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Stephen J. Friedman
Pace Law School

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THE U.S. LIFE INSURANCE INDUSTRY— THE NEXT FIVE YEARS

STEPHEN J. FRIEDMAN

*Executive Vice President and General Counsel,
Equitable Life Assurance Society of the United States
New York, New York
[Former Commissioner, Securities and Exchange Commission]*

I thought I would talk about the challenges for the life insurance industry over the next few years. I make what is probably a fair assumption: most of you know more about banking and securities than you know about life insurance, so I will spend a little time talking about the way a life insurance company looks to people with a background in banking and securities.

I spent a week in Japan last month talking to executives at Japanese life insurance companies. That was an astonishing experience, not only because of the size and strength of their life insurance industry, but also because the principal subjects of debate in the Japanese life insurance industry are exactly the subjects of debate that have occupied the Morin Center for the past few years. These include the Glass-Steagall Act,¹ deregulation of banking,² and the demutualization of life insurance companies.³

During the occupation of Japan by the United States, General McCarthur imposed the Glass-Steagall Act⁴ on the Japanese financial

¹See *Glass-Steagall: Does It Have a Future in Banking?*, 2 ANN. REV. BANKING L. 51 (1983).

²See St Germain, *The Effects of Deregulation on the Structure of Banking*, 1 ANN. REV. BANKING L. 77 (1982); Cimeno, Jr., *The Challenges of Increased Regulatory Supervision: Introduction*, 6 ANN. REV. BANKING L. 223 (1987) (conference proceedings).

³See Fenske, *Going Public: The Critical Choice*, in BEST'S REVIEW: LIFE/HEALTH INSURANCE EDITION, Jan. 1985, at 28.

⁴Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.)

system.⁵ Someone apparently told him that mutual life insurance companies were more democratic than stock companies, so he mutualized them by fiat in Japan.⁶ They are now wrestling with exactly the same issue with which we are wrestling—from, of course, a peculiarly Japanese angle. For example, in the demutualization debate, the proposal for demutualization comes not from the life insurance companies, which are very happy being mutual companies, but from the banks, because the banks want to demutualize the life insurance companies and then buy them.⁷ That is more than a sidelight on this discussion, I think, because it reflects a worldwide trend. If I can coin a double cliché, I would call that trend the “globalization of the homogenization of financial institutions”; what we are going through is exactly what is going on all over the world.

What is a life insurance company going to face over the next five years? In a sense, the life insurance industry is facing the same types of issues that face other financial institutions. There are three broad categories: the first set of challenges has to do with marketing and product differentiation, the second with deregulation and tax policy, and the third with internationalization. Depending upon one’s views of interest rates, I suppose there could be a fourth, contingent set of challenges that would be grouped under the rubric of inflation.

Let me begin with marketing and product differentiation. To really understand these challenges one has to understand what has happened to the life insurance business. Life insurance companies, as well as life insurance products, have developed in a way that parallels developments in the banking and securities industries.

Look at the insurance distribution system, particularly the career agency system, which is similar to the distribution system in a retail securities firm. I spent two years at E. F. Hutton before coming to the Equitable, and the similarities between them are both extraordinary and striking. Much of the strength of life insurance companies, particularly the large mutual life insurance companies, comes from the career agency system. These companies have an impressive ability to deliver very sophisticated advice about complex financial products to retail

⁵See Semkow, *Japanese Banking Law: Current Deregulation and Liberalization of Domestic and External Financial Transactions*, in 17 LAW & POL’Y INT’L BUS. 81, 119 (1985).

⁶See Murphy, *Japan: Land of Rising Opportunity*, in BEST’S REVIEW: LIFE/HEALTH INSURANCE EDITION, June 1987, at 48.

⁷See Fenske, *supra* note 3.

consumers. Insurance products are not stocks and bonds. Although many are really not very different from mutual funds, there are major differences at the point of sale. What the life insurance salesman talks about with a customer is quite different from what the security salesman discusses. From the perspective of the management of the life insurance company, however, the two distribution systems look very much alike. They are both based on full-time career salesmen; both sales forces are geographically decentralized and highly independent; they both sell complex financial products; both salesmen are compensated on a commission basis, which means that they have their eye firmly fixed on the top line and not the bottom line; and they both present very similar kinds of challenges to management.

There are also many similarities between life insurance and banking. The traditional life insurance company is, fundamentally, a financial intermediary. From this perspective, insurance policies are simply the liability side of the balance sheet. These liabilities are longer and much more complex than a bank's deposits, but from the point of view of asset and liability management, they function in exactly the same way. In that sense, the life insurance company is no more in the life insurance business than a bank is in the checking account and CD business. The insurance sales force gathers assets; that is its fundamental purpose. The company seeks to profit from the spread between the residue from assets and the expense of gathering and repaying liabilities. The challenge for a life insurance company is to match properly those assets and liabilities and invest them so that the company can satisfy its liabilities and make some money in the process.

There are, of course, differences between banks and life insurance companies. Because the liabilities are much longer and much more complex, the challenge of asset and liability management is more daunting for a life insurance company. If you make a mistake, it stays with you for a very long time. Another interesting difference is that a life insurance company sells liabilities—that is, insurance policies—rather than assets. Liability products are responsive to customer demand, and the distribution system is customer driven. Compare that to a bank, which I would generally regard as asset driven. Banks tend to forecast loan demand and then decide the best way to fund those loans, since there are a variety of liabilities available for that purpose. An insurance company tends to focus on selling its liabilities and then figures out how to make money on the assets that are gathered.

Finally, life insurance companies have become very significant investment managers. There are really two aspects to this business. First, many large life insurance companies have bought large investment management firms. Alliance Capital, for example, with more than \$40 billion under management, is a subsidiary of the Equitable. More significantly, the life insurance business itself has become an investment management business. Inflation caused the development of a series of investment products lodged within life insurance companies' variable life and annuity products. These products pass on to the customer the risks and the benefits of the investment management process. Although the life insurance company is still an intermediary, it is really compensated on a fee basis.

What does all of this have to do with marketing and product differentiation? Simply this: As the products offered by all types of financial institutions start to fill similar needs, and as each type of financial institution gains increasing power to offer the products of the other, financial products start to look like commodities to the customer. Life insurance companies have traditionally had a high-cost distribution structure. There is nothing worse than being the high-cost producer in a commodity business.

There are only two ways to deal with this business crunch, and the life insurance industry is working on both of them. The first includes reducing costs. It is extremely difficult, however, to decrease significantly the cost of a career sales force because the strength of that sales force is its ability to deliver very sophisticated advice about the complex products which life insurance companies sell. This strength rests on a substantial investment in recruiting and training, as well as compensation. If that investment is drastically cut, there is a risk of eroding service quality. The second way to address this business crunch is to focus on marketing so that those high quality services are delivered to people who want them and are willing to pay a premium for them. I think this is an area in which the life insurance industry in general has been very weak. Its concepts of market segmentation are rudimentary and in many cases do not exist at all. As an industry, its conception of its customer base is quite abstract.

One of the reasons that the life insurance industry has lagged behind other financial institutions in marketing is that, more than in any other industry, life insurance companies have tended to identify themselves with their own products. Instead of thinking in terms of offering products which meet their customers' long-term financial needs, they tend to think of themselves as being in the business of meeting their customers' needs

for life insurance or annuities. It is only a half step, really, from thinking of yourself as being in the business of filling your customers' needs for life insurance to thinking of yourself as being in the business of filling your customers' need for your kind of life insurance. When you do that you have lost the competitive race. In contrast, if you think in terms of meeting your customers' needs for financial security, you end up with a very different set of products, a different marketing strategy, and a different focus.

Let me turn for a few minutes to the challenges posed by regulation and tax policy. A principal challenge for life insurance companies is going to come from further deregulation in banking. The life insurance industry has adopted the views of other industries in this position: a disbelief that new entrants into the industry can compete effectively and gain substantial market share because "they really cannot do it our way." That was certainly the attitude for many years taken by those in the securities industry. Although banks have hardly taken over the securities business, I think there has been a clear demonstration of their ability to gain market share. Since the market crash of 1987, the inclination of the larger banks to engage in the securities business has lessened along with the declining profitability of a securities business.⁸ Accordingly, many of the larger banks have turned with renewed interest to insurance and, particularly, to selling insurance.⁹ This renewed interest poses two major questions: are the banks going to be successful, on the regulatory side, in gaining that power and, if they are, are they going to be successful in the marketplace?

With respect to the first question, one need only analyze what has already happened in the last ten years in banking and securities to see that there is very little reason to expect the movement of banks into the sale of life insurance to be blocked. There are two events which one might have looked to as creating a trend toward reregulation: the market crash in 1987 and the current state of the S&L industry. Looking at the market crash, it is remarkable that it had almost no impact on the Glass-Steagall¹⁰ debate or on the pace of deregulation. Its sole impact seems to

⁸*IBAA Says Obtaining New Products and Services First Priority in 1988*, 50 Banking Rep. (BNA) 163 (Feb. 1, 1988).

⁹*Id.*

¹⁰Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

have been to get Congress to consider seriously Senator Proxmire's bill¹¹ to abolish the Glass-Steagall Act entirely. I would be very surprised if the market crash had any impact at all on the debate about insurance powers for banks.

There are many people who believe that the state of the S&L industry is largely due to the pace at which S&Ls were given new asset powers¹² in order to cope with the disintermediation that arose in the '70s and early '80s.¹³ Again, I would be very surprised if that had any impact at all on the ability of banks to sell life insurance. I do not think that the sale of life insurance poses any safety and soundness problems. What we are left with is a simple political fight, largely between the insurance agents and the banks.¹⁴ Generally, my experience with such raw political fights is that they hold back the tide for a surprisingly long time, but, in the long run, they cannot stem the pace of change if it makes economic sense.

Although life insurance companies have to prepare for significant bank entry into their business, there is still the issue of whether banks will be successful. I think the answer depends on how the issue is framed. At least in the short run, banks are not going to be successful in developing the ability to deliver highly individualized, sophisticated advice on insurance products. Similarly, banks have not been a significant competitive threat to that sector of the market in the securities business. On the other hand, banks will find ways to build on their own competitive advantages and satisfy a substantial part of their customers' needs for life insurance; just as the securities industry was able to find insurance products that fit its competitive advantage neatly.¹⁵

The second major regulatory challenge goes to the heart of the way that life insurance is regulated in America. It concerns the quality of state regulation. The quality of regulation in many states leaves a great deal to be desired. The resources devoted to regulating life insurance companies in virtually every state—even New York, which, I think, is among the best—are inadequate. The "state guarantee funds," which are analogous

¹¹S. 1886, 100th Cong., 2d Sess., 134 CONG. REC. S3520 (daily ed. Mar. 31, 1988).

¹²See N. EICHLER, *THE THRIFT DEBACLE* 64-65 (1989).

¹³*Id.* at 43.

¹⁴See, e.g., *OCC Urged Not to Approve Citibank's Application to Underwrite Title Insurance*, 52 Banking Rep. (BNA) 324 (Feb. 6, 1989).

¹⁵See Douglas Bremen & Co., Inc., SEC No-Action Letter (Nov. 3, 1988).

to the FDIC and the FSLIC, are not funds at all.¹⁶ They are a “post assessment scheme” to cover the cost of insolvency. A life insurance company that wants to do business in a state must agree to an annual assessment to cover the cost of insolvency. The charge is based on the amount of business that the life insurance company conducts in the state.¹⁷ There is an annual limit on the amount that any individual life insurance company can be assessed in a state in any given year.¹⁸ Those limits, which are necessary to participation, also render the insurance funds inadequate.

Some years ago, when I was still in private practice, my firm was retained by the board of Baldwin-United as it began to collapse.¹⁹ The state guarantee fund for Baldwin-United was in the state of Indiana.²⁰ Baldwin-United had about \$9 billion in annuity liabilities and it did not have enough liquid assets.²¹ We calculated that it would have taken almost twenty years for the Indiana State Guarantee Fund to pay fully all of the Baldwin-United policyholders because of the ceilings on the annual assessments.²² Moreover, the other state that was involved was Arkansas, and it did not have any guarantee fund at all.²³ It does not take much to strain this system.

There are consultants—“futuurologists”—who believe that they can predict future events by counting the lines of newspaper copy devoted to a given subject; it is a kind of free market approach to predicting the future. To a casual reader, anyway, there has been a marked increase in the number of newspaper lines devoted to insurance insolvencies in the last few years. I do not know what is going to happen, but it would not be surprising if there were a couple of smaller, but substantial, life insurance

¹⁶See *Baldwin Case Indicated Flaws in States' Ways of Regulating Insurers*, Wall St. J., Feb. 14, 1984, at 1, col. 6.

¹⁷See, e.g., PRACTISING LAW INST., *INSOLVENCY AND SOLIDITY OF INSURANCE COMPANIES* 122-23 (Commercial Law and Practice, Concise Handbook Series No. 416 (1987)).

¹⁸*Id.* at 123.

¹⁹See *Baldwin Case Indicated Flaws in States' Ways of Regulating Insurers*, *supra* note 16.

²⁰*Id.*

²¹Davline & Solomon, *Baldwin-United Is Forced to File for Chapter 11*, Wall St. J., Sept. 27, 1983, at 3, col. 1.

²²See *Baldwin Case Indicated Flaws in States' Ways of Regulating Insurers*, *supra* note 16.

²³*Id.*

companies that fail, particularly if inflation rears its ugly head again. If a few life insurance companies valued at \$5 to \$10 billion fail, that would really strain the system. Moreover, this is not the best time, as you can imagine, to go back to Congress and ask for a new insurance fund for life insurance policyholders. History teaches us that if that were to happen, there would be very repressive and rigid legislation. The life insurance industry, which is now only throwing off the shackles of an incredibly rigid system that grew out of some regulatory problems at the end of the 19th century,²⁴ would have problems in developing a modern financial institution. I think a very important challenge for this industry is managing that difficult process.

Just a word on tax policy. "Tax policy" in the United States has come to mean "revenue raising policy," and one of the sources of revenue these days is the life insurance industry. A particularly attractive revenue source which is not currently taxed to the policyholder is the "inside buildup," which is the increase in value in a life insurance policy as premiums are paid and the money is invested. The comparable increase in value, for example, is taxed to a mutual fund investor.²⁵ There are proposals,²⁶ and there will be proposals again this year, to tax the inside buildup. In my opinion, this would be very unfortunate, because one of our major problems in this country is the low level of long-term individual savings. Virtually the only major sources of long-term individual savings are life insurance and pension fund savings;²⁷ the life insurance industry plays a key role in providing long-term capital for pension funds.²⁸ I think a tax system that discourages long-term savings would be a terrible mistake. It would be counterproductive because it would sacrifice the long-term interest of Americans for short-term political gain.

To end, let me say just a word about internationalization. The major forces that have shaped the financial markets in this country have been the

²⁴See McDowell, *Competition as a Regulatory Mechanism in Insurance*, 19 CONN. L. REV. 287 (1987).

²⁵STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 2D SESS., REPORT ON BACKGROUND AND ISSUES RELATING TO THE TAX TREATMENT OF SINGLE PREMIUM AND OTHER INVESTMENT-ORIENTED LIFE INSURANCE 25 (Comm. Print 1988).

²⁶*Id.* at 31-40.

²⁷*Id.* at 25.

²⁸Arnt, *Gradison: No New Insurer Taxes* in NATIONAL UNDERWRITER CO.: LIFE & HEALTH/FINANCIAL SERVICES EDITION, Feb. 27, 1989, at 3.

following: First, the institutionalization of savings, which was basically a post-World War II phenomenon; second, the growth of information technology; third, rampant inflation in the 1970s and the early 1980s; fourth, the significantly increased sophistication of individual consumers of financial services; and finally, internationalization. Internationalization is the most recent trend and, therefore, the least understood. I have no doubt that it is going to change profoundly the nature of American financial institutions.

For regulatory reasons, American life insurance companies have really lagged behind the rest of the financial services industry in this area. Today, a New York insurance company—and many of the largest companies are subject to New York law—can only invest ten percent of the insurer's admitted assets in Canada and one and one-half times the insurer's reserves outside of North America.²⁹ Compare that to the lending activities of Citicorp,³⁰ or the fact that the similar limit on a Japanese life insurance company is thirty percent.³¹ This is a significant constraint on the industry that clearly is going to change.

The life insurance industry has been very active about foreign investing. The Equitable, for example, manages over \$2 billion for Japanese investors, largely in U.S. real estate and through LBO funds. Furthermore, internationalization is starting to change the liability side of the business as well. The coming of 1992 in Europe has caused all kinds of financial institutions, and certainly life insurance companies, to scramble to get inside the European Community before the grandfathering rights are set.³² There was a similar scramble to get into the United Kingdom before its "Big Bang," and the high price many banks and securities firms have paid for that process is well known.³³ I think internationalization is probably the area of greatest challenge for the life insurance industry, which has really only put its toe in the water. Life insurance is essentially, at least on the liability side, inherently local.

²⁹N.Y. INS. LAW § 1405(7) (McKinney 1985).

³⁰See *Draft Regulation Bans Loan Referral Fees, Reverses Earlier HUD Position*, 52 Banking Rep. (BNA) 63 (Jan. 9, 1989).

³¹See *Japanese Insurers*, BUS. INS., at 28, Jan. 4, 1988.

³²See *EC 1992, Financial Institutions Policy Will Be Focus of Competitiveness Council*, 52 Banking Rep. (BNA) 1389-90 (June 26, 1989).

³³See *Japanese Securities Industry Opposes Efforts to Eliminate Barriers to Banking*, 52 Banking Rep. (BNA) 798 (Apr. 3, 1989).

There is a great deal of very important strategic thinking that has to be done to compete on this side of the business.

Finally, I would like to close with a word about inflation. Inflation, as you know, transformed the financial markets in this country, and it certainly transformed the life insurance industry. Even the most traditional life insurance products today—for example, a whole-life policy—are now administered in a way that is almost entirely a result of volatile interest rates. Things have recently started to calm down. I have complete faith in the Federal Reserve's commitment to deal with the inflation problem; I have perhaps a little less faith in its complete ability to do so. It is very clear that if the Fed is not successful, then life insurance companies, as well as all other financial institutions, are going to spend much of the next five years dealing with the results of that problem.