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Summary: Panelists address financial reporting issues related to mergers and acquisitions from the opposing perspectives of the buyer and seller. Subjects discussed include the appraisal process, the need for due diligence, and systems conversion issues.

Mr. Scott R. Munse: I'm from Lone Star Life Insurance company, and I'll be your moderator. We have three distinguished panelists, each of which have had quite a bit of experience in the M&A field. I truly believe we're fortunate to have these three gentlemen to share their thoughts and ideas.

First on our program will be John Schreiner, who will speak from the seller's perspective. John is an FSA, and a consulting actuary from the Chicago Life Practice of Milliman & Robertson, Inc. John and his partner, Bruce Winterhof, have been heavily involved in the actuarial analysis of life insurance companies in the past ten years as the pace of life company M&A has accelerated. John has been involved in more than 50 transactions during this time period, including a majority of the major transactions.

Mr. John P. Schreiner: I want to talk about three things. First, I think a review of recent transactions that have taken place over the last couple of years would be helpful to not only reiterate just how timely a topic this is, but also to set the stage for the rest of the discussion. We'll spend some time looking at what has been going on in the last couple of years.

Second, I was asked to take the seller's perspective on this panel. I tried to look at the recent transactions, and I have tried to see what might have motivated the seller in the transaction. Why has there been all this activity from the seller's point of view? Third, the financial reporting considerations are much more interesting and I think important from the buyer's point of view. Bob is going to handle that. The seller will inevitably prepare an actuarial appraisal of the book of business. The actuarial appraisal consists of financial projections of the insurance operations. We're going to spend some time on the actuarial appraisals process and see how that's done.

There have probably been more than 100 transactions of U.S. life insurance companies during the past two years. I'd like to list the major, recent transactions. *Major* is defined as having a sales purchase price in excess of \$100 million. I've been able to come up with, believe it or not, 34 of them in just the last 2 years. Yes, we've had 34 separate transactions involving U.S. life insurance companies in the last 2 years, with a transaction value of at least \$100 million. If we extended that list beyond the cutoff point of \$100 million, we'd be well over 100 transactions, and that is just in the last 2 years. This gives you an idea of the activity that has been going on recently.

What I've done is separate transactions into three groups of buyers. The first group is foreign buyers or foreign insurance companies. We have several transactions that have taken place in the last couple of years that involve a foreign buyer purchasing a U.S. life insurance company. We have one that was just closed last week. ING, a large Dutch company that already has substantial operations here in the U.S., bought Equitable of Iowa, in a \$2 billion plus acquisition. Earlier this year we had another Dutch company, Aegon, that already has substantial operations in the U.S., buying the insurance operations of Providian Corporation in a deal that was close to \$3.5 billion. Zurich, in conjunction with their partners here in the U.S., a group called, Insurance Barkers, bought the Kemper Life Companies and made a substantial investment in Provident Life and Accident. Farmers Group here in the U.S., part of BAT, was just announced as being acquired by Zurich. Irish Life of North America is another company with smaller but not insignificant operations in the U.S. that bought Guarantee Reserve, a direct-mail life insurance company in the U.S. Finally, we have Manulife, kind of by default, buying North American Security, which was really a jewel. North American Security was the U.S. variable annuity (VA) company of North American of Canada. It attracted a lot of interest about two years ago when it was put up for sale. Manulife came in and bought all of North American Canada, and, by default, North American Security.

The next group of buyers is what I like to call the usual suspects. These are U.S. companies whose names are inevitably mentioned when there's a rumor about an

acquisition. In fact, we usually take them and show up to the party with them to take a look at the property. At the top of anybody's list would be a company that most people think of when they think of acquisitive companies in the U.S. life insurance market, and that's Conesco. Conesco has a long history of buying a great deal of business. It is a very well-regarded consolidator of companies and blocks of business. In the last 2 years, they've done 10 deals that comprise probably 15 or 18 life insurance companies. The total value of these acquisitions is in excess of \$5 billion, and that is just in the last two years. Conesco bought Health Insurers, Pioneer Financial, American Travelers, Capitol American, and Transport. They bought percentages of companies where they already have a significant stake. It bought the remaining percentage held by companies other than Conesco when it purchased Bankers Life Holdings, American Life, and CCP. It just announced that it is stepping in where it stepped out by buying Washington National and United Presidential.

Another usual suspect that comes to my mind when I think of companies to look out for in the life insurance industry, particularly in the M&A arena, would be American General. This company has a long history of being very active. I think it was 1989 when American General received its own wake-up call when it was the subject of an attempted hostile takeover of the company. American General really turned the tables, and it has been a major player in growing through acquisitions. This company has been primarily in the home service area, with Home Beneficial and Independent Life and Accident. American General picked up several life insurance companies with the purchase of U.S. Life. Finally, the company picked up the percentage of companies that it did not already own by buying the unknown percentage of Western National. Again, several life insurance companies were involved here. There was over \$4 billion of transaction activity.

G.E. Capital is a nontraditional player. It was not an insurance company until about five years ago, when they got into the insurance business by buying the annuity company, GNA. Since then they've been on somewhat of a buying binge. In the last two years, they have done over \$3 billion in deals buying First Colony, Life of Virginia, Union Fidelity, and AMEX Life. It looks like GE wants to be a big player in the insurance industry. When you have a market cap in excess of \$200 billion like GE does, obviously you're going to be a major attacker if you want to be.

Jefferson-Pilot was a sleepy company up until a couple of years ago. When new management was brought in, it took what had really been underutilized capital within the JP Life companies and utilized it. They utilized it by spending about \$1.5 billion in the last two years buying Chubb Life and Alexander Hamilton. JP is obviously a high-profile acquirer these days.

Another company on my list would be SunAmerica. This is a company that focused exclusively on annuity companies, buying four annuity companies and/or blocks of business in the last couple of years. Reliastar, the old Northwestern National, is a company that demutualized several years ago and has gone on to be a major factor in the buying of life insurance companies. Protective Life is a company with a long history of buying life insurance companies and blocks of business, making two transactions in the last couple of years. One is Cal Farm Life, which it bought from SunAmerica.

The third group of buyers is basically everybody else. This has become a long list, even if we put the transaction hurdle at \$100 million. I think the list mushroomed during the last two years, and it will continue to grow. Lincoln National bought two very significant blocks of business—UNUM TSA Business, and recently, the CIGNA Life business. General American is buying the annuity operations from Xerox. American Annuity Group is buying the Laurentian Companies. Equitable of Iowa is an interesting one. It bought Golden American a couple of years ago, and I think most observers at the time thought it was a really rich price to pay for that company. In retrospect, one of the things that really made them attractive was the VA capabilities at Golden American. In hindsight, it was a real steal for Equitable of Iowa.

We saw Midland National buy a company called North American Company for Life and Health. We have something you rarely see—a mutual life insurance company buying a stock company. Metropolitan bought Security First Group, the U.S. faction of London Insurance Group, which is a big annuity carrier. Americo bought Ohio State. I think we will see more examples of a mutual holding company structure using its newly issued stock to buy annuity companies; Amerus bought Amvestors and Delta L & A. Finally, Penn Corp picked up four companies: Southwestern Life, United Companies, American Amicable, and Integon. There were many other deals that I won't mention.

What has been motivating the companies to sell? Why has there been so much activity in the last couple of years? I believe three things are going on. The first thing is focus. If you look at all of these major transactions, it all goes back to focus. Providian Corporation was a combination of very large insurance operations and a rapidly growing bank credit card operation. Providian is concentrating on the credit card operation, and has effectively spun off the insurance operations to their shareholders by doing a tax-free stock exchange with Aegon. First Colony is a company owned by an energy company. Life of Virginia and Union Fidelity Life Insurance Company (UFLIC) are two companies owned by Aon, a large company concentrating in the brokerage business these days. AMEX is the long-term care company of American Express. Chubb Life is a relatively small company owned by

Chubb Corporation, the large property and casualty (P&C) carrier. Chubb Corporation was obviously focusing on the P&C in the market, and was rewarded significantly for it. The list goes on and on.

The common theme here is the seller's focusing. In fact, I saw a study not too long ago done by J.P. Morgan, the investment bankers. It had looked at 400 large industrial companies, but not insurance companies. Of those 400 companies, they identified 100 companies that, during the past year, had taken some corporate action that could be logically interpreted as focusing the corporation on its core abilities. About 25 companies had taken some corporate action that could be widely interpreted as diversifying away from the corporate activities. Then J.P. Morgan tracked the stock price of these 125 large industrial companies, and found that, on average, those 100 that refocused saw an increase that was 15% points higher than the market. They outperformed the market by 15 points, and the 20 or 25 that diversified, on average, underperformed as compared to the market. So, at least the investment bankers will tell you, and I think the stock market will tell you too, that the market really rewards focusing. That's certainly a major motivation up until now. For those of you who might be looking for opportunities, I would look where sellers may have an opportunity to focus.

I think the other motivation, access to capital, was probably more important years ago, at least to the stock companies. It has become less important today. The Kemper acquisition really started after several downgrades of Kemper by the rating agencies. Again, Provident Life and Accident effectively got capital from Zurich Insurance. North American Security, a U.S. jewel of a troubled Canadian parent, was up for sale. Because of the capital needs of its Canadian parent, North American ended up staying with Manulife in Canada. Federal bankruptcy court allowed Southwestern Life, a subsidiary of Southwestern Corp, to be disposed of. Integon was also a so-called troubled company. Finally, I think the demutualizations at mutual holding companies, in terms of seller motivation for capital reasons will be on the mutuals in the upcoming years.

It is a seller's market. Every time the property becomes available, it has no trouble attracting a long list of reputable and qualified buyers. The prices that are being paid never cease to amaze the community that's looking at them. It has certainly gotten out of line with actuarial appraisal values, and we're going to touch on that a little bit later. It is clear that there's a favorable market, so I think that many sellers are looking to simply maximize value. Nationwide and Hartford are selling a minority share of their VA companies to the public. The Conseco transactions are favorable from the seller's point of view. They feel that they have very favorable prices. Look at the home service transactions like Home Beneficial, Independent Life and Accident, and Reliable. How do home service companies maximize value?

This is an area where there's very little organic growth, if any. About the only way to maximize value in the home service industry is through consolidation or expense consolidation. American General is a master at that. Home Beneficial, to its shareholders, was worth a lot more selling to American General than it would have been as an ongoing operation trying to grow organically in the home service field.

As I said earlier, the actuarial appraisal often contains the financial projections that are used during the negotiation in the due diligence phase of the transaction. Let's walk through the actuarial appraisal process. The first thing I'd say, is the actuarial appraisal is almost universally developed as part of a transaction, usually by both the buyer and the seller. Other times the buyers will simply utilize the seller's actuarial appraisal and their projection, adjusting them as appropriate for their own view of the world, their own view of capital cost, their own view of expense, their own view of what they would do with the portfolio, and how they would grow the company.

What do appraisal values really represent? The bottom line is they are discounted cash flows. If the assumptions are correct in the appraisal (because the models are correct), the discounted cash flow usually gives the best estimate of the true economic value of the insurance operations. These financial projections underlying the actuarial appraisal values, if used with appropriate assumptions and if used with credible models, give the best estimate of economic value of the insurance operation.

What is the actuarial appraisal value? We'd like to think that it is made up of three pieces with a fourth adjusting the first three. The first of the three is adjusted statutory book values. The appraisals are always done on a statutory basis as opposed to a GAAP basis, because again we're trying to get to the concept of discounted cash flow. Adjusted statutory book value is capital surplus with the asset valuation reserve and possibly some miscellaneous liability added back in. The second piece is the in-force business, which is simply the present value of the statutory profits on the business in force at the date the appraisal is done. The third piece is the value of the future business, which again, is the present value of the statutory profits on the business to be written in the future. Typically future business values are illustrated showing 5, 10, maybe even 20 years of new business production.

Finally, there's cost of capital. Cost of capital really adjusts the sum of these three items to a discounted cash-flow basis. It reflects the fact that a certain minimum amount of capital must be retained within the legal entity insurance company to run the operation.

What are the key assumptions? Obviously the actuarial appraisal is only meaningful to the extent that the models have integrity and that the assumptions are meaningful. The actuarial assumptions, such as mortality persistency, are typically in the purview of the actuary setting those assumptions, and they are typically based on recent experience. New business production is usually not an assumption that is set by the actuary. It is mechanically calculated by the actuary, but set by the companies' marketing people and management; hopefully, it reflects a credible business plan into the future.

You can look at how new business production fits into actuarial appraisals. If your new business has a return equal to the discount rate in the actuarial appraisal, the value of new business will show up as zero. Again, we've moved more and more towards a seller's market. That means discount rates will go lower and lower if we try to equate actuarial appraisal value to any kind of transaction price. We're finding that new business production has value at those lower discount rates. Operating expenses and other key assumptions will often be split into two assumptions. For the lack of better terms, I call them the direct expenses and the overhead expenses. Again, we have many companies out there, like Conesco, a well-known consolidator, that perhaps runs the operations at a much lower cost than they're currently being run off. So it makes sense to build into the actuarial appraisal an ongoing efficient company operating expense, but still take into account all of the expenses somewhere in the actuarial appraisal for the company. Again, you end up with two pieces. One is the ongoing efficient maintenance operating expenses that are built into the profit projections, and the other is unallocated or overhead expenses that are being picked up on the tail end.

We discussed cost of capital. When we try to equate actuarial appraisal value to the prices that are being paid on transactions in the last couple of years, you can see the discount rates have come down further. I'm sure that part of the reason is because general interest rates have come down. I think a bigger part is simply the pressure that's being put on the prices through the seller's market.

Let me wrap up by just saying that there are some useful by-products of the actuarial appraisal. Purchase GAAP (PGAAP) has been very important. One thing that has been driving what has been going on in the last couple of years is the ability for companies to use PGAAP for the acquisitions, show a creative earnings per share, and have the market reward them for acquisition. The financial projections underlying the actuarial appraisal are typically the financial projections that form the basis for the PGAAP analysis.

Asset/liability modeling (ALM) analysis is a second by-product. In an actuarial appraisal, you have very detailed models for both the assets and the liabilities, so

it's a relatively small step to go forward and do ALM analysis off the actuarial appraisal.

New business profitability analysis is another by-product. New business is an integral part of the actuarial appraisal, and it will really facilitate the analysis and the profitability of new business.

Finally, as a by-product, financial performance measurement can be useful. If these actuarial appraisals are kept current after the acquisition, they can be pretty good tools, in terms of simply monitoring and measuring the financial performance of the entity in question.

Mr. Munse: Bob Beisenhertz will speak from the buyer's perspective. Bob is the present director of Reassure America Life Insurance Company and director of Life Reinsurance Corporation of America. Reassure America is a subsidiary of Life Re, a major life reinsurance company. Through Reassure America, Life Re acquires companies, and of course, blocks of business. As a principal and consultant with Lewis and Ellis from 1973 to 1990, Bob was involved in many M&As of life insurance companies. His areas of expertise includes M&As, strategic planning, and regulatory issues.

Mr. Robert L. Beisenherz: I got my experience and some of the expertise Scott was talking about when we borrowed money to do deals in the 1980s. We used a great deal of leverage. Today it's not quite that way. I want to talk about five areas, as I look at acquisitions and this whole market from the buyer's perspective. The first is buyer motivation. What's happening out there? Second is the actuarial appraisal process from the buyer's point of view (most of which I agree with). Third is due diligence, which is that process of verifying the actuarial process. Fourth are some issues at and following closing. Finally, I will discuss PGAAP.

The buyer motivation can generally be broken down into three general areas, although most buyers would say that motivation is a combination of the three: strategic, financial, and consolidation. More than one of these come into play at any one time.

When I refer to strategic, I mean access to market, an increase in market share, or a complementary market profile. Some of the home service companies expand their marketing territory by acquiring companies in other territories rather than starting up agency operations from scratch. The main thing in a strategic transaction is you would expect for the goal to be that the sum of the two parts is greater than the individual parts. There should be some synergy and some added value by putting the companies together.

There are financial buyers. I alluded to the 1980s earlier. When we could go out and borrow money at 8% or 9%, pretax, and invest it at 14% or 15% after tax in a transaction, obviously there was a financial play there. It's much harder today because of the rating agencies, the constraints on debt-equity ratios, and the leverage in transactions. What we're trying to do is leverage our capital or deploy access capital. We're trying to increase our returns on equity through proper utilization of our capital.

Consolidation is a big motivator here. Most companies believe they have unallocated expenses, excess capacity, and expenses in excess of pricing. These companies might view acquisitions as a way to utilize what they believe is an underutilized plan. The truth is, a poorly run business that makes an acquisition is a bigger poorly run company. If a company, however, has invested wisely in technology, systems, and people, and has the capacity to use that infrastructure through acquisitions, then perhaps they have an advantage as they look at target companies.

As I move to the actuarial appraisal process I look at it in three categories. There is the buyer adjustment, the fact that the actual value can differ between the buyer and seller, and the discount rate, which is a huge factor today.

Remember that I'm speaking from a buyer's perspective. John's idea is to get the price up as high as you can. Mine is to figure out what's really in there and what you get from it. Therefore, the first thing I do when I look at an actuarial appraisal is to find out where it came from. Is it an outgrowth from a cash-flow testing model? Was it an internal management model that they ramped up then to be a sales document? Is it a sales document at all? Was it done inside or outside? The truth of it is, the better documents are done outside, not only because there's more experience and more expertise, but because the modeling and the validation process will be more actively done. Sometimes we look at very good actuarial studies done within a company. It's a small part of a bigger company, such as a subsidiary, and it was never material enough to cause a good validation process to go on. Just because it's inside, we can't assume it has been validated by anyone closer than an outsider.

Once we kind of determine that, one of the purposes is to decide, as John said, whether, as a buyer, we're going to do our own to adjust what's there to reflect our assumptions, or whether we're going to ask whomever created the models to run the alternative set of assumptions for reflecting our view of the world. One of the things that I do right off the bat is form some opinion about where the value is compared to where I'd like it to be. I use rules of thumb or previous studies that I've had access to. I keep a library of these things. When I see how much higher it

is than what I would have expected, then I set about the process of figuring out why. It could be valid or it might not be valid.

One of the things we find in this environment, as John said, is it is a seller's market. I sure agree with that. One of the things we find is that the seller uses the buyer's assumptions as to expenses. Now it's true the seller puts in this little excess expense piece, which it braids off over three months. The seller expects to sell and benefit from the expenses of the buyer. It expects to replace the investment income it is achieving on the portfolio with the ones it expects the buyer to achieve. It expects to take a value for a tax loss carry forward that they've never been able to utilize and couldn't justify in a million years, but when it's consolidated with the buyer, it now has value. The ones that I have trouble with are cases in which the seller assumes that the buyer will lower credited rates, raise the costs of insurance, and increase expense loads to maximums and not be sued and not have persistencies fail.

What we tried to do is take the appraisal and adjust it to the buyer's values, sharing whatever part of those things we really want to share. We have to do that in today's environment. The truth of it is, the value does differ between the two parties. This should make for great transactions because the property can be worth more to the buyer than it is to the seller. You'd think that would be fertile ground for doing transactions, and that's how it has been.

As I said, today's sellers expect to reap most of that differential for themselves rather than have the buyer benefit from that. The expenses are generally lower for the buyer because he or she anticipates a consolidation and utilization of the structure. Investment returns may or may not be higher but certainly the larger companies anticipate being able to improve the portfolio. There are perhaps tax benefits. Of course, if a small company that is able to utilize the small company deduction sells to the big company, that benefit can go away. On the other hand, there are opportunities for 338-type transactions utilizing a step-up in basis. There's an opportunity to use tax-loss carry forwards. So there are some benefits that can be different between the two parties.

The cost of capital may be different or it may be that the buyer is willing to settle for a cost of capital that is lower than the seller. The seller is opportunistic in achieving a higher return embedded in the value of the company. Then there's structure value, which takes in the agency force, the distribution system, the franchise, the charter, the licenses, and all those things. When we study an actuarial appraisal, we always look at it in two pieces. We don't let the new business become part of the basic actuarial appraisal. We look at the value of the existing business, and we separately look at the structure value. I agree that with

these lower discount rates, there will be significant value put on this franchise or this new business or distribution capacity.

Sometimes you can boil all of the assumptions down to fairly narrow ranges. There are just not that many variables in some of these, particularly where we have an existing block of closed business with no distribution. Now there's no wild card that would cause it to be wildly different in value for one party versus another. We're looking at a closed block, and it comes down to discount rate. Ten years ago, I'll venture to say that what we generally saw when we looked at three parts did not include cost of capital that was built in most of the time. We saw discount rates of 15% after tax on the existing in-force business, and then we paid dollar for dollar for adjusted book value and assigned some value perhaps for structure. When we built in this cost of capital, it gave us a blended rate, so that the buyer can say it is a blended return on the entire investment, instead of having some at 15% and some at 7% or 6% after taxes. Of course, the number will vary depending on how much capital it takes to support the value of business, but for those life operations, it's equivalent to 11.5% or 12%, including cost of capital.

I believe we're seeing 9% and 10% discount rates in transactions where it's pretty clear the discount rates, the variables that have to satisfy the difference between the buyer and the seller, relate to the value of existing business only because there isn't a structure value that's causing confusion. This is occurring because of the low current interest environment and the availability of capital. I think it's clear that there's also a desire among many of the larger companies to capture market share, or to be a survivor as this consolidation continues. There's a need to increase the bulk and to increase the policy count or the process or whatever to justify the plans or the fixed overhead that we have. The real truth is, there are more buyers than sellers and that is as much a factor as any of those other things that seem to cause this to grow.

The current conditions will probably continue for the foreseeable future and they might even get tighter. But we have to remember that an increase in the interest environment would radically decrease the value of many of these small-to medium-sized companies. The portfolio is fixed, so it will drive the discount rates up and quickly decrease the value of the holding. A downturn in the market could shrink capital flow and have the same effect. Some of these big companies that haven't historically been acquired are taking big bites now. They get their plates full as to their resources and their management and technical resources, and that could slow down at least some of the competition in some of the strata of the sizes.

I want to talk about the due diligence process itself. I hope to cover assets, other economic issues, administrative issues, regulatory/legal issues, and resolution of

issues. Some 15 years ago when we went to do due diligence, we used actuaries to do it, and it was assumed that the asset portfolio had 30-year bonds and mortgages. We're a little more careful now about the asset portfolio. It is the first thing we look at. If we can't overcome the problems there, the best actuarial valuation in the world is not going to make a difference. We make sure that we can get to a market valuation of the assets. That is not because the actuarial valuation reflects the market value (it reflects book value for the assets underlying reserves). It is because we assume we're going to have to restructure the portfolio to some extent. To the extent we can't, such as if it's not possible to value, then it would be a hindrance.

Today actuaries are more skilled in characteristics of the portfolio: the duration, the convexity, and the risk factors. We look at the cost to restructure the portfolio, recognizing that if we pick up a billion dollar portfolio, there's definitely a measurable cost associated with restructuring. It must be something that we're comfortable with in our corporate environment. Finally, we have to figure out what to do with the assets that are unique to the seller, that are unique to the portfolio, or that are just undesirable from our point of view.

The other economic issues are really the problems of the actuary. Regarding assets, I should say that now we turn that analysis of the portfolio over to investment professionals. The role of the actuary there is to tell the investment professional what characteristics of his or her liabilities have (such as duration, risk, and convexity) and let the investment professionals evaluate the portfolio.

Issues that are really in the province of the actuary are mortality, persistency, spreads, risk factors, and that sort of thing. Other risks would be disintermediation and opportunities for antiselection. There are some really obscure ones that we have to pay more attention to now. Has the portfolio of life products been monitored for tax qualification and things like that? These things can jump up and get you when you least expect it.

If we look at a possible transaction there are a huge number of administrative issues that also have reared their head. We have to be aware of them. First of all, we make some expense assumptions whether we think they are the buyer's assumptions or the seller's assumptions. We have to determine if we're able to achieve those assumptions, either as a stand-alone entity, if that's the decision, or through consolidation. If we decide that the way to achieve it is to consolidate with existing operations, we must consider the cost to move or convert the business. The year 2000 is on our minds. Think about the system that the business is currently using. Maybe even some small block of the business embedded in the company is being run on a system that does not have the ability to process past or even up to the year 2000. We have to make sure that we have the resources to convert that

block, and it may force us into a conversion when we approach the transaction when that wasn't the desire.

We run into all these other complexities that can keep us from achieving our expense goal, such as product complexities that we hadn't banked on. There are some rather unusual persistency bonus schemes out there. It keeps us from fitting this block of business into our existing system, and it can really foul up our assumptions. Those things have to be examined during due diligence.

Regulatory and legal issues are sort of outside our province, but as risk managers, we want to look at the litigation risk. There is current litigation, threatened litigation, and potential litigation. Market conduct is a huge thing. As we look at a block of business, we need to look at when it was sold, how it was sold, how it was illustrated, and what the people were probably told. There is the vanishing premium issue. Did people who were promised the vanishing premium understand what they bought? Did the company that was targeting do a good enough job explaining what they were buying so that we don't have ongoing regulatory and legal issues?

Once we've identified issues in the process of due diligence, we have to deal with them. I think we can break the method of dealing with them into three general categories. I'm going to skip to the third one first-price. If it's a measurable economic issue, then we simply have to take that into account if we determine what the price is. Sometimes it's not quite that simple; sometimes it's only a 5% risk, but if that 5% risk happens, it's a huge dollar amount. There's indemnification. If the seller is an entity this could be substantial. Escrows are another problem. That's not the case if the seller is an individual or if a holding company goes away after this transaction.

Another way to handle some of these issues that you discover during due diligence is structure. An example would be you might buy the insurance company out of a holding company, and leave the holding company with its tax and legal issues behind. You might structure the whole transaction as a coinsurance transaction or an assumption reinsurance transaction, and leave the whole life company behind. Hopefully, you'll be leaving behind market conduct issues and liability since you simply cannot assess it.

After due diligence we end up with a whole array of issues that I'm not going to go into any great detail about, but they are ones that we are immediately familiar with such as the regulatory process. What happens to the entity during the 60–120 days that you're going through that process? Who's running it? The buyer can't run it because it hasn't had a change of control approved yet. There better be some

contractual and agreement processes in place to deal with during that period. If the selling company or the company that was purchased is in fact going to be moved and consolidated, there are people issues, such as stay-on bonuses and attrition that can certainly cause you problems while you're going through this mundane process of getting approvals to acquire the block.

The consolidation has to be managed. The transaction is not over at closing. There must be a substantial commitment of management time and energy to do one of these consolidations. If it's a substantial transaction, it can't be left to one or two people to bring this in and make it work. If it is not managed properly there are considerable additional expenses that can be incurred on the front end, which have the effect of raising the purchase price. You can fail to achieve your expense assumptions going forward. The market that you acquire could be damaged or lost while you're in the middle of doing this transition, and your existing business can suffer at the same time. These are issues that you need every part of management to address.

I learned some time ago that you can't ignore the culture. You may be moving it, you may be consolidating, you may own it, but every company I've encountered has a culture. It's part of the company. It doesn't keep you from doing what you have to do or want to do, but it's best to study it and understand it because it's there and it's real and it's distinct for every company.

Beware of system conversions. Every conversion costs at least 50% more and takes 50% longer than estimated. A piece of advice I will give anybody embarking on a consolidation and doing a system conversion as part of it, is to have a businessman involved. If you tell your systems people to convert that, they convert it exactly, even if it has flaws in it. They will convert exactly what the other company was doing, so all the flaws, all the errors, all the mistakes, and all the inefficiencies will be brought over with the conversion. Don't convert and retain that company's bad habits. Don't convert their administration system with their procedures; convert it to your procedures. Finally, absorb it and get it done before you move on because it takes more resources, more energy, and more time than you might anticipate, and if management moves on to the next acquisition while you're still swallowing the last one, then you're finding yourself stretched too thin to do a good job on any of them. Did it sound like there was some experience there?

I am not a good purchase accountant. When we first started doing deals back when GAAP was pretty new, there weren't any firm rules. There were some principles, and as long as you followed the principles, it was fine. Now there are rules. There's *Financial Accounting Standard (FAS) No. 60*, which controls the traditional

fixed-premium type business. There's *FAS No. 97*, which controls the interest-sensitive business, and there are very specific rules as to how this takes place.

The value of business acquired (VOBA), as John said, generally comes from the discounted cash flows of the existing business that we acquire. It's an overstatement to say it is amortized in proportion to earnings; that's not really true. If it's *FAS No. 60* business, it's amortized in proportion to premiums. If it's *FAS No. 97* business, it's in proportion to gross margins. What happens to most of what we're handling right now, at least in terms of the bulk of the values that are interest-sensitive, is the value of the business essentially gets amortized over the life of the business, more or less in proportion to what would otherwise be the emerging earnings.

Accretion is an interesting word. I didn't even know what it meant until we started doing acquisitions. In GAAP earnings accretion, all you have to do is see that your discount, or the embedded return on investment, is greater than the alternative use of the capital. If you have your capital invested in bonds, you have excess capital sitting around, then anything higher than 7% or 7.5% before tax is accretive to earnings. On the other hand, if you want it to be accretive to your book value, the discount rate has to be higher than your blended cost of capital on a cost-to-capital book basis. Let's say you want it to be accretive to market value or real value. In a public company, the market value is higher than the book value. If it is the leverage, the deferred acquisition cost is lower on a market basis than it is on a book basis. In order to maintain and reproduce a return on equity, it has to be higher than your blended market cost of capital. So accretive isn't a unique phrase to me. It sort of depends on where we are and what we're trying to accomplish.

Now one of the things that is interesting about PGAAP is that if the acquired company has a franchise value and has a distribution system, then it's possible that you not only acquired this book of business, but you acquired this distribution system, which is intangible once removed. It's goodwill. If you are conservative with your calculation of the VOBA, it tends to push up goodwill. The sum of the two—VOBA and goodwill—is fixed on the PGAAP balance sheet normally. If you push down VOBA, you push up goodwill. If you're conservative on your VOBA, you reduce the assets that have to be amortized over the life of the business. It does tend to be front-ended because of the accretion business. You maximize the value of assets that get amortized over a period of 40 years, straight line with no interest. So it can be said that if you increase goodwill, you increase your early earnings.

I did an exercise in which I had a fixed price and had no goodwill. I simply assumed that 25% of the bag was goodwill. What it does is it tends to front-end earnings.

Some companies can be very aggressive and use PGAAP a little more liberally. I don't know how they do it. I've surmised that if you set up a liability for excess expenses on the theory that it's going to take you two or three years to get the expenses down to what you priced, it gets amortized or "burned up" over the three years. It tends to increase its liability, so it increases the sum of VOBA and goodwill. It goes into goodwill, so you amortize something in three years that gets spread over 30 or 40 years or whatever the goodwill amortization period is. You can do that with excess expenses or transition losses or whatever. The accountants have said that it can be very good accounting, if that's what has happened. If that's not what happened, if it's an exaggeration, what tends to happen is you radically increase early earnings at the expense of earnings way down the road that some other management has to deal with. I'm told that it can be good accounting or it can be a misuse of the rules.

In summary, I just want to recap a couple of things. First, there is a consolidation occurring. In 1970, there were about 1,750 life companies in the country. In 1996 there were 1,728 life companies. Is this a consolidation? Yes, because the 50 largest companies or company groups (I count Consec as one even though they own 30 companies) control 75% of the industry assets and 83% of the premiums written. Thirty company groups control over 300 life insurance companies. Yes, there is a consolidation occurring; there's no question about it.

The buyers today might be the sellers tomorrow. This is not a case where we're all out there shopping for cripples whose marketing has failed, and now they're targets. Some of the big fish are being eaten by bigger fish. That process can be illustrated by U.S. Life, which, for years, was a major acquirer. Provident and Chubb Life, in their time, were acquirers. Chubb itself is still out there punching.

Healthy transactions will yield healthy companies. It's a way to deploy capital; sometimes it's cheaper to buy it than it is to grow it. Healthy transactions, in my opinion, can be a very good way to deploy capital, utilize the infrastructure, and expand marketing. However, one needs to remember that a transaction is a long-term commitment. It takes years and years and years to earn back that capital. So it's not a panacea; it's a long-term commitment and it's a commitment of resources. I remember that in 1970 everybody said the consolidation is going on, and in ten years there will only be three companies. I didn't believe it then and I'm going to make firm predictions now. I would say that because of the direction we're going, in ten years there will be a few or several megacompanies. There might be either 1 company controlled by a single source, or probably less than 25 of them. Then there will be a number of niche companies that have a reason to be in the niche market. They have a business plan that doesn't require a huge size, but they're successful at what they do. We'll always have a certain number of

captives that have special purposes for big corporations or particular financial needs. But I predict that the number of independent life companies that we have today will be radically reduced within the next ten years.

Mr. Munse: We've heard the seller's perspective and the buyer's perspective. What's left? Tom Skillman is next, and he'll present another view. Tom Skillman is second vice president and director of capital management products at Lincoln National. He is vice president of Lincoln National Intermediaries. He designed reinsurance and nonreinsurance programs to address a wide range of capital management and tax planning needs with particular focus on situations arising from M&A activities.

Mr. Thomas E. Skillman: We've already heard a lot from the two previous speakers about some of the deals that are being done today. It's really clear that people who can do a stock transaction in today's world are in great shape, because stock prices are higher, and it's easy to spend \$100,000 on a dog if you can trade in two \$50,000 cats or something like that. If you have to make a cash purchase, it's a lot tougher. There are a number of companies out there that, because of the strong financial markets that do have enough excess capital sitting there getting 4% and 5% after tax, can deploy it at the lower returns that John and Bob had referred to and still be satisfied.

We're also seeing a number of situations where reinsurance is used in some manner to help optimize a transaction, or to maybe size the transaction to fit your pocketbook. They take quite a few forms. Some of them might be pure joint venture. There was a recent transaction done that way. A reinsurer and ceding company had a buyer, and had a 50/50 joint venture to share the purchase price. The advantage for a ceding company in this is that they get the benefits of the administrative expense leverage, which enables them to be able to spread their overhead over a wider expense base. Although as Bob pointed out, if you're poorly managed, that just makes you a larger poorly managed company. You might have a company that really does have the expertise and the capacity, but it doesn't have the capital to do as big a transaction as they want to be useful.

We've also seen situations where, to make the bid more competitive and to reduce the risk profile, a potential buyer might try to find a reinsurance cover to lock in the mortality experience. In most deals, as you can imagine, if you could find a reinsurer that will lock in your mortality at 95% or 90% of actual appraisal assumptions, then that could have a material impact on your ability to be very competitive in a pricing situation.

Tax planning is another area where reinsurance has been useful, and there are nonreinsurance ways to do some of these things as well. Reinsurance can also be helpful in trying to manage the taxes associated with some of these transactions. Bob had referred to small company deductions. I have a good example. We were looking at a transaction a few months back, where there was a company that was located outside the U.S. They didn't have any tax. They were talking to U.S. buyers that had Sub-Part F tax to deal with. Sellers were trying to get the buyers to price on the basis of no tax, but the buyers would indeed have tax and it causes a conflict in the negotiating process. The small company tax deduction, especially if you are getting purchased by a large company, or if you are selling off a block of business where you can get a large gain, can really cause some unnecessary taxes.

We were involved in a transaction a couple of years ago, for example, where the seller of a block of business was going to incur a very large gain on which it was going to be paying big tax rates rather than spread the income over several years where they could have a substantially lower tax burden. For this company, the amount of tax was 50% of its capital and surplus. On the timing basis, about \$2 million would have been a permanent difference. Reinsurance was able to help avoid that problem.

Phase III tax can be a real issue if you're trying to sell off a block of business. You'll sometimes need to buy another block of business and coordinate the timing of the buy-and-sell transaction to avoid doing that. Sometimes reinsurance can be of assistance. Oftentimes the reinsurers, especially foreign reinsurers or offshore reinsurers, are better situated to manage the statutory tax reserve differential, which would otherwise be an additional investment in the business that you would rather not make.

When you look at the industry economic characteristics, overall, the industry is characterized by a lot of excess administrative capacity. There are a lot more computers, people, buildings, than what are needed to administer the amount of business that's out there. There's also a lot of excess capital, and it's a dramatic change from the situation of five, six, or seven years ago when industry, overall, was not too bad. It was just about right. The objectives for companies have increased a lot. There's pressure from the rating agencies but the actual capital has been going up even faster overall because of the strong capital markets, declining interest rates, strong stock markets, and so on.

In addition, the capital markets are pricing capital very cheaply. Bob talked about how back in the 1980s, he used a lot of debt to do a deal, to get your cost of capital low. You can't really do that as much today because it makes rating agencies and regulators uncomfortable. You don't need to do it today because the investors on

Wall Street, the investors in equities, are willing to pay a very attractive price in many cases, and you can finance acquisitions that way. As Bob kind of eluded, you could have accretive earnings, but accretive means different things to different people. In the old days, people tried to make an accretion on the most conservative definitions, but it's not really happening these days.

One thing that we're seeing more and more as we're involved with a transaction is a transaction actually getting done. In the old days we start with the seller's actuarial appraisal and start to negotiate the price down. As a starting point, you negotiate up from there. We were in a situation very recently where a client was selling off a block of business or maybe the whole company. They had five offers, all of which were more than the actual appraisal value. They decided they didn't want to sell it anymore because they were expecting something that would be much higher than the actual present value, instead of just over 20% or 30% over the actual appraised value. It's a crazy world out there.

For those of you who are wanting to get into the acquisition game and are thinking that you can do a deal for a 12%-or 15%-type return because of expense economies, I can tell you these deals are not out there. There are many buyers that, as far as I can tell by back-solving to find the assumptions they must have used, must be using very close to zero for expense. They must be doing so on the assumption they have lots of excess capacity and they can administer another 50,000 or 100,000 policies at essentially no extra cost. They're assuming marginal cost of capital, which is equal to the after-tax earnings rate on their bond portfolio because they have excess capital. They're sitting there with a 300% or 400% risk-based capital ratio, and they only need 250% or 200% to be satisfied. The rating agencies are encouraging this because they have gotten over the asset problems because the asset problems have largely resolved themselves. Now they're looking at growth and the sustainability of your franchise and so on. They're encouraging companies to grow and find the fastest way to grow.

Some companies are looking at outsourcing administration as a way to try to get their expenses in line. I'm always amazed when we talk to companies that currently have expense loads at \$100–150 per policy that want to do an acquisition. Even though the marginal expenses are not very high, you must imagine that they're not going to be able to realistically get their expenses down to \$30 or \$20, and keep them there.

Securitization is a very new topic, and it is something we're going to see more of. It has not really been prevalent on the life side yet. It is making a lot of progress on the property and casualty side, and I think that in five years it will be a very common way of financing things.

Mr. Robert J. Lombardi: I was struck by Bob's comment that, in the future, there might be 25 conglomerates. I'm wondering about some of the industries that are government regulated. The government tends to step into these industries where there's more of a concentration, and sometimes it changes the deals. Some of the conglomerates have companies in various states; in fact, they may have numerous companies. If we ever reach the point where the industry is controlled by 25 groups, could that perhaps lead us towards federal regulation? How will regulators perceive an industry like that?

Mr. Schreiner: I think we certainly have some elements of federal regulation with or without the view of conglomerates or market control. As you probably are aware, every time we do a transaction that involves a whole company, and there are some exemptions, we make a filing called a HartScott-Redino Filing, to address this trust issue. I've been involved in some fairly large transactions. I know John has, and we've never had a Hart-Scott-Redino stumbling block. There's not enough concentration at this point to qualify this as an antitrust issue. Look at the banks. We don't approach the bank holding companies and the bank concentration that certainly has occurred over the last ten years. I don't believe 25 megacompanies would have problems either. So I don't think the concentration of 25 large companies is going to have anything to do with federal regulation. That's not to say that I don't expect some elements of federal regulation.

From The Floor: You made a couple of comments about how the acquisitions that are being done today can be accretive either by additional leverage or by the way the accounting is handled. I'm troubled by that because I agree with you; a lot of transactions are being justified in that fashion. It seems to me that if we're acquiring any company at a discount rate that's less than our rate of average cost of capital, we're destroying economic value. Whether or not we're masking it with accounting gimmicks or additional leverage is beside the point. Based on the transactions that I see happening, it seems that this industry is trying to destroy the shareholder value. Could you comment on that?

Mr. Schreiner: First of all, I want to be clear and I'm sure you do too. The vast majority, I hope, are being accounted for straightforwardly and in a quality way. My concern is if there are only a few that are using transactions to be transactions. That is, if they don't do a new transaction frequently, then they reach a point where those declining earnings overtake the accelerated first early earnings. That will reflect on the entire industry, and it will cause a presumption that we're all doing that. That would have very serious implications for the industry.

Mr. Beisenherz: I think it gets back to what I said earlier. I think actuarial appraisal value, assuming the assumptions are correct, is the best indicator of economic

value. Over a long period of time, economic value is economic value. Whether we have statutory earnings, GAAP earnings, or PGAAP earnings, these are going to be the earnings over a period of time. I guess I would echo what you're saying. I think some companies, through the PGAAP process or through other processes, may be showing favorable earnings in the short term. What they might be doing is locking themselves into a lower return on their capital investments than maybe the hurdle rate over the long term.

Mr. Edward B. Martin: This is a question for Bob or John. You both commented on the consolidation and potential expense savings as a driving force for acquisitions today. If you look back to transactions you were involved in two, three, or four years ago, how did actual experiences match what companies anticipated in the way of synergy expense savings? Is that something, in addition to discount rates, that you see as becoming more aggressive in today's acquisitions? Are the assumptions being made or not?

Mr. Beisenherz: We're certainly getting more aggressive. It's difficult I think to split discount rates from expense savings and from new business value when you're trying to equate the cash flows from an actuarial appraisal value to the market prices that are being paid. You can push on discount rates and excess expenses will pop up again, so it's hard to split them. I think we are getting more and more aggressive on all three of those to try to find a number on the actuarial appraisal value table that equates to the market price or the transaction price. Have companies been able to achieve it? Clearly some have. Some are very good at it and have made a living out of doing it. Others are not.

Mr. Skillman: I would agree with that. Many of the clients that I had the privilege of working with were excellent consolidators and achieved expense reductions just as they anticipated. I think that's going on today. But I think some companies are sitting there with \$50 per policy plus overhead, and assuming \$15 marginal to do the transaction. I think there's a lot of that.

Mr. Lawrence A. Miller: Purchasing our future business opportunity involves many more risks than purchasing a run out on the profits of business already in-force. Do you detect a significant difference in discount rates or the cost of capital that's implied in prices that are being paid for business transactions?

Mr. Beisenherz: I haven't figured out how we're valuing the franchise. I don't think it's using a present value of future profits on business yet to be written in some reasonable discount rate. I think the in-force business is being valued with some actuarial model and some discount rate, and I think the franchise value is out of the hands of actuaries. I simply can't figure out how we're doing it.

Mr. Schreiner: Again I think different companies look at it differently. Some of the foreign buyers just put a "strategic value" on their new business operations. It may be just strategic value on being in U.S. insurance markets. The U.S. has the largest insurance market in the world. Japan is a fairly close second, but effectively, the U.S. is the largest open market in the world. What you see with a lot of foreign buyers is that strategic premiums tend to be in the U.S. market, be it through new business opportunities or just by being in the U.S. market. Again, I don't think people explicitly take a higher discount rate and discount future profits on new business at say, the existing business discount rate, plus 5%. That's not mechanically how it's done. I think if they're limiting new business at all it's probably through the number of years of future business production that they're giving credit for.

Mr. Craig W. Reynolds: John this is a question for you. I noticed on your list that there was a long list of foreign companies buying American companies, but I didn't see a list of American companies buying foreign companies. Is that happening at all? If it's not, is that a potential market where we might be able to start getting deals back in the 12–15% range, rather than the 8–10% range?

Mr. Schreiner: I think it is happening in Latin America. American General for example, which was on the list as one of the usual suspects that is buying U.S. companies, recently announced that it is doing a strategic partnership with a company called GNP in Mexico. It is capitalizing off the privatization of the Mexican public pension system. We're seeing a tremendous amount of activity. I'm not always sure about what's driving it. There is clearly a tremendous amount of activity, not only by U.S. insurers but international insurers in Latin America. In Latin America, the currencies and the markets, at least up until the last week, seem to have stabilized greatly. Look at a country like Brazil that had a 1,000% inflation rate 3 years ago, but has an 8% inflation rate today. It has a relatively small insurance market on a world standard, but it is a rapidly growing insurance market. The U.S. insurance market is growing at low single digit rates. The Latin American insurance markets, at least in the 4 major countries that people look at, are growing at 30–40% per year so everyone is looking at that as a growth opportunity. There is some activity down there. Latin America is looking for not only capital, but U.S. and European expertise on the insurance and bank insurance side. There is a lot of activity.

Mr. Skillman: I'd like to add that even if you are getting 12–15% returns, you need to keep in mind that these are inherently risky situations as viewed from the viewpoint of the U.S. buyer, in that you have currency risk and political risk in some cases. Even if you are pricing for a 15% return on a risk-adjusted basis, that may not necessarily be enough.

Mr. John E. Wade: Could you comment on the advantages or disadvantages that some of the large European purchasers have when they're dealing in the U.S. market? Are problems occurring because of the expectations on return or because of the management style, or because of the difference in focus on business in general that comes from their culture?

Mr. Skillman: I think you hit most of them. I think management style is clearly an advantage. I think a lot of foreign insurers would be looked at as a white knight. Would you rather be owned by Zurich or ING or Consecro if you were senior management at a company? Would you want a job or not? I think the return expectations may be lower also. We've certainly seen things like the foreign buyers who are looking more toward the lower end of the discount range as opposed to the higher end. There is a lot of capital overseas that can be utilized.

From The Floor: Is there also a degree of that lower discount rate that is maybe attributable to different capital standards at those foreign corporations?

Mr. Skillman: I'm not an expert on their accounting rules. They get to do things like cooling as opposed to accounting using goodwill. And so, their earnings emergence is completely different from what ours is. Because of our accounting rules, it is difficult to compete if you have a public company and the rules are different.