

THE STATE OF THE INDUSTRY: MEETING THE CHALLENGES OF A NEW MILLENNIUM

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ABSTRACT

The new millennium has arrived, bringing with it tougher competitive conditions than most insurance companies would have thought possible a few decades ago. While the state of the industry today is the direct result of the transformation of the overall financial services industry over the past 20 years, its metamorphosis is still in progress. Staggering changes have taken place in the financial services environment during this period. What do these changes mean for insurers, and what will the industry look like 20 years down the road?

A brave new world lies before us—a world dominated by the advent of a more financially astute and demanding customer and the power of the Internet. The retail marketplace is being transformed as providers scramble to meet the needs of sophisticated, technology-smart consumers. To reach these consumers, insurance companies must rethink the way they do business, embracing multiple distribution channels and seeking out bold new alliances. The stakes are higher than ever, and companies that remain mired in the past will not be around for long.

“MODERNIZATION”—A MISNOMER?

It's clear that insurers and other financial services providers must respond more fully to customers' demands for higher-value products and more efficient and convenient service. But despite the hoopla over enactment of the Gramm-Leach-Bliley Act last fall, it's unlikely that such steps will take the form of a flood of bank-insurer mergers.

Through April, the lack of new insurance and banking marketing alliances—especially the dearth of merger-and-acquisition activity—supports our early view that this long-awaited law would not unleash a wave of bank purchases of insurance companies or spur them to take a big position in the industry.

Indeed, financial services reform may have arrived too late to be characterized as “modernization.” Banks already can sell virtually any insurance product, and many have found a way through the regulatory thicket to underwrite selected products. Moreover, as technology reshapes the landscape,

partnerships with portals like AOL, Yahoo! and Excite seem to make more sense for both insurers and banks than mergers with each other.

To many it seems that the appeal of one-stop shopping has been exaggerated. One hears little from consumers about the advantages of “cross-buying.” Surveys show customers will buy additional products from the same institution only if it offers the best products at the best price. Thus, getting consumers to keep their financial activities all in one family—unless the mega-institution offers extraordinary value in each area—will be a tough sell.

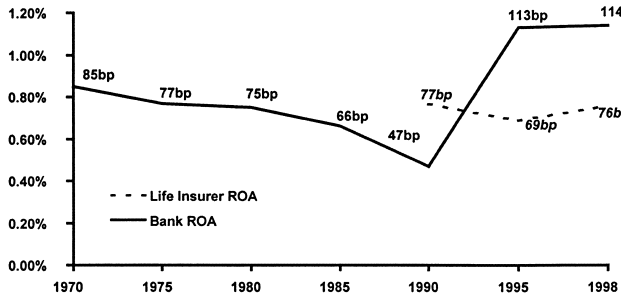
The recently issued regulations implementing the privacy provisions of the Gramm-Leach-Bliley Act—raising compliance standards to a higher, more costly level—may further prevent institutions from leveraging the tantalizing cross-selling opportunities that were expected to come their way in the wake of financial services reform. But perhaps the most telling deterrent to cross-sector mergers is that from the banks' perspective, partnerships with low-profitability life insurers may not be attractive, given insurers' sagging returns compared with those of banks (see Figure 1).

Adding to banks' reluctance is their existing ability to offer whatever insurance products they want

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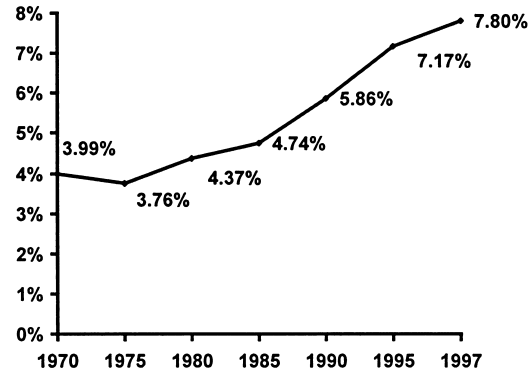
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Figure 1
Bank and Life Insurer Profitability



Source: Moody's U.S. Life Insurance Statistical Handbook, Federal Reserve, and FDIC.

Figure 2
Financial Services as a % of U.S. GDP



Source: Bureau of Economic Analysis; GNP was used prior to 1990.

to market. In recent years, insurance companies have been lining up at banks' doors in search of marketing alliances. The only dilemma for banks has been how to make effective use of insurers' availability—a skill they have yet to master, except in the annuities arena.

THE GROWTH OF FINANCIAL SERVICES

Nonetheless, the new century finds *all* financial institutions, not just insurers and banks, battling for their share of the consumer's wallet. The prize is well worth the struggle. The monetization of wealth in the U.S. and around the world has been phenomenal. Since 1980 the business of financial institutions has grown at about one-and-a-half times the rate of growth of the U.S. gross domestic product (GDP). And since 1990, its growth has outpaced GDP growth by about two to one.

In 1980, assets held by U.S. financial institutions were under \$3 trillion. In the ensuing 20 years they leapt to over \$20 trillion, a growth rate of about 11%. Since 1990 that growth rate has accelerated to about 12.5%. We remain in the midst of a veritable explosion of the business of financial institutions (see Figure 2).

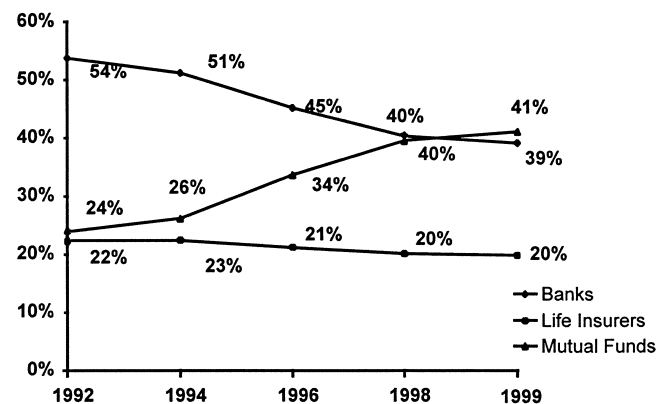
In the past decade, the big story has been the tremendous growth of mutual funds, which now account for 41% of the total financial assets held by banks, life insurers, and mutual fund companies, up from just 24% as recently as 1992. Most of this growth has come at the expense of banks, whose market share has declined dramatically, while life insurers have barely held their own (see Figure 3). Looking at compound growth rates rather than mar-

ket share, mutual funds have been growing by about 40% a year for the past seven years.

CATALYSTS FOR CHANGE

What has produced this current situation of high-growth opportunities in a market dominated by consumers who are demanding revolutionary change? In recent years, the unique confluence of demographic shifts, deregulatory trends, and the revolution in information technology has transformed the industry and now works to accelerate this transformation. These forces are reflected in the convergence, consolidation, and globalization trends that have radically altered the industry's structure and competitive dynamics.

Figure 3
Share of Financial Assets among Three Sectors



Source: Federal Reserve, FFIEC, and Investment Company Institute.

Convergence

Long before Congress took up debate on financial services reform, the once-impregnable walls between the various segments of the industry—insurers, banks, securities firms, mutual fund companies, and asset managers—had been tumbling down as financial services providers were forced to become much more customer-focused and much less product-focused. And now, convergence is spreading even outside the financial services sector itself as powerful dot-com companies like Amazon.com expand their offerings into the financial services arena.

Customers' greater understanding of their financial situation and options, coupled with vastly increased customer power, is driving product convergence. On the retail side, the products needed to serve that business include a wide range of offerings such as mutual funds, individual stocks, whole life insurance, annuities, bank CDs, and credit products. Convergence is occurring, not necessarily at the institutional level, but at the delivery level.

On the wholesale side, products are converging between investment banks, commercial banks, and commercial property/casualty insurers. But in our view, the most recent phenomenon—holistic risk and integrated products—will be a passing fad. After a period of experimental bundling of risks, large commercial companies will recognize that taking pure, unbundled risks directly to the capital markets is a more efficient way to finance risk. They won't need an insurance company or an investment bank to bundle their risks together.

Consolidation

In their efforts to grow and reduce costs in response to these competitive pressures, insurers have turned to consolidation—a trend that has been more pronounced in the life sector. Even the venerable mutual life segment has all but disappeared as mutuals scramble to demutualize in order to access the capital that will enable them to be major players on the mergers and acquisitions (M&A) stage.

But compared with the massive consolidation and frenzied M&A activity occurring in the banking sector, the pace of consolidation in the life industry has been relatively moderate. Also, unlike the banking industry, the life sector has not yet seen many “mergers of equals,” a trend that we think is right around the corner.

Moreover, much of the consolidation that has occurred has been accomplished through acquisitions by aggressive European competitors. And although domestic acquirers are increasingly making their presence felt, European powerhouses will continue to lust after brand-name properties in the U.S.

Meanwhile, except for the already largely completed restructuring of the reinsurance industry, very little consolidation has been occurring in the property/casualty sector, where monumental overcapacity continues to fuel an unrelenting soft market, and underwriting losses for 1999 increased by almost 40%. Although scattered deals have been consummated, there has been virtually no change in market concentration.

Why has the property/casualty (P/C) industry avoided significant consolidation? The first reason is costs. The fixed costs of a P/C insurance company as a percentage of total costs are relatively low compared with a life insurer, and much lower than a bank's cost structure. The second, even more compelling reason, is the liability structure of the P/C insurance industry. Quite simply, who wants to buy a P/C insurer when the company itself doesn't know what its reserves should be?

Absent a dramatic change in these conditions, more and more P/C insurers will find themselves unable to compete in the next 10 years. Many will simply give up by selling out, increasingly at bargain basement prices, to acquirers with the stomach for reducing the capacity in this industry.

Globalization

Globalization increasingly has left its mark on the industry. In the commercial marketplace, primary P/C insurers, struggling to efficiently deploy their massive capital base, are being forced to “think global”—a mindset already well established in the reinsurance sector—as national boundaries shrink and more and more corporate customers establish a presence in foreign markets. Globalization is a necessity in commercial and investment banking, but it is not yet finished in the commercial P/C industry. On the retail side, providers are looking to enter global markets mainly as a growth vehicle and to obtain the scale needed for large investments such as technology.

A DEMAND-DRIVEN BUSINESS

Yet of all the changes that have rocked the industry, the most significant has been the shift from a supply-driven business to a demand-driven business. As competition has increased customer choice and greater productivity has reduced prices, markets have coalesced around customers, not products.

More knowledgeable and sophisticated about their financial affairs than ever before, customers no longer quietly accept what the product providers are offering. The best single measure of the new consumer is that about a third of household assets are in direct equity investments. When we pair the intelligent consumer with the emergence of a financial economy, the result is unprecedented customer power. The long era of the complacent provider is over. Providers must now focus on customers and be more sensitive to the changing needs, values, and buying behaviors of their potential customer base.

This shift is most apparent in the decisions by financial institutions to be either predominantly retail or wholesale, but generally not both. That's certainly true within the insurance industry. The larger, bank-driven financial institutions do tend to address both markets, although it's not clear whether those financial institutions have the capability to successfully manage such a diverse business portfolio.

In their search for convenience, customers have also sought out new distribution channels. The rush to new channels has put the traditional agent in jeopardy. And when one looks at the potential of the Internet and what's happening on the retail product side of financial services, one sees that traditional brokerage and bank relationships are also at risk.

This has given rise throughout the financial services industry to the general belief that multiple distribution channels are now the only way to survive and, in fact, are critical to increasing customers and revenues, achieving profitability goals, and meeting shareholder expectations. Increased customer power also has brought traditional retail marketing concepts to the financial services sector, so branding has now become a critical element of every retail financial services institution.

UNBUNDLING OF PRODUCTS

The seeds of the future transformation of the industry are now being planted as insurance companies unbundle their products by further disaggre-

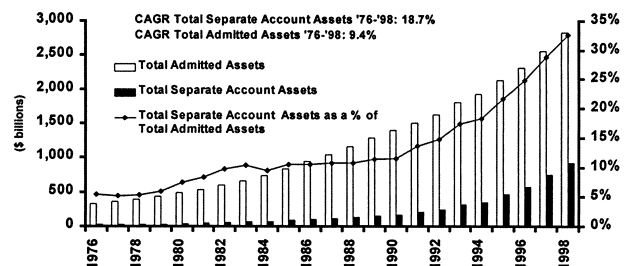
gating products and services. Back in the late 1970s, the universal life product was the first effort to unbundle the investment and underwriting functions. That simple product design change, coming in response to newly volatile economic conditions, has transformed the industry. More recently, variable life and variable annuity products have pushed that concept further and have fundamentally changed the way a life insurance company uses its balance sheet (see Figure 4).

For these products, which are the growth engine of the industry, insurers are no longer using their financial position to take asset risks. Instead, these risks are being assumed by policyholders, who have placed most of their investment decisions in the hands of third-party fund managers. Thus, we find that about 75% of the assets that underlie variable life and annuity products are being managed by third-party investment advisers. The insurance company is merely a conduit—and, some would argue, a relatively inefficient one—to a more effective customer investment.

Life insurance companies are being reduced to managing distribution channels, which are increasingly not their own, and to providing underwriting and various administrative functions. The ongoing unbundling of insurance products is turning the industry into a delivery and service mechanism.

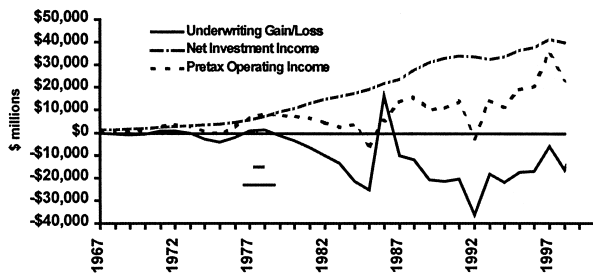
The same general trend is occurring in the P/C industry. Here the separation of investment and underwriting results has given rise in the last 10 or 20 years to increased customer retentions, self-insurance programs, and the more efficient excess coverage programs (see Figure 5). By most measures, between 40% and 45% of the commercial market is already in the alternative risk transfer

Figure 4
Growth of Separate Accounts



Source: *Best's Aggregates and Averages*.

Figure 5
Divergence of P/C Underwriting and Investment Income



Source: *Best's Aggregates and Averages*, and Ernst & Young.

marketplace. And these vehicles are only going to grow as insureds increasingly use alternative mechanisms to transfer risk, including directly into the capital markets. Thus, P/C insurers, like their life insurance brethren, are moving away from being risk takers and toward providing risk management, advisory functions, loss control, and claims services.

Throughout the financial services industry, there has been a broad movement toward advisory and management services, which consume little capital and are relatively more efficient on a return-on-equity and earnings-growth basis. In the banking sector, this kind of transformation is demonstrated by the relative growth of net interest margin and fee income. In the last three years, there has been low, single-digit growth in the net interest margin of banks. On the other hand, fee income has been growing by 15% to 20%.

In the commercial banking sector there is another trend that will redefine business. It is increasingly clear that the unpredictability of proprietary trading and similar activities can wreak havoc with the share prices of the large public banks. Now there is growing interest in moving these activities off the balance sheet to make the core banking business more appealing to the capital markets.

In the banking sector we believe capital market pressures will fuel the same kind of trend that we have seen in the risk-taking profiles of both life and P/C insurers. Specifically, the next decade is likely to see many of these more volatile activities packaged for movement off the balance sheet, directly to the public and private capital markets, where more suitable investors can be found.

THE DEMISE OF PACKAGED PRODUCTS

In light of these trends, the traditional packaged insurance product—one that combines distribution services, investment advice and management, underwriting functions, risk management, portfolio reporting, and claims services—is clearly in a secular decline and will face a very difficult time over the next 15 to 20 years.

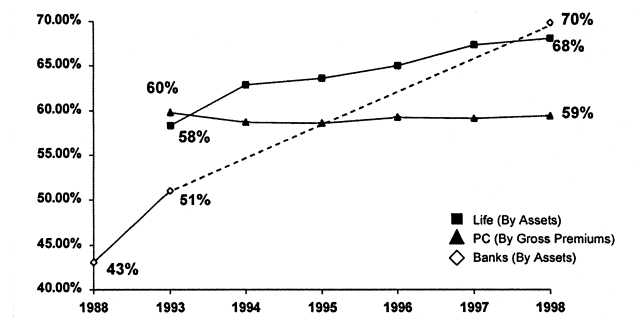
Policyholders now see more clearly that direct investment, off the balance sheet of insurance companies, is more efficient. Securities firms like Schwab or PaineWebber can do a better job of accumulating an individual's assets and risk mitigation vehicles, as well as a better job of portfolio reporting. In addition, distribution channels other than insurance agents frequently provide a cheaper and much more suitable source for product. This leaves underwriting and risk management as the insurance industry's core set of competencies. If there is any place where a sustainable competitive advantage can be built in the next 20 years, it will be around these activities.

CONCENTRATION OF MARKET POWER

Looking to the industry's future competitive structure, two things stand out regarding the concentration of business among the top 25 institutions—banks, life insurers, and P/C insurers (see Figure 6). Most obvious is the weaker position of the P/C industry relative to banks and life insurers; the other is the slope of change in the banking industry compared with the life industry.

Banks and life insurers are at about the same concentration level: nearly 70% of sector assets are

Figure 6
Concentration of Top 25 Institutions



Source: *American Banker*, FDIC, *Sheshunoff*, and *A.M. Best*.

held by the top 25 companies. Both banks and life insurers are likely to continue to move up, with the top companies probably reaching 80% of assets over the next five or ten years. The P/C industry is the anomaly, since its position has declined marginally over the last five years. It is virtually certain to move up over time, but that will not occur until some of the volatility in the industry's liabilities is eliminated.

What does the further consolidation of the industry mean? When the consolidation trend is combined with the increased power of the customer, the result is accelerating competition. In the new millennium, we see larger institutions, driven by a specialized focus on customer solutions, such as asset accumulation and asset protection.

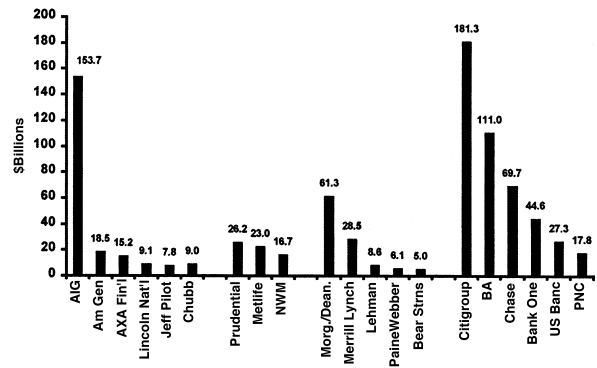
To provide those customer solutions, the distribution channels will need access to virtually all products and many more touch points with their customers. Product manufacturers will need more distribution channels, and to be cost-effective they'll have to sell to a much larger base of customers than a single distribution channel allows them to do. As a result, highly focused customer strategies, executed through multiple distribution channels, will become the norm.

NOT A PRETTY PICTURE

Which traditional sector will drive this further consolidation? We don't envision many cross-sector mergers, because current conditions for most of those unions are unfavorable. As noted earlier, for the last 10 years the insurance industry has underperformed the banking industry on both a return-on-assets and a return-on-equity (ROE) basis. ROEs for 1998 were about 13% for the life industry, 15% for the P/C industry, and 20% for the banks. For 1999, P/C insurers' ROEs may be in the single digits. There is no question that banks are more profitable.

Also from a market capitalization standpoint it's clear that in a shooting war, insurers lose (see Figure 7). Both national and regional banks can buy virtually any insurance company they want, with the exception of AIG. But again, why would they want to? If distribution of high-value product is the most important factor, then the banks' experience with the product that is most likely sold through the bank channel—the annuity—is instructive. Life agents have lost the dominance that they had in

Figure 7
Comparative Market Capitalization of Financial Services Competitors



Note: Market caps for mutual companies are estimated using year-end data for 1998. Market caps for stock companies are as of November 2, 1999. Source: Yahoo! Finance, Moody's Investor Service, and Standard & Poor's.

selling this product (see Figure 8). Banks have tripled their sales, and the broker dealers are selling more annuities as well. In other words, you don't have to own it to sell it.

We believe that alliances with banks will make more sense than mergers. Some bank-insurer mergers are inevitable over the next few years, but many may come apart five to 10 years thereafter. Mergers are likely to struggle, because of the difficulty of being the best of breed in everything. How many mega-institutions can offer the highest-value products through all distribution channels? It will be a rare occurrence when a company will be able to achieve best of breed in both its products and its distribution channels.

Figure 8
Annuity Distribution

	Early '90s			Today		
	Fixed	Variable	Total	Fixed	Variable	Total
Agents	64%	55%	58%	56%	38%	48%
Broker/Dealers	12	38	24	10	47	32
Banks	23	4	16	30	12	17
Direct, Other	1	3	2	4	3	3
Total	100%	100%	100%	100%	100%	100%

Source: Moody's Investor Service, LIMRA, and Ernst & Young.

NEW BUSINESS MODELS

What emerges from all of this turmoil? What we see evolving in the next 10 to 15 years is the emergence of three broad business models: universal institutions, global/regional specialists, and domestic specialists (see Figure 9). Universal institutions will have a full range of life and savings products, securities capabilities, state-of-the-art asset management capabilities, retail banking, and various credit product capabilities. Many of those organizations, especially those that come from a commercial banking background, will continue their historic wholesale capabilities as well, if they can show a consistent ability to manage these diverse businesses.

The specialists will generally be either retail or wholesale, and will offer a more limited product line. Those with insurance roots will not have any securities business, nor will they have any retail banking operation. However, many of them will offer a full spectrum of retail insurance products. To some degree, we'll see a return of the multiline, at least in the retail markets. Of course, the surviving life companies will have a robust asset management capability as well. There will also be much more specialized players, including some of the niche companies that are operating today.

The universals, because of their scope of product, will need scale to make these complex businesses work. This sector will be composed of very large global, and possibly regional, firms. Today, Citigroup is the best example, but other companies are either moving closer to that model or facing a decision as to whether they should adopt that kind of model in the near term.

The specialists, which can be categorized as global and regional or domestic companies, will be more sharply defined. The specialists will have a narrower product line, and as one moves down into domestic markets, these companies will have an even narrower product line, approaching what many today would call the product manufacturing specialist.

All companies within the financial services sector, be they the niche P/C company or the broad universal bank, will be competing for the same customers in the same competitive market environment. Even the domestic specialists will be vying with very large global universal institutions. In many respects, they may be product providers for those institutions, and they will certainly be competing with large regional domestic specialists as well. When this market environment is understood, it's not hard to predict an intensifying competitive battleground as companies fight to stake out their position within the marketplace.

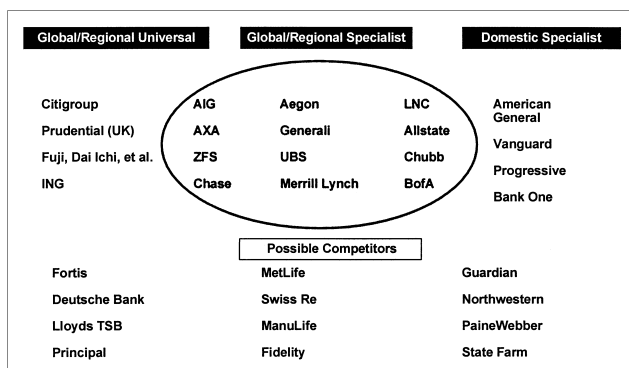
PREDICTIONS

Clearly, the degree of the transformation of the financial services industry has already been enormous, but even more change lies ahead. As we enter a new century, the only certainty is that the rate of change will accelerate. Maintaining a lasting competitive advantage will be harder and harder. Survival will be based on the ability to adapt to a rapidly changing environment, but at the same time, the next 15 or 20 years will bring enormous opportunities for all financial services institutions. So what lies ahead? Here are our predictions.

Financial institutions will tend to adopt either a retail or a wholesale market strategy. Some of the combined organizations we see today will separate over time. Particularly on the retail side, vastly broader product lines will be assembled in response to customer demands. Many of these products will be rented, that is, there won't be any in-house manufacturing or service. But having a best-of-breed product line will be a prerequisite for competing in the retail marketplace and for building a valuable relationship with customers.

All financial institutions will increasingly use many stand-alone distribution channels, but the successful company will have solved the puzzle regarding how to integrate these channels effectively.

Figure 9
New Business Models



Such companies will enable the customer to use a variety of channels without fearing loss of knowledge about that customer as he shifts from channel to channel. So far, no organization has been able to do this.

Clearly, there will be far more brutal competitive conditions, as global players take on an increased importance in U.S. markets. Partially in response to such conditions, we see continued intrasector consolidation taking place, with a general increase in the size of the more successful institutions.

Some selected mergers between banks and insurance companies will occur, but for reasons enumerated earlier we do not envision a wholesale run at insurance companies by banks. We also see further unions between banks and securities firms, insurers and securities firms, and, especially, insurers and fund companies.

Marketing alliances will dominate the relationships between financial institutions. Increasingly, the market will separate those institutions with meaningful customer access and relationship management skills from those companies that are product manufacturers and service providers.

Both insurers and banks increasingly will be competing in a commodity marketplace, and sustaining a competitive advantage will be very difficult. Insurers will fall back on their unique underwriting and risk management expertise. Competing with specialized and highly efficient asset managers and credit providers will be a formidable challenge for most companies.

Finally, the role of technology will be of the utmost importance to the future of the financial services industry. One of the defining characteristics of the top companies will be their deep use of technology, both as an enabler in the middle and back office and also on the front end as a distribution channel.

During the last five years, we have witnessed the absorption of product providers by broader financial institutions with better market access and better customer management capabilities. Banks' assem-

blage and distribution of insurance, securities, and mutual fund products illustrate how those with customer access can set the rules of competition. Organizations whose knowledge is limited to products will continue to lose power to organizations that have strong customer access and the technology to leverage those relationships.

In the next 10 years, technology will determine whether our core financial institutions, principally banks and insurance companies, will be able to consolidate their market power or whether nonfinancial institutions, like an Amazon.com, will win the battle for customer access. If such nontraditional players do prevail, more and more financial institutions, including banks, will end up simply providing products to organizations that are adept at managing and influencing customer behavior.

One battleground that will help shape the ultimate outcome will be whether nonfinancial institutions can steal a march on the financial services industry and capture the electronic bill presentment and payment process. This activity has the potential for being at the hub of the network that serves the needs of the retail financial services customer. Insurers are not likely to be able to attain this position. And if banks don't get their act together and this hub falls to another party, then banks will forfeit their claim on being the core financial provider for retail customers. They, too, will become product and service providers, making their wares available to customers owned by someone else.

What happens in these technology areas in the next 10 years will be critical. It is these developments that will determine whether financial institutions or other, more creative and customer-focused organizations will be able to provide the greatest value to the increasingly demanding retail customer.

Additional discussions on this paper can be submitted until January 1, 2001. The author reserves the right to reply to any discussion. Please see the Submission Guidelines for Authors on the inside back cover for instructions on the submission of discussions.