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WHAT IS A LIFE COMPANY WORTH?

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MR. SAMUEL J. WEINHOFF: I think before we talk about what a life company is worth, we have to look at today's environment for life insurance company mergers and acquisitions (M&A). And, of course, I'm talking about life insurance companies in the U.S. The first thing you need to understand is that there are lots and lots of sellers. There are dozens of companies who officially put themselves on the block, and, we suspect, there are many dozens more that would go on the block if they thought there was any hope of being acquired. We'll talk about why that's true a little later. Second, there are very few buyers and fewer still strategic buyers. Many of the buyers today are financial; in other words, they think that through some financial engineering or financial alchemy, they can create value where a strategic buyer doesn't see any. What does that mean? That means the prices are low and probably are going to stay that way for awhile, and we'll go into those reasons also.

So let's talk about that. Why does that condition exist? One of the big concerns is asset quality and liquidity. Junk bonds have certainly had their publicity, and in recent times, commercial real estate has had its publicity. But I think I'd make a couple of different points there. Ninety percent of the bonds in the U.S. today are at par or north of par. Because of that, life companies are probably feeling, by the nature of their accounting, pretty good because they mark to market and say in their minds that this is terrific. But let's look at the reasons. Obviously, it's falling interest rates. I think one of the principal reasons is because the U.S. economy is at best mixed, though many observers feel it's crummy and not getting better at any time soon. And, in general, the worldwide economy is poor. So that suggests that interest rates

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are going to stay down and head lower. But it also suggests something more serious for life companies, which is that people are going to prefer financial assets over physical assets. That suggests that the real estate or the commercial mortgage loans on their books are not worth the cost, which is what you're allowed under GAAP accounting and statutory accounting to keep them at. So that's very troublesome and it is certainly troublesome to a buyer.

Commercial real estate, in fact, is overbuilt in almost every city in the world. No one sees that turning around very soon. Last week, a building in downtown Manhattan changed hands for $57 million; it had been appraised by legitimate appraisal people two years ago at $160 million. Now that's a deep discount, and the big U.S. life companies own a lot of commercial real estate and a lot of commercial real estate mortgages. That speaks to the quality, but let's talk to the liquidity. Liquidity is important because, and I'm quoting directly from Moody's last report on the industry, which is just a couple of weeks ago, "There has been a serious erosion of public confidence in the life insurance industry." Suddenly there is a genuine belief out there that some companies, and maybe many companies, are unable to pay. I would point to the Mutual Benefit case as a watershed event because that was always perceived as your typical dull, sleepy company that did not do anything wrong, though they did not do anything terribly right either. And when it was seized, being a AA rated company just a couple of months before seizure, that set the world on its ear.

In addition, as to commercial real estate as a source of liquidity, it is very hard to sell commercial real estate loans when you have somebody called the Resolution Trust Corporation (RTC) who is flooding the market with commercial real estate loans. And besides hydro-sell, we are talking about something that even in the best cases is time-consuming and costly. On average, about 20% of the life insurance industry's assets are in mortgages; that is one of the things a buyer is looking at and is concerned with.

On the liability side, the cost of liabilities is simply too high. Now Tricia said we can't talk about price fixing or antitrust, but I would submit to you that if there has been some price fixing, whoever was doing it, has been doing a terrible job. The average Universal Life policy was paying eight and a quarter a couple of weeks ago; you can't pay eight and a quarter when treasuries yield seven. Yes you can, but it means you have to put it in riskier assets to get a spread, and riskier assets mean the possibility of either a mismatch or additional credit risks. An additional problem is there is an expensive and antiquated distribution system. It costs too much to distribute the interest-sensitive products of this generation. But, a more subtle problem is that agents who are naturally articulate, forceful in my opinion, control, in effect, the large mutual companies. And they have control because they are a very vocal, very articulate majority within the companies. And what those agents want are commissions because that is how they put food on the table; we all understand that. This conscious or subconscious control causes these mutual companies to design products that are in the agents' interests rather than the underwriters' interests. What does that mean? That means that capital does not get an adequate return and that means that, eventually, business enterprise becomes unattractive for acquisition. Of course, you can say, "Well, we're a stock company" or "We sell through brokers." Believe me, if your competition is doing foolish things, you're going to wind up doing foolish things or else you will not have any business. That is the nature of our enterprise system.

The next point is that it is harder than ever to match assets with liabilities. The industry has already talked about the liability side and lapse rates. All of that has been talked to death. I'm more concerned about the asset side. What you have on the asset side is, on the one hand, mortgage borrowers coming in and saying, "Refinance me at X or here are the keys," and on the other, insurance companies who have no choice quite frankly. So they do the refinancing, and now you're talking about an extension of the assets and you're talking about something more subtle; something called antiselection. Because the better guys, can go somewhere else and get better terms, and the worse guys, of course, are the ones you are stuck with. That is a problem.

The next problem I will mention is the regulatory concern. It is one thing to make an acquisition, but you have to understand what your return is going to be. If regulators are going to change the capital requirements and you don't know what they are going to be, it is going to be very hard to figure out what to pay for something. Because as the future goes on, you will need to capitalize it appropriately. In addition, buyers are very concerned as to whether we are going to have state regulation, federal regulation or, the worst of all worlds, both. Again, if you don't know the ground rules going forward, that should give you pause.

I finally will point to a longer-term problem which for life insurance companies, as the second largest holders of financial assets in the U.S., is a major problem. That is what I call "changing morality." When I started in the investment business many years ago, when a bond defaulted and you were the bondholder, you got the keys. Now when bonds default, you begin the negotiations. We have a client who owned a lot of various Donald Trump-related bonds in the casinos. We said, "We don't understand why he still owns so much of the company." And the client said, "Well, those days are gone, now we sort of need him to work this thing out." There is a change in morality there. Bondholders do not think they need to pay you back necessarily. They view it as needing to pay you back only to the extent it hinders them from doing the next deal. And that is a problem when you're a life company and you own a lot of bonds.

There are more serious problems. My company just took a huge write-off in the Optima platinum card area. It's very important that you understand the following: People who got the Optima card, which was our attempt to compete with the bank cards where you pay off some tiny amount each month, had been good American Express customers for at least a year and many for many more. We knew their credit history and we believed that if they could pay $500 a month at the end of every month, they could make their minimum $65 a month payment, but they could not. What does that mean? It turned out, first of all, this is the most serious white collar recession we have ever seen in recent years. Second, 50% of the people had borrowed up to the maximum limit of their cards more than 49 days or 50 days before declaring personal bankruptcy. In other words, they had gotten the cards with the concept that they were about to go into bankruptcy. They borrowed the money, waited until the 50th day, and then declared bankruptcy. Those are amazing numbers and should cause all financial institutions to take note.

After seeing this picture, you will say, "Why would anyone buy one of these things?" First of all, it is one of the last tax shelters left in the U.S., and I believe that the Treasury has made its last run for many years of trying to disrupt the inside buildup. I think that this administration, and I think the next administration, realizes that insurance companies are the second largest providers of capital in the U.S. They do not want to upset that mechanism by destroying the inside buildup. Second, the demographics are in the industry's favor. People are getting older in the U.S., more affluent. When you are 21, you are thinking about buying "Nike Pumps" and believe you are invulnerable. But as you get older, you realize your own mortality and of course, you have responsibilities and therefore you become a buyer. The population is aging; that is in our favor.

Because of all this, they're cheap. And when there are a lot of sellers and few buyers, you are likely to get a very good deal. I think this is the environment we are dealing with today. I would also go on to say that there are quite a few attractive niches. One is payroll deduction, where you control your selling costs; the tax sheltered annuity (TSA) market, a market much less likely to lapse; and then of course, as in most industries, selling to lower-income people is very attractive. You have the home service market which sort of plugs along. I still think there is some life in the direct response business; however, it is tougher because Americans are inundated with ads, but I think it is still profitable. And finally I would point to the hospital indemnity business where companies make a remarkable guarantee they will pay you, say, $100 every day you're in the hospital, and you can use that money for any purpose you want. I still think that's attractive business.

Let's talk about valuation. Obviously, a buyer is going to look at assets and is going to want to be paid for any assets that are either of doubtful quality or illiquid. In addition, a buyer is going to look very hard at the quality of the distribution force. When I talk about quality, I'm talking about cost-effectiveness, exclusivity, etc. I have always thought of the first part of an actuarial valuation, looking at the net worth and the in force, as in effect buying a bond. But buying a bond in a different sense because you can, through actions or inactions on your part, affect the lapse rate. The idea is to agree to buy assuming a very high lapse rate and later doing those actions required to lower the lapse rate. And, to the extent that's possible, you can "improve your return" on that bond.

The other thing I think a buyer has to take into consideration is the back office. Is it capable? Is it efficient? Is it better off closed? Is it better off merged with your own? Is it better off going to a third-party resource? Because that's often a large expense in these things.

Let's talk about pricing. Ms. Guinn said, "How could you not have slides?" because I guess this is a genetic thing among actuaries. They like lots of slides in presentations. If you saw a slide on price to book or price to earnings, you would find that year after year, for certainly the last 10 years, it is 1.1-1.3 times GAAP book in general. But you know what; it's not really that. Because often there is some sort of take-back paper where the seller suffers a loss on that paper based on asset deterioration or a higher lapse rate than assumed. In fact, it is sort of interesting. We completed an acquisition last year where the purchaser was able to convince his accountants quite easily that the paper he had issued was worthless and should not even appear on his balance sheet. And the seller valued it good money and they announced a gain on the transaction, even though they had in economic terms, a sizeable loss from everything we could see.

Let's talk about what is the most important thing to me: financing. How do you pay for this? That's where you are likely to need our services. The banks in the main are out of the game. And they're out of the game because, in the recent First Executive, Fidelity Bankers, First Capital situation, the insurance commissioners took over the companies and basically said, "We will meet with the banks, but that is all we will do." Banks realized then, for the first time, that their loans which were secured by the companies' stock meant nothing because owning the stock meant nothing when the commissioners seized all their assets and liabilities. You can still do some deals with the banks, but it is going to be tougher and tougher.

High-yield bonds have improved enormously. Total returns in the high-yield market have been, depending on whose index you use, 32-38% year-to-date. One sector that has not had those kinds of returns is the financial services sector. I do not think there is a market today for a leveraged buyout (LBO) in the public market of insurance companies. Interestingly, the private market is more distressed, but for a different reason. Largest buyers of private placements are other insurance companies, and they are always loathe to finance competitors. But in addition, because insurance companies are so sensitive to liquidity today, they're looking askew at any kind of product. So that's going to be very hard.

What do I see for the future? I would see more likely blocks of business being sold rather than companies. It allows the purchaser to select his niche more carefully. It allows the purchaser to pick and choose his assets, though I think the regulators are having more and more trouble with that, but it is still being done. And it is a much cleaner way for the purchaser to merge with his current back office. And at the end of the day, the buyer does get, if not a capital pick up, at least his capital ratio has improved by downsizing his balance sheet.

Next, I would see no upturn in pricing or increased interest in life insurance companies until a couple of things happen. One, people have to believe the commercial real estate prices have at least bottomed. And that I do not see. Second, there must be a clarity on capital requirements; how do you know how to get into an industry if you don't know what you'll have to put in over the future? And then finally there needs to be clarity on the regulatory side. People just need to know the ground rules.

I believe life companies will continue to sell at a deep discount to industrial companies and you can see that in the stock market every day, where insurance companies sell at eight, nine times earnings and U.S. industrials sell at 14, 15, 16, 17 times earnings. I don't see that changing because of all the other problems I have mentioned. Now Mr. Baird will go through what a buyer looks at.

MR. PATRICK S. BAIRD: I spent most of the last two years working on acquisitions in the life insurance industry. I don't know how I got there. I can honestly say I have never read a book or studied any theories on the acquisition process. So what you are going to hear from me is what I have learned by doing. If I were not here now, I would be working on one of three acquisitions that Aegon is involved in.

They are all in excess of $100 million and each is a little bit different. One has a demutualization sponsor; one is a rehabilitation situation; the other is a sale of a stock subsidiary.

Today's environment is very hectic. It seems like every company that I have run across is either for sale, looking for an equity partner, or is actually making acquisitions. I do not think I have talked to anybody with a life company who is happy just conducting business as usual. They are always in need of something or are involved in acquisitions in some way. From my position in the industry, I categorize the sellers of life insurance companies as follows:

- Noninsurance organizations
- Life insurance companies in need of downsizing
- Demutualization
- Regulatory authorities

Noninsurance organizations; who I have in mind here are those companies that got into the business 10-15 years ago, either as diversification or, in their view, as a way to compliment their existing core of businesses. Examples are the savings and loans and the most recent acquisition I've done, Western Reserve Life, which was owned by a child care company, Kindercare. Either the noninsurance organization screwed up the life insurance company that they acquired and decided to get out of the business, or else its core business is screwed up and it needs to sell the life insurance business to generate capital to support the core business.

Life insurance companies in need of downsizing; Mr. Weinhoff mentioned Mutual Benefit Life Insurance Company. I think, initially, Mutual Benefit fell into this category when they sold their group operations. They were hopeful of getting $400 or $500 million and support their ordinary operations and issue new business. I don't think it turned out that way. But there are a number of companies looking at downsizing to support their core of businesses.

Demutualization is really a form of raising equity or a form of rehabilitation. And then, of course, once the company has already failed, the regulatory authorities. The RTC is now involved in selling life insurance companies which I have been involved in a bit.

As to the buyers in the marketplace now, I categorize them into four groups:

- Foreign insurers
- Domestic insurers
- Noninsurance organization
- National Organization of Life and Health Guaranty Associations (NOLHGA)

Most often I see foreign insurers. The exchange rate is still right, the dollar is still relatively weak, and the U.S. is still seen by foreign companies as a substantial growth market in the stable environment. Despite what's happening in Europe in 1992, most people do not see it as a substantial growth opportunity. Next I see those domestic insurers who were smart enough or lucky enough -- and after seeing enough of them, I think it's a little bit of both -- to stay away from the asset and liquidity problems.

For the first time, I have seen some noninsurance organizations -- this is almost full circle I think -- who heretofore have not been in the business but who have done a good job in their other core of businesses, who are now sensing because of the reasons that Mr. Weinhoff said, that maybe the life insurance business is an attractive opportunity right now. Finally, I have mentioned the NOLHGA. Quite frankly, I still don't know what to make about this, but there's no question that they have had a substantial impact on the Executive Life Insurance Company transaction. I have no idea how that's going to play out, but the talking process in Executive Life has been significantly impacted by NOLHGA. And the last I heard, they are to be considered a serious buyer. So in rehabilitation situations, they are a force to be reckoned with.

You may hear that there is such an excess of sellers over buyers that there may be great deals in the marketplace. I don't know what a "great deal" is, whether you can price it at 25% after-tax return or 30% or what. Obviously, this is going to be tempered somewhat. I think NOLHGA is going to temper it in rehabilitation situations, and the noninsurance organizations are going to temper how great the deals become. While I think deals are very good right now, I don't think they're going to become great. People say that in two, three, four years, all the buyers are already going to have used up their acquisition capital and there are going to be many sellers left; then the deals are going to be very good. I think there are enough other businesses out there who have money that are going to get into the market and therefore, we are not going to see it turn into a fire sale.

Let's talk a little bit about the rehabilitation process. And remember, I'm just giving you experience from Aegon. Let's face it; insurance commissioners are either elected or political appointees. They don't like any conflict. Believe it or not, you can get great deals in companies that are in rehabilitation or being run off. Keep in mind a couple of things, however. First of all, your great deal comes from the policyholder's hide, not a shareholder. What you're doing is coming out with a restructured contract. You're reducing what the policyholder is going to get. Recently, insurance commissioners have been willing to give indemnification. Where does the indemnification come from against unknowns? It also comes from the policyholder's side. Now while you can get great deals out there, and Executive Life initially was perceived to be a great deal for whoever operated the insurance company, keep in mind that the next commissioner, the next elected official, likes to chew on the old one. And if you have taken advantage of the policyholders by getting a great deal on the company rehabilitation process and you're also an operator trying to do business in the ordinary course of things on a long-term basis, you need to think about the next administration if you will. And I'm not sure my company has the stomach to really go out and hit policyholders that hard. On a sale of a company by a corporation where you're in effect getting your deal and your indemnifications from a shareholder, I think we have the stomach for that. I think there are some very competitive deals out there, but I don't think they're as good as you might be able to get in the rehabilitation situation.

There are a number of reasons to buy. Certainly we've been thinking about all of them as we go. One is you can strengthen an existing business that you have, you might bring scale to an existing operation that has excess capacity. You might be able to fill in a geographic deficiency. Two, you might be able to buy into a new business that's very difficult to get into. Some are almost prohibitive to get into;

prohibitively expensive to get into. Three, you can achieve a higher rate of return on an acquisition than you can from originating new business. When you hear Mr. Weinhoff discuss the great opportunities that are out there, and for those who are lucky enough to be able to buy, you ought to buy. I think that's true, but you also need to keep in mind that this is an unusual situation. And while it may last four or five years, you still want to be in the insurance business forever. And you don't want to sacrifice, in my view, existing sales efforts for acquisitions. I don't think you quit doing your core of businesses because it's a very attractive acquisition market. I think it's a complement. And keep in mind, some day it's not going to be as attractive as it is now.

And finally, buy if you have one hell of a deal, if it doesn't take too much effort. You can find some great deals out there, and if you've got a little bit of excess capital out there, why not? How do you locate a deal? Well that's pretty easy. They usually find you. If you're really looking for something, one, you can contact any investment banker. They'll contact you whether they're representing a seller or whether they're looking for a buyer to represent. Two, by being an attractive owner. This is something that has come Aegon's way. I don't know why, I don't think it's because we're that nice of guys, but I've actually had companies who were in a situation that they know they need a new owner. They know that they need an equity infusion. And they have actually come to us and said, "We need an owner. We think you would qualify." It's kind of the reverse thinking there, where you try to go find an acquisition. Well, some companies are actually out trying to find owners right now and we've had some come our way. And knowing your competition, of course, professional advisors, I'd say half of the candidates that I learn of come through contacts like Tillinghast, Peat Marwick, a couple of law firms.

As far as other intermediaries are concerned, I just want to give you a little word of advice. The day after I made my last acquisition, I got a congratulatory call from an intermediary, an independent, who said, "Congratulations." And I said, "Thanks." He said, "By the way, I'll send you a finder's fee invoice." And I said, "Well, who are you?" And he said, "I'm the one who called your attention to this acquisition that you just completed." And I said, "I started it at the beginning and I just closed it, and I've never heard of you before." He said, "Well, I called somebody in your company." Be careful; every time we've made an acquisition, I've had at least two or three lawyers write me representing an intermediary who said they called our attention to it and they deserve a fee. Never sign anything unless you actually plan to use somebody. And never say anything other than, "Yes, I already know that."

Once you decide to get into the game, the first thing you will receive is an executive summary of the target company, which is typically four to five pages. It doesn't tell you a whole lot, and they'll request that you execute a confidentiality agreement. I have just one bit of advice on the confidentiality agreement. The purpose of the confidentiality agreement is to ensure that you won't misuse the confidential information of the company for your own benefit. They usually have some provision in there that says you can't recruit any of this company's agents or you can't hire any employees. And then the definition of the word "you," meaning the buyer, is anybody -- any of your employees, any of your agents. And I'm sure in many of the times I've executed confidentiality agreements, as I was executing it, one of our agents was trying to recruit someone from this company. So we always try to limit who is subject to the confidentiality agreement to those people who are actually involved in evaluating the transaction, with only one exception. And that was the RTC – I've not been able to get that through. So just be a little bit careful with it.

Following the execution of the confidentiality agreement, you then receive a detailed description of the operations, distribution system, management capability, administration. You generally receive a "seller's actuarial evaluation" as well as a request for nonbinding expression of interest. Now what that is, you look at the actuarial evaluation, you look at the materials, you talk to third parties and you think, "Okay, what would I be willing to pay for it solely based upon the information I've received." Now keep in mind you've never paid an on site visit. You don't know anything about the management. All you know is what you get. The purpose of this nonbinding expression of interest is to just get you to the next dance. The next dance is when you actually make an on-site visit. What I would suggest is that you don't highball the price. What I would suggest is that you come up with even a little bit of a lowball price, but you also demonstrate your ability to move quickly and you demonstrate your ability to buy. In other words, where is the cash going to come from? You always make it to the next dance. It doesn't matter what I put in the letter, as long as I've got cash and as long as they know that we could move quickly, we always make it to the next level. I think the purpose is just to kick out some of the tire kickers. Assuming that you do get to the next dance, so to speak, you are then generally one of no more than seven or eight parties. What that entails then is a one- to three-day on-site inspection where you actually go to the company that you want to buy and you listen through a management presentation, you get access to data, and you get some limited access to confidential information.

I am now going back to the agenda and talk about the risks associated with the acquisition process. Let's face it folks; if a company is being sold, something is wrong. It doesn't have to be wrong with the target company, but something in that organization is wrong. They need to sell for some reason. And when you need to sell, that creates a whole lot of uncertainty. Now there's a gentleman in our company that I respect very much who has been through a whole lot in his life. He's had experiences in war. He's had experiences in government. He's had experiences everywhere. And he told me that human beings can deal with good news and they can deal with bad news, but they cannot deal with uncertainty. And the entire acquisition process is nothing but uncertainty for the people that it affects. For those of you who have gone through it like I have, you'll know what that is. What you're dealing with is an organization that is not going to be worth as much, is not going to have the same value after the acquisition as it does before. And here you're going in as the buyer, and you're going to have some input. It's a very unpleasant experience, so let's talk about some specifics. Perception is all important. I think a number of you know the names of companies where perception has actually brought the company to a halt. And as a buyer, you can impact the perception. Even if you're at the preliminary due diligence stage where you're just one of 70 or 80, if you want this company to continue as a growing concern, to the extent you can excite management, to the extent you can excite the distribution system, you can keep your arms around the perception in that company. And if you do a bad job, then you can also start the bleeding. A going concern clearly is worth more than a liquidating run-off situation. And trust me; in an acquisition situation when you're out doing due diligence, you can change a company from being a going concern to a liquidating company. Good agents don't have to put up with, let's say, uncertainty -- you can put in what you want. I've talked to a number of agents who just said, "Well, I would continue writing, but I just don't need to write for some company that I don't know what's going to happen to them. I just don't need it. I've got other companies I can write for." And of course, you all know this; that good employees are the first ones to leave.

During the acquisition process, there are three things that I always try to worry about. Disaster can happen during the acquisition process, even with healthy companies. And as I said before, assuming that you avoid a disaster, it's nevertheless rare that a company is worth more. It's been my experience that employees virtually shut down during an acquisition process. First of all, the buying company takes up a whole lot of time of employees. Agents just don't need to put up with it. So what can you do? There are lots of ways I can tell you what to do, but I like this one the best. You have to remember when you first walk into a company, the person you sit across from, your counterpart, is going to be thinking, "This is the person that's going to replace me. This is the person that's going to displace me." And if you don't remember that one, remember this one. Keep in mind that during this period of uncertainty, you represent the solution to the uncertainty in effect, how you deal with this situation up here and given that it's the key management that controls the distribution system, how you deal with this determines what the company is going to look like after you acquire it. The easiest thing to do is keep communicating. Never stop. Silence is a horrible enemy during the acquisition process. When I got back on the third day, the CEO of the company we were acquiring said, "Have you people backed out?" And I said, "No. I've been worrying about my swing. I haven't been worrying about this company." And he said, "What's going on the last two days?" And I said, "Well, I played golf." And he goes, "Oh, thank goodness." I mean, that person was very upset. Just because I was out on a golf course somewhere. Usually the people I play with are very upset on a golf course. As a buyer, take the responsibility for what is communicated to the employees. Key management wants to wash their hands from dealing with the employees. They don't know what to say. They've got friends. Their friend may be out of a job. They just don't want to deal with it. As a buyer, you tell them. You take responsibility. I've actually gone to the extreme of supplying a target company that we look at with a book for their employees. I actually buy it and give it to management and say, "Hand it out." It's called *The Employee's Survival Guide to Mergers and Acquisitions*. It tells them it's not the end of the world. It tells them the best thing they can do is to keep their head down and work. It tells them that there is life after a merger. And believe it or not, this has had a positive impact, or I'm told it has anyway.

Well, if the acquisition is a shutdown, you may have a situation where you just know that it isn't going to make sense to continue that operation as a going concern. Given today's technology and so forth, I'm guessing we'll probably see a lot more of that. You have to give incentives immediately to the key people. And that can be very expensive. I've seen arrangements whereby if someone stays for a year they get another six month's salary. If they stay for two years, they get a year's salary as a bonus. So it can be very expensive. I just suggest you price it. You need a back up plan nevertheless because good employees are always the first ones to go. And please remember to treat employees fairly because -- and I'm not going to mention any names -- but there are a few companies that when they show up as a potential buyer, just raise panic in the target company because they know what they've done in the past. So please keep in mind your image. Treat employees fairly. And I would just suggest you build all the costs of bonuses and severance. Be more than fair and build it all in the pricing.

At this point, if you decided to continue and you decide that the company is not going to deteriorate, it's time to find legal counsel and start negotiating the purchase agreement. I think in my years of experience, you need to start thinking about regulatory approvals, you need to communicate with the rating agencies, and of course, you need to lock up financing. I have to tell you; it's been my experience that this process takes anywhere from two to four months. This period of uncertainty that I've told you about, that you have to babysit the situation through, continues to exist all the way up through the day of closing. So while I'm going through this rather quickly, I don't mean to make light of it. It is just as important to continue your communications, continue talking to agents, continue to direct the key management to communicate to employees during this entire process.

If you were to ask me back next year, and I'm not suggesting that you do, but if you were, I'm sure I'll have a whole different story to tell you, because the rules are changing so quickly. You have to be very nimble, and the best advice I can give is be nimble as hell but never give up your discipline. Whatever you want to get from this company, there are lots of ways of getting it. And while you can acknowledge that a change has to take place and you have to do something differently than you originally intended, make up for it somewhere else. Don't give up your discipline.

MS. PATRICIA L. GUINN: There are a few actuaries who are involved in strategizing or negotiating or being on the deal side of an M&A transaction. But for the most part where we get involved is in the pricing or the appraisals and evaluations. In 1988, the Actuarial Standards Board commissioned a task force to look at developing a standard for actuarial appraisals. On October 10, 1991, a standard was finally adopted. Let's look at the definition of what an appraisal is. It's an assessment of value of an insurance company or a block of business or even some sort of insurance-related enterprise that's based on projections of anticipated future statutory earnings that are associated with the evaluated business, discounted to the present value at an appropriate risk-adjusted rate of return.

Now, in coming up with that definition, just about every single word in the definition was hotly debated. Some of these hotly debated words were "statutory"; statutory versus GAAP versus XYZ kinds of earnings, and "discount rates." We'll talk a little bit more about each of those things. But another thing about the standard that I like to point out is that the appraisal value is supposed to represent a value to a particular user under a specified set of assumptions. And that the actuary performing the work should be coming up with a value that's relevant to the user of the actuary's work. The other point is that an actuarial appraisal value is not necessarily market value. For reasons that Sam and Pat have discussed, market values change with the times. They depend on whether there is a dearth of capital available or a lot of capital available, and whether life companies are the favorite investment or not. An actuarial appraisal is sort of theoretical – it's a very actuarial sort of value. It's meant to represent the value that might be agreed on by a willing buyer and a willing seller when neither one of the parties is under unusual duress to complete the transaction.

Typically in the past, in most of these fields there will be an actuarial appraisal. It might not be called one. It might be called an actuarial analysis or valuation, but let's call them appraisals. It's been typical to present the value in three pieces: adjusted net worth, the value of in-force business, and existing structure value (Chart 1).

And while it's not necessary to develop an appraisal value in these three bits, it's been pretty common to do so in the past because conceptually you can see different levels of risk associated with each one of these pieces. The adjusted net worth was viewed as the relatively least risky piece. The value of in-force business is the next level of risk. And finally, existing structure value is viewed as being the most risky.

Now I'll take you through some definitions, starting with adjusted net worth. If you take any real-life life insurance company, the balance sheet will be more complicated than what is shown in Table 1. But on a simplistic basis, determining adjusted net worth usually means taking statutory capital and surplus, and adding back the Mandatory Securities Valuation Reserve (MSVR), because we view it more as an allocation of surplus than a real-life liability that somebody can knock on the door and ask you to pay out today.

TABLE 1
Adjusted Net Worth

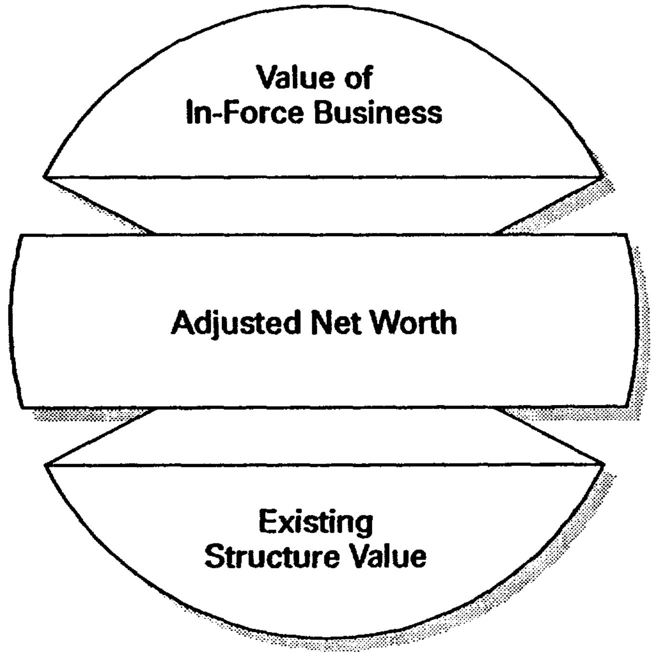
Statutory Capital and Surplus	
+	MSVR
+	Nonadmitted assets with real value
±	Excess value of subsidiaries
=	Book value of adjusted net worth
±	Market value adjustments
=	Market value of adjusted net worth

Then add back nonadmitted assets, things that are nonadmitted simply because of the quirks of statutory accounting; but add them back at their real value and not some funny book value. And then to the extent there is stacking and you've got subsidiaries whose economic value is more than statutory carrying value, make an adjustment for that. Do all of that and we might come up with what I call the book value of adjusted net worth. And often the value is further adjusted by looking at the assets you are assigning to the various components of value, and bringing those assets to market.

The next example is the value of in-force business. Conceptually, this means the discounted expected future profits of business that are already on the books today.

And the standard approach has been to develop a model. Traditionally it's been a liability model only, but now asset models are becoming more and more important. To develop a model, you select appropriate assumptions. They might be one-scenario best-estimate assumptions supported by sensitivity tests, or you might use a

Components of Value—Traditional Approach



stochastic approach where you test a range of assumptions, particularly with respect to interest rate environments to develop future statutory profits along each assumption set. And then discounting the projected profits gives you a value for the in-force business.

Existing structure value goes by a lot of names; value of new business, good will, etc. What it means is trying to put a value on the ability of the company to continue to produce new business at a profit in the future (Table 2).

TABLE 2
Existing Structure Value

- An empirical attempt to value
  - reputation
  - charter and licenses
  - current products and ability to produce new products
  - marketing and distribution systems
  - administrative and information systems
  - management effectiveness
- Technique
  - PV profits of one year's issues
  - estimate production
  - discount profits from production date to valuation date
- Dual discount rate

It's sort of going concern value. A common technique is to look at the profitability of one year of sales. Once you've got that, develop a capitalization factor, looking at future production and maybe growth in production and a number of years of production at a discount rate, and say for example, good will be three times the value of one year of sales. Often there is a dual discount rate employed here, the discount rate that's used to discount statutory profit to the assumed date of issue which will be the same discount rate that the actuary uses in valuing the in-force business. Then a higher rate will be used to discount profits from the assumed production date back to the valuation date. This is meant to recognize the additional risk that this future production will never be realized. That's just a quick overview and maybe in some ways a simplistic view of how an appraisal is done.

I'd like to go through a case study to discuss some of the issues that we see in appraisals today (Table 3).

My case study is very cleverly named "ABC Life Insurance Company." ABC is a single premium deferred annuity (SPDA) company. Let's say it's been writing business for the last five years and it's got $1 billion of annuity reserves on the books. Together with its MSVR and capital and surplus, it's got $50 million of adjusted net worth. On the asset side of the balance sheet are mostly bonds and the accrued interest on the bonds. It's got a tiny bit of common stock and real estate. ABC's parent is in the donut business and it's really doing well in donuts and needs more capital to grow the donut business. So it wants to sell the life company. It gets an actuarial appraisal done, or an actuarial study that's sent out to all the prospective buyers in the world.

TABLE 3
Case Study: ABC Life Insurance Company

Assets		Liabilities & Surplus	
Bonds and Cash		Annuity reserves	1,000
1	300	MSVR	20
2	600	Total liabilities	1,020
3	50	Capital and surplus	30
4	30		
5	10		
Common stock	10		
Real estate	10		
Accrued interest	40	Total liabilities and	
Total assets	1,050	surplus	1,050

This appraisal shows you the pretax profits (Table 4). It's presented on page 3 of the report; the present value of pretax profits is shown at three discount rates; 10%, 12.5%, and 15%. In each case, our adjusted net worth is basically the $50 million sum of capital and surplus and the MSVR. The value of in-force business ranges from a high of about $90 million at 10%, down to $69 million at the higher discount rate. And we've got a positive value for existing structure ranging anywhere from $53 million to $85 million. So we come up with total values of $225 million at 10%, $195 million at 12.5%, and $173 million at 15%.

TABLE 4
ABC Life Insurance Company Actuarial Appraisal

	Present Value of Pretax Profits		
	10.0%	12.5%	15.0%
Adjusted net worth	$ 50.0	$ 50.0	$ 50.0
Value of in-force	89.8	78.3	69.1
Existing structure	85.1	67.0	53.4
Total value	$224.9	$195.3	$172.5

Let's say we look through the appraisal, we look at the approach, the methodology that was used, and the assumptions, and we're pretty comfortable with a lot of it. We've just got four little areas that we want to consider: expenses, the C-1 and C-3 risks of the business, and federal income tax, because I'm not so lucky to be a nonprofit organization -- they're going to have to pay tax. I want to see how it's going to impact the pricing of this deal. And finally, there is the cost of capital.

Let's see what happens or what sort of adjustments might be made to an appraisal on the buy side of a transaction (Table 5). Let's say we got out ABC's prior year statutory statement and we tried to do a little expense analysis and saw that their actual total expenses were $8 million and the best that we can see is that they were about 5.7 on acquisition, 2.3 on maintenance. We see that the models were run with say a $30 annual maintenance expense per policy and say $100 per policy acquisition. We compare this with the assumed production and the in force, and the company has a current expense overrun on the acquisition side of $2.5 million, and a half million on the maintenance side. So there's a total annual expense overrun based on last years numbers of $3 million. It's assumed we're going to continue to write let's say $300 million a year. It's going to cost us more, and in fact, we don't see how we can cut down on ABC's acquisition expenses. So we think that the acquisition expense overrun is permanent and we want to take it into account in our pricing.

TABLE 5
Expense Analysis

	Acquisition	Maintenance	Total
Actual	5.7	2.3	8.0
Model	3.2	1.8	5.0
Expense overrun	2.5	0.5	3.0

On the maintenance side, we do have a block of annuities and we probably can get the cost down to $30 a policy, but it's going to take us awhile. So let's say that we price the deal that the maintenance expenses will run off over five years. We do our calculations and say we need to adjust on a pretax basis the value of ABC Life. This adjustment is for a total of $11 million at 10% and so forth (Table 6).

TABLE 6
Expense Adjustment

	Present Value of Pretax Profits		
	10.0%	12.5%	15.0%
Acquisition (permanent)	9.8	9.3	8.8
Maintenance (5 years)	1.2	1.2	1.1
Total	11.0	10.5	9.9

So now we've got our expense adjustment. Let's move on to the next one; C-1 and C-3 risks. The base case assumption that was made in the appraisal was 190-basis-points gross spread and 10 basis points of investment expenses (Table 7).

TABLE 7
C-1 and C-3 Risks

•	Base Case:	190-basis-point gross spread 10-basis-point investment expense
•	C-1 Risk:	Asset default/loss of value
•	C-3 Risk:	Intermediation/disintermediation

That validates ABC's last couple of years of experience pretty well. So far so good. But ABC had about 10% of its assets in high yield and they just bought those over the very recent past. So they haven't had a lot of experience with default so far. And so we feel that potential defaults really haven't been priced into the value yet. Similarly, the value was developed by just assuming we'd earn 190-basis-points spread forever. We feel that probably doesn't take into account that interest rates are volatile and we aren't locked into a 190-basis-point spread. We have to set credited rates in relation to what's going in the market and we want to take that C-3 risk into account.

Let's look how we might price each of those. On the C-1 side, we look at what the assets are of the company and we assign sort of an expected default cost to each one, calculate the weighted average, and we think that we need to deduct out of the value a margin for default costs of about 11 basis points (Table 8).

TABLE 8
C-1 Risk

Bonds and Cash	Default Cost (basis points)
1	3
2	8
3	20
4	80
5	200
Weighted Average	11

For C-3 risks, we look at our liabilities, look at the options that are embedded in them. All the products have 10% free withdrawals, and about a quarter of the business was issued with a bail-out provision, and our new business continues to be about one quarter bail out. On the asset side, we've got quite a bit of collateralized mortgage obligations (CMOs), and so we've got a lot of prepayment risk on the asset side. And we go off and we do our stochastic analysis and we do our option pricing, and we decide that the C-3 risk is worth about 14 basis points (Table 9).

TABLE 9
C-3 Risk

• Liabilities:	10% free withdrawal
	25% bailout
• Assets:	30% CMOs
• Estimated Cost:	14 basis points

So we add 11 basis points for default and 14 basis points for C-3 risk; a total of 25 basis points. And again we calculate what's the pretax present value of the adjustment of 25 basis points less spread on the in-force business and on the new business. And I now have another adjustment to make between $37 million and $28 million (Table 10).

Federal Income Tax. This is a fairly simple company, it doesn't have any prior 334s or 338s. And we don't contemplate one for this transaction and don't have to worry about that. The company doesn't have any tax less carryforwards. It's been profitable on a tax basis, and the tax loss of its assets are pretty close to statutory. So that's not something that I have to worry about. All I need to worry about is basic federal income tax, recognizing statutory/tax reserve differences, and I have to price in the deferred acquisition cost (DAC) tax. And for this purpose, we're going to assume that the impact on the in force is nothing. We'll just look at DAC tax on the new business (Table 11).

TABLE 10
Adjustment for C-1 and C-3 Risks

	Pretax Present Value		
	10.0%	12.5%	15.0%
In-force business	15.9	14.1	12.7
New business	21.6	18.1	15.4
Total	37.5	32.2	28.1

TABLE 11
Federal Income Tax

• Statutory/Tax Reserve Differences:	Excess interest
• DAC Tax:	New business only

Now for the in-force business; we had a base case pretax value – we've got to focus in on one column; so let's use values at 12.5% – of $78.3 million. Let's assign our maintenance expense adjustment to the in force. So we deduct the 1.2 expense adjustment and we deduct the 14.1 for the C-1 and C-3 risk adjustments. We're down to an adjusted pretax value of $63 million. What's the tax impact? Well first of all, there's 34% of the pretax value, that's $21.4 million (Table 12).

TABLE 12
Federal Income Tax – In-Force Business

	Present Value of Profits		
	10.0%	12.5%	15.0%
Pretax value			
Base case	89.8	78.3	69.1
Expense adjustment	–1.2	–1.2	–1.1
C-1 and C-3 adjustment	–15.9	–14.1	–12.7
Adjusted pretax	72.7	63.0	55.3
Federal income tax			
34% pretax	–24.7	–21.4	–18.8
Statutory/tax reserve	0.6	0.5	0.5
Total tax	–24.1	–20.9	–18.3
After-tax value	48.6	42.1	37.0

Then, we recognize the statutory tax reserve difference on the in force. Basically we're setting up statutory reserves, let's say, that includes half a year excess interest. On a tax basis we haven't been able to deduct that yet. So as that statutory reserve runs off over the life of the block, it will come back to us on a nontaxable basis. So we've got a little tax benefit from the tax reserve difference on the in force that's worth $500,000. So our total tax adjustment is $20.9 million, and on an after-tax basis, present value of statutory profits after tax is $42.1 million after adjustments.

Let's do the same thing on the new business (Table 13).

TABLE 13
Federal Income Tax – New Business

	Present Value of Profits		
	10.0%	12.5%	15.0%
Pretax value			
Base case	85.1	67.0	53.4
Expense adjustment	−9.8	−9.3	−8.8
C-1 and C-3 adjustment	−21.6	−18.1	−15.4
Adjusted pretax	53.7	39.6	29.2
Federal income tax			
34% pretax	−18.3	−13.5	−9.9
Statutory/tax reserve	−0.7	−0.7	−0.7
DAC	−2.3	−2.5	−2.7
Total tax	−21.3	−16.7	−13.3
After-tax value	32.4	22.9	15.9

Our base case value at 12.5% is $67 million. After adjustments it's $39.6 million. We've got three components of tax to recognize on the new business; the 34% of pretax is worth $13.5 million.

The statutory/tax reserve difference for new business is a cost because I'm starting out with zero liabilities on both the statutory and the tax basis. And I have to set up my statutory reserves faster than I get to deduct them for tax purposes. So it costs me $0.7 million, and the DAC is going to cost me $2.5 million, so my total tax on the new business is $16.7 million for an after-tax value of $22.9 million.

And we have four adjustments to make; expenses, C-1 and C-3 risks, taxes, we've made all of those, we're left with cost of capital (Table 14). My philosophy, let's say, or my client's philosophy in pricing an acquisition, is to look at the return on the purchase price, look at the hurdle rate as applying to the entire purchase price. And the typical approach in an appraisal of including net worth at book value or market value is akin to either one of two assumptions. One is that all of the net worth is immediately distributable from the company. The second way is the discount rate that applies to net worth or an appropriate discount rate is the after-tax new money rate. And that's debatable. It's pretty reasonable to view that net worth has less risk than in-force business. So maybe a different discount rate is appropriate. But if you're going to price a deal looking at your return on the total purchase price, and let's say your hurdle rate is a composite hurdle rate, capital does have a cost. So let's look at this example. Based on the current assets and what else we've used, the current assets in our assumed investment strategy for the future and the types of liabilities, we say that our target surplus for this block of business, this company, is going to be 5% of reserves. And so our initial target surplus is $50 million.

TABLE 14
Cost of Capital

- 5% target surplus = $50
- 9% pretax earned rate
- Annual cost = Hurdle rate − After-tax earned rate

Hurdle Rate	Cost
10.0%	4.1%
12.5	6.6
15.0	9.1

It's invested in bonds and a little bit in real estate and common stock, and we have a 9% pretax earned rate. Our cost of capital is the hurdle, our annual cost is the difference between the hurdle rate and the after-tax earned rate. If I earn 9% on this bond called target surplus and at book it's yielding me 66% of 9%, if I want to earn 10% and I'm really earning 5.9%, my cost is the difference. It's 4.1% each year. And as the hurdle rate goes up, the cost of capital goes up.

The net worth in this company was $50 million, and we need $50 million; it has zero free net worth (Table 15). On the in-force business, if I revalue that target surplus from $50 million at book where it's earning say 5.9% after tax, to yield 12.5%, I need to discount it by $18.3 million. My in-force value, together with the surplus that's dedicated to it, is worth $73.8 million instead of being worth $92 million -- the 42 plus the 50 (Table 16).

TABLE 15
Cost of Capital

Adjusted net worth	$ 50.0
Target surplus at 5%	−50.0
Free net worth	0.0

TABLE 16
Cost of Capital -- In-Force Business

	Present Value of Profits		
	10.0%	12.5%	15.0%
After-tax statutory profits	48.6	42.1	37.0
Target surplus	50.0	50.0	50.0
Cost of capital	−12.9	−18.3	−22.5
After-tax distributable profits	85.7	73.8	64.5

On new business, cost of capital has a dramatic impact. Say at 12.5%, the present value of my adjusted assumptions' present value of profits was $22.9 million. Taking into account the strain from writing new business, not only the statutory strain associated with expenses in setting up reserves, but also the capital I have to dedicate to that business, this strain almost wipes me out (Table 17).

TABLE 17
Cost of Capital – New Business

	Present Value of Profits		
	10.0%	12.5%	15.0%
After-tax statutory profits	32.4	22.9	15.9
Cost of capital	−15.1	−20.9	−24.6
After-tax distributable profits	17.3	2.0	−8.7

So the after-tax value of new business is now worth $2 million. It's worth more at 10%. It's got a negative value at 15%.

Let's look at our revised actuarial appraisal for ABC. I've got a total value at 12.5% of $75.8 million. I have no free net worth. The in force is worth $73.8 million and the new business is worth $2 million. The original value was $195.3 million (Table 18).

TABLE 18
ABC Life Insurance Company -- Revised Actuarial Appraisal

	Present Value of After-Tax Distributable Profits		
	10.0%	12.5%	15.0%
Free net worth	0.0	0.0	0.0
Value of in-force	85.7	73.8	64.5
Existing structure	17.3	2.0	−8.7
Total value	103.0	75.8	55.8

So I've got a haircut of a little over 60% to the value. Now it's been said in joking form before, that the factor that's applied to actuarial appraisals to come up with purchase prices is 0.4. And I just wanted to show you an example of why 0.4 is a reasonable value.

MR. FRANK V. BROLL, JR.: Comment was made earlier in the presentation about the difference between buying blocks of business and buying old companies. While there are some advantages to both, there may be a serious disadvantage if the regulatory movement afoot to require positive policyholder consent to an assumption reinsurance of a block of business is put into place. What is the status of that movement?

MR. BAIRD: From what I've read, I couldn't tell you exactly what the status is. But from what I've read over time, that's going to become more prevalent. And that's going to knock out another whole slew of buyers and get prices even lower, because while a policyholder I'm sure would have no problem agreeing that American National would be a terrific policy to hold, if it was "Sam Weinhoff LBO firm fund #17," he might be a bit queasy. To the extent that happens, it's going to knock out a lot of the strategic buyers.

MR. JEFFREY C. HARPER: I have a couple of observations about NOLHGA. We've been engaged by NOLHGA to perform a significant amount of actuarial work and other types of analyses for some of these insolvencies, but we have not been engaged to act as a spokesperson. So some of the things I'm going to say probably should be viewed as my observations from being involved in the process. GALICO, which is the acronym that NOLHGA is using for their company, is pretty new and still not formed all the way, and there isn't much historical perspective for it. The other proposals that NOLHGA has on the table, for example, the enhancement plans for some of the other potential purchasers, have never really been done before. So it's pretty different. The situation changes daily or even hourly and I haven't spoken to any of the staff involved in this for up to 12 hours. So if I tried to tell you the current situation, it probably would not be correct.

But all that behind, there are a couple of things I think are interesting that tie in with what Mr. Baird was saying earlier. NOLHGA has acted as a buyer, to some extent a buyer of last resort, for companies that are insolvent or blocks of business that have gotten into trouble. I think NOLHGA should also be viewed as a seller. They have a unique perspective, at least different from Aegon or Capital Holding or ICH whoever it might be, in that they're not intending to build a large group of companies. They have to build the companies because somebody has to cover the policyholders, but they're equally interested in getting rid of the blocks of business once they've got them. So they're actually both buyers and sellers. Second, the reference to the "great deals," where Company A may take advantage of Company B, I think is different from the NOLHGA perspective. From the NOLHGA perspective, the seller is eventually the industry itself and finally the policyholders. They either have higher insurance costs because the assessments will raise that cost, or eventually even the taxpayers in the state will be the Company B. So it's different than a donut company selling something and having advantage taken of them, because it's actually the industry or the policyholders or even the state taxpayers.

And the final observation I guess would be the balancing act that NOLHGA has to go through. We mentioned the policyholders sometimes take a haircut. The efforts of NOLHGA are usually on behalf of the policyholders to reduce the amount of haircut the specific policyholders in an insolvency will take. But also to a large extent, they're trying to reduce the haircut that the industry takes in having to make larger assessments against their companies.

MR. BAIRD: I'll just make a couple of comments. NOLHGA is really an interesting situation. You could make the statement that when you're competing against NOLHGA, you've see the enemy and the enemy is us in a way. The thing that is confusing to me about NOLHGA is what their role is going to be in, for example, the Executive Life situation. Let's say they are chosen as the buyer. Are they actually an operator? The California department as I understand it is trying to figure that out. They're trying to understand who NOLHGA is. Who do we have to talk to about administrative problems, about employee benefit problems, about the other problems associated with running a company? And as far as I know, no one as yet knows the answer to that. And to the extent we've been involved in a competing bid, I've tried to figure that out because I don't know whether they are on our side, whether they are a true competitor, and I'm only talking in terms of the acquisition process. I guess time will tell. One thing that they have done, certainly at Executive Life though, is that they have made the competition stand up a bit. So to the extent they want to reduce the exposure to the rest of the industry, they have certainly done that and have done a good job. My only comment is as a buyer, what are their qualifications as an operator? I think that's the only thing that's outstanding with me at this point.

MR. HARPER: Obviously, the problem they've had is that it's not a well-defined organization. NOLHGA stands for National Organization of Life and Health Insurance Guarantee Associations, and it isn't clear that they actually have the statutory authority to own or start up an insurance company. I think they probably would have less trouble finding executives to run the insurance company since basically everybody in this room is a member of NOLHGA indirectly. The problem that the California court has is saying which of these fine executives is the one who is in charge.

MR. WEINHOFF: I think NOLHGA attempts to speak to a much broader problem, and that problem is lack of public confidence in life insurance companies: this whole idea that many are poised to default and the industry has to do something much more far reaching than NOLHGA to restore that confidence. A second observation is that a First Executive or any other "First Executives" require capital. The question is where that capital comes from. Whether it comes from the French or whether it comes from the Dutch or whether it comes from assessments through the industry, there is an economic hole. Somehow that hole must be filled so NOLHGA doesn't erase anything. It's a zero sum gain. The assets are worth what a First Executive is worth. The problem is no one knows what they're worth. But I would agree with the statement that certainly to the extent that they've gotten the policyholders "a better deal than they would have," that's terrific.

MR. ALLAN BRENDER: Just a question about the standard. Why does it refer to statutory profits? Why not GAAP? Why not in fact distributable earnings?

MS. GUINN: Well, each one of those was considered and debated and let's take them one at a time. On GAAP, financial literature and accounting literature typically define the value of an asset as the present value of cash flows from the asset. In doing an actuarial appraisal of an insurance company, the cash flows we need to look at are cash flows to the owner. It was decided that the construct of statutory accounting represented those cash flows better than anything else. You can't dividend out GAAP earnings. Your statutory balance sheet determines what can be dividended, either to shareholders or to policyholders. On the subject of distributable earnings which are typically statutory earnings adjusted for working capital needs, there was a lot of discussion about that. And the standard as passed, deals with the situation by saying that the actuary in an appraisal needs to discuss the issue of capital needs and the cost of capital, and to say to what extent it's been considered or taken into account in the appraisal. You're not precluded from using the after-tax interest rate as the implied discount on adjusted net worth and the higher discount rate on in-force and new business.

MR. ROBERT C. TOOKEY: I want to address the question raised by Mr. Frank Broll. Will we have any assumption reinsurance if some of the suggested restrictions to it actually go into effect? They were suggesting, and this is an NAIC group, that we require policyholder approval in all cases. Now, there is a big movement afoot to permit an assumption without policyholder consent if it can be demonstrated that the policyholders are passing into stronger hands. And they do have some very specific definitions and criteria for what a stronger company would be like. If you take a look at American National's balance sheet, I think Frank Broll has no problems.

MR. BAIRD: I didn't comment on that area last time. Aegon has done a couple of things recently. We've been trying to just reduce the number of legal entities that we have by combining them. And we also are looking at assumption transactions. From what I know there is a growing list of exceptions that is expected to surface. One is when it's intercompany, if it's assumption reinsurance between companies commonly held. And two, if there is a rehabilitation process, the commissioner is going to have to step up and take some responsibility. And the last comment that was made about if it is a strong deal, I have heard that again, it's going to have to go to the commissioner. There's going to have to be somebody to make the decision that yes, this is a better deal for the policyholder. I'm not sure how up to date I am on that, but at least as of about a month ago, having to receive a positive confirmation from policyholders that they will approve the assumption of their policy is becoming less likely. They're going to find another way around that because it's just not practical. And when you think about it, what if the policyholder says no? You need the alternatives and I don't think anyone has come up with alternatives yet.