

WILL CONSOLIDATION OF THE U.S. LIFE INSURANCE INDUSTRY CONTINUE?

Alan J. Levin, Esq.
Michael T. Griffin, Esq.
860.541.7747

The U.S. life insurance industry has experienced incredible changes over the last thirty (30) years, due in large part to diminished profit margins and increased competition. This article will discuss the consolidation of the U.S. life insurance industry. It will begin with an overview of the U.S. life insurance industry over the last thirty years and various factors leading to consolidation of the industry. Next it will discuss some of the more notable mergers, acquisitions and demutualizations of life insurance companies and insurance holding company groups. Finally, the article will conclude with an analysis of the future of the U.S. life insurance industry and whether consolidation of the industry will continue.

The Life Insurance Industry from the 1970s to the 1990s

In the 1970s, premiums paid on life insurance policies accounted for the largest source of revenue for U.S. life insurance companies.¹ The majority of the policies sold were whole-life policies that were extremely profitable to insurance companies and popular with consumers.² Consumers traditionally favored whole life insurance to other life insurance products because it offer both a death benefit and savings component, as a portion of the money paid is guaranteed back to the policyholder in the form of a guaranteed cash value.³ This is in direct contrast to term life insurance, which is life insurance for a specified period of years, with a set death benefit but no cash value component.

Rapid inflation and fluctuating interest rates in the late 1970s and early 1980s led to stagnating sales of life insurance products. The small but stable rate of return on whole life products did not keep pace with inflation. At the same time, mutual funds and other non-insurance stock market based investment products became more popular. Whole life insurance policies fell into disfavor with consumers because the policies were not providing competitive returns on investment as compared to investment products. Increasingly, consumers turned to non-insurance investment products and satisfied their life insurance needs by purchasing term life insurance coverage.⁴

The life insurance industry in turn responded by diversifying its product line to compete with mutual funds directly through the sale of annuities and other market-based products.⁵ These new life insurance products, however, were not as profitable as the traditional whole life policies as insurers were forced to pay to the policyholders a portion of earnings on invested premiums.⁶ Further, the pressure to increase the rate of return on investments caused insurers to make riskier investments in order to offer policyholders returns based on market rates.⁷ These riskier investments resulted in significant losses for many life insurers in the 1980s and 1990s.⁸

During the economic boom of the 1990s, overall insurance company profits rebounded as sales increased. Profit margins on individual products, however, remained low. Life insurance companies also faced increased competition from banks and securities brokers. For example, in 1995, the Supreme Court upheld the right of banks to sell fixed and variable annuities in *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 259 (1995). Faced by capital erosion due to decreased profits and market share, many U.S. life insurance companies and holding company groups were forced to unite with their competitors in order to remain profitable and competitive.

Some of the more noteworthy transactions in the life insurance industry during the 1990s:

- American International Group, Inc.'s acquisitions of SunAmerica, Inc. and American General Life and Accident Insurance Company
- MassMutual Life Insurance Company's merger with Connecticut Mutual Life Insurance Company
- Metropolitan Life Insurance Company's merger with New England Mutual Life Insurance Company.

Factors Leading to Consolidation

Management of these companies believed they would be better equipped to respond to the external market pressures by merging with or acquiring their competitors through increases in: (i) efficiency resulting from economies of scale; (ii) sales resulting from a larger client base; (iii) access to capital; and (iv) financial strength and assets under management. Increased efficiency can result as expenses are combined and spread throughout a larger organization, including expenses associated with building and supporting a brand, maintaining a distribution channel and other administrative and capital expenses.

Improved earnings can also be achieved through economies of scale. According to the law of large numbers in insurance, by increasing the size of the overall policy pool through a merger or acquisition, insurers can better predict losses and reduce earnings volatility.⁹

A merger or acquisition also increases the customer base and improves access to clients. Large insurance groups and companies with well-recognized brands can offer customers one-stop shopping for their life insurance and investment needs. Many clients also favor the financial strength and services offered by larger insurance companies and holding company groups.¹⁰

In 2004, Manulife Financial Corporation (“Manulife”) completed its acquisition of John Hancock Financial Services, Inc., (“John Hancock”), making Manulife the second largest life insurer in North America and the fifth largest in the world.¹¹ Size and scale were cited as key factors for the acquisition. John Hancock’s CEO D’Alessandro stated that “[n]ot only is consolidation in our industry inevitable,” he said, “but for companies of our size to compete and grow in the future, it is necessary. This transaction gives us the scale, capital base and diversity of product and distribution to grow as a business.”¹²

In January 2005, it was announced that Metropolitan Life Insurance Company (“MetLife”) would acquire Travelers Life & Annuity (“Travelers Life”) from Citigroup, Inc. (“Citigroup”) and substantially all of Citigroup’s international life business for \$11.5 billion. The acquisition will make MetLife the largest individual life insurer in North America, based on sales. MetLife Chairman and CEO Robert H. Benmosche elaborated on the reasoning behind the acquisition in stating “[t]his transaction increases MetLife’s size and scale in our core products and markets. The transaction solidifies our leadership position in the industry, will be immediately accretive to earnings and will enable us to enhance our return on equity going forward.”¹³

Other Factors Leading to Consolidation

Two other factors contributed in some degree to the consolidation of the U.S. life insurance industry in the late 1990s. The first factor was the passage of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (“GLBA”). Prior to the enactment of GLBA, insurance companies and banks were prohibited from merging. GLBA removed these Depression era restrictions. Many industry observers predicted that GLBA would result in consolidation of the financial services industry as a whole, as banks and insurance companies could now be affiliated in the same holding company structure. Such predictions have been inaccurate, thus far, as there have been relatively few cross-industry transactions involving banks and insurance companies. The most noteworthy cross-industry transaction was the merger of Citicorp and the Travelers Group, which resulted in Citigroup, a so-called one-stop financial services company. In 2002, Citigroup completed a transaction to spin-off Travelers Property Casualty. The recently announced sale by Citigroup of Travelers Life to MetLife calls into question whether the insurance and banking industries are destined to consolidate, as many predicted following GLBA.

The demutualization of several large mutual life insurance companies was the second factor that contributed to the continuation of the consolidation trend in the late 1990s. In response to the environmental and market pressures of the late 1990s, several of the largest mutual life insurance companies in the U.S. were converted to stock insurance companies. It was felt that demutualization would allow these companies increased access to capital, enhanced corporate structure flexibility, the ability to use stock as an acquisition currency, and more favorable tax treatment.¹⁴ The conversion of these large mutual insurance companies also increased the number of companies interested in merging with or acquiring other life insurance companies, and thus leading to further consolidation within the industry. The demutualization of John Hancock and its eventual acquisition by Manulife is a prime example of how

demutualizations have contributed to further consolidation of the industry, as the transaction could not have occurred if John Hancock was still a mutual insurance company owned by its policyholders.

Consolidation Should Continue Into the Near Future

Experts predict consolidation of the U.S. life insurance industry will continue. When Fitch Ratings released its outlook for 2005, Julie Burke, managing director and head of the life insurance sector predicted, “[w]e think more and more of the industry’s business will be concentrated in the larger, stronger, diversified players with competitive market positions and good market flexibility.... Smaller, less diversified companies will be increasingly marginalized, and this will drive consolidation.”¹⁵ A November 2004 survey of North American life insurance company Chief Financial Officers (“CFOs”) also predicted, “Consolidation is expected to expand at a fairly brisk pace over the next few years....”¹⁶ Ninety three percent of the CFOs surveyed expect the top life insurance companies to increase their market share from 40% of total assets (at year-end 2003) to at least 45% by year-end 2007.¹⁷ As the market factors leading to consolidation persist, the trend is likely to continue.

The prevailing view is that only the largest life insurance companies or those with highly specialized niche markets or defined specialties will prosper. Ramani Ayer, Hartford Financial Services Group, Inc., chief executive describes it as follows: “The ongoing consolidation in the mutual fund and life insurance industry has made scale a critical factor in sustaining market leadership.” Life insurance companies are positioning themselves based on this new reality. “It’s like a game of musical chairs,” said Andrew Kligerman, an analyst at Bear, Stearns & Co. Inc. “There aren’t that many chairs. And if you don’t get one, you’re going to be left behind.”¹⁸

Is Bigger Better?

Not all mergers and acquisitions involving life insurance companies, however, will be successful. In considering a potential transaction, upper management and the board of directors must carefully weigh the potential ramifications and have a clear strategic focus. Only with clear-cut goals and a proper fit between the two organizations will a merger or acquisition be successful. Differences in corporate culture, staff redundancies and the difficulties in managing the complexity of the larger company could overshadow any of the gains that could be achieved through consolidation.

Management must also carefully consider potential political and regulatory issues associated with any transaction. Elected officials and state regulatory officials may oppose a transaction that results in job loss or damage to the local economy. MetLife, which has an agreement to acquire Hartford, Connecticut based Travelers Life from Citigroup, has faced strong resistance from Connecticut Governor M. Jodi Rell (R). Connecticut State Attorney General Richard Blumenthal has threatened a lawsuit opposing the merger and there is pressure on Connecticut Insurance Commissioner Susan Cogswell to deny MetLife’s application for acquisition of control based on the grounds that it is against public interest. In response to this pressure, MetLife recently announced that it will only cut 390 Connecticut jobs, rather than the 600 jobs originally planned.¹⁹ Even if local and state officials are not successful in thwarting the acquisition, it could lead to a protracted fight that will delay the close of the deal and result in negative publicity for both companies.

Conclusion

Despite opposition from politicians and regulators, industry experts predict that consolidation of the industry will continue for the foreseeable future. Only time will tell whether the transactions resulting in the consolidation of the industry will ultimately pay dividends to the shareholders of the resulting companies or prove beneficial to the industry and the insurance buying public.

Endnotes

1. Wilmarth, Arthur E., Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*. 2002 U.Ill. L. Rev 215, 414 (2002).
2. *Id.*

3. Glossary of Insurance Terms, 271 (Merritt Publishing, 5th ed. 1994)
4. Wilmarth, at 415.
5. *Id.*
6. *Id.*
7. *Id.* at 415.
8. *Id.* at 416-17.
9. *Id.*
10. *Id.* at 3.
11. “Manulife Financial and John Hancock Complete Merger Creating North America’s Second Largest Life Insurance Company,” Manulife Financial Press Release, April 28, 2004.
12. “Manulife Financial Corp. (MFC) Buying John Hancock Financial Services Inc.” (*JHF*), SNL Financial Insurance, Mergers and Acquisitions, September 29, 2003.
13. “MetLife to Acquire Travelers Life for \$11.5 Billion; Firms Also Plan Distribution Partnership”, (insurancejournal.com), Jan. 31, 2005.
14. Smallenberger, James A. “Restructuring Mutual
15. Will Consolidation of US Life Continue? Continued on page 5
16. Will Consolidation of US Life Continue? Cont’d from page 4
17. Life Insurance Companies: A Practical Guide Through the Process.” Insurance Law Annual, 49 Drake L. Rev. 513, 521 (2001).
18. Fitch. “Mergers Foreseen as Trend Continuing into 05.” Annuity Market News, January 1, 2005, at 1.
19. Towers Perrin and Tillinghast, “Interest Rate Risk, Market Consolidation and Implementation of Enterprise Risk Management Are Key Concerns for U.S. Life Insurance Industry in 2005, According to Tillinghast Survey.” Press Release (Nov. 1, 2004).
20. *Id.*
21. Treaster, Joseph B. “Push to Merge Is Driving Insurance Industry.” N.Y. Times, March 15, 2001, at C2.
22. Levick, Diane. “Metlife Gives Ground on Jobs.” Hartford Courant (courant.com), April 16, 2005.