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Creating Shareholder Value in the New Millennium

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Moderator: MICHAEL A. HUGHES
Panelists: MICHAEL ALBANESE†
PATRICK FINNEGAN‡
TIM FREESTONE§
Recorder: MICHAEL A. HUGHES

The wave of consolidation that has been sweeping the insurance and financial services industry has created a heightened awareness, even a sense of urgency, that companies must change their behavior in order to survive and thrive in the years ahead. The ability to raise capital is generally considered crucial; hence, many mutuals are examining their "stock options," and all companies are paying more attention to creating shareholder value.

Mr. Michael A. Hughes: We have a distinguished panel here today: Mike Albanese from A.M. Best; Patrick Finnegan from Moody's, and Tim Freestone from Seabury Insurance Capital.

Mr. Michael Albanese: We can also think about this session in terms of searching for shareholder value. I'm going to talk about shareholders value from the standpoint of value creation. Because we really don't want to ignore the companies

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†Mr. Albanese, not a member of the sponsoring organizations, is Vice President of A.M. Best Company in Oldwick, N.J.

‡Mr. Finnegan, not a member of the sponsoring organizations, is Vice President, Senior Credit Officer of Moody's Investor Service in New York, NY.

§Mr. Freestone, not a member of the sponsoring organizations, is Managing Director of Seabury Insurance Capital in New York, NY.

Note: The charts referred to in the text can be found at the end of the manuscript.

that are not publicly traded entities, and given the fact that many mutual companies are rethinking their organizational form, it really has broader applications than for just those companies who are publicly traded today.

It's probably a topic that doesn't get its due attention from our vantage point. Certainly the trade press is cluttered with articles about market conduct, class-action lawsuits, financial services, reform, and so forth. Those topics and other emerging issues are capturing everybody's attention, whether it be management, regulators, media, rating agencies, consultants, and so forth.

It seems that the issue of value creation really has been the purview of senior management or consultants. But I'd add one caveat, that any of those other larger issues that have been capturing everybody's attention probably need to be looked at also in the context of what implications they have for value creation for any organization.

When we look at the capital markets today, there may be some conditions that also may be overshadowing the issue of value creation. There's no doubt that several organizations come to everybody's mind, whether they be Travelers, Sun America, or Conseco. They really have one overriding theme in their operations, and that is shareholder value. Other organizations, whether it be Hartford, Nationwide, or companies like AFLAC, also have a very clear focus on value creation and they're continuing to leverage their brands and their prominence in their chosen markets. Their stock valuations obviously are reflective of that. But it's difficult to recall market conditions that really have been awarding companies with multiples that might normally be associated with high growth stories, or those that have very formidable consumer or commercial franchises, giving them the same valuations in terms of (price/ earnings ratios) and other measures of value to companies that maybe have more limited aspects or prospects for growth or are in relatively lower value-added businesses. The question from our standpoint is, what does this mean for the future and why do we care about this as a rating agency? Those are the points that I want to cover.

We don't really have a crystal ball, contrary to beliefs and perceptions about rating agencies. But we do think that it's reasonable to expect that conditions are going to change. When we look forward, we think the pressures are only going to become more intense. And, we believe in fact, the long-term viability of many companies that we're involved with, is predicated on management's abilities to respond to the current market dynamics, and be able to refocus their strategies and create some sort of differentiation at the end of the day, creating some sort of value because that is, in our opinion, what is going to be vital for success, if not survival, given the current market conditions.

On the topic of crystal balls, we have two quotes. We found these to be very appropriate for the dynamics in the marketplace. These appeared in an article that we published earlier in the year. The first is a quote from Ken Olsen, who was president of Digital Equipment Corporation, in 1977: "There is no reason for any individual to have a computer in their own home." We found something by Peter Drucker, 20 years later, saying, "It's pointless to try to predict the future. But it is possible—and fruitful—to identify and prepare for the future that has already happened." These two quotes really illustrate a lot of the differences in thinking that we're seeing among companies within the industry. We do believe that companies different themselves with regard to strategic vision the execution of strategies to reflect market dynamics. This positions those companies to take advantage of change. Probably has the greatest bearing overall in terms of value creation.

The reason why we believe this is the most important aspect of value creation is predicated on how we see the market dynamics evolving. I don't think anybody would disagree that there are some fairly profound and structural shifts occurring in the marketplace today, and they all seem to be converging almost at once. In terms of demographic shifts I don't think anybody really can underestimate the impact that demographics is having on all commercial commerce in the U.S. Certainly the aging of the population, the reshaping of consumers needs, preferences, and buying habits, are in large part driving domestic economic activity.

The distinctions have blurred among financial service companies. We haven't seen the formal repeal of the boundaries that have traditionally separated financial service companies, but they're becoming more and more ambiguous. We've had the Valic & Barnett rulings over the last several years. Recently, we've had the Travelers/Citicorp deal. When we think about it in the context of global economics and global competition, financial services modernization, it's a very real possibility that financial services regulation is going to need to be changed to keep up with what is already being mandated in the marketplace.

The explosion of information technology is also having a dramatic impact on the way that business is being conducted and it has certainly contributed in some respects to an erosion of traditional boundaries between insurance companies and financial services organizations. We haven't seen widespread acknowledgement yet, but it seems that within the industry, technology has become a strategic function. It is no longer just a back-office process.

We can probably add a number of other issues to this short list. For example, market conduct, tax reform, potential repeal of tax advantage products, and so forth. There are about 1,700 companies that are licensed to do business in the U.S., so it's

very reasonable to expect that some companies are going to find opportunities in a changing environment and others are going to become threatened by it, or in some cases, potentially overcome by it.

When we look at the dynamics, we think that they have implications for just about every company. To us they raise questions about traditional business models, and in some respects, they're melting down existing value changes, if not permanently mutating them. In some respects, many companies' operating fundamentals and their economic earnings really are being impacted by what's going on in the marketplace, despite what might look like a cursory review of statutory or GAAP financial results. Certainly the composition of many companies' business mixes are changing and we're seeing top-line revenues and bottom-line earnings becoming increasingly pressured, and, in many cases, less stable than they were if we went back five or ten years ago. The migration from traditional risk products to lower margin fee-based businesses or interest-sensitive products is not in all cases effectively supported by existing expense infrastructures, and certainly not supported by existing legacy administrative systems.

We look at competition. It's not what it used to be. In some respects, we think competition is characterized by some larger, more nimble, or so-called nontraditional organizations. In some sectors the primary competition is dependent on companies such as Fidelity, Schwab, and Merrill Lynch. In other cases, it could be information providers. It could be Intuit or Microsoft. Consumer-oriented organizations might also be another form of competition. For example, despite the recent problems that "Ascendant" has had, it claims to have access to more than 100 million households. That's incredible access, even for some of the largest insurance companies in the industry today.

In short, as I mentioned, we're seeing a chasm between those companies that we believe are preparing to compete in a new environment and those that are just trying to find ways to make old business processes work going forward.

The companies that we think are in the best position to take advantage of all that's going on in the marketplace and will ultimately build the greatest value, whether it be for stockholders, policyholders, or whomever the constituents may be, start with the basics. Typically, they have an extraordinary command over the fundamentals. Appropriate strategies are well articulated, and well understood throughout the organization. They also have incentive programs to make sure that all oars are pulling in the same direction. It becomes indispensable for a company to meet its objectives. That doesn't happen in every organization.

In terms of strategic positioning and corporate strategy, companies can do a number of things. They can provide existing products to new customers. They can provide new products to existing customers, which doesn't happen all that much, but we're starting to see more and more of that. They can pursue external activities, perhaps to add scale and breadth and to acquire some core competencies. They don't necessarily possess themselves. Or they can simply exit marginal businesses.

Success can be built around any combination of strategies and there's no one absolute way for companies to position themselves in order to build value. But there are certain tenets that absolutely have to exist. For example, it's hard to build value if you don't have any customers. Despite the path that a company may choose, it seems to us that some of the more successful companies also have a very clear understanding of who their customers are. Based on our discussions with companies, we find that there are different people in different organizations who are on different pages about who the ultimate customer may be.

Successful organizations, those that we consider to be the top-performing organizations, also have very, very clear goals. They know whether they're on or off target. Broadly speaking, they might seek to try to maximize policyholder value, profitability, and/or financial strength. They might have more specific targets relating to product performance, revenue targets, profit objectives, or capitalization targets. Those can be used also as a means by which companies can evaluate whether they're headed in the right direction and make appropriate changes as needed.

We have to be careful with market share, because this can mean different things, to different people. There are a lot of issues surrounding market share. This may just be a byproduct and an indication that a company is executing upon its strategies and operating effectively and efficiently.

Certainly, all companies have a multitude of stakeholders. We talked about some of the macro or external factors that come into play, and certainly there are times when the perceived needs of the various stakeholders can come into conflict. Balancing the demands of various constituencies is very difficult. We understand that. But we don't necessarily view the demands or the ability to balance the demands of these constituencies as necessarily being a mutually exclusive proposition. It's not one or the other. In fact, on some levels, we believe that they are very much interdependent on the ability for a company to market competitive and attractive products to provide attractive returns to their owners, whether they be stockholders or policyholders, and to maintain appropriate levels of capital to support growth into the future. That normalizes the essence of value creation. Those are really the three legs of the stool for value creation.

What we find more often than not, is when companies have problems and they're not able to meet these conflicting demands, one has to give up at the expense of another. It tends to reflect in that may exist somewhere in the organization. That can reflect shortfalls in operating efficiencies, which can be related to ineffective or underproductive distribution. In some cases it relates to problems in terms of their balance sheet with underperforming assets. Value creation, as I mentioned, only becomes relevant in the context that a company is a viable enterprise. I really don't want to get into a lot of detail about this because I think everybody has seen this. The point is that value creation can't occur without revenues. I talked about the implications that demographic changes have on companies and it seems to us that most companies are trying to sort out what this all means. Any organization that operates in a low-touch, high-volume type of segment probably has little chance for success and an inability to build value if it really doesn't have the organizational structure that's necessary to operate as an efficient and low cost producer. Similarly, if we looked-at companies that were operating in more complex segments of the market that require higher touch, they're really not going to be able to offer very much value over the long term if they can't develop long-term relationships—compete on some level of differentiation, and be a little bit more responsive to the needs of their particular markets.

The implication here, without getting into Marketing 101, is that companies will have to define on what basis they're willing and able to compete. We've seen some of the more successful companies developing strategies to compete less on price and more on value-added taking the commodity aspect as much as possible out of the business. That doesn't necessarily imply that they don't need to be competitive and that operational efficiency is unimportant. Rather, it is recognition that price or commission is a necessary but not a sufficient condition for success over the long haul.

We found that some of the better performing companies are in the process of transitioning their organizations. They're no longer simply pushing products. They're no longer viewing their distributor as the end customer as a number of organizations do today. They're trying to break down those silos that might have developed among various business units over decades to get a more integrated approach towards operations. And they're recognizing, importantly, a completely different set of dynamics and economics by penetrating their existing customer base. That's probably the greatest and probably the most underutilized asset for many companies. That's quite different the historical single-sale approach that many companies have used in the past and are still using today.

What a company needs to do is break down the market segments in a little bit more detail and overlay various products that serve those markets. What we're trying to

say here is that there are going to be critical decisions that need to be made with every organization about the markets that they're going to operate in. And whether or not they have the core competencies that are aligned with those market needs. Obviously, that's also going to be predicated on the underlying characteristics of those markets that they're targeting.

Chart 1 shows that the greatest potential for growth in the financial services marketplace is essentially in the upper right quadrant. That's where the high net-worth individual is and where estate planning, retirement planning, and portfolio management-type products and services come into play. Demographics-suggest that's where the money is. Although this may offer some of the greatest prospects for growth, it's also becoming one of the most crowded segments of the market. Just about every large insurance company and every large financial service company, one way or another, is trying to make their presence known and build market share in that particular quadrant.

It may require a completely different way of approaching the market than in the past, such as integrated delivery systems or broader product portfolios. Once you get the assets under management, you must maintain those assets and provide more products and services to make sure that those assets stay on your books. Merrill Lynch is an example of a Company that seems to be prospering. It has an integrated, broad organization that has, not only proprietary but external products to help serve that marketplace from which they also collect a fee.

The lower left quadrant also has prospects for growth. This is essentially the lower touch, a high-transaction segment in the marketplace is where the volume is. This is really where the majority of households would fall if we broke it down in terms of demographics.

The ability to compete in this market is based on a completely different set of competencies than if a company was in the upper right quadrant. Companies like Fidelity or Vanguard, are examples of companies in that particular marketplace. When we look at the majority of life insurance companies today, they're neither targeting the classes which, belong in the upper right quadrant or the masses belonging in the lower left. We put them somewhere in no-man's land. That is, they're trying to serve complex markets, and in many cases maybe don't have the delivery systems or product portfolios to be as responsive as they need to be over the long haul to meet those customers needs.

Others might be trying to compete more in the transaction business, but don't really maintain the same level of efficiency and transaction processing that other competitors in that marketplace do. It's difficult to understand how companies will

be creating value over the long term if they don't have the structures and the competencies to align with the needs of the marketplace.

Probably the most revealing evidence of what's going on in the marketplace today is in terms of mergers and acquisitions (M&A). Essentially, everybody is doing it, but because of some of the recent prices we've seen, we do have a lot of questions about what the long-term impact is on organizations, particularly in some of the recent deals.

By historical standards, the level of activity that's been going on in terms of M&A throughout the industry, is unprecedented. There are a number of ways of measuring economic activity. The figures contained in Table 1 may be slightly different from what you might have seen published or used by others. There may be different perspectives as well. Are we seeing a rapid pace of consolidation or does the pace of consolidation lag the underlying reality of what is going on in the marketplace?

TABLE 1
MERGERS & ACQUISITIONS
SUMMARY OF L/H TRANSACTIONS
AS OF DECEMBER 31, 1997

	1995	Value*	1996	Value*	1997	Value*
Acquisitions	33	$10,408	78	$26,827	86	$47,034
Mergers	12	$1,933	21	$3,648	10	$40,699
Spin-offs	6	$14,674	4	$850	0	$0
IPOs	1	$838	6	$1,005	3	$1,359
Demutualizations	4	$526	0	$0	1	$124

*millions

Table 2 expresses consolidation that has not only taken place within the insurance industry, but is happening across various segments of the financial services arena. This is probably more revealing or defining to us as to what is going on in the marketplace today. We've labeled these as being watershed transactions. Certainly, the quest for market share, distribution, globalization, expense efficiency, and so-called synergies, are the catalysts behind the activity that's going on. Certainly this activity also is capped off by the mother of all transactions the $83 billion Travelers/Citicorp deal announced in April 1998.

TABLE 2
WATERSHED MERGER AND ACQUISITION ACTIVITY
FINANCIAL SERVICES TRANSACTIONS

Acquiror	Acquired Entity	Announced Date	Transaction	Amount in Millions
Travelers Group	Citicorp Inc.	April 1998	Merger	$83,000
NationsBank Corp.	BankAmerica Corp.	April 1998	Merger	$62,500
Banc One Corp.	First Chicago NBD Corp.	April 1998	Acquisition	$28,900
Union Bank of Switzerland	Swiss Bank	December 1997	Merger	$25,800
General Accident Ins. Group	Commercial Union Ins. Group	February 1998	Merger	$25,000
First Union Corp.	Core States Financial Corp.	April 1998	Merger	$17,100
Dean Witter Discover & Co.	Morgan Stanley Group Inc.	February 1997	Merger	$10,200
Travelers Group	Solomon Inc.	September 1997	Acquisition	$9,000
Credit Suisse	Winterhur Group	August 1997	Acquisition	$9,000

There are two basic reasons why companies pursue M&A activity. They can be strategic or they can be financial. There's no guarantee for success, but these are just some of the issues that we believe will position companies best for adding value to their organizations. Ideally, they offer both a strategic as well as a financial benefit. Hopefully, the management's who are involved will be able to deal with the conflicts that invariably are going to arise anytime a deal is done. It is also hoped that organizations have the ability and the discipline to measure the progress and the success of the transactions.

Companies really need to establish a benchmark and answer the question. Are they better off for having done a deal versus not doing that deal? Hopefully, we're seeing deals that are being done to add long-term economic value to the organizations, and not necessarily for their accounting impacts alone. At the end of the day, we hope that they're solving real business issues and that those are going to outweigh any of the potential issues that they may create.

In terms of the rating impact, to date it's been neutral and positive. That's a reflection that weaker companies are being bought by stronger companies, although we do hear a lot of talk about mergers and vehicles, but I think we would be hard-pressed to ask, "Who were those mergers and vehicles?" We're really trying to look beyond the accounting impact to some point where accounting and economics really come together, whether it's done on a pooling of interest basis or a purchase-accounting basis. Those are really the long-term drivers that we're looking for.

You might ask, Why does an investor or any rating agency for that matter, care about value-added? It sounds like an equity analyst's type of orientation. This really reflects the factors that go into our rating process and have been embedded in our rating process for years. It's also reflected within the ongoing dynamics in the marketplace. We believe that it really supports the ratings function that we're assigning, because ratings, are essentially opinions of companies' abilities to meet long-term obligations for their policyholders. For the most part, for the companies whom we're dealing with, these are long-term businesses.

I would hope we'd all agree that the extent to which a company has built financial strength today, is very much a reflection of its past strategies. We're thinking about their ability to honor obligations into the future, but it is very relevant to think about the strategies that the company is employing today and their ability to execute on their strategies. That source is essential as part of this value creation process. Ultimately, value creation is going to be determined by ability and not just ratings in the marketplace.

Obviously, there are various scorecards that companies can use. Statutory and GAAP financials, earnings per share, along with policyholder dividends, also as a value proxy for mutual companies. A number of companies have experimented with alternative approaches, such as Economic Value Added, and Market Value Added. Those have been approaches used in other industries. We've seen companies trying to employ them in their organizations to gain greater insight about the long term economics of their organizations. We can talk more specifically about that perhaps in the question and answer portion of this.

One of the problems with any of these measures, is that they're all subject to interpretation. They all have their own limitations, as you would imagine. They may be dependent on supporting assumptions. Another important implication is the fact that very few companies are using these alternative measures, so it's very difficult to benchmark or assess the appropriateness of methodologies that are being utilized. Probably as important as anything in the context of shareholder value, it doesn't seem the alternative measures will be embraced by the capital markets or at least by the equity analysts who follow publicly traded organizations. That may change over time as they get a better understanding of what this means, but were still seeing the emphasis on earnings per share, ROEs, and so forth.

We don't necessarily believe that any one of these measures, of value creation is the magic bullet. We've seen some companies that have experimented with some alternative approaches, and found them to be very helpful exercises. But it's difficult for us to imagine any successful organization that doesn't look at ways in which it's creating value on any of these various measures. Ultimately, we think that

financial flexibility is driven by the strength of companies' core business activities. Financial engineering, or capital structures may be helpful for a company to achieve its goals, but that's not where long-term value creation comes from. It's really, again, the strength of the core businesses.

Mr. Patrick Finnegan: The topic of value creation is extremely hot today, so much so that once again *Business Week* has devoted the front cover of their magazine to the story of GE and, in particular, Jack Welch, who, according to this article, has created more shareholder value than any other CEO in this century. It is a very, very topical discussion. I thought I would begin by discussing or highlighting what forces are driving change in the U.S. life insurance industry, and why there is so much focus today on the issue of value creation.

Competition, excess capacity, and the migration of consumer preferences are, from our perspective at Moody's the largest or most important secular forces bearing down on the insurance industry today. We have discussed these often in conferences such as this one and in our special comments in our industry outlooks. I don't want to dwell on them. But in order to set the stage, I think it's important to of reinforce where this industry is in terms of its life cycle and how it is reinventing itself, if you will, in order to be more competitive in a broader financial services marketplace.

What is value creation and how do we measure it? Well, assessing value creation involves taking stock of where a company is today, what its franchise has been, and where it is headed. In this area, we clearly spend most of our time making qualitative assessments about the size and predictability of a company's cash flows. I recognize a number of you in the audience with whom Moody's has a rating relationship. I won't dare ask how many people here are satisfied with their ratings for risk of having a rotten tomato thrown at my face. But the question has always come in terms of where you place the most amount of emphasis in your analysis. Clearly, it's with respect to qualitative information and the track record of a company.

Sustainability of cash flows. That really speaks to the core businesses of a company and how strongly or how competitively positioned they are, as a niche player, or otherwise. Last, but certainly not least, is the question of management stewardship. While you may not see it referred to directly in our credit reports, investor briefings, management stewardship probably the single most important element in our analysis. The question always comes up as to what we think about the credibility of the management, its track record, the likelihood of them continuing to pursue the path that they're on or whether they'll diverge from that path, their risk appetite, etc. The predictability of management and their stewardship of the enterprise is the most

important element in our analysis in evaluating whether or not a company is creating value or eroding value.

Let me talk a little bit about the strategies that we are seeing insurance companies use being used in the marketplace. Most of my time is spent in the U.S. life insurance sector. I cover about ten relationships on the life side, maybe five or six on the property and casualty (P&C) side, and a handful of managed care operators. I've had the opportunity over the last five years, since I've been with Moody's to visit with and see a lot of different insurers. There are a lot of different strategies being pursued out there, but these are some of the ones that, we feel resonate the most and have the most common thread.

The separation of multiline operations, is the breakdown of the multi-line insurance strategy and elimination of non-core lines of business is an activity that we've generally viewed as favorable for companies. If I had one word to put on it, it's focus. Companies that focus on their markets, focus on their customers, focus on their products, tend to perform much better than those companies that don't have a high degree of focus. And examples in this area, for better or for worse, Aetna, Travelers, and Lincoln National, have all gone to this type of strategy where they're focusing on one or two business lines.

Rebalancing investment portfolios. At the beginning of the decade, we saw many U.S. life insurers rebalancing their investment portfolios, primarily in response to improving the asset quality on their books. Recently, what we're seeing with very low interest rates, the desire to optimize portfolio returns. I recently had the opportunity to visit with a small group that was focused on this topic of value creation and in particular, the subject of dynamic financial analysis, which I'm sure most of you, as actuaries, are familiar with. It's topic of discussion within insurance companies that we visit, clearly, as an area of focus to create additional value for both policyholders and shareholders alike.
But in this arena, one of the considerations that we're obviously concerned with is when companies shift their asset allocation to some degree. It usually involves a greater amount of risk taking. The key issue is just how much additional risk taking. We look to organizations that we rate, in order to get an understanding as to whether they have a good feel as to how much additional risk they're adding to their balance sheet in order to generate additional return.

Growth through leveraged M&As. I highlight the word leveraged, because that has generally been the way in which many companies have made acquisitions. Mergers tend to be a safer type of business combination from a financial point of view, although they present the same types of business integration risks that an acquisition does. The greatest concern that we have in this arena is whether or not a company

has taken stock adequately of its resources and has a real sense of what their potential is in a marketplace when they embark on an acquisition. Are they doing it solely to build a certain level of assets under management or to be a consolidator in a marketplace, in essence to be the hunter instead of the prey? With very little consideration of what the endgame is, and what they end up with at the end of the day? Those are the types of issues that we tend to focus on, in addition to the financial risks, obviously, that are added to the balance sheet when a company levers itself to make an acquisition.

Repatriation of capital to shareholders is another means by which companies have sought to return value to shareholders. Part of the problem with this industry is top-line growth. When it doesn't exist, many companies have sought to return what they consider to be excess capital to the shareholders in lieu of spending it on negative net present value type projects. In general, Moody's does not have a problem with that, as long as we're both on the same page in terms of what is considered to be excess capital, and the manner and aggressiveness with which that type of activity is pursued.

In general though, I'm sure you know, that when you do return capital to the shareholders, that erodes the base under which the creditors sit. That, in general, is not a favorable thing, done with prudence, and as I said, as an alternative to investing in projects which have negative net present values, can be a better situation.

Finally, in this area, new management with a fresh perspective. We've seen this adopted by several large mutuals you're all familiar with in terms of getting a new perspective on the organization and how it's going to compete in a dynamic financial services marketplace. Based on the companies that I've been visiting with I anticipate that this trend will probably continue, particularly, in the mutual life insurance sector, much more so than on the stock side, as companies start to gravitate towards mutual holding companies and demutualizated types of organizations.

To close this discussion on strategy, (Chart 2) highlights the history of upgrades and downgrades in the U.S. life insurance sector at Moody's. As you can see, excluding the impact of acquisitions on rating activity, downgrades clearly outweigh the number of upgrades in our ratings universe. Most of that activity occurred in the early part of the decade, in response to what Moody's saw as a weakening of asset quality, particularly in the commercial real estate sector. But it goes probably without saying here that as short as ten years ago we had companies in this industry, the life side in particular, that were peers, that today are substantially lower rated. The key-differentiating quality over that period of time from our vantage point was

management, and their ability to steer through choppy waters and meet competition head-on.

I believe, looking back in 1991, Moody's had 17 triple A rated organizations and today, when you just look at stand-alone life companies, we only have 1.

Let me touch briefly on how the value creation activities of mutual and stock life companies differentiate. In this area, I guess we're talking about three major types of activities: mergers with other mutuals, the mutual holding company concept, and demutualization. Mergers with other mutuals have been a strategy that's been used infrequently, but effectively, by a few mutuals. We anticipate that this form of reorganization is going to get a lot more discussion and talk within the board-rooms of companies that we've been visiting with. What is the driver for that?

I think it simply boils down to the fear of falling behind the competition and the desire to remain independent. Moreover, I think it goes without saying there are probably a limited number of growth opportunities, particularly for companies that are focused on selling participating life insurance products. There's probably no better way of gaining market share in this arena than through a merger with another mutual.

The mutual holding company (MHC) strategy is something that has been getting a lot of attention recently. As you may know, it was first used as a means of reorganizing in the savings & loan industry, and became popular when thrifts were hungry for capital. Nevertheless, it has quickly become popular in the insurance industry, and managements and boards of directors of numerous mutuals have concluded that the MHC structure offers their company a superior alternative to either remaining a mutual or implementing a full demutualization.

I get the impression from talking to companies that were considering this move, that a key motivation was the avoidance of the equity tax. I'm sure you're aware the IRS has recently taken a position that a reorganization under a mutual holding company law will not in and of itself alleviate the equity tax for a mutual. In that regard, we've heard some companies talk about the prospect of then issuing stock, to reinforce the notion that this reorganization has more substance than form. Today we've seen just one company issue stock. Perhaps others may be considering that, but at this point in time when you look at the potential for litigation surrounding the reorganization as a mutual holding company and the prospects at least in near term. That its not going to eliminate the equity tax, I think the MHC state is probably nothing more than a creeping demutualization, not a permanent state of affairs.

Demutualization has been a very hot topic. There are a number of companies that have announced that they are pursuing that or, in fact, have concluded a demutualization. The benefits of demutualization obviously include improved access to capital markets, and heightened market discipline resulting from new ownership structure. In that respect, it has very strong similarities to the MHC structure, but probably allows the company to raise more equity capital in one step than does the MHC structure. From that perspective, it has a very strong positive advantage.

The flip side of demutualization is that with the loss of a company's mutual status, policyholder and company owners are no longer one and the same. You have a bipolar state of affairs in which management has to not only balance the interest of policyholders with competitive products, but also the need for building appreciation for stockholders.

The number of companies that will be looking at demutualization as a means of creating value for policyholders as prospective shareholders, as well as remaining as policyholders, we think will continue over the near term.

The prospect of a number of large mutuals pursuing demutualization may end up pushing many mid-sized and smaller mutuals to look at the issue of demutualization or a merger. From discussions that I've had with companies on the subject, many believe that the charge and the defense of what is going on in the insurance industry is really carried by many of these large companies. When you see them move from a mutual company status to a stock status, a lot of that burden will no longer be carried by the large mutuals. In particular, I'm thinking about matters like the equity tax. The transition from stock to mutual, is a very, very important trend and probably the single most important trend for the mutual life insurance industry over the near term.

The last area I'd like to address is the question of, does the company's capital structure affect its value creation opportunities? I think it goes without saying that the magnitude of competitive force mentioned earlier really argues for a company to have multiple attachment points to the capital markets. If you are a mutual considering the MHC structure or demutualization, it makes a whole lot of sense in this brave new world. Companies that enjoy such benefits from our view do have a competitive advantage. In assessing an insurer's capital structure, the first distinction we generally make is between the claims of creditors obviously, and those of owners. The key point to remember here is that the creditors claims on an insurance company level must be met first, and thereafter, creditors claims at the insurance holding company must be met before the claims of owners.

Various hybrid instruments have become important parts of the capital base of a large number of financial institutions in recent years. Billions of dollars of tax-deductible preferred securities have been sold in this marketplace and for very good reasons. I've highlighted here some of the advantages that we've heard articulated by Wall Street intermediaries, as well as issuers of the securities. I think, by and large, we would subscribe to most of them. The fact of the matter is, as tax deductible instruments, these instruments provide a tax shield, which generally leads to a nominal lower weighted average cost of capital. They offer some degree of greater financial flexibility, depending on where you sit on the credit spectrum, in terms of your ability to defer dividends, as well as delegate the nature of these instruments. There is relatively little refinancing risk.

Where we tend to get bogged down most in our discussions with companies is on the issue of whether or not these instruments receive "equity credit." I don't think Moody's would argue the point that these instruments have equity-like features. But that doesn't necessarily mean they are equity-like, or in fact, receive equity credit. As a matter of point, our firm generally does not assign a certain level of equity credits to these hybrid instruments. So when you're trying to determine your overall debt to capitalization, we don't come up with a composite measure and say this tax deductible preferred or this mandatorily-convertible preferred is 40% equity and 60% debt or vice versa. We tend to look at the aggregate amount of preferred stock a company has, for example, its capital structure, and aggregate amount of debt and how those instruments are being used in the overall execution of the company strategy. But, by and large, we tend to aggregate them and look at them as financial leverage, because that's essentially what they are, although they may have different characteristics. In the long run, essentially what a company is doing when they issue these instruments is levering their assets.

It has been my experience that we have not downgraded a company as a result of issuing a hybrid type of instrument. If, in fact the downgrade was linked to the issuance of a tax-deductible, preferred-type security, it was usually done in the context of taking on greater operating risk, perhaps in the event of an acquisition. But, in and of itself, has not generally resulted in much change in credit quality.

The final point that I'd like to leave with you is the need for insurance companies, particularly stock companies right now, to balance the interest of creditors and shareholders alike. The changing competitive landscape, as Mike indicated, will continue to make this balancing act much more difficult for insurance companies. The notion of convergence and competition is as keen today as it has ever been. With a view towards creating value for shareholders, many companies will probably end up taking on greater risks for the organization as a whole. We'll be examining and looking closely at how well companies choose to balance those risks.

Mr. Albanese: I have one quick question for you. Looking back to the upgrades and downgrades in Chart 2 I'm wondering how that chart would look from the perspective of the banking industry or the securities industry. Have the trends been similar and how do you perceive the life insurance industry to be positioned relative to the other players?

Mr. Finnegan: There are three questions there. The first in terms of how the bar chart would look if we compared the U.S. life insurance industry with the banking industry, in particular, in the U.S., as opposed to, for example, Japan. The history of Moody's ratings in the U.S. banking sector, generally followed a pretty clear pattern of downgrades outweighing upgrades in the early part of the decade. That probably was out in front of some of the changes that occurred with respect to the credit quality for the U.S. life insurance industry.

More recently, I would say since 1995, at least for many of the big money center banks, and large regional banks, there has been an upward trend in credit quality. That has been propelled by an improvement in their balance sheet, and a tremendous amount of fee income being earned from different products that they've been offering, as well as consolidation which has taken a tremendous amount of cost out of their operations. I would say the trend has been somewhat in the opposite direction for the U.S. banking industry. With respect to securities firms, I would say it's been more of a steady state. There really hasn't been a tremendous change in the credit quality there, except for some acquisitions. As you know, many securities firms, and smaller regional firms have been acquired by good size banks. So in that context, there's been somewhat of an upward trend. Remember, if you factor in acquisitions into Chart 2, you get a totally different picture. You would definitely see the number of upgrades exceeding downgrades.

Why is that? In general, the U.S. insurance industry in Moody's rating universe was, and probably still is, on average the highest rated sector when you look at any kind of industry or financial institution type of sector. The weighted average rating is probably Aa3, or A1. A lot of the reason for that is the fact that ratings for approximately 85-90% of the industry's liabilities were focused on the biggest companies, which tend to be the highest rated organizations. There is a tilt there, if you will, a skewing of ratings.

Mr. Tim Freestone: I'm with Seabury Insurance Capital. We're a securities firm. We engage in a full line of activities, including underwriting, recapitalizations, and financial advisory. We manage the capital of a number of large funds that invest in the insurance industry. There are three things that I'd like to speak about. The first has to do with the degree to which size confers benefit in either the life insurance

industry or financial services. Second, I'd like to talk a little bit about the specific drivers that we've identified in shareholder value, and third, I'll share some general observations about things that we see firms doing specifically to enhance their shareholder value, but inadvertently destroy their shareholder value.

The first part of this presentation–how much benefit does size confer–really came about as a result of a conference that I attended last fall at which a number of quite senior insurance executives spoke with some anxiety about the coming competition from these super institutions that are being created by the bank mergers, the convergence, and the fact that banks will be in the insurance business. There was enough trepidation reflected in their speeches and, what their organizations were doing, to achieve a sufficient amount of size to be on the same playing field, that we wanted to take a look and see how much advantage really does come from of just being a large organization, because clearly, an awful lot of the intellectual capital and physical energy of their institutions was being consumed by, "how do we get larger?"

I'm focusing on banks, because that's where most of the merger and consolidation activity has been going on. If there is a benefit that is conferred through size, then we would expect to see it in the market premium of these institutions. You would expect to see progressively larger market premiums accruing to the largest institutions. I took the liberty of merging a couple of institutions that have announced, but have not yet physically merged, like Travelers and CitiGroup, etc., but what we can observe here is the relative market-to-book premiums.

For the top ten, the market to book average is about 3.1, and for the next 15 it's about 3.5, so we don't to see the larger market premiums accruing to the largest institutions here. But let's pursue this line of reasoning a little bit further.

There was absolutely no correlation between the asset size and the market-to-book premium. Some of you are probably already thinking, well what's happened is the market has already bid up the value of all those stocks to reflect their merger value and if, in fact, these institutions don't find the appropriate merger partners, the market will reduce their market premium. In fact, it's a bit of a tautology. Banks ranked number 90 to 100, have assets ranging from approximately 1.6 to about 2.7 and the average market-to-book on these institutions is about 2.86 actually, so what we observe is, yes, there does appear to be some benefit conferred to size, but it doesn't appear to be that dramatic. Let's see if we can identify precisely where the size benefit is here.

We did this for both the life industry and banks, and what we observed is, once again, there is a size benefit, but it's not nearly as material as most people would

believe. Actually, it taps out much sooner than most people would believe: $30 billion for the life industry around $40 billion for banks. In fact, there's a significant drop off after you go past that size.

If you listen to the spin that the financial journalists put on a lot of this M&A activity, you would definitely think that there was more value being created than the actual numbers here reflect. As a matter of fact, in the Travelers/CitiGroup deal: that is a merger of complimentary businesses, as opposed to just getting larger, and it's perceived that that is where a great deal of value is going to be achieved in the consolidating market. A couple of the architects of that particular deal said this is really nothing new. Investors should look to Europe to see basically what the archetype is for this.

So we did look to Europe. We got the 14 largest institutions in Europe. Unfortunately, this data was reasonably hard to come by, and it's 1995 data, whereas, the other data was from 1997 except for the market values on the first sheet, which was 1998 data. What this would reflect is that these institutions have been involved in a lot of complimentary businesses for a long time. But again, their performance isn't particularly compelling. In fact, we see that it significantly lags behind that of the U.S., so we were a little bit skeptical that a great deal of value is necessarily going to come from the merging of a lot of complimentary businesses. In fact, it may even be a little bit tougher in the U.S. where the rate of new business formation and financial services is exponentially higher than it is in Europe, which would suggest that it's going to be difficult for a lot of these large institutions to really earn this synergy that they're trying to capture.

Once again, just to reiterate, there doesn't seem to be a lot of excess shareholder value being generated. Nor is the value being destroyed, although we did say that the benefit seems to tap out for banks at around $40 billion, and for life companies at around $30 billion. Also, understand this is survey data. It doesn't specifically apply to all facets of the market. I was just having a discussion with the panel members before and the presentation about the group health business, and HMO business, which can certainly be a scale business. You must have a certain level of size to be in that business and to be effective in that business. There are other businesses like that. Understand, this is a top-view-looking-down survey and is not specific to any particular business, but there is, I think, a lot of truth in terms of the generalities that comes out of this data. That size alone is not going to provide that much benefit. There are too many other things that are driving market premiums that are more important than how big you are.

Now I'd like to talk for just a moment about some of the specific drivers of shareholder value. You can do pretty well no matter what your size is, as long as

you focus on how to create value. Let's focus on some of the things that you can do to create value.

Taking a look at what the conventional measures of performance are that the industry uses, what explains the variation in share value of an institution? The graph on the left of Chart 3 reflects everything but financial services. The graph on the right specifically relates to the life insurance industry. The first bar is sales growth or revenue growth. It's the top line of the income statement. What we observe is that the growth of the top line explains less than 1% of the share value of a life company.

The second bar is the earnings-per-share growth. We see that it is responsible for determining about 10% of the variation in share price performance for a company. Again, neither of these factors are particularly significant. We see they're higher outside of financial services as seen in the graph on the left. I'll explain that in just a little while.

At the next bar we're looking at, basically, cash flow. And we see that it has a far bigger impact, so we go to ROE. Which explains 35% of a firm's share price performance. I've had a lot of companies come back and say, "Yes, those are the measures that we use, but if you put those all together, we'll really have something." We put them all together and we got up to 40% because there's obviously a lot of colinearity between those first 4 bars.

If these are the measures of performance, they come to one conclusion if they're performing very well against these gradients, yet the market isn't responding. They conclude that the market's not rational. I've had so many senior managers in these companies say, "The market is not a rational basis to measure the performance of our company. We have to be sensible people." They see the market going up 500 points one day and down 300 points the next so and it's not something they want to use as a report card for measuring the performance of their people or organization.

We come at it from a slightly different perspective and say, "Maybe it's the numbers. The lack of congruence that you see between the conventional measures of performance that you're using and the failure of the market to respond might have something to do with the conventional measures."

To accentuate that point, we add one more bar in Chart 4, which is a performance measure that we use when we're attempting to value a company. It's what we call the shareholder value formula. Again, it's a market-to-book premium, equal to the ROE, divided by the discount, which here we call the required return, minus the growth. When we apply and unplug this formula for valuing each part of an

enterprise, it can have many different lines of business. This measure explains in excess of 90% of the value. It's very rare that we would miss the value of a company by more than 2%, so it actually explains considerably more than 90%. We're able to know that because a lot of the companies that we work with, in fact, will value something and they'll do a divestiture, diversify a subsidiary through an initial public offering (IPO). In effect, what we're able to watch is its trading value at equilibrium. So, when I say in excess of 90%, that's the basis for a corroborating value.

Before I joined Seabury Insurance Capital, I was in the consulting industry with KPMG, and we would discuss these kinds of issues with many organizations. What we found was there was tremendous resistance to changing the basic conventional measures that these companies use. It's virtually in the DNA of the industry. If organizations could significantly improve their performance and their shareholder value by using different performance measures, then why don't they? That's it. It's just very difficult to get organizations to change this particular type of behavior.

There is a basic unfamiliarity with the shareholder value model. I began by saying that I'm very pleased to be able to address this audience, because it's basically the actuarial profession that is most familiar with the numbers, and most adept at reasoning through the numbers that generate a great deal of value in the industry. But when we get into rather intense discussions on the shareholder value model within a lot of companies, it's not a message that is particularly well received. Again, they know that they're being measured along the conventional measures, even though the conventional measures don't work. And very often, when the CEOs see that the conventional measures don't work, the usual thing that they discuss is that the market doesn't recognize the value in the company.

I told you we'd come back and discuss the shareholder value model in a little bit more depth. The ROE, which is in the numerator, is the net income over the capital that gets allocated. One of the biggest issues, which Pat discussed a little bit earlier, is capital structure. Does capital structure affect the value of a company? Yes. How you allocate capital has a great deal to do in determining what the discount rate is and how the market discounts the cash flows of a particular business in your company.

The reason why ROE doesn't explain very much about the value of a company is because it's simply the rate of return on the capital that you've allocated to a specific business. What if you've undercapitalized that business? You get a very high ROE. Very often, companies that we've taken public or that we've valued have extraordinarily high ROEs, but very low market-to-books, again, because the discount rate is very high. The way you allocate capital in your firm is

extraordinarily important in determining the ultimate value of that particular business in your firm, and, ultimately of the business as a whole.

The required return is the market risk you have as a company. That's how correlated your company is to the market. I distinguished that from the operating risk, which is in the numerator, which determines how you capitalize individual businesses.

We usually describe this as the beta risk. Again, it explains how correlated your company is to the market. When we talk about the growth, we're talking about not what your analysts say the next three to five years of projected earnings are going to be, but what they will be in the next three to five years plus the terminal value. The terminal value is mostly driven by how the market thinks you are positioned for the future. That's really a perpetuity value. That's a 20-25 year growth that we're looking at. For a lot of people who value the company and even use this particular formula, if they're not using the long-term-growth factor, they're going to get a very bad estimate for the value of a business.

So, where is value being created in the insurance industry today? Table 3 shows a combination of various life, and P&C businesses. Beginning again with the top line, we see that the HMO business is actually driving the largest market capitalization rates at 3.34%. We also see that it has the best long-term growth. Observe that if you have the market- to-book premium, you know your net income is. You can figure out the required return by using the capital asset pricing model, you can solve for the growth. Basically, you're solving for the unknown variables, so you can find out what the growth of a business is.

Another interesting thing in terms of using the shareholder value model is that a lot of times I'll have somebody question me and they'll think to themselves, what's the riskiest business in the insurance business? And they'll say, "It has to be catastrophe P&C." "What's the discount rate on that?" When they see it's low at 11.3%, relative to a lot of other businesses, they lose all faith in this model, because that just goes against their intuition altogether.

If you go down to the bottom line of Table 3 where it lists the number of standard deviations of capital that are required to support a business, you see that P&C commercial requires 5.23 standard deviations, which is the highest of all the businesses. Now, this might bring into focus different parts of the model. Remember that a P&C company, is not particularly correlated to the market. The degree to which a catastrophe affects a company's economics is not related to the overall economy. What a P&C company has is a huge degree of specific and operating risk, and the only way that that can be mollified is by allocating a lot of capital. So you see it has a lot of capital, a reasonably low discount rate, but as the

result of the amount of capital that has to be allocated, it also has a low market-to-book premium.

TABLE 3
WHERE IS VALUE BEING CREATED
IN THE INSURANCE INDUSTRY TODAY?

	HMO	**Group Insurance**	**Retirement Annuity**	**Traditional Life**	**P/C Reinsur**	**P/C Retail**	**P/C Commercial**
M/B	3.34	1.78	2.62	1.09	1.82	2.66	1.92
P/E	27.5	19.9	19.8	10.1	15.7	18.0	14.4
Required Return (RR)	15.3%	12.3%	13.6%	11.3%	13.2%	12.9%	11.3%
Long-term Earnings Growth	11.7%	7.3%	8.5%	1.1%	6.8%	7.7%	4.3%
# of standard deviations of capital	2.71	3.49	3.51	3.88	3.73	3.81	5.23

These numbers come from using a large number of surrogates in the market in each business. This is kind of a benchmarking exercise, where we'll use, perhaps 20 P&C companies in the catastrophic business. What we're observing here is the average performing. This is not to say that the best you can do in the HMO business is 3.34. Or the best you can do in the P&C business is 1.92. This is the average.

This is just an example to say that, if you're looking to acquire or you want to figure out where real value is being created in your company, you might want to value other aspects of the organization like distribution channels. You can use the very same shareholder value model, and the very same surrogate process, so that if you were going to buy one company. Let's say you're going to go into virtually any insurance business, but one business does it on a direct basis, one on a wholesale basis, and another on retail, you can basically use a benchmarking process, using a shareholder value model to find out how the market is capitalizing different kinds of distribution, and claim handling to find out where the market is putting the highest value on the different components of these organizations.

I want you to imagine for just a moment that you're the CEO of an organization that has three divisions. You have a fixed budget and you have to allocate that budget to maximize the value of your company. How do you do that? If you're using the conventional measures of performance, in this particular instance, you notice that each division is earning a 15% rate of return on capital. So they're all performing equally well there.

The next thing, observe is that, they all have the same earnings growth rate. What we observe is that division, 1 is earning a market-to-book premium of 3 to 1, division 2 is at about 1.8, and division 3 is losing 25 cents on every dollar that you allocate. If you're using conventional measures, they're all performing at about the same rate. What's creating the distortion here? It's the required return or the discount rate. We run into this phenomena with organizations all the time.

What else could cause this distortion? Here we're focusing on the discount rate. Let's look at what happens if we do the same thing with the growth. This time the discount rate is the same in all divisions, but the growth is different and we end up with the same distortion in value in terms of the market-to-book premium.

I mentioned a little bit earlier that we work with firms, that are looking to demutualize, particularly those that are looking to do an IPO, or their stock price is just down, and they're trying to get the stock price up. What we typically find is that most organizations create a majority of their value with the minority of their businesses. What they aren't doing is distinguishing which businesses are the valuable businesses. If you're using the conventional measures and you're revenue driven, you're looking at the revenue and not focusing on the discount factor. You're not focusing on, the market driver, which is long-term growth. You can make some very radical and bad decisions about restructuring unless you use this kind of a model for assessing where value is being created and where it's being destroyed.

Mr. Albanese: Tim, I found that very interesting. You opened by talking about how size doesn't necessarily create value. But when I look at the components of your shareholder value formula, it seems as if size could impact value on a number of those elements in terms of expense takeouts. That would lead to greater earnings in terms of lower capital requirements for larger firms and a potentially lower weighted average cost of capital. It may not affect growth, per se. I'm just wondering how you reconcile your shareholder value formula with your premise that size doesn't add value?

Mr. Freestone: No, you're absolutely right, Mike. It could, but rarely does. We did at one point in time, and I know this study focused on the P&C industry, but we did a very exhaustive, what we call cross sectional time series regression to figure out what the drivers of value were in the P&C industry. We used all public P&C companies, and we did a factor analysis. I've never seen so much data in my life. I hope I never to have to repeat that kind of study again. But I can simplify the result focus.

What we found, contrary to my own and most people's expectations, was that companies with the highest market premiums were those that had the fewest products, and the least geographic diversification. That went against everything that I believed. The idea is that it focuses. One of the most important elements in business, is understanding the products you have, the customers you serve, and the markets you're in. On paper, the formula looks like it could work for you. But it's very difficult to maintain focus, the bigger you get.

From the Floor: How do you arrive at the required return?

Mr. Freestone: Well, that's a very complicated process. Let me start at the top level. The simplest way of arriving at the required return to use the capital asset pricing model. The required return is equal to the risk free rate, plus beta, times the market premium. As in all things, there are a number of ways that formulas can get more complex. There are other models of what is called Arbitrage Pricing Theory, (APT). There are multifactor models. We usually use about four or five different modeling techniques because beta, while it's pretty good and has served the markets well for a number of years, compresses a lot of information. For example, in the insurance industry, one of the reasons why the APT model is attractive, is because you can factor out the influence of interest rates. There are a lot of reasons to use other models, but that's one of the ways to arrive at the required return.

CHART 1
ORGANIZATIONAL EFFECTIVENESS
AND THE NEEDS CONTINUUM

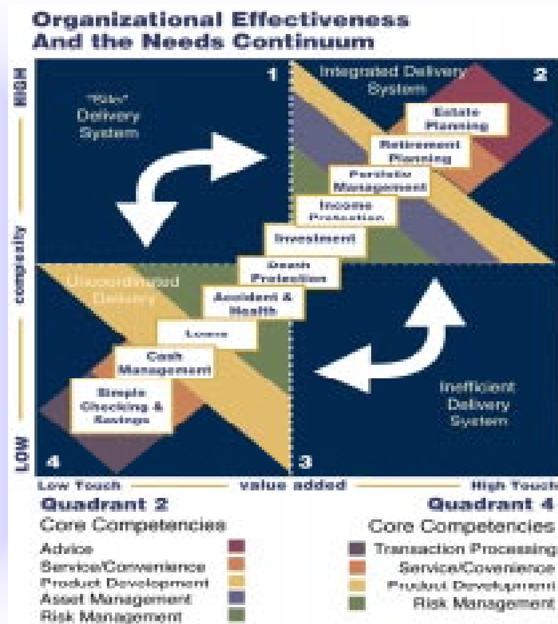


CHART 2
HISTORY OF UPGRADES AND DOWNGRADES
FOR U.S. LIFE INSURANCE COMPANIES

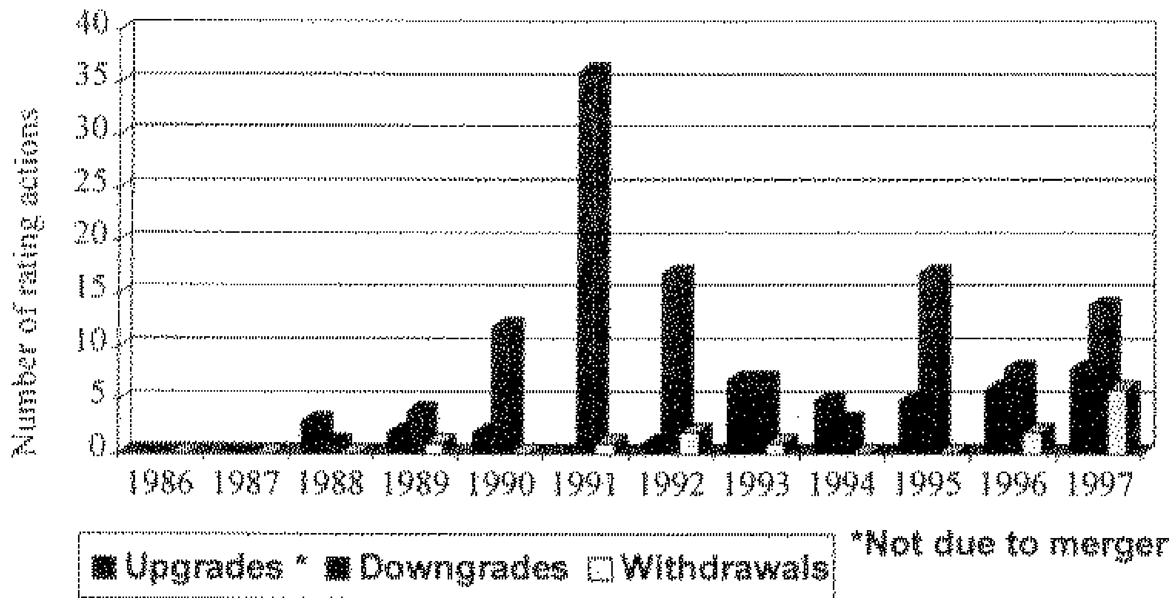
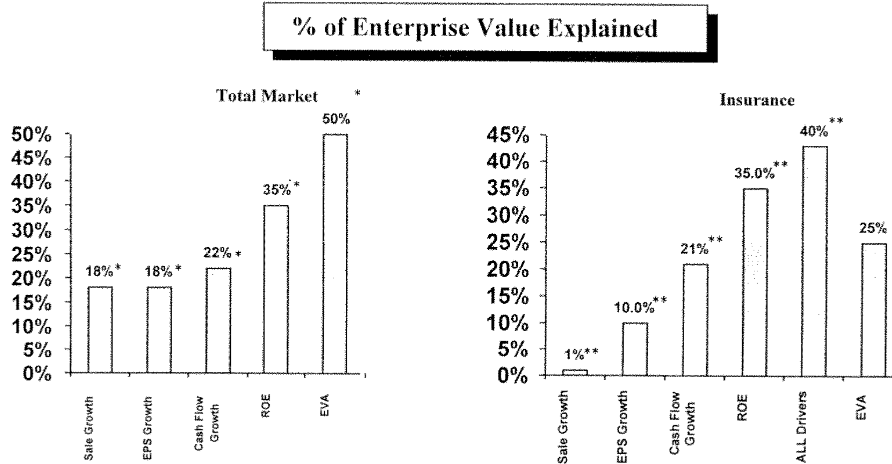


CHART 3
MOST MANAGEMENT TEAMS USE THESE
CONVENTIONAL MEASURES OF PERFORMANCE



Yet, we observe these measures only provide a minimum of insight about a company's value

* According to Stern Stewart & Co., sample includes Stern Stewart Performance 1000.
** Based on Valueline beta and historical financial data. Sample data includes all insurance companies analyzed by Valueline

CHART 4
BETTER PREDICTIONS OF MARKET VALUATION