RECORD, Volume 25, No. 3*

San Francisco Annual Meeting
October 17-20, 1999

Session 30PD
CEO Perspective: The Future of Financial Services

Track: General
Key Words: Financial Management, Actuarial Profession

Moderator: IAN M. ROLLAND
Panelists: RICHARD M. KOVACEVICH†
DANIEL J. MCCARTHY
THOMAS C. SUTTON
Recorder: IAN M. ROLLAND

Summary: This session features a frank discussion by senior executives in various financial services companies about the future of financial services and the role the actuary can play.

Mr. Ian M. Rolland: The future of financial services will pose challenges but also provide opportunities and rewards to those who are able to figure out what the future is going to bring. Clearly there are enormous forces that are bringing about this change, and we're going to talk about some of them, including the growth in the consumer markets, with the maturing of the baby boomers causing an explosion in demand for financial services.

The oldest of the baby boomers are now in their 50s. They have an increasing demand for financial services and are driving a lot of the change that's going on today. These baby boomers are much more educated and sophisticated consumers than we have dealt with before, and they are more demanding. They want services they need delivered on their terms.

Technology is another issue that is driving enormous change in our business. Technology is transforming the power of the marketplace from providers to consumers. For many years when I was in the insurance business we developed products, and if we could find some agent to sell them, we had a pretty good chance of selling enough of them to make it worthwhile, but with technology the power of the marketplace is now shifting to the consumer. Providers of financial services need to understand that.

____

*Copyright © 2000, Society of Actuaries

†Mr. Kovacevich, not a member of the sponsoring organizations, is President and CEO at Wells Fargo and Company in San Francisco, CA.

Technology is also driving us much more to information-based marketing. We're now able to gain information about our customer base that enables us to be far more sophisticated about the way we market our products. Technology enables us, if we're good at it and use it effectively, to turn every contact that we have with a customer into an opportunity to strengthen the relationship with that customer. Another trend related to technology is the Internet. The Internet will have dramatic impact on all of us in the future.

The next trend forcing change is that of increasing competition. There are more and more providers of all of the different financial services products, and this is causing all of us that compete in this business to become better at what we do. Then, finally, deregulation and legislation. Just this week Congress is considering SB–900, which will completely revolutionize the financial services business and allow the combination of banks, insurance companies, and brokerage firms in single organizations. It looks like we're closer than ever to having that legislation enacted. We'll get into a little more detail on that subject later.

Our panel will discuss all of these issues and more. Our panel brings a wide variety of experiences from the financial services business, and they're all qualified to give their opinions and insights into the future of financial services. They are all very much involved in the change process in their own organizations. Dan McCarthy is an FSA, a vice president of the AAA and is chairman of Milliman & Robertson (M&R), a preeminent actuarial consulting firm that has gone through significant change of its own in recent years. Dan will be discussing that with some focus on how the changes in financial services will affect the role of the actuary.

Next is Dick Kovacevich. Dick is the CEO of Wells Fargo and Company. He has been CEO of that organization since November 1998, with the merger involving Norwest Corporation and Wells Fargo and Company. Prior to that he was Norwest's CEO. He was named to that position in 1993 and became chairman in 1995. He joined Norwest in March 1986, as vice chairman, chief operating officer, and head of the banking group. Prior to that he worked at Citicorp in New York. Dick has had a significant role in the banking industry in many issues involving changes in financial services and has been deeply involved in the work done in Washington on SB–900. He's overseeing the operations of a financial institution which has gone through significant change of its own, expanding from a pure banking operation into now a financial services firm offering a variety of financial products.

The third panelist is Tom Sutton. Tom is an FSA. He is currently CEO of Pacific Life. He joined Pacific Life in 1965 and progressed through a series of actuarial and management positions in the corporate divisions and in the life insurance area until his election as president on September 1, 1987. On January 1, 1990, Mr. Sutton became chairman of the board and CEO. Tom has served a term as chairman of the ACLI and a term as chairman of the Health Insurance Association of America, so he has been very deeply involved in many of the issues producing changes in both the life and health business.

We want to keep this discussion informal. We've structured this to be more of a dialogue and an exchange of ideas rather than a lot of long talks, and we want in the process to encourage participation from the audience. What we're going to do is start with some remarks from each of the three panelists, who will briefly discuss their views about the future of the financial services business. We then have some questions and issues that we'll kick around among ourselves, and at various times we'll open the session to questions and comments from all of you.

Mr. Richard M. Kovacevich: I'm just going to take a few minutes to explain the vision of our company and what our strategy is to execute that vision. First and foremost, we see ourselves as a financial services company much more than a bank, and we've been pursuing this vision for well over a decade. Having hailed from the Midwest at one time there's a saying: "Are you fishing where the fish are?" There are a lot more fish in the financial services pond than there are in the banking pond. The financial services industry is about a $2 trillion industry. It is growing in the mid- to high-single digits. The banking industry, on the other hand, is a $500 billion industry, which is about one-fourth the size of financial services. At best it's holding its own. My guess is it's actually declining and has been for some time.

Our strategy is to get 100% of our customers' business, and we do that for 2 reasons: business and stockholder. The business reason relates to the fact that the costs of our distribution are basically fixed. It's a very high fixed-cost business. We have 6,000 stores across the country. We have 6,500 ATMs. We have 102,000 people. Our advertising, computers, and high-priced CEOs are all basically fixed. And the incremental cost of selling an additional product to an existing customer is very small relative to the incremental revenue. For example, what's the incremental cost to us of getting an extra $500 in an existing checking account? It's, in essence, zero. What's the incremental cost to put a statement savings account on an existing checking account? Again, very small. What is the incremental cost of selling a home-equity loan to an existing mortgage customer, or selling management products to an existing commercial customer? Again, very small compared to the incremental revenue.

Second, putting it in some quantitative perspective, if we sell a customer 2 products, we make on average $90. These are consumer households now. If we sell that same household 9 or more products, we make over $500. Again, a huge opportunity. The second business reason is retention. The more products you sell someone, the longer they stay with you. I don't care what business you're in, usually your most profitable customers are those who stay with you the longest. Again, some statistics. If we sell someone 2 products, 53% of them are gone within 3 years. If we sell someone 8 or more products, 87% of them stay with us. Only 13% are gone within 3 years, mostly because they physically move.

The final value is that the more you sell someone, the more you know about that customer. The more you know about someone, the more you can sell them. It's the only perpetual motion scheme that I've ever discovered. Again, think about the pleasure you have had in filling out one of our mortgage applications. Is there

anything we don't know about you financially as a result of that application? We know what you have, what you paid for it, where it is, everything about your family history, financial history, and so on. The cost of that has basically been paid for by our mortgage company. The rest of the enterprise now has a wealth of information that others would spend literally millions of dollars to get, and we have it, in essence, free of charge. Those are the business reasons.

The stockholder reasons are the following. As I don't have to tell this group, financial stocks sell at a discount to the market. My opinion is it is not for financial results reasons. In fact, our results are actually better than the S&P 500. It's because of earnings volatility. The market hates volatility. And if we're in narrow segments, by definition we're going to have volatile earnings. If you're in a mutual fund business and the stock market drops significantly, you're going to have problems. If you're in the banking industry and lending business, and the economy has a problem, you're going to have volatile earnings. If you're in the mortgage origination business and interest rates rise, you're going to have volatility.

But if you think about it, money and totality of financial services never decreases. It only goes up. What money does is it moves, and it moves in response to economic cycles, interest rate, stock market, whatever, and the life cycle of the customer. You're a net user of funds early in your life. You're a net investor of funds later in your life. The way to have consistent earnings over time and, therefore, a better price/earnings ratio is not to be able to predict economic cycles because I don't think anyone has the ability to do that but, rather, keep your customers as they react to economic cycles or their life cycles. If you do that, we believe you can have consistent earnings over a long period of time.

Now, how do you know that any of this works? There's no really good example in financial services, but I would argue that a CD, a mutual fund, and an annuity are basically the same. They are basically attempting to satisfy the same need, that is some sort of savings for the long term. In the past customers had to pay for three different distribution systems—a stockbroker, a banker, and an insurance agent—to get these three products delivered to their door. The customers had to decide for themselves which of these three products were best for them because they couldn't believe any of the salespeople because they were all biased and only in favor of their own product.

I would simply ask, is there a business proposition in providing all three products to the customer at, say, about one-third the cost and helping the customer decide which of these similar but somewhat different products best meet their needs? I would argue that better service at lower cost is what a unique distribution system is all about. We have plenty of examples of that in other products. What does Wal-Mart not sell? It's all based upon taking sporting goods stores, automobile shops, dress shops, and grocery stores and putting them all under one roof and gaining the distribution and marketing advantages of that.

Similarly, Home Depot did it in terms of wallpaper, paint shops, lumber yards, and so on. It put them all under one roof and gained distribution advantages. In the supercenter pet stores now there are 30,000 dog and cat supply items under 1 roof. I would simply argue if you can do it in general merchandise, food, home-improvement products, and dog and cat supplies, why can't you do it for CDs, mutual funds, and annuities?

Mr. Rolland: Let me ask you one question before we turn to Dan. You call your locations stores. That's kind of unique for a financial services company. Would you talk about that?

Mr. Kovacevich: It gets back to what I just said. I think what we have to demonstrate to our people is that we are a store where we sell things to customers. We attempt to sell everything in that store that our customer wants. It's not a bank. It's not an insurance company. It's not a broker. It's a store of financial services. We want that feeling of selling, retailing, and merchandising to occur, and sometimes words are useful in getting that across.

Mr. Daniel J. McCarthy: As you will see, each one of us is going to talk about this subject from our own perspective. I'll take a minute at the outset to define my perspective. I use a couple of numbers that are unique to M&R, but if anybody's sitting up here involved in the management of a major consulting firm or giving this talk, some of the facts might change a bit to suit their firm, but the direction would be pretty much the same. When I say major firms, by the way, we've had a lot of conversation in the opening session about 16,000 actuaries. Of those who are not retired, about 25% work for the 10 largest consulting firms. It's not a perspective that's trivial from the point of view of actuarial employment.

M&R is an actuarial firm at its core. Today we employ about 425 actuaries. Out of a total number of consultants, somewhere in the 600s, perhaps two-thirds of our consultants are actuaries.

When I joined this firm 28 years ago, 100% of a much smaller number of consultants were actuaries. As recently as a decade ago it was 90%. Fifteen years ago we had no operations outside the U.S. Today we are involved in a key role in a network of firms worldwide. It's a fundamental change, globalization. The actuarial core is shifting, though still here. We have had to learn, and I might add are still learning, to be worldwide rather than domestic, to be multidisciplinary rather than actuarial. Neither of those starting positions is easy to overcome and change. I think that's true both in terms of how we as individuals think about who we are and what we do and how our employers think about who we are and what we do.

Finally, why did we do it? Perhaps that's the most important thing, and I should have started with that. We had to make those changes because we would have become irrelevant to the marketplace if we hadn't. Our clients are increasingly global. Our clients are increasingly multidisciplinary; they have many different kinds of activities going on. If we couldn't serve those, somebody else would. I wouldn't have thought perhaps to put it quite the way Dick did, but it comes down to that.

We'd like to fish where the fish are too, and the fish are increasingly diverse. That's all a little by way of background.

We talked about some key trends, and I would categorize a couple of them because it's helpful to make distinctions. First, I'll say consolidation. By consolidation I mean within industry, within a country, banks buying banks, insurance companies buying insurance companies, and HMOs buying HMOs. Every time you think you've seen the biggest one, you discover that tomorrow's is bigger than the biggest of yesterday's. It keeps on going. It doesn't seem like it's slowing down for the moment anyway.

Second, globalization within an industry but across country. We've seen actually more of that in insurance than in banking, and in the U.S. we have seen more of it in terms of people arriving from other countries at our doorstep to buy than we have actually been, in effect, exporting out capital to buy elsewhere. That is changing. It is particularly changing in Asia, Latin America, and developing countries in general. I think that change is important for the U.S., and it's important for actuaries who work for historically U.S.-based firms to be part of that.

Third, integration. Integration is across industries, whether within country or across country. Ian mentioned SB–900. There's been a lot of financial services integration already. We've seen nothing yet. I guess if I were Bill Bennett, I would say we ain't seen nothing yet. Finally, I think there is one somewhat countertrend, and that is what I will call differentiation.

I am a little bit skeptical that everything can be sold under one brand and under one roof. That doesn't mean it can't be sold under one ownership, but I think that there are diverse brands that will have value and will continue to have value, and in some channels I'm not sure that the same salesperson can actually deliver all of those services. Some supersalespeople, perhaps. Others not. I really think that as we go through these trends we will see a countertrend of differentiation continuing to exist. How strong it will be we may have different views on, and we can talk about that.

What does that mean for the roles of actuaries? I'll offer four thoughts. First, if actuaries are going to survive in this environment, we need to be able to communicate our own skills and our special competencies in ways that transcend professional and business boundaries. If you think about pricing, for example, pricing at its core has to do with cost of capital, cost of service, and cost of risk. Different kinds of people describing different kinds of products describe those things in very different ways and have difficulty talking to each other. If we can't talk to other professionals in their terms, we will either not survive or, at very least, not thrive.

Second, have a global outlook not only in terms of business but in terms of culture, history, and current events, generally. Thinking globally means being globally aware. And, by the way, I'm guilty of this, too, in the long run. I think being global

means being multilingual, although it's still true that if you're only going to know one language, it'd be a good idea if it's English.

Third, within those two things be the best actuary you can be. The people in our profession who survive and thrive globally and across industry are by and large our best people. Now, that's not a terrible surprise. Aspire to be the best.

Finally, as you think about defining an area of specialization, and we all need to do that in one degree or another, I will offer a piece of advice that's not my own. It was offered by Walter Klem, a president of this organization 45 years ago who died within the last year. He said, "Define your area of specialty as broadly as possible." He said that in a talk I heard when I was a brand new student studying actuarial exams. It impressed me. Do not define yourself narrowly; define yourself broadly. If you define yourself broadly and think broadly, you'll survive in this environment.

Mr. Thomas C. Sutton: My qualifications to speak about the future of financial services are, first, I know very little about the subject and, second, I don't know anything at all about the future. I was in South Bend, Indiana, attending the Notre Dame/USC game. This is something that's very unusual for me. I've never gone, or at least for 20 years, I've probably never gone to a college game, but my daughter's a prospective student there, so we went, and I was yelling my lungs out sitting in the rain. There were several lessons I learned from that experience that I think bear on our topic today.

First, the future is inherently unpredictable. It's always different from what we expect. Second, even if you correctly predict an outcome, the way it's achieved is usually a surprise. And, finally, an excellent way to generate profound thoughts is to sit in the rain for two hours. In any case, I'm going to lay out a few outcomes that I expect by the year 2010. That's far enough away that I will have been retired by then. I do reserve the right also to change my predictions at any time, even later on during this panel.

All these predictions concern the top 20 life insurance operations in the U.S. The astute among you will immediately realize that I have an implicit assumption that life insurance continues to be a financial service of consequence by 2010 and that there are at least 20 companies engaged in the business. In the year 2010 the top 20 companies will be doing 90% of the business in the U.S. They now do about 70% in most product lines, although right now it's not necessarily the same companies in each product line; nevertheless, the top 10 companies in 2010 will do 60% of the business in the U.S. They now do about 45%.

At least 18 out of the 20 will be a part of a holding company structure involving 1 or more of the following: banks, trust companies, mutual fund complexes, securities firms, asset management operations, brokerage, and savings and loans. Those affiliates in that structure will generally be in the top 20 in their own respective fields. At most, 2 of the top 20 will be mutuals. Both of those will be in the process of demutualization. And to assist them in that endeavor they both will have retained Dan McCarthy.

The top 20 will be regulated based on a uniform system of rules that apply in all states. At least half of the top 20 will be part of a global financial enterprise which itself will be among the 20 largest institutions in the world.

Now, this picture, I must admit, is being presented by someone who is skeptical of economies of scale and cross-marketing opportunities, at least in the markets which my company is in. I'm also skeptical of one-stop shopping, and I'm someone who retains a warm feeling about mutual life insurance companies, but, nevertheless, that's what I think will happen. This consolidation will be driven primarily by marketing and economic issues, in particular by ratings, branding, financial markets, and competition. In short, we'll see a continuation and acceleration of the level of change in our industry.

How can we as individuals deal with such dramatic movements? Well, first, I think we all have to stay tuned in. Pay attention to what's going on. The constantly changing circumstances around us do give rise to surprises. Second, we have to be flexible in our thinking and in our life. Certainly, global issues have to be a part of our thinking whether or not they're a part of our experience. Third, we all need to expand our skills to the widest possible range that we are capable of. Dan alluded to that issue as well. And, finally, I think we all need to keep a sense of humor because we're going to need it.

Mr. Rolland: I thought we might start and fill in a little more information. We've had a couple of mentions of SB–900, which is being worked on by Congress as we talk here. Dick Kovacevich has been very much a part of that effort. Dick, I thought you might fill the group in on what's in SB–900. What is it going to do to us?

Mr. Kovacevich: Well, I do think we're going to get legislation. In fact, there's a meeting today that may resolve the Community Reinvestment Act (CRA) issues; for all practical purposes that's the last major stumbling block. Basically, this bill will allow the affiliation of banks and insurance companies and brokers in practically an unhindered way. It will require that insurance underwriting and real-estate development, and for the first five years of the bill, merchant banking be in a subsidiary of the holding company. All other financial activities, or those things to be determined as financial in nature, can be done in a bank or in an operating subsidiary of the bank.

The accumulation of the subsidiaries of the bank cannot be more than 50% of the capital of the holding company or be more than $50 billion in assets, and that's the major framework. There'll be functional regulation of all of these activities by the respective regulators that exist today. The restrictions on intercompany transactions will be very similar to 23(a) and 23(b) that the Federal Reserve requires today, and there won't be too many onerous restrictions on your ability to share information within affiliates. There will be some restrictions of sharing information with third parties without permission of the customer, but within affiliates there won't be undue restrictions. You'll basically be free to do whatever you want to do on a level-playing-field basis.

The CRA will be quite similar to what exists today. It will only apply to banks, but insurance companies will have the pleasure, I predict, in the future of participating in this wonderful process, but it won't be a requirement. It'll be restricted to banks. There will be a prohibition of commercial firms buying unitary thrifts backdated to May 1, 1999. All others will be grandfathered. The probability of this passing is very high. We're very close. It'll be done in 1999, and it'll be signed into law within the next couple of weeks.

Mr. Rolland: I take it they've resolved the issues with the White House? Will it be signed by the president?

Mr. Kovacevich: They definitely solved the operating sub issue. CRA is the one remaining one which has not been resolved, but I don't think it will be a stumbling block by the time negotiations occur this afternoon.

Mr. Rolland: Let's move on and talk about the issue of consolidation because that's come up several times in our discussion. Tom Sutton was brave enough to give some predictions about percentages of market share that indicate your view, Tom, that there will be consolidation in the insurance business, at least. I thought we might all talk about consolidation. How far will it go? What form will it take, that's assuming that SB–900 does pass? Let's discuss consolidation within industry groups, across industry groups, and globally.

Mr. Sutton: As a mutual holding company, our company has the luxury of not really being in on that issue particularly. We haven't had an ax to grind one way or the other. In my capacity with the ACLI, of course, I was involved in promoting it, but from the ACLI's perspective as part of SB–900 we have neither feared the advent of the integration of financial services nor been a proponent because we don't lust after buying a bank. But within that context I think I still would suggest that all the things that I described will happen—that is, the integration within our industry and along various industry lines. All of that will happen.

One of the things which brings that to me as forcefully as anything else is the variable annuity (VA) business, which is very concentrated in the leading providers and getting more concentrated. You know that most of the distribution of those products is essentially through stockbrokers or broker dealers of one form or another, often major stockbrokers, regionals, or planning broker dealers, but in all of those organizations there's a limit to the number of carrier relationships that they can establish. There's a limit to the amount of complexity that they want to be able to support. Compliance issues have also been an element in saying that we ought to condense the number of products that we offer so that we can get our arms around them. Shelf space or mental shelf space is clearly an issue there, and I think that's a very clear, immediate driver of consolidation and concentration of market share in a particular product line.

Mr. McCarthy: It's interesting. If you look at countries where the equivalent of SB–900 has been around for a while, you see quite a variation country-to-country as to the extent to which this distribution under one roof happens. I would

recommend to you a recent report issued by a Boston consulting group, which took a look at that country-by-country. What it said to me is that it appears that the historical distribution systems that existed within a particular country and the relative roles of insurance agents, banks, and whoever else have a lot to do with the nature and the pace of the ways which distribution does begin to come together once the organizations are free to do so.

It's kind of tricky to look at the history in other countries and offer some thought as to how that pace will move here just because it is so different country to country. You look at just France and the U.K., to name two. There are dramatically different kinds of numbers because there have been significantly different historical factors. It's obviously something we all need to get ahead of the curve on, but it's very difficult to say because this happens, x will happen.

Mr. Kovacevich: I think the forces that are causing consolidation to occur are still with us and will remain so for at least another decade. We will be consolidating within the segments of the financial services industry, and we're going to be now consolidating between the segments. There were 15,000 banks in early 1990. Two years ago there were 7,500. My guess is in another 5 years it'll be more like 2,500, and that's just banks; all these things are going to occur. Wal-Mart has 40% of the discount department store business. The largest market share in financial services is 3%. It doesn't make any sense. If you look at any other kind of consumer or commercial product, the leading market share companies have 15% minimum. Many have 20-25%. There's nothing unique about our business other than historical restrictions because of regulation that has caused this to occur. How long will it take? Or what's going to happen in 2010? I don't have a clue, but you just have to know directionally that's the way it's going to go, and it's going to move at some pace.

The reason for the movement is not just economies of scale. It's what I would argue as economies of skill. People who know how to sell, service, manage risk, and use technology, and find, develop, and motivate people, and who have some fun along the way are going to be successful whether they're in the insurance, banking, or brokerage business. It has nothing to do with the product you're selling. Those are the skills that are all common to all of us, so if you can do it in one business, you're going to be able to do it in another, and because of the economies of scale when you have such skills you're going to have a competitive advantage over the single-product provider.

Mr. Rolland: Who benefits from all this? Each of our companies has a lot of different constituencies. We have shareholders, customers, employees, and the communities where we do business. Are there winners and losers in this or does everybody win? Is there enough to go around for everybody? Let's comment on who comes out ahead in this deal.

Mr. Sutton: I think customers come out the best simply because of the effect of competition. Who comes out the worst? Possibly local communities and

employees do, except for those employees who have the kind of skills that you're talking about. Those are in high demand, and that's an important ingredient.

Mr. Kovacevich: My own view is it's very hard to talk about these things when it hasn't occurred in your industry, but when it has occurred in a bunch of others it's very simple. Look what's happened again with Home Depot and Wal-Mart, those big distributors of commodity products. That's all we are, people, big distributors of commodity products. What they did is deliver to the consumer lower prices than they got before, and the stockholder makes a lot more money over a longer period of time. I would differ from Tom in that I think employees and stockholders are all the big winners if they participate in the change process. The losers will be those who do not have skills.

Mr. McCarthy: It's interesting to speculate about what is cause and what is effect here. We've had a rapidly expanding economy for a longer period of time than we've ever experienced. That's been in a period of consolidation and shakeout within the industry, to be sure. Every time you read it, you say x thousand jobs lost. Then you turn around the next day, and in the aggregate there are more jobs and less unemployment. I'm not arguing cause and effect to that, but I just observe that it does seem like the benefits of the improved efficiency which results from consolidation are spread fairly broadly. I know you can do this top quintile/bottom quintile stuff and that sort of thing, and it's real, but, nonetheless, as people have commented, even the middle class, which lost ground considerably for about a decade, has begun to turn around in the last five years. I think it's more broadly spread than you might think.

Mr. Rolland: I might ask you, Dick, to comment on the experience in the banking business because clearly consolidation has been going on longer there than in the insurance industry and has been more dramatic. Has the customer really benefited in a tangible way that most individual customers will understand? I know an example from my own town where there were three banks, all of which have been acquired by much larger banking systems. In the case of two of those three, conversion to the new systems has not gone well and customer service has suffered. The customers of those banks are not sure they have benefited from the mergers. Would you comment on that trend?

Mr. Kovacevich: First of all, when you go through the changes we're talking about, evaluating the results after two or three years is inappropriate, whether it be good or bad. This is a nine-inning game, and we're in the first half inning here. But, again, if you look at things like margins and revenue per full-time employee and so on, they're all getting lower margins and generating more revenue per person. These are the kinds of efficiencies that are getting back to the ultimate customer.

One of the great things about SB–900 and the change is that the people in Ft. Wayne will no longer only have three institutions to choose from. They're going to have insurance companies that can deliver their banking products. They're going to have brokerage houses. And, by the way, it's already occurring, as we all know. This is a process where, again, those who are skillful are going to win, and those

who are less skillful are going to lose. The ultimate beneficiary is going to be the ultimate customer who's going to get a better deal and lower price. We haven't even talked about channels, which we should talk about pretty soon.

Another phenomenon is that as products are changing and the companies are changing, their distribution channels are changing. The stockholder is also going to win because he or she truly will get rewarded for superior performance. Today the difference, at least in the banking industry, between the best banks and the worst banks is 10%. That doesn't make any sense. That's, again, because of the lack of distinction and the lack of concentration that will occur when you get down to just the 100 or so providers instead of 7,500.

Mr. Sutton: Ian, one of the items on your list was communities. I think it depends a little bit where you come from. If you come from Los Angeles, and you're thinking about banking, to have Security Pacific and First Interstate disappear from the core of the business community in Los Angeles was quite a shock. It's a shock in a number of ways. I think, people in that area wouldn't perceive it as positive. Then, moving to San Francisco, to have the headquarters of Bank of America disappear to some place on the distant East Coast was another blow in bank business. At least Wells Fargo had the foresight or the insight into local character to actually make their headquarters here.

Mr. Kovacevich: Again, I don't think it's about headquarters. I think that you can work as effectively in your community, and I would argue our company does whether or not the headquarters are in Minneapolis, San Francisco, Ft. Wayne, or wherever. There is no difference in our contribution levels, community involvement levels, or volunteer levels because we measure all of those same things whatever community that we're in. We believe it's important, and we believe it will have a competitive advantage. Where your headquarters is located is, in my opinion, irrelevant.

Why is it correct for General Mills to disproportionately work in the community in Minneapolis where it manufactures nothing but not in Buffalo where it has one of the largest cereal producers? I don't think headquarters means a thing. I think it's where you do business either with customers or where you have employment. You should be doing the right thing for the community. Who cares where a headquarters is? I'm not disagreeing that some people have acted that way. I'm just saying it shouldn't be that way. The successful companies, not the ones which don't exist anymore, but the successful companies, are going to be as good in their communities where they are not headquartered, where they have team members, and where they have customers as they have in places where they're headquartered. It's something you have to figure out, and when you do you're going to be superior, and you're going to win.

From the Floor: What will be the impact of the Internet? Along with that, how will companies which already have in place relatively high-cost distribution systems, most of which are driven by agents or salespeople, resolve the conflicts between

marketing over the Internet and marketing through that existing sales infrastructure?

Mr. Sutton: I'll take a crack at it because it's something that no one can predict. A lot of the comments that have been made, particularly those about cross-marketing and Wal-Mart, assume that you're targeting the Wal-Mart target market. In upper-income markets it's not necessarily the same or it's not the same as it would be in middle-income markets. For example, for Internet services which may be provided in a way that are related to high-ticket, complex structures, either financial structures, or, in the case of complicated products being the solution for a complicated set of issues that an individual has, using the Internet to directly sell is not going to work very effectively.

The only example that my company would have isn't Internet-related, specifically, but it's direct marketing. It's marketing without an agent involved. And it was under the auspices of the American Association of Retired Persons (AARP). We joined with The Hartford. We're in a joint venture where we were selling first fixed annuities and then VAs to AARP members, and I can't tell you the amount of effort that went into designing the marketing materials. Everyone wanted not only to fulfill all the compliance issues but also to be educational.

One of AARP's requirements is that any attempt to market a product has to leave the subject with a positive feeling about AARP and with more knowledge about the product that is being sold to them, whether or not they buy it. And so a great deal of effort went into marketing materials—the way that the approach worked, the multiple approaches, where they were indicated, all those kinds of things—and we went at this for about four to five years and essentially pulled the plug on it this year.

In my mind it's the kind of thing that says maybe in ten years as a new cohort goes into that age group it may be possible then to get people to part with large sums of money because of a contact they've had over the phone or through the mail, but right now it's not. For people who have a relatively small amount of assets it becomes a very large chunk, and they don't want to part with it that way. For people who have a large block of assets, they already have a set of advisors. It is very difficult to break the relationship with the advisor by mail and on the phone. At the moment, at least for the short term, I have a relatively negative view of high-end marketing either on a direct basis or through the Internet.

Mr. McCarthy: I guess I would suggest that even for products other than that I'm not sure that Internet marketing is going to be substantially successful. The one thing I am sure of, it's not cheap. For that reason I'm not sure if it's as much of a wild card as you suggest. Granted, the market has until recently been very open to almost any Internet idea, and I suppose if there's cheap money around from that point of view that enables you to spend it, but it's one thing to get a site out to market form. It's quite another thing to do the advertising and to get people to it. It's another thing yet, and I will testify from our own firm's experience, not a cheap one to be geared up, to provide efficient customer service that way. I tend to think

that if the Internet is successful, it's going to be the people with the deep pockets and the economies of scale who in the long run will make the best of it. They may do that by buying up some other start-ups, but I think in the long run it may not be a wild card from the point of view of consolidation.

Mr. Kovacevich: I am convinced, at least in my business career or the next decade, that the following channels will be used sufficiently by customers to be viable channels: stores; in-store, such as supermarkets, Wal-Marts , or inside anybody else's store, to separate it from their own stores; direct mail; telephone; ATMs; and the Internet. The Internet is for real. Don't kid yourself. I think the hype is greater than the reality of it at the moment, but it is a viable channel, that is with us, and enough customers are going to use it that it will be one of these six channels.

I'm not smart enough to know ten years from now, and in a way in our company we don't care because we're in all six channels, what percent or how many customers are going to use which channels. I believe that the adjustment will occur at a slow enough pace that you can adjust. If you're in all six already you can adjust the ingredients of your channels. We're in all six channels, and we're generally the biggest and, I would argue, the best, but others can determine the biggest in each of the channels. I can tell you that 99% of our customers are multiple-channel users, and our competitive advantage is going to be giving our customers a choice.

I would simply ask you as a customer or anyone else, if you have a choice of multiple channels and you can get roughly the same products and services, why wouldn't you want access to more than one channel? Even if you use 1 channel 90% of the time and all the others 10%, why give up that 10% if you have access to these channels? I think that the most successful financial services companies are going to be multiple-channel providers, and they will have a competitive advantage over the single-channel provider, not that the single-channel provider won't be successful, but the multiple-channel provider will have a competitive advantage because most customers, given a choice, will prefer to deal through multiple channels than a single channel.

Mr. Rolland: Put some numbers to your Internet business, Dick.

Mr. Kovacevich: We have 1.2 million customers on the Internet. I don't know whether you think that's impressive, but I think you will think this next statistic is impressive. We are running at 100,000 new customers a month or 2 a minute. It's moving.

From the Floor: That's on the Internet?

Mr. Kovacevich: Yes.

Mr. McCarthy: But what are they, in fact, doing?

Mr. Kovacevich: Most of the things they're doing are what I would call basic financial services: checking their balances, transferring funds, and buying stocks and bonds, but that's what we have given them the best. Our delivery is not equal, and we haven't given them all the bells and whistles as easily on the Internet as the more basic.

From the Floor: The 100,000 a month, is that truly new Wells Fargo customers, or current customers beginning to use the Internet?

Mr. Kovacevich: About 20% are new, but what's interesting is we're not advertising at all to new customers. Remember I said we're after existing customers and 100% of their business. We're not even trying to get new customers; 20% are coming in on their own. I don't know what we could attract if we were trying to attract. As I said, we're trying to get depth of relationship not breadth of customers. The customers who are on there compared to the ones who aren't give us 50% more revenue, buy 50% more products, stay with us 50% longer, and are 14% less expensive.

From the Floor: This is away from the Internet question. It gets back to some of the things primarily that Dan said earlier. Are potential customers analogizing what's happening in the business to the consulting firms?

Mr. McCarthy: As a minimum, what's already happening in the major firms is that we are beginning to hire people who work in and know the different financial service industries so we can figure out what the best intersection is. We're doing it right now, and most of the firms are doing it organically, but I could certainly see specialist firms of that type being acquired. We've seen that in other specialties already. And I was thinking about that. I said before that the changes that we saw are changes that we're driven to by our customers. You don't see very many medium-sized firms anymore. You see very large firms, and you see very small, one-, two-, and three-person firms. You don't see many firms with country fences anymore. You see the firms which are, in one way or another, international. We will see more firms which are, in one way or another, multidisciplinary. Say our numbers are already from 100% actuaries with that particular kind of a focus now down to about two-thirds. That'll continue to go down. It'll continue to cross industry. By whom in the end, I don't know.

Mr. Kovacevich: My only comment on that is that if the consolidation of advisors goes much beyond where it is now, if you're involved in a very complex deal, you're going to have a difficult time getting representatives for everybody without conflicts.

Mr. McCarthy: Yes. We've certainly all become expert at Chinese walls to deal with that, but I think the question wasn't so much consolidation in that way as it was cross-specialty consolidation—bringing in kinds of firms which we haven't had until now.

From the Floor: And if two CEOs are running a multifinancial company, do they want to work with one consulting firm rather than choose one investment specialist, one actuary, and one investment banker?

Mr. McCarthy: My way of saying it, first of all, from somebody who sells consulting services is we're going to have to prove ourselves. They're going to want to work with the best, I would think, and we're going to have to prove that we're the best of any firm in any area we're working in. Your question then is, what will it take for us to be the best?

Mr. Rolland: My suspicion is it's the best you can get for whatever the specific problem is.

Mr. Kovacevich: I think I'd have a reluctance to only have one firm for everything. I wouldn't want to do that anyway as a principle.

Mr. Donald M. Peterson: There are some other political issues going on in Washington right now using different words and phrases. One has to do with privacy. I'd like to have Dick address how that's going to impact the financial services industry in the future. Second, we could get into the healthcare area. Tom, why is Pacific still in that field, which is somewhat contrary to the tone here? And how about some of the tort reform issues and the legal issues involved in both health care and HMOs, as well as with the large life insurance companies in recent years?

Mr. Kovacevich: I think the privacy issue is one of the most serious issues that those of us who live in financial services face. It obviously is a hot button for consumers. Some people have acted irresponsibly in protecting privacy. As often the case, I think we're at risk that the legislators attempt to control things by laws that they pass as opposed to let things evolve. Phil Gramm mentioned that his idea of privacy is for every firm to spell out their privacy principles, and if the customer doesn't like them he or she will go to some other firm where he or she likes the privacy principles. I think it's very important, quite frankly, we get some privacy laws in this bill to stop this tide for a minute.

In my own view, what's going to pass, and probably should pass given the political issues, is freedom to use information among affiliates and some fairly severe restrictions without customer agreement for third-party sharing of information.

Mr. Sutton: On your second question, if I can generalize it, certainly we've seen a lot of consolidation within the health business and companies that had a health segment deciding that they couldn't make a go of it or didn't want to make a go of it—it was a distraction, it was unprofitable, whatever the set of reasons were—and discarding it in favor of someone who is building mass. I think that's just a part of the general trend that we're seeing for not only health but for everything else. In our case, it's not a distraction; from my point of view it's good management, and they've been profitable. Why would you get rid of something like that?

Mr. Rolland: One of my best days as CEO was when we finally completed the deal to sell our health business to somebody else. I've never regretted it. We might pick up there and ask you, Tom, to talk a little bit about the future of the mutual insurance industry. You've gone through one step in converting to the mutual holding company system. Is everybody going to do that? Is that a way station on the way to full demutualization? Will there be any mutuals left in the future? What do you want to say about the future of the mutual business?

Mr. Sutton: I think it's obvious to all of us that the historical roots of mutual companies came out of traditional whole life policies where there was a very long time frame and essentially a black-box policy at a time, maybe the first 50 years of this century, when there wasn't illustration selling. It was a conceptual sale. Black box. Depend on the company for an indefinite period of time. Under those circumstances I think a cooperative form, a mutual form, makes sense. However, as companies, especially the larger mutuals, have migrated into a much broader range of products outside of life insurance, for example, but even within life insurance to say that variable life and universal life, that essentially have most of the moving parts quite visible, the whole sales process is very much focused on value and fitting with your own needs. I'm not sure that the mutual concept makes any sense there.

I don't think that you would be seeing companies moving to a mutual organization any time in the future because there just aren't the reasons there to do so. Indeed, there are reasons to do the opposite. You've seen a great deal of the larger mutuals at least demutualizing. Some of that has to do with changing of the guard of management, which provides an opportunity to do that. Some of it has been generated by financial pressures, either negative pressures because of things going wrong in the company or positive pressures in the sense that the market valuation right now is so high on companies you might have to ask yourself if your members really understood that they had an option to receive a value of x as a result of your changing of form. Even though it might have the negative effect of a long-term differential in the treatment of their policy, which would they pick? Which would you pick? I think it's really pretty clear that if members really understood the issues, they would make the choice to demutualize.

I also think that while those of us in the industry have assumed that Prudential, Metropolitan, Hancock, and the Canadian companies have already demutualized, that hasn't really happened yet in terms of people getting stock dropping out of the sky.

I think after all of those events occur—literally tens of millions of people in the U.S. will receive this bonanza—it will become incumbent on the remaining mutuals to answer questions that may be put to them; that is, if it's OK for Prudential and Metropolitan, why isn't it OK for you? Why don't you demutualize and give us our liquidated value for the company at this point? Or even a more pointed question that might be put to those which don't have any intention of demutualizing is, how can you demonstrate that you are delivering value over and above what a stock

company can deliver to me? How can I see that and touch it and feel it so that I can feel convinced that you should continue to be a mutual?

I think those issues are ones that really haven't been thought about by any others very much ten years ago or before and that are going to be very much in everyone's thinking, and I think there may be increasing social pressure on the remaining mutuals to demutualize.

Mr. Rolland: I think some of us who fought through the stock/mutual tax wars would have never expected those wars to end because of the demise of the mutual insurance industry.

Mr. Sutton: We kept telling you we were just vulnerable here.

Mr. Rolland: What happens to the last mutual under Section 809?

Mr. Sutton: The calculations will be much easier.

From the Floor: Would you at Wells Fargo be in favor of giving the banking information over to the life insurance people so they can go and use that in their sales activities? For example, in Canada, as banks can now buy life insurance companies, they cannot use the information to get their bank customers to buy life insurance. What is in SB–900 on that score?

Mr. Kovacevich: Again, SB–900 hasn't been concluded yet. We expect the conclusion to be that if it is owned by that holding company or within the family, you will be able to share information. Outside the family there will be restrictions.

From the Floor: And what about the notion of inappropriate pressure put on a person to buy the second product in order to get the first product? Want to get the loan? Then you have to buy life insurance.

Mr. Kovacevich: That's already against the law in the U.S., and you can go to jail and so on. You can't even do that with an outside party. Tying is illegal in the U.S.

We are allowed to sell credit life today. It happens to be with an outside company who underwrites it. But it is illegal for us to tie the sale of credit life with granting the loan. It doesn't make any difference whether it's an outside company dealing with credit life or a company that we own. If there's tying involved with any other product, it's illegal. What is not illegal is to say if you buy these two products from me, I can give you a better deal.

From the Floor: Will you address the issue of how deposit insurance for banks and guarantee funds for insurance will be handled in the future?

Mr. Kovacevich: My favorite topic. This is a very serious problem that our politicians and regulators are unwilling to address because it's all about power, and they will lose power. Let me make myself perfectly clear. Regulators have trouble

understanding the risks of the banking business. We had 2 small banks; one, $1.5 billion in West Virginia, the other, $300 million in Colorado Springs that failed in the last month and lost 50% of their assets and about 800% of their net worth. You don't have to be big and complex for them not to understand. This can only be monitored by the market.

We must get rid of "too big to fail." It must be declared today that there will not be government backup other than some sort of minimum level. You could use $100,000 on deposits if you want to. Insurance companies have had their own fund. That $100,000 should absolutely be paid solely by the banking industry. There shouldn't be a nickel to the taxpayer, but it has to be clear that there's a limit and anyone who has more than $100,000 to put in a bank can gauge whether that's an appropriate risk reward to take, just as they would with mutual funds for example. We have to address this, and we have to make it clear because there is, as we've seen in other countries in Asia, not enough money around to support irrational risk-taking, and there's lots of irrational risk-taking going on out there.

Mr. Sutton: Let me make a parochial comment about insurance companies. Under the current form of the bill an insurer would have to be a separate operating subsidiary of the holding company so that if a banking entity went bankrupt or lost a lot of money, the bank would go under. The holding company probably would go under. But the insurance company as an asset would presumably be sold intact. And so in that sense it wouldn't carry over its effects to policy owners.

Mr. Kovacevich: Yes, but the reality is there were holding companies that had banks. We mentioned several that were allowed to survive. Believe me, they wouldn't have let Citicorp go under. That's just the reality.

Mr. Sutton: But I'm saying if the bank did go under, it still wouldn't take an insurance company under necessarily.

Mr. Kovacevich: Not necessarily. I'm saying the politicians and regulators don't act that way in a crisis. I'm just saying we have to make it clear so it is that way, but this "too big to fail" is out there.

The point is, however, that every regulator that I know of who has left regulation said that it was a mistake to do everything that they did to, say, Continental, long-term capital, and so on. I believe only either a committee of Congress, the President, or the Treasury should have to approve the bailout and a price for a bailout approach. You have to make it so politically difficult to do it that it has to be a crisis, not shoved under the rug, to use banks' or insurance companies' money to pay off things. If any time the Congress wants to bail out a troubled company, they're allowed to do it. I'm just saying regulators aren't allowed to do "too big to fail."