MERGERS AND ACQUISITIONS IN LIFE INSURANCE

by

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About the author

Neil Taverner is a member of Watson Wyatt Worldwide's life insurance mergers and acquisition team, and advises on transactions throughout Europe. He also advises on business and strategic planning, embedded value calculation and analysis, and asset-liability modelling, focusing particularly on France.

Prior to joining Watson Wyatt in 1999, he was Actuarial Director of GEO New York Life in Mexico City. He began his career with the AXA Group, where he worked for eleven years. This included three years at the AXA head office in Paris, where he was responsible for the actuarial aspects of life insurance merger, acquisition and joint venture projects worldwide.

Neil qualified as a Fellow of the Institute of Actuaries in 1990, and speaks English, French and Spanish. He has worked on life insurance M&A and joint venture projects in many countries throughout the world, including Australia, Belgium, Finland, France, Hong Kong, Hungary, Ireland, Japan, Malaysia, Mexico, Norway, Singapore, Slovakia, South Korea, Spain and the United Kingdom.

Part 1

1.1 Introduction

1.1.1 This paper is not an attempt to exhaustively cover the actuarial technical aspects which can arise in life insurance merger and acquisition transactions. Rather, it is intended to give a flavour of the types of issues which can arise, and some of the techniques which can be adopted in practice. Every M&A transaction is different, and so no paper could hope to address all the potential problems and solutions.

1.1.2 The second half of the paper moves on to look at recent merger and acquisition activity in two major life insurance markets, which from their geographical proximity might be expected to be very similar – the United Kingdom and France. The aim of this part of the paper is to show how tax, regulatory, distribution and consumer issues render even two well-developed markets within the European Union substantially different from both technical and strategic points of view. The differences which arise between other markets can be even greater, demonstrating the need for potential acquirers in markets which are new to them to ensure that they fully understand all the issues involved.

1.1.3 I would like to thank my colleagues in the M&A team at Watson Wyatt for much of the source material I have drawn on for this paper. The interpretation of this material is my own, and the analysis and opinions I present are not necessarily those of my employer.

1.2 Why do life companies do mergers and acquisitions? Is M&A activity an essential element of strategy?

1.2.1 Many reasons are cited (internally or externally) by life insurers who engage in merger and acquisition ("M&A") activity. Some of these are discussed briefly below.

- Where price is a key driver in a market, mergers may be necessary in order to build up the critical mass necessary to cut costs to a competitive level. As insurance companies' main costs are still often salary-related, this is more difficult in countries where employees have higher levels of job protection.
- M&A activity can also provide critical mass for distribution channels within an insurance organisation, or open up new channels to diversify distribution.
- M&A activity is a "ready made" way to diversify one's business in many other ways – geographically, by product range, target market etc, to protect to some extent against the effect of cyclical demand, and the impact of changes in, for example, tax and legislation.
- M&A activity can sometimes be driven by the wish to obtain access to better IT systems or skills. Conversely, "serial acquirers" in a particular market need to have flexible IT systems to absorb new companies' portfolios. This is particularly important in the case of "vulture funds", which have become a feature of UK M&A activity recently. These are companies who specialise in buying small life companies, closing them to new business, and running off the portfolio. They charge expenses to policyholders at levels consistent with those incurred before the acquisition and hope to make a profit by actually adminstering the business more efficiently.

- Many multinational insurance groups state that they are looking to develop internationally recognised brands. Consumers may feel more happy buying financial services products from large, well known names. To this end, many of the multinationals have targets such as being within the top five providers in the main insurance markets of the world. So many multinational groups have such targets that by definition they cannot all succeed!
- Economic integration (such as the introduction of the Euro) is a potential driver of M&A activity, as back office integration becomes (a little!) more straightforward.
- Companies may look to buy others in order to gain the critical mass needed to avoid being a takeover target themselves.

1.1.1 Successful acquirers tend to be those who approach M&A activity in the context of their overall strategy. The stages of M&A work can be summarised in the diagram below (the "FLINI" process).

1.1.2 The first three stages are crucial to the success of any deal. They focus on
- formulating the strategy within which M&A activity is intended to add value,
- locating suitable targets which will add value, and
- investigating these targets to ensure that value can indeed be realised, and how much

1.1.3 The remaining two stages are also important, but depend critically on the outcome of the first three:
- negotiating a price can only be done effectively in the light of the outcome of the earlier stages, as it is these which will determine the strategic and economic value of the target to the acquirer
- integration of the acquired company into the acquirer's organisation is where the value is actually realised, but again only if the first three stages were done in enough detail to ensure that the integration plan is realistic, and that the end results are likely to contribute value to the acquirer's strategic aims.

1.1.4 A key stage in the acquisition process is therefore that of defining strategy. The company should have a clear idea of where it is going and how it wants to get there. If the company's vision of where it wants to be cannot be achieved by organic growth alone, then M&A activity can fill the gap. Alternatively, M&A activity can speed up the timescale involved in arriving at the desired objectives.

1.1.5 The company's strategy should therefore be defined in terms of specific goals it wants to achieve. The company should then identify in which of these areas M&A activity could help it in realising its goals. Examples of goals which companies might set themselves as part of their strategies could be:

- increasing scale
- diversifying profit sources
- widen product ranges

- extending distribution
- filling skill gaps
- catching up on "missed" opportunities

Generally speaking all of these goals could be achieved with or without M&A activity – the question is whether they can be achieved within the required cost and time constraints. Note that M&A activity itself is not listed as an example of a goal!

1.1.6 There are of course many companies which do not actively pursue M&A activity. They may be relying on other (perfectly valid) approaches to realising their strategies, such as:

- organic growth
- being a niche (focused) player
- expanding by launching start-up operations
- entering into partnerships

1.1.7 So, are M&As an essential element of strategy? The answer has to be no, as there are perfectly viable business strategies which do not require them. However, I believe that considering the M&A angle when defining strategy is essential. M&As could enable the company's chosen strategy to be implemented much more quickly if the right acquisition opportunity came along. In other situations, M&A activity may be the only feasible cost-effective way to achieve the required results in a reasonable time frame. Also, strategy must bear in mind the possibility of the company becoming a takeover target in itself.

Part 2 – Actuarial Aspects of Mergers and Acquisitions

2.1.1 Strategic considerations are not necessarily the domain of actuaries, and so actuarial involvement in the first stage of the acquisition process may be at a non-technical level. However, the actuaries who will be involved in technical work on M&As (whether these are internal, or external consultants) should ideally be aware at all times of the strategy and goals of the company, and how M&As are viewed as a means of realising these.

2.1.2 They should also be involved in initial selection of companies which might be the object of an acquisition bid. This selection could be on a proactive basis, with analysis of potential targets being made on the basis of publicly available information, or on a reactive basis, waiting for companies to "come into play" and announce that they are looking for an acquirer. In the latter case the target will often produce an information memorandum setting out the key elements of a commercial valuation of its business.

2.1.3 The danger of the reactive approach is that it can lead to companies buying the wrong targets, by not analysing in enough detail the possible and expected synergies or strategic advantages of the deal, and by not searching out the companies which offer the best potential strategic fit. Even if the approach to deals is to be more reactive than proactive, it is essential that the company continually reflects on the aims of its M&A activity within its overall strategy, so that when the right opportunity does come along the company is not starting from scratch in its assessment of potential synergies, new product or distribution channels, cultural fit etc.

2.1.4 Continually thinking through the potential benefits of different types of acquisition can also help the company or its advisers to more rapidly assess the most beneficial structure to integrate various types of acquired company (merged, parallel or subsidiary companies, merged or separate life funds, closure of one fund to new business, reinsurance arrangements between entities, etc). The structure adopted can have significant impacts on expense levels following the merger, and also on tax.

2.1.5 Thinking through the possible approaches to valuing future new business in advance is also advantageous. Different types of acquisition will present different possible levels of synergy or counter-synergy. Adding a new distribution channel or client segment may increase production and/or productivity to more than the sum of the constituent parts, as cross-selling or expense reductions generate synergies. Increasing the size of an existing distribution channel may generate cost savings, but combined production could be less than the sum of the parts, due to distributors leaving the merged organisation. The latter is particularly likely where distributors are not employees of the companies involved. In either case, the acquiring company will need to construct "plausible" projected business plans with and without the acquired company, and determine how much of the added value it is prepared to pay for. If various alternative possible models have already been constructed prior to entering into serious analysis of a particular deal, the fine tuning required can be done much more quickly than starting modelling from scratch at that point.

2.2 Valuation of net assets, in-force business, and goodwill

2.2.1 However, for an acquiring company, it is generally when looking in detail at a particular target that most actuarial energy is expended. This is because it is only at this point that the particular characteristics of the target, its products and structure, can be examined. If the acquisition is to be a "friendly" one then generally the acquirer's actuaries will have access to most of the information they require to perform as full analysis as possible of the target's value and the risks involved. In the case of a hostile bid, then the information which is available may be severely restricted, and the experience of the acquirer and its advisers in looking at similar companies may be of more use than the data on the target itself which is available.

2.2.2 The valuation of a life insurance company has traditionally been done by estimating the "appraisal value" of the company, comprising:

- The net assets of the company;
- The value of future profits generated by the portfolio of business in force at the date of valuation; and
- The value of the company's capacity to generate future profitable new business (often referred to as "goodwill")

2.2.3 The sum of the first two items is generally referred to as the "embedded value" of a life company. Adding the goodwill item produces the "appraisal value".

2.2.4 The techniques used to value these three elements of value have been widely documented elsewhere (some examples are given in the bibliography), and I will not repeat the technical details here. However, many issues arise in valuing companies for M&A purposes which do not necessarily arise when using embedded value analysis for internal purposes. International acquisitions also frequently give rise to considerations which are not normally encountered in the acquirer's home market. I give some examples of both types of issue below.

Net asset value

2.2.5 The net assets are usually valued directly from the balance sheet of the company as the difference between assets and liabilities, adjusting as necessary to bring the value of assets to their market value. Special consideration needs to be given to the treatment of assets in excess of the liabilities which are nevertheless required to remain within the company, to provide the required regulatory solvency margin, or higher levels of solvency if this is required (for example for marketing purposes or by ratings agencies). This is normally done by reducing the projected profits on existing and future new business by the difference between the acquirer's required rate of return on its investment in the company, and the net investment return which it is expected can actually be earned on the blocked assets.

2.2.6 This can be complicated by the regulatory environment – for example in France, companies are required to pass any profits made on the sale of fixed interest investments into a special reserve (called the "réserve de capitalisation" or "RdC") rather than distributing them to either policyholders or shareholders. Losses on the sale of fixed interest investments reduce the RdC. The complication arises from the fact that since the RdC is not distributable it does not technically belong to either the shareholders or the policyholders, and although it is therefore not a policyholder liability it equally cannot be deemed to form part of shareholders' net assets. On the other hand the RdC is allowed to be treated as capital available to provide the regulatory minimum solvency margin. In practice therefore it is often taken into account in determining the appraisal value of a French life company insofar as it reduces the amount of solvency capital which the shareholder has to provide.

2.2.7 In the United Kingdom, "with profits" business is usually written within a segregated fund. The structure of the products involved is of annual bonuses which are added to policy liabilities each year, at a level which is on average less than the surplus arising during the year. The remaining surplus is held back, and paid out (on average) as a "terminal bonus" at maturity. As this terminal bonus is not guaranteed, no mathematical reserve is required in respect of it, and the assets which build up over the policy term to provide it are therefore eligible to provide the required solvency margin. The structure is designed to enable a higher proportion of the assets backing the policies to be invested in equities, as part of the "liability" (the terminal bonus element) is not guaranteed at any stage. The terminal bonus actually paid is based on smoothed investment performance, so that the policyholder is not exposed to the full risk of a sudden downturn in equity values just before maturity, for example.

2.2.8 The structure means that with profit funds usually provide their own solvency capital - as the terminal bonus element is not a liability the assets representing it are available for solvency coverage. There is therefore generally no requirement for shareholder capital to support such business. The "downside" is that the profits which shareholders can extract from such funds are typically limited to 10% of the surplus distributed to policyholders in any year. And of course the assets within the fund cannot be counted as part of the shareholders' net assets. The structure of with profits business causes particular complications in the case of the demutualisation of a mutual insurer in the UK, and this is considered in more detail in Section 3.6.

Value of future profits on in-force business

2.2.9 The value of future profits on in-force business is usually undertaken by constructing a computer model which projects the expected future cash flows from the in-force policies under given assumptions regarding the future economic and demographic experience of the company. The model may project cash flows on a policy by policy basis, or model points may be used to represent blocks of business. In the latter case it is important to verify that the chosen model points do adequately reflect the projected behaviour of the business, not just in the "central" (most likely) scenarios of future experience, but also in other possible future scenarios which the acquirer may wish to analyse.

2.2.10 Leaving aside the technical aspects of choosing model points (if necessary) and of accurately projecting cash flows for each type of policy written, the most important aspect of valuing future profits from the in-force portfolio of business is often that of determining the experience parameters for the cash flow model to be used. An important element of due diligence is therefore the investigation of the company's past experience, and the setting of suitable assumptions for the future.

2.2.11 A key analysis is that of the allocation of the company's expenses between product lines and distribution channels, and in particular the allocation of per policy expenses between acquisition costs and renewal costs. Functional costing and unit cost analyses are widespread in many developed insurance markets, but typically less so in developing markets. Acquirers in many such markets can find that the target has overestimated acquisition costs and underestimated renewal costs significantly. If not corrected this has the effect of overstating projected future profits on the in-force business (which are often deemed to be "safer" and therefore valued at a lower risk discount rate) and understating projected profits from future new business (which are often valued by an acquirer at a higher risk discount rate). This can have a major impact on the apparent appraisal value.

2.2.12 Where an acquirer is expecting to be able to make cost synergies by merging the target with an existing company, or by establishing a separate company to provide services to both the existing and the acquired company, it will need to value the impact of expected reductions in expenses, both in the value of the acquired company and in the value of its own business. This can clearly be done by reducing the assumed expenses appropriately in the models of the two businesses. The extent to which an acquirer will wish to pay for the resulting increase in value will depend in part on the degree of competition for the target, and whether any other potential acquirers are likely to be able to realise similar synergy benefits (and whether they are likely to be willing to pay for these). This is an example of an issue for which actuarial rigour has to give way to "second-guessing the opposition". Decision makers will however almost always require a full analysis of value with and without synergies in order to pitch a bid at a suitable level.

2.2.13 Lapse and surrender rates are often also of critical importance in the value. Again, it is often the case in developing markets that companies have not maintained the data required for a full analysis of historic lapse rates by duration to enable a suitable lapse profile to be derived. The experience of the actuaries performing the valuation in looking at similar companies, or of performing a suitable range of sensitivity tests, will be critical in assessing the possible impact of different plausible profiles.

2.2.14 Historic mortality experience is almost always available to enable suitable assumptions to be made with some confidence. Complications can arise with such issues as assumed future improvements in annuitant mortality, for example in the case of guaranteed annuity options in the United Kingdom, covered in Part 3.

2.2.15 The existence of guarantees and options within the products modelled requires careful consideration. These guarantees may become valuable in specific circumstances (economic and/or demographic) and sufficient sensitivity testing should be performed where possible to measure the possible impact on value. Where such testing cannot be performed, estimates of the impact will have to be made, with appropriate account of the possible margin for error being taken, perhaps by increasing the required risk discount rate. Where guarantees and options are complicated, or where the probability of their biting is difficult to assess, stochastic modelling would ideally be required to fully analyse them. Unfortunately, given the timescales involved in M&A transactions, detailed stochastic modelling is often only a practical solution in the case of a "friendly" bid with no competitive or time pressure. In other circumstances it may be that the best which can be achieved is a high-level model, again with suitable adjustment for possible margins of error. It is interesting to note that the current direction of proposals for International Accounting Standards suggests that a stochastic approach to valuing such liabilities may be adopted for the published accounts – M&A due diligence in this regard would then be a case of verifying the methodology and bases already used.

2.2.16 A final example of an issue to be aware of in valuation of in-force business for M&A work is that of discretionary bonuses. Sellers sometimes produce appraisal values assuming that future bonuses are declared at or near the minimum required by the regulations in the country concerned. Where normal market practice is to pay higher levels, or where this has been the practice of the target company in the past, serious consideration should be given to the impact on other assumptions such as future lapse experience or the expected levels of future new business. It may be that the potential negative impact of such a change in bonus policy outweighs the increase in value.

Goodwill

2.2.17 Goodwill is often based around the value at the point of sale of one year's new business, typically the last full year for which data is available. This is valued using the same type of cash flow model as for the in-force business, but of course including acquisition expenses and commissions. The issues around the assumptions of future experience are similar to those for the in-force portfolio.

2.2.18 Turning this analysis of the value of one year's new business into a value for the capacity of the company to write business in future at a profit is once again an example of where actuarial rigour can take second place to competitive bidding pressure. However, a number of techniques are used in practice to arrive at a "scientific" value for goodwill (which can then be disregarded as necessary in the bidding process!).

2.2.19 The traditional approach was to simply multiply the value of one year's new business by a multiplier, calculated according to the expected rate of growth of future new business, the risk discount rate applied to discount profits back from the point of sale of future business to the acquisition date, and the number of years of new business. If the multiplier is to be applied to the value at the point of sale of the new business sold in the year ending with the date of acquisition, the assumed future rate of growth of new business is g%, the assumed risk discount rate from point of sale to acquisition date is r%, and n years of future production are to be valued then the multiplier is derived as:

$$(1+r)^{1/2}\, a_{\overline{n|}}$$

where $a_{\overline{n|}}$ is calculated at rate of interest

$$i = (1+r)/(1+g) - 1$$

2.2.20 Multipliers for a range of possible g, r and n are shown in the tables below. This shows the wide range of multipliers which can be derived from fairly similar sets of assumptions, and thus the highly subjective (and approximate) nature of the approach.

Theoretical new business multipliers assuming ten years of new business value (n=10)

	g = 0%	g = 2½%	g = 5%	g = 7½%	g = 10%
r = 7½%	7.1	8.1	9.1	10.4	11.8
r = 10%	6.4	7.3	8.2	9.3	10.5
r = 12½%	5.9	6.6	7.4	8.3	9.4

Theoretical new business multipliers assuming valuation of new business in perpetuity (n=¥)

	g = 0%	g = 2½%	g = 5%	g = 7½%	g = 10%
r = 7½%	13.8	21.3	43.5	-	-
r = 10%	10.5	14.3	22.0	45.1	-
r = 12½%	8.5	10.9	14.8	22.8	46.7

2.2.21 The method can be further refined by subdividing the new business value by product line and/or distribution channel, and deriving different multipliers for each, but this also suffers from subjectivity and approximation.

2.2.22 A more sophisticated (but still subjective!) approach is to explicitly project the expected volumes of new business by product line and/or distribution channel for a period of years. Profitability factors at the point of sale (for example present value of profits divided by annual premium) can be derived based on the analysis of the previous year's sales and applied to the expected volumes. An "exit value" at the end of the period of explicit projection can be added (perhaps based on the multiplier approach) if necessary. The method has the advantage of allowing for different rates of growth in each future year of the explicit projection, and of enabling sensitivity testing to be carried out.

2.2.23 A further refinement can be to allow for any expected evolution in the profitability of future sales. If competition is expected to increase in future, then profit margins at the point of sale can be assumed to reduce according to an assumed profile. If synergies are expected to increase future profitability then this can also be modelled.

2.2.24 The subjective nature of the projections generally leads to the construction of a number of possible scenarios for future new business volumes and profitability – pessimistic, best estimate, optimistic etc.

2.2.25 At the end of this analysis, the value which is assigned to goodwill in the final offer price tends to be defined by the "formula":

Goodwill value = offer price – embedded value

2.2.26 That is, it is a balancing item representing the difference between the price which the acquirer is willing to pay (and which it hopes the seller will accept) and the embedded value. That being said, in deciding the offer price the seller will of course bear in mind the range of possible values of goodwill which result from the calculations outlined above, and will generally attempt not to pay more than its optimistic valuations. Indeed, where possible an acquirer will attempt to pay less than this, particularly where it believes that the more optimistic growth rates and/or lower future expenses will arise at least in part from its own experience, good management or size.

2.2.27 The calculation of a goodwill value is often particularly difficult in rapidly developing markets. Such transactions arise for example where a multinational wishes to sell off a recently created subsidiary in a developing market, as its own strategy changes (perhaps to focus exclusively on developed markets). The seller will try to convince the acquirer that it should pay for future new business on high projected rates of growth, and may succeed in this if there are a large number of interested potential acquirers. Acquirers need to take care in this situation that they do not pay more for the company than they would need to expend on setting up a greenfield operation in the same country and developing it themselves to the same size as the current size of the target concerned!

Global adjustments

2.2.28 An issue which also needs to be taken into account in respect of recently set up or rapidly growing companies is that of expense overrun. Typically such companies are incurring overheads which its current levels of in-force and new business are unable to support. In this situation, an approach which is often adopted is to value the in-force and new business using assumptions for unit costs which it is expected the company will be able to support once it reaches a stable situation. An negative adjustment is then made to the appraisal value representing the present value of the difference in each year between the projected future expenses of the company as whole and the total of the costs calculated by applying the unit costs in each year to the projected volumes of business (in-force and new) each year. As this calculation can only be performed for the company as whole (i.e. it involves projection of both the existing portfolio and assumed future volumes of new business) it is generally performed as an adjustment to the overall value of the company rather than being deducted from the value of the in-force and/or new business.

Risk discount rates

2.2.29 The risk discount rates which are to be used in valuing the in-force portfolio and the value of new business (before and after the date of writing the new business) are also subjective decisions, and will tend to be based on the acquirer's own methodologies for setting risk discount rates. These are often based on the risk-free rate which can be earned in the country of acquisition (the yield on medium-long term government bonds) plus a risk premium reflecting the reward required for the uncertainty of investing in an insurance company rather than such bonds. Typically this additional premium will be of the order of 3 to 5% for valuing in-force business.

2.2.30 In calculating goodwill values, two risk discount rates may be used. One is to discount profits generated by new policies back to the point of sale of the policies. This is often done using the same rate as for valuing the in-force (as once business has been written it is no more risky than the business which is already in force). A higher discount rate is often used to discount the resulting value of profits at the point of sale back to the date of acquisition, reflecting the intrinsic uncertainty surrounding the projections of future new business volumes. Where there is significant uncertainty regarding the projections, or where particularly optimistic growth is being assumed, the discount rate can be of the order of (for example) 5% higher than the post-sale rate.

Part 3 – Analysis of merger and acquisition activity in the United Kingdom

3.1 Background to recent merger activity

3.1.1 Over the last ten years a wave of merger and acquisition activity has swept through the UK insurance industry, particularly the life sector. The reasons for this increased level of activity are several, notably:

- The impact of the Financial Services Act in 1989;
- The pensions mis-selling episode in the early 1990's;
- The impact of guaranteed annuity options; and
- The introduction of "stakeholder pensions" in 2001.

3.1.2 These issues, and the reasons for which they have led to increased M&A activity, are described briefly below.

The Financial Services Act

3.1.3 The Financial Services Act ("FSA") came into force in 1989, with the intention of improving and formalising the protection of purchasers of long term financial products, notably life products. The main change introduced by the FSA was the "polarisation" of advice. Persons advising on long term products were required to opt for one of two extreme positions:

- Either to become representatives of one life insurance company, and sell only the products of that company
- Or to become independent financial advisers ("IFAs") and advise on the products offered by all life companies in the market.

3.1.4 Representatives of a sole life company were generally of two types:

- "Tied agents", not employees of the life company but having entered into an exclusive agreement to sell its products, or
- Salesmen employed directly by the life company to sell its products (and known collectively as "direct sales forces" or "DSFs")

3.1.5 Both types were obliged to recommend to clients the product chosen from the life company's range which best met the client's needs. In order to do this they had to conduct a "factfind" interview with client to determine these needs, and provide a written explanation of why the product chosen was selected. In both cases, whether the salesman was directly employed by the company or not, it was the life company's responsibility to ensure that factfinds were conducted correctly, that the advice given was reasonable, and that proper records were kept to demonstrate this.

3.1.6 IFAs had the same obligation to conduct factfinds, but as well as recommending the product type best suited to the client, also had to recommend the company from which the product should be bought, with a responsibility to provide "best advice" in this regard. In theory this requires the IFA to constantly monitor the whole range of products offered by all life companies in the market. A key difference from tied representatives is that the responsibility for ensuring compliance with the FSA rests with the IFA in all cases, and not with the product provider.

3.1.7 The second key change introduced by the FSA was the standardisation of information given to the client before and after the sale of any long term financial product. This information (given mainly in a document referred to as a "key features document" or "KFD") included:

- Details of the structure of the product
- Estimates of the surrender values at certain specified intervals and of the maturity value, under specified assumptions regarding future experience
- The impact on the financial return to the policyholder of the charges deducted under the contract
- The risks involved in the contract
- The type of advice given (tied or independent)
- The amount of commissions paid to the adviser
- The reasons for which the product was recommended

3.1.8 The impact of the FSA was enormous, for both tied and IFA distribution. Tied agents found that their costs increased dramatically, as recruiting and training salesmen to a standard to comply with the rules was much more expensive, and the costs of complying with the rules for each sale (notably of documentation) were significant. Smaller life offices with direct sales forces or tied agent networks found that the costs of ensuring that all sales complied with the rules were prohibitive. Many tied agents and direct salesmen left the market, with the larger life companies left in the market acquiring smaller ones.

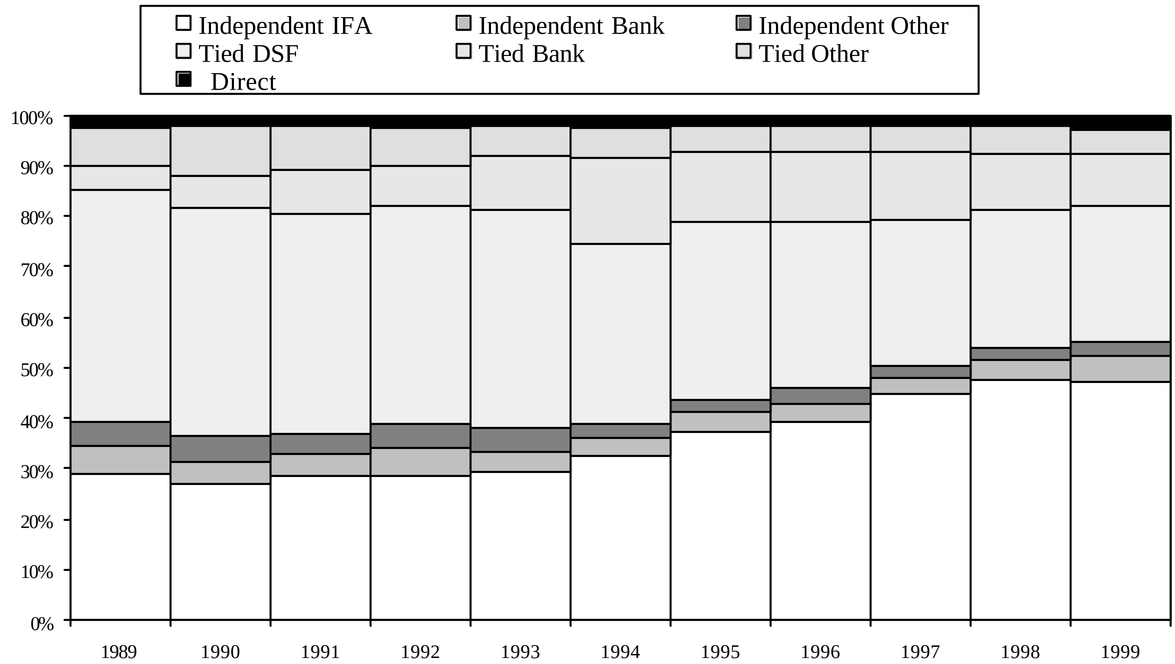
3.1.9 The banks, however, found that they were better placed than life companies to control direct sales forces at a reasonable cost, as the salesmen were usually based in their branches. Several major banks set up their own life offices to exploit this advantage, and their captive client base.

3.1.10 IFAs also saw their costs increase, for the same reasons as for tied agents, but also because of the requirement to constantly research and compare all the products in the market. To share the costs of this research, many IFAs formed into networks with a centralised research function, or merged into larger IFA companies.

3.1.11 The requirement for best advice and the information in the KFD also forced life offices to reduce their charges, in order to appear at the top of the IFAs' comparison charts. At the same time, the increasing size and power of the IFA networks and large IFA companies increased their negotiating power with the life offices. IFAs were therefore able to demand lower charges for their clients at the same time as higher commissions for themselves, and life offices wishing to be major players in the IFA market found themselves caught in a margin squeeze.

3.1.12 The impact of the FSA over the period from 1989 can be seen in the following graph – the relentless growth of the IFA sector, the decline of the tied agent sector, and the (temporary) rise of the banks.

Individual new business annual premium equivalent by distribution channel, 1989-1999



Source: ABI new business statistics. Annual premium equivalent = annual premiums plus one-tenth of single premiums.

3.1.13 IFAs also focus on other issues when selecting providers, including solvency levels, service levels and investment performance. Life offices therefore needed to reduce costs, improve service levels, provide top investment management services, and maintain a strong solvency position, all at the same time. Weaker offices found it difficult to compete, and larger offices (looking to expand their portfolio of business to reduce unit costs, and their distribution capacity) were ready buyers.

3.1.14 The FSA by itself would have led to a large proportion of the M&A activity experienced over recent years (and it is interesting to speculate whether similar effects will be seen in other markets which have followed the UK in introducing such sales regulations). However, other factors also accelerated M&A activity.

Pensions mis-selling

3.1.15 Despite the introduction of the FSA, and the procedures of factfinds and KFDs, a major scandal surfaced in the UK life market in 1994. In their desire to maintain commission income, many salesmen had sold individual pension policies to people who were (or could become) members of their employer's group pension scheme. In many cases this led to these people losing out on significant benefits of their employer's scheme, such as contributions made to the scheme by the employer rather than the employee.

3.1.16 Under the terms of the FSA, all cases of potential mis-selling of individual pensions products from 1989 to 1994 all had to be re-examined. For cases where the client could have been financially disadvantaged, projections and comparisons had to be made of the retirement benefits expected from the individual policy and the group scheme, and where the latter was more advantageous, equivalent compensation paid to the policyholder.

3.1.17 The majority of cases of mis-selling were from sales by tied agents or direct sales forces, where the responsibility for compliance rested with the life office concerned. Many life offices were therefore hit by both the administrative cost of investigating a huge number of potential cases dating back several years, and the compensation costs where mis-selling was revealed. These offices had to make large provisions for the potential cost, reducing their solvency and therefore their competitivity in the increasingly important IFA market.

3.1.18 The scandal also accelerated the shift from tied to IFA distribution – consumers had more confidence in independent advice. This shift also hit the banks, as mistrust of non-independent advice from any source reduced their previous advantage as one-stop purveyors of financial products.

Guaranteed annuity options

3.1.19 These options have also hit solvency. They too arose from sales of pensions policies, typically dating from the 1970s and 1980s. Pensions policies in the UK are savings policies producing a fund at retirement, the majority of which must be used to purchase an annuity. The rates used for the purchase of the annuity are those in force at the life office at the date of retirement (and policyholders have the right to purchase the annuity from a different life office to obtain a better rate if they wish). However, many offices incorporated within their contracts a guaranteed minimum amount of annuity which could be purchased from them for every £1,000 of retirement fund. When the contracts with these options were sold, the rates which were guaranteed appeared very conservative. Unfortunately, the combination of the fall in interest rates and the continuing fall in mortality rates at post-retirement ages means that the options have already started to become valuable for policyholders reaching retirement for many life offices. As mortality rates are expected to continue to improve, costs are expected to increase, and the UK regulators have required that offices establish reserves for the potential costs, which in some cases have been very significant.

Stakeholder pensions

3.1.20 Arising in large part from governmental concerns over the pensions mis-selling episode, stakeholder pensions were launched in the UK in April 2001. These are a new generation of pension products, which must comply with certain government-imposed criteria, notably a maximum level of charges of 1% each year of the funds invested (although the costs of advice can be charged for separately). As this level of charges is much lower than UK life offices have historically charged, offices which wish to be active in this sector have needed to look for methods of reducing their administration costs. This is particularly the case since the target market for stakeholder pensions is those who currently have no pension provision, and whose average premiums are expected to be low.

3.1.21 The existence of stakeholder pensions is also driving down charges on other pensions products to similar levels.

3.2 Impact on M&A activity

3.2.1 All the factors outlined above have combined to produce the increased levels of M&A activity over the last ten years. Consolidation has taken place as companies seek critical mass – to reduce unit costs, maintain solvency, and enlarge their distribution capacity.

3.2.2 Table A.1 in the Appendix shows the scale of activity over the period from 1990 to 2000. The table shows the market share (measured by the traditional UK measure of new business production of new annual premium plus one-tenth of new single premium) of the top 25 life insurance groups (each group may comprise several life companies). The level of consolidation is summarised in the table below, which shows the new business market share of the top 5, 10, 15, 20 and 25 groups in various years during the period. Note that as the data for Table A.1 is drawn from various (slightly incompatible) sources, the market share figures are approximate, but give a reasonable indication of the trends.

Approximate new business market share by group, 1990 - present

	1990	1994	1998	1999	2000	Current
Top 5 groups	34%	34%	35%	34%	41%	41%
Top 10 groups	54%	51%	57%	57%	69%	69%
Top 15 groups	67%	63%	72%	74%	86%	86%
Top 20 groups	76%	72%	82%	83%	93%	93%
Top 25 groups	83%	79%	89%	89%	97%	98%

See notes to Table A.1 for details of the analysis

3.2.3 The apparent lack of consolidation activity over the period 1990 to 1994 is due to the fact that there were several new entrants to the market just before and during this the period, notably life companies set up by the banks, which rapidly gained market share. The traditional companies had to develop their own business (organically or by acquisition) to preserve their market share. Since 1994 business has concentrated significantly, and the market is now essentially concentrated within the top 15.

3.2.4 M&A activity has been significantly more pronounced since 1994 as the increased IFA market share, the strains on capital for smaller offices caused by mis-selling and GAOs, and the preparation for stakeholder-compatible charging have taken their toll.

3.2.5 Table A.2 in the Appendix lists the major mergers and acquisitions which have impacted the top 25 life insurance groups since 1990, and the main trends are discussed below.

3.3 Domestic mergers of proprietary insurers

3.3.1 There have been two major examples of the merger of proprietary composite groups (i.e. insurers writing both life and property-casualty insurance). The market-leading position in both life and non-life of CGNU has been obtained by a series of mergers – notably Commercial Union and General Accident merging to form CGU in 1998, and CGU merging with Norwich Union to form CGNU in 2000.

3.3.2 The other example is that of Royal Insurance and Sun Alliance merging to form Royal & SunAlliance in 1996. This merger was primarily driven by non-life considerations, as neither company had a significant life market share. At the time of writing it appears that the group will be selling off its life operations in the UK as they (at around 2.5% of the market) do not have sufficient critical mass, and are in need of further capital support on an ongoing basis.

3.3.3 CGNU replaced Prudential as the market leader in life business. Prudential has battled to retain its leadership position for a number of years, as its original business model (focusing on selling through a direct sales force) was hit by the cost of FSA compliance, and a particularly heavy pensions mis-selling cost. Prudential acquired Scottish Amicable to broaden its distribution base in 1997, but its UK market share has since fallen steadily. It now appears to be focusing on overseas development while restructuring its UK distribution strategy.

3.4 Foreign acquirers and mergers

3.4.1 A strong trend throughout the period has been of UK companies (particularly mutuals) being acquired by overseas groups. The attraction of the UK to international groups has presumably been due to its size and significance – as mentioned earlier, many multinationals have mission statements to the effect that they will be leading players in the world's significant markets.

3.4.2 The steady flow of acquisition targets putting themselves up for sale has been largely due to the solvency pressures experienced by small to mid-size players, particularly the mutuals.

3.4.3 The main multinational groups who have constructed significant market shares by acquisition over the period are Aegon, AXA, Zurich and AMP.

3.4.4 Aegon demutualised and acquired Scottish Equitable in 1993. They also acquired the life operations of GRE in 1999 from AXA, the latter having bought the GRE group for its UK and European non-life operations. Rather than merging GRE's life operations with its own life companies (which at the time were still settling down from the rash of subisidiary mergers following the AXA-UAP group merger), AXA chose to sell these on to other buyers.

3.4.5 AXA had acquired Equity & Law (a medium sized UK life office) in 1987, when it bought E&L's French owner, Compagnie du Midi. Sun Life was acquired jointly by UAP and Liberty Life of South Africa in 1991, with Liberty withdrawing a few years later. The AXA-UAP merger in 1997 led to the merger of Equity & Law and Sun Life to form AXA Sun Life, forming a top five player in the market. It has since slipped back, partly due to lower new business growth than the market average, but also due to other mergers forming bigger players.

3.4.6 Zurich acquired the UK life operations of the BAFS group (Allied Dunbar and Eagle Star) and merged them with its own small operation in 1998. The Australian AMP had already acquired Pearl Assurance at the end of the 1980s, and added NPI in 1999. NPI was a mutual which had a shortage of capital, and had attempted to remain independent and mutual by raising capital through issuing bonds secured on the future profits of a block of its business. This securitisation of part of its embedded value was the first of its kind, but merely delayed the inevitable.

3.4.7 GE Capital had bought several small life operations before finally breaking into the top 25 with the acquisition of National Mutual in 2001.

3.4.8 It is interesting to note that the most rapid growth in new business by overseas groups has been by two groups who have not made acquisitions, but entered the market by focusing on "niche" products. Skandia has built a large market share by focusing on unit-linked products linked to a wide range of external managers' funds. AIG has focused on high premiums products distributed through IFAs. This strategy of focusing on one type of product (and becoming the "default" choice of IFAs for the products concerned) appears to have been more effective than attempting to grow IFA share by merging together two or more life offices which had previously both been selling a range of life products through the IFA market. A drawback of the second approach has been the fact that without a clear reason for IFAs to choose a particular company over another, they will tend to spread their business around the market and avoid concentrating large percentages of their business with one provider. Merging two such providers together can produce such a concentration, resulting in the IFA choosing to place less business in future with the merged company than it did with the previously separate constituent parts.

3.5 The banks

3.5.1 As mentioned in section 3.1, the banks enjoyed a period of growth in life insurance sales up to 1994, as their advantages of a strong customer base and a controllable in-house sales force less to strong sales. Many banks set up their own life insurance subsidiaries, often outsourcing the administration of the business to existing life companies.

3.5.2 The strategy of the banks began to change as they saw that other distribution channels were necessary to achieve a high market share in life assurance, and that high volumes of business under management could remove the need to outsource. In some cases (such as the Halifax's demutualisation and acquisition of Clerical Medical) it was the original provider of the administration services who was acquired. Halifax is one of several banking groups who have been serial acquirers, both of insurers and other banks. Its acquisition of the Leeds building society expanded its banking network, and it has also recently acquired majority ownership of J Rothschild Assurance (an upmarket direct sales force operation) and the sales force of the Equitable. It therefore has a multi-distribution strategy of bank-related sales, IFA sales, and upmarket direct sales.

3.5.3 A similar multi-distribution strategy has been adopted by Lloyds TSB (the product of the merger of Lloyds and TSB in 1995). Lloyds had already acquired Abbey Life in 1988, and both Lloyds and TSB had their own life subsidiaries. The group then demutualised and bought Scottish Widows in 2000, giving it a major IFA player – it has since closed Abbey Life to new business, selling the salesforce to Zurich. Scottish Widows effectively now provides products to both the IFA market and Lloyds TSB's own customers.

3.5.4 Abbey National has similarly acquired both Scottish Mutual and Scottish Provident.

3.5.5 However, the downward pressure on product charges (and therefore profits) has recently started to reverse the process of integration of life and bank businesses. Barclays has decided to close its own life subsidiary to new business, and instead become a distributor of products provided by Legal & General. The latter is a specialist in providing low-charge products through achieving high volume sales through a variety of channels.

3.6 The mutuals

3.6.1 The period has been one marked by great change for the mutual insurance companies in the UK, mainly due to the pressures on solvency and the need to achieve sufficient volume to compete effectively. Mutuals which have demutualised and been acquired by proprietary life offices, UK banks or foreign groups (discussed above) include Scottish Equitable, Clerical Medical, Scottish Amicable, NPI, Scottish Widows, Scottish Provident and National Mutual. Norwich Union demutualised and floated independently on the Stock Exchange in order to have access to capital for development, and subsequently merged with CGU. Friends Provident has recently floated for similar reasons, amid feverish speculation as to how long it will last as an independent entity before being acquired or merging.

3.6.2 As mentioned earlier, the structure of with-profits business in the UK complicates demutualisation. All UK life assurance demutualisations have been carried out by transferring the entire business (including all the assets, liabilities and policies) to a proprietary life insurance company owned, in the case of a sponsored demutualisation, by the acquirer. UK legislation requires an independent actuary to certify that the proposed transfer will not damage policyholders' "reasonable expectations" of their future benefits, looking at both the policyholders of the original mutual, and of the company to which the business is transferred.

3.6.3 The assets of a mutual can be considered to comprise:

- Assets backing with profits business (known as "with-profits asset shares" and representing the sum of policyholders' accrued benefits, including any assets representing terminal bonus which has already accrued in respect of each policy).
- Assets backing non profit business (the "non profit reserves")
- Any surplus assets (the "estate", representing assets which are not required to meet current policyholders' benefits)

3.6.4 The with profits asset shares are usually transferred to a ring-fenced with profits fund, and will be used to pay benefits, including future bonuses, on with profits policies.

3.6.5 The non profit reserves can either be transferred to the with profits fund (where future profits will accrue to with profits policyholders) or to a non profit fund (where profits will accrue to shareholders). In the latter case, the shareholder will have to pay for the future profits (i.e. acquire the embedded value).

3.6.6 The estate poses some of the biggest issues in a UK demutualisation. While the mutual continues as such, the current policyholders have no expectation of receiving distributions from the estate. However, for a demutualisation to be attractive to the mutual, it is likely to be necessary to provide the current generation of policyholders with close to the full value of the estate. Prior to the Scottish Widows demutualisation, this was generally achieved by transferring the estate to the with profits fund and using it to enhance future bonuses. The Scottish Widows transaction introduced a new possibility, when a large part of the estate was transferred to the non profit fund (and therefore attributed to shareholders, although needing to be retained within the company to provide financial strength). In this latter case, the new shareholders paid the existing generation of policyholders cash benefits representing the value of the estate.

3.6.7 It will be apparent from the above that the price paid for a mutual will depend materially on the demutualisation structure adopted. For example:

- Is the embedded value of non profit business to be acquired? Doing so increases the "headline" price offered, and provides a stream of earnings to the shareholders. There is, however, usually tax leakage involved in such a transaction, meaning that the business is less valuable to the shareholders than it was to the with profit policyholders, although complicated tax sheltering schemes may reduce this difference. In addition, the required risk discount rate for the shareholders is likely to be rather higher than the with profits policyholders would be expecting as a return from the business. The combination of the two factors will tend to result in agreeing a suitable price being difficult.
- Is the shareholder to have an interest in the with profits fund? This fund could be set up on a 100% mutual basis, with all surplus going to policyholders. Alternatively it might be set up on a proprietary "90:10" basis, where 90% of future surplus distributions are used to pay policyholder bonuses, and 10% is transferred to shareholders. Of course, in the latter case the shareholder has to pay for the embedded value of the acquired profit stream., and similar considerations as above will apply.
- Is part of the estate to be transferred to shareholders? This is typically only possible in the case of stronger mutuals, as some excess assets need to be retained within the with profits fund to provide a cushion against miscellaneous risks and costs (for example, mis-selling costs and the costs of guarantees). Even if part of the estate is attributed to shareholders, the regulator will require that it is largely tied up in the long term fund as capital to support investment freedom and to avoid a deterioration in the financial security of the company until the with profits business transferred from the mutual runs off.

- Are there to be expense agreements with the with profits fund? Fixing the basis for charging expenses to the with profits fund (usually at a level consistent with the expenses incurred before demutualisation) can enable the new shareholder to obtain the benefits of future expense savings.

3.6.8 The price paid for non profit business, and the goodwill value (including any payment in respect of expense savings expected), are often distributed to policyholders in the form of cash payments to "compensate" for the loss of membership rights in the mutual. Where part of the estate is also acquired, the price for this can also be paid out as cash. The estate which remains within the with profits fund enhances policyholders' future benefits, according to principles which are defined as part of the legal scheme which implements the transfer.

3.6.9 With the increasing number of demutualisations in recent years caused by solvency pressures, a new pressure has arisen for the stronger mutuals. As members of these mutuals see policyholders of weaker mutuals receiving large cash "windfall" payments, there is an inevitable pressure from them for their own mutual to demutualise in order that they can receive similar (larger) payments. Standard Life, the largest remaining UK mutual has been under particular pressure in this regard.

3.6.10 In recent years, some of the stronger smaller mutuals have embarked on acquisitions themselves, often acquiring small-medium sized proprietary or mutual companies which are in a weaker position, but are not attractive to the multinational or bank acquirers due to their relatively small market share. In the case of acquiring another mutual, mutuals are often in an advantageous position compared with a proprietary purchaser from a tax perspective.

3.6.11 Recent examples of this activity include Royal London's acquisition of the (proprietary) United Assurance Group and (mutual) Scottish Life, and Liverpool Victoria's acquisition of Permanent Insurance in the "fire sale" of the now defunct Equitable's assets, and the Royal National Pension Fund for Nurses. Royal London and Liverpool Victoria are now both top 25 players in the market.

3.6.12 The case of the Equitable has been widely covered elsewhere, but merits some comment here. Equitable's problems arose from a past tradition of distributing most of its surplus arising immediately as policyholder bonuses, rather than holding back assets to form a terminal bonus cushion and even a non-attributed estate. This policy exposed them to the risk of running out of solvency capital in the event of unexpected losses. These losses arose from a particularly large exposure to guaranteed annuity options, which crystallised when a controversial ruling from the House of Lords rendered their method for reducing the problem (reducing the terminal bonuses on policies which elected to take the guaranteed annuity rate) illegal.

3.6.13 The problem was all the worse when it was revealed that guaranteed annuity rates applied not only to funds built up from past contributions and the current level of annual premiums, but would also apply to funds purchased by future increments and single premium payments from policyholders with the options contained in their policies. The potential "black hole" scenario of policyholders pouring money into their policies just before retirement to make instant large profits when this cash was converted into an annuity at very favourable rates, meant that no purchaser could be found to accept the risk. Equitable, the oldest life insurer in the UK, was forced to close to new business and go into run-off.

3.7 Summary of M&A activity, 1990 to the present

3.7.1 The activity over the last decade has changed the UK life market immeasurably. The tables below (based on the analysis in Table A.1) indicates the extent of these changes, looking at the top 25 groups.

Top 25 groups by type, 1990 - present

	1990	1994	1998	1999	2000	Current
Mutuals	11	10	7	6	6	4
Bank-owned	3	3	5	5	6	6
Foreign-owned	2	5	7	8	8	9
Other	9	7	6	6	5	6
Total, top 25	25	25	25	25	25	25

Market share of top 25 groups by type, 1990 - present

	1990	1994	1998	1999	2000	Current
Mutuals	38%	32%	27%	21%	17%	12%
Bank-owned	9%	8%	12%	13%	20%	20%
Foreign-owned	3%	15%	24%	27%	30%	32%
Other	33%	24%	26%	27%	30%	34%
Total, top 25	83%	79%	89%	89%	97%	98%

See notes to Table A.1 for details of the analysis

3.7.2 Concentration has increased dramatically, the number and market share of foreign groups and banks has risen, and the number of mutuals has shrunk to just four (Standard Life, Royal London, the Cooperative Insurance Society, and Liverpool Victoria).

3.8 The future?

3.8.1 The UK market seems likely to need to consolidate further, in the current environment. Pressures on the pricing of the key products (pensions, risk products, guaranteed bonds, and annuities) appear likely to continue, as stakeholder charging structures become the norm, and as the number of IFAs reduces with further consolidation.

3.8.2 The Barclays / Legal & General example looks likely to be followed and expanded, particularly as the "polarisation" rules introduced by the FSA are starting to be relaxed, so that distributors can sell the products of more than one provider, on the condition that the products sold meet certain criteria. The first example of this depolarisation is stakeholder pensions, and the principle looks likely to be extended.

3.8.3 It would seem likely that "horizontal expansion" will become the new driver of M&A activity, with companies seeking economies of scale in one or more of administration, distribution, or asset management. This contrasts with the more usual "vertical expansion" of the past, typified by the bank distributors becoming manufacturers. Some companies may abandon existing parts of their business to concentrate on one part of the chain.

3.8.4 The number of manufacturers looks likely to continue to reduce, particularly if depolarisation does spread to other products. Smaller players are unlikely to be able to compete effectively. "Vulture funds" (insurance companies who buy blocks of business and then run them off at lower unit costs than could have been managed by the original insurer) look likely to have plenty of opportunities.

3.8.5 The UK looks likely therefore to become an environment in which the provision of financial services becomes one of specialists providing individual elements of the overall package at the lowest cost. It is likely to be the distributor (or rather the holder of the client relationship) who has the negotiating advantage in determining how profits are divided amongst the providers of the different elements.

Part 4 – Analysis of merger and acquisition activity in France

4.1 Background to recent merger activity

4.1.1 Although France is the UK's nearest neighbour, the French life insurance market is extremely different from that described in Part 3. Two major factors have shaped the current state of the market, and the uncertainty over its future direction – taxation advantages for life insurance savings policies, and the structure for pension provision.

Savings policies, and the bancassurers

4.1.2 The French life insurance market is the fourth largest in the world, and the second largest in Europe, by premium income (source: Swiss Re). It is unusual, however, in being dominated by a product that would not be considered a life assurance product in many other markets – a single premium savings product, with no protection element, benefiting from tax advantages if held for the relatively short period of eight years. These tax advantages were reduced gradually over the 1990s, notably at the end of 1997 (causing a sharp fall in premium income in 1998), but it remains one of the most tax-efficient investment vehicles available. It is now widely available in unit-linked form, as well as its traditional "interest plus annual bonus" structure.

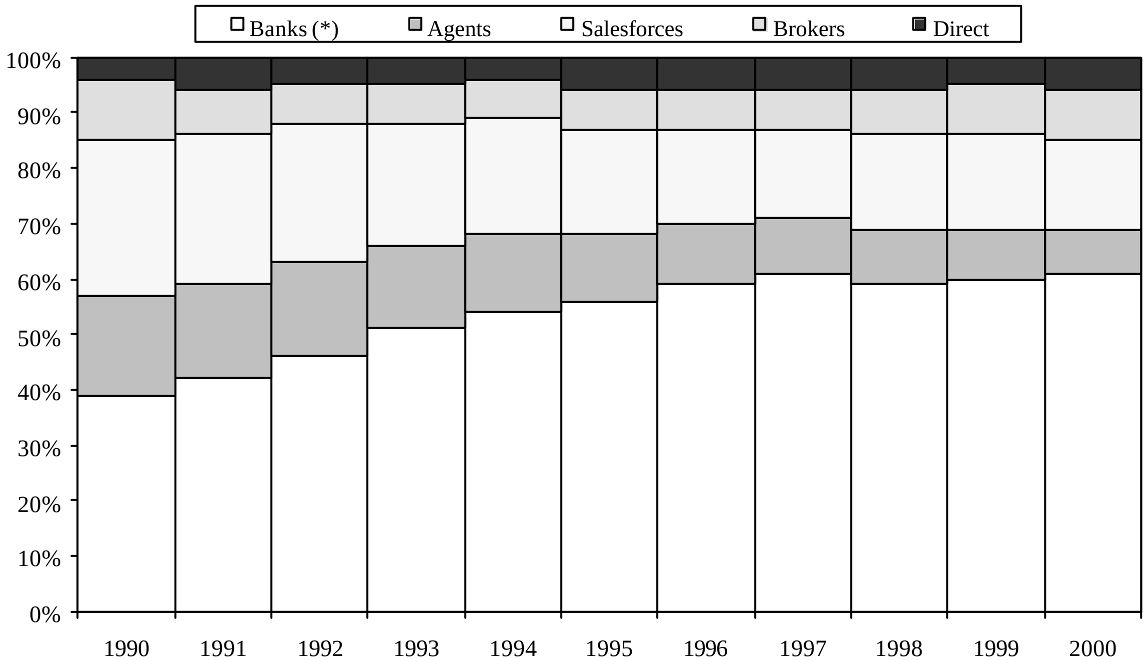
4.1.3 The market is dominated by bancassurers. This is due to the "one product" nature of the market – a simple, short term, tax-favoured product is relatively easy for banks (and the Post Office) to sell to their customers. The banks created their own life companies to take advantage of this, and rapidly built up significant market shares (see graph on the next page).

Other products, and pension provision

4.1.4 The non-bank insurers also sell savings products, through salesforces, agent networks and brokers. However, they also sell protection business, retirement and protection plans for self-employed people ("Loi Madelin" policies), and group products to a far greater extent than the banks. The market is almost split into two – individual short term savings (dominated by the banks), and the "real" life insurance sector (group and individual protection and long term savings). It will be seen from the graph above that (in contrast to the UK) very little business is written through independent brokers.

4.1.5 Loi Madelin products are the only individual tax-favoured retirement savings vehicles available. All employees (public and private) are covered by the basic State system, but also by compulsory supplementary benefits régimes. These régimes vary by type of employment, but generally provide levels of income in retirement which obviate the need for additional retirement provision by all but the higher paid.

French premium income, life and "mixte" insurers, by distribution channel, 1990-2000



Source: FFSA

(*) Banks include the Post Office. "Mixte" companies are life companies also permitted to write health business

4.1.6 The problem facing the State and supplementary régimes is that they are run on a "pay as you go" (or *"répartition"*) basis, with current workers paying current pensioners' benefits. The demographic outlook for France is similar to that in many other countries – projections show that the current four pensioners for every ten workers will increase to five by 2020 and seven by 2040. A *répartition* system will struggle to cope with such a situation. The previous, right wing, government passed legislation (the "Loi Thomas") in 1997 which would have created tax-favoured additional retirement savings vehicles, enabling a gradual move from *répartition* to at least partial provision by *capitalisation* (or pre-funding). This was opposed by the left and the unions, who view the *répartition* system as inviolable, and the law was immediately abandoned by the incoming socialist government.

4.1.7 The government has still not clearly identified how it will avoid the potential shortfall in the *répartition* system, other than by proposing increases in the contribution period required to obtain a full pension, the creation of a reserve fund, and reliance on future economic growth and a return to full employment. A small step to increasing employment-related saving is the proposed introduction of tax-favoured employee savings plans (which have to be held for at least ten years), but even this modest proposal is currently bogged down by political argument.

4.1.8 It seems almost inevitable that pre-funded retirement plans will be introduced at some stage – either on a future change in government, or if it becomes apparent that the *répartition* system is irreparably overloaded. Assuming this involves insurance products (either group or individual), the insurance market would be turned upside down. The bancassurers would not necessarily be able to dominate this market as they have the short-term savings sector. The most successful sellers of "Loi Madelin" policies, and group products to small and medium sized companies, have been those with specialised salesforces. A move from *répartition* should therefore benefit the "real" insurance sector much more than the banks. Any similar moves to reduce the State's heavy involvement in other benefits, such as healthcare, would have similar effects.

4.2 Analysis of recent merger and acquisition activity

4.2.1 Table A.3 in the Appendix shows the development of market share for the top 25 life insurance groups in France since 1995. As much of the market is recurrent single premium business, market share in the French life sector is usually measured by total premium income rather than by new business, and this approach is adopted here. The level of merger and acquisition activity has been much lower than it has in the UK, due largely to the absence of the regulatory and solvency pressures which afflicted the latter. Consolidation has also been less marked, but the table below shows that the French market was considerably less fragmented than the UK to start with.

Approximate market share by group, 1995 - present

	1995	1997	1999	Current
Top 5 groups	50%	57%	56%	56%
Top 10 groups	71%	74%	79%	80%
Top 15 groups	84%	85%	91%	92%
Top 20 groups	91%	91%	95%	96%
Top 25 groups	94%	94%	97%	97%

See notes to table A.3 for details of the analysis.

4.2.2 The market leader, CNP, itself controls around 20% of the market, notably through its exclusive distribution agreement with the French Post Office.

4.3 The banks

4.3.1 With their dominant positions and relatively low cost bases, the banks have had no need to seek alternative distribution channels, product innovation or expertise, or economies of scale by acquisitions. There have been no examples of banks purchasing life insurers over this period.

4.3.2 There has been one example of the reverse – CCF selling part of its stake in its life subisidiary, Erisa, to its partner Swiss Life, giving the latter overall control. As CCF was later acquired by HSBC, the future of this arrangement looks uncertain.

4.3.3 There have also been some example of banks themselves merging, and thus their life subsidiaries also merging together. BNP and Paribas' merger in 1999 resulted in the combined bank having fourth place in the French life market. The two banks had quite different strategies in life insurance, however – BNP's Natio Vie selling exclusively through the bank branches, whereas Paribas' Cardif is unusual amongst

French bancassurers in selling though other partners, and having an extensive portfolio of international subsidiaries.

4.4 Domestic proprietary mergers

4.4.1 By far the largest insurance merger in recent years in France was that of AXA and UAP in 1996. This had impacts throughout the world, as both groups had substantial subsidiaries in many major insurance markets. In France, UAP had a much stronger position than AXA in the life market, and the merger gave AXA the number two position in this market, behind CNP.

4.4.2 UAP had until a few years earlier been a state-controlled insurer, but had been privatised and floated. A further privatisation, that of GAN, took place in 1998. In this case, a direct buyer was sought, and it was the French mutual insurer Groupama which was successful.

4.4.3 AGF acquired Athéna in 1998, but this acquisition was then partially unravelled as Allianz and Generali launched bids for AGF. Allianz was successful, but Generali obtained two of the original Athéna subsidiaries, GPA and Proxima, as the two European giants shared out the spoils.

4.4.4 It is a peculiarity of the French life market that apart from AXA, the only other domestic proprietary insurance group in the top 25 is the small, privately owned, Groupe Prévoir.

4.5 The mutuals

4.5.1 Again in contrast to the UK, there has been no demutualisation of a life insurer in France. This is largely due to regulations governing mutuals, which stipulate that if the business of a mutual is transferred to another company then any surplus assets which the mutual owned must be transferred to another mutual.

4.5.2 Mutuals have been active in acquisitions, however. Indeed the AXA Group was originally a small French regional mutual insurer, which embarked on a programme of expansion by acquisition, raising capital by adopting a mutual holding company structure which also protected it against acquisition. Continued expansion meant that the mutual eventually owned less than a controlling interest in the listed vehicle, and so the group is clearly now a proprietary one.

4.5.3 A similar structure was adopted by Groupama for its acquisition of GAN.

4.5.4 As both AXA and Groupama are composite insurance groups, a somewhat different example is that of La Mondiale, a specialist life mutual, which had achieved impressive growth via its strategy of selling protection and retirement products to self employed people and professionals by a highly trained salesforce, financing growth by the use of subordinated debt. The acquisition of La Hénin Vie (a unit linked specialist) from Groupe Suez in 1999 both broadened the product range and distribution channels.

4.5.5 Other mutuals have adopted loose partnership arrangements to achieve economies of scale and distribution. Groupe Azur and GMF began working together in 1993, and Mutuelles du Mans and MAAF came together in 1998. While MMA and MAAF remain separate legal entities, there is a shared management team. In both these cases, however, the mutuals involved are far more active in non-life insurance than life.

4.5.6 The analysis of market share, and the discussion above, focuses on companies, including mutuals, who are regulated by the *Code des Assurances*. There is another group of mutuals in France, regulated by the *Code de la Mutualité*, who are primarily healthcare expense insurers. These mutuals have historically benefited from tax advantages and less restrictive solvency requirements than those regulated by the *Code des Assurances*. These advantages are in the process of being removed, and this may lead to partnership arrangements amongst these mutuals.

4.6 Foreign activity

4.6.1 Most M&A activity in the French life sector over recent years has been connected with non-French groups building a presence in the market. In 1995 only Commercial Union and Generali had significant market shares (and these were as the result of acquisitions in 1993 and 1995 respectively). The purchase of AGF and its subsidiaries, referred to above, catapulted Allianz into a leading position, and reinforced Generali.

4.6.2 The lack of other targets of a large size (most being either mutual or bancassurers) has led other foreigners to rely on organic development (which has been relatively unsuccessful) or to make serial small acquisitions. The main example of the latter strategy has been Swiss Life, which has acquired the French operation of La Baloise, Assurances du Griffon, a majority position in Erisa, and Lloyd Continental, but has still only just made it into a top 15 position.

4.6.3 Other mergers and changes of control have been as a result of deals outside France. Zurich acquired Eagle Star Vie to add to its own small French operation when it bought the UK parent. Commercial Union, in addition to its acquisition of Société d'Epargne Viagère in 1997, added the French subsidiaries of General Accident and Norwich Union as its successive UK mergers turned it into CGNU. Le Continent, a subsidiary of the Italian Toro Assicurazioni, picked up GRE's French operations which were surplus to AXA's requirements when it bought the GRE group.

4.6.4 The result of this activity has been an increase in foreign presence in the top 25 to nine groups, but of these only Allianz, Generali and CGNU are of significant size. The remainder (and several others of even smaller size) are presumably holding on their presence in France in the hope that eventual reform of the pension system will create opportunities for product and distribution innovation, and wrest the advantage away from the bancassurers.

4.7 Summary of M&A activity

4.7.1 The summary below of changes in the French life market in recent years (derived from Table A.3) shows some considerable differences from the trend in the UK.

Top 25 groups by type, 1995 - present

	1995	1997	1999	Current
Mutuals	6	6	7	7
Bank-owned	9	9	7	7
Foreign-owned	4	5	9	9
Other	6	5	2	2
Total, top 25	25	25	25	25

Market share of top 25 groups by type, 1995 - present

	1995	1997	1999	Current
Mutuals	6%	6%	12%	12%
Bank-owned	52%	54%	51%	51%
Foreign-owned	8%	10%	19%	19%
Other	29%	24%	14%	14%
Total, top 25	94%	94%	97%	97%

See notes to Table A.3 for details of the analysis

4.7.2 The number of mutuals in the top 25 has remained fairly constant, but growth and acquisitions (by Groupama and La Mondiale) has increased their market share. Banks' market share has remained constant, their number reducing due to mergers. Foreign-owned companies have grown their market share substantially, by acquisition, leaving only 2 French proprietary companies in the top 25.

4.8 The future?

4.8.1 The future of the market, and the outlook for M&A activity, depends almost entirely on if and when pension reform is introduced. If this is done, and the solution involves the use of insurance products, then the structure of the sector could change considerably. Bancassurers could look to acquire product expertise and alternative distibution capacity. Further new entrants could join the foreign groups already present, or launch new operations either in France or cross-border (Prudential of the UK has recently started to try to export some if its products).

4.8.2 The alternative scenario is that no such solution is adopted in the near term, and in this case it is possible that some of the many foreign companies with small French subsidiaries will cut their losses and sell out (probably to other foreigners?).

4.8.3 A possible alternative for foreign insurers looking to gain a strong foothold in the market could be to explore partnerships and cooperations with mutuals. The latter may become increasingly in need of finance as margins reduce, or to support development of new products and new business growth in any new pensions environment. Structures such as joint subsidiaries would need to be examined, if demutualisation itself continues to pose problems.

Part 5 – Summary and conclusions

5.1.1 The main conclusion of this paper is that there can never be any generalised conclusions regarding mergers and acquisitions in life insurance! Each life market around the world presents particularities which require a different approach to one, several, or many of the key areas which need to be addressed in acquisitions, for example:

- strategy
- financing
- taxation
- distribution
- competition
- future new business volumes
- future new business profitability
- future existing portfolio experience
- cost of guarantees and options
- future regulatory development
- etc, etc

5.1.2 The variations from market to market (and often from sector to sector within a market) require potential acquirers to fully research and understand the issues involved before attempting to value potential targets.

5.1.3 Another conclusion which could be drawn from the cycle of events which have affected the UK over the last 10 to 15 years, and the uncertainty over the future development of the French life market, is that relying on one market to generate shareholder value consistently is perhaps a risky strategy. Diversifying into other markets is a way to protect against adverse events in any one market having too significant an impact on overall results. Different strategies for achieving this have been adopted, some of which concentrate on the current major insurance markets, while others strive to achieve a mix of developed and developing markets – the latter have the advantage of being likely to avoid (for the near to medium term future) the rapid reductions in profit margin which have taken place in the UK, but on the other hand while rates of return may be high, business volumes are (again for the near future) less significant.

5.1.4 As strategies of multinationals and domestic groups shift, there will continue to be major and minor mergers and acquisitions around the world. Actuaries have a responsibility to ensure that they are well placed to assist insurers throughout the FLINI process, in developing strategies and identifying and exploring promising markets and targets, as well as in the more traditional stages of valuation and trying to make the resulting acquisitions work.