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Industry Convergence—Bank Participation

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Summary: With the impending passage of HR10, industry convergence is expected to continue at a feverish pace. This session addresses the multitude of issues companies face as banks and insurers become partners. Panelists discuss:

- *Legal issues surrounding mergers of banks and insurers, including the focus of federal regulators.*
- *Recent applications by insurers for thrift charters and acquisitions of thrifts.*
- *Successful bancassurance models in other parts of the world and "best practices" applicable in the U.S.*
- *U.S. bank distribution models.*
- *Financial implications of the manufacturers and distributors having the same parent, including impact on product development, underwriting, and transfer pricing.*
- *Impact on carriers relying on banks for distribution when those banks merge with other carriers.*

Mr. Barry Jacobson: I'm the moderator for this session, and I'm going to give a layout of what you're going to hear and then I'll introduce each of the speakers.

First up is Les Cantlay. Les will talk about industry convergence mostly from the U.K. perspective, but will also touch on other parts of the world. He will talk about what has happened elsewhere, who have been the winners and losers, and what kind of lessons we can learn about what might be happening there.

Second, will be Marla Berman Lewitus, who is going to talk about the Citigroup story. Everyone has heard about the merger of Citicorp and Travelers, and I

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thought it would be worthwhile to hear why the merger happened, how it was able to happen, and what the implications are. Marla will also finish up by giving a status on HR10, which is now called SF900.

Finally, a discussion of consolidation and convergence wouldn't be complete without talking about distribution. Bob Shapiro, our last speaker, has spent a lot of time on mergers and acquisitions (M&As) from the distribution side. We've asked Bob to talk to us about the distribution side of consolidation and convergence.

Les Cantlay is from the U.K. He is managing director of the Oryon Corporation, which is a consulting firm that specializes in financial services. Les's experience is entirely in financial services. He joined General Accident Life in 1973. In 1988, he left General Accident to develop the Thomson Barrett Organization, which started as a training company, and then successfully expanded its services to embrace all aspects of the distribution process. Les has personally worked on distribution projects in the U.K, Europe, Australia, and Southeast Asia.

The business of Thomson Barrett was acquired by CSI, a subsidiary of General American. Following this, Les left to set up the Oryon Corporation. In the last few years, Les has been involved in a number of leading-edge distribution projects, including designing an innovative method of selling term life in the U.S. bancassurance market. This has been likened to cracking the code, which has enabled access to the considerable underserved middle market.

Mr. Leslie James Cantlay: What I plan to cover is a background to consolidation and convergence in the U.K. market. I really want to look at the playing field for about the last ten years. I also want to look at the winners and losers because I think there are a number of lessons to be learned from the winners and losers in the U.K. market. I think you're probably about to go through the same sort of consolidation, and see more mergers between banks and insurance companies, as Marla is going to talk about. We've had a fair number of bank and insurance company mergers in the U.K. We will also look at whether any of these lessons are actually applicable as to where the U.S. market is heading.

Changes to the Playing Field Over the Past Ten Years

Let's look at the playing field some 10-12 years ago. There were approximately 300 life insurers operating in the U.K. The distribution methodology was equally split between brokers and career agents, with career agents being the dominant force. There were between five and 10 banks and 22,000 brokers. The brokers, in fact, have been retitled independent financial advisors. I'll talk a little bit more about them shortly.

At that time, the banks' involvement with insurance was mainly as brokers. They did not see it as particularly strategic. Following the Financial Services Act, they were just about to have to make a decision as to whether they remained as independent financial advisors, or whether they represented only one company. Regulation certainly helped in that respect because it forced the banks to make a decision. When banks started to have to make that sort of a decision, distribution of insurance products became much more strategic, something I think we have not really seen here in the U.S. yet.

Let's look at the playing field in late 1999. We've lost a considerable number of life insurers for a variety of reasons. Some from M&As and the consolidation process, but some simply decided to get out of the market, some retreated, some even folded in that period. We've seen quite a considerable growth in the number of banks. It has been fairly slow, but nevertheless it is significant as far as the U.K. is concerned. These numbers come from the building societies demutualizing and turning themselves into banks, from an increasing activity from new type banks and direct banks, and, last, from the implementation of what I call the insurance company bank, which is a fairly new phenomenon in the U.K.

The brokers have remained significantly consistent and robust in terms of the distribution potential in the U.K. The numbers haven't really changed very much during these ten years. What has changed is 22,000 brokerage firms representing something like 75,000 registered individuals, the people who are licensed to actually sell life and investment products in the U.K. regime. That took a little bit of a dip over the ten years, but has built back to about the 75,000 mark now.

That has been remarkably robust, and you could be forgiven for thinking that any insurance company that met its strategy to serve the brokers would have actually done pretty well. You probably would have been wrong because that wasn't really what happened, although this has been the most robust distribution channel.

Let's look for a minute at the changing consumer in the U.K. We certainly have had new patterns of income and wealth distribution. We have an aging population and a growing professional segment in the market that are both acquiring wealth at a faster rate than would have been previously imagined.

We have seen considerable change in people's perception of the responsibility for providing for themselves as opposed to reliance on the state. People have become more financially aware, and they're very open to cross selling, although they don't particularly like a one-stop financial shop. There is a contradiction as far as the public is concerned.

As far as the U.K. buying population, two other issues have become very important. First of all, there is a huge perception of distrust of financial services businesses in the U.K.; it is much more prevalent in the U.K. than I think it is in the U.S. That is primarily because, for the last six to seven years, there has been a sustained attack on financial services institutions from the members of the press, and the government hasn't really helped. That, together with people having a greater financial awareness, has really made the public much more discerning.

However, on the other side, there are many more reasons for the public to actually buy financial services products over a 25-year period. Disposable income has almost doubled. People are more aware of their responsibilities and actually more aware of the financial products that they could buy. There are a couple of factors that actually are causing the impact of those trends to be slightly meshed. I believe these two things are very important.

The public is, clearly, becoming much more aware of value for money. More importantly, a lot of U.K. public is very much more aware of value for effort, and that is something that I think we're going to hear a lot more about. It is one of the things that is stopping the development of financial services on the Internet because there is a perceived negativeness about the value for effort. Value for effort, I think, is when you look at something like Amazon.com, and you can use the one-click settings. One click actually does the whole transaction for you; you don't have to do anything else. That's value for effort. Other research that I have seen, as far as the U.K. public is concerned, is that they're becoming much more interested in that side of the equation. It is not just value for money, but value for effort, which I think is something that is particularly interesting.

Bancassurance is still growing and it is still predicted to grow in places like France and Portugal. The U.K.'s inability to match France and Portugal stems from the fact that there's a different political system. It's very clear to see that bancassurance has worked extremely well in countries that are very socially democratic and where the relationship between the individual and the state has been changing financially. I think that really helped the French make huge steps in bancassurance. That has not been the case in the U.K. I make the point because I don't see the conditions being the same in the U.S. either. I don’t ever see the U.S. and France being sufficiently similar to see the sort of implementation of bancassurance that you would see in countries like France.

There are, however, many different meanings for bancassurance. Over the years, I've tried to split them into four different levels, and it's interesting to see where the U.S. is in relation to these levels.

Level one is to add some agency sales people. It can work short-term, but it is not particularly successful longer term.

Level two is to be much more culturally sensitive and recruit some people from the bank to sell insurance.

Level three is important because it's the first time banking and insurance become an integrated product range. It's a move away from the product silo mentality. The person who is representing financial sales in the bank sells the complete product range.

The highest or fourth level is to totally integrate the culture.

What’s interesting is that some of the companies in the U.K. took 25 years to evolve through levels one and two. We implemented a level three bancassurance operation in Malaysia where we did have that integrated product range, and we had dedicated financial consultants.

The best example of level four I can give in the U.K. is that National Australia Bank actually acquired three regional banks in the U.K., and set about to just eliminate the difference between insurance and banking. It's a very good example of convergence. They put in place one insurance company that they developed themselves, which was literally virtual. The people between the life insurance company and the banks are all interchangeable. The head of the life insurance company goes on to have a significant role in the bank and vice versa. The platform bankers are trained to respond to consumers' financial needs across the whole range of banking and insurance products. I think that probably works the best. I think we've probably got quite a long way to go in relation to that in the U.S., although I think you might see Citibank trying to move in that direction.

What has been the banks' strategic response over these ten years? One of the banks' biggest problems today, as far as the retail network goes, is that 80% of the profit generally comes from 3% of the customer base. That's a frightening statistic, and it's getting worse. One of the ways that you can start to improve that is really by making cross-selling an imperative and by widening the range of products that your customer holds with the bank. That was one of the prime drivers for banks moving aggressively into the insurance business in the U.K.

They had a number of choices to make as they started off; they were choices between becoming a single supplier, being in a relationship with a single supplier, or becoming a bank that was tied to an insurance company. In the early period of the ten years that we are looking back on, being tied to an insurance company was the most favored option. As these ties were being set up, insurance companies were looking to develop joint ventures, and eventually the banks were looking to do their own manufacturing. We have seen the whole continuum along that range. The other thing that I think they took as fairly strategic was this integrated financial services products range that became a strategic imperative.

Many insurance companies simply ignored what was happening; others thought that they could be partners in distribution and stop at that level. In other words, it was a super agency agreement that integrated more of the processes between the insurance company and the bank. Other insurance companies decided to go for a formal joint venture. Some decided that they would just try and compete with the new bancassurance. One or two since decided that the best option was really to converge. The convergence option has probably been driven by the banks' multi-insurance industry.

Winners and Losers from the Past Ten Years

Who are the winners and losers? Well, I think more banks won than lost. I'd say NatWest, National Australia Bank, and Royal Bank have all been significant winners in the bancassurance equation. The definition of winning is a little loose. It's my perception.

The losers were the banks that were primarily building societies that converted, but that did not aggressively move towards establishing their own manufacturing.

On the other side, with the insurance companies, there have been fewer winners. One thing that stands out is that the companies that have decided to ignore bancassurance and see it as competition and as a threat have, I think, lost out a good bit. Whereas the companies who have embraced bancassurance, and probably did more than they should have in trying to help the banks get into the business, actually have won considerable advantages.

A very good example is General Accident and Commercial Union, now merged together as CGU. Their strategy was really to go very quickly from tying a lot of the smaller banks on single supplier relationships, acquiring joint ventures, even to offer their administration systems and expertise on a third-party basis to banks to help establish them. I think that gave General Accident a much wider appreciation of the market and the needs of banks early on. This allowed them to win not only these joint ventures, but also allowed them to win a lot of just single supplier relationships.

On the other hand, there are examples like Friends Provident. It tied with Abbey National, and Abbey National went on to create its own life company. Friends Provident didn't get a look in. Standard Life is another similar example. It tied to the Halifax Bank, a great distribution opportunity, but then kept it pretty much at the level of the tie. It did actually move into joint venture as far as unit trust business was concerned. I think the lesson to be learned is to embrace it sooner rather than later, because it's inevitable, at the end of the day, that banks will want to get into manufacturing of life insurance.

It's quite interesting to talk about the insurers' fight back. I don't know if you've been tracking the insurance banks. Both Prudential and Standard Life are two of the largest players in the U.K. in the last two to three years. They have established their own direct bank and have been tremendously successful in terms of customer base. Prudential is attracting something like 555,000 customers and $6.7 billion in savings. They actually did create two brands. They kept the Prudential brand for existing customers, and they created a new brand called Egg for getting new customers in the door. I think there is probably some differential pricing in there. Standard Life very quickly built up a huge customer base.

None of these banks have reached profitability yet, but they do have some tremendous advantages. They don't have any legacy systems. They should have the best possible opportunity to profile these customers and make cross-selling work on a direct basis. But that's still to be seen.

One of the things driving recent consolidation is the European market, the wish to be bigger and better. It's not so much consolidation in the U.K. industry, but probably consolidation of the European industry. Can they be really better? I don't know. It could be questioned. I don't know how many of you noticed what happened to NatWest Bank in the last couple of months, but it is an interesting tale.

NatWest made a bid for Legal and General, one of the largest insurance companies in the U.K., and the market did not react terribly well, probably because NatWest does not have a great track record in doing M&As. NatWest's share price actually started to fall rather than going in the opposite direction, which triggered a bid from a very small bank, the Bank of Scotland, which the market judged as rather outrageous, but very brave; that bid is still running.

What really has happened is that the NatWest bid for Legal and General had fallen apart, and they will have to find a new suitor.

One of the rationales that Bank of Scotland gave, as well as delivering a fairly vicious attack on the management, was that NatWest had become a little too large and it wanted to run back on the size of the business and also the actual physical side. It was really telling the NatWest management it ought to stick to its knitting. It's perhaps ironic that the Bank of Scotland is the largest bank that drives credits on life companies at the same time, and can be a key to them actually diversifying as well.

Clearly, people are looking at M&As and consolidations as a way of actually consolidating and getting access to more distribution. Many of the banks that have natural distribution for the middle market are creating their own life companies and have also bought life companies that have distribution and an independent financial advisor market to ensure that they plug that gap as well.

An interesting point is that in the early days, a lot of banks would do joint ventures thinking that one of the best things they could get from the insurance industry was the systems. The banks almost always found that the systems really weren't worth a carrot, and they've had to invest substantially in these systems.

The Future for the U.S. and the World

The real issue for the future that is actually driving consolidation is customer base migration. Bancassurance probably has to be accepted as a step on the way to electronic trading. The customers who are using the Internet in the U.K. are probably the most profitable customers of the bank network, and that leaves the banks with the possibility of having increasingly unprofitable customers using the branch retail network. There has already been some political fallout as banks have intimated that they will probably migrate customer bases and dump the unprofitable customers. The government is already saying that they don't really want to see that happen.

If we look at the U.S. situation, I don't believe we'd see comparisons that are hugely relevant. In the U.K., we're much more integrated in terms of investment products and life products. I know that you're very successful in the U.S. in selling investment products through the bank, and tend to beat yourselves up a little bit about your inability to sell protection products to the bank. It's probably no easier in Europe or in the U.K. It's just that we have the products somewhat more bundled together.

One of the things that really does stop bancassurance from developing in the U.S. in the way that it has in other places is there's still a huge product silo mentality; banks are buying specific products from insurers and not buying the whole insurance company package. Another item stopping bancassurance in the U.S. is that there is little leverage in the prime distribution asset—the branch network. I know that the branch networks might be disappearing; nevertheless, if you are to build volume in bancassurance, then you really do have to use the branch network and not just the annuity fellows.

Bancassurance has a huge middle market opportunity. Will banks get into manufacturing and start to chase embedded value? I don't know. Clearly, that was one of the motivating factors in the U.K. and Europe. In the U.K., increases in embedded value were sought after, and the percentage of bank profit being supplied by the insurance operation started to increase during this ten-year period.

I have a good example, although it's not from the U.K. Credit Lyonnais purchased the Union des Assurances Federales in 1970. By 1994, it became a top ten insurer. They quoted it for $1.2 billion. The investment advisors said they had a 42% premium on embedded value, or a 116% return on initial investment. It's generally thought that a merger, an equal merger of an insurer and a bank, probably can increase a return on equity of around 1%. And I think that's probably still worthwhile for people to chase.

What are the Lessons for the U.S. Market?

- Insurers need to collaborate more effectively with banks.
- Volume is built by utilizing the branch network.
- Accept responsibility for financial planning because, at the end of the day, they are both your customers and the bank's, and they should have your view of financial planning.

One thing I always say is good broker general agents will always endure in any marketplace despite what everyone might say.

Banks have to service the complete range of consumer needs as the strategic issue. Banks must recognize that the use of their channel is part of the electronic migration, and that is probably a change in what happened in Europe. Banks must maintain good agent value. No one has really been able to replace the agent in the affluent market in the U.K. The banks have tried and, despite having some serious private banking opportunities, a lot of that business is still run by the broker market. Banks must move into manufacturing with some caution. The ones that credit new businesses in the U.K. find something out very quickly. Because bank balance sheets tend to be cyclical, crediting new business might have looked like a good idea in the first place, but, when the balance sheet was on the downside, the banks didn't particularly want to take all the cash storing of the new business credit.

Finally, in an information rich and electronically convenient environment, it really will be the consumers who decide the what, why, when, and how to of buying financial products.

Mr. Jacobson: Let's talk about Citigroup. Being an actuary in Citigroup has been an interesting ride for me over the last year. Before the merger happened, the biggest regulatory issue I faced was how do you get a product approved in New Jersey. By a show of hands, how many of you know what KYC is? What about OFAC? Okay. What about section 23A? Everybody knows 7702. You know 1035. Not many people know about 23A, and that's a major item. It has been an interesting world with insurance regulation now being a part of bank regulation.

Marla Berman Lewitus is the senior vice president and general counsel at Travelers Life and Annuity, a member of Citigroup. Until recently, Marla served as associate general counsel of corporate law for Citigroup. In that capacity, she was closely involved in the Travelers and Citicorp merger. During her eight years in the corporate law department of Citigroup and its predecessors, Marla focused primarily on M&As, including the acquisition of Travelers, Aetna's property and casualty insurance businesses, and Salomon Inc. She also focused on various security law matters. Marla received her J.D. from New York University School of Law and an undergraduate degree from Georgetown University.

Ms. Marla Berman Lewitus: I'm here to talk to you about Citigroup. Citigroup was formed in October of 1998 in a merger of equals transaction between Citicorp and Travelers Group. Citicorp, as you all probably know, was primarily a bank. It was primarily a banking, lending, and credit card operation. It had a big foreign exchange component and a lot of asset management businesses as well.

A big thing about Citicorp is that it was global. Citicorp was operating in a lot of different countries. I don't know how many, but we're operating in about 100 now, and most of that was on the Citicorp side since Travelers was mostly domestic U.S. operations.

Travelers was a more diversified financial services company doing business in four different segments; the investment services businesses through Salomon Smith Barney (SSB), life insurance business, property & casualty (P&C) insurance business, and consumer finance operations.

This was a merger of equals from a management and organizational standpoint. It was technically accomplished through Travelers' acquisition of Citicorp. Citicorp merged into a wholly-owned subsidiary of Travelers, and Travelers applied to the Federal Reserve Board to become a bank holding company.

Under existing law, forgetting HR10 for a minute, banks are not permitted to own insurance companies. But a new bank holding company has two years to bring itself into compliance with the law. You've got a two-year period where you can figure out what to do with things that don't fit. That period can be extended for up to three additional one-year periods if the Federal Reserve Board finds that such an extension would not be detrimental to the public interest.

The merger created one of the world's largest financial services companies. From a managerial standpoint, Citigroup is organized into three basic business parts: the Global Consumer Bank, the Global Corporate Investment Bank, and the asset management businesses. The Global Consumer Bank includes the domestic banking and lending operations and the credit card operations of Citicorp; it also includes the consumer finance operations (CitiFinancial) that have come from the Travelers side. The insurance operations include Travelers Life and Annuity, which is life insurance, and Primerica Life Insurance, which consists mostly of term life insurance. There is the Travelers Property/Casualty Corporation's personal lines of insurance, homeowners, and automobile. The international businesses have the Citibank banks, which are scattered all over the world, and E-Citi, which is our e-commerce initiative.

The Global Corporate Investment Bank included Salomon Smith Barney. We have been focusing on Citigroup as a combination of a bank and an insurance company. To further complicate our world, Salomon Smith Barney is our securities business. There are also a fair number of restrictions on the securities operations that banks can do, so there's another little wrench in the organization.

Citibank's global relationship banking and its emerging markets business also fit in the Global Corporate Investment Bank as does Travelers P&C commercial lines business. Basically, this is geared towards your corporate customer.

The asset management business, SSB Citi Asset Management, includes every asset management piece we have. Smith Barney is mutual funds. Salomon Brothers tends towards more institutional clients. This also includes Citi's asset management business and the global private bank of Citibank.

Why did we do this? On the consumer side, I think the merger gave us a phenomenal opportunity to combine some great distribution channels with a wide range of products. We have checking accounts, savings accounts, brokerage accounts, car insurance, homeowners insurance, life insurance, credit cards, mortgages, student loans, personal loans, and long-term-care insurance. Cross marketing, which I'll talk about a little more in a bit, is a way to marry the distribution and product manufacturing arms of the company. That becomes particularly important on the consumer side.

If you look at the different parts of the consumer businesses, the merger gives us a leading position in three areas, and in the other three areas it gives us a top-tier position.

For the corporate customers, the combination of Salomon Smith Barney and Citibank's global banking operations allows us to provide one-stop shopping on a global basis, which I think is more important nowadays on the corporate side than it is on the consumer side. It also lets us provide a full range of services to the corporate customer as well. The merger also strengthened the company's trading businesses. Salomon Smith Barney and Citicorp had complimentary strengths in these areas, and it provides a global platform upon which we can build our asset management businesses.

Basically, Citigroup is a company that can address all the financial needs of its customers and is able to compete with the foreign companies that sell all types of financial products that aren't living under the same restrictions that we in the U.S. are.

Regulatory Issues

We operate in a very highly regulated industry, and each part of the financial services business has its own regulator and its own rules and, in some cases, like in the insurance industry, it has a whole bunch of different regulators that it has to deal with. Instead of going through the whole regulatory scheme, I thought I would give you a sampling of some of the hotter issues that we're dealing with right now.

Anti-money laundering and know-your-customer roles have been getting a lot of press lately. What that basically means is you've got to know where your money is coming from. You've got to know the source of the funds, and you must know who's sending it to you. Citigroup has an anti-money laundering policy. Each business has to figure out how to appropriately train and implement that policy because different issues are raised when you're selling a life insurance policy than when you're opening a checking account or doing wire transfers back and forth among different parts of a global organization.

The global privacy promise: Citigroup, even before the merger, recognized that privacy is becoming increasingly important and drawing a lot more attention, so we went through and picked out what we were doing to safeguard all of our customer information. We put out a privacy promise to every customer. Again, each business unit has its own implementation plan for that promise because the insurance industry has medical information to deal with, which is different from credit information that the bank has. The privacy promise applies to every Citigroup customer. We'll get back to privacy when we talk about HR10.

Section 23B of the Federal Reserve Act is very similar to what everyone is used to in the insurance industry. It basically says that if you're doing business with affiliates, it must be fair. Because this is a bank regulatory thing, it says it has to be fair to banks. A bank can't do business with its affiliates on terms that are any less favorable to it than it could get from an unaffiliated party.

Section 23A of the Federal Reserve Act is a little more complicated, and I expect we'll all be hearing more about that in the next few months as well. It deals with what it calls covered transactions, primarily the extension of credit by a bank to its affiliates that are not within the bank chain. In the banking world, they talk about bank chain vehicles and corporate chain vehicles. You're either a bank, a bank subsidiary, or neither. If you're a bank or a bank subsidiary, you're not under suspicion and if you're a corporate chain, then you are. Therefore, 23A is something that will kick in more in the months to come.

I'm sure all of you are really sick of hearing about Y2K, but it hasn't gone away yet. We're still dealing with all of that. It's still taking up a fair amount of time and energy. One of the other reasons I mention Y2K is because it's an example for us of one of the areas where there's different regulatory schemes that were subject to cross over. We had to convince the federal government that, as part of a bank holding company, Travelers Life and Annuity has a decent Y2K compliance plan. We also had to convince the Connecticut Insurance Department of that. When we did our presentation for the federal government, the insurance department came and sat through the same presentation, which was a good thing because it meant we didn't have to do it again.

Cross-marketing at Citigroup means selling the product of one business through the distribution channel of another business. It's something Travelers did before the merger. Now that we have better distribution opportunities and more products, we've expanded a lot. We carefully monitor all of our cross-market activities on the legal side to make sure that we're complying with all of the regulatory rules. You have to make sure you're complying with the bank rules or the securities rules, or whatever. We get all the lawyers in on this just to figure it all out.

Currently, we have insurance agents who are marketing checking accounts, student loans, and credit cards. We have brokers marketing variable annuities, life insurance, mutual funds, and mortgage loans. The Primerica Personal Financial Analysts are selling almost everything; checking accounts, personal loans, variable annuities, personal lines insurance, and various mutual funds as well.

All of that is already going on under, if you will excuse the expression, the Citigroup umbrella. But under current laws, as we said, there are limits. There are limitations on the affiliations among banks, security firms, and insurance companies, and that's where HR10 comes in, which is now appropriately called S900, but nobody really knows what we're talking about if we call it that, so we still call it HR10.

What HR10 would basically do is permit full financial affiliation of banks, security firms and insurance companies. It would do that by repealing Glass-Steagall, which limits the affiliations between banks and securities companies, and it would amend the Bank Holding Company Act to provide that insurance would not be a prohibitive activity for a bank.

The real question here is whether the bill is going to increase the restrictions that are currently applicable to financial services companies sharing customer information. There have been a couple of movements to amend the bill to restrict the sharing of customer information with third parties and among affiliates of a company. This is not an easy one, and we'll just have to see what happens.

Thrift charters are interesting. For purposes of the bill, the only issue with thrift charters is, when the grandfathering goes away. A unitary thrift charter is this nifty thing that anyone can get today. It's going to go away. It's going to be repealed. Any company could apply to the office of thrift supervision to become a unitary thrift holding company and start off at thrift institutions. Thrifts are federal things. They can do all sorts of banking stuff.

The really interesting thing there is that there is no restriction, or there was no restriction about commercial or industrial companies owning thrift charters as well. When I talked about HR10, I said it would permit full financial affiliation of all three—banks, insurance companies, and securities firms. It does not permit a company like GM to own financial services companies. It doesn't mean anybody in the world can run a financial service business. It just means that if you're already in the financial services business, you can do all the different pieces of it.

One of the things that HR10 is likely to do is eliminate the unitary thrift charter provision and prohibit the transfer of thrift charters to commercial or manufacturing companies. The big question: if you're already a thrift company, what does that mean for you?

Mr. Jacobson: When I was recruiting for this session, I initially thought to call Bob Shapiro. Bob, as you know, has been very involved in the merger and acquisition field and he knows a lot of actuaries around the country. The Shapiro network was formed in 1987 and is managed by its president, Bob Shapiro. Bob has been a consultant investment banker to the insurance industry since 1965. He has extensive experience in M&As and strategic change in financial management. His experience includes work with hundreds of North American insurers, including almost all of the largest 50 companies. Bob has also worked with a number of European insurers and with non-insurance organizations seeking to develop, acquire, or divest significant insurance operations.

Bob is an FSA and a chartered life underwriter. He's a regular speaker and author on the management and diversification of insurance companies. Bob is a member of the executive committee of the Pacific Insurance Conference, and a trustee of the Actuarial Foundation. He has also served on the Board of Governors of the SOA.

Mr. Robert D. Shapiro: I'm going to talk about a parallel consolidation and convergence at the distribution side of the business that is going on at the same time as the businesses themselves, the manufacturing institutions are converging. I think one way to look at this is that there's a consolidation going on at the distribution level creating larger and larger distribution organizations having more and more power.

These former farm system agents have become free agents, and they're now consolidating to become self-sustaining leagues, and they're going to be formidable entities, you're not going to have 125,000-200,000 entities to deal with. I believe you're going to have a handful of large organizations in which these agents operate.

The convergence is a little different. I think the convergence that we see is around the customer, and it's affecting the way agents are looking at the business and the way the companies look at the business. I think there are two different concepts that are important to consider as you go on.

Underlying Marketplace and Industry Trends

Today, the public needs the life insurance industry, as we've always known it, less and less. It needs life insurance. It needs advice. But the traditional way of having a life industry is probably becoming irrelevant. Second, the way I summarize it is the individuals are taking responsibility for everything.

Competition is really different today. Look at the Schwabbs and the companies that are engaging customers in different ways. You'll find companies that are concerned about building relationships with customers and not policies. If I ever came back as something other than a life company, which I'm used to being, I would want to come back as a mutual fund because they seem to have great relationships. They engage customers on a no friction basis.

It's interesting to note that they're starting to build face-to-face distribution around this engagement platform that was direct; there is different recruiting, training, management, and consultation. It's a whole other model of face-to-face distribution going up around that.

In addition to the competition changing, we life insurers have to change dramatically in what we're doing. There's a fundamental change going on. The normal things we try to do to gin up the operations, push our products through more distribution systems, and add distribution systems really is flawed if you think in terms of the power going from the distribution to the consumer. The consumer being in power, pushing products through more channels, and adding more channels will just keep us measuring policies and not dealing with customers.

There is some support for the point I'm trying to make. The number of individual life policies that have been written within the last 15 years has declined on the average of 3% a year to the point that today we are at about 60% of the number of individual life policies that we wrote in 1983. Considering sale statistics in 1997 and growth rates by distribution system., there is an interesting phenomenon, one in which the growth in annual premiums from career systems is negative (-1), and the growth from independent systems like personal producing general agents (PPGAs) (+17%) and brokerage (+13%) is significantly positive. There's a change in where this business is coming from and the relative power of the distribution source.

When producers were asked by Prince about their perception of whether or not consolidation would happen to them in 1993, 2.7% foresaw a consolidation. In 1997, it was 41.6%. There has been a significant change in what's going on in the field.

Distribution Roll-ups

A part of all this, and probably one of the drivers of the changing perspective, are distribution roll-ups. I will spend most of the time on this.

The drivers of roll-ups are basically businesses that are set up to acquire agents. It could be at any level: brokers, general agencies, career agencies, worksite, and so on. They are bringing these things together with the hope of creating value through enhancing revenue potential, reducing expenses, enhancing customer loyalty, and creating special back offices. There are all sorts of different things that they talk about doing. Ultimately, most of them talk about going public and creating the value for the agent not only in the initial public offering (IPO), but in transforming income taxation of annual income to capital gains taxation.

I had not even heard the term roll-up in the industry 15 months ago. You see roll-ups going on in manufacturing firms and dental practices, but I wasn't paying much attention because that's not my business, and I don't know much about those businesses. When we took the first roll-up that we ran into and started looking for financing, what Wall Street, at least in some of the houses, said is, "Well, it's a nice idea. Conceptually, it makes sense. The most important thing is who's going to run this thing."

Dentists and manufacturers are different than life insurance agents. The life insurance agents are the best negotiators in the world, and they're the consummate entrepreneurs. How are you going to roll those people up into one entity? What Wall Street was saying was, "Don't bring us a fancy business plan. We know it works in other businesses. We have to be really careful about who's going to do it and how it's going to be structured because it's a much tougher animal." One thing to look at here is I don't think these will work as easily as in the other businesses. It's not easy to think of a $100 million roundtable of entrepreneurs giving up too much of their independence and not negotiating a pretty tough deal with whomever is buying them.

The roll-up drivers to the sponsors, which sometimes are Wall Street firms and insurance companies, are the rewards of the IPO, the benefits of being at the forefront of distribution consolidation so as to be able to, in some instances, acquire the distribution. Another driver is power in negotiating with the carriers if you're a Wall Street firm.

To the sellers and the agents, the drivers are: equity ownership, liquefaction of their ownership interest, performance enhancement opportunities to other products, higher growth dealer concessions that you might be able to negotiate, and professional and business relationships of entrepreneurial peers.

All of the benefits create value in one way or the other to the agent. They can increase their revenue and, hence, increase their commission potential, increase the growth dealer concession that they can negotiate with the carrier, increase their customer relationship and loyalty and retention, or create capital gains out of ordinary income.

In 1998, there were a lot of brokerage and agency acquisitions. Most of them are P&C agencies. This started occurring in P&C long before it ever hit the life industry.

There are a couple that we should talk about. One is USI. USI is the first roll-up that was conceived in the way that I think of a roll-up in the insurance industry is formed. In 1993-94, it was set up to roll-up P&C agencies. It has rolled in dozens of them. I think it's public and it has paid a real value for the owners of it.

Clark Bardes has been around a long time. It is a holding specialist that has acquired several things and a stated strong acquisition strategy. Clark Bardes is a predominant life operation.

Banks and thrifts did a number of the deals last year. Forty-four deals were tracked for a bank or a thrift to acquire an agency. I think this is consistent with what the other speakers were talking about. They are buying distribution. This is, I think, indicative of the turmoil in the market. These aren't necessarily roll-ups, although they could be rolled up within the institution. They would be more apt to be consolidated than rolled-up in the classic sense.

There have been some life-related field consolidations. They're not all roll-ups, but I thought it would be interesting just to spend a minute on this. For many years, 3-Mark Financial has been around. It's really a high-end producer, and most people know about it. It has been effective. It has its own reinsurance company. 3-Mark Financial has created significant value. As I understand it, it is producing $300–400 million a year of new life premium. That makes it one of the top five life producers in the country, so it is a significant force.

National Financial Services was funded by Leon Black last year with $125 million. It hired a named figure to be CEO. Since it was funded, which was less than a year ago, it has made dozens of acquisitions. This is, clearly, a financial play. It is going to put these together and go public. One of the things it says to the producers, as I understand it, is when it buys them on Friday that you can walk into your office on Monday and nothing will change, and you'll drive the changes. It caters to the entrepreneurial independent broker. I think the counter-balancing issue is, how do you ultimately institutionalize these producers so that, when you go public, everybody is tied together in the value that somebody will pay you for that equity you created?

CSI is another roll-up entity that was funded initially by GE. It is a brokerage general agency. It was funded about mid-year. CSI has made five acquisitions of brokerage general agencies, and it is in the process of putting together additional capital. It doesn't have the $125 million, so they're approaching this a little differently. There are both the agents and the brokerage general agents rolling-up, and there are other entities out there starting to form.

In a typical acquisition model, you'd take an agency with $1 million of revenue and maybe $250,000 before owner compensation. The owner has $750,000 a year of compensation. What they'll do is they'll buy 100% of the agency and pay five times for 50% of the pre-tax cash flow. Pre-tax cash flow is $750,000.

They'll buy 50% of the pre-tax cash flow, or $375,000 at some multiple. Let's say it is five times 50% of $750,000. The value they'll pay for that 50% of the cash flow is, in this example, $1,875,000. Then the producer is required to take some proportion of that in stock. Let's say the producer takes 20% so that they would get stock in the ownership entity. There would be an equity of $375,000 and cash of $1.5 million.

They'll give the agency owner a management contract that basically says, "We've bought the first $375,000 worth of earnings. That's going to come to us. You'll get the next $375,000 and we'll share, in some way, everything over that. We should be able to create value over that by providing more product and more support, by cutting expenses, and by taking over your back office." That's the basic model.

There are lots of issues, and I'll just touch on a couple. One issue is, whom do we target? How do we go through these thousands of agencies and pick the ones we want size-wise, character-wise, etc.?

The second is valuation. How are we going to value these things? There are many ways you can look at this thing.

Of course, the deal structure is aligned with valuation. This is the one we just talked about. You can buy half the earnings and share earnings above a certain level. That buyer in that other model is pretty protective. It gets the first charge of earnings. Then, if earnings go down, the owner takes the hit all the way down to that $375,000. That's one structure.

Another issue is deal execution. This occurs when, all of a sudden, this entity is not just an agency. You're doing deals and you need an M&A function as a functional target to help negotiate.

Then there is integration. How do you integrate it? Do you build a separate platform within which you're going to integrate? Do you find somebody at your first acquisition with a great platform and use that to consolidate all of the decisions that you have to make?

Insurance Business Segmentation

As the field is growing up, I see the producers or the manufacturers splitting distribution up from manufacturing. At that level, you're seeing distribution split off in separate fields. You're seeing it build up into big entities. There are several companies that have announced this and other companies are looking into this.

Just as an aside—Manufacturers have talked about separating distribution and manufacturing for a long time. It has all been words. When you really separate distribution in a separate entity, you have to wrestle through some things that are really difficult. Let's start with the issues.

You might separate out distribution and say, "This is our distribution. This is our manufacturing." The question that always comes to the surface is, who's going to fund new agent development? When that's looked at as a separate business, it's almost always uneconomical. Without doing a lot of actuarial work, you decide to hire 1,000 agents. After four years, 150 become free agents in this marketplace. They're not yours. They can go anywhere. The 850 you lose write a bunch of business at a terrible persistency because, if they leave, the business goes. How easy is that to make economical? You don't have to be a rocket scientist to be worried about that equation. Now, that worked when those 150 were really yours 20 years ago. It doesn't work real well today.

A second issue is getting these agents when they're acquired so they don't think they're cashing out. The drivers are what you would expect at the manufacture level. Create a broadening of their ability to attract and retain top producers, incent the best producers, create an equity for them, facilitate succession, and exit as they do retire. Give them a means to do that. Some companies must do it to counteract the roll-up activity. You have to have a response to those agents. Many of them are pivoting from the historical manufacturing and distribution models.

We're in three businesses in most of our companies. We're in, I hope, innovative product manufacturing, customer-relationship management, and infrastructure management. I don't think most of us can sustain two businesses like that anymore in this environment. You have to pick. Are we going to be an innovative product manufacturer? Are we going to develop a culture and systems to support that? Are we going to be a customer-relationship manager, which has a different culture, a different set of economics, and is a different business? Are we going to be an infrastructure manager? What this process is doing is enabling companies to start to figure out what they're good at and what they want to do, and what they're not good at and what they don't want to do.