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Session 4PD
Financial Services Modernization—"What's the Impact on Banks and Insurance Companies?"

Track: Nontraditional Marketing/Product Development

Moderator: JAMES B. SMITH, JR.
Panelists: STEVEN D. LASH
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Recorder: KERRY J. KIXMILLER

Summary: Now that the Financial Services Modernization Law is about a year old, how are banks and insurance companies repositioning themselves?

Session topics:
- *New or modified strategies*
- *Any imminent changes in the federal law*
- *Have legislative efforts shifted to state laws*
- *Status of the state privacy laws and impact on customer segmentation*
- *"Leading Banks-In-Insurance Report" trends (10/00 Association of Banks-In-Insurance)*
- *How will products, distribution, and competition for the insurance industry be redefined*

Mr. James B. Smith, Jr.: We're very fortunate to have speakers who will , present the issue of bancassurance from two different perspectives. We have one speaker who is coming at it from the perspective primarily of banks, although he works with both banks and insurance companies. The other speaker is coming at it from the perspective of insurance, although he's working, I'm told, with a lot of banks. Ken Reynolds will be our first speaker. Ken is the executive director for the Association of Banks-in-Insurance (ABI). That association is located in Washington, D.C., and it represents both banks and insurance companies as they come together in the sale of insurance products. To give you a sense of the size of the association, the banks that are part of that ABI group represent about 60% of the bank assets in the U.S. So, you can see that Ken comes to us with a lot of good contacts in both the banking and the insurance industry.

Mr. E. Kenneth Reynolds: I spend 90% of my time studying financial services modernization. We're going to focus in more detail on one aspect of the

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†Mr. Reynolds, not a member of the sponsoring organizations, is executive director for the Association of Banks-in-Insurance in Washington, D.C.

modernized financial services marketplace, and that's specifically the sale by banking organizations of insurance.

I need to point out, that a study we're going to talk about is sponsored by, interestingly, insurance companies. The group that contributes significantly each year in order to make it possible for us to do this nationwide survey includes: American General Assurance Company, SCOR Reinsurance Company, HRH Financial Institutions Group, Inc., Balboa Life and Casualty Company in California, Minnesota Mutual Life Insurance Company, AEGON Financial Services Group, Life Insurance Marketing and Research Association (LIMRA, an organization that many of you are familiar with and that we work a lot with), Century-National Insurance Company, and the Assurant Group. Some of these are specialized companies that work with coverages that are unique to the bank channel, such as credit-related insurance. Others, for example AEGON, are major international insurance and banking conglomerates. These sponsors are really an important part of making it possible for us to create this 99 pages annual study.

Let me talk a little bit about the survey results. All 50 states were involved in the compilation of the information. We had a response from at least one institution in each of the 50 states. A total of 2,300 forms were sent out, and we got a 13.1% response rate. While that represents only 3% of the almost 9,000 banks and savings and loans in the country, it represents a much larger percentage of the assets because the response rate from the larger institutions was greater. The response rate, for example, for banks over $10 billion in assets was 45%, and the response rate for organizations between $1–10 billion was 39%. That means that 27% of all of the banks in the country that had assets in excess of $1 billion provided information for the survey.

Let's talk about key findings. The study determined that 78% of the respondents sold insurance in 1999. This was up slightly from the prior two years that we've done this study, 76% in 1998 and 71% in 1997. Another finding was that 48% of the respondents distribute general lines insurance, by which we mean coverages other than annuities or credit-related insurance. That includes non-credit-related life insurance, property and casualty coverages, and commercial coverages. The 48% that are now selling general lines coverage compares to 40% and 42% in 1997 and 1998 respectively.

The premium growth was 18% in 1999 over 1998. We're estimating from these responses that the total premium volume was about $36.7 billion compared to just a touch over $31 billion in 1998. Annuities, as a part of this total, grew at 23%, slightly faster than the overall total, and is still the largest category of sales, representing $24 billion of the $36 billion obtained.
The expansion of current programs was the primary contributor to the growth. In the earlier studies the growth seemed to come more from banks acquiring insurance agencies and establishing themselves with new programs. We're beginning to see some maturation, if you will, in the bank insurance business, and the growth now seems to be characterized more by expansion of pre-existing programs than by the establishment of new programs.

I should also point out for the analytical folks in the audience, as you'll see if you come across a copy of this study, that the study included a larger representation of larger banks this time. So, as you think about, as we have, the conclusions that can be drawn from the study, you have to bear in mind that we got more weighting from larger organizations than we have had in prior studies. The fact that more larger banks are participating may have affected the sense that these programs are expanding, because the larger banks have historically been more involved in adding to their product lines than the smaller banks have.

An analysis of the products that are being sold shows that of those banks selling general lines insurance, the vast majority, 63%, are selling both life/health and property/casualty coverages. Those selling only property/casualty products represent a very small 5%, and 32% only offer life and health. That's interesting because we're seeing a broad-based entry into the insurance business, in contrast to largely an annuities focus five, six, seven years ago.

The customer focus is interesting also. Sixty-six percent are addressing both the commercial and retail markets. Less than a third, 30%, are focusing simply on retail customers, and, a very small percentage, 4%, are focusing on commercial customers alone.

It's interesting also to take a look at the geographic patterns, which are similar to what we have seen in prior years. Participation is high in the central and eastern regions, but the west and southwest continue to lag behind the rest of the country in terms of banking organizations entering the general lines insurance business. Many of these banks in the west and southwest have been involved in credit-related coverages and, to some degree, annuities as well, but they haven't been as quick to embrace the other elements of the insurance product line.

The breakdown by institution size demonstrates, as I've indicated before, that 88% of the organizations that have assets in excess of $10 billion are involved in distributing general lines insurance and have been for several years. Organizations that are less than $100 million in assets, which by the way represents a very large percentage, like 65%, of all of the banks in this country, and you'll find that only one-third (33%) of them are involved in general lines coverages. This may also affect the geographic distribution, because the smaller organizations tend to be typical in a lot of western and southwestern communities.

Many banks, however, are planning to expand their product line and begin marketing these products. Out of the study responses, we drew five product areas that seemed to be, according to the responses, the most likely products that new organizations or organizations new to the business, plan to begin marketing in the next two years. This is also an indication of what additional products are being planned by those organizations that already have bank insurance programs up and running. Homeowner's, at 26% is the most significant of those, but they're all pretty close. Personal auto, long-term care and commercial property/casualty coverages are likely to be offered. Accident and health is likely to be offered by 23% of the organizations not currently offering those products.

The marketing methods being used: in spite of all of the technology and the internet and the whiz bang automated systems and voice response units and all of the things that we hear, face-to-face selling continues to be the way people like to buy many products, including insurance. Interestingly, the personal lines, property and casualty, auto, and homeowner's, seem to have a fairly significant penetration in electronic media or direct marketing, with 32% being face-to-face selling in that particular marketplace.

Things change more slowly than would often seem to be indicated by the headlines in our press. The message that banks are using, is, not surprisingly, trust and credibility, with the only exception being those so-called commodity products, the ones that don't have very much complexity to them. There, the marketing appeal tends to be convenience, price, value, and ease of acquisition, as opposed to the trust and credibility of the institution offering the coverage.

In terms of entry methods, primarily agency acquisitions are being used. This is particularly the case with the smaller organizations, the majority of those institutions in the country that operate just within a single state or, in many cases, within a portion of that state. Their entry method is property and casualty agency acquisitions.

The currency used for these acquisitions is generally cash as opposed to bank stock or a combination of stock and cash. Multiples have been edging up, that is, financial institutions are tending to pay a little bit more in terms of the size and revenue created by the agency. The average, for example, in terms of a multiple of revenue tends to have 1.5 to 1.7 as the most common range. In terms of the multiple of pro forma, pre-tax earnings, the most common range is between 5–6 times pre-tax income.

The fact that banking organizations are becoming a little more knowledgeable and sensitive to the factors involved in operating an insurance program is indicated by the fact that 31% of the time the results are more favorable than they had anticipated in the pro forma.

Regarding banks' interest in underwriting, you might be particularly interested in this, since I think many of you get involved in this very complicated part of the business. The level of interest is consistent with what we've seen in prior years. We did a smaller study five years ago that indicated that most of the banking organizations had little or no interest in underwriting. This is interesting because Congress just passed a law making it possible. It makes you wonder why Congress bothers if there isn't much interest in the underwriting business. I look forward to your questions in that regard. I'm not going to answer that question now, you're going to have to ask later. Then we'll figure out what Steve has to say in response.

Progress in sales effectiveness, however, is being made. One of the ways we are measuring this is by the contribution to income that arises from new business as opposed to just renewal volume or revenue from purchased business that came

with the agency that was bought. The contribution of new business written for long-term care is 97%–that leaves only 3% from renewal and from purchased business-compared to 74% in 1998. Homeowner's is 46% new business versus 28% from 1998. Commercial lines are almost better than double (47% now, 24% in 1998). That indicates that this engine, this mechanism of cross selling which the financial institutions have been looking for, may be starting to happen. You're getting some synergies as a result of the combination of insurance marketing activities and banking activities which can begin to drive and improve sales volume.

However, penetration rates continue to be very small. Although auto insurance is a very popular product, banking organizations have still penetrated less than 4% (3.6%). Four out of 100 of their customers have acquired automobile insurance from the banking-affiliated insurance agency, and that's the high point. It goes down from there. Only a little over 1% of the banks' customer base has acquired a long-term care product.

The contribution to the average bank's income is also quite small at 0.97%. The leaders, that is, the organizations that have the very best performing programs, still are only averaging a little over 2% (2.13%). The percentage of non-interest income, or all of the fee income that banking organizations acquire, including: all those nuisance charges for using ATMs and for not sufficient funds (NSF) checks, charges for cashing a check, minimum balance requirements, all the fee-generating things, that is coming from insurance revenues is still less than 3.5% (3.48%).

That leaves a long way to go, but, nevertheless, the grade that insurance programs in banks is achieving is pretty good. Of the respondents, 11.5% felt that their program was very successful, that is, exceeded their expectations. Thirty-eight and one-half percent felt it was successful. Thirty-nine percent gave it an I-think-it's-doing-okay kind of answer. Six percent said this thing is not doing too well. Four and one-half percent said we've got to figure out how to unwind this. Generally, it's pretty good, and it's a little bit higher level of satisfaction than we've seen in the prior two years' worth of studies.

Each year the responses that we get from our organizations are reviewed to identify the best or the leading programs which is how we got to the title of the study, "The ABI Study of Leading Banks-In-Insurance." In 1999, in picking through all of the responses and looking to identify very efficient programs, we identified eight bank insurance leaders: four were repeats from 1998 and four were new organizations. The smallest of these eight had less than $500 million in assets, and the largest had hundreds of billions. I'm not able to tell you the identity of those eight organizations because we promised them we'd keep it a secret, but there's a wide range from smallest to largest, which indicates that you don't have to be big to be successful. In fact, I think there are many of us who think that the bigger you are, the more difficult it is to be successful. There's a penalty from bigness, it seems to me.

In reviewing the results, when we find one of these leaders from the survey form, we give them a call. We talk to the executive who is at the policy-making level to

better understand what they're doing to make their programs successful. The compound annual growth rate of successful programs of these eight organizations was, on average, 27%, which is almost twice the average compound growth rate of premium volume, which is 15%. We find that these organizations have good growth in both the annuity products and as general lines coverages. They tend not to be stellar in one area and weak in another. Their strength seems to be broad based. They are getting an 11% compound annual growth rate in contribution to net operating revenue, which, again, is about twice what the overall average bank insurance program provided.

Finally, I want to touch on some of the best practices that came out of our discussions with the executives from these organizations. We can't really say precisely that the factors that we identified improved the programs significantly, but in the judgment of the executives that we spoke with, these are some of the keys to the success of their efforts. One that immediately comes to mind that was universally cited is that the organization had incorporated incentives for the sale of insurance into the banking organization's basic employee incentive program. So, if they provide sales incentives, as most banking organizations do nowadays, insurance plays a part in that incentive system, as opposed to being one of those extra things that you don't get paid for. I guess it's not surprising that this has helped them create a much higher level of sales and profitability than organizations that don't do that.

The focus of these organizations tended to be less on individual product profitability and more on premium volume, which is unlike banks, at least unlike banks in the last eight or ten years, which have spent so much time trying to evaluate profitable products and profitable customer relationships. There seems to be a feeling on the part of these larger organizations, and the small ones that are more successful, that you've got to establish a threshold. You have to get out there, and you have to be doing some business. The analogy I like to use is you have to have forward motion to be able to steer the enterprise. You can't make any refinement to your program and improve its profitability if you haven't been able to create sales in the first place.

So, there seems to be recognition that in these early phases we need to be focusing on getting the word out that the financial institution is in the insurance business and that you can buy insurance products from the institution. Certain investment levels are being made in order to begin to get some traction, to get some momentum developed with a view to refining the program for profitability in the years to come. One of the executives in these eight large organizations said, "Who cares how profitable we are if we're not contributing at least 5% of the bank's revenues?" It is commonly said in the banking business that you're not on the radar screen if you don't get up into at least 5% contribution to revenue.

Another thing that seems to characterize these most successful programs is focus and planning—a decision to make this a strategic commitment on the part of the organization which is evidenced by the fact that it is willing to invest some money in

building the volume and to incorporate it in the incentive compensation programs. That comes with, of course, executive management commitment.
They are doing some good customer segmentation and internal segmentation. That is, they're looking at various units within the bank, whether it's the commercial banking area, the trust group, private banking group, or retail bank, to identify organizations that have customer groups and management for that part of the business that is sensitive to and responsive to the insurance need. It's also typical of the most successful programs that they are providing lots of different mechanisms. They've acquired resources. They've hired people. They've bought agencies, in many cases. They've developed their own personnel. They're not using just one device to attack the insurance marketplace.

Finally, there seems to be a growing tendency toward simplification in products. This might be of particular interest to actuaries who enjoy sophisticated products. It seems that the most successful programs have taken out some of the bells and whistles and the complicated devices that tend to be used and have focused more on simplified products and, in many cases, simplified issue. Life insurance with limited health questions and speed of issue seems to be increasingly important.

Mr. Smith: Steve Lash is a partner with Ernst & Young in New York City. He tells me he is working more for banks than insurance companies as he deals with Banks-in-Insurance.

Mr. Steven D. Lash: I'm going to try to take you through an expansion of Ken's comments and try to give you some ideas of how we, as the insurance community, can work with banks and actually expand the pie. I'm going to talk a little bit about some statistics regarding bank participation in the insurance market. I'm going to focus a lot on some of the partnership strategies that are taking place now and what some of the things are that we can do. Then, I'll talk a little about mergers & acquisitions. One of the dangers, of course, about these presentations, is when I talk about bank participation, there is the possibility that my statistics won't be in line with Ken's; we can talk about a few that might be picked up that may not be in line.

Let's talk briefly about what the bank participation is in the market, but, to ground us all, I'd like to talk about the bank insurance continuum. Basically the continuum goes from no insurance activities at a bank to having a full insurance company, owning an insurance company, and in between you obviously have a lot of different steps that banks take in getting into insurance. If you look at the banking world, there are banks that are in every spot on this continuum.

Historically, a lot of banks that did not have any insurance activities usually started with credit life, distributing that product and then reinsuring that product. Once they became comfortable with that, they moved on to distribution through various other channels. What we've seen over the last five years or so are a lot of banks looking to take a bigger piece of the pie and actually putting profit-sharing arrangements into place. In particular, annuity reinsurance is something that's being explored and that a number of banks are doing. I want to get into the distribution aspects later

on. It's interesting what Ken stated about banks not wanting to get into underwriting, which is generally true, but there are a lot of banks that are trying to play on the margin and actually are taking on some risk. It is true they don't want to take on the full underwriting aspect, but they're trying to pick their spots concerning where to participate. One of those areas is annuity reinsurance. Some banks are also exploring the reinsuring of life and property/casualty products; that's in its infancy at the moment. Finally, you have those that own an insurance company, which are few and far between, but an obvious example of this is the Citicorp/Travelers acquisition. So, again, on that continuum, you have banks that participate.

I want to make a few brief comments concerning regulatory changes. The Gramm-Leach-Bliley bill passed, and I think the expectation, at the time when it passed, was that you were going to see a huge number of these mergers of banks and insurance companies. This just hasn't happened, and I think part of the issue, related to that, is that the legislation that was passed really didn't do much for the bancassurance industry. All it really did was validate what banks and insurance companies are already doing together. From an insurance perspective it didn't really open any new paths for banks and insurance companies. Banks were doing, and are still doing, everything they want to do, whether or not we had the legislation. When there's a will, there's a way. Banks found ways through various loopholes in regulations to underwrite if they wanted to. It was a little bit more costly, and there was some friction in doing that. Gramm-Leach-Bliley got rid of some of the friction cost of doing business; but business was already finding a way of getting it done. Gramm-Leach-Bliley really didn't do anything except ease the process. We can talk about that more.

To put things in perspective and to echo some of Ken's comments of where banks have been successful, clearly, it's been with annuities. Ken mentioned $31 billion in 1998—I have statistics of $28 billion. We're not too far off. Maybe that's from rounding, but clearly the message is that annuities are really the area that banks play in. All the other products have been fairly unsuccessful, with a few exceptions. The volume has not been there on anything but annuities: fixed and variable. Banks have been selling a little bit more variable than fixed of late, but they're almost at a 50/50 level.

In 1999, annuity sales skyrocketed to $26.5. That's somewhat of a tricky number because it includes the Citicorp/Travelers merger. Travelers' annuity sales, whether they're through banks or not, are now included in those statistics. So, the growth really hasn't been as dramatic as the numbers might imply.

Annuities are really the name of the game for banks. They have about a 30% market share, which is a pretty dominant market share on the fixed annuity side. On the variable annuity side, it's around a 13% level. So, from a market share perspective, banks have a much lower market share on variable annuities, but in absolute dollars they're selling more variable annuities than fixed annuities right now. That's pretty consistent with what we've seen in the market as to the growth in variable annuities.

The life market has been pretty poor. Bank market share is less than 2%. Bank after bank is struggling to find ways to sell more life insurance product and move from the annuity products. There are some programs out there that are deemed somewhat successful; but certainly the volume is not there, and banks are still struggling to figure out the best medium to deliver that product.

As I mentioned, banks are continuing to adopt and are continuing to explore different profit-sharing arrangements. There are a number of bank clients, bank institutions, that are examining the value chain of an insurance product, whether it be an annuity product or life product. For instance, on an annuity product, if the spread is 200 basis points, where does that money go, and where can we, as a bank, play? We want to get the most bang for our buck and get the most spread or the most profit from that product and get decent returns, but we don't necessarily want to play in all areas. We want to pick the major areas that we're going to play in. Distribution continues to be an issue, not only for banks, but for us in the insurance industry. All these issues regarding sharing the pie and what banks are going to do really are irrelevant, if we can't figure out ways to sell more products and actually expand the pie for all of us to share.

As I said, banks are about a 30% market share for fixed annuities and a 13% market share for variable annuities. It's been somewhat volatile in the fixed market, but see it's been a continual climb on the variable market, and, like it or not, banks are here to stay in the distribution of annuities.

As to who plays in this market, these are the insurance companies that play in the bank market and have deemed the bank market to be an area where they're going to focus a lot of their energies. What's interesting is that clearly the volume for the top players is very significant. The Hartford, through primarily variable annuities, has over $4 billion through banks out of about, I think, $11 billion of their total premium. So, around 40% of their volume comes from banks. It has taken a clear direction and this is a clear marketing strategy of distributing through banks. The top five players have always been the top five players, at least in the near past, from 1997 to 1999. There's been a real concentration of those institutions that have come out and said they are going to put a lot of time and energy in banks by training their wholesalers, getting out there and marketing.

Ken and I were both at the ABI meeting last week. You notice that when you watch what people are doing, you listen to people talk, there are a lot of relationships. There are a lot of people at these top institutions that know everybody at these meetings. These institutions are really somewhat of a family, and it would be very hard, I realize, for insurance companies to get in there and crack that family. It would take a lot of time and effort. The people that are there, the marketers and the wholesalers from the insurance companies, are well-known people and they have really good, strong relationships.

Moving on to the banks that are actually players, this is sort of the flip side of which banks are participating. Citigroup has a clear advantage, but, again, I would

discount those statistics because they encompass all of Travelers' annuities, whether or not they're sold through banks. So, I would discount Citigroup; and the growth rate from 1997 of $8.3 to $9.3 billion again is all Travelers. The Citibank life entity that existed before that merger only sold $600 million of annuities. So, the growth has all come from Travelers.

Again, the banks that are the leaders have almost always been the leaders. First Union has been a tremendous seller of annuities, mostly fixed annuities. So, during the boom of the stock market in variable annuities First Union has made their money on fixed annuities. For any institution, $2.7 billion is a very impressive number, and the growth has been there. That's enough from a statistical perspective.

We now move on to the question of what does this all mean? How can we in the insurance industry play? and How can we make this a win/win for everybody? That's what we need to do, figure out how this can be a win/win for everyone. So, I want to talk about five steps in the value chain. This is how I like to think about an insurance product, in terms of where the areas are that you can play. They're somewhat broad. I'm sure we can whittle them down and talk about a lot of different areas, but there are really five areas that we can think about: distribution, asset management, transaction processing or the back office, doing a reinsurance transaction, or actually directly underwriting. So, I want to put our thinking in that context of where can banks and insurers partner up and make it a win/win. So, let's talk about some of these different strategies.

Clearly, distribution is the area where banks have participated the most. That's how they got into the insurance business. Although this is an arguable point, they generally own the customer, and they have a lot better access to customers than we do in the insurance industry. Customers trust their local banks. Banks have, at least in theory, a much better way to touch their customers than the insurance companies. So, they've been more successful in distributing products on the annuity side than on the life side, and they tried different ways of distributing that product. I'll list some of them: the bank branch, the traditional agency, telemarketing, direct mail, and the Internet. From an annuity and a life perspective, the bank branch and the traditional agency have really been the successful way to sell products. These are the more traditional ways of selling product.

There are a couple of banks that are trying Web sites to which a policyholder can log on, fill out an application, answer six or seven questions, and be instantly bound for insurance. They mail the application to the applicant, and if the applicant doesn't mail back the application with their signature within 15 days, the insurance goes away. I think that is going to change now with the e-signatures and the bill that was passed and signed by Clinton recently. It's a very interesting concept, and I actually tried a few of these Web sites; it is pretty slick, and it works pretty well. It's a very interesting process as to how it works. I don't think the banks have said that it's been all that successful to date, but it is certainly an interesting concept, and only time will tell how that will work.

The commission structure for banks is really no different than a commission structure for a traditional distribution model. There are heaped commissions up front, and, as we all know, those commission structures can generally inhibit persistency. In this regard, banks are no different. Bank persistency rates at the end of surrender charge periods are just as poor as traditional models of distribution. So, we need to find ways to better improve the persistency of product. One way to do that is for banks to share more of the insurance pie to actually align everybody's interest. As I said earlier, we really have to find ways as a team of banks and insurers to sell more, and help the banks do training and wholesaling so they can actually sell more of your product.

Asset management is another area that is not necessarily new for banks. Banks that sell your variable annuities will, many times, insist that their funds are part of that variable annuity wrapper. It's a logical choice for a bank that is going to sell you a product; the bank's shelf is very full. There's a limited amount of players that can go in there. So, of course, a bank is going to use that leverage and try to get their funds into those variable annuity wrappers. Another area of management I've seen relates to banks selling fixed annuities and insisting that they manage a certain aspect of your portfolio in the fixed annuity side of the house. That seems to work pretty well; obviously it gets that partnership going. It also gives the bank incentive to focus on your products versus other products.

Let's move on to back-office operations. I find this one of the more interesting aspects. It's probably the least glamorous aspect of insurance and not something actuaries focus on all that much, but back-office processing is an area that we all know is a problem in the insurance industry. It's where a lot of our costs are, and what I'm finding, from the banking perspective, is that a lot of banks are thinking this through and saying, we are, at least in theory, technologically more advanced than insurance companies. We have things like ATMs. We have great Internet sites. We have e-banking and that sort of thing. We collect deposits, we pay out payments and we process checks. Is there a way we can use this technology to do back-office operations?

There are particular aspects that are being focused on. There's conversation now that is beginning between an insurance company and a bank that I'm working with on how they can take their mutual fund operations and expand that to be a variable annuity processor. The theory goes that the insurance company will help train the bank and help the bank establish itself as a variable annuity processor. In return, the insurance company will get their variable annuity product on the bank's shelf. Then the bank will process that insurance company's product at a below market rate. There are clearly issues regarding arms'-length transactions, but it's a very compelling thing for the bank. There are a lot of revenue out there for a bank that actually processes variable annuities. There are also very limited choices of processor and third-party administrators, and the ones that are out there have really been somewhat sub par, at least according to the feedback that I've gotten from insurance carriers. So, there's a real opportunity for a bank to explore that part of the marketplace. Regarding life products, it's a lot more complicated than

variable annuity products and processing, but clearly it's an area that banks are exploring at the moment.

One of the more interesting aspects of what banks are doing is reinsurance of products. This is something banks were doing prior to Gramm-Leach-Bliley. Annuity reinsurance is one aspect that banks were doing. Credit insurance, which was allowed prior to Gramm-Leach-Bliley, is another thing banks are doing. Accidental death and dismemberment, where banks are reinsuring the risk back to themselves, is also popular. It's very compelling to a bank, because effectively, all it needs to do is meet with its carrier, put a reinsurance agreement in place, and within two to three months, at least in theory, it could be taking another piece of the pie from the insurance carriers.

Now, obviously it's an issue for the insurance industry, because the dollars are out of the insurance company's pocket, but the key is to, again, expand the pie. If you come up with a relationship with a bank where your interests are aligned, then hopefully the bank will focus more of their sales on your product. With the help in training and with the interests being aligned, the bank should hopefully sell more and more of your product. This is something that is happening now. Banks do have strong control regarding distribution and strong control of their shelf. So, if it's an area that insurance companies want to play in, obviously the banks have a lot of leverage over an insurance company in taking some of that profit away.

It's a very compelling argument for banks because it gives them the flexibility on product choice. For banks that want to underwrite and take some more of the risk and take some more of the profit obviously one aspect of doing this is reinsurance. The other is direct underwriting, but for direct underwriting you go out and buy a carrier or you start your own carrier, which some banks are doing at the moment. You're limited on product choice—with reinsurance you can say, "I want to be a player, I want to underwrite; I'm going to go pick Product A from this carrier, Product B from that carrier, Product C from the third carrier; therefore, I can pick the best-of-breed that's out there. I can actually take some of the profits and do reinsurance. So, it's a very compelling argument.

Regarding direct underwriting, I think when Gramm-Leach-Bliley passed, it's something a lot of banks explored. We did a number of projects with banks just exploring the idea since they needed to learn what it means to underwrite a product, and banks are still looking at that, but it's not as compelling given the return arguments that we'll also talk about going forward. But there are banks out there that are choosing to underwrite. There are a number of banks that are exploring carriers and are looking at acquisitions. Nothing's come to fruition. There are also banks that have decided to go the de novo route where they've gone out and bought shelves, and they're in the process now of developing their own products to distribute.

From an insurance company's perspective, banks that are developing their own products are the most challenging for us, but there are roles that we can play in helping banks in product development and working in valuation, and also in

reinsuring risk. There's one bank in particular that was looking at a term product that they were private labeling and that they were going to underwrite directly, but they wanted to give away all the risk. Banks are generally risk adverse institutions, and the bank was very uncomfortable, at least initially, in taking on all the mortality risk. They were looking to reinsure most of that risk.

So, those are really the five areas that I think banks and insurers can work in together, and I think we all need to think about how we can take advantage of the current market and play in those areas.

Now, what about mergers and acquisitions? Again, there were a lot of articles written when Gramm-Leach-Bliley passed. There are potential acquisitions out there that have never come to fruition, but there were two in particular that I want to talk about, and they are Citibank/Travelers and Conseco/Green Tree. I find some of the information I'm going to share with you interesting. If you go back and think about it, a lot of it is explainable, but it's interesting nonetheless. These are very different acquisitions, particularly in market reaction as we'll talk about.

What we've done is to track the stock performance of Citigroup and Conseco. What makes this very convenient to do is that the mergers of Citibank/Travelers and Conseco/Green Tree happened a day apart. The announcements happened a day apart. So, it makes it very convenient to line up the progress. On April 6, when Citicorp announced its merger with Travelers, the stock went from about 40 to about 50, a pretty significant increase as the market reacted positively. A day later Conseco announced its merger with Green Tree. That stock went from about 58 to about 50. There was almost a complete mirror reaction of the market with the announcement of those acquisitions, on those crossover acquisitions. As we move forward, the mirror reaction is going to be a very compelling sign to the future of what will happen. If you follow the stock prices, they pretty much tracked each other for a while. There was a big drop when the Russian debt crisis caused all financial stocks to do pretty poorly. As you get towards April 1999, there is a huge divergence of the stock performance on the two stocks, with Citicorp/Travelers doing very well and, as I'm sure most of you know, Conseco having a lot of troubles of late.

There are a couple things to take out of this. One message is that, obviously, these mergers were very different. People would argue that the Citigroup acquisition, if it weren't for Salomon Smith Barney, would never have happened in any way. Citibank and Travelers didn't merge for their insurance operations. That's one argument. Obviously, you're talking about real blue chip type companies that merged versus Conseco/Green Tree where Green Tree focused on a very lower end market of loans. So, it's obviously a very different area of acquisition, but it does show that you have to be very careful of who you pick for your partners, and you can have very, very diverging results. What I also find interesting in the market reaction on the days of acquisition is that the market was pretty smart. You know, those who participated in the market reaction downward for Conseco and upward for Citicorp were pretty on point as the stock market moved forward. So, I just find that a somewhat interesting study to look at.

Finally, I want to point out some other information that I saw in *Business Week* that I found interesting. You hear people say that banks and insurers will never merge because of the return-on-equity argument; why would a bank ever want to buy an insurance company when the returns are so poor? I think that's generally true, but I think some of these statistics are very interesting. *Business Week* showed that industry composites for the banks have a return on common equity of about 19% and a Price/Earnings (P/E) ratio or market valuation of 13. The insurance composites have a return on equity of 13% and a P/E of 18. Now, if you just look at that, I would take out of those facts that if I'm from a bank, I do want to merge with an insurance company because I would get an uptick in my P/E multiple. The market is valuing insurance companies more than they're valuing banks, low rate of earnings (ROE) or high ROE. P/E ratio is what drives, at least as an indicator of value.

So, I found that interesting. Obviously when you start digging into some of the numbers, if you look at what's driving the insurance numbers, AIG is a big number; it's 33 times earnings which is obviously getting the P/E up. The second thing that's interesting is that, if you look at the top ten banks versus the top ten insurers, besides AIG, all these insurance companies are going to have a hard time merging with a bank. So, an insurance company buying a bank would almost never happen. All of the top ten banks could buy insurance companies. Obviously there's a lot more information and analysis that goes into this, but it is compelling when you think about why banks and insurance companies would merge, and people talk about the valuation perspective that I think people need to take a closer look at. There are some reasons that it's worth a look at buying insurance companies. Now, in reality, the whole argument of cross selling has really not been proven or really been tested as being successful. So, that's really what's going to drive the argument and drive the acquisitions of banks and insurers, but, again, there are some statistics that at least cause you to pause and do some thinking about mergers and acquisitions.

Mr. Richard S. Robertson: I have the impression that banks have been relatively ineffective in selling individual life insurance, and I think the data you presented tends to support that impression. One would presume that banks would have lower distribution costs than traditional individual life distribution and, therefore, ought to be effective. The experience in continental Europe and some other markets around the world suggest that they can be. What is holding banks back regarding the sale of individual life insurance? Do you see any prospects of that changing in the near future?

Mr. Lash: I think your point is right on that banks, at least the way they're structured now with their distribution, have lower costs. What effectively is happening with banks is that you, as an insurance company, are paying the bank a commission. The bank is turning around and paying very little to their distribution force for that. Therefore, most of the commission falls to their bottom line. One of the issues is that the branch platform personnel are trained to sell products, sell insurance and a hundred other products, and they're not necessarily incented in a

way to sell products and focus on insurance. For example, I can think of a bank that's trained their branch platform personnel, and the only compensation they get is salary. The only other compensation they get is points toward the prizes. There's not necessarily an incentive for platform personnel to sell an insurance product versus just let me get my loan, sell my loan, do my auto loan, and move on. Something has to change, I think, in the incentives of the people that are out there.

As far as your comment on Europe, I think that's obviously true. France, in particular, has something like a 55% penetration rate. There are some major differences between their market and our market from a tax perspective and a product perspective, but I think that does show that it can be more successful. I believe the Internet will help in that aspect. Banks need to find a way to get more exposure to the under-served middle market and get to those customers that are not being touched by an agent. I think it's a matter of incentives, a matter of training, and a matter of how to get in front of more people. One of the issues I know banks talk about is that most of their customers aren't aware that they sell insurance. Banks are putting a much bigger push toward at least getting the word out and educating their consumers that they sell insurance. Only time will tell if those three aspects will increase the actual market penetration.

Mr. Smith: I remember about 10 or 12 years ago as we were first looking at bancassurance, the thought was that, since the distribution costs are lower, the products will be much superior, or the profits to the insurance company will be much superior. As you get into this, the banks will want to have compensation that's as competitive as what an insurance agent would get, and the product quality is about the same as what you would get if you purchased it from another channel. I think a good example would be in the arena of annuities, which are very similar between bank-sold products and other distribution channels, and a typical commission would run in the neighborhood of 6%. The bank would probably spend for all of its costs, not just the platform people but any insurance support staff, something less than 2%. The bank is definitely viewing that difference, that 4% spread, as an incremental profit that it wants to take to their bottom line. It is in competition with other banks, and it needs all the incremental profits that it can get.

Mr. Paul J. Donahue: This is a follow-up to the previous question, namely your comment on the greater success of European banks in selling insurance and the comments about why insurers are relatively unattractive acquisition targets for domestic banks. Does this point to a possibly much greater role of foreign banks in acquiring American insurers, not only as a place for capital investment but because they could see efficiencies based on their own success in selling insurance in Europe?

Mr. Lash: Yes, I think the possibilities are higher. Clearly in Europe there are a lot more statutory combinations of banks and insurers, because they are more comfortable with it. I guess my hesitation on whether we're going to see a lot of that is based on the fact that people knew Gramm-Leach-Bliley was coming. Now it's been in effect almost a year, and nothing's really happening. The only more

recent one we've heard about is Royal Bank of Canada buying Liberty Life which is really a very small acquisition as far as insurance goes. You would think that Europeans would be a lot more comfortable; only time will tell, but nothing's really happened to date, and you would think by now that you would have seen some acquisitions happen. I think you're going to see more European insurers looking at American insurers as opposed to banks coming in and looking at American insurers.

Mr. Reynolds: Let me comment, if I may, on Dick's question and the second one also. I agree with Steve's comment in terms of what is causing American financial institutions that are selling insurance not to be very successful in life sales. One of the things we encountered years ago is the old adage in the life insurance business that life insurance is not bought, it's sold. Well, the banking industry is not a selling mechanism. Just think of your own experience when you go to a bank. You don't go to a bank and ask them what they have. You go to a bank and open a checking account. They've got 60,000 branches that are order-taking facilities and transaction processors. They're not sales centers. As much as the banking industry and the management of the banking industry today want them to be a sales center, they are not yet there. So with a product like life insurance, our studies indicate that the way to make sales is with face-to-face communications. There's no face there that is knowledgeable, and banks are struggling to figure out how to avoid replicating a dedicated agent field force distribution system and cost in order to make the sales happen.

They're struggling with both a cultural change and a delivery system conundrum. How can they make that sale happen without creating another version of the people intensive and expensive agency distribution system? Now, having said that, if you look at the 40,000 insurance agencies across this country, the majority of them are poor life insurance sales units as well. It's not something you just blame on banks. The extent of life insurance sales in this country is, compared to the rest of the civilized, industrialized world, very limited. A large percentage of the American population is not adequately insured for life insurance. Whose fault is that? It's, I would submit, at least in part, the fault of the salespeople and the fault of the insurance industry that has not activated mechanisms, products, and distribution systems to make it effective. It's not just banks. It's a problem of the nature of life insurance which raises questions that people don't really want to have raised.

The subject of the foreign activity in this country is very interesting. For example, in the U.K., a lot of their laws changed in the early and mid 1980s, and they moved through several iterations. In some cases the big U.K. banking organizations, set up joint ventures with established companies, and over the years they've gone more to the establishment of virtual insurance companies, and have created their own insurance company. That's a little more difficult in this country, in that you've got 50 state requirements to deal with, but it is still doable. I think Steve's comment is right on. What you're likely to see is more cases where foreign insurers buy American insurance companies. You're going to see that more, I think, than you're likely to see banking organizations come and buy American insurance companies, because they've concluded that they don't have to buy an existing

operation. They can form one and not inherit all of the systems limitations and all of the problems of an existing book of business. They can start from scratch and have a better chance of controlling the elements of economics in order to make the venture more effective.

Mr. James F. Reiskytl: I have three questions. First, I was most interested in what you think Gramm-Leach-Bliley is going to do. Projected forward five years or so, is it going to be a non-event or does it take something else to make something happen?

Mr. Lash: My feeling is that, Gramm-Leach-Bliley, from an insurance perspective, dealt with a lot of other aspects of financial services.

Mr. Reiskytl: It's changing the NAIC and how it goes about its processes.

Mr. Lash: I think there are nine or ten new working groups related to Gramm-Leach-Bliley that I know of, but I think as far as banks and insurers combining or joint venturing or expanding the market, I don't know that it's done much to date. I don't think it's going to do much five years from now. That's not going to be the driving force. The market drives itself, and the legislation almost always catches up.

Mr. Reiskytl: Ken, I'd like to ask you a question. Any time I see a survey I always think about the person's salary. The people that respond are always people that have the highest salaries. Do you have that same issue in your survey? Most of your banks aren't responding. Is that because they don't participate? If so, then you're getting a biased sample of only those who participate. Have you tried to sample those who aren't responding to give us a feel for what the survey means?

Mr. Reynolds: Yes. That's an excellent observation. You always worry about that. One of the ways we get up to a little bit better than a 13% response rate is by telemarketing. We send the survey out (2,300) and then do a telemarketing follow-up. The survey forms are selected randomly, and then we follow up randomly to try to get as many responses as we possibly can. We're always hammering at trying to avoid the bias of response. When all is said and done, about all you can do is be guided by the people that will answer the question. We work hard to get responses, including the wording in the survey itself. For example, if you don't sell insurance, please indicate that on the survey form and just send it back. The good news is it's only going to take you two minutes to do it. The bad news is if you sell insurance, it's going to take you 30 minutes. Then we supply free copies of the study to all of the respondents so that if they're not selling insurance and might be interested in it, then they've got an incentive to respond, but it's a concern we always have. I guess that exists with every kind of research project.

Mr. Reiskytl: Steve, I have a question for you about annuity sales and banks, and that's the age-old issue of whether savings ever increase when you change the rules. For example, if you have more large IRAs, all you do is replace one thing

with another. I'm most curious about what happens to certificates of deposits in the bank when they introduce an annuity program? Are they just replacing the money, and is there a compliance problem waiting to happen? I can only cite a personal, unscientific survey. The bank spent three hours trying to convince my mother, who is 85 years old, to move to this new non-taxable certificate of deposit, never told her it was an annuity, and one wonders if this is atypical or typical. Have annuities replaced CDs or is this but a supplement to the bank's income? Where do you view the sales process?

Mr. Lash: I have a scientific survey that I can talk about. Regarding your comment that banks aren't really doing anything more, I like to think they're just cannibalizing their own deposits. I think that's a fact. In particular, again, my own unscientific survey is that I have a CD with a bank, and every six months, when it comes up for renewal, I get a phone call. "Mr. Lash, you know, you could do much better if . . . "—they do tell me it's an annuity. From that perspective maybe this bank is better trained, but they try to move me to a fixed annuity product from my CD. So, there's no question they're cannibalizing the market. That's not to say that they're not expanding in some way. However, regarding that $18 billion in annuities, I'd be completely speculating on what amount of that is new, but I would say the majority of that is not new money. They're just transferring the money over.

I never really thought about it from a compliance perspective; that it might be an issue. There are certain banks out there that are critical of other banks, of their products, particularly on the bonus side where they believe there's going to be a huge compliance issue. I don't know if it's compliance so much as just a huge issue when these 2–4% bonus products come into renewal. Some of the banks' leaders are selling these products, and there's going to be a huge issue when the renewal rates come in and customers say, "What did I buy here? What's going on?" So, yes, I think very little or a substantially less amount of money is coming in that's new, but the banks are really trying to change that. They really are trying to advertise, a little; part of the problem is that part of the success is based, as Ken said, on face-to-face, and banks are closing branches, not expanding branches. You're going to get a lot less of that face-to-face contact, whereas in Europe, they're expanding the number of branches. So, that's another difference between the U.S. and Europe. But you are going to have those issues of banks not being able to sell more and expand the market versus just cannibalizing.

Mr. Smith: I know in talking to different bank executive committees, and I'm talking about committees within a bank, this issue always comes up: Well, aren't we just shifting funds from a CD into a fixed annuity? I think that's a good thing to be aware of and to address, but the next thought that comes to mind, and somebody besides me will usually bring it up, is well, if we don't do it, another bank will be cannibalizing our business. So, it almost becomes a defensive reaction to prevent the 1035s from rolling out of Bank A into Bank B. Indeed, the CDs in Bank A may move into Bank A's fixed annuities, and that's a push, although the bank may be up-fronting some profits which they like because the annuities will give them an up-front profit, and the CD spreads it out. So, there's some pressure

there. But the defensive mechanism in not wanting to move their CD money across the street to Bank B and have them sell the annuity is a very high motivator. Ken, have you seen that in your group?

Mr. Reynolds: There is a certain defensive reaction, but banks concluded generally about 10 years ago that the more money they move out of CDs and into annuities the better off they are. Banking organizations found that they were making very, very thin spreads on CDs with the deregulation of interest rates; by very thin, I mean 20, 30, or 40 basis points on a 3-year CD. They found they could make 600 basis points on an annuity. So, they'd move that money as fast as they possibly could, even realizing they were paying commissions to do it. They were, as Steve and Jim have indicated, retaining the relationship, and that was a benefit, because the relationship was jeopardized if they didn't put an appropriate customer into the appropriate product. The movement of money from CDs to annuities is not, given an appropriate customer situation, a bad thing in terms of bank economics. It is a very desirable and profitable shift to make.

Mr. Reiskytl: Is there a different GAAP reporting on CDs and annuities that might lead to different P/E ratios and different other earnings ratios? I don't pretend to know how the bank system works, but I presume you do. Is there a shift in profitability or earnings rates as a result of a shift from a CD to an annuity?

Mr. Lash: I think that's true in that banks will, regarding the 600 basis points we talk about on commission, recognize that all up front. One of the interesting things is that on a GAAP basis a bank will sell an annuity. You'll pay the 6% commission as an insurance company. Banks recognize it all, but you defer it; there's not mirror imaging there. It gets more interesting when you get a bank that now reinsures that product. Do they recognize that whole 6% up front? Many of them do, yet now they're reimbursing themselves on the back-end through reinsurance, and they're deferring it. It's a very interesting concept. The answer to your question is that there is the difference that the banks recognize all that income up front.

Mr. Smith: I think you are right in that you do have to look at risk-based capital requirements which banks are also very familiar with, and, with an annuity, it's a very heavy requirement. A fixed annuity might be in the range of 4–5%. I think that's one of the reasons why you may see the return on equity for the insurance companies is lower, because I don't think the banks have that same relatively high level of risk-based capital requirements. I think you also have to understand that the return-on-equity represents a lot of what the insurance company can do for itself. When you look at the P/E ratio, you're getting in on market factors as well. So, you have to be real careful in trying to evaluate what an insurance company would do in terms of buying a bank or vice versa. We know the marketplace can really shift that P/E ratio around dramatically, but I feel like the inherent value, the intrinsic value, of the business is probably better represented over the long term by the ROE.

Mr. Reynolds: It's my sense that the difference in profitability levels isn't a result of accounting differences; I think that they're both on a GAAP basis. I do think, though, that these relationships between the average levels of profitability and the P/E ratio of banks versus insurance companies vary from year to year. I remember several years ago, I worked on a study of a large bank acquisition of an insurance company. It was a brainstorming kind of study that involved visiting 6–8 of the largest investment banking organizations to explore the idea of a bank buying an insurance company. In every case, and this was the big names, the Salomon Smith Barneys of the world, an investment banker would love to figure out a way to put together a deal that would cause one big organization to buy another big organization, because that's how they make big, huge fees.

We had 6–8 of us on this team, and it'd be a room with 8–12 analysts around these big mahogany tables. We'd go in and present the question to them. We wanted their reaction to the idea. They would hem and haw for a little while, and then every one of them said, well, we have been studying this issue, and I'll be darned if we can figure out why a bank would want to buy an insurance company. Insurance company rates of return are significantly lower than banks have been, and the P/E ratios are significantly lower, as you would think. Since they've got a lower rate of return, their P/E ratios have historically been lower than banking organizations.

It's one of the things that I think may have motivated Travelers to buy a bank, because their hope is that we can become more bank-like, and we can get a higher P/E ratio, and we can average up our rates of return. Also, I think it's one of the things that continues to slow up bank entry into the business. But, it is interesting that so many of the nation's larger insurance companies, while we were talking about the fact that very few bank acquisitions of insurance companies have taken place, have formed thrift institutions. What is it, 60 or 80 of them in the last two years? Their conclusion is we might be better off by acquiring a thrift institution and then selectively involving ourselves in some banking activities, as opposed to the banks having concluded that they ought to go out and buy a wholesale insurance company. I agree with Steve's point. I think there's going to be selective participation in underwriting by banking organizations but not likely wholesale major purchases of a great number of such organizations.

From the Floor: You mentioned earlier the comparison of the Conseco acquisition versus the Travelers. Could you expand a little further what the differences were and what happened in connection with Conseco and Green Tree?

Mr. Lash: I think the consensus in the marketplace is that they overpaid for Green Tree. I may get my numbers wrong, but they paid something like $6 billion, and they're trying to unload it now for about $1 billion. It was a huge overpayment which is one aspect. The whole issue is that they thought there was this huge market for cross selling which is a lot of the aspects of why banks and insurers, at least theoretically, should combine. That certainly didn't materialize. I think the bottom line was just overpayment for Green Tree, for a sub-prime lender, that really had a part of the market that wasn't that successful.