

ACTUARIAL APPRAISALS
SOA Spring Meeting
June 14, 2004

Tom Herget – PolySystems, Inc.
Rick Farrell – Ernst & Young Chicago
Jim Hawke – Conseco, Inc.

Society of Actuaries

New Textbook

Insurance Industry
Mergers & Acquisitions

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Authored by Seasoned Practitioners

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Actuaries, investment banker,
accountants, attorney

Chapters

- Introduction
- Process
- Financing
- Due Diligence
- Other Corporate
- Taxes
- Accounting
- Integration
- Tales from the Crypt

Chapter One – Introduction

- Rationale for M & A
 - Earnings growth
 - Economies of scale
 - Diversification
 - Tax
 - R&D
 - New markets

Chapter Two – Process

- Role of professionals
- Preparation
- Marketing
- Buy-side evaluation
- Execution
- Closing steps

Chapter Three – Financing

- Structure
- Debt/Equity instruments
- Reinsurance
- Securitization
- Surplus notes

Chapter Four – Valuation Technique

Most common

Actuarial appraisal

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Rick Farrell
Ernst & Young, Chicago

**Understand
Scope of Appraisal**

- Statutory vs. GAAP vs. PGAAP
- Liability-only vs. Asset-liability model
- How will appraisal be used:
 - Sell-side vs. buy-side appraisal
- Confidentiality – Who can you talk to?
- Available time (or lack thereof)

Background Information & History

- Data integrity issues
- Data scrubbing

Setting Assumptions

- Sources of data
 - Experience studies
 - Pricing
 - Financial statement data
 - Company personnel
 - Company Plan
 - Cash Flow Testing report

Setting Assumptions

- Building model office
 - Compression
- Key Assumptions
 - New business (# years & amounts)
 - Discount rates (How to Set?)
 - Premiums from inforce block
 - Expenses & inflation
 - Cost of Capital
 - Taxes

Running the Model

- Using existing models
- Model validation
- Use of stochastic models (e.g. GMDB costs)
- Sensitivity tests

Presentation of Results

- Calculating actuarial appraisal value
 - Cost of capital
- Report
 - AAA standards of practice
 - Don't underestimate time involved
 - Start drafting on day one
- Educating non-actuarial audiences

Sample Appraisal Value Calculation

	Discount Rate X%	Discount Rate Y%	Discount Rate Z%
Adjusted Net Worth			
Statutory Capital and Surplus	xxxxxx	xxxxxx	xxxxxx
Asset Valuation Reserve	xxxxxx	xxxxxx	xxxxxx
Market Value Adjustment for H.O. Building	xxxxxx	xxxxxx	xxxxxx
Market Value of non-admitted assets	xxxxxx	xxxxxx	xxxxxx
Value of state licenses	xxxxxx	xxxxxx	xxxxxx
Tax loss carryforwards	xxxxxx	xxxxxx	xxxxxx
Value of Existing Business			
LOB 1 (PV after-tax profits)	xxxxxx	xxxxxx	xxxxxx
LOB 2 (PV after-tax profits)	xxxxxx	xxxxxx	xxxxxx
LOB 3 (PV after-tax profits)	xxxxxx	xxxxxx	xxxxxx
Cost of Capital Adjustment	xxxxxx	xxxxxx	xxxxxx
Value of Future Business			
LOB 1 (PV after-tax profits)	xxxxxx	xxxxxx	xxxxxx
LOB 2 (PV after-tax profits)	xxxxxx	xxxxxx	xxxxxx
LOB 3 (PV after-tax profits)	xxxxxx	xxxxxx	xxxxxx
Cost of Capital Adjustment	xxxxxx	xxxxxx	xxxxxx
Expense Shortfall	xxxxxx	xxxxxx	xxxxxx
Tax Benefit from Coinsurance Structure	xxxxxx	xxxxxx	xxxxxx
TOTAL	xxxxxx	xxxxxx	xxxxxx

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Jim Hawke
Conseco, Inc.

Conseco's Situation in 2002

- Parent Company bankruptcy
- Insurance & Finance holdings
- Finance side divested by auction under BK
- Appraisal of insurance holdings to serve as creditors ongoing expected value
- Complex FIT issues on Finance NOL's

Appraisal Purposes & Uses

- Value of creditors settlement
- Bank debt versus other debt
- “Fresh Start” purchase GAAP upon emergence from BK

In-house Actuary’s Role as Data Provider

- Time limitations – planning
- Quality of data – electronic is best
- Completeness
- Blocks which can be skipped
- Product information
- Experience studies

Assumptions

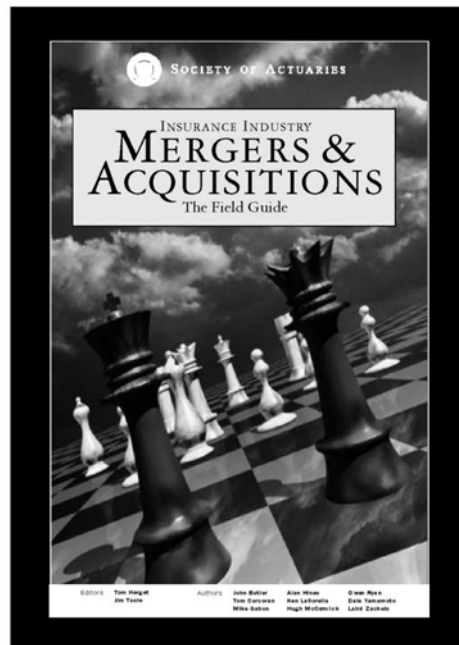
- Discount rate – Conseco's considerations
- Replacement programs running on the inforce block
- Nonguaranteed element issues
- Mark to market complexities & pitfalls
- Expenses

Reviewing the Report

- In-house Actuary as interpreter for management
- Plan on significant time and resources for this step
- Appraisal projections have implications on business plans – it's not ALL about present values, incidence is important - especially early on
- Sensitivity tests address areas of uncertainty

PGAAP & Audit Preparations

- Implementation – master the details
- The sensitivity of VOBA and goodwill determination
- In-house Actuary as facilitator between appraiser and auditor



Chapter Five – Due Diligence

- Check everything!
- Teams
- Confirm value to be realized

Chapter Six – Other Corporate

- Employee benefits
- Captives & self-insurance

Chapter Seven – Tax

- Taxable or tax-free transaction
- Consolidated returns
- Due diligence matters

Chapter Eight – PGAAP

- *SFAS 141 and 142*
- Liabilities
- VOBA
- Goodwill
- Impairment testing

Chapter Nine – Integration

- Planning
- Value drivers
- Culture
- Project management
- People issues

Tales from the Crypt



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Q & A