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Article abstract

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Life Insurance Companies: The Driving Force Behind Reregulation in Quebec [1]

by

Denis Moffet [2]

L'auteur passe en revue les grandes lignes de force derrière la réforme des institutions financières et, principalement, via le décloisonnement et la reréglementation des compagnies d'assurance de personnes. Le besoin de croissance des compagnies d'assurance-vie, les rôles joués par les chefs de file québécois dans ce secteur, l'expertise historique des mutuelles d'assurance-vie au Québec tout autant que la prédominance du mutualisme expliquent les transformations actuelles. Finalement, l'auteur mentionne les pièges associés à la diversification des services financiers des compagnies d'assurance de personnes.

My main field of interest being insurance, I must admit at the very beginning that I might be somewhat biased in my view that reregulation is led by the insurance industry.

In the first part of this exposé I will introduce the main actors of the reregulation movement (I was tempted to use the word revolution). In the second part, I will review the main reasons that made the life insurance industry the driving force of reregulation in Quebec. Finally, in the third part I will examine some of the pitfalls inherent to growth through diversification of activities.

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[1]This article was published in *Canadian Journal of Life Insurance*, Vol. 9, No. 53, 1990, from a speech given by the author at the meeting of The Association of Canadian Financial Corporations, on May 23, 1990. We are grateful to CJLI and the author for their kind authorization to publish this text.

[2]Professor of Finance and Insurance and Director of the Chair in Insurance at Laval University, Mr. Denis Moffet is also a member of our journal's committee.

1. The architects of reregulation

Most Québécois appear to be quite proud of the leadership the province has taken in the reregulation of financial markets. Both major political parties have successively played an active role in building up and promoting this leadership. Furthermore, a strong unity of thought shared by the influential elements of both the financial and political circles has given birth to a very efficient politico-financial network that has shaped up the Quebec financial landscape.

According to many observers, the financial reregulation that is still unfolding in Quebec can be traced back to the 1969 Government Study on Financial Restructuring chaired by Jacques Parizeau. Under the Parti Québécois régime, Mr. Parizeau, then Minister of Finance, had the *Loi 75* passed in 1984. This broadened the power of life insurance companies by allowing them to set up downstream holdings authorized to span all four traditional pillars of financial activities (banking, insurance, brokerage and fiduciary activities) by means of acquiring subsidiaries.

In December 1985, the Liberal party formed a new government and Pierre Fortier was appointed Associate Minister of Finance in charge of privatization; Mr. Fortier stuck to the course already set by Mr. Parizeau. It seems to me quite logical that the reregulation of financial institutions should sooner or later lead to the reregulation of financial intermediaries. The latter was indeed enacted in 1989.

In 1988, under Mr. Fortier's reign, the Mouvement Desjardins was granted, through the Savings and Credit Union Act, the long sought authorization to form holdings in both financial and commercial activities. The restructuring of the Mouvement Desjardins was quickly undertaken and, almost as quickly, Mr. Fortier undertook a career reorientation by joining the Mouvement the following year as C.E.O. of the newly formed Financial Holding.

Over the last twenty years, strong ties have developed between the financial and political communities. We have even witnessed occasionnal intercommunity movements. For instance, Claude Castonguay, Jean-Marie Poitras, Claude Forget and Raymond Garneau have all been significant figures in both arenas.

As top executives at the Laurentian Mutual, Mr. Poitras and Mr. Castonguay were undoubtedly the trend setters in reregulation within the financial community. Their joint action spans the last twenty years. In the last few years they gained strong public support from Mouvement Desjardins' C.E.O., Claude Béland, and from Le Groupe Les Coopérants' C.E.O., Pierre Shooner (who left Les Coopérants in 1990).

L'Industrielle-Alliance, under Robert Bégin and Raymond Garneau, was also active in the reregulation movement, though at a somewhat more moderate pace than La Laurentienne and Les Coopérants.

2. Why did the life insurance industry promote reregulation?

It is generally agreed that the internationalization of markets will induce greater concentration. In such a context, our politico-financial elite was convinced that if Quebec were to play any significant role, then the development of larger financial institutions ought to be encouraged.

In this matter, Quebec could do little about the banks since they fall exclusively under federal jurisdiction. However this is not the case for the Mouvement Desjardins and for life insurance companies. As it turns out, reregulation was first activated through the life insurance industry, and from now on I will emphasize the role of this industry.

I see four main reasons explaining the reregulation movement in the life insurance industry:

- the need for growth;
- the presence of influential leaders;
- the existence of local expertise;
- the predominance of the mutual form of governance.

2.1 The need for growth in the life insurance industry

In Canada, from 1961 to 1987, personal disposable income (PDI) has grown from $1,475 to $14,199 per capita. Meanwhile, total savings per capita went from $48.85 (3.31% of PDI) in 1961 to $1,357.54 (9.56% of PDI) in 1987. Total personal savings per capita reached their peak in 1982, accounting for 18.31% of PDI.

During the same period, savings in the form of life insurance increased from $30.87 (2.09% of PDI) in 1961 to $391.73 (2.25% of PDI). We can see that life insurance savings remained quite stable at about 2% of PDI while other forms of savings swelled from 1.22% of PDI in 1961 to 7.31% of PDI in 1987. This clearly shows that, in relative terms, life insurance deteriorates as the rate of savings increases.

During the last five years, the rate of savings has decreased and predictably the relative importance of life insurance savings has increased. In fact, in 1982, for each dollar committed to life insurance savings, nearly eight dollars were saved into other forms; by comparison, in 1987 one dollar of life insurance was matched against a little more than three (3.25) of other forms of savings.

These data on the distribution of savings dollars highlight a deterioration of the relative importance of life insurance as a means of saving.

At the beginning of the sixties, assets of life insurance companies totalled 9 billion dollars, close to 30% of all assets in Canadian financial institutions. By 1987, their share had fallen to 14%. It is also true that in terms of assets, the relative position of life insurance companies has been slightly improving since 1982; one explanation would be the decrease in the rate of savings since 1982.

If insurance companies wish to improve their position among financial institutions, they could devise a strategy along these lines:

1. Increase the share of personal savings channeled into life insurance;

2. Enlarge potential markets by launching new products or expanding operations;

3. Diversify into activities other than life insurance.

As I see it, in the Province of Quebec the diversification strategy was given top priority.

2.2 The presence of influential leaders in the life insurance industry

At the end of the seventies, Jean-Marie Poitras and Claude Castonguay, a most formidable team, played a key role in activating reregulation when they were both top executives at the Laurentian Mutual. Sometimes anticipating changes soon to be enacted, they made very significant moves, as for example taking over control of Geoffrion-Leclerc, an investment dealer, and later La Banque d'épargne de la cité et du district de Montréal, soon to become the Laurentian Bank.

When *Loi 75* was ratified in 1984, the Laurentian Mutual gave birth to a downstream holding: the Laurentian Corporation, itself controlling subsidiaries in each of the four financial pillars.

The trend set by the Laurentian Mutual was soon followed by most other life insurance companies; in particular by the Industrielle-Alliance and by the Société des Coopérants. It is worth mentioning that the latter switched from a federal charter to a provincial charter in 1988 so as to take full advantage of the flexibility of the Quebec legislation in matters of reregulation.

2.3 The existence of a local expertise in the life insurance industry

French-Canadian life insurance companies are much smaller and also much younger than their English-Canadian counterparts. Indeed, many English-Canadian companies were established in the nineteenth century; the oldest, and still running, being the Canada Life established in 1847 at Hamilton (Ontario). On the other hand, among the French-Canadian companies, only two were established prior to the turn of the century: La Société des Artisans, founded in 1876, now known as Les Coopérants following a merger in 1981, and La Mutuelle Alliance, founded in 1893, now operating under the name of L'Industrielle-Alliance following a merger in 1987.

As the local life insurance industry expanded, the need for specialized education in insurance was recognized. An undergraduate programme in actuarial science was set up at Laval University in the fifties, and the results were soon to come. At the beginning of the sixties, about 2-3% of all fellows of the Canadian Institute of

Actuaries were from Quebec; since then, their membership has grown to about 25%.

The need to train business students in insurance and to promote research was fully recognized in 1975 when Laval University, in collaboration with the industry, became the first Canadian university to host a Chair in Insurance.

As a high level of self-confidence was building up in the life insurance industry, it was quite natural that a "revolutionary" movement could emerge from that sector of the economy.

2.4 The predominance of the mutual form of governance

As mentioned before, reregulation in Quebec has meant growth through acquisition of subsidiaries. Taking over control of another enterprise does not go without a price. Indeed, it has been estimated that the premium for control can reach 30% of the book value of the target enterprise. Therefore, not only do acquisitions exert pressures on the liquidity of the acquiring firm, but they also inflict a postponement of return on investment. An economist would say "short-term pain for long-term gain."

The "short term" might be too long for some investors. Since last October, the stockholders of Provigo and Métro-Richelieu, two major players in the Quebec food industry, have expressed unequivocally that the returns on growth through acquisitions were too slow to come: in both cases the C.E.O. chose to step down and a return to core business was made a priority.

In mutual life insurance companies the policyholders are, at least in theory and by law, the owners of the enterprise. In fact, each member is entitled to one vote and only one vote; as a consequence, individual power decreases steadily as membership increases. Therefore, if little effort is made to incite policyholder participation in the governance of their company, apathy prevails and, as a consequence, through management's control of proxies, a somewhat autocratic régime may settle in.

However, there are to my knowledge two mutuals in Quebec, La Société des Coopérants and Les Services de Santé du Québec (SSQ), which have established a system of regional representation which precludes voting by proxy at the general assembly.

In a stock company, a non-performing management can be displaced if necessary through a takeover bid. This market discipline is not possible in a mutual company since votes cannot be bought on the market place. The only way to displace an incumbent management in a mutual would be through a proxy contest, and in a proxy contest, the incumbent management has a decisive advantage since it controls the list of policyholders. Challenging the management of a mutual would be an extremely costly operation.

Because of a lack of interest, or because of the implicitly high cost inherent to getting involved, mutualists have a tendency to delegate their power to the management. Therefore, I contend that it is much easier in a mutual than in a stock company to, first, initiate, and second, prolong a strategy of diversification through acquisition of subsidiaries.

3. The pitfalls diversification belies

Beyond the objective of seeking growth to compete head on with the international financial giants, a life insurance company may seek growth to achieve economies of scale and economies of scope (synergy).

Many studies claim to have uncovered economies of scale in the life insurance industry. The problem with many of these studies is the choice of the variable being used as a measure of output.

Quite often, premiums are used as a measure of output, which is questionable. Other factors being kept equal, if a company sells more term insurance, it should collect less premiums; does that imply this company is underperforming? The answer is obviously no. Therefore premiums are of dubious value as a measure of output. So, studies that point to economies of scale based on the use of premiums as a measure of output are not convincing.

It does not seem either that larger size induces a higher propensity to innovate. In an empirical study he conducted in 1984, S. Globerman found evidence "that large insurers in the U.S. and Canada were, if anything, slower to computerize their head office activities than their smaller rivals."

Furthermore, a quick glance at the *Fortune* magazine 500 (April 23, 1990) does not unveil any obvious link between the size of a firm and the ratio of its market value over stockholders' equity.

What appears more likely to me is that greater size flatters the top executives' ego and may impress politicians. The survival (or prolonged agony) of Chrysler is one good example of what I mean.

Economies of scope, or the synergy effect, is a rationale often invoked in support of acquisition of subsidiaries. This synergy should, in particular, manifest itself in the common use of distribution networks. This theoretically appealing idea must overcome sizable obstacles in practice, notably in the joint distribution of life and general insurance products.

We have here two sales operations with quite different approaches. Traditionally, life insurance is sold by exclusive agents while general insurance is sold by brokers. Since an agent's mandate comes from the company that employs him, and a broker's from his client, their cultures are distinct.

Furthermore, their work habits differ significantly. A life insurance agent is always prospecting; most often he has to demonstrate to a potential client the need for life insurance. On the other hand, a broker's work consists more in servicing adequately a need that the client is fully aware of.

Finally, the characteristics of a good client in life insurance are not necessarily the same as those of a good client in general insurance. For instance a broker might feel compelled, after a few successive claims, to raise his client's premium; will he do it if this client is also a good life insurance client?

As we can see, synergy cannot be taken for granted in the joint distribution of life and general insurance products. These few remarks should lead to greater moderation as to the anticipations of synergy effects in diversification.

Because subsidiaries are not liquid assets, any life insurance company embarking into a spree of acquisitions will find it more difficult to match maturities of assets and liabilities. The investment in a subsidiary may well appreciate. However, except in rare circumstances, the parent company is unlikely to sell a subsidiary to materialize the capital gain.

It should be clear that a life insurance company investing in a subsidiary rather than in securities may create inter-generational inequities. This latter point was well expressed by R.M. Hammond, the federal Superintendent of Insurance, in a letter he wrote on May 11, 1987 to Mr. G. Devlin, then president of the Canadian Life and Health Insurance Association (CLHIA), a letter which was subsequently circulated among the members of the Association.

Furthermore, one should be aware that whenever the parent company of a holding is a mutual, there exists a real possibility of conflict of interests. If the managers of the mutual are also stockholders of the downstream holding they will have a personal interest to favor a strong capitalization and the accrual of profits at the level of the holding rather than at the level of the parent mutual.

Due to the substantial transaction costs involved in switching to another insurance company, many policyholders are in some way captive. Therefore, should diversification activities cause an undercapitalization of the parent insurance company, unless they agree to liquidate their company, they may have to refloat it. Before such an extreme case is reached, they may have unknowingly bolstered diversification through decreased policy dividends or through the non-upgrading of their insurance coverage.

Conclusions

The reregulation process that has transformed the life insurance industry in Quebec has fostered a new entrepreneurial attitude that has undoubtedly sparked a positive spillover effect well beyond the life insurance industry.

This reregulation process also stimulated high anticipations as to the financial results to be achieved. For many observers, myself included, the expected benefits have been slow to materialize up to now.

As seen from the above, I have rather mitigated feelings about the process of reregulation that went on in Quebec. Indeed, I express a certain reserve as to pursuing an objective of growth in order to get as big as the biggest, and as to expecting much synergy effect.

As an economist, I still promote the pursuit of profitability as a primary objective. I have enumerated many pitfalls that plague takeovers. It appears to me that ad hoc alliances and networking arrangements with other institutions may sidestep or alleviate these pitfalls.

Finally, I believe that financial institutions will better contribute to the permanent betterment of our society by promoting economic democracy over economic concentration. This objective requires wisdom and patience. I wish this wisdom and this patience to us all.