that liability that has been assumed. In the case of some of the banks that are now beginning to manufacture insurance products, are they doing something that may or may not be similar? There's some word on the street about debt cancellation contracts; that may or may not be good for the consumer. The bank may charge this and may not establish a liability; it will handle future claims out of current cash flow. That cancellation contract will cover deaths, disabilities, unemployment, and failure to repay the loan. Should insurance be left to the insurance experts, or should the banks be allowed to move into this area, vis-à- vis some of the experiences I just cited?

Ms. Williams: Well, I think that the banking industry is moving gingerly into areas that involve principal risk. The main activities, in recent years at least, have been struggles that have related to being able to provide insurance in an agency capacity. The major litigation, for example, that I referred to deals with selling insurance, not producing it, as you say. Debt cancellation contracts, say, a particular line of business that was litigated some time ago, and is something that banks are allowed to do, they don't do very much of it, as far as we can tell, and we do generally monitor that sort of thing. It has been a type of activity, in terms of risk assumption, that has been handled as part of a sort of general supervisory process of our oversight of the banks and is not treated as an underwriting of insurance. The question of whether it was permissible, and how it was characterized as being banking or insurance was an issue that was litigated some time ago. I look at the types of activities that banks are interested in becoming involved in, in a principal capacity, and as I said they're proceeding fairly gingerly. Most recently, for example, in the mortgage insurance reinsurance area, they are seeking to do it through bank subsidiaries that are regulated by the particular states that are the cognizant regulators in the same way as any other particular insurance company that is engaged in that particular line of business. Most of the mortgage reinsurance captives that we have seen over the course of the last year are all going to Vermont. I'm getting to be great friends with the people in the Vermont insurance department, as I send them copies of our documents on the particular applications that we get. We've been very clear in our approvals, and we expect that these particular bank subsidiaries will be regulated like anybody else, by the Vermont insurance department.

From the Floor: I have a two-part question. With regard to our companies, primarily small- and medium-sized life companies, when it comes to banks and insurance, I don't know what it is that we've been able to tell them to excite them. Everything thing that I've been trying to tell them, after Julie and a number of others have spoken to our group, that there is a future for small companies in the banks and insurance mix. First, what kind of message can I bring them to give them more of an insight, that they can be players other than remaining within their niche? Second, for Julie, from the perspective of market conduct in insurance companies, and the plaintiffs' lawyers, the plaintiffs bar, they look at insurance companies as making money. But when they start looking at the marketing practices of banks, will realize that banks, in their minds, are money. They don't just make money; they are money. I guess the question is, when you talk to some of these banking institutions, what kind of message can you give them on the kind of compliance, from an insurance perspective, they will need to be able to put in place, in connection with market conduct problems that may arise, instead of relying on the insurance company?

Ms. Williams: I can start with the tail end of the question and work back. We expect that banks or bank subsidiaries that are selling insurance will comply with generally applicable standards, market conduct standards. We've also, in advisory that we issued to all the national banks, indicated that we would like to see a variety of additional things. In some cases, we would expect to see banks in connection with their insurance sales. There are certainly issues. Whenever an insured depository institution is selling products that are both insured and uninsured, of making sure that there's good disclosure given to customers so that reasonable customer's have information about the basic characteristics of the product that they're buying, that you try as hard as you can to minimize customer confusion. There will always to be situations where it doesn't matter how many acknowledgment forms you have people sign or how much signage you have around the office, there will be people for whom, it will just not click. So it is probably impossible to achieve 100% perfection here, but that we expect banks to do various things, whether they're selling insurance or whether they're selling other types of investment products, to make sure that customers understand the nature of the product that they're getting.

We also think it's very important that banks do, basically, due diligence in connection with the companies that they're contracting with and the product that they're going to offer through the bank channel, so that they're providing product that is appropriate for their customers and they're providing product that is coming from a solid source. So, we see this as being sort of a two-part question of compliance. There are the kind of baseline compliance requirements that we would expect that banks would follow that apply to any company that is doing the same thing, with the particular product. There are also certain issues that are unique to banks, where we think that they need to be particularly careful. Those are the sorts of things, in the latter category, that our examiners do and will, in the future, be checking on. I thought the comment about the bank compliance environment is a very good one. In many of our larger banks, for example, we have examiners who are there all the time. Their office is there; our compliance examiners are resident in the nation's largest banks. Every single day they walk around, checking things. So, banks are very attuned to a compliance mentality, and they have, in many cases, a constant, daily reinforcement of that, because our examiners are there on site.

Mr. Landberg: When I was at Citibank, I always used to teach all the operations people that good compliance is good long-term business. Whether or not it was what was appropriate from a regulatory point of view, that was really the right way for you to hold onto and build customer relationships. So I think it's the right way to do business. In terms of what you can take back to your management team, I guess the first thing is that it is happening. The success models are still evolving, and now is an interesting time to figure out how to play. I think it's appropriate, if one decides to do this. You have put together a strategy with a good business case. What exactly do you think you will get out of going into this business? Do you think that's a realistic thing to pursue? Is that of sufficient size for your organization to warrant the specific focus and expertise that's necessary to pursue that? I know it's a round-about answer, but I think that's really the tradeoff you have to feel comfortable about. Then you have to be able to convince them that's the right thing for them to do as well. There is a risk, obviously, with pursuing this.

Mr. Hillman: We're a small company and we've written quite a bit of business relative to our basic block. It's a challenge in the sense of, you're no smaller than some of the largest insurance companies when it comes to bank insurance marketing. They have not really hit the ball out of the park yet either. Perhaps, if in fact the model was true, you may be more nimble, have less channel conflict with an existing distribution system. You may be able to focus more regionally, because there is a strong regional affiliation within the bank marketplace, and perhaps there might be an opportunity within smaller regionals that are also community-type banks, to get at them through existing distribution systems.