Article from:

The Actuary

April 1990 – Volume 24, No. 4

Are 1,800 life companies too many?

by Edward S. Silins

Approximately 1,800 active life insurance companies exist today in the United States. I am not alone in predicting the market will force a significant consolidation of this industry.

Perfect competition

The life industry exhibits all the characteristics of perfect competition: no single company controls price, there is instant access to new products (no patents), and an apparent unlimited capacity to produce sales exists. Add to this a nonloyal agency force, complex products that are sold rather than bought, and price-sensitive products, and the result is classical economic competition.

Why should the life insurance industry be exempt from a "shakeout" that has impacted countless other competitive industries in Western civilization, from airlines to personal computers? It shouldn't, and despite the current regulatory environment, companies will become insolvent, go out of business and merge.

The coming consolidation

The recent poor results for the life and health industry were reflected in *Forbes's* annual report on American industry, which showed the figures in the table below.

These life and health results are unacceptable, although there are a number of individual companies with significantly better results. These results are indicative of mutual companies as well as the smaller stocks. There also is a notable increase in debt in the industry. Because debt recently appears to carry a higher cost than equity, this would cause a decrease to the ROEs provided in the accompanying table.

A number of "natural causes" exist for life industry consolidation as opposed to the external cause of increased capital requirements that may be imposed by regulators. These include:

- Unsatisfactory profit margins
- Increased cost of capital
- Mutual company capital raising ability
- Excessive administrative expenses
- High cost, low loyalty distribution
- Diminished "quality" of surplus
- Technologically driven environment
- Insufficient pool of management talent
- Inadequate actionable information

We anticipate these "drivers" of consolidation will be powerful enough even if increased capital is not required. Given a workable consolidation, the potential for increased profitability, product and distribution symbioses, and access to capital is too large to ignore. At the time of consolidation, the involved companies will reevaluate strategies; lines of business may be dropped, administrative costs will be decreased through specialization or other means, new product development will be more economical, distribution channels will operate more efficiently, and a new management team will spread a new enthusiasm to the organization.

Success factors

Given this hypothesis, I would like to focus on the critical success factors for the consolidation process:

- Strategic role – Any business combination should "fit." By this, I mean that some function, be it distribution, product, or expense should benefit existing operations. The combination should place the new organization closer to the idealized vision of the organization as of some date in the future, say 2010. The vision is subject to modification, but the burden of proof should be on those changing the vision once it has been established.
- Economic sense – There is much emotion in simply "doing a deal." Many deals made in the past didn't make economic sense because the price was too high, too much of the entity had to be spun off, marketing didn't fit, etc. It is imperative that reasonable growth, improved ROE, increased income for the sales force, or increased stakeholder (policyholder, shareholder, employees, agents) value arise as a result of the transaction.
- Management commitment – Any acquisition or merger requires a high-priority assignment. The larger the business combination, the more "hands on" involvement by top management is required to achieve success. Assuming that management has set its strategic vision with board of directors' agreement, it is only natural for top management to be personally and emotionally "into" its success. Presumably, compensation would be keyed into the achievement.
- Proactivity – An organization that waits for deals to come to it is not actively pursuing its vision. There's little chance that those deals put in front of a company will fit the profile sought in the strategic plan. Unless it is a distress sale, it probably won't meet economic goals either. Successful organizations will be those which actively pursue targets for merger or acquisition.

Given these success factors, each company should then: 1) establish a strategic vision of itself for the future, say 2010; 2) establish a high priority, including top management's commitment to getting there; 3) actively seek consolidation partners, making sure the result makes economic sense. Although this process will consume considerable time, it will be well worth the effort.

Organizations that don't successfully consolidate will continue to have an uphill climb, trying to achieve a reasonable ROE and growth rate while meeting probable increases in capital requirements. It is possible for a company to remain successful without consolidating. There will always be a few successful "niche" players. Other managements will be able to reverse poor profitability trends. The major advantage to consolidation, however, is symbiosis, i.e., the new whole is far greater than the sum of the parts.

Pitfalls

Over the years, significant problems have arisen in connection with acquisitions or mergers which, in retrospect, could have been made manageable or eliminated completely. A rundown of

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Median ROE	1987	1988	1989
Life & health insurance	14.2%	7.5%	8.6%
All industries	13.6	14.1	14.4

Thanks, Dan

(Ed. note: Daniel F. Case, Actuary with the American Council of Life Insurance, is resigning as an Associate Editor of The Actuary *after three years of service.* Actuary *Editor Linda B. Emory wrote the following letter of thanks to him.)*

On behalf of the entire Editorial Board of *The Actuary*, I would like to thank you for your contribution as Associate Editor for these past three years. You have solicited meaningful articles, edited them, edited other contributions to your issues, proofed the articles and features, and have never missed a deadline. You have also served us well on the Publications Policy Committee. You have fulfilled the commitment that you made to the new format of *The Actuary* so admirably and capably that you have been one of the principal reasons that the newsletter has succeeded in its current form. Yours was the first issue in the new format, and you set the standard for all subsequent issues. You will be sorely missed.

Life companies cont'd

some of these may be helpful to those considering some type of transactions.

- Overpaying – In a rush to "do a deal," or on the basis of inappropriate advice, too high a price may have been paid. In cases where debt was used to finance the acquisition, statutory earnings may not be sufficient to service it.
- Strategic misfit – Often, anticipated synergies between the organizations do not materialize. Reasons could be distribution related (no overlap), geographical, administrative, or economical. When this happens, intangible assets acquired are frequently not worth the price paid and subsequent divestiture results.
- Administrative complexities – If lowering unit costs is a major goal, systems involvement is critical. Assessments must be made to determine the cost and time frame for making necessary conversions.

  A number of transactions have been severely hampered by the inability to capitalize on the cost savings that were anticipated and occasionally paid for. The addition of new lines of business requiring sophisticated administration has been particularly troublesome.
- Adverse experience – Even though the risk of adverse experience can be priced, poor experience has caused disastrous unanticipated results. Most of these cases have resulted from health and accident lines, usually in a "down cycle."
- Overacquiring – Occasionally, organizations have made too many acquisitions in too short a time, spreading management too thin. One acquisition should be "digested" prior to embarking on the next, allowing the organization to determine how the pieces fit into the overall game plan.
- Distressed targets – This category of potential problems includes political cases as well as financially troubled companies. Although a price exists to make these transactions attractive, additional planning and discussions with insurance departments are required. In some cases a bail-out of a problem case would be considered a favor to the regulators. Frequently, the reputation of a troubled company is difficult to dislodge, so adverse lapse and sales results could be anticipated.

Conclusion

Consolidation will be a positive step for the life insurance industry. Hopefully, it also will benefit the consumer by lowering costs and strengthening the companies with which they do business. If organizations can focus on requisite critical success factors and avoid the pitfalls, we can avoid some problems that have plagued other industries and become a more efficient and profitable industry.

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Pension plans of government contractors

by Ronald L. Solomon, Eric H. Shipley, James E. Norris and Patrick E. Ring

The article by Bernard Sacks in the April 1989 issue of *The Actuary* presented an overview of how pension costs for work performed under a government contract are reimbursed. He pointed out the concerns of those involved in government contracting: overfunded plans, asset reversions from terminated pension plans, terminated divisions, and unfunded plans. We would like to expand upon some of these issues.

Pension cost, expense and contribution

The original Cost Accounting Standards Board (CASB) was aware of the distinction between the principles of good accrual accounting and the reality of how plans were actually funded. CAS 412 and 413 were developed contemporaneously with the Employees Retirement Income Security Act (ERISA). The ERISA standards, which governed the funding of pension plans, and the accounting standards (Opinion Number 8 of the Accounting Principles Board), which governed the pension expense shown on financial statements, were reasonably consistent; in fact many corporations used their contribution as the accounting expense. The CASB was able to walk the tightrope between the comparability and consistency goals of financial accounting and the funding goals of ERISA. From a contracting point of view, a meld of the correct period cost with the deposit to a fund was an ideal situation.

The result, however, was that the pension cost, computed under CAS 412 and 413, for a contract was neither the ERISA contribution nor the accounting expense. Furthermore, during the 1980s, when funding standards and accounting standards increasingly diverged, there was no CASB to ensure that the government's procurement rules reflected the changing environment. FASB's Statement 87 emphasized standardization in the measurement of pension expense to promote comparability.

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