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Demutualization in the Life Insurance Industry - A Response to Shifting Industry Opportunities

Industry Analysis: Life Insurance Industry

ABSTRACT

The life insurance industry is changing quickly in response to increased competition, falling regulatory barriers, globalization, the Internet, demographics, and a shift in product demand. These shifts are making it more difficult for the smaller insurance companies to compete and as a result insurance companies are merging to bring down costs. Insurance companies are also merging into larger financial institutions in order to combine retail/commercial banking, investment banking, brokerage, and insurance. The advantages primarily involve reduced back-office costs and the ability to cross-sell products to a larger customer base.

Insurance companies that are owned by their policy-holders are moving to “demutualize” or transfer the ownership structure from policy-holders to shareholders. The trend towards demutualization began in the early to mid-1990s but has recently come to the attention of the markets due to the demutualization and IPOs of industry heavyweights John Hancock and MetLife. Prudential is expected to complete its demutualization plan later this year. The trend is likely to continue as the life insurance industry move to stock ownership to participate in the active M&A arena and maximize returns for their owners.

WHAT IS DEMUTUALIZATION?

A mutual company is a corporation that is owned by its members and has no stock or shareholders in the conventional sense. A mutual *insurance company* is owned by its policyholders who have ownership rights that are defined by their insurance contracts, the corporation's rules of incorporation, and state insurance laws. These rights include the ability to collect dividends, elect directors, receive the company's liquidated assets if the company is dissolved or demutualized, have the company operated

primarily for the benefit of the policyholders, and receive certain other fiduciary rights. A policyholder in a mutually owned insurance company is not able to separate the ownership rights from the insurance policy, whereas in a publicly-held insurance company holding a policy and owning the stock are completely separate activities.

Full demutualization occurs when a mutually owned company becomes a stock company and all of its net worth is distributed to policyholders in exchange for their membership rights. The value distributed to the policy holder is usually in the form of stock but can also be in the form of cash or policy enhancements. The company also has the option of issuing stock directly to the public to raise cash and to create a liquid market for its stock. The IPO sale of stock to the public also allows the company to set a guaranteed purchase price for policyholders who have agreed to sell their stock in advance.

A full demutualization is a complex and expensive process which can take up to several years to complete. Regulations vary from state to state and the companies usually become the targets of litigation over the fairness of the plan.

An alternative to full demutualization is the organization of a new mutual holding company which is created as part of a multi-tiered insurance holding company system. Under this method, two new entities are formed: (1) a new mutual holding company (MHC) which is a non-stock holding parent corporation, and (2) a new stock intermediate holding company (SHC) which is a subsidiary of the MHC. Then, the original mutual insurance company is converted into a stock insurance company that becomes a subsidiary of the SHC.

Under this new arrangement, the insurance policies remain with the converted mutual company which is now a stock company. The ownership rights that went with that policy, however, are transferred to a new parent mutual company. Now the contractual policy rights are with one company and the membership rights are with another company.

This mutual holding company structure greatly increases the mutual company's ability to raise capital, to make acquisitions and to diversify its operations, while retaining the mutual aspect of policyholder membership. The MHC system avoids some of the costs and length of time associated with the process for a full demutualization.

However, critics contend that the MHC structure makes an insurer immune to takeovers because policyholders as a group always have at least a 51% ownership stake. The structure also has come under fire because policyholders aren't compensated for the control they lose when outside shareholders are brought in, even though a conflict of interest can exist between shareholders and policyholders.

Both policyholders and the stock market have frowned on the MHC structure. Therefore, the MHC structure is less attractive to companies and has been seen less often in recent years as companies opt instead for full demutualization.

ADVANTAGES AND DISADVANTAGES OF DEMUTUALIZATION

The mutual ownership structure of insurance companies has several advantages. The main advantage is for the policyholders who in theory will pay less for the insurance policies. Since the company is owned by the policyholders, and since the company is being run for their benefit, the company has a strong incentive to keep down the price of the policies. It doesn't matter that the company will have a narrow profit margin on selling the policies because the policyholders, i.e., the owners of the company, get the economic benefit of cheaper policies. Mutual ownership also eliminates the conflicts of interest inherent between shareholders who are focused on dividends and ROE and policyholders who want inexpensive policies from a highly rated company. At the same time, however, a mutual company must ensure that it earns enough profit to provide the company with a strong capital base and fund future growth. Life

insurance is a long-term contract, possibly for decades, and its buyers must believe in the long-term viability of the company.

Another advantage of mutually owned companies is that management can operate the company with a focus on the long-term and does not have to worry about producing stellar profits each quarter to impress Wall Street. Stock life insurance companies, on the other hand, are under pressure to deliver impressive results every quarter and their management may be more worried about short-term profits than about building the company for the long haul.

On the other hand, one potential disadvantage of a mutually owned insurance company is a possible lack of management accountability. Policyholders at mutual companies typically pay little attention to how the company is operated and management may be given what amounts to a free pass. Managers at mutually owned companies do not fall under the heavy scrutiny provided by Wall Street and institutional investors. Thus, a mutually owned company may have less aggressive managers who run the company more for their own benefit than for the policyholders. The managers, for example, may not put an emphasis on cost-reduction and may provide themselves with excessive perks.

Although the mutually owned form of organization has served many companies well in the past, its luster is diminishing given the broader trends in the industry. In fact, there are a number of advantages to be gained by moving to a shareholder owned company: (1) the corporation takes on a more profit-oriented culture and is under pressure to keep costs down, (2) management becomes more accountable to its owners and receives intense scrutiny from Wall Street and institutional investors, (3) the company can use its stock to make acquisitions and grow, (4) the shareholders of the demutualized company may receive an impressive buy-out offer from a larger financial institution, (5) the company has the flexibility to tap the stock market for secondary stock offerings to raise more capital, and (6) the company has stock and stock options available to attract and retain top managers.

Another advantage of demutualization is the possibility of a higher credit rating. The sale of public stock is accompanied by much greater financial transparency and the use of bank credit facilities requires restrictions on some financial transactions that may improve creditworthiness. Stock companies also have a more flexible operating structure with subsidiaries becoming units of a holding company. Subsidiaries of a stock insurance company may also enjoy higher valuations than those subsidiaries associated with a highly regulated mutual parent company. Demutualized insurers also enjoy the possibility of a lower federal tax burden.

One downside of demutualization is the high cost of converting the organization's structure. John Hancock, for example, took a huge \$110.4 million charge for demutualization expenses in 1999. Demutualization is also very time consuming and can distract top management from larger issues. Managers in a stock company also needs to spend more time complying with SEC reporting and investor relations activities. In addition, management may be worried about becoming an acquisition target since it has tradable stock, although that can be a benefit for shareholders if they receive a lucrative buyout offer.

INDUSTRY TRENDS

The primary driving force behind demutualization is increased competition and the drive to become more efficient. This is due in large part to the seismic shift in the regulatory landscape over the past decade where the barriers between financial sectors slowly eroded and were finally completely torn down by the passage of the Gramm-Leach-Bliley (GLB) Act in November 1999. The insurance industry saw the writing on the wall and the process towards demutualization began in the early 1990's for companies like Equitable Life (1992) and Guarantee Mutual (1995). The pace picked up with this year's demutualization of John Hancock and MetLife.

In order to be players in the financial industry, insurance companies need to have publicly-traded stock. This allows them to pursue a growth strategy through acquisitions and it also allows them to merge with other firms if management believes that it will be beneficial for the shareholders. As stock prices rose through the 1990's, fewer acquisitions in the insurance industry were made with cash. The value of shares in stock life insurance companies rose, giving them a definite edge over mutually owned companies when it came to making acquisitions.

Mergers and acquisitions are now a key part of the broader financial services landscape as the industry consolidates into large service providers. There are numerous examples of this trend including Chase Manhattan's recently announced \$35.6 billion merger with JP Morgan, UBS's \$16 billion purchase of Paine Webber, and Credit Suisse's \$13.4 billion purchase of Donaldson, Lufkin & Jenrette. If they wish to be serious participants in the M&A arena, mutual insurance companies need to convert to stock-owned companies and then strive to boost their stock's value.

The pressure to cut costs and become more competitive has led to speculation about mergers within the US life insurance industry. Potential consolidators in the US include American General, Jefferson-Pilot, MetLife, AIG, and Protective Life, companies that are big enough and financially strong enough to pull off an acquisition.

Shifting customer demand is also pushing insurance companies to take a more aggressive posture. The bull market is forcing insurers to offer different types of wealth maintenance financial products (tied to stock market performance) such as annuities and mutual funds, as opposed to more traditional products like whole life policies that are designed to protect survivors. The result is that variable annuities have become the fastest growing product at many insurance companies. John Hancock's variable annuity sales, for example, rose 20.1% year-on-year in the second quarter of this year. Part of this is due to

the rise in interest rates in the 1980s and the strong rallies in global stock markets through the 1990s that caused whole life policies to under-perform other investments. Variable annuity sales, however, are putting insurers in direct competition with other financial services companies that already sell annuities and mutual funds.

The product mix is also changing because of the increased popularity of self-directed retirement funds such as IRAs and 401k plans. Today's workers know that they will probably receive little income from Social Security and that they need to make their own provisions for retirement. This is particularly true since people are expected to live longer given advances in health care. This has resulted in a huge increase in demand for retirement products

Insurance companies are also taking a more aggressive posture because of the huge amount of cash that is expected to flow into financial products in the next several decades. Baby-boomers are entering their peak earning years and their saving rates should rise substantially in coming years, meaning they will be looking for investments and financial products to buy. Baby-boomers are also expected to receive a huge inter-generational wealth transfer from their parents of approximately \$10-20 trillion over the next 20 years. Moreover, in the next 15 years as baby-boomers actually reach retirement age, up to one-half trillion dollars of retirement assets are expected to be unlocked, allowing retirees to switch to other investments.

The consensus is that the long-term survivors in the financial industry will be the largest companies selling the broadest array of financial products at the most competitive prices. In order to avoid being run over in this free-for-all, insurance companies are demutualizing and are adopting a modern structure that provides them the most flexibility to adapt and compete.

THE GRAMM-LEACH-BLILEY ACT - A PRIMER

Many measures of the Gramm-Leach-Bliley (GLB) Act went into effect on March 11, 2000, after being signed into law on November 12, 1999. Passage of this historic Act repealed sections of the Depression-era Glass-Steagall Act that had separated commercial banking, insurance, and investment banking in the US. Those walls were put in place following the stock market Crash of 1929 and the Great Depression. Legislators of that era pointed fingers at the securities business for the near collapse of the US banking system. Legislators wanted to put a firewall around the investment banking and brokerage industry so that failures in that sector would not bring down commercial banks or insurance companies.

The modern consensus among academics, however, is that the Depression was not due to the financial structure of the US at that time, but rather to the Federal Reserve's inappropriate monetary policy. After the stock market crash of 1929, the Fed failed to respond to deflationary conditions and didn't pump enough liquidity into the banking system. The resulting liquidity crunch caused many commercial banks to fail, leading to panic and further deflation. Now that the Federal Reserve has many more years of operating experience under its belt, the chances for another depression are remote. In fact, the Fed has shown a remarkably successful ability to guide the economy in the past two decades, giving legislators the confidence to allow changes in the structure of the financial industry.

Passage of the GLB Act has brought the US financial services system closer in line with the European and Asian banking systems. It also helped to spark a wave of competitive merger activity that is creating huge financial services firms like Citigroup which has a stock market capitalization more than \$230 billion.

Perhaps the most significant aspect of the GLB legislation for the insurance industry is the permis-

sion for financial institutions to own both banks and insurance companies. Bank holding companies are now free to merge with brokers and insurance companies and are also allowed to engage in the insurance underwriting business. This lets them take on the risk of paying policy holders' claims in return for premium payments, a practice once set aside only for insurance companies.

Conversely, insurance companies and brokerages are now allowed to acquire commercial banks. MetLife, for example, announced on Aug 16 that it would acquire Grand Bank, N.A. of Kingston, New Jersey in order to offer banking and investing services to its customers. Terms were not disclosed but MetLife has said that it was interested in making acquisitions in the \$20-30 million range. The amount of the purchase is immaterial to MetLife's financial position and the deal was made to acquire the banking license so that MetLife can offer FDIC insured deposits. MetLife pays out some \$20 billion annually in claims and the company believes that it will be able to capture customers with above market interest rates since it does not have to support a system of branch banking offices.

Competitive pressures are currently centered on the life insurance business as opposed to the other sectors of the insurance industry. Banks are showing less inclination to enter the health, property, and casualty insurance businesses due to the differences in underwriting these policies as compared with life insurance products. The risks of underwriting these policies are very different than life insurance policies which are cut and dried based on actuarial science. The property and casualty insurance industry, for example, is subject to the whims of nature and earnings can be volatile depending on the number of disasters in any given year. Property and casualty insurers are in a more specialized business and are therefore facing less pressure to demutualize. There is less cross-over expertise with the financial industry and therefore banks and brokerage firms might be overstepping their core competencies by investing in casualty or property insurers.

Part of the impetus behind the GLB Act is that regulators believe that the ability of financial services companies to participate in different markets will benefit consumers and that diversification will strengthen the overall financial system. A lack of diversification is one of the factors blamed for the savings and loan collapse of the 1980s which was triggered by the sharp rise in interest rates that destroyed the S&L's niche of providing fixed-rate long-term mortgages. Diversified financial companies may see losses in one particular division such as mortgage loans, but that by itself would not bring down the company which would still be profitable in its many other divisions.

In addition, legislators adopted GLB because the economies of scale of the financial supermarkets may be good for consumers by bringing down costs for consumers. The financial sector can streamline its disparate distribution systems (e.g., branch offices for commercial banks versus local and independent agents for the insurance industry) and potentially reduce costs. The end result for consumers may be that they will be able to shop in one place for insurance, loans, and brokerage services and will presumably enjoy lower prices due to the forces of competition.

However, commercial and investment banks are not rushing into the life insurance industry, probably because it is still early in the game and the consolidation is occurring first between investment and commercial banking. Earlier this year there were expectations that a wave of insurance company takeovers by banks would occur after Citigroup bought the balance of Travelers Property Casualty which it did not yet own. That M&A activity, however, has yet to materialize, possibly due to the strong rally in the life insurance stocks since March which would make takeovers more expensive.

Banks are probably also concerned about venturing outside their core competencies. A cautionary tale is told by Consecos, a once highly successful insurance industry consolidator. In 1998, Consecos bought Green Tree Financial Corp., a consumer fi-

nance company with no insurance business. Consecos, however, did not foresee operating problems at Green Tree over accounting practices and Consecos was forced to take over \$300 million in charges. Consecos tried to recover by billing itself as the "Wal-Mart of financial services" but the much touted synergy of cross-selling never developed and the red ink continued to flow. The company has since lost its investment-grade credit rating and senior management was abruptly ejected. Consecos's stock traded as high as \$58-1/8 in April 1998 but has spent much of this year consolidating below \$10 per share. The Consecos saga shows that M&A in the financial industry is not a guaranteed success and that hard work needs to go into analyzing the strategic advantages of the combined unit and taking advantage of the synergies over the long haul.

GLOBALIZATION

Business is going global and the financial industry is among those leading the charge. Insurance companies that have publicly-traded stock can participate in this global M&A arena more easily.

In fact, the US insurance industry is currently the object of takeover speculation by overseas financial services companies looking for footholds in the huge US consumer marketplace. For example, the life insurance sub-index of the S&P 500 recently rose to an 8-month high in mid-September after French financial services giant Axa agreed to sell its Donaldson Lufkin & Jenrette unit to Credit Suisse First Boston for \$13.4 billion. Investors bet that Axa would use some of the proceeds to shop for a US insurer, especially with interest rates stabilizing. Another example is the recent \$5.1 billion acquisition of ReliaStar Life Insurance Co. by Amsterdam-based ING Groep N.V., the fifth largest European financial services company in terms of market capitalization.

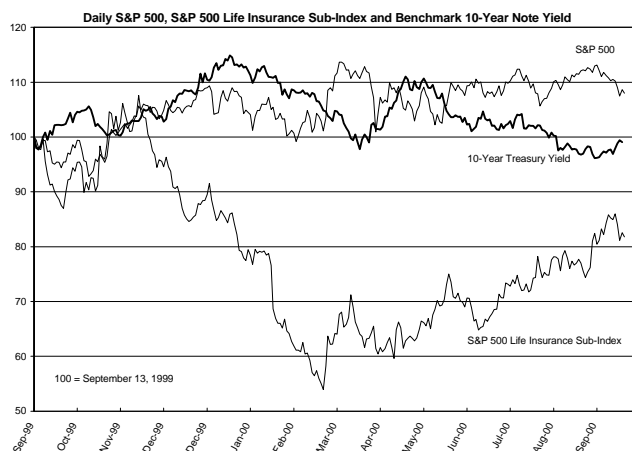
US life insurance companies are attractive to overseas financial services companies for their asset management businesses and their distribution capabilities. Aside from John Hancock, other potential takeover targets include Nationwide Financial Services and Lincoln National, i.e., mid-sized life insurers with publicly traded stocks and a broad range of products.

US insurance companies are also on the hunt for overseas acquisitions in order to expand into overseas markets, particularly in the emerging economies of Asia and Latin America where the life insurance market is far from saturated and there are huge opportunities for growth. Examples of this trend include the announcements earlier this year by AIG of its acquisition of a license to operate a wholly-owned life insurance company in Vietnam and by Ohio National Financial Services Inc. of its intention to acquire a life insurance and annuity provider in Chile. Prudential and Allstate both recently announced that they are seeking life insurance licenses in India. More industrialized nations, however, also represent lucrative markets for US insurers, especially after Japan surpassed the US as the world's largest insurance market in the 1990s.

INDUSTRY PERFORMANCE

The life insurance industry is coming off a very poor year in 1999 which showed the worst stock market performance for the sector in a decade. Companies cut policy premiums in the belief that their investment returns would be high. Instead, interest rates rose and hurt their bond portfolios and their profits. The sector languished through March 2000, weighed down by the insurance industry's poor performance in 1999, the continued downtrend in credit market prices, and stock supply overhang from the John Hancock and MetLife IPOs.

Investors' appetite for the life insurance sector, however, has since improved. The above chart shows the S&P 500 Life Insurance Index versus the S&P 500 and the yield on the benchmark 10-year



Treasury Note. The life insurance sub-index is composed of (in order of weighting from highest to lowest) Lincoln National, Jefferson-Pilot, Unum-Provident, Torchmark, and Conseco.

The relationship between credit market yields and the life insurance stocks is readily seen in this chart. The rise in the 10-year note yield to a 3-1/3 year high on January 21 of this year sent the life insurance sector tumbling through the following two months. The recent downtrend in the 10-year yield, however, has helped the life insurance sector to broadly outperform the overall S&P 500 in recent months.

Aside from the drop in interest rates, the sector has been supported by M&A speculation with Lincoln National believed to be a takeover target due to its extensive distribution system. There is talk that the company could demand a price of up to four times book value or close to \$100 per share. Jefferson-Pilot boosted the sector in early August after beating Q2 earnings expectations by two cents per share.

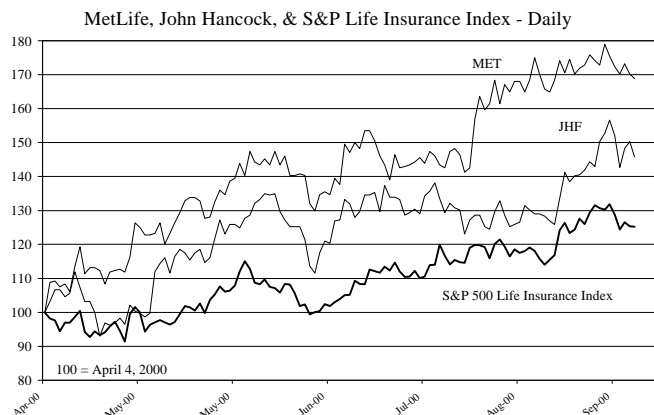
Bargain hunting has also certainly come into play after the industry's extremely weak performance in 1999. As a result, the sector's stocks have risen from very inexpensive levels in relation to the broader market. The S&P 500 Life Insurance index in mid-March was trading with a 12-month trailing P/E of around 9.7, which was only about

1/3 of the S&P 500's P/E ratio at the time of 28.5. By early September, the P/E ratio on the life insurance sub-index had climbed to 23.3 where it was about 75% of the S&P 500 P/E ratio of 30.1 but still below the 10-year average of closer to 80%. The life insurance sector's current P/E ratio of 23.3 is only moderately above its 4-year average of 18.1.

Insurance Industry Data

	Average
Current P/E	22.3
High P/E Over Past 5-years	25
Low P/E Over Past 5-years	9.7
Price To Sales	2.6
Price To Book	4.3
Dividend Yield	2.4%
Avg. 5YR Rate of Revenue Growth	13.5%
Avg. 5YR Rate of EPS Growth	17.6%
Avg. 5YR Return on Equity	17.6%
Avg. 5YR Return on Investment	9.1%
Avg. 5YR Operating Margin	14.6%
Avg. 5YR Pretax Margin	14.6%
Avg. 5YR Profit Margin	9.5%

Other factors in favor of the insurance industry include a shift in investors' appetite for value stocks with predictable earnings. The S&P 500 Barra Value Index has gained 4.7% over the past six months versus a 4.6% drop in the S&P Barra Growth Index. Earnings of the life insurance industry have historically been stable since 75-90% of earnings come from policy renewals. Therefore, the current strong pace of sales should allow future earnings to remain stable. There is, however, an element of volatility in earnings from fluctuations in the stock and credit markets. In general, the life insurance industry is expected to show earnings growth of 14% y/y in 2000 and 12-13% in 2001, well above what is currently expected for the S&P 500.



NEWLY-DEMUTUALIZED INSURERS' PERFORMANCE

Investors have generally taken a somewhat dimmer view of newly demutualized life insurers in comparison to peers with longer operating histories as public companies. The recently concluded demutualizations of both MetLife (MET) and John Hancock (JHF) saw both companies set their IPO price levels below book value in order to coax buying from investors.

However, since their IPOs, both John Hancock and MetLife have rallied sharply and have smartly outperformed the S&P Life Insurance index, as seen in the above chart. John Hancock is up 54% since its IPO and MetLife is up 74% since its IPO. Despite those rallies, however, John Hancock and MetLife are still trading at a discount to the overall sector. John Hancock's stock traded at 1.5 times book value for the most recently ended quarter while MetLife's book value was 1.3. Relative to earnings, John Hancock is trading at about 10.8 times expected year 2000 earnings of \$2.34 per share and 9.8 times estimated year 2001 earnings of \$2.57 per share. MetLife is trading at 12.6 times estimated year 2000 earnings. These valuation levels are below those of the more established public insurers like Lincoln National (which went public in January 1993) that trades at 2.4 times book value and 15 times year 2000 earnings. Likewise, Hartford Life trades at 15.8 times year 2000 earnings

and 2.4 times book value. Part of Hartford Life's high valuation is due to its place in the US industry as the largest provider in the fastest growing product area of variable annuities.

The main reason that JHF and MET trade at a discount to peers like Lincoln National is that mutual insurance companies have historically been more stable but less profitable than stock companies. For example, John Hancock has lower margins (operating, pre-tax, and profit) than the industry average, below-average operating efficiency (net income and revenue per employee), and a below-average return on assets. MetLife has a ROE of about 9.5% which is well below the industry's average of about 15%. In fact, the profitability of a newly demutualized company usually lags the profitability of established public companies for the first several years until costs are trimmed and a corporate culture emerges that is geared more toward profits. MetLife is targeting expense cuts of \$250 million by the end of 2002.

MetLife has also been aggressive in share buy-backs, planning to purchase \$1 billion of its shares over the next 1 to 1-1/2 years, in order to help boost ROE and EPS. The company repurchased 11.3 million shares in Q2 which was more than expected.

The downside of a newly demutualized company's reach for stronger ROE may be lower credit ratings as managers weaken strong risk-adjusted capital positions. The push to generate more earnings will also inject more risk into life insurers' asset portfolios.

However, the valuation gap between John Hancock and MetLife has narrowed as the two stocks have widely outperformed the industry since early April. Investors appear to be finding confidence in both company's ability to reach EPS and ROE growth targets of 15% y/y.

Publicly Traded Financial Services / Insurance Companies

Company	Symbol	Recent Close	Market Cap (\$ Mlns)	Consensus: 1 sell / 5 buy	12M Trailing PE	Beta	1-year Total Return (%)	Yield (%)	Est. 2000 EPS(\$)
Aetna	AET	56-1/8	7,922	3.4	12.0	1.06	-18.26	1.4	4.07
American General	AGC	76-1/8	19,226	4.0	15.6	.86	+17.61	2.3	5.19
Citigroup	C	51-1/2	231632	4.6	20.5	1.33	+61.87	1.1	2.73
Conseco	CNC	8-3/48	2,846	3.4	6.4	.97	-57.62	2.3	1.31
Jefferson-Pilot	JP	65-5/8	6,763	3.9	16.2	.83	+5.53	2.3	4.26
John Hancock	JHF	26-3/8	8,311	4.7	N/A	N/A	N/A	N/A	2.30
Lincoln National	LNC	50-3/16	9,573	3.6	20.9	.91	+31.76	2.3	3.52
Metropolitan Life	MET	24-1/16	18,647	4.6	N/A	N/A	N/A	N/A	1.96
The MONY Group	MNY	39	1,800	3.7	5.8	.69	+54.59	1.0	4.71
Nationwide Financial Services	NFS	36-1/8	4,650	4.7	11.1	1.3	+2.80	1.3	3.46

INDUSTRY OUTLOOK

The performance of the life insurance industry will depend on the direction of the general stock market, whether interest rates continue to fall, and structural changes in the industry. If stock market prices remain high in the insurance sector, then more companies will be encouraged to demutualize since they will be able to sell their stock at a higher price to receptive investors.

M&A speculation will continue to swirl around the financial services industry. There will be attempts to create the next Citigroup and Merrill Lynch, which already own life insurers. Merger and acquisition deals will likely continue to be initiated in Europe where insurance markets are more mature and insurers' share prices remain high.

Yet, M&A activity in the US insurance industry may be somewhat less than expectations. Some bankers are concerned about the insurance industry's low return on equity. In FY 1999, for example, Citigroup enjoyed a ROE of 22.1%, much higher than the insurance industry's. In addition, life insurance companies are already entering into, and are prepared to expand, distribution agreements with banks who are not interested in engaging in the actual underwriting. Through partnerships, the banking industry can enjoy earnings from insurance sales without absorbing their comparatively lower ROE.

The life insurance industry could see further pressure on margins due to the commodity-like nature of its products. Insurers selling term life or annuity products, where the primary competitive positioning is price, will face further margin pressures as banks use their customer databases and distribution systems to cross-sell. M&A activity may pressure margins if banks acquire life insurers at higher valuations with the expectation of making up for the high cost through higher volume at lower prices.

The life insurance industry will also be increasingly affected by the Internet. John Hancock's CEO recently noted that the company has sold close to 16,000 policies through the Internet and expects that

25% of all policies will eventually be sold through the Web. This will reduce the dependence on the agent distribution network, put downward pressure on policy prices and industry profits, and put a premium on having a well-known brand name.

FUTURE DEMUTUALIZATION DEALS

The focus is currently on Prudential Insurance Company of America's planned IPO. The company announced its intention to demutualize in early 1998 and is expected to submit a conversion plan to its Board for approval by the end of the year. Prudential is the largest life insurer in the US in terms of assets which totaled over \$366 billion as of the end of 1999. After the demutualization of John Hancock, MetLife and Prudential, the market share of mutual life insurers will be down to less than 1/4 in 2001 from about 1/3 in 1998.

After Prudential, the next major deal appears to be Indianapolis Life which announced earlier this year that it would merge with AmerUs Life Holdings. Both companies are expected to fully demutualize, pending policyholder and regulatory approval. In April, Phoenix Home Life Mutual Insurance Company announced that its Board had authorized management to develop a plan for demutualization.

SUMMATION

The long-term fundamentals for the life insurance industry appear strong given favorable demographics, increasing efficiency, and strong financial conditions for the sector's major players. There are approximately 1,500 life insurance companies operating in the US but less than 200 of them write two-thirds of the policies. The increased demand among consumers for lower margin products and service enhancements (daily updates, easier account access, better phone support), combined with expensive distribution costs, will force many of these small companies into mergers in a quest for economies of scale. The pressures to merge will in turn encourage the other firms to demutualize. The advantages of demutualization are clear and the trend is likely to continue.