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Has the Reinsurance Market Benefited from Consolidation?

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Summary: Over the last few years, the wave of consolidations of financial service organizations has included reinsurers. This increased consolidation often raises questions about reduced competition and possible antitrust implications. Compared to other industries in the financial services sector, there are far fewer players in the life reinsurance industry. Should there be antitrust concerns? Have the consolidations led to less competition among reinsurers and fewer options for the direct companies? This session discusses recent consolidation trends in the reinsurance market, calculation of the Herfindahl index, and the prospects for the future.

Mr. J. Wade Luther: I'd first like to introduce our two esteemed panel members. Mike Barnhart, from Transamerica Re, is a graduate of the University of South Florida. He began his insurance career as an underwriter with Western Reserve Life in Clearwater, Florida. In 1986 Mike heeded the call of the life reinsurance industry and began a career in reinsurance marketing, first with Duncanson & Holt and then with CNA Life Reinsurance, before joining Transamerica in 1991. Our second panelist is Mike Pado from Swiss Re. Mike is an FSA, a member of the Academy, and an MBA. At Swiss Re Mike is vice president of strategic markets and is responsible for the design and development of reinsurance solutions for products containing capital market guarantees. Mike Barnhart will primarily be addressing consolidation in the reinsurance industry and its effect on purchasers of reinsurance. Mike Pado will address postconsolidation integration issues. I'm sure that Mike, having been a participant in the Swift Re–Mercantile & General (M&G) combination, will have some unique insights into that topic. I'll start the ball rolling

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by providing an overview of consolidations in general and potential antitrust implications.

As you are no doubt aware, there has been a merger and acquisition (M&A) wave over the last few years, which has continued to intensify in 1998. In 1997 M&A transactions totaled $919 billion, which is almost a 50% increase over 1996's then record of $626 billion.

So far in 1998, deals worth more than $630 billion have been announced, more than double the amount in the same period one year ago. And the figures I have used do not include the recently announced Norwest Bank–Wells Fargo merger or the Tellabs acquisition of Ciena. So there certainly does not appear to be a slowdown in activity as 1998 rolls on. While a number of different industries have been involved in M&A activity, the two main ones are the financial services industry, particularly banking, and the telecommunications industry. It's interesting to note that in both of these industries, there seems to be a convergence among the different sectors in each industry. In financial services, there have been a number of deals involving some sort of combination of commercial banks, investment companies, investment banks, insurance companies, securities brokerages, investment boutiques, etc. The Travelers–Citicorp deal and the CONSECO acquisition of Green Tree Financial are a couple of recent examples involving life insurers. In telecommunications, the aforementioned Tellab–Ciena combination is an example of a telecommunications equipment maker acquiring a data networker. More such combinations are likely to take place. In fact, recently the talking heads on CNBC were discussing the Northern Telecom acquisition of Bay Networks, which had just been announced that morning. Last on this subject, I'll mention that soaring stock prices have made many of these deals feasible because companies can essentially use their stock as currency in a stock-to-stock pooling of interest transaction, which is how most of the deals are structured.

Over the last few years, the Department of Justice (DOJ) and the Federal Trade Commission have at times seemed almost oblivious to much of the M&A activity. However, at other times, the idea of excessive industry concentration does come up, so I thought we'd take a look at a couple of the measures of industry concentration. First, there's the traditional measure—the concentration ratio. This ratio is simply the sum of the market shares of the four largest firms in an industry. The weakness of the concentration ratio is that it doesn't recognize the relative market shares of the four firms involved. As an example, consider an industry with a concentration ratio of 80%, where the four largest firms each had a 20% market share. Then consider another industry, which also has a concentration ratio of 80%, but where one firm has a market share of 70% and the other three firms each have a market share of 3% or so.

The first industry with each of the four firms having a 20% market share is likely to be quite competitive. The second industry, where one firm has a 70% market share, is likely to be dominated by that firm. But if you evaluate the two industries solely in terms of the concentration ratio, you conclude that the market concentration in the two industries is the same, which is certainly not the case. So that brings us to the second measure of industry concentration, the Herfindahl index.

This is the more sophisticated tool for measuring market power, and it gives greater weight to the largest firms in an industry. The calculation of the Herfindahl index is straightforward. In a nutshell, you take the market share percentage for each industry, each firm in an industry, and square it and then sum the squares:

$$H = S_1^2 + S_2^2 + S_3^2 + \cdots + S_n^2.$$

For example, say an industry has 10 players, each with a 10% market share. The square of each firm's market share is 10^2 or 100. Then you add 100 ten times, and you come up with a Herfindahl index for the industry of 1,000. The Herfindahl index can vary from a high of 10,000 for a pure monopoly, which would be 100^2, down to a very low number for an industry with many participants, each with a very small market share. Last but not least, the Herfindahl index is used by the DOJ in antitrust policy.

Speaking of antitrust policy, according to the DOJ 1982 Merger Guidelines, the department recognizes the potential value of mergers for efficiency purposes. Also, the DOJ calls for challenges only to proposed mergers deemed likely to harm consumers. So the important point here is that big is not necessarily considered bad. The operative issue is whether or not consumers will be harmed. In assessing whether a merger results in too much market concentration or market power, the DOJ uses our newfound friend, the Herfindahl index, to help in this assessment.

Here is how they do this. Basically, if a merger results in a Herfindahl index of less than 1,000, the resulting market is deemed unconcentrated, and the merger will generally not be challenged. On the other hand, if the index will be above 1,000 after the merger, and the merger would add at least 100 points to the index, then a challenge is more likely. However, other factors are also considered, and a merger is less likely to be challenged if one or more of the following exists: (1) If foreign firms are an important source of competition in the industry. So domestic competitors may be allowed to merge if they face a significant level of foreign competition. (2) If one of the firms might otherwise go out of business. Basically, a merger might be accepted if it presents an insolvency, regardless of the resulting market concentration. (3) If the firms in an industry do not produce a homogeneous product. In other words, there are differences in product features, qualitative or otherwise, as opposed to being in a pure commodity type of industry. (4) If barriers to entry are low, and new firms are likely to enter the industry as current producers raise their prices.

So it's important to note that the Herfindahl index is a guideline, not an absolute standard. Instead, the circumstances for each industry are taken into account, and a merger may be allowed, even if the Herfindahl index is above the threshold that we mentioned. So rather than being an absolute standard, the facts and circumstances of a particular industry are taken into consideration.

Now that I have presented the calculation and use for the Herfindahl index, I thought that it might be interesting to apply it to a particular industry. I picked one that most of us are familiar with, the life reinsurance industry in the United States.

The first step is to obtain the market share of each firm in the industry. Fortunately, every year the reinsurance section conducts a market share survey for all companies in the U.S. life reinsurance industry (Table 1). Transamerica is at the top of the list, with a market share of over 13%, and three other reinsurers—Reinsurance Group of America (RGA), Swiss Re, and Lincoln National—also have a market share in excess of 10%. To digress a bit, it's interesting to note that the year-over-year in-force volume growth was 26%. This year's survey also showed that recurring new business grew by some 45% from 1996 to 1997. So the industry is showing impressive top-line growth at a time when the direct market is flat or only slightly higher. Unfortunately, we don't have any premium figures, but I have a funny feeling that the premium growth is probably at a somewhat lower rate than the volume growth. Anyway, I think I've digressed enough on that, and I'll let you draw your own conclusions about relative premium and volume growth.

TABLE 1
1997 INDIVIDUAL LIFE REINSURANCE MARKET SHARE IN THE U.S.

Rank	Company	Reinsurance in Force		Percentage Increase
		Amount	Percentage	From 1996
1	Transamerica Re	$208,882	13.4%	9.4%
2	RGA	176,249	11.3	20.4
3	Swiss Re	171,305	11.0	30.4
4	Lincoln National	166,747	10.7	14.8
5	Life Re	140,956	9.0	35.6
6	Security Life of Denver	139,489	8.9	48.4
7	Phoenix Home	76,770	4.9	57.1
8	American United Life	69,784	4.5	30.0
9	Allianz	64,884	4.2	25.1
10	Cologne	60,981	3.9	16.0
11	Employers Re	59,863	3.8	52.8
12	BMA	59,387	3.8	26.3
13	Munich American	43,637	2.8	44.4
14	CNA	43,079	2.8	-2.2
15	Gerling Global	37,693	2.4	28.9
16	Crown Life	14,265	0.9	9.6
17	CIGNA Re	13,705	0.9	-5.3
18	Reassurance Co. of Hanover	7,113	0.5	20.1
19	Optimum Re	4,824	0.3	10.4
20	Winterthur	2,233	0.1	15.0
21	World-Wide Re	1,329	0.1	14.7
	TOTAL	1,563,175	100.0	26.0

The above data were obtained from an annual survey conducted by the Reinsurance Section of the Society of Actuaries, and are provided by the companies contributing to the survey. While these numbers are believed to be reliable, they have not been audited and no responsibility can be taken for their accuracy. Data includes only conventional, recurring mortality risk reinsurance. Financial reinsurance and retrocessions have been excluded.

Now that we have the market share for each of the U.S life reinsurers, we can calculate the Herfindahl index for the industry. In 1997 we come up with a value of 829. Now I'll make a few observations on the Herfindahl index calculation for our industry (Table 2).

TABLE 2
HERFINDAHL INDEX
FOR THE LIFE REINSURANCE INDUSTRY

Year	Index Value
1993	846
1994	829
1995	808
1996	869
1997	829

First, the index value for the U.S. life reinsurance industry is a relatively high one. Certainly the reinsurance industry is much more concentrated than the direct market that it serves. Second, while the concentration in the industry is relatively high, it does not appear to be increasing over time. In fact, the 1997 value, 829, is actually below the value in 1993, when we had a value of 846. It is interesting to note that this downward trend temporarily reversed in 1996, when the index value increased from 808 to 869. This was the first year that the market share survey reflected the M&G—Swiss Re combination, as well as the one involving Employers Re and Francona. However, one short year later, the downward trend has reversed. So, basically, it does not appear that there is a life reinsurance version of an Intel or a Microsoft seeking to dominate the industry. In fact, those of you who have followed the reinsurance section's market share survey over the years have probably observed a trend of a company's ramping up its production for a couple of years and then leveling off its rate of growth, at which time another company may take its place in exhibiting a high rate of growth for a short period.

And last but not least, I'll make the observation that the Herfindahl index is within striking distance of the threshold level that can theoretically lead to some sort of antitrust scrutiny. In fact, you can easily take the market share percentages of the individual companies and recalculate the index, using some hypothetical combinations of existing companies. However, I think it's important to consider the extraneous factors that I mentioned earlier, which might preclude any antitrust action based solely on a Herfindahl index calculation.

First, there are several foreign firms active in the U.S. life reinsurance market, which results in a significant source of competition for domestic firms. Second, barriers to entry are low for the life reinsurance industry. By this I mean that it does not require an investment of millions of dollars of plant and equipment to get into or out of the reinsurance business. In fact, many direct writers can very easily become a reinsurer, and several have done so over the years. I believe that Mike will also discuss barriers to entry in the industry, so I won't elaborate any more on that.

Mr. Michael E. Barnhart: The big force at work today, which I think is more powerful than anything we've dealt with in the past, is the force of the free market. The free market is a very strong thing. Just ask anybody in telecommunications or the airline business, or even the utility business. Now it's the insurance industry's turn. For the first time in about 60 years, the life insurance industry may confront the force of the free market without the protective shield of regulation. I said "may," okay? It hasn't happened yet, but I think you all realize that I'm referring to Glass-Steagall. If there were any doubts about this, you know, the Travelers-Citibank deal—which is a blockbuster deal—should put that to rest.

The marketplace, not the regulators, is shaping our future right now. The regulators are just trying to understand where it is. The entire financial services industry, including the safe, regulated world of life insurance and life reinsurance, is in the midst of massive restructuring. Nobody knows how our industry will look in ten years, or even five years, and frankly some days I wonder about next year. But one thing I do know is that I don't believe that it'll be anything like we've experienced in the past.

Despite the failure of the U.S. legislature to dismantle Glass-Steagall, the walls that separate financial services are tumbling down. I think we can all agree on that. Three obvious signs of a new, wide-open market are consolidation, convergence, and globalization. I want to define my terms quickly. By consolidation, of course, I mean where companies within the same industry are buying each other. Banks are buying banks, and insurance companies are buying insurance companies. The next one is convergence, which occurs between industries, such as when banks buy insurance companies and vice versa. Now, you can make a point that there are several levels of convergence and consolidation. Most people put banks and insurance companies in the financial services industry, but I'm taking it a little lower than that, trying to get it down to our normal working layers. And then the last would be globalization, which, of course, is where we compete in a worldwide market of financial services from one area to another.

Reinsurance has always been a global industry. Today, globalization is becoming prevalent in the direct market, a trend that has increased the pressure for deregulation. Many industry observers believe that the first stage of restructuring is consolidation. Reinsurers feel the impact of consolidation from two sides, among our client base, many of you, and, to a lesser degree, consolidation among our competitors.

It's easy to see the advantage of consolidation among primary life insurers. You know, the economies of scale and all those things that you've all heard about. It's a little harder to see among reinsurers, simply because of the fact that we do have fewer expenses and take a much thinner profit margin off of that. So it's a little harder to get economies on that basis, but it can be done and it does happen on occasion.

Life reinsurance does create some difficulties with that aspect. The second piece to that really is that there are 2,000–2,500 life insurance companies out there. But there are only about 25 strongly active professional reinsurers. It's a much smaller base to try to create economies with.

Also, it may not be impossible to buy a division of a life company that is a reinsurer, much like Transamerica is, but it does create some difficulties buying something like that, because of some of the reduction in economies. But beyond that, reinsurers generally do have leaner infrastructures and a little bit greater operating flexibility; also, life reinsurance, as Wade mentioned, has very few barriers to entry. If a company wants to enter this market, they can set up relatively quickly. I think you've all seen in the press recently the Annuity and Life Re deal, which is a company that started up in Bermuda. That happened pretty quickly, I think, from a press coverage aspect. They raised, I believe, $280 million or so overnight. Something like that, but maybe not necessarily overnight. But it happened very quickly. They're in the market. We'll see what happens with that. It is one of the first new start-up entries in reinsurance that I'm aware of in quite a long time. And I'm specifically saying life reinsurance too.

Consolidation

Life reinsurers have always operated in the shadow of the property and casualty (P&C) reinsurers. Some people really don't realize this, but if you take all the life reinsurers, or all life reinsurance consolidation deals, you really have to look hard to find a life only deal in this group. The only one that really comes through is the Employers Re and Frankona American Life deal. That was truly a life-only transaction. Now, the Swiss Re and M&G deal, while it didn't have the biggest impact, was a life consolidation. From what I understand, the parent company, Swiss Re, did a lot of the acquisition, and that was motivated, from what I hear—and I hope Mike can straighten me out on this—more from the casualty side of the business, in an attempt to expand into other lines of business and to expand in the United States.

Now, one thing that the recent wave has demonstrated is that when reinsurers make a major acquisition, they don't stray far from their core business. Again, reinsurance buying reinsurance or consolidating reinsurance which, again, represents the consolidation, not the convergence.

Convergence

The financial services industry is still spinning over the recent Travelers-Citicorp deal, which will position Citigroup for leadership in insurance, consumer finance, investment banking, securities, and asset management. The merger shows how far ahead the market is of current laws regulating financial services. This deal is expected to speed up deregulation.

From a reinsurance perspective, the convergence of financial services poses more of a threat to the status quo than the consolidation within the life reinsurance industry. And that's a strong point I'm making up here. I think we're more concerned about convergence than we are about companies buying within each other.

As banks and investment bankers become familiar with the life insurance risks, they may be able to apply their core competencies to these exposures. A *Business*

Insurance article on the Travelers-Citibank merger commented that banks have always thought they could finance risk better than insurance companies. Now they'll be able to find out if they can. One thing is sure, when different viewpoints come together, the possibilities seem endless. We could see risk-financing packages not imagined by bankers or insurers on their own. Many observers believe that the integration of traditional reinsurance and capital market solutions may influence the future reinsurance marketplace. We're already hearing a great deal about the securitization of risk as a way to transfer from insurance companies to the capital markets. So far, it's mostly talk and has not really happened in life reinsurance. There may be one deal out there, but I don't know a great deal about it. But it's the only one I've really heard about.

The effect of converging markets will not be felt overnight. It could be several years before the new financial giants figure out how to integrate their vast financial capabilities and direct them toward insurance companies. However, if reinsurance capacity dries up, there could be a strong incentive on both sides to develop alternative risk management solutions, but there are no signs of that happening in the immediate future.

Globalization

Many reinsurers have concluded that to be a major player in the current reinsurance arena they must be global. The sheer size of the U.S. market presents a growth opportunity for European reinsurers. The United States is the most important market in the world for reinsurance. As one European executive put it, "That 1% or 2% share in the U.S. market is much greater than a 10% share in the French market," which makes sense.

As foreign reinsurers are acquiring and getting into the U.S. market, U.S. reinsurers have set their sights overseas. Several U.S. reinsurers are making significant investments in Latin America and Asia Pacific, by combining growth through sales and equity investment strategies, whereby they invest in the companies that they're getting reinsurance from.

American reinsurers have acquired companies in Germany, France, the United Kingdom, and many other parts of the world. Concurrently, non-U.S. reinsurers have purchased U.S. companies. Again, these acquisitions are largely among P&C reinsurance, but most of them do have life operations as I mentioned earlier. As the large P&C reinsurers execute their diversification strategy, which includes the U.S. life market, we may see more of a market presence by these people.

Strategic Positioning

This is the part that I want to spend a lot of time on. It has a real-world impact on everybody here in this room, and it's really the day-to-day activity that we see being very important. Consolidation, convergence, and globalization may be getting the press coverage, but the more prominent activity among life reinsurance today involves strategic positioning on a less grand scale. Alliances or market alliances: reinsurers have been utilizing these to help improve their business and their services to consumers. We have been setting up joint ventures to help provide you with extra operating efficiencies and have been doing some equity investments in customers for getting pieces of their business as well as horizontal acquisitions.

Most of these strategic positionings occurring today do involve a broadening of capabilities. In a market as soft as life reinsurance, the competitive edge is gained through customer service, and it goes without saying that standard reinsurance services like facultative underwriting and product-pricing support are essential, but a growing number of reinsurers are building a storehouse of value-added services that can help client companies achieve marketing and profit objectives.

Does anybody doubt that the reinsurance market is soft right now? Good. Glad to hear we're all on the same page. Wade had a similar comment about the ranking and the reinsurance marketplace, pretty close to mine. I think my point here is that there isn't a significant amount of shifting—not a lot of change, which is kind of surprising, but some of the changes did occur because of acquisitions. The Employers Re deal brought them up a little bit, only from 10. So it didn't have a major impact.

Growth trend, again, is assumed business. The change in the players may not be dramatic, but the change in the size of the market is, especially given the flat performance of the direct market. Historically a reinsurance product reflects the direct market, but not any more. As you can see, in the past few years growth has been significant. In fact, this growth here might explain exactly why so many P&C reinsurers are trying to expand into the life reinsurance marketplace by acquiring or adding money into their current players.

New business reinsured in the United States increased by 27% in 1996 and by almost 130% in the period 1990–96. This dramatic growth occurred during a time when the underlying individual life insurance market increased by 3.5% in 1990 but only 6.5% from 1990 to 1996. So we see significantly more increase in the reinsurance marketplace as a percentage than in the direct market. One would think that this may make more sense, simply because we are a smaller group. But the issue here is that they're not tracking like they had been in the past. It's a much sharper curve for the reinsurance growth.

Most of the growth in recent years derives from portfolio reinsurance. There has been significant growth in the last three years for portfolio. Everybody, I hope, understands portfolio? Let me explain it quickly; I hate to assume what people know. Portfolio is where a reinsurer takes on an in-force block of business from a customer. It may be just his retained business. Typically, it is only what he is retaining now, and typically it should be listed as portfolio.

The other piece of the growth is recurring. Now, the recurring actually has even more significant growth, and most of that is because of the term insurance marketplace. As you're probably all well aware, much of the term business right now is ceded on a first dollar quota share. There are very few deals under 50%, and many deals as high as 90% or even 100%, ceded to the reinsurer. On top of that, because of the soft reinsurance marketplace, I believe it's going to encourage this trend, and it may even spill over into other products.

Competitive reinsurance rates are driving a great deal of this growth. Make no question about that. On top of that, the companies' risk attitude may be changing out there in the industry.

Retention Levels

This is another tie-in to understand a little bit about what's going on. The *National Underwriter* showed what is happening to the retention levels. Interestingly, it's the opposite of what conventional wisdom has always taught us; that is, when your asset size grows, your retention grows. That isn't happening right now. Retentions are shrinking even though asset sizes are growing. The percentage of life sales reinsured has doubled from about 14.5% in 1990 to 31% in 1996. To me that is significant.

The reinsurance market or life reinsurance market is attracting new interest. The life reinsurance market is less influenced by consolidation than by new or existing players, with renewed interest in the market. Another key point I want to make is there isn't a lot of acquisition activity, but there's a tremendous amount of investment going into existing companies to help expand their growth. There is a lot of money pouring in the current reinsurers is what I'm saying.

Again, direct companies are expanding their businesses. P&C reinsurers and foreign reinsurers are looking more closely at the U.S. market and are investing capital in their life and health affiliates, because of a great deal of the growth that I was discussing. There are new companies involved right now, at least one that I'm aware of. I've heard of a couple other companies that would like start-ups, and again the growth in the reinsurance marketplace is really driving that.

I also want to stress that there are very few barriers to entry. Wade mentioned that, but that's so significant—it is so easy to get into this business. The only major key barrier, which everybody has to know about, is extremely low profit margins, and that usually scares a lot of people. We're all out there to make some money. But the profit margins are going. And I'm also doing a little advertising piece to try and tell my customers, "Hey, we're barely making it." So we're not going to reduce our rates.

Let's look at the outlook for the industry. The short-term outlook is more of the same basically. I don't see a tremendous amount of change occurring. I see the competitiveness on the pricing continuing. Value-added services keep coming out. The expectation that direct companies look for from the reinsurer is just going right through the roof—as well as it should because we've been telling them they should be getting it, so we had better start delivering.

Excess capacity will continue to keep the reinsurance rates low. Let me define that again. By capacity, I'm not talking about facultative individual life, where I want to maximize how much I can insure some individual for. That capacity is definitely limited right now. We don't know what the limit is, but we know that if you go out to the entire market and pull in the retros, I don't know if there is anybody out there insured for $150 million. But looking at the market as a whole, if you went out and tried to get automatic capacity, you have tremendous options to choose from: tremendous companies, everybody is beating your door down. That's what I mean by excess capacity.

Direct writers who are looking to outsource operations can find extremely strong partners in the reinsurance marketplace. Many of us have set up facilities where you can pretty much outsource your operations to the reinsurer, get underwriting, administration, and product development. We can even help with asset/liability matching, and at Transamerica we even had a marketing side that would actually produce your brochures to help sell the product.

But if reinsurance performance continues to be strong, then companies that want to grow their market share may find acquisitions more productive than internal growth strategies. So what I'm saying is much of the same again, the growth is there, and there could be more activity. I don't think there will be, but I do believe it is available.

Long-Term Outlook

Over the long term, the outlook for the life reinsurance buyer could best be described as the same but different. Ceding companies will always need to manage risk, and risk transfer will always be a fundamental strategy. Clearly, the reinsurance agreements in use today will not be replaced, but as the financial services industry converges, the supplier may look a little different. It may be a diversified financial giant like Citigroup, and instead of transferring risk to a reinsurer, the risk could be bundled up and sold in the capital market, the way mortgages are sold today.

One thing is certain: the financial services industry is converging, and this will produce new products and services for the reinsurance buyer. It won't happen overnight, but ten years down the road we could all be operating quite a bit differently than we do today.

Mr. Michael W. Pado: I'm going to talk a little bit about a few items relating to the drivers of consolidation. I think some of this has been covered a little bit earlier, so we'll briefly go through it. I'm going to talk a little bit about the potential partners of consolidation, as well as some integration issues, which were pointed out earlier. I am part of an organization in which two reinsurers did consolidate and had some interesting times doing that. Also I'll discuss some critical factors for success.

As Mike pointed out, there's a new convergence, if you will, an emerging face of the financial services industry, that's made somewhat possible by technological advances that allow players access to a substantial marketplace. Things that were heretofore unavailable to them. Also, changes in regulatory acceptance, as well as some attitudinal changes, and increased consumer awareness. Who are the players? Security firms are certainly in the mix, as well as banks and insurance companies for the purposes of our discussion today.

In terms of securities firms and banks, I think you've all heard about the consolidations of Bankers Trust and Alex Brown, Swiss Bank and John Reed at Citibank is another, as well as NationsBanc and Montgomery Securities. Those companies are coming together. On the banking side, the banks have made inroads into the insurers' domain, mainly because of the aggressive campaign on the part of the Comptroller of the Currency to expand bank insurance distribution powers, and it seems very likely that this will expand into insurance underwriting powers as well. And this may or may not happen—it may not require, I should say, any formal legislation on the part of Congress.

On the insurance side, insurers are making inroads into the banking industry, in part by applying to the Office of Thrift Supervision for charters to operate federal savings banks. And as you probably know, insurers are also entering the trust business. Now, given all this change and all this convergence, Conning & Company did a reinsurance study, and they stated that reinsurers need to reposition themselves to cover an evolving marketplace. It's no longer sufficient to rely on a strong balance sheet, or industry reputations, or current relationships. And while traditional reinsurance is the main source of risk transfer today, a changing market will force adjustments. I think Mike made mention of things like securitization, and, in fact, that has happened in the United Kingdom with a company called National Providence, as I recall.

In terms of consolidation and the reason for it, there was an article written by Peter Mattingly and Bob Shapiro in a recent *Actuarial Digest* that, I think, concisely talked about several drivers of consolidation. The first was increased effectiveness, where it allows you to trade economies of scale, pursue a more aggressive management strategy, and allow more efficient use of available capital. They also cited heightened focus, which allows you to strengthen areas of competence and even exit noncore businesses.

The third is related to growth and marketing power. You certainly get increased size, which was a definite outcome in our case. It also allows you access to new products and new distribution channels, which also happened in the Swiss Re–M&G merger. The next is the availability of cheap financing. Mike mentioned the stock price and also the use of inexpensive debt.

Fifth is being defensive: beneficial accounting treatment via pooling and purchase accounting. Last, insecurity: everybody else is doing it. I think, and quite rightly, that on the P&C side there was a great flurry of activity that, I believe, put some pressure on us to look into that same type of activity on the life side.

In terms of consolidation, I guess, one question is with whom. Other reinsurers seem like a natural. We know each other's business. It's easy to see increased economies of scale. You can definitely gain access to additional products and additional markets by doing so, thereby increasing your core competencies and competitive advantages. I think the probability of this is relatively high, as was pointed out earlier. There are few barriers to entry. There are a number of players that don't have sufficient size in my opinion at the lower end of the market, and the increased pressure on price, increased pressure on execution, and an increased pressure on range of services will force players to take some action.

In terms of convergence, some convergence or consolidation with banks is possible. Conning & Company did a study of reinsurers and claimed that 55% of primary companies will access the capital markets to obtain risk-transfer vehicles. This is going to put pressure on reinsurers to adapt to that marketplace and be a factor in it. Another element to this is that the capital markets are permanent. They're much larger than the insurance industry's capital base, and I think that this will put pressure on us to react.

In terms of integration, you essentially have two organizations that are two systems of value, two systems of belief, and two systems of ideas. And while the new union will form synergies, some compromises are involved. But I think the first and most important aspect of integrating is to come up with a new strategic intent that is broadly stated to all in your organization. You now need one plan. I keep thinking of a marriage ceremony, where you have two candles that are used to light another one, and then you blow the other two out. I think that's what's necessary to have a successful integration. So you need to restate your strategic intent. You also need to restate your strategic positioning within the market and be clear about where you're heading.

There's always talk about the devil being in the details. In our situation we needed to do a fair amount to clarify operational details to redefine, in a sense, roles, goals, and responsibilities of all the individuals in the merged entity. All three things tend to be somewhat internally focused and create somewhat of a problem, because while you're trying to integrate, your client has a number of concerns, which I'll talk a little bit about later, that need to be addressed. It wouldn't be any fun if we didn't have the competition at that same point in time, trying to take advantage of this internal focus in periods of stability.

Last, there is a need to emerge anew with a new organization, and a new value proposition. You can tell that McKinsey has been to our shop.

In terms of the operational details, I found a number of specific areas of interest after we had merged together, where there were, say, current proposals in-house, and/or common clients, and we needed to get a few things straight. One was marketing strategy. Each company had a way of segmenting and accessing the market. In terms of the marketing strategy, do you approach your client with a marketing representative, or do you utilize a team approach? Other aspects to marketing: do you advertise and if so, how often? Every element of that needed to be addressed and somewhat quickly.

In terms of pricing protocols, it stands to reason that each party may have different pricing systems: some homegrown, some third-party systems; which one is better? You likely have different methodologies for setting assumptions. You need to end up with one. Both can't be right. And you also have different profit goals that need to be brought into one framework.

If you look at underwriting standards, there are differences there as well. Obviously, companies have different underwriting manuals. There are different ratings for each impairment, different attitudes for facultative shopping, as well as different attitudes toward the range and scope of different underwriting services that can be provided.

There are differences in claim handling and adjudication, as well as administrative processes. Some companies have a different attitude toward bulk versus electronic data transfer, and different requirements in terms of what data that you expect to get and in what format. And even different views as to whether to audit and, if so, how often.

Another interesting area is treaty provisions. Obviously we both have been doing business for a long time. You think that you're doing it the right way, and the treaty is particularly interesting, because if you look at the overall treaty structure, they're likely to be different. What we found was each and every article within the treaty had slightly different provisions. All of these details are not equally important, but they need to be addressed to allow you to move forward as smoothly as possible. Unresolved differences, obviously, result in future administrative and operational difficulties.

The main source of concern, and certainly the client's concerns, which I think it is fair to say increase, is a function of time. One thing they would like to know is, who will service my account? You had two representatives from two companies. Do you call on representative A or representative B? Even if you're speeding along toward having a new marketing plan in your own organization, you may very well approach the client and tell them your plan is for them to use representative B. What do you do if the client says, but we really like A? That poses some interesting challenges.

They also would like to know if service will be maintained during this period of internal focus. There's enormous pressure to maintain facultative time service, claim payments, and response requests for proposals. It's an interesting balancing act.

In the case of common clients, or if you're making proposals to two companies, obviously the client would like to obtain the more favorable of the terms: one, with respect to pricing, and, two, with respect to limits, and last, with respect to requirements. I'm referring to things like recapture provisions, maybe audit requirements.

And last, client concerns: are we giving you too much business? Has Company A received a 25% share in the past and Company B received another 25%? It's somewhat unlikely that the new entity would be awarded 50% for any length of time going forward. There are simply too many other players in the market to allow that.

Among other considerations that we've experienced in our new entity is that basically it's a demand for a speedy return to a stable environment. For the employees, particularly during stressful times, they would like to know if they have a job and if it's interesting to them. Customers like to know who will service their account and so on and make sure that their service goes uninterrupted, and sponsoring management and shareholders would like to know if the time and investment in the consolidation is turning out to be worthwhile.

Another element, an important consideration, is the need to provide a forum to access and share information. It's been our experience that the lack of information simply caused, at least in the New York area, a great deal of internal focus and discussion away from the business itself, almost away from working on finding a new entity. So clinical factors for success include frequent and forthright communication, reformulation of the strategic business plan, and a redefinition and implementation of an integrated systems plan, so that the two organizations can communicate with one another and reformulate and implement the operational plan.

Mr. Luther: I have one other comment. The title of this session posed the question, "Has the reinsurance market benefited from consolidation?" Certainly, there are several potential benefits. Synergy would be one, or one plus one equals something greater than two. There are cost efficiencies, operational efficiencies, and lots of these things that can be translated into lower prices for customers. So M&As aren't necessarily a bad thing for the consumer of reinsurance.

From the Floor: I notice that there are only two purchasers of reinsurance in the room, so this might not be a good question. But, depending on how you measure it, there are between 10 and 20 reinsurers in the marketplace right now. If that number were to consolidate to a much lower number, I'm wondering what the reaction from direct purchasing companies would be. Many of them have five to eight reinsurers in their pools right now, and I would think that consolidation might, you know, be unwelcome among the direct running companies, since so many of them have multiple reinsurers in their pool.

Mr. Luther: That's a good point. Looking at the reinsurance survey, there are 21 companies on the list. Several of them have very small market shares, so it's hard to say they're active players. But certainly if you had consolidation to the point where there were only four or five companies actively involved in the market, that might have an impact on companies who were accustomed to having multiple players in term pools and things like that. It could result, I guess, in shifting the balance of pricing power to the providers of reinsurance. But, again, I don't know whether in the long run that equilibrium would hold true. We talked about low barriers to entry, things like that.

Mr. Pado: The only thing I would say is that we've looked at quite a few scenarios. Obviously, any time you look at acquiring a company, and as a reinsurer too look at acquiring reinsurers, one of the questions we always ask ourselves is something that Mike hit on. This reinsurer, what business are they in that we don't currently already share? Now, that's a major question of ours internally, because we're not always certain that our customer is going to buy going from a three-person pool to a two-person pool. They may go back out and get another three-person pool, so all we've really bought is just an existing act of faith, which is okay, as long as that's all you're looking for. But if you're looking for it to grow your block, it may not necessarily happen in the long run.

On top of that, to get our market to reduce to a very finite group of reinsurers, all the negative things have to happen, not the positive things that are happening now. Again, the barriers to entry to market are pretty small. If it continues to be a good market like it is, and while we do have fairly small margins, they are good margins and they're acceptable margins in the investment community. Companies do want to come in, so if, for some reason, we went out and bought three of the top five next week, my feeling is that immediately we'd see four or five new entries into the market within the next year. I'm not so sure that's very likely in an environment that we're going to see in the next couple of years.

But, indeed, if we were to converge or consolidate because of negative things such as extremely negative profit margins, an unknown disease that comes over and blanks out our mortality—sure, that negative implication could reduce the number of reinsurers. We thought it might have happened when the AIDS virus became known in the early 1980s, but indeed it did not. So that was one of our worst-case scenarios back then, and it didn't come to fruition, which we're all happy about. So I think it would have to be a negative aspect for the industry to converge to a such an extent that the consumer would be negatively impacted.