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The Impact of HR-10 on Insurers' Risk Exposures

Track: Investment

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Summary: The Gramm-Leach-Bliley Act aims to modernize the antiquated regulatory framework of the Glass-Steagal Act of 1933 and the 1945 McCarran-Ferguson Act by permitting closer affiliations among financial services companies. The implications to the insurance industry may be far-reaching, providing an important opportunity for companies to reposition themselves, form strategic alliances, and create new service and delivery models.

Mr. Max J. Rudolph: In this session we will discuss the impact of the Gramm-Leach-Bliley Financial Services Modernization Act (HR-10). This is an Investment Section-sponsored session. We have two presenters today. Jim Overholt is a senior consultant and manager with Milliman & Robertson (M&R) and head of the financial institutions practice in Chicago. He was previously president and CEO of Great Western Financial Corporation's three non-banking subsidiaries: securities, capital management, and insurance. Great Western Financial Securities Corp. was one of the five largest sellers of annuities in the bank channel and one of the 10 largest sellers of investment products overall. Jim's 25 years of experience include senior management positions in bank trust, investment, retail, and private banking departments. Jim is a frequent speaker at insurance, banking, and investment trade association meetings and is often quoted in the financial press.

Francis de Regnaucourt, is a senior consulting actuary at Ernst & Young (E&Y). He has 20 years of experience in the life insurance industry with an emphasis on credit and financial analysis, corporate issues, and mergers and acquisitions. Prior to his association with E&Y, he was a senior credit officer at Moody's and in the management of Met Life. He's an FSA, FCIA, member of the AAA, and a chartered financial analyst. He's also a former Vice Chairperson of the SOA's E&E Committee for Pensions and is a frequent speaker at life insurance, professional investor, and trade association meetings. He is a Member of AIMR's Insurance Task Force.

Mr. James Overholt: My claim to fame for talking about this particular product lies not in my experience with Great Western's securities affiliate, even though we were a large seller of annuity products, but with my background in the insurance business. For those of you who aren't familiar with Great Western, it was a thrift, not really a commercial bank. As a

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consequence, it had been in the insurance business for some time prior to insurance becoming popular in the banking industry. We were also a top-five seller of traditional insurance products, divided equally between property and casualty (P&C) products and life products. Our footprint in the U.S. is 450 retail-banking offices in California and Florida and loan production offices in the mortgage business in 35 states. We had quite a broad distribution business in traditional insurance products as well as investment-oriented products.

As you might expect, I will be speaking from the bank perspective. Francis will talk from the insurer perspective. At the end I think you will conclude, as I have, that our perspectives are almost identical in terms of the opportunities and the way the business is likely to shape up.

I'd like to make a few brief comments on the topic of deregulation. If you look at the history of the process over many years in the U.S., you'll find that the goal was to keep all of these industries separate, not just banking and insurance, but also banking and securities, securities and insurance, and so forth.

Most of the activity in Congress was designed to accomplish that up until the mid-1990s. Then you began to see a lot of proactive activity on the part of the banking regulators, particularly the Office of the Comptroller of the Currency (OCC). They began, in their customary fashion, to reinterpret many of the laws that were already on the books. They redefined some of the parameters to permit banks to sell things like annuities and do things like underwriting corporate bonds to a very limited extent. They used the administrative powers of their positions at the Federal Reserve, the OCC, and even the FDIC. All of the major regulators got into the act.

All of this was, of course, challenged in the courts by the various insurance industry organizations. In almost every case the regulators were upheld. You can see from this that the deregulation process did not occur with the recent HR-10 legislation. This process has been going on for at least 10 years. I think you'll see that HR-10 in many respects was almost a nonevent.

What's really happening as a result of the legislation to keep these industries separate was that we still had, up until recently, three very distinct and very product-driven industries. By that I mean that, if individual consumers wanted insurance, they needed to go to an agent. If the consumer wanted banking services, they needed to go to the local banking office; if they wanted securities, they needed to go see their broker. All of these forces in the U.S. combined to preserve the product-driven nature of the industries much longer than you might otherwise have expected. As a result, you've got some significant disconnects in the consumer marketplace.

Let's look at the average number of service providers in the consumer market. The average financial services consumer, and by this I mean someone in the $50,000 income range, has eight different providers of financial services, meaning eight different statements at the end of every month. In the affluent marketplace the number goes up to 12. The average number of financial products owned by consumers is 16.

At the same time, 78% of consumers have come to prefer purchasing all of their financial services in one place. This is primarily due to the fact that consumers are aging, and they are becoming more affluent. They want things simplified. They don't want to get 12 different

statements every month. We've created a disconnect in the U.S. market. The essence of convergence is that we're fixing the disconnect. These industries are going from product-driven positions to customer-driven positions, and this has been going on for quite some time.

But it's not just consumer driven. It's also competitor driven. Here's where you start to get into the risks to the various industries. Who is going to be the ultimate provider of financial services? Can banks, with their vast distribution networks, get to the position of a financial services company (as opposed to just a banking company) faster than insurers can get there? This is really what we're talking about in terms of the development of convergence in the marketplace.

Taking the bank's perspective for a moment, I think it's clear to most people that banks have a very strong incentive to get there first. Banks' margins have been declining for many years. This has significant implications in terms of bank earnings. It also has some significant implications in terms of the reliance by banks on specific consumer markets. Banks rely on a very small segment of their customer base for more than 100% of their profits.

Banks have some very unprofitable customers who are getting services from banks and not paying their fair share of bank costs. You also have the vast middle marketplace, where banks are basically breaking even. If you looked at a scattergram of the population in these different segments, you would see that a very small number of people are in the first segment, providing most of the profits. A huge number of people, mostly the consumer markets, fall into the middle category. That's where banks are targeting insurance sales, and that's where bancassurance has been so successful in Europe.

If you review the financial results of banks, you would see record profits in each of the last several years. You might wonder why this is the case if margins are shrinking. The answer primarily lies in a study that was done two years ago and looked at the recent acquisition trend. Banks have been able to improve their bottom line by doing acquisitions, but the reality is that the costs of servicing customers have continued to go up.

In fact, if you translate the acquisition price to cost per customer, it has doubled. This pressure on margins has actually grown worse during the process of acquisition. As a result, there is a very strong incentive for banks to create non-interest income instead of simply margin or interest income. That is also reflected in the difference between fee income and spread income. Many years ago there was a very small reliance by banks on fee income. Most of their earnings were interest margin.

In 1997, that ratio hit roughly 50% and has held there. Clearly that number needs to go up, but the reality is banks are searching and are in greater need now for fee income than they have ever been. People ask the question, Why now for banks and why not five years ago? They could do many of the same things five years ago they can do now. The answer is that the struggle for fee income has now become critical in the banking industry.

Chart 1 shows the percentage of revenue and after-tax operating profit in the financial services market. When you look at the results of these industries, you can see that banks are relatively efficient in generating profits for a given dollar of revenue. The insurance industry has very significant revenue opportunities that banks are focusing on, but so far, on an after-tax profit basis, traditional insurers are delivering much less. A new value proposition is of great interest in financial services not only from a consumer, but also from a financial, standpoint.

The Bank Administration Institute, in conjunction with the Boston Consulting Group, did a study a year ago. They looked at the opportunities to create in the U.S. the same kind of reengineering of the value proposition for selling insurance through banks and came up with a model. If you could create a bancassurance business in the U.S. marketplace, you could get a very significant increase in revenues both for the insurance companies and for the banks. This is the promise of bancassurance, and this is what many of the bankers have focused on.

If you can implement that in the U.S. marketplace, you get a very different picture of the economic attractiveness of banks in the insurance market. It begins to approach the amount of after-tax earnings created by just banking alone. When you add in investments, including the opportunity for investment products, you can see that it equals banking. The theory is that there is an opportunity to double profits, most of it coming in fee income that they are desperately seeking.

If you think about the process of European bancassurance, in France, for example, almost 60% of insurance is sold through banks. Similar results have occurred in other European countries. There are a number of caveats to this, not the least of which is the fact that in some ways you're comparing apples and oranges. The products are somewhat different.

Most importantly, the Europeans got started much earlier. The equivalent of Gramm-Leach-Bliley occurred 15 years ago in the U.K. In France, there were very few restrictions on banks. They were able to evolve more naturally. It is only in the U.S. that federal regulations have kept these industries separate for so much longer. Europe got to this point without federal regulation, and, of course, we all know where we are with federal regulation. The sale of traditional insurance products through banks is currently less than 2%.

Bancassurance can be much more profitable than the traditional agency process. Sales costs are reduced. You have an embedded distribution system. You are not paying the high commission rates that are typically earned by the agent salesforce. Improved efficiencies in back-office operations are no surprise, in fact, in Europe you did not have the encumbrance of the systems problems that continue to plague the U.S. insurance market. A much more efficient kind of back-office operations will have a similar impact on pricing.

After the Citicorp-Travelers deal, when Sandy Weill talked about expecting a flood of new entrants into the marketplace, I think there are three kinds of things that he was thinking about when he made his prediction. First, banks have a fee income imperative that simply forces them to move into new products. They have had spread erosion. They have opportunities to leverage their brand; they have opportunities with their distribution system. They need to take advantage of them.

Second, they need to have diversified financial services kinds of menus. Banks will need to stop being just banks and become financial services competitors in a variety of products, as their traditional core products are commoditized. Consumers want to reduce the 12 monthly statements they receive today. We're unlikely to see one-stop shopping, but for most individuals it's not going to be 12-stop shopping either. There are going to be a finite number of winners, and the question is, Who has the best opportunity to do that?

The final issue is capital. Banks have a huge amount of capital available. One of the CEOs in the insurance industry recently observed that there is as much excess capital in the banking industry, over and above their regulatory capital requirements, as there is in the entire market cap in the insurance industry. There are significant amounts of capital available for acquisition.

But we haven't seen this big flood of acquisitions in the marketplace, and Francis is going to talk about some specific reasons for it. The bottom line reality is that a bank can earn 80% of the economics of the insurance industry without buying the company. Most of that lies, as you probably know, in distribution. If you buy a company, you are, in effect, paying the whole price for an incremental 20% of the economics due to underwriting. With that 20% unfortunately comes a dilutive transaction simply by virtue of the differentials between return on equity in the two industries.

You also have an industry where growth is very capital intensive just at a time when, despite the abundance of capital, there are other demands on capital. Much of this capital is focused on customer data mining, which is hugely expensive. If we are going to understand what our customers want and be able to target our offers, we will have to spend a large amount of money on that area, as well as other technology.

In addition, there are various new kinds of earnings volatility, particularly on the casualty side of the insurance business. There are many CEOs who have commented about how they might explain a lapse in one quarter's earnings due to a hurricane in Florida, and the prospect of doing that frightens them. This is not necessarily a kind of risk that they're unwilling to take and manage, but it is a different risk, and that by itself is a significant factor for many of them.

Finally, integration issues always come up. Usually in the traditional banking mergers you get a lot of economies of scale by merging back-office systems and creating those kinds of competitive advantages. A bank buying an insurance company would not have that available to them. The issue might actually be not how much can you save in a systems integration, but how much will you have to spend over and above the purchase price to make the systems talk to each other, much less merge them. And certainly we've all heard about the cultural differences between banking and insurance.

If you can overcome all of those things and begin to look at potential merger candidates, there aren't that many really good fits. If you surveyed the insurance industry in the U.S., you'd probably be able to count on one hand the number of insurance opportunities that are a really good fit for banks. Companies that are significant in the annuities business would be natural fits for banks, but only a small number of them are annuity focused and really make sense.

On the other hand, there might be another six to 10 that are not excellent fits, but good, acceptable fits. You're talking about less than 12 that really make sense for banks. Once you decide that you do want to acquire them, it's going to be tough. As one of our actuaries pointed out, the really good companies are going to be expensive, and so are the bad ones. It's a very difficult process, and although we are aware of a couple of near misses where banks made a serious attempt to acquire some major insurers in the U.S., none of them have happened yet.

Clearly you can make a case for acquisition, but it's a less solid case. It rationalizes the outcome. You could argue whether prospective dilution is really material. If you have a huge bank acquiring an insurance company, the market cap differences will likely be so significant

that you could argue that the dilution is really not material. You've got a huge company buying a small one. It's dilutive, but it's also very small. The question is whether it would even be material.

In discussing regulatory capital versus ratings capital, you're talking about the practice of maintaining capital in the industry to satisfy the analysts, not necessarily to satisfy the rule of law. You could argue that if an AA+ quality financial institution has acquired an insurance company, then that company may not need to maintain the same level of capital. Certainly it has to meet regulatory capital requirements, but in that kind of environment, with a large well-capitalized financial holding company, you could argue that you wouldn't need to maintain the same level of capital in a subsidiary. Therefore, the returns on capital of the business itself would go up.

Can you fix these concerns? The answer is probably yes. There are ways to economize and optimize the capital structure within a financial holding company that are not available in either a bank by itself or an insurance company by itself. Merrill Lynch analysts have suggested that if you could economize on capital in a financial holding company structure, you could potentially increase the returns on the insurance business by as much as 250 basis points. That's pretty significant. If you believe that kind of analysis, then you can actually make it work. You haven't really seen it work yet, however.

Banks and insurance companies have been using the same market entry and growth strategies. In the traditional U.S. approach to bancassurance, there is a bank on one side selling, and an insurance entity on the other manufacturing. The easiest way to go about this for a bank is to outsource the sales force, and there are many examples of that in small community bank organizations. There are also some examples in the very largest banks. A good example of this is First Union, which is one of the largest insurance players in the marketplace today, and also one of the largest banks. If you call the 800 number looking for commercial insurance in response to their advertising and promotional materials, it does not ring at First Union. It rings at a large insurance company in New York that answers as First Union. For smaller companies a good way to get into the business is by outsourcing, but it's also true for the very largest companies as well.

Third-party marketers (TPMs) have been around for a long time. Their claim to fame in the early days was to put investment representatives in banks that were not bank employees. Most of the banks throughout the course of several years have internalized those employees. They are now bank employees. TPMs have been falling by the wayside, at least in the investment business. That's changing now. TPMs are now turning their attention to the insurance business, just as they did to the investment business 10 years ago. You now have many examples of an insurance agent sitting in a bank branch who is not a bank employee, and this has become a very popular way of getting into the business. It has been permitted by regulatory exceptions to the law, which have been approved by the regulators.

Alliances are the most common form of U.S. bancassurance. They include a manufacturer of insurance products sold by a distributor of insurance products, typically a bank-owned agency. A joint venture is another possibility. I distinguish between the two in that a joint venture is a third company jointly owned either by a bank and an insurance company or by a bank and an insurance agency. There are not very many good examples of this, but certainly it is a form that

holds some promise. Ownership is the ultimate commitment. We talked about the prospects of owning an insurance company, but there are other ways to go about the business, too.

A final note on this. When I was asked to write a comment on this topic about a year-and-a-half ago by *American Banker,* I titled it "Be Careful What You Wish For," for some of the same reasons that I've talked about here. In that article I suggested a different way for banks to approach owning an insurance company. It's something that's very familiar to the insurance industry, but not as familiar to traditional bankers. When you ask bankers why they would want to own the company as opposed to simply owning 80% of the economics, most of them tell you the first reason is they want to control it. The second reason they give you is they want to control it. The third reason they give you is they want to control it.

Certainly there are critical mass issues and buying immediate expertise kinds of issues, but mainly they want to control the business. They want to control the product development, the customer service quality, and so on. Let me describe a method that is being investigated by a number of very large banks. Some of them are a fair piece down the road in this, in fact. For a virtual company, a bank simply acquires a charter, adds capital, gets a license, puts management in place, sets up the accounting, and outsources everything else. You probably would want to retain distribution by using your own branch distribution system. You may want to retain asset management. There's some of that being done now already. You may even want to retain some elements of customer service, driven by the control issue.

Virtually everything else can be outsourced to others. You can outsource customer service. You can outsource product development, administration, claims management, and underwriting. You don't really need any of the infrastructures yourself to conduct the business. This is an approach that you will see announced in the near future, with major banks entering the business this way. There are a number of them that already have the charters in place and are entering into the various outsourcing agreements.

The real issue that we're talking about here is one that applies not just to banks but also to insurers. That has to do with the evolution of the sales model, particularly in banks. In the past it has been very product centered. Banks sold bank products. It was a "Field of Dreams" strategy. The idea was that if you build it, they would come. In fact, the lack of a sales culture in banks with this approach for all their businesses is pretty legendary.

They have not completely overcome that, but they are moving in the right direction. They want more of a sales-centered culture. This means that, for the first time, they have hired sales managers. The sales manager's responsibility is to get people to want what the bank offers. For the first time in banks you have sales management doing those kinds of things.

Banks, insurance companies, and securities firms need to get to a customer-centered approach. This is what's happening with respect to convergence. It is not how to get people to want what you have, but, How do I have what people want? This is a very different kind of approach to the business. There is an array of financial products that are now delivered through eight to 12 different providers. There is no reason why any institution, whether it is a bank, an insurance company, or a broker dealer, can't do all of this. In many cases they're doing most of it already. Chart 2 shows the kind of multi-product imperative that everyone is trying to get to and the questions are, Who's going to get there first, and Who is going to have the most impact?

When you look at who has the present advantage, one of the things that you have to consider is who owns the customer. By that I mean who has the greatest wallet share. Gallup has done a consumer survey every year for the past six or seven years. It talks about which customers own at least one service from a provider and, more importantly, which industry is designated as being the lead financial institution for that client. There is a very significant competitive advantage for banks, owning not just some service for the customer, one of those 12 or 16 products, but having the major relationship. The reality is that banks have a cross-sell ratio somewhere in the range of two to two-and one-half products per family, so clearly nobody is doing a really good job at this.

The financial services industry has an identity crisis. For the first time managers need to decide what kind of company they want to be. Are they taking a stick-to-your-knitting kind of position, or do they choose to be all things to the people that they serve? This is a big issue in boardrooms around the country. In the insurance industry in particular, what kind of competitor do you want to be? Can you afford to be vertically integrated by manufacturing the product, selling the product, and servicing the product?

When you look at a virtual company structure, there is a strong incentive for companies to unbundle their services, to spin off their servicing capabilities and lease them to the highest bidders. A lot of the bankers are doing exactly that. They might contract with the service provider of a major insurance company that used to be a department in the company and now is a separately capitalized subsidiary.

In summary, banks have a strong competitive advantage in large, underserved markets. They have a major customer wallet share. They have a huge distribution capability. They have the potential to dominate growth in what has been a slow growth industry. Look at the number of banks. The conventional wisdom is they've been shrinking over time, and that's true. However, if you look at their distribution capability over the past 20 years, you'll see that the number of branches has actually grown by 60% while the number of banks has shrunk by 40%. This is not well understood in the marketplace.

Let's compare bancassurance in the U.S. and Europe over the past 20 years. The U.S. has a very similar number, probably within 10% of the European number of banks. If you look at the number of branches, where European bancassurers have been allowed to grow their distribution not just in banking products but also in securities and insurance, you see that they have grown much faster, to more than three times the number of U.S. branches. If you think we're following the European pattern, you might expect more branches, not less.

Banks also have a strong capital base, giving them the capacity to acquire. This also gives them an Internet advantage. With respect to acquisition, most of the activity has been in insurance agencies. This year we'll likely see more agency acquisition by banks than in the three years prior combined. With this activity going on in bank acquisition of agencies, to the extent that you believe this is a zero-sum game, it's a fairly significant risk for insurers. If a bank buys an agency, that's one less distributor for the insurer. We hear a lot of insurance industry executives complaining that banks have now acquired some of their best sellers of product, and that distribution relationship is now at risk.

Most of the information suggests that banks are ahead of the insurance industry in Internet penetration. Most of the insurance industry surveys I have seen suggest that insurers can at

best hope to be somewhere close to where banks are now over the next five years. I think this is going to change very significantly, but currently the range of expectations by insurance executives is for a minimum of 2% and a maximum of 10% share of the market on the Internet. I think that will change.

Banks also have a more competitive cost structure. They have pricing advantages to the extent that they can reduce distribution and administrative costs, and this notion of pricing transparency is one you're going to see quite a lot of activity about. By this I mean simply that the mystique of insurance pricing is going to go away, largely driven by the Internet. This will be very similar to the process of deregulating commissions in the securities industry. When the rules permitted deregulation of commissions many years ago, discount brokerages started to spring up.

If transactions through a discount brokerage are $2 a share, versus transactions at a Merrill Lynch type of company, at $30 a share, customers begin to ask, What additional services are they receiving for the other $28? And that really is the issue. You had better be able to demonstrate that you're creating value for that $28, or it's going to go away. The same kinds of things are happening in the insurance industry. If you can buy insurance products dramatically cheaper, either over the Internet or through a cheaper distribution system, you had better be able to justify the higher cost. That kind of pricing transparency is going to create a huge need for demonstrated value added in the sales process.

The full-service-competitor issue says, "I'm a financial services competitor, not a bank, not an insurer, not a securities company." To what extent is this going to force insurers to invest heavily to achieve parity with that kind of competitive offering? To what extent is it going to force them to unbundle their various services to achieve greater focus in the things that they do well?

At the end of the day, I think acquisitions are a strategic, not a financial, decision. There will be decisions made to acquire. We've seen some near misses already. I think it's an issue of scale and expertise versus an integration nightmare. Most bankers think that integrating an insurance company into their business mix would be a nightmare, and I think they're probably right. The real issue is positioning strategy. It's the same issue for banks as it is for insurers and securities companies, and it's not as easy as many people think.

Mr. Francis de Regnaucourt: Jim has given you a very broad overview of the way banks look at this. I will focus on the effect of HR-10 on life insurance companies risk exposures.

Today, we know the law as Gramm-Leach-Bliley. HR-10 goes back at least five years. Prior to that people just called it the repeal of McCarran-Ferguson. It's had a lot of different names and it finally happened, but if you've gone to any of the other sessions on this topic, you must be awfully disappointed, because a lot of us are telling you that not very much happened.

At another session someone commented, and I think quite accurately, that the legislators who passed Gramm-Leach-Bliley are probably wondering why they bothered. It has been anticlimactic. We've been talking about it for a long time. The rest of my presentation will tell you why not a great deal has happened. We can dress this up any number of ways you want. We can put lipstick on the pig, but there's not much to say.

I will get into a little bit more detail and look at it through a couple of different lenses. We'll talk about what people thought was going to happen when Gramm-Leach-Bliley was passed, what really happened, and what did happen but doesn't matter. The first thing I've got to say is that the act does add flexibility. It used to be that a bank could not buy an insurance company, and an insurance company could not buy a bank.

Now, you'll say to me, well, Citigroup did it, didn't they? In fact, they did it a couple years ago. If HR-10 hadn't passed, they would have had to modify that transaction. There are some things that have come from it. As Jim pointed out to you, although you can keep the lawyers happy and actually buy the insurance company if you're a bank, there were ways of getting around it and taking 80% of the economic value. Why do these people do it? They don't do it to put their name on an insurance company. They do it for the economic value, and we'll get into a little bit more about how that worked.

Sandy Weill said there would be a flood of new entrants. I'm still waiting. I know it was only passed a short time ago. This isn't to say it's not going to happen, but you'll notice that it's not like the floodgates opened and a couple of weeks later a few deals were announced. There was another deal, involving Conseco and Green Tree. That's run into some trouble, but I don't think it's tied at all to legislative types of problems. It was just the risk exposures of the buyer, the seller, and then the combined risk exposure when they got together.

There's one last thing I want to point out to you that people maybe haven't realized, and this is part of your risk exposure. If you're a bank and you buy an insurance company, or if you're an insurance company and you buy a bank, you bought all kinds of good stuff, but what you've also bought is a new regulator. If any of you in the audience are regulators, I apologize in advance. When I was at the rating agency I rated insurance companies, but I also went to a good number of bank meetings, maybe 30 or 40 in the five years I was there. I drew the conclusion that bank managements are at least as frustrated with their regulators as you are with yours.

Let's go into a little bit more detail. Why do I say that not much is new? A bank can own an insurer. Lawyers will be happy. Now you can own it the real way by having your name on the door. Prior to owning it banks could sell insurance and annuities. In some ways the Barnett decision was more of a watershed for this industry than the passage of Gramm-Leach-Bliley. You could participate in the profits. New York State has commission limitations, but if you're not in New York State and you're a wholesale distributor, you can set up whatever commission arrangement you want. If the commission arrangement happens to have a share of the profits, that works just as well. This has always been done with credit insurance. Or, if you want to get really clever, you create an offshore reinsurance company. It's a way of doing the same thing and usually is more tax efficient. You spend a bit more money, and consultants love you.

Mr. Peter S. Kreuter: I'm one of those regulators in the audience. I want to mention that New York has revamped its commission regulations, and a profit share would be allowed under the new law.

Mr. De Regnaucourt: Thanks for the clarification. Now we're going to look at specific lenses. In a way most of the conversation has been about banks buying life insurance companies. People have been talking about this for a long time, and to some degree it happened. If you

look at it through the bank's eyes, if you are asking the board for $100 million to buy a life insurance company, this is what they see.

Currently bank ROEs are doing pretty well. This hasn't always been the case, but for the most part they are in the 15–18% range. Then they look at a life insurer taken as a whole, and they see 12%. Some of them do a bit better. You see a lot of life insurers that are lower than 12%. P&C insurers earn about 10%. There is an obvious and rather simplistic question. Why take my capital that could be earning 15–18% and put it in a 10–12% business?

If you buy the whole thing, you get the underwriters with the underwriting and the processing parts, and you're getting lousy returns. Jim just spent a lot of time telling you that fee income is the bank's mantra. Fee income doesn't take that much capital. It doesn't disappear when claims go against you. It doesn't disappear while your expenses go on into the future. It's hard dollars. From where they sit, why would you buy these things?

This discussion has focused on the life insurance industry as a whole. We've all seen in the last 10 years that annuities, especially variable annuities (VAs), have had a lot more growth. They've had a lot more return; they take a lot less capital and they resemble bank products. You've got a mutual fund, you've got a VA—your customer can't always tell the difference. There are a lot of differences behind the scenes, but in their economic value they look similar.

It would make sense for a bank to buy an annuity writer and bypass some of these lousy returns. Here's the rub. Most annuity writers are already getting a pile of their distribution from banks. This means that if you buy one of them, you're probably buying something where 30% of their business depends on and feeds the profits of your competitor. Next you search for unaffiliated writers. Insurers that aren't already in relationships with other banks are hard to find. When you find them, they're expensive. As Jim said, they're expensive if they're good. They're expensive if they're bad. That's one of the reasons you haven't seen a flood of new entrants.

What about insurers buying banks? In the mid-1980s, the insurance companies were going to be everything to everybody with one-stop shopping, full service financial institutions. They had these agents, these trusted advisors. If the guy was so trusted and he sold you insurance, which was a difficult sale, why couldn't he sell you a CD? Why couldn't he sell you U.S. Savings Bonds? And while he was at it, if he was that trusted, why couldn't he underwrite your mortgage?

There was a time when life insurance companies were seriously thinking of getting into the banking business because they thought they had good distribution. Now things have changed. They like bank distribution, but that's history. Look at it from their standpoint. If the distribution of the banks is what they want, they already have it, and if they don't, their competitors have it. Think of how many annuity sales banks are already doing these days. Then they also saw the additional regulator. It's expensive not only because you have to hire lawyers, but also in terms of the capital you have to put up. It's expensive in terms of the extra requirements you put on yourself at point of sale in your contracts and systems.

Then they looked at it from another standpoint. When you're running a financial services institution you've got to look at risk management, and, generally, you try to diversify your risks. I spent six years looking at the risks in life insurance companies, and at the end of the day, life

insurance companies were, from what it looked like to us, deposit-taking institutions. Sure, there's a part where they do insurance risk. Take out the health insurers, because that's not whom I'm talking about. There's term; there's the insurance part of universal life; there's the insurance part of whole life.

But do you know what happens? People die at the same rates regardless of what happens. It's not tied to economic cycles. It's pretty predictable. The improvement in mortality is pretty predictable, and even if you can't predict it, it's very efficiently reinsurable. At the end of the day on the mortality side you don't make a lot of money, you don't lose a lot of money, you don't take a lot of risk. Most of the problems are still tied to expenses.

If you're an insurance company, especially in the eyes of outside investors, you are a deposit-taking institution. You have the same risk. If interest rates go down, you get hammered the same way. If interest rates go up, you get hammered the same way. You bought the callable bonds. You gave the options to your depositors or to your policyholders as the case may be. When an insurer buys a bank, they are not diversifying risk. A lot of them were scared off by that possibility.

I'm going to take a different point of view. People were predicting a flood of new entrants. People were predicting big megamergers. Why were they saying that? There were two things. The cross-selling possibility is one of them, along with the back-office consolidation leading to increases in efficiency and economies of scale. You've heard all the terms.

I'm not quite sure what went wrong, but if you go back over the last 20 years, there hasn't been much success at cross-selling. When I came out of college in the late 1970s, the big thing was P&C companies and life companies. A lot of life companies had big P&C operations. A lot of companies were both, and they said, "We've got this whole network of P&C agents." That's insurance. They have customers who trust them. Why can't they sell life? We'll give them some training. We'll give them a specialist in their office. And then the life guys were told, "You can sell P&C." Well, it didn't happen.

I talked a little bit about the mid-1980s. The life guy was going to sell a variety of products. He certainly learned to sell annuities because that paid a good commission and was an easy sale, but underwriting a mortgage—that's a detailed thing. Life insurance is a whole different kind of sale. These people are taught from the moment they come in that their mission in life is to wake people up to their real responsibilities, to buy insurance and spend a lot of money.

It's a culture. They're very good at what they do and they're very much into that culture, but these are not the detail people who are going to sell U.S. Savings Bonds for you or who are going to underwrite mortgages. This is just my read on what happened, but I think it's conventional wisdom. Whatever was going to happen in cross-selling really hasn't, and all I can do is point in a general way at cultural channel conflicts to say why it hasn't happened.

Customer privacy issues are a fairly current topic. You hear about it a lot in the press, especially the consumer press. James Valentino at a session on e-commerce said, when people are surveyed they all say privacy is a big problem, but if you offer them air miles they'll give you whatever information you want.

It's tough to know how big a deal this is, but the fact is we're talking about regulation. We're talking about legal defensive postures. We're talking about systems. We're talking about the kinds of things that make credit-rating analysts stay up at night wondering what the next thing is that's going to happen and cost you $1 billion. It's out there, and that is a crimp in the cross-selling idea.

There are a couple of things that can go wrong in today's market acquisitions environment. This is a good stock market. There are good properties that are for sale. They are expensive. There are lousy properties that are for sale. They're expensive, too. That means you pay a premium for them. To justify the premium you've got to hang your hat on something. We're paying more than this is worth because we think that we can cross-sell. We can add some value. Because we think we can cut out some of the back room, that will cause some added value, and that's how we can justify the prices. It takes some pretty creative financial people, but they're there. And that's how they justify the prices. They do the deal, and 18 months later they take $1-2 billion goodwill and write it off.

This leads to disappointed investors, although disappointment is not the word that investors have used when they see $1 or $2 billion write-offs because the execution of the deal didn't work. Remember that there's a lot of execution risk in these things. Very few acquisitions and mergers have really worked. Some of them have worked partly and added some value.

But if you're sitting there as the manager, one good way to end your career is to do an acquisition, hanging your hat on some of these things that are highly unproven. I would say that the current thinking among company managements is, We're not paying a premium unless we are really sure we can get the savings," and more and more they're realizing that the savings may not be there.

I'll give you a little sidebar. A few years ago when demutualization was just starting, a lot of company CEOs would visit us at the rating agency and tell us why demutualization was the best thing that was going to happen to them. They brought out all the usual reasons. They were able to do more acquisitions, more efficiently use capital, and have more access to the capital markets.

I remember one of them beaming from ear to ear as he told me that they would get market discipline. I thought for a little while about what he said. What exactly is market discipline? Market discipline is when you do something that doesn't work and the markets don't like you anymore. Your stock price goes down. When the stock price goes down, the big institutional shareholders start voting blocks of shares. They apply the only point of pressure that's available to them. They sack the CEO. But here was this smart man, the CEO of a really good insurance company, grinning away and talking about market discipline. This is one way that market discipline affects mergers and acquisitions, holding back the flood of new entrants.

Economies of scale seem to make sense. You join two operations. You don't need two accounting departments; you sack one. Wait a second. If you sack the life insurance accounting department, who's going to do your statutory accounting? Does everyone know statutory accounting? It takes a lot of years to learn that. You've got to hire some of them back. What about this GAAP stuff? Does anyone understand deferred policy acquisition cost? Unearned revenues? What's all this stuff? Better hire some of them back. There's different accounting. You don't get all the economies of scale you wanted.

You can sack one of your two investor relations departments or regulatory relations departments, except guess what? Your new state regulator is a whole different person, and he talks a whole different language and has a different act that he's enforcing. You need to get those people back. By the way, toss in a few more lawyers and a few more actuaries. Add something to systems. Get those people back.

You thought you were able to have one head of agency sales. The guy who speaks to the bank clerks and to the people who sell you U.S. Savings Bonds and gets them all charged up to do their work is a different guy than the one who goes to the sales conventions in Hawaii and charges up those people. In the long run, do you really save that much?

Banks and insurers sell different products. You thought you could toss out the systems. Nothing will ever replace the systems for whole life. In fact, if we ever had to get into that COBOL code, some of which was put into Assembler, and really change something, we'd be in deep trouble. It was a close call at the end of the year 2000.

My point is that the economies of scale haven't really worked out that much, but I'll give you one caveat. My advice would be to look at Citigroup. Just watch them. They're a smart group of people. Travelers, especially with Sandy Weill, is a smart company. Citi has had its ups and downs but by and large has been one of the best global firms over a long period of time. If it can be done, my bet is that they will do it. But if they do it, there are no patents and no secrets. What they do will be easily duplicated. It hasn't happened yet, at least to my knowledge, but watch them. If there's potential to make it work, that's the place to look for it.

There hasn't been a flood of potential acquirers. Let's round up the usual suspects and see what they're doing. Conseco is otherwise occupied for a little while. For other companies, keep in mind that their press releases don't include everything they're doing. There hasn't been a rush to form more Citigroups. It doesn't mean that won't happen in the future.

In fact, by way of a counterexample, look at AXA Financial. It used to be The Equitable Companies. They've gone the other way. It has nothing to do with Gramm-Leach-Bliley. It has to do with the fact they made a pile of money in DLJ. They're not sure they're going to make that much more. The markets are changing. You can sure get a good price for it. They did get a good price for it, and they might need the cash for something else, perhaps to fund their stock buy-back. The existing consolidators aren't doing much.

On the other hand, something has changed for the foreigners. I'm speaking here mainly about Europeans, but it's not limited to them. When they came to the U.S., they had to decide between being a bank or an insurance company. One of the best examples I can give you is ING. Outside of the U.S. and Canada there isn't an airport that I have been to that you can't drive away from and see a great big billboard, one of the first ones when you drive away, that advertises for ING Bank. Worldwide, it is a bank.

Their most recent chairman came up through the bank side. His claim to fame is that he bought Barings. They are both a bank and an insurance company internationally, but in the U.S., where they're already quite a large presence, ING is an insurance company, period. It had to choose. Now there is a real possibility that it, or some other firm similarly situated, can be both and do what they do best in their home country.

To conclude, I'll restate what I said at the beginning and hope that what I said in between was in the same general direction. The added flexibility of HR-10 is good. On the other hand, what really matters is the economics, and most of that was already being taken care of.

Combinations can add value, but it's not easy and it's not happening that much. Finally, extra regulation is expensive and is, generally speaking, a negative. It's one thing that anyone who enters into a combination of this sort will have to deal with. If you're used to your state insurance commissioner, wait until you meet the feds, and vice versa.

Mr. Rudolph: Jim, in your presentation (Chart 3) you talked about the household profitability by decile. And you talked about the group that provides all the profits to the banks and another group that is a huge cost. Would you discuss the demographics of these groups?

Mr. Overholt: I could talk about some of it, and keep in mind that this will vary from bank to bank. This is a representation derived from a number of banks in a study, and it is pretty much replicated across the industry. The significant parts are that first decile and second decile. What characterizes the people who are providing most of the revenues? They are primarily the users of fee-based services, typically affluent, private-banking-type customers who also have trust-related business or investment-related business for which they're paying a fee. But don't be led to believe that it's all just affluent kinds of customers. There are a large number of middle-income-type customers and a fair number of low-income-type customers. It surprises people to find out that some of the largest payers of fees to banks are those customers who overdraft their accounts with a great deal of frequency and are paying overdraft fees. Some of the largest fee payers on average fall into that category.

That mass middle segment is typically the mass consumer marketplace, income levels in the $30,000–50,000 range, heavy users of transaction-based services, but not necessarily in the branches. These are the charge-card customers. These are the lending and credit customers. The money losers are the folks that use transaction services but typically use them in branches. These are the customers that insist on going to a teller to have a check cashed, and, believe me, brick and mortar kinds of platforms with real live people is a very expensive way to cash checks instead of using an ATM.

Mr. Martin E. Uhl: Along the lines of those fee incomes you're talking about, you showed some impressive ROEs for banks. What are the possibilities that a consumer backlash against some pretty horrendous fees I've seen around the country might bring those ROEs down and make the life insurance industry look a little better comparatively?

Mr. Overholt: My comment would be that you're already seeing that. Particularly here in Chicago, beginning some years ago when First National Bank of Chicago decided to charge $3 for a teller visit. Of course, there was a huge consumer backlash for that. There has been a huge consumer backlash in California and other places for users of ATM services outside the bank's own network. A bank goes to the expense of creating a very expensive ATM network and charges a fee for the users of that network who are not already depositors of the bank.

There has actually been legislation introduced, and in a couple of instances passed, that would purport to prevent banks from charging a fee for the use of ATM networks. It has subsequently been overturned. There's none in place that I know of now, but you're right. There is a

significant need by banks to drive their costs down. They are in a commodity type of business with a very expensive distribution network. Their risk is being able to get the expensive kinds of transactions out of the branches and into an electronic means. Instead of check cashing, use your ATM system and, in turn, employ the branches to sell very fee-oriented kinds of products. This is much the same as you might get walking into a brick and mortar agency or a brick and mortar Merrill Lynch office. That's the transformation that's occurring. Banks are not trying to get customers out of the branches. They're trying to get certain customers out of the branches.

Ms. Sarah L. M. Christiansen: In Iowa there is a law that says there are no fees for ATM use. There's also a requirement that every ATM card work in every ATM machine if the bank is local to the state. I think if there's a bank that doesn't serve Iowa, and they're not on an Iowa system, then that may not hold, but it certainly does work within the state. I don't have to worry about what symbol the ATM machine displays unless I'm out of state.

Mr. Overholt: I was not aware that Iowa had that law still standing. Has it been challenged?

Ms. Christiansen: It was challenged recently by someone who put an ATM in a Sears store and wanted to charge. I don't think it was an Iowa bank. The law had been in effect for at least a decade. My comment is, if banks want customers, you can't charge for both the walk-up teller and the ATM machine. Take your pick, but you've got to give us access one way or the other.

Mr. Overholt: Don't misunderstand. I'm not an advocate of the banks' position on this, particularly when it comes to the bank's own customers. The reality, though, is that banks lost huge amounts of money when they deployed their ATM networks. They were simply very early to the game, and Citicorp was one of the leaders. The analysts raked the banks over the coals during those days because they literally were losing hundreds of millions of dollars in putting those ATMs out there. They thought their customers would use those machines instead of taking up space in the branches that could be better used to service customers looking for advice and more consultative kinds of sales. I don't know where the answer lies. I suppose you could nationalize the ATM network, but the reality is, it costs banks a lot of money to maintain the systems. It does provide an added amount of convenience to consumers, and the question is, How do they pay for it? If they are already bank customers, the bank could take the position that the relationship is valuable enough that they can provide the network for all of its customers and assume that each one of them is contributing on some pro rata basis. If they consider it to be a separate business line and it costs $200 million to maintain it, then they have to charge $200 million in fees just to break even. They are going to do that.

I do not think it is the province of our regulators to regulate the activity for banks. To the extent that they tell you what you can charge and what you can't charge, we're moving away from that. By the way, it applies not just to banks but to other automated systems using charge cards. Nordstrom's is one of the biggest issuers of charge cards. It's not just banks. It's a lot of different industries that are basically in the same boat.

Ms. Christiansen: A question was raised at an earlier session on market collapses and people who would naturally take opposite stands. If everybody had a 60/40 split between stock and bonds, you would get a very different picture than if you had 60% of the people with 100% in equity and 40% of the people with 100% in fixed income. They would react differently to changes in the markets. They would naturally step in at different times. Are we losing some of that with financial integration?

Mr. Overholt: I'm not sure I understand the question. Do you mean that the history of that relationship between equity and fixed income may change because of a new set of buyers entering the equation?

Ms. Christiansen: The way it was presented at the other session was that some of these major market collapses feed themselves, and you've got people who demand liquidity and people who supply liquidity. For example, there are a number of times when the stock market might be going down. People will start shifting from stocks into bonds and vice versa. If everybody is well diversified, then everybody may want to go the same way at the same time, whereas other people would think that equities are a great bargain right now. You might not have someone to naturally take the opposite position.

Mr. Rudolph: As I recall, what the presenter was talking about was, if everybody diversifies in exactly the same way, there's no market to buy and sell because everybody wants to sell at the same time and everybody wants to buy at the same time. It becomes a liquidity issue.

Mr. de Regnaucourt: You can look at this from another standpoint. Leaving aside the instruments that are there, look at the providers of those instruments. What if Fixed Income Company A only did fixed income and Mutual Fund Company B only did equities? If markets shift from fixed income to equities, Company B gets really rich really fast. Company A is out of business. If, on the other hand, you have Conglomerate C that happens to do both and sells a variable annuity for which it offers a fixed component and all the same mutual funds, they're neutral to the change. In that case consolidation added stability. It diversified the business risk from the point of view of the provider. The markets can do whatever they want behind them. The customers can do whatever they want in front of them. In the middle they are—I won't say immunized, that's going a little bit too far—but relatively neutral.

One of the big reasons insurance companies jumped on the variable annuity bandwagon is because they saw exactly that happening. The ones that did only fixed annuities were being left high and dry as they saw that trend continuing for quite a while, as it has done up until the last few months.

CHART 1

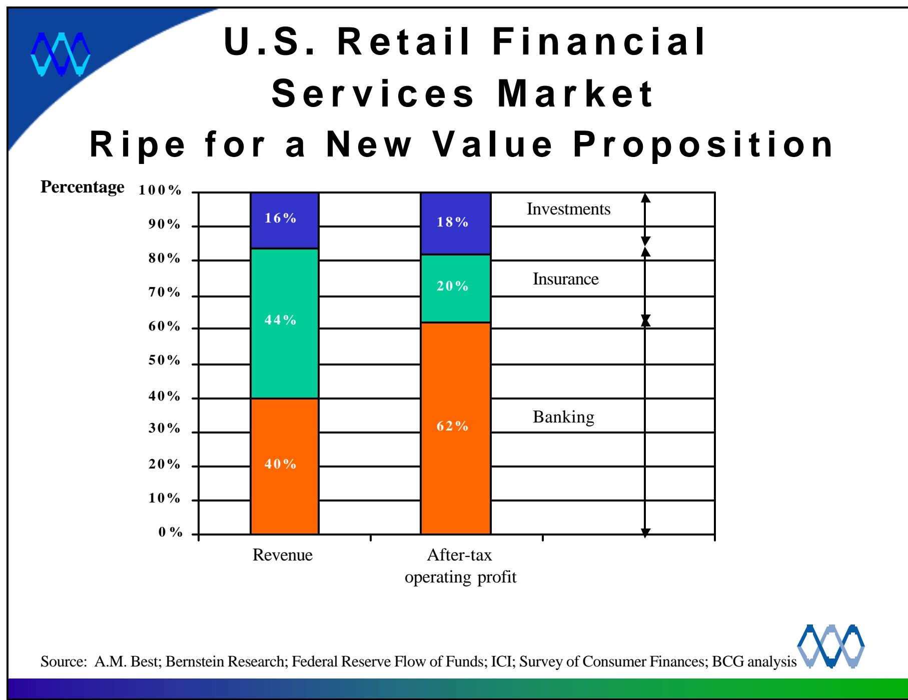

CHART 2

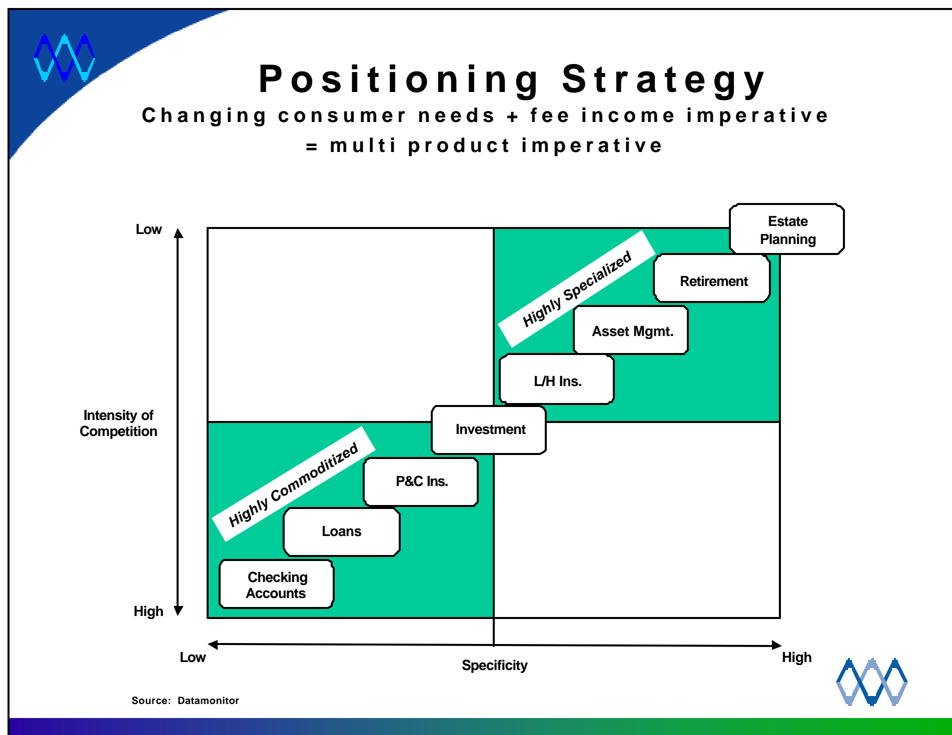

CHART 3