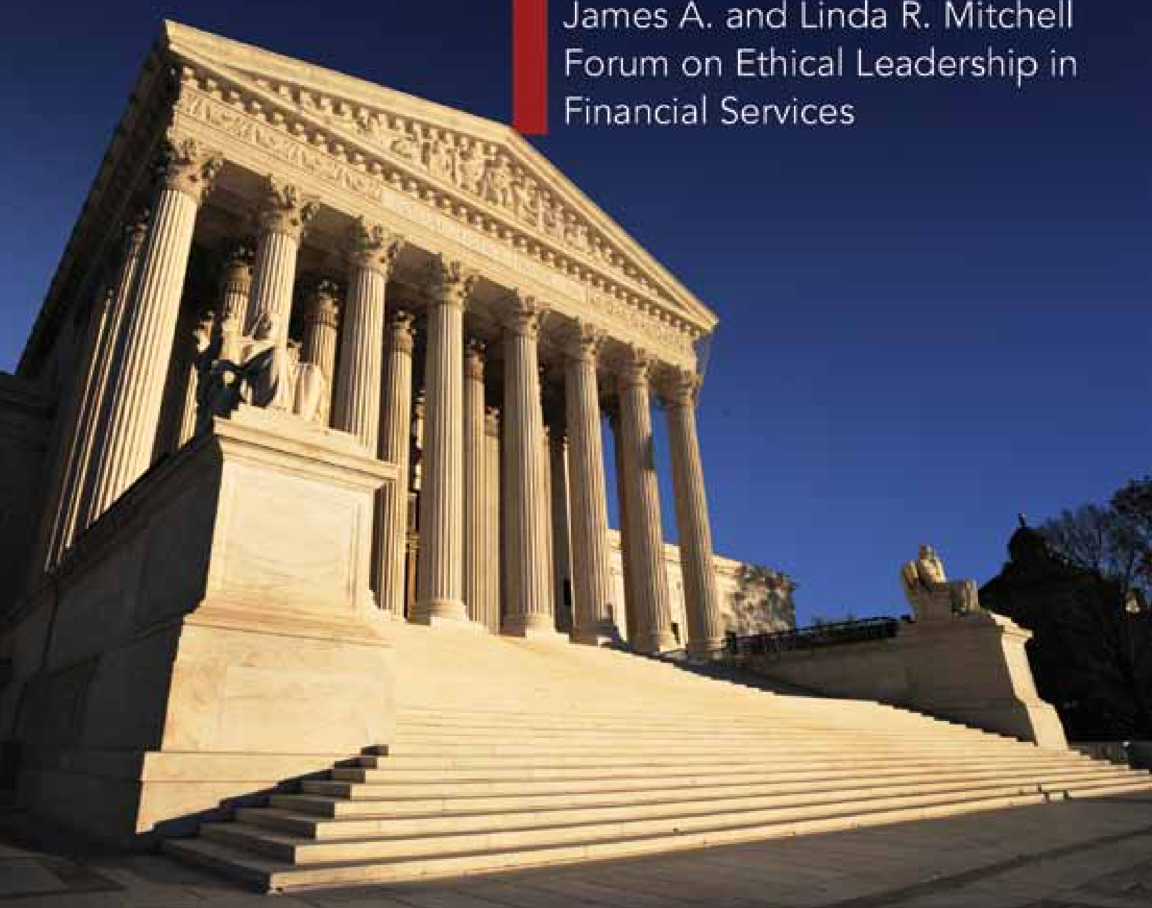
THE AMERICAN COLLEGE

PERSPECTIVES ON ETHICAL LEADERSHIP 2012

Twelfth Annual

James A. and Linda R. Mitchell Forum on Ethical Leadership in Financial Services



FORUM ON ETHICAL LEADERSHIP

The Twelfth Annual James A. and Linda R. Mitchell/The American College Forum on Ethical Leadership in Financial Services took place on January 14, 2012 in Naples, Florida. The event featured a discussion of several key issues confronting the financial services industry, along with an examination of practical ethical dilemmas encountered by executives during their careers and questions raised by business ethicists from major colleges and universities around the country.

THE EXECUTIVES

Laurence Barton, CAP®, President and CEO, The American College, Bryn Mawr, Pennsylvania

Bradford Hewitt, President and CEO, Thrivent Financial for Lutherans, Minneapolis, Minnesota

Terri Kallsen, Executive Vice President, First Command Financial Planning, Fort Worth, Texas

James Meehan, MSM, President, 1847 Financial, Conshohocken, Pennsylvania

James Mitchell, CLU®, ChFC®, Chairman and Chief Executive Officer (Retired), IDS Life Insurance Company, Longboat Key, Florida (Host)

Linda Need, Senior Vice President, Managing Director, Life Insurance, Wells Fargo Insurance Services USA, Inc., Charlotte, North Carolina

THE ETHICISTS

Thomas Donaldson, Professor of Legal Studies and Business Ethics; Director, Zicklin Center for Research in Business Ethics, The Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania

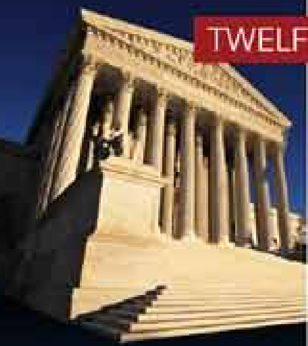
Katherina Glac, Assistant Professor, Ethics and Business Law Department, Opus College of Business, University of St. Thomas, Minneapolis, Minnesota

Kirsten Martin, Assistant Professor of Management, Department of Business and Economics, The Catholic University of America, Washington, DC

Robert Phillips, Associate Professor of Management, Robins School of Business, University of Richmond, Richmond, Virginia

Julie Ragatz, Director, Cary M. Maguire Center for Ethics in Financial Services, The American College, Bryn Mawr, Pennsylvania (Host)

Linda Treviño, Distinguished Professor of Organizational Behavior and Ethics, Smeal College of Business, The Pennsylvania State University, University Park, Pennsylvania



EXECUTIVE SUMMARY

On January 14, 2012 a group of six executives ("practitioners") and six academic ethicists ("philosophers") gathered in Naples, Florida to participate in the Twelfth Annual James A. and Linda R. Mitchell/The American College Forum on Ethical Leadership in Financial Services.

The purpose of this annual event, established in 2001 by Jim and Linda Mitchell, is two-fold:

- To provide executives with an opportunity to reflect on ethical issues they confront on a regular basis with questions posed to them by academics engaged in business ethics education.

- To afford academics the opportunity to engage in discussion about these issues with top-level executives so they can bring that experience back to their classrooms.

FAIRNESS AND SERVING THE MIDDLE MARKET

Following the introduction of the participants and discussion of their goals for the day, the conversation turned to ethical problems posed by an underinsured middle market. The participants identified two factors to account for the underinsured state of this segment of the market. The first is that the market is underserved by a financial services industry that lacks the incentives to sell to middle-market consumers. Executive participants discussed how life insurance has historically been a product that was sold rather than bought. Selling life insurance requires a significant investment of resources to educate clients and persuade them of the importance of life insurance and its place in a comprehensive financial plan. Simply put,

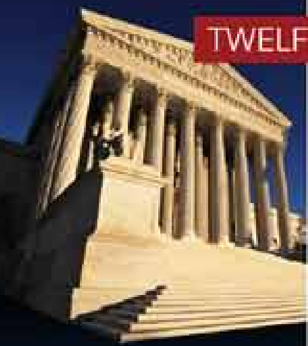
The participants listen as Kirsten Martin makes a point

this investment pays greater dividends when a larger life insurance policy is purchased. Given the dominance of the commission-based compensation model, practitioners are rewarded for directing their attention to the high net worth segment of the market.

The second explanation is that middle-market consumers simply choose not to purchase sufficient insurance to meet their risk protection needs despite having a variety of well-priced and accessible options. In some instances, participants believed that economic pressures lead middle-market consumers to curtail expenses, such as life insurance premiums, that do not appear immediately necessary. In other cases, participants thought that perhaps middle-market consumers fail to understand the importance of life insurance to their overall financial security or fail to estimate how much life insurance is actually required to meet their protection needs, often relying solely on employer-funded policies that are not sufficient. Moreover, some participants believed that while life insurance used to be perceived as a priority by all segments of the market, it is now viewed as more of a discretionary item.

Focusing on this point, some participants wondered whether the existence of an underinsured middle market was an ethical issue at all. If people willingly choose to forgo life insurance, what ethical obligations does the industry have to this segment of the market? Aren't their obligations fully met by offering a wide variety of products that meet the needs of consumers in a wide variety of life stages and within a wide range of income levels?

Some participants believed that the answer to these questions turned on whether the financial services industry could be considered a profession and its practitioners considered professionals. If so, practitioners have more robust responsibilities to look towards the good of their clients and an obligation to consider the common good or social welfare. The implication would be an increased level of responsibility to inform and educate the middle market, even in the absence of a direct financial incentive to do so. There would be a responsibility, in other words, to make sure that more middle-market consumers were insured at sufficient levels. The participants also debated where this responsibility would lie; can we expect individual practitioners to act to advance the common good or does this responsibility lie with the insurance companies, or even more broadly, with a coalition of companies? Participants also considered whether certain organizational structures, namely, mutuals and fraternal organizations, had a greater level of responsibility and accountability for these social goals.



"Preserving and understanding how trust is built, and how ethics play a role in building that trust, is incredibly valuable. Not just because it's the right thing to do, which I also believe, but because it's good business practice."

Brad Hewitt

POSSIBLE SOLUTIONS

Some participants suggested that this problem could only be solved by different organizations within the financial services industry coming together to think creatively about solutions. This is, some participants suggested, not only an ethical, but also a strategic imperative. If the benefits of life insurance are perceived by regulators to be limited only to a small segment of the market, this could threaten the continuation of tax advantages that render life insurance an attractive product.

Participants thought imaginatively about a variety of options to increase the number of middle-market consumers who are insured at sufficient levels. These could include a mandate to purchase life insurance that would be similar to the mandate to purchase automobile insurance, and reaching middle-market consumers through alternative channels such as their work environments and affinity groups. Work environments may be particularly attractive, especially if employers would arrange an 'opt-out' model as opposed to an 'opt-in' model. While the nature of life insurance has often required a face-to-face sales approach in the past, this may be changing as people become increasingly acclimated to purchasing products online or at various non-financial retail outlets, such as big box outlets and grocery stores.

PRACTITIONERS' ETHICAL DILEMMAS

In this segment of the Forum, the executives each presented an ethical situation or problem that they had encountered in their careers.

The first dilemma concerned the difficulty of balancing the interests of the various stakeholders. Every insurance company is concerned about their sustainability and therefore the leaders of these organizations emphasize the importance of developing a robust reserve. A robust reserve not only insures the future of the enterprise, but also benefits future generations of policyholders. On the other hand, placing emphasis on increasing dividends and growing sales rewards current policyholders and employees of the organization. The problem gets even more complicated for companies owned by stockholders, where their interests need to be taken account of, also. How does an ethical leader balance these competing imperatives?

The second dilemma focused on the importance of removing even the appearance of a conflict of interest in order to build trust with the consumer and avoid the reputational damage that the revelation of this perceived conflict could impose on the organization. The challenge is that there are situations in which striving to avoid the appearance of a conflict could result in perverse consequences that hurt the consumer. Specifically, the example centers on the number of products available on a financial institution's distribution platform. In order to prevent even the appearance of a conflict of interest, it would be necessary to provide space for every company whose products meet the organization's due diligence requirements. Since organizations pay different rates for access to the platform, deciding to limit the number of choices may lead to charges that the organization made these decisions motivated by the desire for financial gain. However, a crowded platform is not helpful to consumers, often paralyzing them with too many choices. Moreover, it is impossible for financial advisors to become familiar with such a wide range of products.

The final dilemma concerned how to adjudicate a dispute between two high-performing producers. The goal was to create a process to resolve the dispute in a way that was perceived as fair by the two individuals and outside observers. At the same time, we want to preserve, as much as possible, the relationship between the two individuals and the relationship between each of the producers and the leadership of the organization. There is always a concern in situations like this that a disgruntled high-level producer will simply leave the organization.

Elizabeth Rohr listens to Tom Donaldson

PHILOSOPHERS' QUESTIONS

In this portion of the program, each of the academics posed an issue or raised a question for the group to discuss.

The first questioner noted that people working within an industry inevitably have better knowledge of the problems and risks that face their industry than the government regulators charged with overseeing it. The challenge is for practitioners to recognize these risks and work together to develop creative solutions that go beyond increased regulation and oversight. This can be challenging, since many organizations are unwilling to move out of competition to collaborate with potential industry partners. The philosopher wanted to know which practices, if fully known by the customer or the public, had the potential to cause significant trouble for the industry.

The second question concerned the value of professional oaths. There is a movement among MBA programs to offer their graduates the opportunity to take an oath committing them to a higher standard of behavior. This project is often viewed as part of a broader movement to make management itself a profession. One of the challenges to the establishment of management as a profession is the lack of infrastructure to support the certification of professionals, as well as the sanctioning of practitioners who failed to live up to their oath. The philosopher wondered whether executives would see 'oath-taking' as a benefit among potential job candidates, and if they had any suggestions on how the missing infrastructure could be developed.

"I know from experience that executives are pulled in a lot of different directions and don't always take time to reflect. It's hard to do the right thing if you don't step back from time to time and think about what that is."

Jim Mitchell

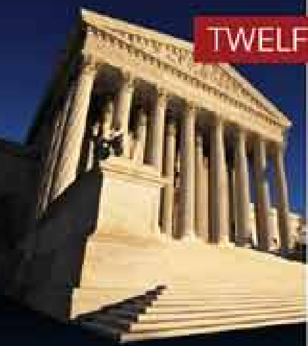
The third question considered how it was possible to reward restraint in executive leadership and strategy. This philosopher noted that the financial crisis exposed how difficult it was for senior leadership to exercise restraint in the face of short-term gains that were being exploited by competitors. It takes strong leadership skills coupled with strong ethical values to stand one's ground and explain to shareholders and other constituencies why these opportunities should be forgone. How can we support and encourage these leaders?

The fourth question asked the executive participants how they were able to ensure that their young sales people adhered to the ethical standards of their respective organizations. She believed that it was important to acknowledge these salespeoples' desire for autonomy, but noted that it may be easy for young and impressionable people to be led astray by others or to make mistakes on account of their lack of knowledge. Since poor decision mak-

Tom Donaldson shares his thoughts with the group ing on the part of new salespeople has the potential to be a real threat to the organization, how do senior executives protect themselves and their firms?

The final questioner argued that perhaps the greatest problem in business ethics is the diffusion of responsibility. People are often willing to act ethically and be accountable for their actions as individuals, but when people act in groups, there is always someone else to blame when things go wrong. One example of this tendency in the financial crisis was the process of securitization in which companies were able to move responsibilities for assets, such as mortgages, to another party. The philosopher believed that one of the reasons that the insurance industry emerged relatively intact from the recent crisis was that they avoided securitizing their assets. The philosopher wanted to know whether this avoidance of securitization was still the case, and the executives' thoughts on whether it was possible to mitigate the dangers of this diffusion of responsibility.

Julie Ragatz and Jim Meehan enjoy the discussion



"In leading The College, one of the things I am reminded of is that we don't really talk about global issues…. Students will often push back on case studies and say that does not apply. It can be difficult when you are asking someone from another culture to buy into somebody else's ethics and code of conduct."

Larry Barton

INTRODUCTION AND GOALS FOR THE DAY

The Twelfth Annual James A. and Linda R. Mitchell Forum on Ethical Leadership in Financial Services began by Jim Mitchell asking the participants two questions: What does ethics mean to you in your organization? How do you hope to benefit from today's discussion?

Jim Mitchell affirmed his belief in the importance of ethics to the long-term success of a business. "I spent a lot of years running the insurance operations for American Express. We tried to serve our customers really well and treat our employees well and be good citizens of the community. And in the process we did very well by our owners. I truly believe in that stakeholder model. Since I retired a dozen years ago, I've tried to encourage others to behave in the same way."

Mitchell remarked that he hoped the day would provide an opportunity for organized reflection. "I know from experience that executives are pulled in a lot of different directions and don't always take time to reflect. It's hard to do the right thing if you don't step back from time to time and think about what that is." He hoped that the academic participants would not only come away with stories to share with their students, but also with the sense that many executives are really trying to do business in the right way.

Jim Mitchell pays attention to the conversation

Brad Hewitt said that he believed that ethics is the foundation of trust, and trust is the most valuable commodity in this marketplace. "Preserving and understanding how trust is built, and how ethics play a role in building that trust, is incredibly valuable. Not just because it's the right thing to do, which I also believe, but because it's good business practice. That has been the foundation of our company for 100 years."

Rob Phillips noted that he was concerned about the increasing siloing of knowledge. "We get so specialized in what we do that the opportunities for cross-fertilization of all sorts are rare." He tries to read across a variety of disciplines, but believes that practitioner challenges often create the most interesting questions. "Especially if I'm going to be teaching these things, I think the stories that come from our actual life experiences create really strong opportunities for critical thinking."

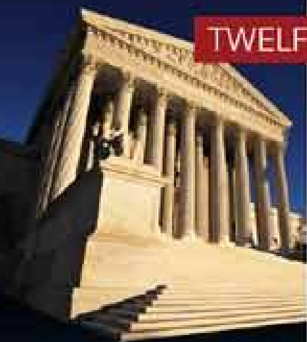
He added that it is easy to take for granted what you think you know. "What is the saying? The only thing that is more dangerous than what you don't know is what you think you know that is wrong." He was glad for the opportunity that the Forum provided, "to test what I think I know and my own experiences against those of other people."

Kirsten Martin remarked that she was interested in learning more about the problems that the financial services industry faces in more depth. "We know that there are commonalities among different industries, but it is also important to focus on what's unique and very particular." She was glad for the chance to talk with practitioners. "Ethics is not a very grounded discipline in that we don't touch the ground that often." Martin noted that academics have a tendency "to write to each other so the process of coming back and asking what this theory or this framework means in practice is very helpful."

Linda Treviño commented that she approached business ethics from a management perspective and specialized in organizational ethics. "So I'm very interested in leadership and one of the things that I always like about these sessions is that I get to talk to people who are ethical leaders. That's a wonderful opportunity for me." She noted that some of her best research ideas were generated from conversations with practitioners. "Having this chance to engage with both my academic colleagues and practitioners gives me ideas, and all that we do is based on ideas. Great ideas can emerge from conversations with practitioners."

Katherina Glac observed that the mission of the University of St. Thomas reflects a commitment to educate students to become ethical leaders who are able to contribute to society in meaningful ways. She mentioned that one of the challenges she encountered was that her students, usually mid-career professionals, have a hard time seeing the ethical dimension of situations and imagining that they will be facing difficult ethical dilemmas in their professional lives. "Part of what I hope to take away from our conversation are stories so I can tell my students that dilemmas happen to the best leaders and you will encounter these situations in the course of your careers. But even if it's difficult, if you have the right motivation and you apply the right tools, it is possible to find a solution."

Regarding her role as a researcher, Glac agreed with Treviño that she was looking forward to getting some new ideas from the conversation with practitioners. "I want my work to matter in a larger way than simply ending up in a journal that gathers dust on a shelf."



Linda Need said that while it "goes without saying that we all try to act ethically and model that behavior for the people around us," what she is really interested in is how do we take it to the next level and build an ethical organizational culture. "The point is that it is never as clear cut as it looks on a piece of paper. You have multiple stakeholders, all of whom have different objectives and they do not always go together. Given these conflicts, how do you as a leader help people make the right choices throughout the organization?"

"Having this chance to engage with both my academic colleagues and practitioners gives me ideas, and all that we do is based on ideas. Great ideas can emerge from conversations with practitioners."

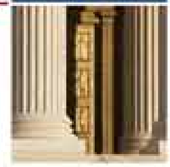
Linda Treviño

Larry Barton hoped that the group would be willing to adopt a broader, more internationally minded perspective in their discussions. "In leading The College, one of the things I am reminded of is that we don't really talk about global issues." The increasing diversity of The College's student body can create interesting dilemmas. "Students will often push back on case studies and say that does not apply. It can be difficult when you are asking someone from another culture to buy into somebody else's ethics and code of conduct." Barton challenged the participants to think not just as Americans and to consider the ethical issues from a global perspective.

Tom Donaldson believed that an important benefit of the Forum is that it helped to break down stereotypes between academics and executives. He drew an analogy with baseball. "The people who play the game, in a sense, know it best. But there are a lot of people sitting in the stands who spend a lot of hours studying the game and they can see it from a different vantage point. Each group has something to teach the other, and I think that the same is true in business."

But, Donaldson cautioned, the academics certainly do not have all of the answers. "The academics are not going to come up with great solutions for problems you've been working on for a long time. What I think we can offer are some frameworks that are pretty well respected and that take some of your good intuitions and put them in a context." He agreed with other academics who believed that this sort of interaction was highly productive. "I hope that through our interaction, we can come up with some novel ideas. This is a crucible which creates different possibilities."

Terri Kallsen shared that she had run across an article in *Bloomberg Business-week* that had really made her think about the role of ethics and perception. The article argued that executives must overcome their own moral hubris. The danger is that business leaders suffer from moral overconfidence or



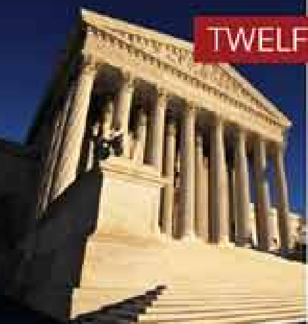
an inflated sense of their strength of character. "That really struck me because I can tell you that every company that I've worked for believes that they have the corner on integrity and ethics. And in their world they do."

Kallsen wondered whether it is possible to teach business leaders moral humility. "In most big sales meetings that I've been to, our executives, myself being one of them, want to build the confidence of our employees by talking about how ethics-based we are versus those people out there. I don't know if that's the right message because we don't always make the right decisions. I don't think very many executives come to work with bad intentions, but we are forced to make difficult decisions and sometimes they're wrong."

Jim Meehan observed that the financial services industry needs a spokesperson for ethics. "If Wall Street or CNN wants to report on ethics, who do they turn to right now? I think that's the opportunity for The American College and I would like us to be that beacon. Whenever there's an ethics issue that comes up, we should be the first people they want to talk with to get clarity on the issues." Meehan was convinced that ethical leadership could be taught and he was looking forward to interacting with the professors who would be teaching his future employees. "I am good at listening to a short story and having discussions about it. I would like to help in my way to contribute to the process of educating future leaders."

Julie Ragatz remarked that she looked forward to the Forum every year and was delighted to have the opportunity to bring this group of academics together. "It was exciting for me to invite a group of academics whose work I respect and whose ideas would really encourage the executives to look at things in a new way." She also noted the presence of Larry Barton. "It's also a privilege that the leader of my College is here as well, and that's wonderful for me."

In terms of how ethics mattered to her organization, Ragatz noted that The American College has increased its ethics offerings in recent years. "In an environment in which many other institutions are cutting their stand-alone ethics classes, we have expanded our ethics courses and teach ethics across the curriculum." She believes that this is largely in response to industry demands. "More and more we are hearing from the industry that they want to employ people who have an understanding of ethics and are committed to doing business in accordance with ethical principles."



A CASE STUDY: MAGIC OR MISCHIEF IN THE MIDDLE MARKET?

"So what did you think about this morning's session?" John asked as they walked out of the large conference room and to the tables of refreshments. He and his fellow Agency Managers for Superior Life Insurance Company were attending their annual business meeting. "They had some pretty distinguished speakers this year. I was impressed with the guy from CNBC. I didn't think I would be, but he knew his stuff."

"It must be the economy," joked Jill, one of John's colleagues. "One benefit is an improvement in the quality of the speakers at these events. It almost makes up for the dismal food and entertainment."

"I can't disagree with you there." John bleakly surveyed the snack table. "But I suppose we're not here to be wined and dined."

"Not anymore!" Jill laughed. "But honestly, John, if I have to sit through another presentation on the 'Magic of the Middle Market'. . . well, I think I'd rather another night of Mervin the Magician. It's always the same thing. The problem is really simple: too many middle-income families don't have any insurance at all and, of those that do, the vast majority doesn't have enough. The speakers just find ways to restate the problem to make it sound like an opportunity, but without offering any real solutions."

"You don't have to tell anyone in this room what a tough sell life insurance is to the middle market, especially in this economic climate." John pointed to an empty café table and they both walked over. "I think that our company has really tried to reach out to this group. But you know what I hear from my agents? Consumers understand that they need life insurance. With a lot of people, it's not about convincing them it is important. They get it. . ."

"But," Jill interrupted. "They also need to pay for their kids' college degrees, they need to save for retirement, and they need to take care of their ailing parents. I hear the same things, too."

"And maybe they would like to use whatever small amount of money they have left to take their family on a vacation," John concluded. "I understand where they are coming from. I really do. And then you add on the fact that most people have a group life insurance policy at their job. It's like 'Okay, I've checked that box off'."

"Then you have to explain that most of those group policies only replace a year or two worth of lost income," Jill noted. "And that isn't nearly enough, for example, to pay off debt, arrange for child care or fund a college education. When you explain all of that, there's just this silence. It's like people tell themselves, 'well, at least I've got something' and that's the end of that."

"But they don't have nearly enough to maintain their family's financial independence. Can you imagine the strain this is going to put on the social safety net? I don't think that I am being alarmist in saying that this could really be a crisis for our country."

"You don't need to convince me, John. It's a frightening prospect, especially since social support services at the every level of government are being cut. But," she continued, "How do you convince consumers? It seems like all of these speakers are short on solutions and long on statistics. You can't force people to buy life insurance."

"There's another problem, too." John noted. "The government is looking for money wherever they can find it these days. There is certainly a story some

Linda Treviño listens to Kirsten Martin politician could tell about the tax benefits of life insurance just benefiting the rich. Unless our industry does a better job of serving the middle market, we may not have a very strong argument to maintain the tax advantages of our product."

"That would be a terrible thing for this industry and for society in general." Jill responded. "Everyone with insurance benefits from these tax benefits. It is one of the most powerful selling points our agents have in the marketplace. If you take that away from us, I'm not sure what we have left."

"I don't know. I am not sure how you convince your agents to even try to serve the middle market, given the time that goes into making these sales. And I am not even talking about the underwriting and approval process." John stopped and shook his head. "Anyhow, the agent not only needs to sell them on the importance of life insurance, but also sell them on the fact that they can afford it."

"I don't know what the solution is," Jill mused. "Are we talking about some sort of government mandate to buy life insurance? That can't be the answer."

"No, I agree with you there." John replied. "What the government can do is not make it harder to sell insurance by taking away the tax benefit. But other than that, I really think it is up to the industry. This is what it means to be a profession. I really believe that. We have to find a way to educate

Tom Donaldson listens to the discussion

the middle market, and we need to find a way to motivate our agents to sell to this market. Somehow we have to make life insurance a valuable proposition for everyone."

SOME THOUGHTS ON 2012 CASE

A question to get clear on at the beginning is "who benefits from the tax benefits associated with life insurance products?"

Society—does not have to expend resources to take care of financially dependent family members after the death of the breadwinner

Beneficiaries—material needs are met after the death of the insured

Insured—discharges moral obligation to promote the well-being of loved ones

Insurance Agent—benefits materially from the sale of life insurance products

Insurance Company—benefits materially from the sale of life insurance products

Shareholders—benefit materially from the sale of life insurance products of a publically traded company

Other Policyholders—benefit materially from the sale of life insurance products of a mutual company

Ethical issues concerning the difficulty of selling life insurance to the middle-market consumer:

1. Concern that in a time of a decreasing government safety net, as well as diminishing corporate benefit packages, many American families are not prepared for the financial consequences of the death of a breadwinner. This issue falls under the general topic of "preventing harm".

2. Concern that failure to serve the needs of the middle-market consumer will jeopardize the tax advantages of insurance products for all consumers. Some fear that Congress, especially in the current revenue-seeking environment, will begin to view life insurance products as investments not deserving of the

tax benefits they enjoy. This view may be buttressed by the supporters of other financial products whose products (often used for the same purposes) do not enjoy similar tax benefits. This is a practical issue for the sustainability of the insurance industry. It is an ethical issue insofar as removal of the tax benefits makes life insurance even less attractive to middle-market consumers leading to the harm described in #1.

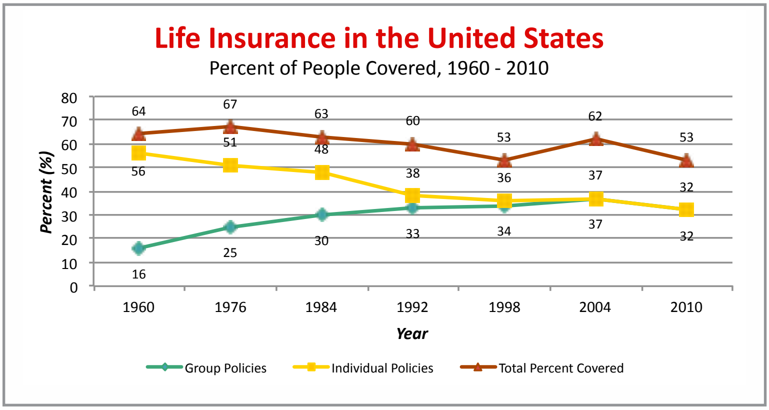
3. Concern that failure to meet the needs of the middle-market consumer will undermine the social mission of the insurance industry, a mission that justifies its status as a profession. This issue falls under the general topic of "professional service" to society and may be equivalent to the imperative of physicians and attorneys to accept some portion of their work at below-market compensation to promote the common good. (The assumption, certainly not definitively established, being that it is difficult to make money by selling to the middle-market consumer.)

4. Evidence suggests that middle-market consumers choose not to purchase a sufficient amount of life insurance, even though they understand the importance of life insurance to promote the financial security of their loved ones. How should the life insurance industry respond to this reluctance? Is there a role for government here? This raises the classic conflict between autonomy and paternalism.

NOTES AND QUESTIONS ACCOMPANYING 2012 FORUM ON ETHICAL LEADERSHIP CASE

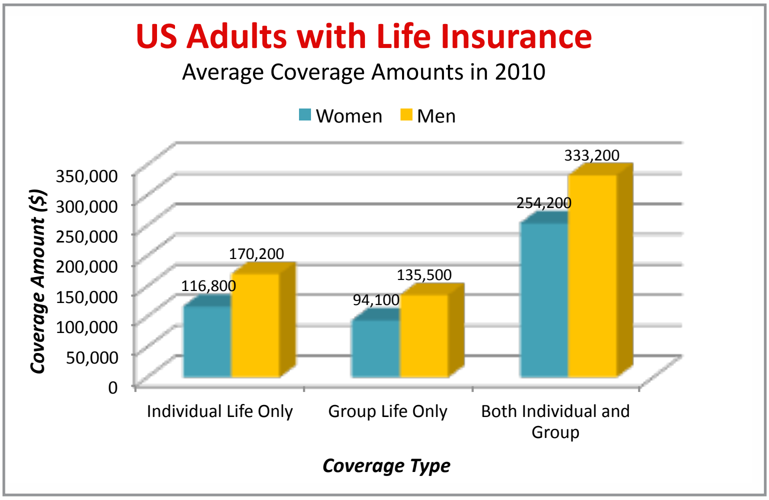
A GENERAL CRISIS IN LIFE INSURANCE?

Fifty-three percent of people living in the United States are covered by some type of life insurance. This represents a decline in both individual life and group life policies since 2004.[1]



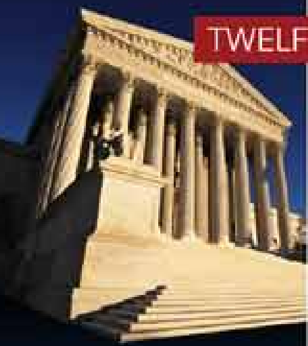
AVERAGE COVERAGE FOR ADULTS IN 2010[2]

Men and women with only individual life insurance carry larger amounts of coverage than those with only group life insurance obtained through their employer.



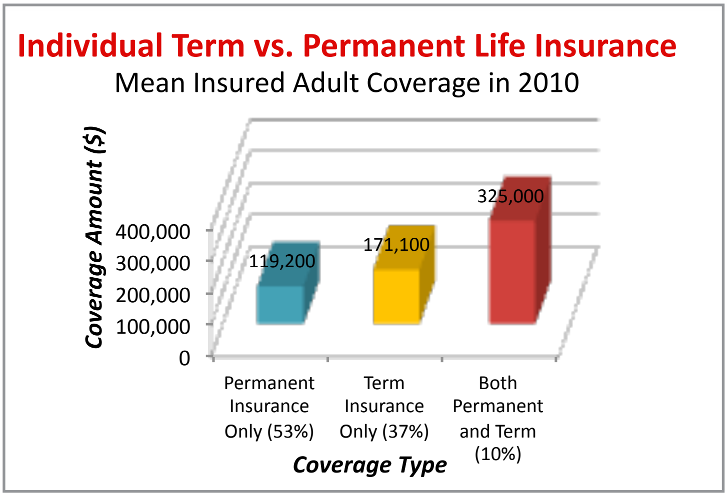
1. Person-Level Trends in U.S. Life Insurance Ownership. LIMRA Report 2011: 10

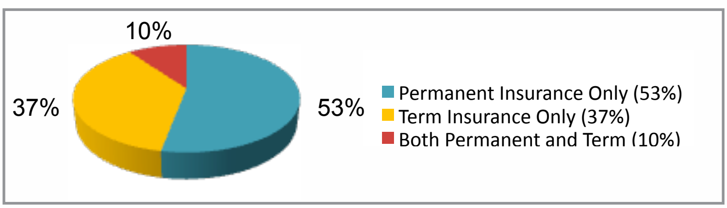
2. Person-Level Trends in U.S. Life Insurance Ownership. LIMRA Report 2011: 10



INDIVIDUAL TERM INSURANCE V. INDIVIDUAL PERMANENT INSURANCE IN 2010[3]

More individuals (53 percent) rely on permanent insurance alone than rely on term insurance (37 percent) to meet their coverage needs. However, the mean coverage amount for those individuals with only permanent insurance was significantly less than those who only had term insurance. The most coverage was obtained by those who held both permanent and term insurance, but this group only represents 10 percent of the population.





MEAN COVERAGE BY THE AGE OF INSURED IN 2010[4]

It is difficult to establish an exact formula to determine how much life insurance is required. The first step is to identify and value the individual's assets and liabilities and to establish the family's objectives. A commonly stated objective is to allow the family to maintain its current living standard. Other objectives may include:[5]

3. Person-Level Trends in U.S. Life Insurance Ownership LIMRA Report 2011: 16 -17
4. Person-Level Trends in U.S. Life Insurance Ownership LIMRA Report 2011: 19
5. Skipper, Harold D. and Wayne Tonning (2011) The Advisor's Guide to Life Insurance, American Bar Association, Section of Real Property, Trusts and Estate Law: 12-13

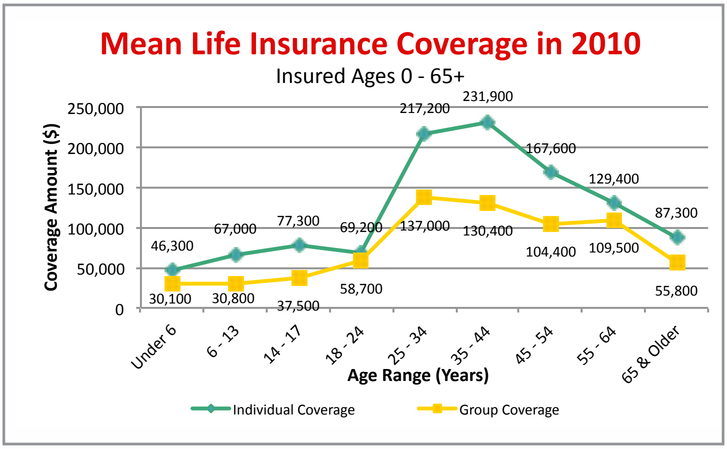
• Pay off liabilities

• Cover funeral and other final expenses

• Establish a family emergency fund

• Establish a fund to finance children's education

• Give to charities or other organizations



TAX ADVANTAGES OF LIFE INSURANCE

In 1913, Congress devised an income tax structure that encouraged individuals to transfer financial risks to life insurance and annuities. The National Association of Insurance and Financial Advisors has argued that the deferral of tax liability of accumulating "inside buildup" life insurance policy values is appropriate under the income tax rule of constructive receipt.[6] Income is not considered to be "constructively received" if the taxpayer's control of the receipt is subject to substantial limitations or restrictions.[7]

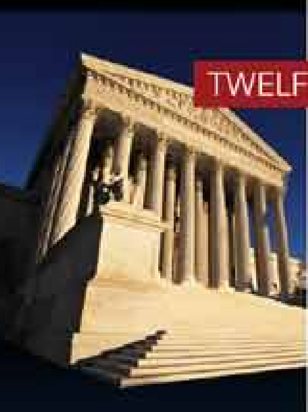
Life insurance policies provide two tax advantages. The first is that most death benefits are income tax free.[8] The second is that income tax otherwise due on interest credited to the policy cash values is deferred either until the policy is surrendered or matures. It is excused altogether if the insured dies.[9]

6. http://www.naifa.org/advocacy/taxissues/

7. Friedman, Steven and Samuel H. Hoppe (1999) "Constructive Receipt: Timing is Everything" Commercial Investment Real Estate. (Mar/Apr). http://www.ccim.com/cire-magazine/articles/constructive-receipt-timing-everything. Accessed on 11/22/11

8. This is the case unless the policy is payable to an employer or policy ownership has been transferred for a valuation consideration. However, exceptions exist to these two exceptions. (Skipper and Tonning, 140)

9. Skipper and Tonning, 140



Some argue that middle-class families receive a smaller portion of the overall tax benefits since most hold term insurance rather than permanent insurance. This is the case for two reasons: (1) only term insurance does not involve a tax-advantaged investment account, and (2) the advantages of the tax-free death benefit come into play less frequently since many purchasers of term insurance remain alive at the end of the term.[10]

If the "inside buildup" in life insurance were taxed currently, it would have raised an additional $22.6 billion of federal revenue in fiscal year 2012. Between 2012 and 2016, that amount is estimated at $129 billion.[11]

According to Federal Reserve data, 22 percent of assets accumulated in tax-free whole-life and universal-life policies were held by the wealthiest 1 percent of families in 2007. In total, 55 percent of assets in such policies were held by the wealthiest 10 percent of families. The bottom half by net worth held only 6.5 percent of these assets.[12]

DIFFERENT TAX TREATMENTS OF INVESTMENTS UNDER CURRENT LAW [13]

Investment Type	Tax Rate	When Taxes Are Due
Bonds • Municipal • Federal • Federal Savings Bonds (not for education) • Corporate Bonds	 • Tax-Free • Regular Rates • Regular Rates • Regular Rates	 • Never • Yearly • Time of Sale • Yearly
Savings Account or Certificates of Deposit	Regular Rates	Yearly
Corporate Stock • Capital Gains • Dividends	• Capital Gains Rate • Dividend Rate	• Time of Sale • Year Received
Small Business	Regular Rates	Yearly
Housing	Tax-Free up to $500,000	Time of Sale
Annuities and Whole Life Insurance	Regular Rates	Year Received

10. Maremont, Mark and Leslie Scism "Shift to Wealthier Clients Puts Life Insurers in a Bind" Wall Street Journal (Online) New York, NY. 10/3/10

11. Sean Hanlon and Jordan Eizenga. "Tax Expenditure of the Week: Tax-Free 'Inside Buildup' of Life Insurance." 3/30/11. Accessed on 11/22/11 at http://www.americanprogress.org/issues/2011/03/te_033011.html.

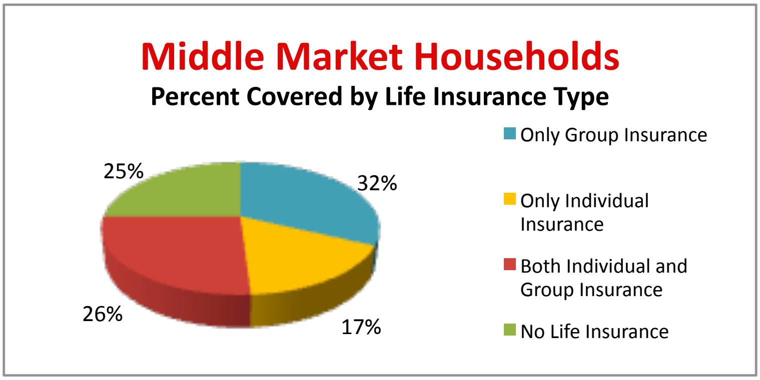
12. Maremont, Mark and Leslie Scism "Shift to Wealthier Clients Puts Life Insurers in a Bind" Wall Street Journal (Online) New York, NY. 10/3/10

13. Mack, Connie et al. The President's Advisory Panel on Federal Tax Reform (November 2005) Accessed on 12/5/11 at http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_1_11-1.pdf

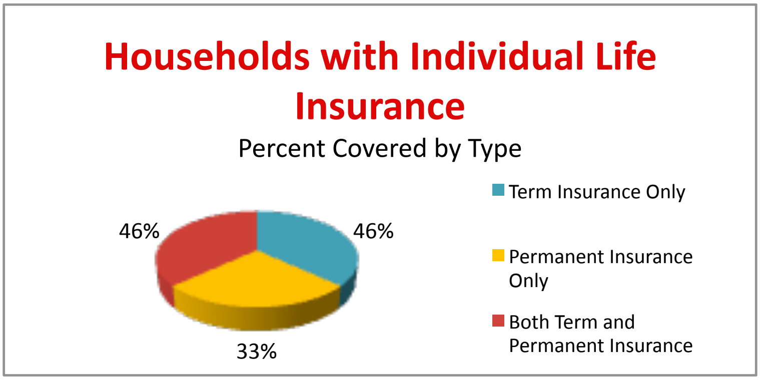
THE STATE OF THE MIDDLE MARKET

The Life Insurance Marketing and Research Association (LIMRA), in a 2008 study of financial goals and well-being, defined the "middle market" as age 25 to 64, with household incomes of between $35,000 and $125,000, with someone in the household employed. Their findings included:

All Middle Market Households[14]

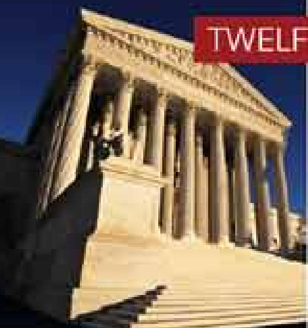


Households with Individual Insurance[15]



Middle-market families do believe in the importance of life insurance. Seventy-three percent of middle-market consumers and 83 percent of middle-market families believe that life insurance is a necessity. But 31 percent of all middle-market households and 37 percent of middle-market households with dependent children admit that they do not currently have enough life insurance.[16]

14. Retzloff, Cheryl D. "Is There Magic in the Middle Market" LIMRA's MarketFacts Quarterly. Summer 2009: 35
15. Retzloff, 35
16. Retzloff, 34



Middle-market households don't spend a lot of their budget on life insurance, averaging only $766 and a median of $500 annually for all individual policies and any group life insurance where they pay all or some of the premium. This equals only 1 percent of the household income.[17]

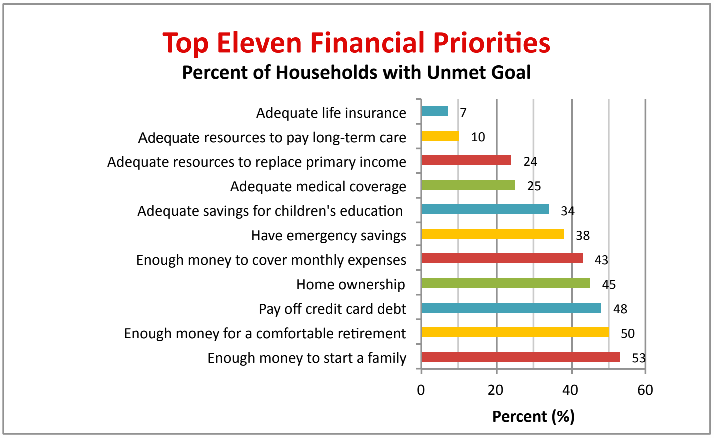
WHY THE LACK OF LIFE INSURANCE AMONG MIDDLE-MARKET CONSUMERS?

(1) Life insurance has not been viewed as a priority in our "culture of consumption". Americans tend to focus on living in the moment rather than preparing for the future.[18]

(2) Financial security goals have a lower priority relative to other goals.

Top Financial Priorities[19]

Respondents chose their top three financial priorities from the goals they had not yet achieved from a list of 20 possible goals.



(3) Many middle-market consumers are burdened by debt. Half of middle-market households say that their debt payments limit their ability to fund financial goals.[20]

(4) Not only has there been a decline in number of life insurance agents, those remaining agents may be less interested in selling to the middle-market consumer on account of the time required and lower commissions (since middle-market consumers purchase smaller policies).

17. Retzloff, 35

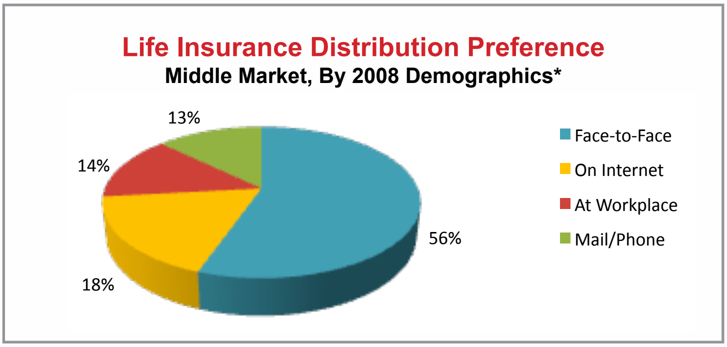
18. Katcher, Anne M. "How to Reach and Teach the Middle Market" Life Insurance Selling 86(4). April 2011: 44

19. Katcher, 44

20. Retzloff, 38

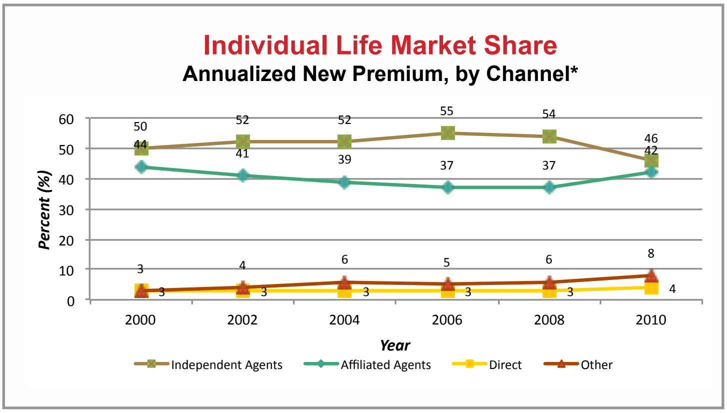
LIFE INSURANCE DISTRIBUTION PREFERENCES

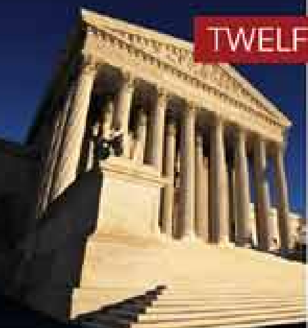
A recent LIMRA report shows that 31 percent of consumers would prefer to purchase life insurance through non-direct methods (internet and/or by mail or over the phone). This may challenge traditional assumptions regarding the sale of life insurance, particularly the assumption that life insurance is 'sold' and not 'bought'. These changes in distribution models could impact the relationship between financial services professionals and their clients.

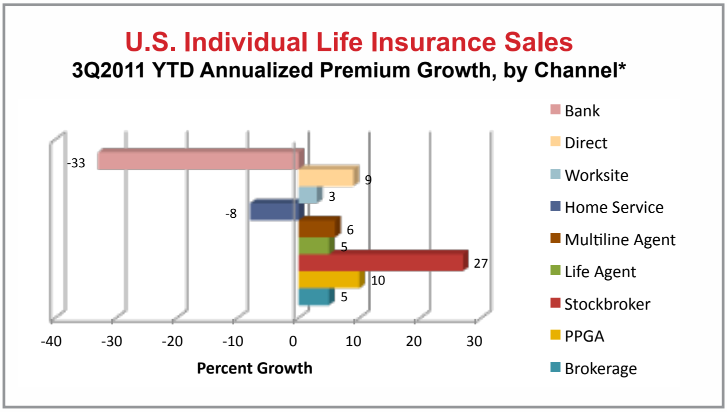


WHO IS SELLING LIFE INSURANCE?

The data indicates that there has been a decline in percentage of independent agents selling life insurance, which has been accompanied by a slight increase in the number of affiliated agents selling life insurance. Together, independent and affiliated agents sell 88 percent of all life insurance. The second table shows relative levels of growth of annualized new premiums by distribution channel for 3Q 2011.







TOWARDS A SOLUTION? REACHING OUT TO EMPLOYERS

According to the LIMRA report, two in ten households say that they prefer to buy life insurance through the workplace in the future. Of this 20 percent, people prefer to purchase insurance in the workplace because it is:

- Easy and convenient (33 percent)
- Believe it will cost less or be a better value (26 percent)
- Trust their employers (20 percent)
- Like being able to have the premiums deducted from their paychecks (13 percent)

Questions

(1) Frank Keating, the former Governor of Oklahoma and previous President of the American Council of Life Insurers, argues that the tax benefits of life insurance represent sound social policy. This is because these benefits encourage a wealth accumulation that helps feed capital formation and job creation. "Declaring war on people who are savers and investors is not a positive agenda." Do you agree or disagree with Governor Keating's suggestion that the tax benefits on life insurance represent good social policy?

(2) Mark Hug, an executive at Prudential Life Insurance, is quoted in *The Wall Street Journal* as saying, "If all we do as an insurance industry is focus on the affluent, then I think we can lose sight of the original tenets of life

insurance." Do you agree or disagree? How important does the social mission of the life insurance industry remain to its practitioners?

(3) A potential obstacle to selling life insurance to middle-market consumers could be the reluctance on the part of agents to sell life insurance to this demographic. This could be occasioned by the perceived lack of compensation or on account of the 'hassle factor' commonly associated with selling life insurance (i.e. difficulties in underwriting and in 'selling' the client on the need for the product). Do you think that agent reluctance is an obstacle? If so, how can it be overcome?

(4) According to Anne Katcher, "A carrier's culture is able to influence whether financial professionals approach the middle market. Companies that instill the importance of the fundamental purpose of life insurance can motivate financial professionals with a sense of duty, even a passion, to ensure the people they interact with everyday are adequately insured."[21] Do you believe that this is true? Why or why not?

(5) Cheryl Retzloff points out that many middle-market consumers are not great savers. "26 percent do not save at all, 32 percent save only whatever is left after paying bills and buying items that they want, and only 42 percent set aside specific amounts to save for specific financial goals such as retirement, education, vacations or major purchases."[22] How does this lack of propensity to save act as an obstacle to the decision to purchase life insurance? How can the industry overcome this obstacle?

(6) The data indicates that 31 percent of middle-market consumers would prefer to purchase life insurance through non face-to-face interactions (i.e. through the internet or by mail/phone). Is a lack of availability of these channels part of an explanation for the failure of some consumers to purchase life insurance? Would we see a greater percentage of middle-market consumers own life insurance if these channels were expanded or improved?

(7) A suggestion has been made to limit the percentage of income earned on the investment component of permanent life insurance which is subject to the current tax benefits. In other words, above a certain amount, accumulated income would be subject to tax by the federal government. Is this a plausible solution to the objection that life insurance is given an unfair advantage relative to other financial products? Why or why not?

21. Katcher, 46
22. Retzloff, 37

(8) One of the recommendations of the 2011 LIMRA report to increase the purchase of life insurance products among middle-market consumers was to reach out to employers to offer insurance as an employee benefit. Do you think that this is a sound strategy? What would be some obstacles to its implementation?

(9) One theory is that consumers are interested in purchasing life insurance through institutions with which they already do business, such as banks or credit unions. However, the data seems to indicate that these distribution channels are small and growing slowly. What does this say about the interest level of consumers in getting their insurance needs met through other financial institutions? What do you see as the prospects for growth for these alternative distribution channels? How would this impact the percentage of middle-market consumers who purchase life insurance?

Terri Kallsen contributes to the conversation

DISCUSSION OF THE CASE

THE PROBLEM OF THE MIDDLE MARKET

Julie Ragatz began by describing what motivated her and Jim Mitchell to choose the case of the underserved middle market as the case for this year's discussion. "It raises the question of the responsibilities of a profession to a middle market of consumers that lacks adequate risk protection at a time in which the social service network is shrinking. This is not only a business issue, in terms of fending off government regulation, but an ethical issue as well."

Linda Need was not convinced that this was an explicitly ethical issue. "The industry has an obligation to make solutions available to people, but you can't force someone to buy life insurance."

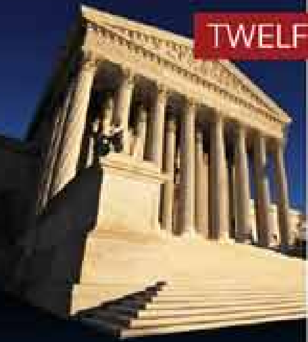
Katherina Glac observed the importance of framing. "I have noticed that in other areas of our economy, such as health care, we often talk about consumers rather than patients. There is a tension here between saying that as professionals we owe something more, but at the same time talking about selling a product to consumers." For Glac, this was where the ethical problem emerged. "Can we expect salespeople to sacrifice themselves for the greater good?"

Jim Mitchell noted that The American College was founded with the objective of making life insurance selling a profession. "And part of how The College does this is to try to create a common body of knowledge, to encourage continuing education for financial services providers and to try and ensure that the knowledge they have is applied ethically. We're quite clear about those goals."

Glac agreed, "A profession is based on the understanding that your purpose is to serve the common good and that you have a very special relationship with the people you are interacting with. They entrust themselves to you, and I think that's where you could draw the line between those who are professionals and those who are not."

A QUESTION OF FAIRNESS?

Tom Donaldson believed that the issue is a question of fairness. "You have a middle market who need this protection, and they're not getting it." But while this would not be an issue for other industries, "You have created, I think rightly, an identity as a profession that has to do with serving people beyond yourself; does this generate additional responsibilities? That's what makes this case interesting for me."



Brad Hewitt agreed with Donaldson and drew an analogy with health care. "If someone shows up in the Emergency Room and needs treatment, we don't say 'you didn't buy enough health insurance, so we can't cover you.' In the financial services industry, do we say 'you didn't plan, you didn't do the right things and now you're economically devastated, we can't help you?'"

Kirsten Martin was interested in why middle-market consumers did not purchase sufficient life insurance. "There is a way to frame this where it is not obviously an ethical issue; they're choosing not to buy it. But there may be another story to tell here." She believed that the industry had an obligation to figure out why the middle market did not purchase sufficient insurance. "It might be that the distribution system isn't right, or the products aren't right for this market, or the incentive system makes it really unattractive for agents to sell it."

"A profession is based on the understanding that your purpose is to serve the common good and that you have a very special relationship with the people you are interacting with. They entrust themselves to you, and I think that's where you could draw the line between those who are professionals and those who are not."

Katherina Glac

Need didn't think that these factors explained the failure of this market to buy sufficient insurance. "We have found less expensive ways to sell insurance and the product itself has gotten less expensive over the years. The issue is not how do you sell it to someone who knows that they need it, wants it and comes in and asks for it. The issue is how do you motivate someone who doesn't really understand it or who doesn't fundamentally believe that protection is a priority?"

Mitchell suggested that part of the problem is that life insurance is a product that has always been sold rather than bought. "Most people don't wake up

Rob Phillips listens to Kirsten Martin in the morning and say, 'Gee, I think I need more life insurance today.'" Because of this, the process of selling life insurance is both time and labor intensive. "If you look at the case and think, 'we're really not serving the middle market as we should,' part of why that is true is because the normal process is expensive and it doesn't necessarily pay off well in this middle market."

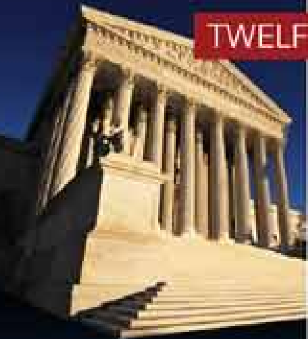
Jim Meehan agreed with Mitchell. "In my experience everybody wants life insurance, but nobody wants to pay for it. The dilemma is that advisors have to invest time explaining and persuading people about the need for life insurance. Are they going to spend their time with a group of people who do not have the financial wherewithal to buy the product or are they going to spend their time in the affluent marketplace? As someone who built a firm, I specialized in the affluent marketplace because it was more beneficial for us and for the clients we were serving. However, ethically, was that the right thing to do?"

Linda Treviño wondered whether the problem of serving the middle market had been exacerbated by the current economic environment. " Have you always faced the same problems or is it worse because of the squeezing of the middle class that we're hearing about?"

Need believed that the changes had come not from the economics but from the way people perceived life insurance. "Fifty years ago when you had your first child, buying life insurance was a moral obligation, and you sacrificed things to make that happen. Life insurance used to be a priority, now it is a discretionary item for most families."

Julie Ragatz and Mike Norton arrive at the closing dinner

Rob Phillips wondered if life insurance was the only way to meet people's protection needs. "Nobody actually needs insurance. What you need is some level of financial security given the vagaries of life over some time horizon. Perhaps the reason people are not buying life insurance is because they have other investments that they think will take care of their families over time."



Meehan believed that the cornerstone of any financial plan had to be life insurance. "The problem is that you don't know when you're going to need the money. If I knew that I needed it 47 years from now, I have a lot of different options. I could invest differently or put my money into real estate. But since we cannot know when our time is up, life insurance is the only thing that works."

Hewitt wondered if the increasing professionalization of the insurance industry had made the life insurance product more complicated than it needed to be. "It does not need to be a complicated product. The body of knowledge is pretty clear. You will die and you don't know when and if you have anybody depending on you, bad things will happen. And it literally is that simple. The products become more complicated since we are serving a more affluent clientele that may have more sophisticated estate planning needs. So we create more complicated products that we sell to people who have the income to afford it. Have we created products that ensure that we aren't going to serve the middle market?"

POSSIBLE SOLUTIONS

Donaldson believed that the industry needed to work together to come up with a solution. "I study pelicans on the side, and it turns out that male pelicans are extremely competitive, individualistic creatures. They're very good individual hunters, but there are key moments in the life of pelicans when males actually cooperate and help each other. And my sense is that the financial services industry should think in terms of pelicans' gambits from time to time. There may be situations in which companies actually cooperate in order to remove some of these competitive disadvantages that threaten the industry as a whole or don't provide an opportunity that the industry might have otherwise."

Larry Barton argued that we needed to think creatively about solutions. "Almost every worker pays into Social Security. Why couldn't we have five percent of your Social Security contribution matched by your employer to go to a term life product? If you start early enough you're probably going to have a moderately good base there to protect that family at a decent amount of annual income."

Need agreed with Barton about the importance of thinking creatively. "I really like where you're going. As an industry, perhaps we should be arguing for a small tax deduction on premiums up front."

Terri Kallsen wondered why there was no life insurance mandate. "We're required to have insurance for our car, and we're required to have home owners insurance. We're required to have lots of insurance by the government, but for some reason if we die, we are all on our own. And I have never really understood that."

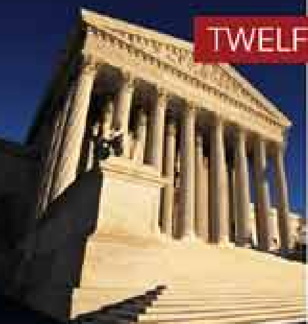
Hewitt thought it was important to consider the potential contribution of fraternals and mutual companies. "The assumption is that all organizations are either charities, who serve the social safety net, or stock companies, who are primarily interested in the bottom line. But perhaps there is a unique role for fraternals and mutuals to serve the middle market."

Martin wondered whether it was possible to make money by serving the middle market. "I had made the assumption that going after the middle market, while not perhaps profitable for the individual agent, was an attractive market for the organization. I did not assume that going after the middle market was some sort of a charity. I thought that as a whole, if you do it well, you could make money from that."


Terri Kallsen listens as Jim Meehan shares his thoughts

Kallsen noted that for a company to make money selling insurance, "it's all about persistency. Many of these products are loss leaders up until about seven years. And the more that the interaction with the advisor is transactional rather than relationship oriented, the greater the chance of the policy lapsing when times get tough. It's the persistency of the product that creates both the right thing for the client and the right thing for the company from an economic perspective."

Treviño thought that perhaps a solution involved employers. "There is a whole body of research that proves that people usually do not choose to 'opt-out' if that is the way the option is set up. If employers would structure their benefits such that you would have to 'opt-out', most people wouldn't. Under those circumstances, the psychology is that 'I'll just keep it'. Inertia can be a powerful force psychologically."



THE PRACTITIONERS' ETHICAL DILEMMAS

EXECUTIVE DILEMMA #1

One question that a CEO at a mutual organization faces is to how to allocate resources between current and future policyowners. One of the ways that the tension between these groups manifests itself is with regard to the question of reserves. Conventional wisdom argues that you should just keep piling up reserves because it gives you a competitive advantage. Reserves are analogous to a university's endowment. I don't know of a single university president who does not think that their endowment needs to be bigger. It's not factually true, but they all think it's true. I do not know of a single insurance executive who wouldn't like to have more reserves.

Another possibility is to take the surplus capital and invest in a new solution to sell insurance to the middle market. Should we do this even if it may not have the same return as expanding our reach into the upper market? This is a high-level question, but it impacts every policy owner in terms of their premium payments, and it impacts the organization in terms of growth and reinvestment. What makes our organization unique is that it was founded by a group of people who weren't only interested in getting a return on their capital investment or making sure that people could get inexpensive insurance. They wanted to pass on their values to their kids and grandkids.

Kirsten Martin believed that this dilemma was not unique to the financial services industry. "In general, whenever you have excess capital, there's always a question of managerial discretion. The question is how to balance my obligations to the people with whom I currently have a relationship and to future generations with whom I have no current engagement."

Tom Donaldson believed that it is a fascinating moral issue to try to figure out this balance. "It doesn't make sense to argue that everyone should count equally. I don't think that there's any question that you have to take into account the interest of future generations, but also that their interests may be discounted to a certain degree relative to the interests of the current generation."

Linda Treviño suggested that it was important to frame the issue in terms of organizational integrity. "It seems your organization has a certain ethical vision and identity, that I assume most of your policyholders share. The more you can explain your allocation in terms of this shared vision the better, since you are able to get feedback from them about what they think."

Linda Need agreed that it was important to secure buy-in from policyholders. "I think it would be really interesting to see how many of your members truly understand the social mission of your organization. And if they are willing to pay more to own a policy with an organization that is going to make allocation decisions to advance a social agenda or protect future generations."

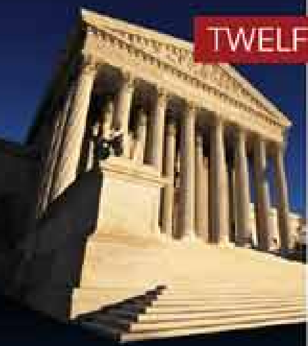
EXECUTIVE DILEMMA #2

My organization functions as a distributor of life insurance rather than a manufacturer. In our industry, the distribution models are shifting away from one in which an organization partnered up with one insurance company and only offered their product. This was a successful model, since clients got the products they needed at a reasonable cost. But it suffered from a perception problem, since some people believed that organizations were only offering one product because they could generate the most money from offering that option.

It was this perception that drove the industry to move to an open architecture model. The expectation is that, as a distributor, we are expected to offer the products of every company that is willing to be sold through our platform. But there are a couple of problems with this approach and one of them is that it is very expensive to adopt an open architecture.

We are starting to look at how to keep an open architecture that provides clients with choice, and makes sure that the clients get a fair price and get the best

Linda Need, Katherina Glac, Linda Treviño and Kirsten Martin participate in the conversation



product they can given their risk situation, while also reducing the number of products on our platform. One of the things that complicates this issue is that companies pay us a fee to place their products on our platform. The fee is supposed to mitigate the costs incurred by putting the product on the platform.

Another problem with the current approach is that it can make it difficult for the advisor to sell the products well. They cannot possibly know the details and differences of 100 products. A complicating factor is the fiduciary debate. Does whittling down our product set to five companies make us, as a corporation, a fiduciary? And if so, what are the implications? Most of the proposals around fiduciary require that, as a fiduciary, you find the best product for the consumer. This opens another set of problems: how do we define what is "best"?

"There has been a trend of giving people more and more information as some sort of panacea for every difficulty. But if you give consumers too much information or too many choices, you run the risk of paralyzing them instead of helping them."

Kirsten Martin

Rob Phillips wondered whether paying for placement privileges is an ethical issue. "This sounds a lot like slotting fees at grocery stores. We don't think the less of grocery stores because food companies pay for privileged access in grocery stores." But the organization needs to ensure that the products were good for the consumer. "It needs to be a good product. They bought it from you and it does not matter to them who actually manufactured the product. They are going to blame you if something goes wrong. "

Kirsten Martin thought that the decision to reduce the number of options was good for both the organization and the consumer. "There has been a trend of giving people more and more information as some sort of panacea for every difficulty. But if you give consumers too much information or too many choices, you run the risk of paralyzing them instead of helping them."

Terri Kallsen wondered if the selection of products on the platform was really that important. "Products are sold through relationships. There are still captive agents and they play a very important role in our industry. But the majority of producers are becoming Registered Investment Advisors and selling nonproprietary products. They're all selling the same things ultimately, and it comes down to the knowledge and care of the advisor. It is very rarely the platform or the product that matters."

Larry Barton expressed concerned about the push to adopt a fiduciary standard. "If you're selling a financial product and if you're actually the person who did the analysis and recommended the right option, then that is one case. But what about the human resources officer? What happens when you sit with your organization's HR representative and you ask about retirement? Are they giving retirement advice? Do they have a fiduciary obligation? There are a lot of questions that have not been answered about this fiduciary issue."

EXECUTIVE DILEMMA #3

I'm a big believer in mentorship teams and team-based selling, and this is a situation that I dealt with several years ago. The number one producer in my company and his protégé at that time had worked on a case together. The protégé then did all of the servicing on this client for the next six or seven years. Literally, the protégé had been doing all of the work and the mentor had not spent one minute on it. The original arrangement in this case is that the mentor would receive 80 percent of the compensation and the protégé would receive 20 percent. The rule was that if they want to change the original arrangement, it needs be to in writing. The protégé now wrote a new piece of business with that client,but only assigned the mentor the 20 percent portion. There was no new arrangement in writing. The mentor obviously objected and technically he is correct, since the agreement had never been formally changed. But is this really the right thing to do?

So now they are in a fight and can't agree on a solution. The mentor and the protégé are the number one and number four producers in my organization,

Linda Need, Katherina Glac, Linda Treviño and Kirsten Martin listen as Rob Phillips shares his question with the group

and I will tell you this: a manager never wins when he or she gets between two producers regarding compensation. One of them is going to be furious with you, and there's a very good probability that you could lose that person.

So I decided to create an ethics committee composed of five of their peers. I asked both of them to write down their version of events for the committee, and I would take out all of the names so they would remain anonymous. They also agreed to

Katherina Glac listens to Linda Need

"It needs to be a good product. They bought it from you and it does not matter to them who actually manufactured the product. They are going to blame you if something goes wrong."

Rob Phillips

sign a one-page document to the effect that the ethics committee's decision was binding and never to be discussed again. The committee debated for about three hours and decided that the protégé should get 60 percent and the mentor should get 40 percent of the commission on that sale. I think it was a pretty good deal since both of them walked away a little unhappy, but neither was so angry that they wanted to leave the organization.

Tom Donaldson speculated on the attitude of the mentor. "I might be thinking through these seven years that I'm prepared to let my protégé handle the case so long as I still receive 80 percent of the commission. I feel justified since I was the one who was the original contact for the client. I think he's still with me. If I had known that you were going to be taking 80 percent of the revenue, I would have gone and seen the client myself."

Kirsten Martin believed that the process was an ethical one. "What is important is that each party was able to have a voice. You don't have to rely on an advocate, you are telling your own story in your own words. It's a type of interactional fairness."

Linda Treviño noted that the outcome was consistent with what researchers know about procedural justice. "If people believe that the process was fair, even though they are not totally happy with the outcome, they're much more likely to accept it than if they did not believe that the process was fair."

THE PHILOSOPHERS' QUESTIONS

ISSUE #1: DONALDSON

I believe that people working in an industry inevitably have better knowledge about the potential problems and risks that their industry faces than government regulators. The problem, and I think this is especially true in financial services, is that there is an incredible reluctance to move out of competition, even on a short-term basis, to address issues that affect the long-term health and security of the entire industry. I believe that there are key moments in which the industry has an opportunity to avoid the kind of catastrophe that eventually results in government intervening and instituting change. What I am interested in hearing from the executives is whether there are the practices that, if fully known by the customer or client, would cause significant concern? And if so, what are they? What stuns me in every industry I've looked at is that about 70 percent of people answering that question, say yes.

Jim Mitchell and Julie Ragatz enjoy the conversation

Jim Meehan suggested that one potential problem for the insurance industry is compensation for replacement policies. "Replacements are a really tricky thing. Let's say that a client had one policy and for whatever reason, it no longer suits his needs. How do we compensate the agent who sells them a new policy?" He added that companies are really trying to grapple with this problem. "It doesn't seem fair not to pay the advisor if he did the work and is servicing the client. On the other hand, if you compensate agents for selling replacement policies, you run the risk of creating 'replacement specialists', agents who replace products to get a commission even if it is not in the best interest of the client. It could be a problem if a story like that hit the newspapers."

Jim Mitchell believed that, for the most part, senior executives in the industry balance long- and short-term considerations of the business very well. "But," he added, "this is a very long-term business, and it requires us to make assumptions, for example, about things like longevity. There is a tendency when making assumptions for people to be over-optimistic about these assumptions, especially if it helps them to be more successful. People may think that these chickens won't come home to roost on my watch, so I might as well be optimistic in my assumptions."

"I think it's a wonderful thing when people decide to raise their hands and say the words, but those are just words. It's the actions that matter."

Linda Need

Linda Need believed that compensation disclosure could create some concerns in the mind of the public. "If we tell our clients that for every hundred dollars of premium they pay in the first year, we are paying an agent $110, that will be a hard sell. There's no way you can explain that to a consumer in a way that's going to make sense to them." This compensation model works in an industry in which these first-year commission payments support young agents who may only make a handful of sales in their early years. "You're financing that very expensive training system. I don't think it's sustainable."

Larry Barton raised the issue of whether the industry has sufficient reserves. "Some companies knowingly sold products with 6, 7 and 8 percent guarantees on fixed annuities, and they know that it is going to be a problem to pay for it." When he asked executives how they will afford these obligations,

Jim Meehan, Julie Ragatz and Jim Mitchell listen to Rob Phillips

Julie Ragatz makes a point to the group

the answer was long-term investments. "But if you look at these investments, they are mostly in commercial real estate and this could be a problem."

Terri Kallsen agreed with Mitchell and suggested that the difficulties in calculating longevity may be a problem for the industry. "The problem is that longevity is such an unknown. That's a pretty big risk for many insurance companies, and they're not even close to seeing the amounts that they'll have to pay for many of these fixed and variable annuities. We have never had a retirement boom like this before and never with the amount of wealth that this country has accumulated."

ISSUE #2: GLAC

At the University of St. Thomas, we do an exercise in which students work in groups to create an oath for business professionals. We've been doing this for a long time, and in the past few years Harvard and other schools have picked it up and they've created oaths for the MBA students to take upon graduation. When I talk to my students about this, they're always very skeptical and that skepticism comes from a variety of different angles.

Some students object that not all MBAs consider themselves professionals. Others object that since there is no infrastructure to enforce the oath it does not have any significant meaning. Finally, some students wonder what they would do if they found that the oath conflicted with company policy or with a more general obligation to increase shareholder value.

I would really like to hear from business leaders the answers to a two-step question: Would you favor 'oath-takers' when you are hiring or would you view this as *dangerous? What do you think would be some of the infrastructure we could develop around the oath if we wanted to go in that direction?*

Rob Phillips shared that while he was on the fence as to whether oaths were a good idea, he believed that the arguments against a professional oath for managers were ill-informed. "For example, CPAs manage the conflict between their professional oath and the demands of their organizations all of the time." He added that if he were hiring employees, "I would want people who had been trained as professionals. If others did the same, it would take roughly a half a generation before this became like a CPA."

Linda Treviño was not sure you could make analogy between accounting and management. "The reason you can have a certification for CPAs is because there is a codified body of knowledge that applies to every CPA. I can think of lots of business leaders who have a different kind of degree completely or no degree at all and they're actually very good at what they do."

Linda Need was not convinced that taking an oath would change behavior. "I think it's a wonderful thing when people decide to raise their hands and say the words, but those are just words. It's the actions that matter."

Jim Mitchell offered that under certain circumstances an oath, would be an advantage in the hiring process. "If a job applicant came to me having taken an oath, and I had enough of a conversation with him that I could understand that he had actually thought about it and was actually committed to this kind of behavior, that would be a plus for me."

Jim Mitchell contributes to the discussion

"And right now, the way it stands, we're basically saying: 'we're going to give you tools, sharp ones, and you basically can go out and do anything you want with them'. It strikes me that we want to convey that the power that comes with that technical knowledge carries with it some responsibilities."

Tom Donaldson

Tom Donaldson thought that ethics had to go beyond an oath. "One-third of all the students at Wharton go into banking. I hope that when they are working with a client and fulfill the regulated disclosure requirements, but they think more should be said and yet they know at the same time that this could result in a failure of the sale, I would at least like that person to be given pause. And right now, the way it stands, we're basically saying: 'we're going to give you tools, sharp ones, and you basically can go out and do anything you want with them'". He continued, "It strikes me that we want to convey that the power that comes with that technical knowledge carries with it some responsibilities."

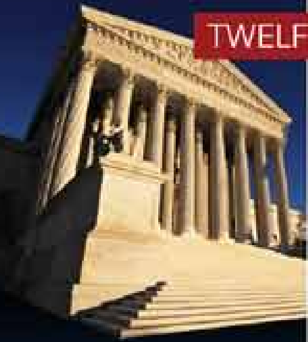
ISSUE #3: TREVIÑO

My question for the executives is the role of restraint in executive leadership and strategy. There were some CEOs during the financial crisis who saw what was happening and said 'we're not going to participate.' But I think it is a challenge to show restraint because there is the sense that everyone is doing it and everybody is making tons of money. How do you explain the decision not to participate in something that looks very lucrative to shareholders? It takes a strong leader with strong values to be able to stick to your convictions when it looks like your decisions are costing shareholders money in the short term. How we can encourage and support these leaders?

Jim Meehan believed that it was important to make the values practical. "At the time of the decision, it's your job and your livelihood and it's too easy to get caught up in it. But if people knew that the consequences would be what we face now as an society, people would have acted differently."

Linda Need believed that the situation was complicated because, in some cases, the decision makers were confident of their good intentions. "Some of the executives at the core of the mortgage crisis believed that they were really doing a service to society by helping more people own their own homes. Now, the way they got more people into home loans, in hindsight, was a disaster. But the disaster was an unintended consequence of good intentions."

Tom and Lauren Donaldson at the closing reception



Terri Kallsen believed that education should focus on developing the critical thinking skills to help people make these sorts of decisions. "People need to be able to ask themselves, 'if I do this, then what are the different scenarios that may play out and what is the right framework to make a decision?'"

ISSUE #4: MARTIN

Before I started my career in academia, I worked in business and I've been at the lower level of the organization. One of the things I struggled with was when I was asked to do something and only later realized the implications of that request. So, for example, someone would come to me and say something along the lines of "I really think our revenue projections are going be a lot better than that, let's look at those numbers in the spreadsheet." So I did it, only later realizing where the numbers were going. Your new financial advisors are young, impressionable, eager to please their bosses and driven to succeed. And they could cause problems for your organization if they sell the wrong thing or make mistakes. How do you actively try to manage them, without being heavy-handed, to make sure that the people on the front lines selling your products are doing right by their clients and your organization?

"People need to be able to ask them-selves, 'if I do this, then what are the different scenarios that may play out and what is the right framework to make a decision?' "

Terri Kallsen

Terri Kallsen believed that it was important to emphasize process. "At our firm, every transaction requires a customer needs analysis. Before we can sell you anything other than the simplest banking products, we have to know who you are, your income history and where it's coming from, your risk tolerance and what do you want to do with this money. Then we match that information up with the product that you are considering to see if it is suitable."

Katherina Glac, Jason Skirry, Jim Mitchell and Linda Treviño at the closing reception

Linda Mitchell, Linda Need, Mike Norton and Jim Meehan enjoy the closing reception

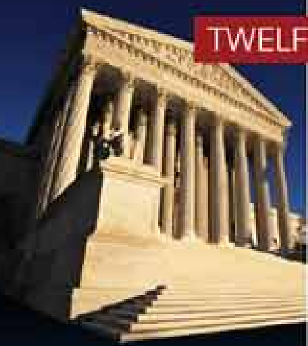
Jim Meehan believed that the solution included team selling and mentorship. "My management team, including myself, are out in the field observing our advisors. In addition to the technical checklist, personal observation is the key to making sure that they are behaving in the right way." He also believed that good communication was essential. "It's when people are acting independently, and you don't know what's going on, that problems surface."

Jim Mitchell added that it was crucial that values and ethics be at the center of the organization. "At American Express, our values were at the center of everything we did. When a decision arose, we had conversations as to whether what actions would be consistent with our values. Would this action represent who we truly are? We were very clear about our values and we used them to help select the employees we wanted."

ISSUE #5: PHILLIPS

I think the biggest single problem of business ethics is the diffusion of responsibility. We all know, more or less, how to act as individuals, but as soon as there is a team, whether of two people or 100,000 people, there's always going to be someone else to blame. Everybody has their theory about the financial crisis. My personal one is the buck never really stopped. And it still hasn't stopped.

I think that part of the explanation for why the insurance industry did not get caught up in the crisis is that they were to a lesser degree, if at all, securitizing their assets. They retained responsibility for those assets. So, I have two questions: The first is whether insurance companies are securitizing their assets in such a way that they no longer have a vested interest in their transactions. More generally, I am interested in whether the executives have any thoughts on how to pinpoint



responsibility and accountability. What can we do in a world where there is literally always someone else to blame?

Jim Meehan believed that lessons could be learned from the military. "There is one captain of a ship and if something goes wrong on that ship, the captain loses his command. Very often they had nothing whatsoever to do with the issue, but everyone knowns when they accept the job that this is part of the deal. When you know that there are consequences and that you're accountable, I think you look at things differently."

Katherina Glac wondered what people meant when they said they were taking full responsibility. "It's like there is this full jug standing in the corner and they're taking it away. But you get the impression that they turn around, put it down and move on to the next job. A job that's maybe even better than the one that they left."

Regarding the question of securitization, Linda Need noted that the insurance industry was conservative. "You're making a 50-year commitment when you sell a life insurance policy. You need to invest in such a way that you can live up to that promise."

Jim Meehan compared the insurance business with other businesses in the financial services industry. "I don't know of any life insurance claim that was denied because a company did not have the money to pay it. Some of the people who had invested money with Lehman Brothers lost everything. In our business, people die and claims get paid. At the end of the day, we have done a good job of managing the promises we make to people."

Jim Mitchell believed it was important to make others in the organization accountable as well. "I think I would agree that the biggest problem in business ethics is the diffusion of responsibility. And as a leader you are ultimately accountable, but you do not want to be the only person in the boat. In order to get results, the leader needs to hold others to account, as well."

"There is one captain of a ship and if something goes wrong on that ship, the captain loses his command.... When you know that there are consequences and that you're accountable, I think you look at things differently."

Jim Meehan

CONCLUDING THOUGHTS

Jim Mitchell asked the group to share their thoughts on two questions: "What did you get out of your participation today?" and "What will you reflect on tomorrow?"

Rob Phillips recognized the value of speaking with senior executives, as opposed to MBA students, about the ethical challenges they face in the workplace. "The more senior positions people hold, the more reflective about ethics they become." This was a lesson he could bring back to his MBA students. "People sometimes say, 'don't dress for the job you have, dress for the job you want' but I think that when it comes to ethics, you could also say, 'don't think for the job you have, think for the job you want.'"

Jim Meehan listens to Terri Kallsen

Kirsten Martin enjoyed seeing examples of academic theory in the executives' comments, "There were times when people would be talking about a phenomena and I would think, 'I know the theory behind that one'. It is helpful to see ideas come to fruition in practice."

Linda Treviño appreciated both the opportunity to learn more about the industry as well as, "the interaction with thoughtful, reflective executives who care enough about ethics to come here and spend the day talking to us." She also

Terri Kallsen, Kirsten Martin and Rob Phillips at the closing reception

> "Every year, I have a chance to see how the theories that academics develop and study apply in practice."
>
> **Julie Ragatz**

believed that the model of the Forum on Ethical Leadership was a good one. "You're getting reflections from each group and also providing a chance for reaction and discussion. I am sure it has evolved over the years, but it is a pretty powerful model."

Katherina Glac shared that she was glad to have been a part of the event. "I think it reenergized me in my role as an educator. There are times when you feel as if you are pouring yourself into your classes and you are not getting anything back from it. But listening to your stories reminded me that if I can provide students with the tools to help them navigate their way through the hard decisions, that is an important contribution."

Linda Need began by sharing that she was grateful for the opportunity to take a day and think about the 'bigger issues' like ethics, and whether it is possible for different organizations in the same industry to find ways to come together and cooperate. She added that she was in the process of building a new organization and was glad for the reminder, "that it's not enough to just be ethical and model that behavior to other people, you actually have to talk about it."

Tom Donaldson noted that he had attended two previous retreats and that, while he always had a very high impression of the industry, he was "blown away by the openness and candor of the participants." He added, "Compared to the banking industry, the insurance business has done quite well. I think that a part of that is that people have been able to recognize what could be done better and what issues may emerge in the long-term."

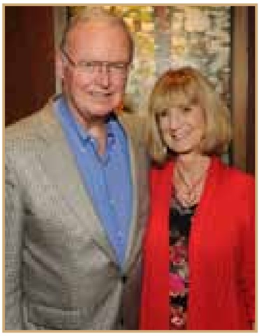
Terri Kallsen shared that one of her daughters has a prism that they like to look at together. "When you look at it with someone else, everyone sees

a different color, depending on the angle you're looking at it from. She's right when she says that she sees blue, but I'm also right when I say 'I see pink'." She drew an analogy with decision making. "At the end of the day, we're all working towards a solution, but we all see things from our own perspective. The prism really demonstrates that we have to work together to see the same things." She was glad to have participated in the day's discussion, "I think that we did a good job of trading places today and seeing things from each other's perspective."

Jim Meehan stated that was he was an eternal optimist. "I feel rejuvenated that my peers in the business are really trying to do the right things and build the right processes and systems." He also was glad to meet academics who were dedicated to talking and thinking about ethical issues. "This country has hit some dark times, but I think that we have good things ahead of us and we all have ownership in that."

Julie Ragatz shared that she was delighted to have participated in another Forum. "Every year, I have the chance to see how the theories that academics develop and study actually apply in practice. It's fulfilling to see how our work is applied in practice, often in ways that we would not have expected." She was also grateful to the executives who attended and the other practitioners who volunteer their time and treasure to support the mission of the Cary M. Maguire Center for Ethics in Financial Services. "It reinforces for me the fact that this business is going in the right direction. It may not move as quickly as we might like, but there are people who are committed to doing it in the right way, and I have the privilege of working with them."

Jim Mitchell agreed with Glac that he walked away from the day's discussions feeling both energized and inspired. "Part of why I get out of bed every day is to try and make a little contribution to increasing the level of ethical behavior in this industry. Everyone here is instrumental in helping that happen, and so I'm grateful to each and every one of you." He added that he wanted to find a way to make the message and the learnings of the Forum available to a broader audience. "We have people in this room who are clearly trying to do it right. At the other end of the spectrum is another group of people who don't understand the meaning of the word 'ethics', and they aren't ever going to be a part of the conversation. But there's a large group of people in the middle: they say they behave ethically and they probably do most of the time, but every once in a while they will cut a corner. That is the market we need to try to reach."



The James A. and Linda R. Mitchell/ The American College Forum on Ethical Leadership in Financial Services

The American College Cary M. Maguire Center for Ethics in Financial Services is the only ethics center focused on the financial services industry. The Center bridges the gap between sound theory and effective practice in a way that most ethics centers do not. Under the leadership of Director Julie Ragatz, the Center's mission is to raise the level of ethical behavior in the financial resources industry. We promote ethical behavior by offering educational programs that go beyond the "rules" of market conduct, help executives and producers be more sensitive to ethical issues, and influence decision making.

The Mitchell Forum is a groundbreaking, one-of-a-kind event that underscores the Center's emphasis on collaboration and conversation among academics and practitioners. Jim Mitchell was recognized in 2008 for his dedication to business ethics and was included in the "100 Most Influential People in Business Ethics" by *Ethisphere*, a global publication dedicated to examining the important correlation between ethics and profit. The list recognizes individuals for their inspiring contributions to business ethics during the past year.

The Forum is the cornerstone of the Center's activities highlighting how to bring industry leaders, accomplished producers, and prominent business ethicists together to reinforce the need to connect values and good business practices.

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