RECORD OF SOCIETY OF ACTUARIES
1995 VOL. 21 NO. 4B

INTERNATIONAL CONSOLIDATION OF THE LIFE INSURANCE INDUSTRY

Moderator: ROBERT M. BEUERLEIN
Panelists: ANDREW GIFFIN*
JAMES B. MILHOLLAND
FREDERICK S. TOWNSEND, JR.
Recorder: ROBERT M. BEUERLEIN

The trend toward consolidation of companies in the life insurance industry is accelerating and becoming a global phenomenon as companies cope with shrinking profit margins, increasing competition, emerging technology, the impact of life insurance company failures, and the changing market dynamics. This session will describe the consolidation phenomenon in various insurance markets (U.S., Canada, and Europe), identify similarities and differences, summarize any lessons to be learned, and draw some conclusions about the future outlook.

MR. ROBERT M. BEUERLEIN: Let me briefly introduce myself and the other panelists. I'm Bob Beuerlein, senior vice president and chief actuary at Franklin Life Insurance Company. On the panel we have Fred Townsend, who is president of Townsend & Schupp. Fred will talk to us about the domestic issues associated with the consolidation of the life insurance industry. We also have Jim Milholland, who is a partner with Ernst & Young in Atlanta, GA. Jim will talk more about North American consolidation, including Canada and Mexico. Then we will go global with our global traveler, Andy Giffin, who is a principal with Tillinghast/Towers Perrin. Andy specializes in multinational insurance operations and integrated financial services.

MR. FREDERICK S. TOWNSEND, JR.: I will start by discussing the expansion and consolidation of the U.S. life insurance industry. Table 1 shows the development, in five-year intervals, of the number of companies in the U.S. since the end of World War II. At the end of World War II, we had 473 life insurance companies in the U.S. (a relatively modest number) of which only one-third were mutual companies, or roughly 160. There was rapid expansion and the number of companies quintupled from 470 in 1945 to 2,300 in 1988 before we began a severe consolidation.

Why were so many new companies added in this postwar period? First of all, banks, finance companies and auto dealers formed life insurance companies that were basically credit life and health insurers. A number of reinsurance companies were formed in Arizona, and a number of limited surplus companies were formed in Texas. Both these states have small surplus requirements, which enabled companies to get into the business with very modest capital contribution.

Large general agents formed their own life insurance companies. Other stock companies were formed which offered stock options to producers, which was very popular in the 1950–60s. Then a number of companies started up with founders' policies and if

---

*Mr. Giffin, not a member of the sponsoring organizations, is Principal of Tillinghast/Towers Perrin in Framingham, MA.

policyholders bought a founders' policy, they would share in the profits of the company.

TABLE 1
NUMBER OF U.S. LIFE INSURANCE COMPANIES

Year	Number	Percentage Change	Year	Number	Percentage Change
1945	473	–	1975	1,746	–2%
1950	649	37%	1980	1,958	12
1955	1,107	71	1985	2,261	15
1960	1,441	30			
1965	1,629	13	1988	2,343	4
1970	1,780	9	1993	1,840	–21

Then we had the new product idea people like the American Association of Retired Persons (AARP), and other associations, low-cost term innovators and companies specializing in investment products that came along with specialty products targeting niche markets such as cancer insurance, cash value policies sold to college seniors, and tax-sheltered annuities. Among the product innovators, the new companies were primarily niche companies. They'd pick out special markets or have specialty distribution systems come up with a specialized product where perhaps 80% of their sales might be in a single product form. If you write 80% of your sales on a single product form, you can operate at a much lower expense ratio than your competitors who have a broad based product portfolio.

Some of these companies had commission rate advantages, which gave them a further competitive edge because of the way they distributed their product, and most of them established low general expense ratios. This enabled them to offer competitive prices, and achieve above average returns to stockholders. These companies fostered their own success.

Thirty years ago, we had the good old days. People were jumping into the business, because it was easy to make money. First, most sales were annual premium contracts. If you're an auto dealer or you're in the steel business, you sell a car this year, or you sell a ton of steel, you report all your revenues and all your profits in the year of sale. You have to go out and sell an automobile or a ton of steel the next year to maintain profits, so your business is cyclical. In the life insurance business, it used to be when you made a sale, you only received 10% of your premium revenue in the year of sale and built in a future revenue stream. This is a very strong factor.

Second, the cost of money was 3%. For companies writing nonparticipating business, the reserve requirement was 3%. Pricing assumptions were often set at 3% or barely higher, but the industry yield rate rose sharply for many years. Third, there were tax code advantages. Tax laws pertaining to the life insurance industry were changing, but the industry was very protective and often put in provisions that enabled either mutual companies or stock companies to escape with low rates of taxation if they had a decent rate of growth.

The largest insurer, Prudential, has only had 4.5% market share. With 2,300 companies, you can become a substantial size company if you get a 1% market share in this industry. How many people in this room would like to be a quarter of the size of Prudential? That's only a 1% market share.

The three factors that brought companies into the industry have all deteriorated, and that's one of the causes for consolidation in the life insurance industry.

First, look at the annual premium nature of the business. Our renewal premiums are dissipated with the product lines that we're writing. Instead of annual premium whole life insurance products, we have a number of single premium products: single premium whole life, guaranteed investment contracts (GICs), and single premium deferred annuities (SPDAs). Then there are other products in which premiums are limited, or they are so flexible that we don't know if we will collect them in renewal years, such as universal life, flexible premium annuities and vanishing premium whole life. And if premiums reappear on vanishing premium whole life, we tend to get sued.

The second factor is the old 3% cost of money. As we introduce interest sensitive products, we no longer have a guaranteed cost of money. We began to credit flexible rates on policyholder value accounts, and crediting rates are adjusted annually on interest sensitive whole life, on universal life (UL), and on SPDA contracts. If you look at the last five years, you'll see that return on assets for the industry has been hovering around 80-basis points. Remember, this is not totally your interest spread. It's the sum of your interest spread, plus your mortality profits, plus your underwriting profits on health insurance. This will tend to be cyclical, particularly because of fluctuation in health insurance profits, but you'll see that we're reporting about an 80 basis point return. Margins have narrowed. It's become a much more difficult business, profit wise.

Third, the tax burden is increased as well. Some of the special codes which were taken advantage of by stocks and mutuals have been eliminated or cut back. We have the deferred acquisition cost (DAC) tax which has severely hurt many rapidly growing companies. The mutuals now face an equity tax which didn't bother them at first. But now that the return on equity (ROE) in the industry has plunged, and their earnings are adjusted to reflect ROEs in past years, which are higher than current ROEs, it's hurting the mutuals.

We're also taxed indirectly with assessments for failed companies, which are substantial dollar amounts for some companies. The industry also seems to be a source of taxation for state governments, incurring substantial market conduct fines.

Also, the cost of doing business is higher. Unit operating costs are going up, basic administrative overhead is going up. There's more regulation and more cost in running a life insurance company. In the area of regulation, there are taxation, fines and assessments. The regulatory exams have been expanded because of the failures we've had in the industry. The industry has statutory accounting, stocks have GAAP accounting, and now the mutuals will be doing GAAP as well, and companies prepare separate tax books. Compliance issues are coming to the forefront, so there is an additional layer of overhead for manuals and forms to be created and distributed to the field and record fines for some large companies.

As any industry matures, it will consolidate. We're in a maturing stage. Companies will attempt to build critical mass. The reason they build critical mass is either to drive costs down or to maintain competitive marketing positions, or both. Price or net cost becomes a dominant factor when you are consolidating. Companies attempt to realize efficiencies. Companies want to bulk up their profitable lines of business, which also means disposing of marginal lines of business. Companies, besides growing internally, will seek external growth through acquisition. Companies that are basically asset managers will try to acquire additional assets. The UL administrators will try to acquire or manage other companies' UL business. Whole life companies will attempt to acquire similar blocks of business or similar companies, and the debit companies either buy other debit companies or buy geographic operating territories to complement their own business. Companies try to obtain low costs to achieve critical mass. The result is, from 1988 to 1993, we have had a 21% reduction from 2,300 companies to 1,800 companies in the life industry, and it will undoubtedly decline further.

The decline in number of companies can also be attributed to declining margins and low returns on equity. The industry has changed. Growth in the industry has been on the investment side and not on the life insurance side. Table 2 shows compound growth rates over 5, 10, 15, 20 years, to the year 1990, comparing annuity premiums and deposits and also annuity policy reserves. Over the last 20–25 years, annuity premium income has been compounding at about 19% a year, more than double that of the individual life business. Liabilities for annuities have been compounding at about 16% a year, no matter which period you look at, 5, 10, 15, or 20 years.

TABLE 2
U.S. LIFE INSURANCE INDUSTRY INDIVIDUAL AND GROUP ANNUITIES
(IN MILLIONS)

Year	Annuity Premiums and Deposits	Annual Growth Rate to 1990	Annuity Policy Reserves	Annual Growth Rate to 1990
1970	3,721	19.40%	40,960	16.01%
1975	10,165	18.46	72,349	17.36
1980	22,249	19.22	171,960	16.59
1985	53,899	19.08	399,990	14.81
1990	129,064		797,923	

The point is that the American public is focusing on investment products. The American public is buying annuities rather than ordinary life insurance. In addition to the annuity products, it has heavily shifted towards money market funds as an investment vehicle, once the interest rate spike took place in 1979–82.

Table 3 compares premium mix between annuities and individual life insurance. In 1970 between those two lines, ordinary life insurance was 81% of premium volume. The two most recent years shown, 1990 and 1993 had leveled off at about 32%. There's been a dramatic shift in premium income from the ordinary life business to the annuity business.

TABLE 3
CHANGING PREMIUM MIX FOR U.S. LIFE INDUSTRY
(IN MILLIONS)

Year	Annuity Premiums and Deposits	Ordinary Life Premiums	Ordinary Life as Percentage of Total
1970	3,721	15,663	81%
1975	10,165	21,032	67
1980	22,249	29,463	57
1985	53,899	46,096	46
1990	129,064	59,961	32
1993	156,445	74,872	32

Table 4 shows that in 1970 life insurance was 74% of industry liabilities. In 1990 and 1993, that ratio leveled off at 30%. Again, we've had a tremendous shift in the mix of business in our industry from the stable, money-making, individual life annual premium business, to the much riskier, unstable annuity lines of business. Money the industry has not captured itself, either for life insurance or annuities, has gone elsewhere.

TABLE 4
CHANGING LIABILITY MIX FOR U.S. LIFE INDUSTRY
(IN MILLIONS)

Year	Annuity Reserves	Life Insurance Reserves	Life Insurance as Percentage of Total
1970	40,960	115,442	74%
1975	72,349	150,063	67
1980	171,960	197,865	54
1985	399,990	235,854	37
1990	797,923	348,774	30
1993	1,041,226	436,293	30

Table 5 is one of my favorite charts. In 1979, just as the interest rate spike started, money market funds were virtually a nonexistent industry of $3 billion. Money market funds or short-term funds had a very low yield. We didn't have an inverse interest rate curve, so it was never a popular form of investment. Individual life reserves, net of policy loans, were $131 billion.

People buy life insurance for a purpose. They would not cancel out when interest rates spiked, but they would take policy loans because they could take loans at 5% or 6% cost and invest them with an inverted yield curve in short-term money market funds that were yielding 16%. You could gain an additional 10% on the money you had in your cash value of your life policy if you'd move it out and put it in a money market fund. The table shows that from 1980 to 1982, individual life reserves net of policy loans only grew by 1–2% a year, and went from $131 billion to $137 billion.

TABLE 5
DISINTERMEDIATION IN U.S. LIFE INSURANCE COMPANIES

Year	Ordinary Life Reserves Net of Policy Loans (Billions)	Money Market Funds (Billions)
1979	131	3
1980	134	–
1981	135	–
1982	137	220
Dec. 1993	323	–
Jun. 1995	–	717

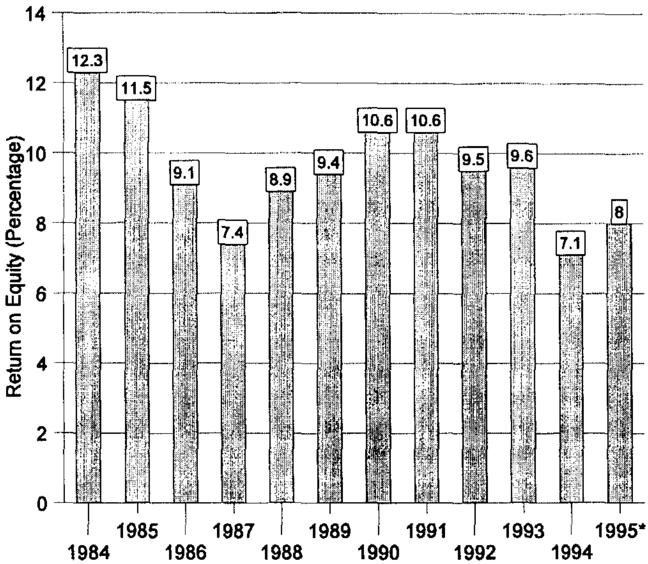
What happened to money market funds? They went from a nonexistent industry of $3 billion, or 2% of individual life reserves, to $220 billion, or 160% of life insurance reserves. In three years, the money market fund industry surpassed the 200 year growth record of the individual life business. At year-end 1993, there were $323 billion of life reserves, net of policy loans. You see in June 1995, there were $717 billion in money market funds. Presumably in June 1995, there was twice as much money in money market funds as in individual life reserves.

Another reason why the life insurance industry is consolidating is a reduced return on equity. Capital flows in the business world to where the highest returns on equity are, and when returns are good, money flows in. When returns are bad, money may flow out and companies in the industry will consolidate. In a mature industry like the automobile manufacturers, we now only have three major domestic manufacturers, where we probably had 50–100 back at the turn of the century.

Chart 1 shows return on equity for 130 U.S. life companies, our Townsend & Schupp universe, which comprises 85% of industry assets. Skipping the first two bars, the remaining ten bars show that over the latest ten years, ROE has not exceeded 11% for the industry. If you skip 1990 and 1991, in eight of ten years it has been under a 10% return for the industry. So ROE has not been as attractive as in some other businesses.

Return on equity is a simple calculation. The numerator is profits, the denominator is surplus. When you think about it, ROE has been hurt in both the numerator and denominator. First of all, profit margins have been declining in the life insurance industry because of the changing product mix. This lowers the numerator. With respect to the denominator, surplus contributions accelerated from 1991 to 1993 for reasons I'll explain later. Surplus contributions increased the denominator and pulled ROE down. At a low point in 1987, when annuities reported very little profits and health insurance reported an aggregate loss, there was a low ROE of 7.4%. It built up the next three years 8.9%, 9.4%, 10.0%, through 1990. In 1991 we had major insolvencies, and companies rushed to put surplus in to prove that the industry was strong. That tended to depress ROE. Then rating agencies started to give downgrades, so life companies put more surplus in that helped to depress ROE in 1992. In 1993, life companies were afraid where their competitors were going to report their initial risk-based capital (RBC) ratios, so companies put more surplus in and tended to push down the ROE ratio again in 1993.

CHART 1
RETURN ON EQUITY* FOR 130 U.S. LIFE INSURANCE COMPANIES



*Note: 1995 Return on equity annualized for the first six months of 1995.

We can see what happened. In 1991, surplus for the industry rose 18%. That was the solvency scare. The next year, to meet rating agency demands, surplus rose 13%. Then, in the rush to meet the initial reporting requirements for RBC, surplus rose 19% in 1993. Now that RBC was met, everybody was comfortably above the guideline. The industry had RBC of about 216% of required capital. People didn't need it in 1994. Surplus only rose 2.5% in 1994 and 5.5% in the first six months of 1995.

During this period of time, mutual companies decided that surplus notes were legitimate and wouldn't be a taint upon the company. They began to issue surplus notes, mostly in the last half of 1993. Those transactions that weren't completed in 1993, in time for RBC, took place in early 1994.

Mutual companies had shrunk from 170 companies in the mid-1950s to roughly 100 companies. Some are demutualizations, others are mergers. The reasons are generally the same, it's just a matter of whether a company decides to demutualize or merge. I'll get to that in a moment.

Looking further at the surplus infusion, the 100 largest stock companies infused $4 billion of surplus in each year from 1991 to 1993. Suddenly they only infused $1.6 billion in 1994 and $0.5 billion in the first six months of 1995. Surplus is not flowing into the industry because it's overcapitalized, and producing low returns on equity. Why make the situation worse? The 30 largest mutuals infused $1.8 billion in 1993, $1.3 billion in 1994 and nothing in the first half of 1995.

The demutualization rationale also applies to merger rationale among mutuals. I think there are three major reasons why you will see demutualization or merger of mutuals. First, balance sheet problems. The Equitable chose the route of demutualization. It hired somebody with credibility who had the ability to raise money from Wall Street, and so demutualization and subsequent raising of money brought the Equitable out of its problems. On the other hand, we have New England Mutual and Connecticut Mutual with poor balance sheets who chose the merger routes.

Then we have some companies that don't have balance sheet problems, but need more capital. You have to remember that many mutuals operated with 3% capital ratios. The industry averages a 9% capital ratio. Some smaller companies, like Guarantee Mutual and Midland Mutual, have demutualized. State Mutual, a larger company, also recently demutualized.

Business expansion could cause a giant company to demutualize, like the John Hancock or the Prudential, if it decides that it's not just operating in the life industry, but operating against major financial services companies. If a company decides its competitors are American Express, Fidelity Investments, Merrill Lynch, and Citibank, then you might see a demutualization of a major mutual company.

What happens when returns on equity are too low? Capital tends to withdraw from the industry. Prior to the major insolvencies, net surplus was paid out in 1990. Then from 1991 to 1993 when we had the solvency scare, rating agency demands, and RBC needs, net surplus paid in was $1.9 billion, $1.5 billion, and $1.9 billion, respectively. After this RBC issue had been met, ROEs were low, and people were asking, "What's our return on equity? Are we achieving our goals?" Capital began to move out. In 1994, there was a net outflow of $1.8 billion, and, in just the first six months of 1995, a net outflow of $1.8 billion.

If capital will be withdrawn from the life insurance industry, companies also want to reduce risk. If you plan to maintain your RBC ratio where it is, if you pull surplus out, you have to reduce your RBC requirements. Strategically, companies wanted to reduce risk, and to the extent that we continue to hire outside people, like from the banking community, to be the chief executive officers (CEOs) of life companies, we can expect to see trends that will move from risk taking to fee generation-type businesses. If you look at trends, you see an emphasis on fee-based businesses, such as management fees. Companies are offering variable life and variable annuities, saying a bird in the hand is worth two in the bush. Let's consider fixed management fees on managing assets for variable life and variable annuities. We don't have the risk of meeting our investment guarantees as on individual life, or investment guarantees, credit risk, or interest rate risk on individual annuities.

In the group health business, the major national companies write most of their business on an administrative services only (ASO) or minimum premium basis, and avoid morbidity fluctuation in their underwriting results. Again, they prefer to have fees in hand versus underwriting risk.

The guaranteed investment contract (GIC) business is a very risky business with investment guarantees, investment risk, credit risk and the timing of transitions. Many companies in the GIC business are trying to emphasize separate account products, where the investment risks are passed on to the policyholder, and they are collecting fees on this business.

Where is the life insurance industry headed? This is my prediction for tomorrow. I think we went through a period where we were managed by external factors in the life industry, and now companies will return to managing their surplus and trying to produce a satisfactory return on their surplus. Companies will continue to try to reduce their exposures. They have exposure to losses, so they want to reduce those. They have exposures to high risk in certain lines, and so they may sell those lines of business. Some lines of business are very capital intensive, and they may reduce or eliminate those lines of business. They will move to reduce their risk and to reduce their capital needs. They should review how their products are designed and select an appropriate portfolio of investments for their product lines.

Some companies are reviewing and redesigning their liability structures. On RBC, you can cut your requirements 75% by moving from surrenderable book value or surrender charge to market value adjusted or nonsurrenderable annuity products.

Companies will free up capital. Many companies have RBC ratios at 250% and higher. There probably is no need to maintain an RBC ratio above 200%.

There will be increased focus on ROE. I think companies have been responding to the rating agencies that initially were looking at asset quality after the failures of 1991. Then, because these were caused by runs on the bank, the rating agencies focused on liquidity. Companies with strong ROEs and strong fundamentals build their own surplus. They don't need nonrecurring events to build their surplus. The investment community has always given high-price earnings multipliers to companies that generate their own surplus growth by having a strong ROE, and the rating agencies are just waking up to this. The rating agencies, which have focused on asset quality and liquidity, are just beginning to talk about the soundness of companies' operations. I think the rating agencies will look more at ROE. You may have gotten by in the past because you had a strong capital position, but I think you are exposed to a downgrade if you have below average ROE.

I think the life industry and individual companies will try to build a high, sustainable ROE. To do that, you have to offer higher margin products or higher margin lines of business. On the same capital base, you have to develop more lines of business. Moody's gives you credit for diversified lines and sources of business. The key is to build more profitable lines of business on the capital base you are operating on. To produce higher total profits, you must eliminate marginal lines of business and drive down your expense ratios on your primary businesses. Companies trying to get more efficient than competition drive down their expense ratios on their primary lines. They want to do it to increase size, which is not only internal growth, but also growth through acquisition.

Finally, I think if companies achieve these steps, they will improve their public ratings. The key to improving public ratings is reducing risk and generating stability in your business. There is nothing a rating agency likes better than to see stability from year to year, rather than cyclical results and surprises, and to achieve high return on equity.

MR. JAMES B. MILHOLLAND: My comments specifically will pertain to consolidation in North America: the U.S., Canada, and Mexico. I will subdivide that into U.S. and Canada first and Mexico second, because I think the situations are different. My comments consist of objective information, some personal perspectives from the southeast corner of this part of the world, and a couple of forward looking comments as well.

I think we all know too well what's happening, but certainly the trend towards consolidation is not surprising. Financial performance and capitalization are the keys. Despite the fact that consolidation is occurring at a rapid pace, the reason it has not occurred more rapidly is because too many boards of directors have been willing to accept substandard performance for too long. As board members get this ROE mentality that Fred talked about and as Wall Street-type thinking starts to pervade board rooms, I think you'll see the trend towards consolidation accelerated even beyond what we've seen in recent years.

Consolidation is a result of many things. The most obvious are outright acquisitions and mergers. I tend to think of mergers as those cases where a company has used capital to make the transaction. Mutual company mergers, in particular, fit this description. Insolvencies, more often than not, result in one less player and frequently the end result is an acquisition of some sort, although not always. I use reorganizations to refer in all those other situations where there is one less competitor. This may or may not surface as an acquisition statistic in somebody's data base. For example, if I have a line of business, let's say individual health, and I decide it's not strategic for me, I might simply reinsure 90% or 100% to you and sign an administrative agreement with you to let you administer the business, perhaps signing a marketing agreement for you to market your products through my distribution system. I'm effectively out of the business, but that kind of consolidation doesn't get the notice in the press and many of the data bases. Nonetheless, the consolidation in these instances is apparent.

Our actuaries in Montreal put together some information from Quebec. They believe that if you were to do this analysis for all Canada, you would get very similar results. The actuaries compare the top ten companies in 1994 to those of just five years ago. The market share of the 1994 top ten have grown from 50% to 70% of market share in Quebec. The top ten are not the same companies as the ten leaders in 1989. The top ten had 54% market share then and the ten leaders in 1994 have 70%. Either way you look at it, there's clear consolidation in market share. Market share here is measured by all types of life and health premiums. It excludes general insurance.

The findings of the Canadian actuaries was the handiest information I had to see if I could find a similar pattern. A.M. Best has been monitoring the top 75 stock companies and the top 20 mutual companies for a while. Although its methods of compiling the consolidated assets have changed a little, I think the numbers are still fairly comparable for this purpose.

If you look at the top 75 stock companies, they have gone from about one-third of the market share in 1984, measured by admitted assets, to nearly one-half in 1994. The top 20 mutual companies have the opposite pattern. Their market share by admitted assets has dropped, which is consistent with the fact that there have been significant demutualizations, causing some significant players to drop out of the top 20 mutual list. The total of the top 75 stock companies plus the top 20 mutual companies isn't very different at the end of 1994 compared to ten years ago. The aggregate data does not merit consideration. You don't need these statistics to know what's going on, all you have to do is read the trade press. In the last year or so, three very significant mergers have been announced to be consummated this year or next. Clearly the top 20 list is going to be affected by this, and maybe its market share will grow. You don't need a data base to know how the industry is consolidating when you have companies of this size being affected and mergers of this significance taking place.

There are other types of data. Conning & Company does a great job of reporting on mergers and acquisitions. I don't know how it gets all its information, but it seems to do a good job of finding and reporting on transactions. The company's data includes much more information than what would be found in *Best's Review* on life companies. Conning & Company tends to be more inclusive of health insurance, including many types of health insurance financing entities, HMOs, and those that would not be in *Best's Review*. The company showed about 80 transactions in 1994, a record year. A trend line fit to this data would lead you to believe that there will be quite a bit more merger and acquisition activity in the future, and if you don't like a technical analysis, the fundamental analysis of all the environmental factors we talked about would lead you to the same conclusion.

The dollar value of the transactions is also quite significant. About half of the transactions from year to year disclose the dollar value. Data is not based on a complete inventory of transactions, but on those scenarios where the information was available publicly. In fact, 1994 was a record year and a trend line would suggest that you would expect to see more. It's interesting that each year the total dollar value tends to be dominated by a few very significant transactions, as Bob Beuerlein will tell you. His company's acquisitions represent about the January 7, 1994 total.

Price bounces around. It would be interesting to try to correlate this to interest rates or Standard & Poor's (S&P) market valuations. I suspect there's a fairly strong correlation. I'm not sure there always should be, and I wonder if as we actuaries evolve better capabilities of doing market valuations and option-pricing valuations, there won't be more stability in purchase prices.

If you're involved in mergers and acquisitions, it's a very exciting and dynamic place; often stressful. Involved or not, it's a great spectator sport, and it's interesting to watch how the marketplace has changed over time. Fifteen or 20 years ago, many of the buyers of insurance companies were from other industries. They were seeking cash flow benefits, stability of earnings, and tax manifests to owning a life insurance company. Many of those buyers are sellers now. It seems as though the other industries are disenchanted with life companies or have become focused on their core businesses. Foreign companies were great buyers for a while, but now seem to be preoccupied with catastrophic casualty losses around the globe, or they are more interested in other countries for their expansion. They have not been as active, but that could change back again.

It will be interesting to watch the consolidation of mutual companies by mutual company mergers versus demutualization/acquisition strategy. Mutual mergers have the advantage that they don't require demutualization. They have the disadvantage that there tends to be a fight for control. I believe we will see more use of merger strategies. Mergers make a lot of sense in the case of stock companies as well, where the acquired company, even though we call the transaction a merger, is privately held and the seller has a limited number of share holders. There are generally some very key tax advantages to the seller to do a stock swap as opposed to a sell out.

There is opportunity for innovation in the financing of transactions. There is still a fair amount of leverage, although the amount of equity in a leveraged buy-out is significantly higher than it was during the mid to late 1980s.

Mexico represents a much different scenario from the U.S. and Canada. The insurance environment there is different. I characterize the environment in Mexico, and this is a hopeful statement, by a stabilization of the economy. It seems that whenever the Mexican stock market takes hold and starts back up again, there's a bump in the road and another sudden devaluation of the peso. Nonetheless, I would say the secular trend is generally positive. If you spend any time in Mexico, I think you would agree that the infrastructure there is just too great and there's too much apparent opportunity for it not to stabilize and present some good opportunities for the insurance industry. There simply aren't as many people who have insurance relative to the total population as in the U.S. and Canada. There's a lot of growth potential if people's job expectations and income and estate planning needs appreciate with the stabilization of the economy. The prognostications for the growth in the insurance market are nothing short of sensational. You hear projections like a tenfold growth between now and the year 2000 or the year 2005.

One thing has to be said, insurance companies in Mexico write all forms of insurance, life, health and property and casualty. Much of this growth potential is in property and casualty, when you figure that only 20% of automobile owners have insurance, and there's the expectation of a law requiring insurance for all automobile owners. The opportunity in life insurance and health insurance is also very great.

There has not been a demographic shift creating the need for accumulation-type products in Mexico the way there has been in the U.S. and Canada. Life insurance is sold mainly for insurance protection. Whole life does have cash values, but policyholders are not buying based on expectations of strong cash value accumulation; they are looking for their protection.

The insurance marketplace in Mexico has evolved rapidly. Insurance companies can belong to integrated financial groups and one of those other companies in the group can be a bank, so insurance is being sold through banks. There are 13 companies in that mold. There are 13 companies having foreign investors. At this time a foreign investor can own up to 49% of the stock. Under the North American Free Trade Agreement (NAFTA), that will increase eventually to 100% by the end of the century. You can wholly own a subsidiary, and there are 12 foreign companies that do. There are three others that are private. There are a couple of governmental-type insurance companies. The nongovernmental private is 41 companies.

The foreign ownership in Mexico is spread among the U.S. and European countries especially. Of the 14 countries with companies having ownership interest in Mexico, all but about two came in within the last five years. It is fairly recent that foreign companies have taken an interest in the Mexican market. The list of foreign subsidiaries shows the same phenomena. The interest in having a subsidiary in Mexico is fairly recent.

This is not a picture of consolidation, but rather proliferation. You can't point to consolidation, but you can point to some very significant mergers. The first one, Gruppo Nationale Provinciale, probably shouldn't be classified as a recent merger, since the two companies had combined operations some time ago. The second was a 1994 phenomenon, namely the formation of Seguros Commerciale America. Each of these companies has about 20% market share, and neither of these are in the category of foreign subsidiaries or foreign ownership. Foreign companies are fighting among themselves for approximately 60% of the market share.

I think that many of the environmental pressures affecting Mexico are the same as here: the economies of scale, the raising bar for use of technology and customer service, and increased competition. Despite the growth in companies, many of the environmental factors that create consolidation are, in fact, in place in Mexico. So there is a trend and a counter trend. There is a trend that would say because of the expected growth and the interest from foreign countries, you would expect more companies and an increasing market, but I believe that this will be a somewhat temporary phenomenon. As insurance company revenues grow, initially, we'll see more companies. But, I have to believe that the economics will cause a shake-out in the not too distant future, and that the growth in the number of companies will not keep up with the growth in the amount of revenues. There will be a period of consolidation and some sort of stabilization at a rational level share of market.

MR. ANDREW GIFFIN: I will try to tackle the rest of the world and in doing so, we'll look at some numbers on how markets are consolidated. We will talk about who the top players are, and what market share they hold. Unfortunately, that's a fairly confusing picture because each country has very different histories and market conditions. I think there is a very consistent view that you can come up with when you put it all together. That is that, yes, the life insurance business is consolidating worldwide, but there's a broader story to be told here. That story is that the life insurance industry is becoming part of a broader financial services industry, and we need to consider what the factors are and what the implications of those are as we go along.

If we look at the life market in most countries, and I will focus particularly on examples of the developed countries, we'll see the top places of the life companies holding relatively steady, although with some shifting of market share. In each of these places, we find a declining role in traditional life insurance. We also will see some new players entering the picture in terms of the top ranks. These players typically are somewhat different types of companies and tend to bring in different kinds of financial services. What we're talking about is, rather than simply a consolidation in the industry, a restructuring of the industry and a development of new, broader financial services industry.

If we look first at the U.K., we see that the top ten companies as of 1993 held a 48% share. That's up from 43% in 1989. The top 20 are at 67% up from 60%. There has been a fairly dramatic movement in the U.K. market, particularly as seen in the 1994–95 numbers. We have the emergence of bank assurers, Natwest Life and others that now take 19% of the premium. Six of the major bank assurers are now in the top 30. That's a recent phenomenon in the U.K. The opportunity for bank assurance in the U.K. has been there for a long time. There's one example that's over 30 years old, TSB. But for the most part, the large clearing banks and the major building societies have developed their own life insurance operations only in the last few years.

Of the Canadian companies, several are selling out: Confederation Life Insurance Company, Manufacturers Life, and Crown Life Insurance Company. In the U.K., there's Laurentian General Insurance Company, Inc., and other Canadian companies that have been in that market for a long time. They are not major players in the market, but consistent players. Another movement is the reduction in the direct sales forces, with major movements of old time players like Lloyds Abbey going from roughly 3,500 representatives to 2,500. Even some of the new players, such as Natwest Life, are looking to move from 1,500 to 1,600, down to about 1,000 as the distribution side of the business has a shake-out with the Financial Services Act and all the problems with pension products and commission disclosure being introduced in that market. The regular premium business has been down as a result of the misspelling and disclosure each year since 1991. We also have the entry of some new players: Marks & Spencer, a major retailer, and Virgin, a music and airlines group—a very interesting retailing group. We have the infusion of some new players, and so in that sense, consolidation is being used somewhat.

The character of the players in the industry is changing rather dramatically. If we look at some recent announcements by the Prudential in the U.K., the largest life insurance company, it's talking about acquisition in terms of rationalization as it sees it in the industry. Prudential also is considering getting into some new lines of business, such as banking and other financial services. The U.K. is a good indication of what the trends are in terms of the change of the structure of the industry and is consistent with the kinds of movements we're seeing in the U.S., Canada, and Mexico.

Australia has an interesting and more dramatic change in structure, and yet the consolidation in terms of the top ten and the top five are actually down from 71% in 1991 to 57%, and for the top ten down from 86% to 78%. The consolidation and restructuring is not necessarily reflected in an increase in the market share of the top companies. The annual premium companies actually dropped from 47% to 36% from 1990 to 1994. Annual premiums are down sharply as a result of some changes in tax laws with respect to retirement income options and a sharp rise in the role of banks and the marketing of those products. The number of life agents is down dramatically from 15,000 to 5,000 over the last four years. These are brought along by tax code changes and products and the introduction of disclosure commission in that market.

We see a growth in retirement savings. This again is another basic market trend worldwide in terms of the movement away from traditional life insurance and the growth of retirement savings business in its place. When we look at the emerging markets, what we see is growth in the life business, but in many cases, a much more rapid growth of retirement savings alternatives at the same time. In Australia, the bank assurers are playing an increasing role.

If we look at Germany's market, traditionally, it has been very stable, slow to change, and highly regulated. We see some change in terms of a drop in the concentration of the top five down from 35% in 1984 to 31% in 1994 and the top ten down from 50% in 1984 to 46% in 1994. The number of companies is now going up from 101 to 125. The top ten are the same companies, with the exception of Deutsche Herold, which is a subsidiary of Deutsche Bank. Deutsche Bank has gotten into the life market first in terms of its own company and then with the acquisition of Deutsche Herold and the development of a broad range of insurance operations. Even in a market as stable and constrained as the

German market we see the introduction of bank marketing, bank influence and restructuring of the industry. One of the major influences on that is the introduction of foreign competition as the European Union rules develop more of an open market approach. The German regulatory system has made it very difficult for foreign companies to come in. That's now increasing with a variety of cross border and direct operations within the German market. We can see that bank assurance will certainly grow in addition to the Deutsche Bank. The largest company, Allianz, has several joint ventures with banks. That will become a major factor. This consistent picture is of the growth of a financial services business, which will be the market we need to talk about in the future, as opposed to simply life insurance.

When we look at the Netherlands, we have a confusing trend in some ways, because we have a highly concentrated market, where the top ten companies moved from 77% to 83% in that period, led by some very large players. For example, Internationale Nederlanden Group (ING) led with 27% of the market and Aegon had 15% of the market, among a total of 90 companies. It is a very concentrated market, and probably the market where the most concentration has occurred in terms of the intermingling of banking insurance, with ING also being a major banking force. A great deal of intermingling of financial services has occurred in the Dutch market and high concentration has resulted, with major banks and major insurance companies being combined.

The significance of the activity in the Netherlands is not simply within the Dutch borders. Rather, the Dutch people have always been active world traders and one of the things they will do is to spread their experience with the combinations of financial services to a variety of markets.

If we look at France, as people who deal with Europe will suspect, it is always a confusing picture. There is a great deal of movement in the French market, but relatively little movement in terms of the top life companies—a movement from 1991 of 40% for the top five up to 41% in 1993, and from 56% up to 58% for the top ten. The large nationalized companies that are all in the process at some stage of privatization, CNP, UAP, AGF, and GAN, still dominate the market. The major new player in the top ranks is the AXA Group, built up from a collection of companies. It is a company to watch in terms of global trends as it develops a large market stake in places like the U.S., Australia, and a new developing operation in Japan. Thus, there is the introduction of a significant new world player who is going to have a significant influence on the French market as well.

The bank assurers have played a major role in France, using a product which is not an insurance product in the sense that it's a tax-advantaged CD with no life contingency. The bank assurers now hold 40% of the premium and actually distribute more like 54% of the total premium. Foreign players hold a large share that's been estimated as high as 60%. That's recognizing a lot of cross ownership within the French market. There's a great deal of foreign participation, but not so clearly defined foreign-controlled companies. You find throughout Europe much cross ownership which further confuses this discrete definition of what is a life market and what are other financial services markets. We see a somewhat slower evolution of the process of development in some ways and yet bank assurance has grown very rapidly in France.

If we look at Japan, it's a very controlled market in terms of regulation and tradition. The top five companies hold 59% of the market; the top ten hold 81%. So the market is fairly highly concentrated with some very large companies in life insurance, which is buoyed up by the fact that they have the highest life insurance penetration in the world. It's a very large business, it's a very large market, and there's been relatively little change in recent years. But also in the last two or three years there has been some major changes in terms of the success of the industry with the down turn of the economy and the down turn of interest rates. There has been considerable pressure for the first time in many years on the Japanese industry. They've had actually a down turn in premium, down 5.5% in 1995.

With all of these changes, we're finding that the Japanese government is responding with the introduction of some structural change, which is rare and will be slow in coming. It is the introduction of allowing the nonlife companies to form life subsidiaries. It's interesting that many of the large nonlife companies historically were combined with the life companies, but are developing new life companies on their own rather than recombining with their old partners. That's the phenomenon that will change the industry the most in the short term if we can think of Japan in short terms. Banks will be getting into the market and foreign players will eventually get more involved. Up to now they hold about a 3.1% market share. There are a variety of means by which the Japanese culture, tradition, economy and regulation make it difficult for foreign players to gain much of a foothold in that market.

If we look at reinsurance, there is even more clear concentration. I think this is a further indication of the growing concentration particularly in the life market per se, with the top four holding 39%, up from 22% in 1984 and rising. What we're seeing is a restructuring in the reinsurance market. An example being those getting into the direct business in the 1980s and then recently getting out of it and reconcentrating on reinsurance. We saw many players get out of the market who were partly in reinsurance, as well as direct business. We're seeing a concentration among the traditional reinsurance specialists and some new entry. There is some money flowing into Bermuda, Mid Ocean Reinsurance Company, and others, to pick off particular parts of the market where the professional reinsurers and the companies that have reinsurance have found it difficult going. In that market, we see increasing risk, increasing capital needs, and globalization of the business to the point where a more traditional form of concentration can be viewed and understood in that way.

When we look at emerging countries, we see different patterns. We see countries like South Korea and Taiwan, where there were traditional leaders until the expansion of the market in 1987 and following. Those leaders have tended to maintain their leadership position, gradually giving up market share to new domestic and foreign players. Then we have markets like Indonesia where we have foreign players playing a major role in the development of that market, and places like Spain where foreign players have always played a fairly significant role. Bank assurance has influenced these developments.

Then we have life insurance markets being built today on top of newly reconstructed retirement savings markets. Chile and Argentina are examples where simple accumulation account retirement programs have been built. Chile is developed, Argentina more recently so, and companies now are trying to build life insurance markets on top of the retirement markets as those economies stabilized.

If we look at one of the market forces that is favoring consolidation, I think the shift in the market from life insurance protection, or various kinds of traditional products in various markets, to asset accumulation, mostly associated with the aging of the population, is very important. Of course, in the emerging markets in countries like Ireland, they don't have the same aging pattern, but in the long term they will certainly move towards asset accumulation for retirement. The demand for simple products there offers the opportunity for banks and some other players to get involved. We see widening competition. I think that suggests consolidation in the traditional life business, but a widening of the definition of the marketplace. The consequence of that is margins being down and trends toward consolidation as Fred described.

Technological and regulatory change add to the changes we see. Along with the market change towards forcing financial services together, regulatory responses in the same direction will reduce the regulatory barriers between types of institutions.

Finally, the search for efficient distribution, as the margin pressures increase, will create another way we move towards restructuring, not simply consolidation. We're not looking at an industry which is going to become smaller, more concentrated within its own previous historical definition, but we're going to see a great deal of restructuring built around distribution alternatives.

The outcome of this quick tour around the world is the fact that the trends we've been talking about in terms of the U.S. and North America are reconfirmed in terms of what's going on around the world. In some markets, Australia, for example, it is a much more rapid restructuring of the market, but it is a much smaller country and a more concentrated market in terms of where the companies are located and that sort of thing. I think we see very consistent trends worldwide comparable to what we see in the U.S., which for better or worse says that they're not likely to change any time soon.

MR. BEUERLEIN: As Jim mentioned, my company was purchased for $1.2 billion last year by American General. As we heard here, we're going to see more and more of it as things continue to change. Fred, you described a trend of companies going down to about 1,800 companies. Where is that number going to stabilize? What is the optimal number of life insurance companies?

MR. TOWNSEND: It's difficult to tell. That number itself is inflated, because it looks at the number of companies, rather than the number of groups. It's not unusual for some organizations to have 6 to 12 companies within the group. AEGON has about 20 life insurance subsidiaries in the U.S. Will it consolidate some of those or leave them as 20 independent companies? I am surprised that 500 companies disappeared in just a five-year period. I suspect that in another decade we'll have 400–600 independent groups and perhaps come down to 1,000–1,200 companies. Many of the 1,800 companies today are just small single purpose companies. Many of them will find that it's not economical to be in the business. You do have many small reinsurance companies, and many small credit insurance companies. To the extent it's not economical to be in the business, or you don't have a defined market to operate in, I'm confident there will be a continuation of the consolidation trend.

MR. JOE B. PHARR: The returns on assets, were those statutory after tax?

MR. TOWNSEND: Yes.

MR. PHARR: We have talked about company failures, mergers and acquisitions, and the lack of returns on equity. Is the panel familiar with the pricing processes that go along within the company? In particular, are actuaries pricing our products and services on a realistic basis to cover all of our costs? Are we recognizing all of the capital that we need and making an evaluation of the risk that's involved in this line of business? Are we being realistic or have we been realistic in our pricing of our products over the years? Eventually if we're not, it's going to show up in returns on equity and GAAP accounting. Shouldn't we as actuaries be more prominent in having more realistic pricing? It's a wide question, but I'd be interested in any of your comments.

MR. MILHOLLAND: Joe, you're right. If you don't price for a return on equity, it's a safe bet you will get it, and if you look at pricing methodologies even five years ago, return on equity was not the primary measure. Frequently companies have not been able to rationalize their earnings to boards of directors by the way the products were priced. We've seen that change. I'd say in my experience virtually every company either prices on a return on equity or does a check after it thinks it has fairly substantially completed its pricing to see that it's getting its desired return on equity. That then brings the question of is the company doing that on a realistic basis for mortality and expense assumptions in particular? My experience is that pricing is getting more rational. I see more realism in the assumptions and improvement in expense ratios. More and more of my clients are getting closer to their target expense assumptions. I'd have to say it's a mixed bag in answer to your question, but I see a fairly positive trend.

MR. GIFFIN: I think the problem arises from a combination of factors. Obviously, there's competitive pressures on repricing. There's some limitations as to how much repricing you can do to solve a variety of these problems. I attended a session on using value added as a means of understanding the relationship between pricing factors and operational outcomes and the various things that drive profit and value in the company. I think part of what needs to be done in response to pressures to reprice is where you can't effectively reprice, you have to respond in terms of lowering expenses and changing the way you operate in a variety of ways. I think we should simply take a closer look at what drives profit in product lines and do a more detailed analysis of what it is we can do. What are the options to repricing in order to get the ROEs in line with what we have to do to attract the capital and keep the business going?

MR. TOWNSEND: My observation is that the stated process of pricing, as explained to us, has improved, but I maintain a healthy skepticism towards whether or not companies adhere to their stated processes. In many companies, anecdotal information suggests that they deviate from their stated process for various reasons.

MR. BEUERLEIN: As we see more of this consolidation, I think that it introduces much more discipline from the acquirers of this business. These acquirers will require ROEs at a much more uniform level than we have seen historically.

MR. PHARR: One of the points I'm trying to make is it seems to me as actuaries, and we're talking about ethics and being professional, we probably better understand what's needed to communicate it throughout the company. It seems to me that we as actuaries ought to take the ball and not allow inadequate pricing to go on. That's the challenge I'm trying to throw out, that we understand how this thing ought to go together, and we ought to take a stand on it to have more realistic pricing.

FROM THE FLOOR: A futuristic question to the panel. In South Africa we have relationships between banks and life insurers, cross-share holdings, and my futuristic question might be a bit fanciful, but is it unrealistic to believe that perhaps one day we could reach a stage where somebody goes to a one-stop financial services institution? Say, for example, there will be a set of boxes and from the one box you can choose your savings, from another box you can choose some disability insurance, from another box you can choose life insurance and so on. And, to simplify this even more, you can even do your retirement planning that way. Any comments on this futuristic, if not fanciful, thought?

MR. GIFFIN: I think that's very possible. The problem is if you're in this sort of business, what would I do in order to move in a direction that would be compatible with that. Because financial services have been very strictly institutional around particular kinds of products and companies, for example, banks have been known for having very specific products. Life insurance companies have been known for specific products. It's very difficult to go from that to one stop shopping. I think the more likely scenario is that financial services start being offered in suites of products. A good example is when you go to purchase a home, there are a variety of financial concerns that surround the purchase of a home. I can see somebody developing a home purchase shop of some sort where people have perhaps access to viewing homes on a computer screen as opposed to going out and walking around looking at them. A real estate agent would be involved in the process at some point, for example, the mortgage process, the acquisition of home-owner's insurance, credit insurance, and then you get to the point of why does somebody buy a home. There's usually some other financial concern that a person has. An individual might be buying a smaller home for retirement, there are retirement savings issues. An individual might be acquiring a home because of an increase in the family—family protection issues. There are other things involved. Now, the real challenge is what does this thing look like, and the only thing I can be absolutely sure of is it doesn't look like a traditional bank branch, and it doesn't look like a traditional insurance agent going door to door. It's something in between, and I think spending a great deal of time developing that kind of scenario is time well spent.

MR. BEUERLEIN: We have time for one more question.

MR. COLM FAGAN: It's more of a comment on the question on return on equity. I'm involved in advising a number of companies internationally. In other words, the company has a base in one country and distributes in another, and I'm often advising the company on the pricing. At the individual product level its pricing is OK, but if you look at individual policies, the company is getting its return on equity of 15% after tax or whatever its target is. I invariably find that individual policies are based on very optimistic assumptions on total sales volumes within that country's particular distribution channel and on the cost of doing business there. It is incredibly difficult to get it through to the marketing people. You have to bring the board of directors into it and to get the members to nail themselves down on the sales volumes that they're going to get for a certain price. So everything does go back to the fixed element of cost, especially if you're building a new distribution channel in a new country. The costs and the risks are very high, and I don't think they're ever factored in sufficiently.