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2010: Where Will the Profits Be?

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Summary: The financial services industry is changing rapidly. Thirty years ago the industry made its profits from mortality and expense margins in premiums. Fifteen years ago it was interest margins on fixed annuities and universal life. Today profits come from fees on variable products, interest margin on fixed products, and mortality on term insurance. Where will profits come from 10 years from now?

Mr. James R. Trefz: As most of us have experienced, the financial services landscape is changing at an accelerating pace. At one time the way that insurance companies could become and remain profitable seemed obvious. To most of us it is no longer so obvious. Sources of profit have changed dramatically, from margins on mortality and expense (M&E) loads, to spreads on interest sensitive products, to M&E charges on variable products. Old models of distribution often seem to no longer work. People's views on what is the most effective corporate structure are changing. The Gramm-Leach-Bliley Act changes everything. Perhaps, as the environment becomes increasingly competitive, companies face difficult and important choices as to how to invest their resources so that they're headed in the right strategic direction to be profitable and successful in the year 2010 and beyond.

We have a distinguished panel of three who have some ideas on this. After describing their company background, each of the panelists will present their views on the future of the financial services industry and what companies must do to be successful. Steve Strommen is an associate actuary in the corporate area with Northwestern Mutual, where he's been since 1984. He's involved with financial modeling and projections. Steven Lash is a partner in the New York office of Ernst & Young LLP, working in their actuarial services group, where he specializes in financial modeling and analysis with an emphasis on bank assurance. Pat Baird is an executive vice president with AEGON USA in Cedar Rapids. In addition to being

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†Mr. Baird, not a member of the sponsoring organizations, is Vice President and Chief Tax Officer at AEGON USA Inc. in Cedar Rapids, IA.

chief operating officer, he's been very involved in setting AEGON's strategic direction and all the many acquisitions that AEGON has made.

Mr. Stephen J. Strommen: I thought I'd get started by giving you a little background on Northwestern Mutual. I'll talk a little about where we've been, where we are, and where we're going. I'll also have a short digression on profit models and what I view as the customer's needs going forward.

Northwestern Mutual is a large mutual company, very traditional, with a large block of individual life insurance, annuities, disability insurance, and long-term care. We have captive agents under a general agency system and by most measures over 80% of our business is individual life insurance.

Ten years ago the life insurance business dominated our company even more than it does today. It dominated our sales, profits, capital commitment, and distribution costs, almost anything you could think of. It was over 90% of our business at that time. However, our annuities and disability insurance began to grow fairly rapidly. We are expanding into a number of new areas, including investment products and trust services. We are starting a new trust company. We just started long-term care a couple of years ago. More importantly, we are starting with a branding effort to introduce the Northwestern Mutual Financial Network. You may have seen some ads on television for that recently.

Now, before I talk about moving forward with our vision of the financial network, let's talk a little bit about profit models as I see them. There are three that jump to mind. There is the new economy or the dot.com profit models that involve trying to get market share at any cost. This is how AOL built up its customer base without really making a lot of profit during the process, but now is an enormously profitable company. The idea is that you sell a lot of product initially and try and generate economies of scale. In the case of a mutual life insurance company, we tend not to look highly on this profit model, because we try to maintain a balance of profitability among all of our product lines. We pride ourselves on not having any loss leaders, so this one is not one that we look at carefully.

The distribution-centered profit model is another option. Product centered is the third option. Both of these have a role in our view of things. Under the distribution-centered model you try to manage the customer relationship and charge for the sales and service that the customer receives. Under the product-centered model you try and manufacture the product that the customer is actually buying and accumulate assets under management, take a little spread off of that for your profit, and charge for assuming the insurance types of risk.

There is a great amount of dependency, of course, between these latter two profit models. The product-centered company needs to have distribution and a distribution-centered company needs product. Because of this dependence I feel that a mutual company with a captive agency force has a very dynamic synergy going, because we have both sides of this and we can manage it to our advantage.

Taking a step back and looking at the consumer's view, or my view of the consumer's view, consumers tend to want professional advice. They don't want to go to Uncle Joe to get financial advice or talk to their neighbor. If they're serious about their financial situation, they want professional advice. Survey after survey has shown this. Consumers prefer specialists to generalists. They like to go to a banker for their bank transactions. They'll go to an insurance agent for insurance transactions or, more likely, the insurance agent will come to them. Consumers prefer an adviser to a salesperson. They'd rather have somebody who they feel has the same interests they do in any advice situation and is not necessarily motivated by providing the special of the month and selling it to them at a commission.

Given this background, Northwestern Mutual 10 years hence expects to be known as the Northwestern Mutual Financial Network and have an integrated web of products and services centered on life insurance and financial security. We will have and already do have local agencies with financial representatives rather than life insurance agents. These financial representatives will be primarily relationship managers. They will maintain a relationship with a customer and try and take all of the needs of that customer and direct the customer to specialists as needed. We will have specialists in a number of different financial service type areas in each of these agencies for the representative to make referrals. The compensation arrangements in all of this are being worked on.

This is what we hope the consumer will see in 10 years or even earlier. The Northwestern Mutual Financial Network is what you see as the main identity of our distribution network. If you go through that distribution network you can get a wide variety of products and services.

For our well-known products, life insurance, annuities, disabilities, and long-term care we have our traditional insurance services. We also have some products that you may not be as familiar with. We have a mutual fund company, Mason Street Funds. We have a broker/dealer, Baird. We have Northwestern Group Marketing Services (NGMS), a facility through which all of our distribution force can sell group insurance products provided by other companies. We hope that when the consumer, say, a small business owner, comes in the door, sees this network, he or she will see that a variety of his or her needs can be met in one place.

Where will the profits be under this kind of design? The profits to the company will still be product-driven. We plan to accumulate assets under management, charge for assuming risk, and grow some of these service businesses. But we expect that in terms of profits. The service businesses will remain secondary to the main profit source that will be writing the products. Making this work depends on a growing, vibrant distribution network. In order to keep our agency force vibrant, we plan to partner as necessary and broaden the array of products and services that our agency force is able to provide.

Mr. Steven D. Lash: I'm going to give a different perspective from the work that I do. When I was asked to do this panel and thinking about the profits, I couldn't help but think about the reality that I'm a consultant working for a consulting firm, and that I'm hoping a significant amount of your profits are with us and you'll hire

us to do work. But having said that, I want to give a different perspective from the bank side. I actually do a significant amount of work with banks since banks are getting into the insurance industry.

There's a cartoon that came about a year ago when Gramm-Leach-Bliley was passed about what's going to happen between banks and insurers. It's just something that seemed on point at the time with having all these customers going crazy, going to banks, buying products from banks and at ATMs and the like. I think the reality is that that hasn't happened and probably won't happen at least in the near term. Maybe by 2010, there's going to be a much more significant proportion from banks. I wanted to give everyone a bit of a feel for where banks are.

I think that the banks are or can be in the continuum of insurance, obviously banks can be on opposite extremes. You can have absolutely no insurance activities at all, which is the left side of the continuum, or you can actually own an insurance company, *a la* the Citigroup model, with complete insurance services. Anywhere in between those ends is a whole bunch of places banks can play and take their piece of the pie of an insurance product.

Obviously, the most common area that banks play in today is on the distribution side. There are many different ways that banks do that, whether it's through a third-party marketer, a traditional agency approach, or a branch platform program. As you move along in the continuum that process gets a little bit more complicated and a little bit more costly. That, naturally, will lead to banks wanting to do more things on profit sharing arrangements and reinsurance and getting closer and closer to actually owning an insurance company.

In today's market, and this is even prior to Gramm-Leach-Bliley, there were banks across the country that were in any part of the spectrum. The one exception might be to own an insurance company completely like the Citigroup Group or Travelers. Although, as people know, that happened before the legislative action and was a big driver in the legislation. But the legislation didn't really do anything to let banks form this continuum. Banks did what banks wanted to do regardless of legislation. All legislation did a year ago was to catch up to the market and to sort of acknowledge the reality that market forces can't be stopped. Banks were underwriting product in annuities, credit life, life insurance well before Gramm-Leach-Bliley. There are all kinds of ways to get past regulation to actually underwrite.

Clearly, though, the one area that banks have been successful is annuities. They're the most bank-like product. They're very close to savings-type products and that's what banks are most comfortable with selling. The argument out there is whether banks are really doing anything for our industry in expanding the market or are they just cannibalizing their own products. We can think the latter is probably what a significant portion of the annuity volume is out there, where banks are just calling their customers with CDs and savings-like products and saying, "Hey, it would be great if you buy this annuity and get customers to switch to that." On the life insurance side sales have been pretty poor and I think everyone would deem that

to be unsuccessful at the moment of what banks are doing on a pure life insurance basis.

One of the points just on the numbers: the 1998 annuities sales were at $18.8 billion and the 1999 annuity sales were $26.5 billion. It seems like a pretty dramatic increase. It's not as dramatic as you might think, because the 1999 sales includes the Citigroup transaction, where it now captures all of Travelers annuities, regardless of whether it's sold through a bank channel. The growth hasn't been nearly as dramatic as the numbers might imply.

From a market-share perspective, there's no question that banks are a significant player in annuities and have a significant market share. On the fixed annuity side, over the last few years it's ranged from 25-30%. It's hit about a 30% market share in 1999. The bank share of variable annuities has been a steady incline over the last 10 years or so. The first year that banks actually sold more variable products than fixed products was in 1999, which is pretty consistent with what I think we've seen in the marketplace on variable products. They're a significant force to be reckoned with. They control a significant amount of distribution. One thing I hope we'll get into discussions about is, what does that imply? What does that mean as banks consider getting into underwriting? What does that mean for us as an industry and you as companies of where your products are going to go if a bank says, "You know what, I sell 30% of the market, now, I want to underwrite 30% of the market?" If you are those players that are counting on that bank distribution, obviously, that can be a risk.

The leading companies in that area of selling through banks and have made a concerted effort to sell through the bank channel include The Hartford, American General Life, AEGON/Transamerica, Nationwide, Allstate Life, GE Companies, Keyport, American Skandia, Jackson National, and Pacific Life. If you consider the top players, you're talking about significant volumes of business in the billions of dollars, so we're not talking about small change. If you look at which were leaders for annuity sales through banks (and this is both fixed and variable), the top players have always been the top players at least for the time period 1997-99. The top five have always been the top five and have made a concerted effort to focus on that market. This, obviously, brings you to the next question, again, of how are banks going to think about this? Do banks want to underwrite? If they do, what happens to all this volume? This is an issue that, hopefully, we can all debate and talk about.

Last, and just sort of framing up the debate that we're, hopefully, going to have, I like to think about the value chain of an insurance product, and value drivers, and the different areas that either insurers play in or banks can play in. I kind of like to think about it in five areas.

The first and the one we've talked about earlier about being the best success for banks is distribution. There's the asset-management side of the business. There's the whole back office and processing of business. There's a reinsurance angle that banks can play in. Then there is, of course, direct underwriting. Again, this is a different type of a spectrum to think about of where banks can play. If banks

choose to, we have a new set of financial institutions coming into the insurance business. If they choose to come into any of these areas, which they are exploring all of these areas, what does that mean for us or what does that mean for you and your companies? That's how I wanted to frame it up so we get some discussion.

Mr. Patrick S. Baird: I was asked to provide a bit of background of AEGON because I have spent my whole professional career there. Clearly, my remarks reflect my views and the views of the company and are influenced by our size, our diversity of distribution, and our business strategy. We are a multinational company. Our largest operations are in the U.S. with the acquisition of Transamerica, followed by the Netherlands, the U.K., and Canada. Then we have smaller operations in Hungary, Spain, and Mexico. We also have start-ups or very small operations in Taiwan, the Philippines, and so forth.

We are not flight planners. We do not go into a country just to say that we are there, but rather we have to know when we go in: we have to see the light at the end of the tunnel that someday we're going to have the size and the scale to be able to compete there profitably on a long-term basis.

In the U.S., with the acquisition of Transamerica, we are now in the top five in terms of, well, almost any measure, whether it's premium income or whether it's assets. A.M. Best just put out, I think, their collective premium rankings as of six months, 2000. I think AEGON is ranked second or third. Unlike many other companies, our definition of core business is quite narrow. We're in the life insurance business, supplemental health products, and asset accumulation product business. We're not in the major medical health insurance business. We exited that, for the most part, about six or eight years ago. We're not in the disability income business. We have no active property and casualty operations in the U.S. and very minor operations elsewhere in the world.

We have also publicly stated that AEGON will not acquire nor do we wish to be acquired by a bank. In fact, we have said for the long run that while we like to date banks, we don't want to marry one on the basis that you can date a whole slew of banks, but you can only marry one, at least in Iowa where I come from. As I said earlier, this strategy and this philosophy you will see echoed throughout my remarks.

Let's talk about industry trends. There will be a few mutual insurers remaining. Northwestern Mutual will probably be one of them. There will be a few others. For the most part, the demutualization, the formation of mutual holding companies should shake itself out in the next three to five years. From the consultants who we visit with, almost every mutual company has some project underway now that will, ultimately, result in their having stock in the market.

Consolidation in the business will definitely continue. In some businesses, like the telecommunication business, you see consolidation and then, all of a sudden, there's some variation or a whole number of new companies start up again, and then we go through consolidation again, and then we go around and around. In the insurance business the barriers to enter the market are quite significant between

ratings and capital and surplus. With very few exceptions there are very few new entrants into the business. When consolidation occurs it's real and permanent.

There's also a presumption that the tax and the regulatory environment 10 years from now will be essentially the same, I think, whether we have a NAIC supported state regulatory scheme at the point of contact regulator or whether there's an alternative or optional federal charter. You know, we're in a long-tail business. I would expect that the regulatory environment will be the same.

Since most surviving companies 10 years from now are likely to be stock companies, you're going to have to accept that a major factor in determining what business you're going to be in is what your peers are in. The key is, who are going to be your peers 10 years from now? Certainly, AEGON, as I said, will have a fairly narrow strategy. But Travelers, Citicorp, and Smith-Barney are competitors today, so they will clearly be there. Will J.P. Morgan and Chase? Will that combination someday acquire another life company? While it's somewhat facetious, consider companies such as McDonald's and Victoria's Secret. Will they combine and buy a life company? Perhaps, more likely, will Microsoft acquire a life insurance company? Will AOL? Will Yahoo? Will they actually get into the life insurance business? If an Internet company started today competing with your company or our company, would you feel the need to start your own or to acquire another one someday?

How does one even think or approach the question of where will your profits come 10 years from now? As always, a good predictor of the future is what we can learn from our history. If you go back in time at least where I come from in Cedar Rapids, Iowa, I remember about 10 years ago when Sears offered automotive products, life insurance, and H&R Block tax returns all right in a row, right down the line in our store. I don't think that that succeeded very well for them.

If you go back just a couple of years, people in the industry were talking about how much sales they were going to generate through the Internet, a bank teller, or even at a kiosk in a mall or an airport. Look at where we are today. Things in our business don't change at the drop of a hat or at least, historically, we haven't seen that change.

Today, companies talk about Internet. We've just come from a round of rating agency meetings and companies are talking about how much better service they're going to offer through the Internet to both the distributor and customer. No one is talking about greatly enhanced sales through the Internet. More than anything else I would expect in our business change to evolve rather than to turn on a dime.

Our products still need to be sold by somebody. Typically, customers still feel like they're best served by a specialist who sells it. Having said that, I do expect even for companies like ourselves that have a narrow strategy to broaden the businesses that we define as our core business. We may have to rethink our core business just to compete. It's possible as a pure product manufacturer that the returns and the growth in earnings may not compete with your competitors.

What other businesses might a product manufacturer get into? Clearly, I think, savings products such as mutual fund complexes and equity fund management may be worth looking into. They are very low surplus intensive businesses and they certainly offer growth and higher returns. They are a natural for most of our companies, if you're not already in that.

I think if you are primarily a U.S. company you need to look international. While there is more risk, there is, certainly, growth and higher returns still possible internationally. In fact, we just started a mutual fund bucket within our mutual funds called Great Companies. One of the criteria to be a great company is you have to be headquartered in the U.S., but you have to have 40% of your earnings international. I think we need to look in our business at more international opportunities.

Owning distribution channels or having equity interest in them may be important. I don't necessarily mean employing sales people. I mean owning a piece of marketing organizations, through joint ventures (20-30%). You can help them with their succession planning. You can protect your business at the same time if structured properly. If banks and other new players, because of Gramm-Leach or some other reason, decide to enter, insurers may be able to generate the income with their back offices. Again, very low surplus, possible higher returns.

I could see if you're in the equity-fund management business, there are other businesses that you can shoot off from that. Can you set up venture capital funds and collect fees? With reinsurance, administrative systems, and asset/liability consulting, if there are new entrants, then what you already do probably can be leveraged. If banks, Fidelity, Microsoft, Victoria Secret, or whatever company, decide to get into the life insurance business, you have a whole lot of experience and expertise that you can leverage and possibly even get a piece of the business.

Finally, at the end of the day I think both types of companies are going to survive. We product manufacturers with maybe a slight expansion of our core businesses will survive. Certainly, there's going to be the broadly diversified everything under one roof stores that will also survive. It all comes down to how well managed you are and how focused you are. At the end of the day that still counts in every business.

Mr. Trefz: Steve Strommen, Pat, what keeps you awake at night when you think about the future of your company? Steve Lash, as a consultant, what should they be thinking about?

Mr. Baird: As a stock company that's trying to compete with the big market, I actually think growth worries me on a long-term basis more than anything else. Where will you get growth? How can you get growth? We've had a strategy of trying to grow our existing businesses 10% a year and then supplement it with acquisitions. Acquisitions come and go. Sometimes you can be in the market and sometimes you're out of it, depending upon your competitors. I think being able to grow your earnings at 10% per year, on a sustainable basis, keeps me up more at night than anything else.

I'm always worried about the next lawsuit around the corner. I think that actually is the one that I lose sleep over, but that's at a point in time. Long-term I worry about our ability to keep growing.

Mr. Strommen: There aren't really very many things that keep me up at night. Part of my job is to make sure that our company is as absolutely safe as possible, but there are things that we worry about. One of the biggest ones is regulatory changes. We have a very large investment in the estate market. As all of you know, there's a movement afoot to eliminate or reduce the estate tax. That could put a very large hole in our new business. Would it kill the company? No, but regulatory changes of that sort are things that I worry about.

Mr. Lash: I guess from my perspective I want to echo a little bit what Pat said. I think you were talking more about the kinds of earnings growth. I think one of the biggest issues facing our industry is on the kinds of sales growth, which obviously flows down to that. You hope that translates into earnings. But we should worry about where we're going as an industry and how we're going to grow the business, whether through a banking organization or an insurance organization. If you look at the famous statistics, which I'm sure we've heard a million times, is that we're not growing at all. If you take business-owned life and corporate-owned life insurance sales out of the insurance market, sales are actually declining for the insurance market excluding annuities, of course. Annuities are the only area where we are growing. I think that's the one of two areas that worries me a lot is 10 years from now if we're in the same position there's going to be some real issues for everybody.

The second thing, to echo some of my comments on banks, that worries me about some of the insurance players out there is thinking ahead and deciding what they want to be. I think we all need to anticipate where the market might be going and decide whether the companies want to be all things to all people or do you want to be just a product manufacturer. Do you want to focus on back office operations or do you want to keep your agency systems and that type of thing? I think people really need to think ahead of where they think the market might be going and decide what they want to do best and focus on that.

Mr. Trefz: Steve, do you think that companies can be successful under all of those options or is there one that's going to be required to be highly successful? Can you be just a product manufacturer or be all things to all people, highly diversified? What's your opinion on that?

Mr. Lash: I'll go out on a limb and say that at least from the research we've done and people we've talked to, I can see 10 years from now that banks are going to control (and they already do control) a substantial amount of the customers. They're going to control that. I think insurers are going to lean more toward just being straight product manufacturers. I think the one area that banks have, I don't want to say failed at, but haven't done the best job is actually mining their customers and actually selling product to their customers. But we all touch our banks a lot more than we touch our insurers. Banks are way ahead from a technology standpoint and in exposure and trust.

I know surveys have been done recently that pose questions to customers on why they would buy insurance from a bank and the number one reason mentioned was trust. The least mentioned reason was price. That says a lot about how customers are comfortable with that institution. I think that if banks get their acts in gear they really are going to control the industry. They already do control a substantial amount of that.

Another fact related to that that I've seen out there is banks are more and more now demanding that insurers reinsure part of their annuity blocks to the banks and do profit sharing arrangements which just shows they're starting to exert their leverage and their control that they have. At least one institution that I work with put a request for proposal (RFP) out to insurance companies for an annuity product. It said, we want all these X, Y, and Z features in the annuity. By the way, you must reinsure 50% of the annuity back to us if you want to be on our shelf. I would say 90% of the companies came back and said "Fine" because they had no choice. If they said no, then you lose all those sales completely. You had to make that choice. That's why I think that the companies have to decide whether they want to just be product manufacturers and, I think, that might be the area to be successful.

Mr. Strommen: One of the things you mentioned was that you feel that banks will be doing the large lion's share of selling in the future. I'm not sure that that's actually the case. One of the things I mentioned before was that customers or consumers tend to like to go to a specialist. In the past, they are not used to going to a bank for insurance and they don't necessarily view a bank as a specialist in insurance. There is definitely room out there, I believe, for a continuation of the distribution model of the traditional life insurance company.

Another point I'd like to make was that earlier when we were talking, both Steve and Pat mentioned growth as one of the things that they worry about. I didn't mention that, primarily, because we did worry about it about two or three years ago and made it one of the primary goals of the company. It was to grow our distribution force and, thereby, grow the company. At this point, we're having much better recruiting success. Our life insurance sales, for example, are up 15% this year. We feel that there's still plenty of market out there for distribution through a traditional agency force if you can grow that force and manage it well.

Mr. Lash: I'd follow up on your comment about banks, distribution, and traditional models. I think that's absolutely true. You said banks have failed miserably on the life insurance side in sales. They're left with a 2% market share right now. But I don't think that we as an industry have necessarily done a great job either on that and so something has to change.

One of the statistics I saw, and the jury's still out in my mind, is the Internet and how that's going to work. We can talk about a couple examples on that. But there's some statistics I saw that distribution through the Internet costs something like $20 per $100 of premium to sell, where a traditional agency costs about a $150 per $100 of premium sold. That is just a huge gap that someone is going to capitalize upon.

Another area of distribution that, I think, has also been somewhat of a failure on the Internet, are the banks out there that are issuing simplified underwritten policies through the Internet. You go on the bank's Web site and you answer the seven questions the right way and you are instantly bound in five minutes for insurance. They're capped, obviously, for anti-selection reasons to about a $100,000-150,000, but it's an interesting concept to get instantly bound for insurance. Now, it certainly hasn't been that successful. But part of the reason I think it hasn't been that successful is the way the bank has advertised it. People don't think about banks as insurance players and that's something that I know banks want to change.

There's one bank in particular, Huntington Bank Shares in Ohio, that recently changed their logo and it mentions three things. I don't remember the three things, but I do remember that insurance is one of the three things that they focus on. Insurance now is in their logo. They've made a commitment to the insurance industry that they are going to be a big player in that. That's why my sense is that 10 years from now the banks are going to be a much bigger force to be reckoned with.

Mr. Trefz: Just to follow up on that and I'd be interested not just from the panel's view on this, but the audience's as well. There are some cultural trends that I at least have the impression are realistic or real. I don't know if they actually are. The trend is that there is a lessening of people's sense of brand loyalty, especially in the younger generation. Our children are very comfortable with the Internet. They're not a powerful force yet in the consuming public. They also have a high expectation of immediate responsiveness because of that. Some of you said that you don't see the Internet becoming a big force in insurance sales. It certainly hasn't made an impact yet and it may happen slowly. Is it sort of inevitable that we will reach a point in the not too distant future where the whole landscape has changed in terms of the buying public's expectations, will that open up some real changes in how we distribute products?

Mr. Baird: There's no question the Internet will have an impact on how the sales process takes place on the process of delivering insurance policies. I tend to think as far as new sales, if that's what you're asking, Jim, I think repeat sales or add-ons could, clearly, come through the Internet. It seems like that initial sale and starting that initial flow of information to the customer needs to be done through a representative. You know, a salesman still has to put the knees under the table and make the sale. But once a sale has been made a concept is out there with a customer, could the customer come back and acquire a second-to-die or could they acquire some add-on protection through the Internet with no load and get a better product? I think that's a real possibility. I think that will make a difference. The rest of it in 10 years I don't think will make a blip in first times sales.

Mr. Strommen: I really feel that the Internet will have a much greater effect on the way policies are serviced than on the way they will be sold. I agree with Pat on the effect on the Internet on first time sales versus repeat purchases. I think that's probably the way that will go. But, in the short run, I think, it will have an enormous impact on the way policies are serviced. People are expecting 24-hour

availability of any of their policy values now. If you have online banking, you can go to your bank and look at your checking account balance any time. Well, why can't you look at your cash value on your life insurance at any time, take out a policy loan or any of the number of other kinds of transactions? I think that kind of thing will be happening routinely through the Internet in the future.

Mr. Lash: I'll just add one other quick point is that it's so hard to tell, obviously, as 10 years ago I know I didn't and I'm sure most people had no idea of what was going to come in the next 10 years for the Internet. I think the next 10 years are only going to be more dramatic in sales. I generally agree with the comments on insurance. The only thing I'll say as a comment: when I was talking with someone from the technology area about the Internet and life insurance sales, and he said, "Well, I don't see the Internet making a big impact, because you still need someone to come and take blood and fluids. You're not going to do that through the computer." He said , "Just wait and see."

Mr. Darin G. Zimmerman: One of the trends I've seen over the last 10 years is the transition from early death protection to asset accumulation. I had assumed I was going to hear about asset liquidation as one of the profit centers 10 years from now. I guess that would be doubly true if America takes Mr. Baird's advice and votes for tort reform and we get 2% invested in Social Security accounts. I'd be interested to hear the panel's thoughts on whether or not they think immediate annuities might be a big portion of profits for the life industry in the future.

Mr. Lash: I think they'll be significant portions. If you asked me to define significant though I might be challenged on that. I think a number of companies I'm working with are developing immediate products, variable immediate annuities, in particular. But I think at least from my perspective it's relatively far from people's thoughts. They're talking about product development. I haven't seen a significant amount of product development, but I think it's inevitable that it has to. There has to be a way that people are going to transfer wealth and actually spend down their wealth as time goes on and all that wealth that's being built up now gets transferred down.

Mr. Strommen: I think a couple things have to happen before immediate annuities and variable immediate annuities, in particular, become widely purchased. First of all, people have to have the idea that they need such a product. Right now the investment markets are doing so well that people feel they could just live off the interest. They think that they will get higher payments just living off the interest than insurance companies are offering on fixed immediate annuities. They are, of course, probably mistaken, but I think there is a big educational need before the product gets widely sold and used, particularly with regard to variable immediate annuities. Because, of course, the initial payment on a variable immediate annuity is even lower than on a fixed immediate annuity or the payment to the annuitant. I don't see that as being a big area of profit in the future, simply because people aren't buying them much now and I don't know that the educational process is taking place now. If we have a big crash in the markets and investment returns are poor for five years, they might come back.

Mr. Baird: I think the reason I didn't say anything about it is because we should be there now, not 10 years from now. We have a large pension operation and I don't profess to be doing as well as we should at holding onto the assets at the date of retirement. But we feel like we're in the business and we need have the products now and not 10 years from now. We are in all of those product lines, so somewhere you hope to hold onto it, whether it's as Steve said, it's that someone just puts it in the equity market and lives off the gains, dividends, and interest or whether it's an immediate annuity or a combination, which is probably the next product you're going to see. It's a combination of a fixed immediate annuity along with some sort of equity kicker, but that's not a 10-year deal. We should be in that business now.

Mr. Trefz: What do you read into where people purchase their life insurance for the future of the industry?

Mr. Lash: It's interesting. I buy through my employer. People buy through a traditional agent, a bank, or the Internet. I think that it's an area actually from a banking perspective that banks are trying to get more involved into the group products. I don't know. Let me think about that one for a little while, but it's an interesting question.

Mr. Baird: Steve Lash, we're talking about the banks and the sales that are coming and should come out of the banks. I think you mentioned there was one bank out there that as part of its RFP wanted or required 50% of the business to be coinsured to it. I have to tell you we've been in the banking business a long time, particularly in fixed rate annuities and, quite frankly, the insurance company returns as a manufacturer don't stack up to what the banks feel like they can get over a long-term period. While we've had a number of banks ask, once we share with them what the returns are, they're happy to be in the commission business and fee business rather than the underwriting.

Mr. Lash: That I think is true. The reason it's worked for some that have done it and is intriguing to some companies that are thinking about it is going offshore, which reduces the capital requirements tremendously and can at least, theoretically, get you to 15% returns which is just making the hurdles for banks to do that. But I think you're right. I think as banks get into it more and more they have to challenge themselves and question whether the returns are high enough. Clearly, in some of the deals that have been the done the returns are just making it.

Now, one other aspect that I'll mention on the underwriting: there's one bank, in particular, that in the last year bought a life insurance shell and they're planning on directly underwriting annuities. One of the areas of banks that hasn't been that successful is sales because, especially in their platform program, they pay their people very little on sales. The platform people sell insurance among 200 other products that they need to sell. Typically, a compensation scheme might be if you sell a life insurance product you get points toward a trip to the Caribbean or something like that. They don't generally pay compensation. AEGON or a Northwestern Mutual might pay the bank a 6% commission, the bank keeps that

money and they pay their person that actually sold it very little, if anything. There's one bank, in particular, that's looking to take that, sell the product directly, and continue to pay its people very little. But now you've freed up 6% commission that it can either credit more or add some bells and whistles. That at least is its model that it's moving forward on as to how it is going to be successful. Only time will tell.

Mr. Trefz: What about bank and insurance company combinations? How likely is it that there will be significant deals happening, and what impact would that have on the life insurance industry?

Mr. Lash: I think that is very unlikely. We have history as a guide in that Gramm-Leach-Bliley passed almost a year ago and nothing really has happened, except Royal Bank buying Liberty Life, which was a very small deal. A number of banks have looked at it. A number of banks have gotten calls. When Gramm-Leach-Bliley first passed you had all the investment bankers running to all the banks and saying, "Look at this property, look at that property," trying to really push banks to buy insurance companies. But they didn't have real compelling reasons why they should do it.

Now, from what I can tell from clients is that investment bankers have changed their tune and said, "Yes, you shouldn't be buying an insurance company." I think it's very unlikely, because I think the returns really aren't there for what a bank needs, generally speaking.

I think you're going to see banks playing on the margin. Of the list of opportunities, I think distribution, asset management, and processing are going to be the three areas you're going to see banks hitting hard. I don't think you're going to see all that much direct underwriting. But the distribution, asset management, and processing are areas that banks are exploring heavily now. I think you're going to see them as decent players in that.

Mr. Baird: We talked about that already, that the banks are minimum 15% return on equity (ROE) up to 18%, I think, and on acquisition they try to do better than that. For insurance companies that would be the top end, so their bottom end would be our top end. It does beg the question though then why wouldn't insurance companies, in an attempt to increase their returns, acquire banks? Now, on that I have heard of only one major life insurance company who has gone to a banker and asked for advice as to who the candidates are to buy a major bank. I mean there's a lot of these thrift charters that are out there and I don't think companies know exactly what they're going to do with them. But as far as buying an established platform, I've only heard of one company express an interest.

Mr. Lash: One of the reasons I think you see that, at least from publicly traded companies, is because if you look at the top 10 insurers and the top 10 banks, the only insurer that's bigger than the top 10 banks is AIG. Everybody else is dwarfed by the size of the top banks. I think part of it is insurers don't have the wherewithal to buy at least a decent player in the banking market.

Mr. Strommen: Certainly, a mutual company that doesn't have access to the outside capital markets doesn't have the wherewithal to buy a large bank. It's not in the cards for us as long as we stay a mutual. What may be more in the cards would be some sort of a partnership in order to make, again, banking services available through our distribution force somehow. But I don't see how that could easily be done. It's not on the top of our list.

Mr. Russell A. Osborn: To what extent do you see a repositioning in our core businesses between life and annuities? I wonder what your thoughts are regarding the mix between annuities and life.

Mr. Lash: I guess I don't see any immediate change of companies focusing on the accumulation products and there's nothing that's immediately going to spur that change in mix. There's nothing on the horizon. You could say the Internet, I guess, but there's nothing really on the horizon that I see in the industry increasing life sales tremendously in the next 5–10 years. But as long as the markets do well, the variable annuities are going to be the driver of growth and continue to be the driver. I guess I don't see any immediate change.

Mr. Strommen: I think annuities and life insurance serve very different purposes. There's certainly room for both and a large share of business being written in both.

Mr. Baird: I've actually never thought about the question the way it was asked. You know, at this point having access to capital, we take all that we can get from our existing businesses. We feel constrained sometimes on an acquisition, but we'll take all the life and all the annuity business, whether it's variable or fixed, that we can get.

Now, having said that, the fact is that a second-to-die variable life or just a plain variable universal life is a great after tax investment. It is a great wealth transfer vehicle. I think there's no question that variable annuities and variable life will continue to far outpace growth in fixed. But between variable life and variable annuities, I'm not sure how that's going to shake out. It's clearly going to be a variable world.

Mr. James P. Koher: Where do you see the special risk market, long-term care and critical illness, fitting in there? They've obviously enjoyed much more success abroad. But with the changing demographics, the aging of the population in the U.S. will there be greater awareness and will there be more popularity in the future?

Mr. Baird: There's no question the demographics and awareness of the need is never greater than it is today. It is also never greater than it is in Washington right now. While AEGON, if you combine all of our companies, is fourth or fifth in long-term care, we started the long-term care division in 1988. We started it from scratch, have grown it, and have really not make any acquisitions in this. I feel like we know this business pretty well.

The one thing that concerns me a great deal about long-term care is the attention of Congress. If Congress decides to incentivize people while they're working through your flex plans or your cafeteria plan to start prefunding for long-term care, first of all, that makes it much more difficult to be able to figure out how to price it. But, second, it becomes a political thing. You know, you're in the senior market and you've got politicians interested and that's a dangerous combination. While I think G.E. Capital is acquiring all that they can, I believe, Travelers has exited. You've got two very good companies going in opposite directions.

I think there are going to be more incentives provided by Congress, more encouragement for employees to acquire this for themselves as well as for their parents. So it's great to be in the business. However, I am very concerned anytime Washington gets very interested in a senior citizen issue. Can you make your returns? It's certainly possible to lose money. Politicians have no problem with you losing a lot of money. But can you make too much money in that market? I'm concerned about it.

Mr. Strommen: I think the long-term care market is certainly poised to grow very dramatically. It's a very immature market right now. As many of you are aware, there's a lot of pricing issues and rate increase issues that are going on. I really feel that some of that has to be worked out or worked through before the general public will gain confidence in this kind of a product. But once it becomes more widely used and the public gains confidence, I have no doubt that long-term care will be a very big piece of the future.

Mr. Lash: I'll echo that and just from antidotal evidence from my firm's perspective, they just added in the last few months a long-term care benefit. Well, they've offered the choice of buying a long-term care policy through a group mechanism, a company that's come into the firm. That was surprising for me to see that there are, clearly, companies that are focusing on the employee/employer market and getting out to the markets. I think it's going to get more and more exposure out there. I definitely think that it's inevitable that it's going to grow tremendously.

On the critical illness side though, I guess, I'm somewhat hesitant to think that that's going to be a huge market just because of the perception issues, and the potential market conduct issues, and just the whole aura around that. I don't believe that that's going to be a huge driver of profitability going forward.

Mr. Trefz: Let me go back to a question that a couple of you touched on, that being the future of regulation. I think, Pat, you suggested you didn't expect or maybe you were just making an assumption that there wouldn't be any major changes in the regulatory environment. But what is your view on the prospects for that and what impact might there be if we ended up with either an option of or the only option being federal regulation of the insurance companies?

Mr. Baird: Two state commissioners from states where we have major companies domiciled, Kentucky and Iowa, George Nichols and Terry Vaughn, are involved in the NAIC's initiative on this issue. I've told both of them that we support both the

federal initiative and the NAIC's initiative to have a point of contact regulator. But if they were in our shoes, we would have no choice but to support it because it has to happen. Personally, I think where the NAIC is going to get in its initiative is that 35–43 states will sign on with the point of contact regulator scheme. That is if you have a 200% NAIC risk-based capital and your major locations in a state, you can use that state for licensing, product approval, and, ultimately, for enforcement. Their oversight will govern the other states. Now, that has a lot less risk and less ominous to me than the idea of a brand new federal agency, where it's not been staffed, and you have New York Department of Insurance Superintendent Neil D. Levin of New York campaigning to be the first federal commissioner.

I think the NAIC is saying the right things. I think they will get their act together. I don't think we need all 50 states to make that a choice for AEGON. We have thought a lot about it. The faster they move, unless the bank folks force it, the less likely that the insurance company is going to need and will support and cooperate with the federal initiative. I'm thinking, at least from AEGON's perspective, that we'll probably still be regulated by a point of contact regulator. In our case, it will probably be the State of Iowa.

Mr. Strommen: I don't have a real strong opinion on that. I'd maybe take a step back from the question and say if our concern is profitability, does it matter? I'm not sure whether our profitability would be more or less affected or more adversely or advantageously affected by either kind of regulation. From a profitability standpoint, it's a moot point.

Mr. Lash: The only thing I'll add is I struggle with this question a lot myself on where it's going to go. I agree with Pat's comments. The one area that scares me a little bit is with Gramm-Leach-Bliley and the regulation that's been changing. We have what we like to term functional regulation.

As you start to develop new products and some of the lines get fuzzy, as we've even debated a little bit, when you start to get a little fuzzy on whether it's an insurance product, investment product, or banking product, I can definitely see down the road arguments happening of who should be regulating what. Getting into all these type of debates will lead to some action, potentially, at the federal level.

Someone made a comment at one of the sessions. I forgot exactly how he put it, but I found it interesting. He said that he is sure that in his children's lifetime there'll be a federal regulator and in his grandchildren's lifetime they'll be an international regulator of financial services. Some people definitely are very strongly opinioned about we're eventually going to get to one regulator.

Mr. David E. Neve: Where the profits are going to come from at least from our company's perspective would be along this line. Our company grew up as a traditional life insurance company. But along that route we developed a lot of expertise to support that business and we viewed those, historically, as support functions. Now many of those areas of expertise we are marketing directly as a fee for service. I'll give you a couple of examples.

Residential mortgages. Throughout our history we invested in residential mortgages. We are in the residential mortgage servicing business and get a significant amount of profit from servicing mortgages around the country. It has nothing to do with our life insurance business. Similarly, consider our investment operation. Of course, we needed to have a support function there. We're going out and selling our services as an investment manager that's somewhat independent from an insurance company. In fact, we'd kind of like to divorce the two to a certain extent. We also provide 401(k) as a fee for service kind of activity.

For our company, a strategic direction is to focus or to grow our profits in some of these fee-based businesses as opposed to risk-based businesses. I'd be interested in your reaction to whether you see the industry moving more and more in that direction. Always, obviously or not obviously, but looking to the risk-based products as being a base to draw from, but then really supplementing that and enhancing profits with more fee-based services.

Mr. Lash: I think from the insurance industry's perspective, I personally don't see a lot of focus on non-underwritten businesses. That is definitely true on the bank side. Banks are very fee focused, very fee sensitive. They don't want to use their balance sheet. They'll do anything they can so as not to use their balance sheet.

There actually is a bank out in Pittsburgh that just sold their entire mortgage business and mortgage servicing business. They don't want to do that. They don't want to use their balance sheet in creating mortgages. I see very different approaches at least of recent times where the banks are definitely getting away from balance sheet and want to do fee for service, but I don't see that on the insurance side at all or very limited at least.

Mr. Strommen: In a mutual company's standpoint, getting into a fee for service business, unless it's directly related to some policyholder activity, would be pretty much off to the side of the purpose for which the company is formed. We look at these kinds of things only when we want to get into them to help our distribution system remain viable and active. It becomes to a certain extent a question of not only where the profits are, but where do they go? We only do this kind of fee-based business if we think we're going to make a profit on it that we can then pay back to our insurance policy owners who are the owners of our company. We tend not to focus on the fee business unless it's somehow necessary to support our distribution system.

Mr. Baird: I agree, Dave, with a lot of what you said. Clearly, on the asset-management side we'd like to develop that. You know, that's close enough to our core business. We're in the reinsurance business. However, we will draw the line somewhere. We have had offers from banks, for example, asking if we would be a TPA only just for the fee and we have said no. It's not worth it for us. At this point, we can still get the additional profit of a product manufacturer. We may not have to have a 100% of it, but we've got to at least have a major piece of it or it's not worth it for us. I think I'm 75% with you on that. When you think about it, think about the size of the company that you have to have in order to have that expertise in such a way that you can leverage it and go out to third parties. I think

that also speaks to if, in fact, that becomes a major part of our returns and our revenues going forward. Then, clearly, the big companies are going to gobble the small companies, because the small companies can't complete in those areas.

Mr. Trefz: Just to follow-up on that, Pat, is there a place for smaller companies in the future or is it just inevitable that only the very large companies will survive and be successful?

Mr. Baird: I think in very narrow niches there's always room for a specialist. It doesn't matter what business, whether you're in hog processing or if you're the insurance business. If you're in a very narrow niche and you focus all of your attention on a very narrow niche, I don't know how big you can get. But you can, clearly, survive as a small player. I do believe that.

Mr. Trefz: Other opinions on that?

Mr. Lash: I have nothing to add. I think that's right on point.

Mr. Osborn: Pat, earlier you had said that the banks were aiming at something like an 18% target return. Do you know to what extent they're actually achieving that? And, if so, how are they able to maintain such a high level?

Mr. Baird: I told you 100% of what I know and that is that their bottom end of the range is 15%. I suspect Steve Lash can help us more here. But going back to when the consolidation first started on a marginal basis, the returns on an acquisition they were shooting for well in the 20–30% range. I know that that's flip-flopped on them the last couple of years. I think they got overextended. But, quite frankly, since we choose to date rather than marry, I've never looked at it beyond that, so maybe Steve can help.

Mr. Lash: I'm not sure I can add much on the acquisition side. Clearly, banks do have that sort of target of 15-18%. They have been achieving those targets, generally, across the banks and it's really been driven by fee businesses. They've moved away from using their balance sheet and from the high-end capital-intensive businesses and have focused on fee business, corporate-finance-type businesses, asset management, processing, and mutual fund processing. There are a couple banks that have big processing houses where they use very little capital and it allows you to get your returns up. You'll see almost all banks are getting away from balance sheet use.

Mr. Trefz: Why would an investor put his money in an insurance company instead of a bank?

Mr. Lash: There are more things that will drive value. Obviously, bank price/earnings ratios (P/Es) have been poor. I would say the bank P/Es at least in the spring were lower than insurance company P/Es. That's always the debate we have internally in some strategy work we're doing for banks on valuations of what really drives valuation.

Actually, we're doing a study on doing all this type of regression analysis on what factors drive valuation. ROEs are important, because long-term you think if you have a high ROE company you're eventually going to have a high P/E and a high value company. But the timing isn't always necessarily the same. I think the markets play funny games and P/Es jump all over the place, regardless of ROEs.

Mr. Baird: Actually, we have done some work on that as well to try to understand what drives market capitalization and P/Es. The issue that drives the highest P/E, with the highest correlation, is growth in earnings or expected growth in future earnings. The second issue is size, market capitalization, either the view of the market that you can withstand regulatory challenges, legislative challenges or your cost of capital. That has the second highest correlation. Third, and as of two or three years ago, in fact, there was no line, because there was no correlation. There, actually, were returns. Returns were least important out of those three.

Steve, you mentioned one your company's concerns is the potential loss of new business in the estate planning market if, in fact, estate taxes are repealed. What do you and the other presenters see as the potential for fee-based financial planning services? With a growing segment of the population approaching their retirement years in the next two decades, I see an enormous potential for insurance companies to generate new revenues via financial planning advice on issues such as asset allocation, retirement planning, wills, trusts, durable powers of attorney (in the event that you're incapable of making important decisions due to illness or injury), gifts to minors, college planning, etc.

Mr. Lash: I think there's a great potential for that. In fact, there is an operation being set-up in our company to facilitate that, in particular, for high net worth individuals. I think it's called the Estate Strategies Group. But I believe there is a significant market for that kind of service that goes much beyond selling a life insurance policy or selling an annuity policy, but helping somebody really secure their financial plan. That is the area we are trying to get our representatives to move toward. That's why we're calling them financial representatives, so that they can address this whole body of needs and not really be primarily product people.

Mr. Baird: We have a group that we identify as the fee-based planner group and we have a suite of products that's been designed for them. We have been out in that market for about four years. Every year we think that it's going to take off this year and it never quite does take off. However, I can tell you in the last 9–10 months there has been more activity. There have been more near misses. You know, kind of like flying into O'Hare. There are more near misses than ever before.

What I think is going to become a major product channel, I really do believe this one is coming, is the tax preparers. You know, there's a lot of trust, perhaps, between banks and their customers. At least that's what the survey or the focus groups suggest. They dare say there's more trust between your tax preparer and a client than almost anywhere else.

When the tax preparer becomes comfortable in selling a spread load, second-to-die variable life, or no load mutual fund, or, rather, trailer fee mutual fund, when that

takes off, I think that's going to be a force to be reckoned with. Because they see that person every year and the person is always asking them, "What do I need to do?" That's a pretty unique combination when someone's asking you what should I do with my money and they see him or her once a year. I think that is going to become a real formidable distribution channel.

Mr. Trefz: If I can ask a question about a mutual company structure, will large companies survive as mutuals into the future? What beliefs about the future might lead a company to decide that that's the appropriate structure?

Mr. Strommen: There will definitely be mutual companies in the future, large mutual companies, in particular. That's because the mutual company form of organization, especially when you have a captive distribution network, has a number of synergies that make it work very well. Again, earlier I talked about the product-driven profit model and the distribution-driven model. You bring those two together and you can have a very fine profit-making engine. I think that will be viable in the future because the need for the kinds of services that that organization can provide will still be there. People will still need insurance products. They will need financial planning advice. Time has shown that that approach is a very viable way of meeting that need.

We've seen a number of companies demutualize, even some very large ones over the last number of years. From a certain point of view, one could speculate that many of those companies were not being operated strictly as mutuals, even before they demutualized. They were already diversifying and looking at alternative sources of profit long before they demutualized and they started to run businesses other than those that are participating insurance for profit long before they demutualized. Many of the companies that demutualized really had lost track of who they were as a mutual company. Others ran into a little financial difficulty. A mutual company without access to outside capital markets has to remain profitable in order to grow. Their growth of capital all comes from retained earnings. If you have no earnings to retain you're going to get into trouble. There are a number of reasons why mutual companies have demutualized.

For a company that maintains its focus, it's in business for the benefit of the policyholders and maintains a viable growth and distribution system. That kind of organization can work. It has worked. It will work and will continue to work in the future.

From the Floor: I'd like to maybe just add a twist to your question, Jim, about the viability of a mutual company. I think you're right. There are many reasons why companies demutualize. In our case the main reason was the strategic decision to go global. In order to go global, we were going to need capital and we couldn't get that just through earnings. If Northwestern Mutual decided to go global and wanted to have to take what they've done so well in the U.S. and then export that around the world, do you think you could do that as a mutual company in that form today or would you also have to then demutualize?

Mr. Strommen: In order to do something like that and remain a mutual company, we would have to start small, because you can't go out and buy a large company. You simply can't dedicate that amount of capital or grow it in addition to what you need to support your own domestic business. It would be very hard to do that without starting small and growing very slowly overseas.

One has to ask the question what's in it for our policy owners if the company decides to grow overseas? Some people are coming up pretty blank when they ask that question. We have, say, 5% of the U.S. market. There's a lot of room to grow in the U.S. market without devoting resources to growing overseas.

Mr. Baird: I think if a mutual company, because there are no shareholders, can sit on a certain amount of excess capital and has their expenses in line, primarily because they already have the size and the scale, like Northwestern Mutual, I think, they're going to price products more favorably at a lower rate than what stock companies can. I think there will be some mutual companies that will have a competitive advantage in this market.

Mr. Trefz: Do you consider that an advertisement for Northwestern Mutual?

Mr. Strommen: Well, I think it's very true. Part of the synergy that we get with a dedicated agency force and working very closely together with a company is good persistency, very good fundamentals, and lower expenses that help us have that competitive advantage.

Mr. Baird: I mean that could be true. We offer stock to our distribution, so we think we have real good loyalty. We're not located in Milwaukee, but we're located in low-cost areas as well. I think it comes down to what's your hurdle rate. If your hurdle rate is 9-10% because you're a mutual rather than unleveraged hurtle rate of 12-13% because you're a stock, that's a competitive advantage. In all else you'd be about the same, but that's still an advantage to you.

Mr. Strommen: That can certainly be an advantage if one's hurdle rate is low. I'm not going to disclose what our hurdle rate is, but I believe it's competitive. That could be an advantage. But, as I mentioned before, our company is trying to grow. We're putting a lot of resources into growth. We're experiencing considerable growth. There's no question that a low hurdle rate can help, but those other advantages that I mentioned before, the synergy with the field force, getting good persistency can help as well. Good persistency helps a lot. It helps keep the expenses down. It keeps the premium flow coming in. It generates a lot of advantage. It helps mortality experience as well.