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# Session 93D
# For and Against Industry Consolidation

**Track:** Smaller Insurance Company
**Key words:** Mergers and Acquisitions

**Moderator:** A. GRANT HEMPHILL
**Debaters:** SCOTT J. CIPINKO†
THOMAS R. DLOUHY
MICHAEL E. SPROULE
MELVILLE J. YOUNG
**Recorder:** A. GRANT HEMPHILL

*Summary: Speakers will discuss the forces driving consolidation and the advantages that small companies have to counter those forces. They will consider costs and smaller specialty subsidiaries within industry giants. They will address which size company provides best for the insuring public while still efficiently complying with government regulation.*

**Mr. A. Grant Hemphill:** The idea for this session was mine. About a year ago, I heard a comment, attributed to Dick Jenrette, that "5% of the eventual consolidation of the life industry has already occurred." I thought then that a debate on that topic would be interesting. Another year has passed with considerable consolidation. Are we now 10% finished with this phenomenon? What is driving it? What could stop it? But, more important, is it a good thing?

Let me introduce our debaters. These gentlemen are all reasonable people. In a panel discussion, they would all probably agree that a few more mergers are inevitable, and probably a good thing. They would also agree that the cost and benefit of regulations should be weighed, and that sometimes small company exceptions are appropriate. It would make a boring debate. I have found two

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†Mr. Cipinko, not a member of the Society, is Executive Director of National Alliance of Life Companies in Chicago, IL.

panelists who are willing to argue for extensive consolidation of the industry and two who will argue that any further consolidation is a bad thing. Perhaps we can present a balanced view by vigorously arguing the extremes.

In light of that I think all four gentlemen here should be allowed to later deny that what they have said here was their real opinion. They were just taking their side of the debate—their assigned point of view.

Arguing for consolidation will be two Fellows of the Society: Mike Sproule and Mel Young. Mel is a principal of Towers Perrin. Mike is executive vice president and chief financial officer at American Mutual Life. They each have extensive experience in mergers and acquisitions. I especially appreciate the fact that they would come here and face a certain home court advantage, because this is a session of the Smaller Insurance Company Section.

Arguing in opposition to consolidation will be Tom Dlouhy, FSA, who is senior vice president and actuary at Mid Continental Life. He's a former co-worker of mine, and I know he's very familiar with survival issues for small life companies. Also, Scott Cipinko, who is not a member of the Society, is executive director of the National Alliance of Life Companies. He has been a very popular speaker at the Smaller Insurance Company Section meetings in the past. I am Grant Hemphill and I am vice president and actuary at Western Security Life. It's a subsidiary of Indianapolis Life.

So the debate will be about the subject, "Resolved: the public would be well served by an extensive consolidation of the life insurance industry."

Our debaters want to know if they've influenced your opinion, so we're going to do a before and after poll. Right now how many would agree with the resolution? And how many are opposed?

**Mr. Hemphill:** I think it is about 50/50.

We have agreed, after much debate, on four questions that will cover this topic. Each side is going to have five minutes to answer the question and then each side is going to have two minutes for rebuttal.

The first question is for Scott and Tom. The question is, how will consolidation affect the life insurance consumer? Please consider products and pricing as well as service and delivery.

**Mr. Scott J. Cipinko:** I actually am the beneficiary of a merger, a merger of two trade associations, the old National Association of Life Companies and the American Council of Life.

I was speaking at an American Bar Association meeting in New York, and Jim Hunt, an esteemed actuary, was sitting next to me. Jim is a consumerist by nature. At the time I was working for the Consumer Credit Insurance Association. He said, Because of the National Association of Insurance Commissioners (NAIC) and what it has been doing, a number of small life insurance companies are going to be forced out of business, and perhaps that's not such a bad thing." How many consumers do you want to put out of jobs?

Insurance companies are made up of individual people who have families. They themselves are consumers. What happens if you have consolidation? Is consolidation a good thing? In a word, "No." Why not? It's not good for the consumers who work for the company.

It's also not good for the consumers who buy the products. And why isn't it good for the consumers who buy the products? The smaller companies are the ones that are out there trying the new products. Universal life comes to mind. The big companies must have their 15% return on equity (ROE). Often, but not always, they are afraid to expose their investments to a risky new product. The small companies, the innovative companies, the companies that are the life blood of the industry are the companies that have kept this industry alive. They've kept this industry at the forefront of progress. As a result, who's the beneficiary of this? The beneficiary of this is the consumer. The consumer gets new products, the consumer gets the aggressive new marketing. Marketing has turned into a bad word. Marketing is not a bad word. Marketing includes sitting in front of those prospects whether it's at their desks or their homes.

I've done this as a salesperson working for a large company when I was an agent. The first thing that we did when we started our agency was to become licensed with small companies. Why small companies? Because the small companies had the products that were more aggressive. At that time, we were operating in a higher interest rate environment. Those smaller companies were still more innovative. The small companies invited us as agents to sit down and design new products, including the second generation of universal life products.

These companies were the ones that put these products together for the consumer. If these companies hypothetically no longer exist, if these companies are merged into larger companies, large companies may have to answer to the Board of Directors. They may not make the required return on investment. Therefore, they're not going to take these risks. Why take these risks when you can market at a nice, safe, plain vanilla, whole life policy, or some participating disability policy that you know is going to make money, even though it will not best serve the consumer. Who is best served by consolidation? The regulators.

Consolidated companies are easy to handle, whereas a number of small companies and a diversity of products are more difficult to handle. However, how many companies have we seen that have dropped whole lines of insurance? Credit insurance is a perfect example. One company that wrote credit insurance, a big company, discontinued its credit insurance lines because their production was so small in comparison to the rest of its insurance products. However, it was one of the leaders in the industry. Big companies are also beginning to spin off small companies. What is going to happen in the future? You're going to see more of this. A small insurance company is going to be able to serve the consumer best; that's what is being recognized in the marketplace and I think that's what is going to happen.

**Mr. Michael E. Sproule:** We're making progress already here. I think the rational people should find any suggestion that consolidation will not make the life insurance industry more effective and efficient to be an incredible statement. So if you're arguing that the public will not be well served by consolidation, you must be arguing against the pursuit of a more effective and efficient industry.

Why would a more effective and efficient insurance industry be undesirable? Our opponents here have suggested several reasons: job losses, developing new or better products, supposedly, by small companies. Supposedly, small companies are willing to take lower ROEs, perhaps even inadequate ones. Aggressive marketing caught my attention in the era of market conduct. I also found it interesting that large companies have to be accountable to their boards of directors, which I felt was not necessarily a bad thing to hear. Also, we don't want to make life too easy for regulators. So I think we will probably have a chance to explore a few of these reasons as we go further.

We believe that not only will the public be better served by consolidation, but it's only through consolidation that the life insurance industry today will even have an opportunity to continue to serve the public in anything remotely approaching it's historical level of importance. But you don't have to believe me. This group is mostly made up of actuaries. You're used to dealing with reality and not perceptions. So I thought we might start by taking a look at a few facts.

The face amount of whole life insurance sold has been flat, in nominal terms, for ten years. On an inflation-adjusted basis, this product has lost 40% in terms of real buying power. Later in this discussion, Mel Young is going to share with you some numbers that show the percentage of insurance assets to total personal assets. The decline on that measure has even been more dramatic and is a decline that has gone on for a 25-or 30-year period.

The number of new ordinary life policies sold per year has declined 20% in the last ten years. I'm talking about the product—the traditional life product—that accounts for 60–65% of the $2.1 trillion of assets of the life insurance industry in the U.S. The tax disadvantages of traditional products, particularly the state premium taxes plus the federal deferred acquisition cost (DAC) taxes, is reduced by the benefit of the inside build up. So a negative number means the consumer comes out ahead. Most policyholders don't hold their policies long enough and are not in a high enough tax bracket to actually benefit. We are, frankly, at a competitive disadvantage versus a number of other savings products that are not subject to these kinds of taxes.

The estimated return on new business is low. In fact, it's inadequate. A study that Tillinghast published recently shows a 9% median ROE. Why is that ROE 9% median? You know the answer. Distribution costs take 20% of the premiums off the table. And this product has to compete against annuities and mutual funds that cost 4–6% to distribute. In addition, life insurance is a very capital inefficient product. Fidelity manages $230 of assets for each dollar of capital. The insurance industry at the end of the 1995 managed $14. If you took out the top hundred groups, the remaining small companies averaged $6 of assets for a dollar of capital, and capital is expensive.

Consumers have become more sophisticated. Ask your cab driver when you go to the airport. Ask the lady who is cleaning your room. What you'll find is that they can talk about interest rates. I'll come back to this point later.

**Mr. Cipinko:** It is interesting that the amount of sales has been flattened. It is interesting that the number of sales have decreased over a ten-year period. What have we seen over that period? Increased mergers, increased acquisitions, decreased outlets, decreased numbers of sales people, decreased numbers of policies, decreased choices, fewer agents, fewer policies, lower face, lower sales. If we continue in the way we are going, this downward spiral will continue. We're not just talking about decreasing numbers of companies so that things can be more efficient. Just remember, more efficient is a bottom line issue, but it's not particularly more effective in the long run. Bigger is not necessarily more effective; bigger does not necessarily mean that you're going to have a better handle on your operations or that you're not going to have market conduct problems in your distribution. Bigger is not always better.

Smaller companies do not necessarily require smaller ROEs, and often do not generate smaller ROEs. A smaller company's ROE, when compared to the larger companies, may be smaller. And yet, some of the smaller companies are very attractive to larger companies for one very good reason—they're out there marketing, increasing their earnings, and increasing their capital.

Once again, the increased merger activity has shown a decrease, or, at a minimum, a flattening of sales, a flattening of premium, and a flattening of the ability for the insurance company to grow. If we keep this up, we're not going to gain ground, but we're going to lose ground on other financial products.

**Mr. Melville J. Young:** Let's discuss a ratings bias by size. Based on ordinary expenses there is, again, a size bias. Part of our argument is that we have to wake up to the fact that there are other financial institutions selling the kinds of products that we would like to sell. We have to be competitive with them. There is a ratio of capital and surplus to assets. It's a size bias. These are averages, not weighted averages. If you need to attract capital, there is a size bias here. These things tend to come together. Scott is inferring that all small companies will disappear. We're not saying that. There's going to be an ongoing role for some small companies. This can be smaller, or fewer of them. It's ignoring that the industry is moving toward accumulation products; that the buyer wants; we can't stop that. The buyer is moving towards accumulation products. We need to be competitive with other financial institutions. That insists that there be some kind of consolidation in the industry. We have to consolidate to remain viable.

He says there's a decrease in the number of sales people. That's the expensive commodity. There has been an increase in alternative distribution. Again, those people tend to sell for the larger institutions. One of the things that belies his comments is that agents haven't been servicing the middle market anyway. It's too expensive.

**Mr. Hemphill:** Gentlemen, you're doing a great job with keeping to the time limit. This question will go to Mike and Mel first. How will consolidation affect the profitability and the viability of the life industry?

**Mr. Sproule:** First I'd like to comment on the last question and finish that one up a bit. What we've seen really is a need to become more competitive against nonlife insurance companies. We cannot look at our competition as only being within the life insurance family. That's really one of the fundamental problems. One of the unfortunate things is that the facts that we've been talking about are terribly inconvenient for those who would argue against consolidation. We'll keep coming back to these basic themes as we go through this discussion.

The issue of improving profitability and viability through consolidation, from my perspective, really is almost a no brainer. My own company is a real example of the benefits of consolidation. In 1994, we went through a merger of the old American Mutual into then Central Life. Central Life took the American Mutual name. As a result of that we were able to, during the course of the period of discussing the merger and finalizing it, take 20% of the pre-merger costs of the two companies together off the table. That's close to 50% of the cost of the smaller company, in this case the old American Mutual. Substantial value is created through that exercise. In present value terms those expense savings are probably the equivalent of about 25% of the statutory capital to the company.

Expense consolidations are very easy, and savings are very real. It's not just savings that you can talk about from administrative operations. You can consolidate product lines, and you can move to common administrative systems. You find you don't need two of a whole lot of things. You don't need two investment departments, and you don't need two human resources departments. You don't need two tax departments, and you don't need two chief actuaries. You don't need two chief executive officers (CEOs), and that often stops these deals from going very far.

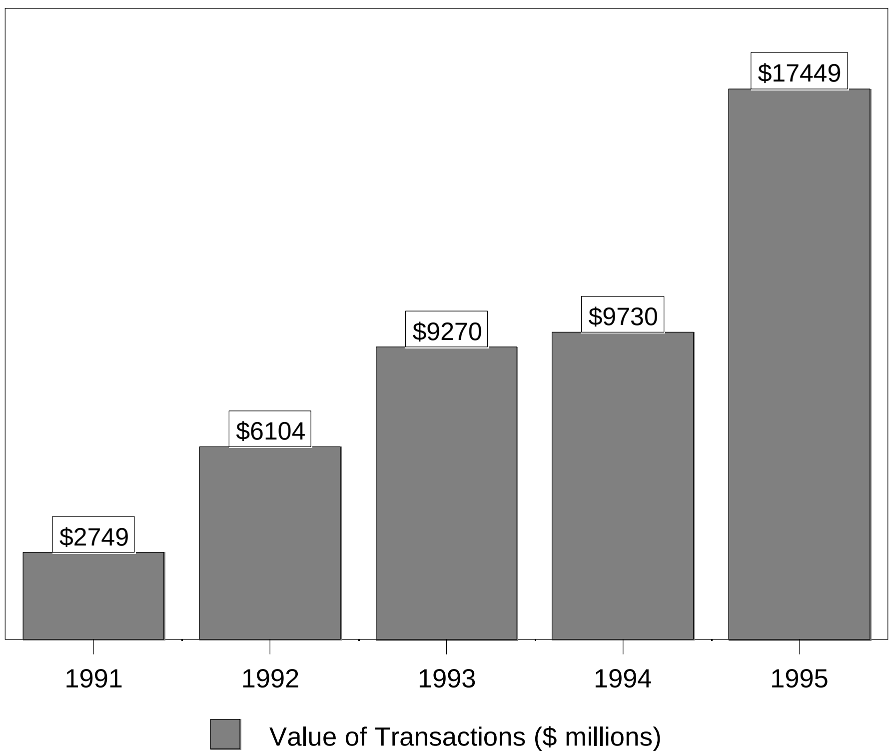
Expense reductions are not the only story though. In our case, sales in 1995, following a merger, actually went up in terms of performance against the industry, and that happened despite going through the simultaneous integration of a personal producing general agent and a career agency distribution system. Rating agencies can react very positively to the benefits of scale and the improved financial strength. Balance sheet quality can be better as a result of the consolidations that are going on in the industry. I think that has been a driving force for several of the companies that have been involved in these kinds of transactions.

But it's not just profits that should improve from consolidation. If the transaction is going to make sense, the new company should be strategically more viable at the end of the transaction. And by that I mean it should have a more sustainable long-term competitive position. Also, as a result of these transactions, it ought to be able to provide the employees who remain with the company past the short-term dislocations with much improved long-term job opportunities and prospects. I know that was true of our particular merger that took place with the two companies in Des Moines.

It also should enable you to offer better products for your agents and your customers. You can cut your expenditures in product development, but compared to either company before you can end up investing much more in terms of product development activity. You can do a better job of providing products that meet the needs of your customers, and that are saleable by your agent and distribution forces.

Given all the potential benefits, what has happened in mergers and acquisitions (M&A) activity? You can see from Chart 1 that M&A was $2.7 billion in 1991. This is both life and property/casualty. It exploded to more than $17 billion in 1995, and 1996 promises to be an even bigger year. So maybe Dick Jenrette was not too far off with his comment that only 5% of the consolidation had been done a year ago, and the estimate of being 10% completed.

CHART 1
REVIEW OF 1995 ACTIVITY



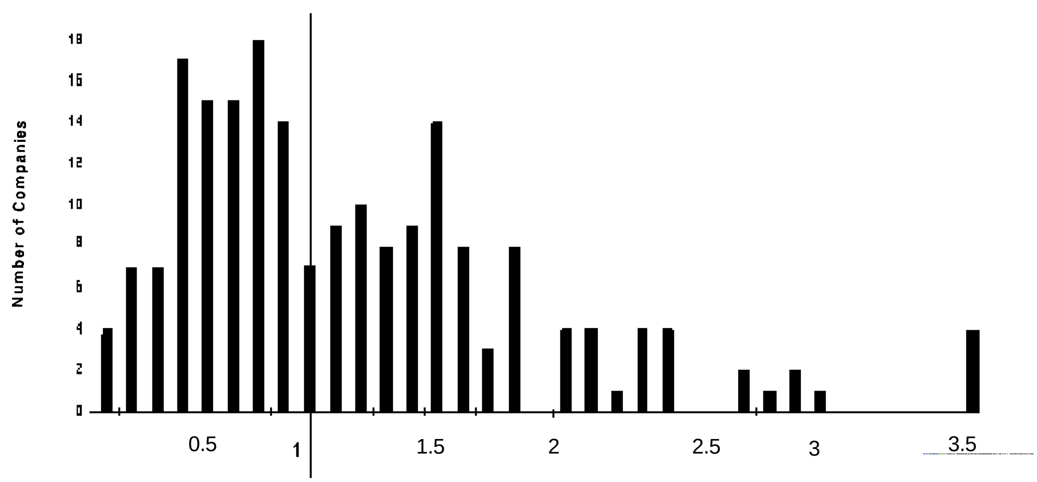

Part of what's going on in the transaction is a sharpening of strategic focus. Met Life, for example, exited the health insurance business and acquired New England Mutual. Travelers exited the health insurance business and picked up Aetna's property/casualty business and promptly spun half of it out the door. Aetna exited the property/casualty business by selling it to Travelers, and then did a major acquisition in the health care arena. What's going on here is that companies are doing fewer things, but they're trying to do those things better in order to remain competitive and viable.

Achieving and maintaining critical mass is important. If you don't have it in your businesses, you better get it. If you can't get it in those businesses you're in, you better find something that you can. Every one of these repositioning moves will not be successful, but I think what we'll find at the end of the day is that all of these transactions will result in a more successful company than otherwise would have been there.

**Mr. Thomas R. Dlouhy:** I would like to address several interrelated topics in regards to the profitability of life insurance companies, and why I believe that extensive consolidation is not the only answer in improving the profitability of life insurance companies.

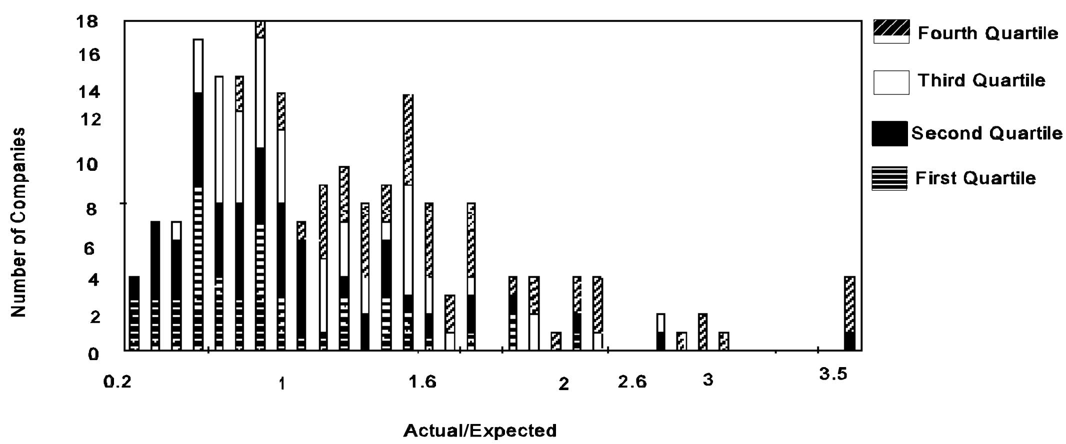
The first item is expenses. In order for the industry to be competitive in the financial services arena, unit expense must go lower—I mean both distribution expenses and home office administrative expenses. Let's look at a graph. Chart 2 is a reproduction of one that was part of the development of the generally recognized expense table. It is a graph of actual-to-expected expenses for the top 200 companies ranked by size of expenses. If I draw a line that is the actual-to-expected ratio of one, about half the companies are on the left-hand side of that line and are companies that have expense ratios below the industry average. On the other side are companies that have expense ratios above the average. Now what's your expectation? Do you think these are all large companies down here and these are all small companies up here? Well, let's take a look.

CHART 2
MEDIAN EXPENSES (ALL COMPANIES)




In Chart 3 the bottom lines here are the top quartile, or the lowest expenses. The bottom bar is the largest companies. The next or solid bar is the second quartile of company size, then comes the white (third quartile), and the slashed shows the smallest companies in the fourth quartile. You can see that there's a wide distribution of companies in the expense levels. I know there are economies of scale. I admit that. There's no denying that there are economies of scale. But notice that there are plenty of large companies across the expense spectrum and small companies across the spectrum. It's the companies over here on the right-hand side that definitely need help and need to do something. But is consolidation the answer? I contend in some cases yes, for companies that cannot fix themselves, and for others, no. Companies out in that right side can restructure, refocus, and grow their business. There are other ways to improve; consolidation isn't the only way.

CHART 3
MEDIAN EXPENSES (BY COMPANY SIZE)




Also, remember that a smaller company that's in a niche market can command a higher price premium, and, therefore, it can support a higher level of unit expenses.

Now an interrelated topic is critical mass. And I contend that it's smaller than what you think. For a company that is focused and doing one thing well, critical mass is attainable at a reasonable level. The key element is to not try to be all things to all people. Focusing on one niche or product line is what a small company should strive for. There's no doubt that a certain level of business is necessary to achieve critical mass and be a viable concern. I contend, however, that level is within reach of most companies if they focus on their core business and shed the burdens of noncore markets or lines of business.

Another point is something that my fellow debaters referred to already. Why is it so difficult for life insurance companies to write profitable business? They put up a graph that showed that profit on new business is below what's expected. Many of the companies were below 10%, but one thing they did not show you from that same study was that about two-thirds of the top one hundred companies aren't even making a 10% return on new business. I find that incredible. How can two-thirds of the top one hundred companies have long-established distribution systems, hundreds of thousands of policyholders and competent management, and not sell a product that provides a fair return to their owners?

It's also my belief that small companies do want a high-level return. I do not argue that small companies will live with a lower ROE level. And the problem is not simply that small companies are not getting the return; it's across the industry, and all companies must achieve a proper return.

**Mr. Young:** Mike suggested that I comment on something that Tom just said. Again this shows clear bias toward size and profitability. We're not saying that every small company doesn't have a good niche or that every small company needs to go away. We're at 1,800 companies and many of them are going to have to go away. Many of them aren't doing a good job. Jenrette was on target about what he was saying. We are going through a consolidation period. If you want to dictate or have a role in determining where your company ends up, recognize that and start thinking about it, and find a way to fit. Perhaps a larger organization is going to have a better chance of competing in today's world. Some small companies will be terrific boutiques in a special focus market. I agree with Tom. Many of the companies are going to have to go away. That's all I need to say.

**Mr. Dlouhy:** I was talking about companies making a good return on new business. I concede that there is ROE bias for the total company. I'm looking forward, not back. There's a lot of in-force business supporting this level of profitability in large companies. But where is a company going as it moves forward? It's the new business that's important and crucial to this industry. If the industry can't return a profit on their new business, that's the problem. Their problem is not where the in-force business is or the fact that there's a lot of business out there and a big company supporting this. So remember that the problem is not looking backward but looking forward. It's important for companies to write profitable new business, and that problem is across the board not just in small companies. The small company has the opportunity to change quickly and sell that higher premium product if necessary in a niche market.

**Mr. Hemphill:** The next question goes to Scott and Tom. How are environmental trends in areas such as government regulation, technology, demographics, consumer opinion and so on, affecting consolidation?

**Mr. Cipinko:** I really think that the size of a company is not as important as the quality of the company and the markets in which it operates.

The NAIC had a meeting with A.M. Best recently because we were concerned about this self-regulatory organization for market conduct that it had all but endorsed in the media. Small companies can't comply with such a system easily. If you have 23,000 independent agents, you probably can't comply with this. This is one of those environmental pressures we're talking about. A.M. Best even stated that if you're not going to comply with this program you had better have a good reason why. We went to Oldwick, New Jersey and asked it to clarify its position. It said, it was misquoted because Larry Majewski (A.M. Best) wrote the article. Larry said he made a mistake, an overstatement. Realistically, big is not better. He hoped to someday give the most superior rating to the smallest of companies. They can do it and they will do it. There is hope out there for small companies.

What is going on now? We testified before the National Commission on Economic Growth and Tax Reform (Kemp Commission) in Cleveland. Seven people testified, but the NAIC was the only one that even cited a section of the Tax Code. It's very scary. Everyone was talking about a flat tax, a fairer tax. We spoke about small company problems. We spoke about the DAC tax. We spoke about Section 809, and about many of these issues that are forcing companies, literally, to consolidate. When it comes to the DAC tax, it is such a regressive tax that smaller companies cannot afford to write new business because they pay the DAC tax on any new business. So what do they do? They buy blocks of business. They may not buy companies; they may not merge; but they acquire business.

A prime example of regulatory pressure is reflected by what Jim Hunt said. In the small boutique companies, credit insurance for instance, regulators keep decreasing the rate in the states. The whole rate goes down irrespective of your cost of doing business.

Technology. What can I say? What does it cost to do cash-flow testing for a small company? If you don't buy a system, if you don't create a system, you must rent a system, or you must hire someone else who rents or owns that system. These systems aren't cheap. In addition, there are annual upgrades.

What is consumer opinion doing? What are the demographics doing? What about the big companies that we always thought of as the safeguard companies. These companies have allegations and multimillion dollar lawsuits thrown against them. There's a shifting ground of public opinion. Where can the consumer turn? Consumers may feel that they can no longer go to the big company. Perhaps they're going to go to the company that's down the block in their town. Maybe they go to the next state. Maybe they go to a company that may not have the absolute highest ratings, but perhaps is doing a good job and has the niche products.

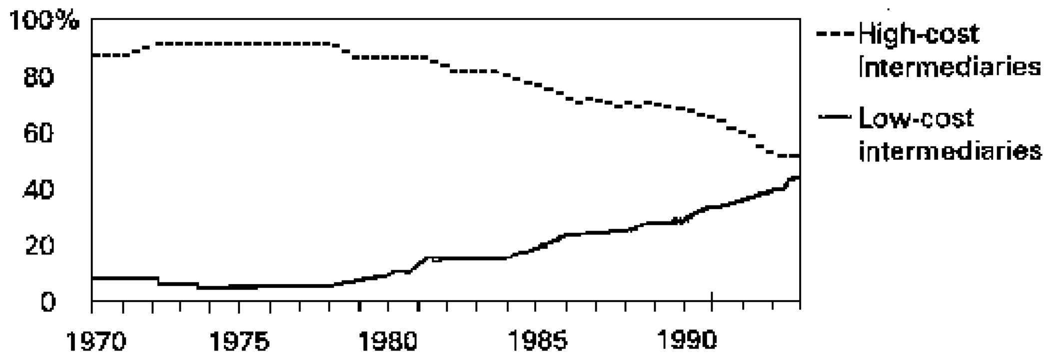
There is still room for the boutique company, and there's room for the big company. There is room for peaceful coexistence; however, what you have now is regulation, legislation, taxation, consumer opinion, and everyone pushing. The effect is like a trash compactor. Ultimately, as the box gets smaller, what's going to happen is what is happening right now. Slipping out of the box are former CEOs of the insurance companies and former head underwriters of insurance companies. They are seeking investors, and we are seeing the rise of the new boutique insurance company. Ultimately, as I said before, there's a reason for that. The market pressures that cause this are not solid walls. These are cracks. And what happens? Quality people slip through, and new companies are created to meet the consumers' needs.

**Mr. Young:** I spent most of my career in the insurance industry, but not in consulting with small companies. I learned that you have to, in small companies, do more with less time. You're caught between the proverbial rock and the hard place in today's environment.

In the past, life insurance has focused on helping a specific traditional family group. That's changing. The whole life product was designed to protect the livelihood of the family, discipline savings, and to provide emergency funds. That's just not there anymore. Consumer expectations and demands are changing in fundamental ways. Wake up America. There's a shift of risk and accountability to employees. There are group purchasing advantages, shorter time horizons, flexibility, and a more informed population. They're expecting more of us, so we have to provide more than we have in the past.

Financial security remains important, but new competitors are appearing and consumer needs are shifting. We have to look beyond what we've always looked towards as our competition Look to the new world, the new competition. Chart 4 shows what's happened to what we call high-cost intermediaries, which is conventional whole life, over this 26-year period. What has happened to the low-cost intermediaries? And by the time you get to the end of this decade they probably will have passed us. These certainly have been major inroads. The world is changing. There's a startling clear trend and we cannot ignore it, as I said before. There's a tidal wave. And we can't hide our heads in the sand. Consumers' expectations of value just aren't in our favor.

CHART 4
MARKET SHARE OF PERSONAL ASSETS HELD BY INTERMEDIARIES




The traditional whole life insurance premium has been your bread and butter; it's what has been paying for your operation. The high-cost distribution has been very flat. The risk pieces have been somewhat flat. The only place we've had growth is within the accumulation side. And there's a strong size bias in that piece of the industry.

And the problem, as everyone has made mention on each side of the debate, has been distribution cost. Interestingly, so far, the people who have done anything as far as expense control have been looking at the home office. Virtually no one has done anything to address this problem other than to start developing alternative distribution systems. Alternative distribution systems typically are not going to sell for small companies. Again, I'm not saying all of you are going to go away, but many of you have to go away, so start planning for it and get yourself positioned so that you end up in the right place.

The way we've been selling our products just isn't going to work in the future. Table 1 shows the importance of bank distribution in other countries. We started talking about tidal waves. There has been a tidal wave in bank distribution, and as an industry we've been hiding our heads in the sand. Again, banks tend to want to do business with larger institutions. There are different ways to get there. You don't necessarily have to merge. We could have mentioned potential alliances, joint ventures, and forming cooperatives. There are many things you could be doing, but you have got to start planning for it, so that you can dictate or have some role in dictating where you're going to be.

TABLE 1
PERCENT OF LIFE INSURANCE AND ANNUITIES
DISTRIBUTED THROUGH BANKS

| Country | 1994 | 2000 |
|---|---|---|
| France | 55 | 60 |
| Netherlands | 22 | 35 |
| Spain | 21 | 40 |
| Belgium | 20 | 40 |
| U.K. | 16 | 28 |
| Italy | 12 | 30 |
| Germany | 8 | 14 |
| U.S. | 25* | ** |

*Primary annuities
**Regulatory and logistical barrier

**Mr. Cipinko:** Let's look at shifting expectations and demands. Let's consider flexibility. Flexibility is important. For instance, one of the things that we learned in the drafts of the NAIC Life Illustration Model Regulation was that some small companies are more automated than the huge companies. Some of these huge companies still, unfortunately, rely on paper and microfiche. Smaller companies have really been able to automate from the group up and thus have more flexibility.

With regard to the competition from banks and from money markets, let me make a prediction. Here is what I see after some time on Capitol Hill. I see a uniform regulatory system for banks, insurance companies, and thrifts if there are going to be any left. What you're going to see is an overarching authority—the Office of the Comptroller of the Currency. Everyone is going to be under one roof. Ultimately, what you're going to have, is a form of state regulation but it may just be for rates and forms. So there is definitely going to be consolidation in the regulation as well.

Small companies, for the most part, have not taken a formal position on banks and insurance. Why not? Many of the small companies in many of the small towns have been doing business with banks for a long time. They've been flexible, and they're going to continue to be flexible. Small companies use pooling of capital, so that the small companies can have the buying power of a billion dollar company and get those types of returns. Modernization is going to be very important, allocation of funds is going to be very important, and pooling of your resources is very important.

**Mr. Sproule:** I don't think we're saying that we're in favor of the present environment. I think what we're saying is that, unfortunately, we have to deal with reality as it exists out there, and not as we might like that environment to be. My company happens to be about a $4 billion life company, 0.03% or so of the U.S. insurance marketplace. We operate virtually nationwide. To Prudential and

Metropolitan we are very much a small company, a flea on the scene from the perspective of that kind of a company. I hope Scott is correct in saying that consumers are going to go past those companies and go down the street and find that company in Des Moines. I hope that's Amerus when they do that.

We need to remember that big companies did not spring fully grown from the womb. There's a need for people and companies that are going to challenge the status quo, and challenge entrenched thinking in the industry, and come up with good new ideas for meeting and exceeding customer expectations. As they do that, those companies will grow into big companies. That's where big companies came from. They didn't start big. However, making the industry more competitive has nothing to do with the consolidation that's going on.

That's not what this is really all about at all. Consolidation also doesn't mean that Met and Pru are going to inherit the earth. There are clear economies of scale, and I think every speaker has acknowledged that fact. There are great variations among companies of the same size in terms of their effectiveness. That's one of the challenges that all of the companies in the industry have. That's why a smaller-sized company can actually have a unit cost lower than many of the giants in the industry.

**Mr. Hemphill:** This question is directed towards Mel and Mike first. How will consolidation affect the ability of life companies to attract and retain talented employees?

**Mr. Young:** Just a little personal history: During my first 11 years in the industry, I was with seven generally small companies, and the reason I went to so many small companies is I kept getting bought out of business. I have a great deal of sympathy for a lot of the people in this room. Also, as a young actuary, I could see some of the positives of being with a small company. You were unable to do a wide range of things. It was perhaps a more interesting job opportunity than my alternative which would have been to go to work at Metropolitan. I have told many young people who were thinking about actuarial careers that it might be useful for them to start out working at small companies. It's good for young people to have a broader vision of the insurance business than they might get from a very big company.

My point is the winners will ultimately be the companies that end up with the most good people. If you look at the pluses and minuses as far as retaining and attracting talent, a big company will have more of an environment that will attract a greater number of talented, good people. I think consolidation creates more meaningful job opportunities at larger companies. The small company provides job diversity, which is good when you're younger, but as you mature, I think that you'd like to be on the larger company side of that.

The big company provides a think-tank culture. I've spent a lot of time in small companies, and it can be very lonely. The only one that you're ever going to bounce ideas off is the consultant and his interests generally aren't the same as your interests. Having somebody within your own organization whom you can bounce ideas off of is very useful. The other side of that is you do have greater authority in a small company. That's nice, particularly when you're younger.

I agree with the research and development (R&D) comment Scott made mention of earlier; because of perhaps greater flexibility at a small company, some of the initial ideas of the industry started at small companies. But the development of those ideas usually came at larger companies where there's an R&D budget that can carry the idea out. Also, the big company can provide the technological support for it. At a large company, except for the CEO, there's greater potential for financial rewards. At a small company you might have more flexibility, but when you mature in an organization and you're looking for more financial reward, a larger company provides greater potential.

As I said before this is a changing time within the industry. You need capital to meet the changing needs, and there is greater financial wherewithal in the large companies to start new ventures. The con on that is that there's less red tape in the small company. There are some big companies whose names will not be mentioned here—no matter how much talent they have, even at the CEO level, they're ground down in cement and they can't accomplish anything. Mike made reference to that problem earlier, but that doesn't mean all larger companies are going to be faced with that. Generally speaking, there might be better job security at bigger companies because you're less likely to be taken over. Although there are some companies in Connecticut and Massachusetts recently that might say no job is safe.

The most important parts of this, in my point of view, are (1) the talent depth, (2) the think-tank environment, which is something that you'll find in a larger company, and (3) the greater resources with which to do things. Again, you're going to find these in a larger company and you'll also see the greater potential for financial reward. I think that a larger organization, again, with a good CEO, gives you a better chance of accomplishing those things.

**Mr. Dlouhy:** I think you've answered the question for me. It's my opinion that the life insurance industry today has difficulty attracting talented employees. And I also believe that extensive consolidation will make it even more difficult. Let me explain why. For simplicity, I will lump employees into two main categories, field or agents and home office employees. Lets talk about home office employees first.

Life insurance companies are considered large, profitable, corporate-type employers by the general public. The home office jobs are considered good, solid, white-collar employment, where an employee can expect good benefits, good job security, below average stress, but also, in many cases, below average pay. It's a conservative environment that encourages conformity, a lot of meetings and red tape, and a nine-to-five work attitude. I believe the industry today tends to dampen creativity and doesn't necessarily reward high-level performance. How will this change with more consolidation? I believe it will get worse. Companies will continue to be buried in red tape. Larger companies may become more efficient over time through economies of scale, but that may come at the expense of creativity and independent thought.

Today many companies preach empowerment and personal accountability. And I'm sure there are lots of companies out there that are making great strides at that. However, I cannot see that extensive consolidation will help the industry get there any sooner.

Now given this environment, what is a talented, young employee looking for today? Just the opposite. There's a strong trend toward entrepreneurialism among people in their 20s and 30s today. I think that trend is good. It's good for the industry and the country. How can the life insurance industry attract this talented youth? I believe it's through giving employees an environment where they feel they have some authority to do things their way, some personal ownership in their work, and the time to be creative. There's no panacea for achieving this environment. I do believe it is achievable in a small company, and even more so than in a large company. Smaller companies, of course, if they have the appropriate leadership, have an easier time creating that environment.

Now let's turn to the field. I'm not aware of any child who grows up professing "I want to be a life insurance agent when I grow up." That's because of public opinion towards them. In addition to the current negative attitude of the public toward insurance agents, many life insurance companies have turned their backs on their agents. They have done this by eliminating recruiting and training of new agents and by turning towards new distribution channels. Finally, they are blaming agents for much of the market conduct situations that are going on in the industry. Now this may be a good strategy for some companies, but if this continues, even with consolidation, there will continue to be an environment where many companies will be chasing the same agents. I contend that a successful company of the future will be one that can attract talented agents through long-term commitments and relationships with the company and establish a sense of loyalty and belonging.

What companies can create this environment? Once again, it's those companies with a focus and a commitment to creating a challenging and entrepreneurial environment. Extensive consolidation, I believe, will only make it harder to achieve that environment.

Mel addressed some of the reasons why I like to work for a small company. The challenges are tremendous. The opportunities are great. I get involved with all aspects of the company. But finally, the important thing, and I believe this is in all areas of specialties, is to make an impact. Employees want to make an impact and believe their job means something. I think employees in small companies have a greater feeling of doing that.

My last comment is that some argue that a large company can provide job security to the employee. I totally disagree. Large and small companies are equally vulnerable to consolidation and downsizing. A talented employee will know that it's his or her own skills and abilities that provide job security, not the size of the company.

**Mr. Sproule:** There are many major trends that we've been talking about, and they've all been creating a much more competitive environment that our industry has to deal with. I think today's board of directors have become much less understanding. If your CEO won't get things done they're going to go out and find somebody who will, and they're no longer reluctant to go outside the industry to find these people. I think the result has been a much greater sense of urgency on the part of the industry to get on with the necessary restructuring and dealing with the reality that we're all facing.

When you hire employees, you like to think you get the best and brightest. But it's hard to get the best and brightest to join a company if they think that company is going to be consolidated out of existence or is going to be a candidate for divestment, or if they think their division of the company is not strategically important to the company that they are joining. That's not a good way to recruit top quality people. I wonder how much job security the Met people in the health business, or the Prudential people in reinsurance, or the Aetna people in property/casualty had over the last few years. It is not just small companies that are going through this difficult time. I think it's everybody in the industry as these consolidations are taking place. Employees have learned it's better to be with an acquire, and it's better to be in the part of the company that's strategically important. Otherwise, they're going to be more likely to be a divestment candidate and subject to all of the difficulties that go with that. It's better to be in an industry that's growing and is profitable, instead of one that's competing for a bigger piece of a smaller and smaller pie. Unless we change some of our fundamental dynamics, we'll be competing for a bigger piece of a smaller and smaller pie, and that's difficult.

Consolidation is going to be very disruptive to many lives. I think you've all seen many people you know, and maybe many of the people here are affected personally by this. That's going to unfortunately go on. One of the rules of thumb that we've come across and that we've reinforced with our own experiences at our company is that 70% of the management team of an acquired company is not there within two years.

**Mr. Dlouhy:** I'd like to touch on a couple of points here. Mel stated that big companies tend to attract the talented employees, and I disagree. It's successful companies that attract talented employees. The talented employees or really any employee wants to work for a company that's doing good, doing right, and being successful. It's not based on the size of the company, but based on its success. Also, it was mentioned that consolidation will provide more meaningful opportunities at large companies. Why? I don't see it. They even said that you don't need two chief actuaries anymore. There are less meaningful opportunities, in my opinion. There may be a few more slots open at the large company that got some more business. But it came at the expense of some other job somewhere else.

Another comment that was made was that there is more financial reward at large companies. That may be true in some cases, but it may not be true in others. There are small companies that reward their employees appropriately, and I think even reward them more appropriately based on their level of performance, not based on some fixed structure that large companies tend to put in place.

Finally, the last thing I'd like to comment on is the think tank. And I agree it is difficult, especially for the small company actuary, to not be able to bounce ideas off of someone. On the other hand, they can bounce their ideas off of nonactuaries, and it does give another perspective to the approach. Now, of course, the technical work will need to be done with consultants to get that help. Let's not look too closely at our own situations, but use the other people in the other resources areas of the company as that think tank.

**Mr. Tom Bakos:** I have a question for the "for" side. In the spirit of the debate and with the political overtones of that, I think everyone should recognize that nothing I'm about to say actually has to be true. I just perceive it to be true. What I see happening is large companies are getting themselves in trouble; it seems to me that they are too large to manage themselves. They failed or they recognized that and tried to do something about it. One of the solutions I see large companies adopting is they're breaking themselves up into smaller segments or smaller operating units. They are managed independently. Doesn't this solution of large companies tend to argue against your mergers and consolidations?

**Mr. Young:** I don't think so, because I think that's a design I would second. There are currently some very good companies that have broken themselves out just the way you described it. They managed to get the best of the small company atmosphere in a big company environment. In the companies that I worked with, the employees in Division A have many co-workers in Divisions B and C and D whom they could talk to. And if they've got a good CEO—once again, I said unfortunately it is very rare, not just in our industry but many others—he or she is fostering that communication and fostering cooperation. So I see that as part of the consolidation movement.

**Mr. Gary Corbett:** On the same point, part of the problem has been, and we've seen some good examples of this, where these units are split up without any control. That gets into the pros and cons, because there's red tape. When you have a large organization, you split it down into five or six independent units. I think some of those companies that have gotten into trouble have allowed almost true independence of those units and have not kept any sort of corporate controls. I have a bias; I've always been oriented more to the control level, and I see the problems when you don't get it. I realize the more controls you put in, the less advantages you get of breaking up and allowing independence of action. But I think in the ideal world, one can allow companies to operate very independently. If you have certain overall constraints, whether they're in financial reporting, whether they're in profit targets, whether they're in anything, you can get the best of both worlds. I realize that may be somewhat idealistic.

**Mr. Cipinko:** One of the things I found is that a number of our companies have merged. Interestingly enough, while they've merged or they've become part of a group, many of our companies remain independent. They're operated independently for one reason: the existing management does a far better job of operating that company as a subsidiary rather than operating it as a part of a group. One of the biggest problems you have, and we've seen this in other areas too, is not just insurance. You have to assimilate the cultures of some of these companies. Some of the cultures are radically different. You have alternative distribution systems and alternative computer systems. A friend's company just got sold for the second time, unfortunately. He works for a health provider, not an insurance company. The company has been struggling since it was purchased by the previous group concerning what to do with the computer system. Its computer system was a prototype when it bought it and obsolete by the time it was acquired. So one of the problems is that it has tried to assimilate the companies into a single culture. It couldn't be done, and as a result, it was sold again.

I think Grant brought up a point about employment for actuaries and what's going to happen. I think the good news for the people in this room, at least for the actuaries, is that the NAIC has embarked upon an aggressive new bridge to the 21st century. It's aggressively trying to attain full employment for actuaries well into the next century. Between the valuation actuary, the illustration actuary, the merger actuary, and the acquisition actuary, there seems to be more actuarial positions being created every day. That's the good news. The bad news is that a small number of actuaries will have to do it all.

What we're seeing now is the same person is going to have to wear numerous hats. This is true especially at the smaller companies and even some of the mid-sized companies that cannot expand their employment. You're going to have to be able to do it well, or, as our opponents were saying, they're going to find someone else who's going to do it well. So that's another pressure. There will be work out there, but you're going to have to do about three times more than you're doing today.

**Mr. Sproule:** In the decentralization issue, I've always believed that the formation of more strategic business units that get a closer focus on groups of their customers is something that's very desirable. But to do that without control can be an absolute disaster. One of the interesting phenomenon that's going on right now, (Prudential is an example) is those companies are rapidly recentralizing. What we're seeing here is this pendulum is coming all the way back and is probably going to go much too far the other way. It's going to be very interesting to watch how this works out. You can get good results on the bottom line in a very short period. But the question is, what's going to happen to the combination of expenses and revenues as they recentralize, and they become again a functional organization much like they were 30 years ago?

**Mr. Young:** I don't think the senior management from either Prudential or Metropolitan, starting from scratch, would create a Met or Pru as the ideal design. So I don't know if that's what we need to focus on. Just one additional point. When we were talking about job opportunities, were not just talking about traditional actuarial opportunities. I think actuaries (obviously I'm prejudiced) probably have the broadest range of knowledge of the insurance industry of any of the disciplines. Actuaries successfully serve many different roles in insurance companies and are best able to do that. I've worked for many little companies and if you're fortunate to have a good CEO, he or she creates interesting jobs for about 10 or 15 middle managers. Ultimately most of those people have to wash out, because there's only going to be one or two top spots at that little company. Most are going to have to go somewhere else. That somewhere else is going to be a medium-sized or a big company. They may have traditional actuarial roles, or they may do something else in maybe marketing or investments, or somewhere else in that company. Ultimately that talent is going to be forced out and has to gravitate away from that small company environment. Some people stay, but most will not have positions at the small company.

**Mr. Cipinko:** I agree with Mel about how Met and Pru could not be built from scratch again. You will never see another Metropolitan and you'll never see another Prudential. You'll also never see another Ford, or GM, or Chrysler. What you will see is some companies that have been acquiring. You have companies out there that are assimilating other companies. You will never see another monolith built. I don't know if that is due to corporate culture. Part of it is definitely a result of regulatory pressures. I think the regulators will discourage the growth from the ground up.

**From the Floor:** What about Microsoft?

**Mr. Cipinko:** Well, that's true. I don't know if this just applies to insurance. I also think that Microsoft and some of the data-related companies are probably the only ones that have become a monolith. But they are in a completely new market, just like GM entered a completely new market. Cars were a completely new market when the Model T was built.

**Mr. Sproule:** But there are other examples like that. And one of my favorites is a Japanese company, Komatsu, which was a tiny little company that set out to bury Caterpillar tractor 35 years ago when it was one-hundredth the size. It laid out its strategy and executed it and brought Caterpillar to its knees. Small companies can become the mouse that roared. We like to think of our own little company in Des Moines as the little company with visions of grandeur. I think that's the only way that mid-sized and small-sized companies have any chance in the consolidation that's taking place. They must find a niche or a product or an area in which they have some distinctive competitive advantage and milk that for everything it is worth.

**Mr. Robert W. Field:** What are the opportunities for a small company to achieve competitive costs through outsourcing and alliances? Do you see that changing in the future? Is the virtual insurance company a possibility in the future?

**Mr. Dlouhy:** I think there's a great deal of possibility for that. It's up to the imagination of an entrepreneur to create something like that. I know there are some companies that are trying to do that at the moment. The opportunities with the Internet and other things may provide us with new avenues in the future. Outsourcing is, I think, important. It's not the panacea for cost savings, but it is one way to do it. I think there will be more of that, and companies can focus on what they do best and outsource what they don't do as well.

**Mr. Young:** In fact, I know of a specific example. General American formed General Life, which, I believe, has eight employees. It's a virtual company. Everything is outsourced. And that would be an example that I would give of a terrific CEO doing some terrific things. It would be a good model for some people to look at.

**Mr. Cipinko:** Interestingly enough, there was a discussion yesterday at the NAIC Life and Health Actuarial Task Force on this subject. Tom Foley from North Dakota, formerly from Florida, made a very interesting statement. He said, with the new nonforfeiture law and the plan concept, the idea would be for us to allow for the plan to be filed, and then get out of the way. Let the regulators get out of the way and let the market control. That's a change of regulatory philosophy from a number of years ago. And I think it's a good change in philosophy. However, in the same spirit as the virtual company, we were involved in the model investment law now known as the defined limits model investment law, formerly the pigeon hole model investment law.

One of the things that we were involved in was the discussion of investment pooling for small companies. You would have thought that we were talking about socialism, communism, and fascism all rolled up into one. The regulators that heard about this thought this was the most horrendous possible idea. Yet, it's going on all the time. Small companies are able to use the capital of other companies for investment pooling, so that $100 million could end up getting the type of investment portfolio and the type of return where they can actually compete with the biggest companies. That is the kind of thing that we need to be able to do in order to survive in this climate.

The only thing that small and medium-sized companies can do is to try to solve the problem of how to compete. Many small companies want to be big. And sure we'd all like to be able to grow up. But you have to be able to find that niche. And as you were saying, you have to be able to milk that niche. If you don't have a niche, and you're just competing with everyone else, then you have to be able to solve the problem. Either solve the problem or become part of it. The virtual company is a fantastic idea, as long as we can do two things. First, we must continue to be forward thinking and think 10 and 20 years into the future, like the

Japanese industrialists did back in the 1950s. Second, the regulators should do exactly what Tom Foley was saying and get out of the way.

**Mr. Sproule:** I would point out that the virtual company is just a different way of consolidating the industry.

**Mr. Young:** A big thing to keep in mind is you need to do a lot of self-inspection at your companies. My experience, and I've worked with many companies in the life insurance industry, is that if you ask people, "How's your data processing?" they say, "We're the best." "How's your underwriting?" They say, "We're the best." Everybody seems to feel as if they have real advantages across the board in many different areas. Obviously we can't all be the best at everything. If you really wanted to decide where your future is, a good place to start is to do some serious self-examination and be brutal about it.

**Mr. Corbett:** I think there are two factors that say to me that there is going to be considerable consolidation. It's not so much whether we're for or against it. It's just the real world. Some of them have been alluded to, but I'm just trying to summarize a couple of things. I think the fixed expense nut has become worse for companies and is going to worsen. I'm referring to the valuation actuary as one thing. We've had the exemption for smaller companies. But I think there's some chance it will go away. I've never seen the justification for such an exemption unless the business is simpler.

If you have a small company that has a wide range of products and a wide range of investments, I've never really accepted that it should have a lower standard. When I was on the Actuarial Standards Board, we had a real problem with that. We refused to go along with it because it really isn't within actuarial principles; however, the regulators allowed it. I think things like the Illustration Regulation also cause this. You are going to have to have more people assigned to one thing. That's a factor leading to more consolidation; there's this fixed cost that every company has dealt with regardless of size.

The other point is boutiques. There's always going to be a place for niche companies, and I think small companies are better positioned to take advantage of niches than the large companies. There are not five or six or seven hundred niches in this country. I don't know how many there are, and obviously, there's no restriction on what they are. There are maybe 30 or 40, but with innovation maybe that can be developed to 80. I have no idea if those are the right numbers. Whatever they are, there are not enough niches for the companies. There are large companies and small companies in this category that are just "me too" companies. They are just out there doing about the same thing as anybody else. I see them being pushed to consolidation. I think that's where it's going to occur. It's not the successful niche company.

**Mr. Young:** I would just say it's not where it's going to occur; it is occurring. Perhaps you haven't noticed. People wouldn't talk to us five or six years ago when we'd try to talk to them about the subject. And now they are saying, "We need to do something." So this is occurring, and our message is, position yourselves so that you're in as good a position as possible to be a winner at the end of the day. It's occurring.

**Mr. Hemphill:** So how do you position yourself in individual career? How should an actuary in a life company think about a career in a rapidly consolidating industry?

**Mr. Young:** It would take more time than we have to explain. I can tell you how I did it 25 years ago. I think I said something a little while ago, and that's both from my own point of view and the companies' point of view: Do some serious inspection and talk about and think about what it is you need to do to succeed. What is it that you want to do? What is it you're good at? What is it that you like to do as an individual? And then work on developing that both as an individual and as a company. Be serious about the effort. Don't say, "I'm really terrific." You might want to get some other opinions.

**Mr. Sproule:** Not too many people are going to have 40-year careers anymore with the same company. Those days are rapidly, if not already, moving behind us. And for the individual involved, it would seem to me that career planning is no different than strategic planning for a company. You better stay abreast of the trends that are going on out there and figure out how you fit in a constantly changing environment. If you only do one thing and only want to do one thing, chances are that one thing is not going to be there from the beginning to the end of a 30- or a 40-year working career. You better be flexible, because otherwise you will be obsolete before you know what happened.

**Mr. Dlouhy:** I agree with all those points. I think that education is important, and continuing education is more difficult for the small company actuary who does not have as many resources. But don't give up on it. Make sure you're getting yourself up to date on different things by attending meetings and reading the appropriate trade journals and such. Keep yourself educated and be sure you're flexible.

**Mr. Young:** Did we change any minds?

**Mr. Hemphill:** Let's try this again. Resolved: the public would be well served by an extensive consolidation of the life insurance industry. Who agrees with that? And who disagrees?

**Mr. Young:** Who changed their mind?

**Mr. Hemphill:** I think that now it's 75/25.