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Evaluating Life Insurance Companies From the Outside

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Summary: As we enter a new age in the financial services industry, life insurers are facing many new challenges as well as some new opportunities. To prosper, and even survive, many life insurance companies need to better understand their environment. Because competitive analysis is a key component of product development, it is critical to evaluate other insurance companies with an outside perspective. This panel identifies ways to do that.

Ms. Deanne L. Osgood: Our first speaker will be David Kimmel from J.P. Morgan. He specializes in insurance industry mergers and acquisitions (M&As) in advisory and capital-raising functions. Mr. Kimmel has completed numerous M&A and financing transactions for insurance companies in the U.S. and internationally. His M&A advisory transactions in 1997 included Equitable of Iowa's sale to ING Group for $2.2 billion, and Marsh and McClennan's acquisition of Johnson and Higgins for $1.8 billion. Next, Jim Overholt of Milliman & Robertson in Chicago will provide a banker's view. He leads the financial services practice. Following Jim will be Jack Ladley, a consulting actuary and partner with Ernst & Young in Philadelphia. He specializes in rating service and life and disability income line evaluations and has also been involved in numerous M&As after-the-fact rehabilitations. Finally, our anchor will be Debbie Gero, a corporate actuary for SunAmerica. She has been involved in the analysis and acquisition of blocks of business that involve indemnity and assumption reinsurance as well as the purchase of stocks of privately held and publicly owned life insurance companies.

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Mr. David S. Kimmel: As an investment banker, I've been asked to discuss an outsider's view on evaluating the life insurance sector. In today's market, that inevitably for me centers around a discussion of consolidation trends.

In the insurance business today, the model truly is acquire or be acquired, and you may not have a choice. The ability to combine companies successfully is a core competency, and technical insurance expertise is simply a given.

We have organized our macro outsider's view of the life insurance sector into three main sections: an overview of the current life and annuity environment, the insured's place within a converging financial services market, and our view on future insurance M&A activity. While our analysis is from a Wall Street perspective, we have not focused on quantitative measures for valuing life insurers, but rather have taken a more qualitative approach in assessing the sector's strategic and market position. As a quantitative matter, our view is that the return on capital (ROC), ultimately, separates the winners from the losers. And many outsiders have a fairly bearish view of the life insurance sector from that perspective.

Many outsiders believe that the life insurer's competitive advantage relative to other financial institutions is, in fact, eroding. Industry consolidation and financial services convergence are creating intense competition in the retail financial services marketplace, with noninsurance players—such as banks and mutual funds—having a competitive advantage. For instance, there's the relative size matter. Citigroup has a pro forma market value greater than the combined market capital of all current U.S. publicly traded life insurance companies.

Concurrently, consumers have been migrating toward investment-oriented products and away from traditional insurance products. Alternative distribution channels continue to take on increased importance and act as catalysts for M&A activity. In fact, the competition for shelf space is forcing everybody to rethink the distribution paradigm. Banks are continuing to distribute insurance products at rapid pace, in particular, asset accumulation products. Potential regulatory changes may make it easier for them to make inroads into your business. Additionally, the reputation of an insurance agent may be at an all-time low, while low interest rates have continued to make insurance products slightly less attractive to the consumer. Robust equity markets, at the same time, have increased the importance of having a variable capability.

In this environment, we see our clients and life insurers looking to achieve certain competitive advantages. ROC, as I mentioned before, separates the winners from the losers. Other advantages include competitive cost basis—in the case of life and annuity players, competitive with the deposit-taking institution—superior service, attractive and broad product offerings, brand-name recognition to compete with better known banks and mutual funds, diverse and dominant distribution channels that effectively reach the consumer, critical mass, and the ratings necessary to compete in a given line of business.

In the face of these pressures, the life and annuity sectors have been perceived quite differently by the stock market. Life insurance has been characterized by slow growth, contracting margins, and increased competition. On the other hand, the annuity industry has been viewed favorably and given much higher growth, capitalizing on the aging of America. Players with a variable annuity capability are viewed even more favorably by the public equity markets.

Differing market perceptions of the life insurance and annuity markets are reflected in relative operating performance and valuation measures. Compound annual growth rates for annuity sector premiums and income have significantly outpaced those of the life insurance sector over the past 10 years. As a result, the market tends to expect annuity companies to have higher long-term growth rates and places a premium value on these asset accumulators.

Variable annuity growth has clearly outstripped that of fixed annuities, largely mirroring the growth of mutual funds. Double-digit growth in retirees will continue to fuel demand for asset accumulation products. Currently, the growth rate in the population of U.S. retirees is about 5%. In less than 20 years the rate will more than double. And in 30 years it will increase sevenfold to more than 35%.

As you know, banks are already significant distributors of insurance products. A bank's branch network is a natural distribution system for asset accumulation products that can be sold through the established bank distribution network for investment-oriented products, particularly to the fairly underserved middle market bank customer.

At the same time, mutual funds have clearly arrived on the scene as competitors look to capitalize on the competitive advantages in distribution and in brand-name recognition. Compared to mutual funds and banks, the traditional insurance agency appears somewhat inefficient. For example, the cost of career agent distribution is about 84 basis points above the cost of mutual fund distribution channels. In addition to wide and cost-effective distribution systems, mutual funds also offer asset management expertise, brand-name recognition, advanced technology, and a very low expense base. Such advantages seem to have recently favored mutual funds and the variable annuity writers, with both sectors growing rapidly in the last several years.

Let's now turn to financial services convergence. Certainly, financial services have been consolidating, globalizing, and now, at least, simulating increasing convergence. Insurers, banks, and asset managers are increasingly finding themselves in each other's businesses. This trend will become even more dramatic with potential regulatory changes prompted by the merger of Travelers and Citibank. Whether it succeeds or fails, Citigroup has certainly been provocative to date. With market capitalization north of $140 billion, the sheer size of Citigroup compels competitors to review and quicken their own strategies. Much of the strategic rationale for this deal centers around cross-selling and the belief that Citigroup could be a potential category killer, providing the most products through the most distribution channels.

Given their larger size and higher trading multiples, banks are viewed by many as the long-term winners in a converging financial services market. It's very interesting to note the relative ROEs in market book value multiples of the banks and other financial services players versus that of the insurance sector. Another interesting factoid is that Merrill Lynch was the fastest-growing annuity writer by growth in premium in 1997.

Even without convergence, the life insurance sector has been evolving and is a dynamic rather than static business today. In the not-too-distant past, life insurers operated in a less competitive environment in which they had well-defined roles. Today's market is one of fierce competition. It is a return-oriented culture and there is blurring of distinctions with other types of financial institutions. In this environment, many outsiders view life insurers as being at a competitive disadvantage based on many metrics, in particular, economies of scale, distribution, service capabilities, and strength of brand name.

Addressing consolidation trends as any strategic evaluation of the sector today is incomplete without some discussion of what's happening in the M&A marketplace. Even prior to convergence, the life insurance sector was changing dramatically and consolidating rapidly. Life insurance M&A activity has been propelled by a number of forces in most lines of life insurance. Top-line growth is very hard to come by. In the case of annuities, margins are so razor thin that economies of scale are essential. The definition of "big" is getting bigger and the definition of "small" is getting bigger. All but the largest players feel vulnerable. One-billion-dollar-plus market-capital companies have been sold because they don't consider themselves large enough to compete going forward, which would have sounded crazy only a few years ago.

Other factors leading to record consolidation are the need to shed underperforming business, excess capital, and inefficient operating structures; the need to expand products and geography; and competition from noninsurers. In the past 4 years alone, U.S. life insurance M&A volume has exceeded that of the prior 12 years combined. It probably is more than 12 years, but we didn't have data going further back.

We see the consolidating life and annuity market as having certain basic characteristics. Almost by definition, everybody's a buyer or a seller and, frankly, many are both. Many small-cap companies won't survive and numerous mid-cap companies will probably have difficulty surviving. There will be continued divestitures as companies look to deploy their capital as efficiently as possible. And we see a continued active use of stock as acquisition currency, and acquisitions putting the mutuals, at least today, at a disadvantage. In the U.S. M&A market this year, stock has been responsible for almost two-thirds of the financing of all M&A deals.

Companies that do not have consolidation expertise acquire it, because it is now viewed as a core competency along with technical insurance expertise. There will always be factors that act to mitigate the force of M&A activity. But these factors, in recent times, have been outnumbered by the forces promoting consolidation. The need to compete with banks and mutual funds will only promote such activity.

Acquisition multiples for life insurers in annuity companies are at all-time highs because of a confluence of events. A real imbalance exists between buyers and sellers. Discount rates are historically low. The stock market has convinced potential sellers that this is the time to sell and potential buyers that they may never have stronger acquisition currencies. Deal makers running aggressive insurance consolidators have certain competitive advantages in making acquisitions, including the ability to extract very aggressive synergies, create revenue enhancements, and credibly sell their deals to the analyst community, which raises the price bar. There is also increased interest in the U.S. by foreign buyers, primarily, European ones, as demonstrated by the Aegon/Providian deal and the ING/Equitable of Iowa transaction.

We see the market as continuing to place a premium on scale and efficiency and look at the link between scale and valuation among publicly traded life, health, and annuity companies. We examined 14 large-cap companies that ranged from $5 billion–20 billion in market cap. These large-cap companies traded at a discernable premium compared to our universe of seven mid-cap and six small-cap companies. Size may not be everything, but it is very important. It creates a virtual circle of success as the market rewards large-cap companies, in part, because of their consolidating ability. Their stock price increases and they then can acquire at higher prices. As they gain more scale and efficiency, the market rewards them for their critical mass and consolidating ability.

In general, companies benefiting from the circle of success are run by deal makers, are very well-capitalized, and have established a critical mass. These winners will continue to drive consolidation. We see buyers continuing to pay high prices for many insurance companies. Low discount rates, the ability to extract very aggressive synergies, the desire to expand product offerings, and the must-win sentiment that characterizes a consolidating market will continue to support high valuations. Last, while life insurers may not have much choice but to participate in the consolidation game, they do have the choice about which deal is the best deal. In the long run, the market will not reward companies for doing any deal, but for doing smart deals.

Mr. James H. Overholt: My job is to view the insurance industry from the banking perspective. In banking, what we're really talking about in the convergence of financial services is bancassurance, specifically, the concept of replicating in the U.S. what has been achieved in Europe and Australia.

The best way to illustrate a bank's view of insurance is to talk about where banks are coming from in this whole arena of convergence, because banks have been in this process now for about 10 years. It is strategically imperative for banks to become involved one way or another in the insurance business and to treat it as a major profit opportunity.

By way of background, the bank views the consumer life cycle the same way as the insurance industry. Banks are very good at transactions and credit, but when it comes to investment and retirement products, banks no longer have the dominance that they enjoy in the transactions business. This is particularly true when you get into the area of investments. Banks lose a large number of customers when consumers begin to mature in the area of investments versus savings and deposits. Unfortunately, that's the precise area where the baby boomer bulge is starting to appear, so it's absolutely critical for banks to become involved in the investment business, which they have done, and, more importantly, for them to become involved in insurance, which they are doing.

If you look at household discretionary income or discretionary assets, it's already evident what's been occurring in the banking industry. If financial services is the bigger pond, banks become a much smaller fish. That is not a good trend. Banks' share of the marketplace has been declining over the past 25 years. It has accelerated somewhat over the last 10 years, particularly as some of the early baby boomers began to move through that investment cycle. The deposit share went from 40–23% over that same period of time and, conversely, securities went from 45–62%. This is an illustration of what's been occurring in the marketplace for banks.

A survey of buyers of mutual funds through brokers, in which questions were asked about where the money came from to fund the purchase, indicates that over two-thirds of the money came from the banks themselves; therefore, you have noticeable convergence already occurring in the banking industry, particularly as it relates to alternative products.

The same is true of alternative channels. If you look at the distribution of money purchased through brokers, you'll find that this is more alarming. Forty-seven percent of the marketplace buys typical CD products from banks. But most people don't realize that almost 42% of buyers of these same traditional bank products buy through brokers and money market demand accounts. Not only is there competition from alternative products, there's also competition for banks from alternative channels.

For the first time in the 13 years of the American Banker Survey of Consumers, less than half of financial consumers now view banks as their principal financial institution; hence, it is strategically imperative for banks to begin to do other things. Pressures on margins can be fought by growth. Witness all of the acquisition activity that has been occurring in the banking industry over the past several years. Growth, however, is a two-edged sword because it has become very, very expensive for banks.

If you look at acquisition prices in terms of the purchase price per customer, you will find that, over the past five years, it has doubled the cost for banks. Increasing the bottom line in the short run is a good strategy, but it compounds the long-term problems of margins. Growth as a strategy is simply not going to be enough to carry forward in the future. You need wallet share to be efficient, hence the drive for investment products and insurance products.

This brings me to my second point: Even if all the foregoing were not true, it is simply a good profit opportunity for banks to begin to build fee income. Insurance and investment products are about 145% of traditional banking revenues, so even if it were not strategically imperative, it's a very, very attractive market.

Banks have some very significant competitive advantages. From a marketing standpoint, they have the trust of their customers. That trust has led to relationships that customers tell them can be extended to all kinds of other products. In addition, they have the most convenient delivery system to the mass middle market, which is viewed as being very underserved in terms of insurance products. Likewise, they have some economic advantages. Distribution costs can be reduced by many people's estimates, somewhere in the 30–50% range. Infrastructure costs—the delivery systems, the brick and mortar, and so on—can be reduced somewhere in the 20–30% range. From a cost side, there are lower commissions, volume sales, and greater lead generation, which by some estimates can triple or quadruple the amount of business transacted in any given month in insurance products.

A soon-to-be released study from the Boston Consulting Group and the Bank Investment Institute, found that different notions of how banks and insurance can combine range from banks selling the customer list and then taking a share of the profits to a fully integrated, perhaps an equity-oriented investment on the part of banks. The theory is that you can almost double or, in some cases, more than double the total revenues available to the whole system. This is a very attractive notion. It seems almost impossible, but if you look at the Australian and European experience, these estimates are conservative by standards of activity that are already taking place in those systems.

How does this get done? Do I want to be in the business of insurance or simply sell the products? In terms of distribution, it's an absolute no-brainer for banks because the systems are in place. Underwriting is another issue. I think that banks are happy to become underwriters, particularly in a situation where they're acquiring an insurance company. Most will do underwriting because they view it as a core competency. They would not go out and buy an insurance underwriter. More and more banks believe in an unbundled world where they can achieve some of the same financial results of underwriting without actually taking the risk themselves. Volume and critical mass notwithstanding, I think that the speed of getting into the market is one of the factors that the very large banks are going to be looking at. Witness the transactions that have already occurred. If NationsBank decides to buy the next insurance company, you can bet that First Union will be right on their heels.

Do I want to be in a simple vendor relationship, enter into a strategic alliance, or have a full equity partnership in the business? This brings us to the notion of unbundling the value chain with respect to the marketing, servicing of clients, underwriting, reinsurance, and asset management. Right now, others can do asset management better than banks at cheaper margins; nevertheless, banks are asking to get into the asset management business because of the margins that exist there. If you asked the question, "If I give you another 15 basis points in return, would you still want to manage the assets?" the answer would be no, simply because it costs banks more to do it than it does for the asset managers either in mutual funds or insurance companies.

The most important consideration that banks talk about when they talk about combining with an insurance company is, first of all, have a good strategic and cultural fit with the partner. When you look at the equation of trust plus relationship plus convenience equals value, you're really talking about the marketing advantage enjoyed by banks. Trust means they're looking for a commitment from the company. They're looking at rating and reputation and actual practices, because you're crossing regulatory boundaries. The bank regulators, when it comes to products like this, are a bit tougher than they are in the insurance and securities industries.

On important relationship issue is who owns the customer? This is discussed frequently and is very significant for banks. Who's going to service them? How well are they going to be serviced? What happens when they have to turn down some of their best customers in an underwriting situation? What happens if they have trouble getting claims settled appropriately? Many regulatory boundaries get crossed there, and how it will work between two companies is an important issue. Technology and simplicity of product are major considerations for banks.

Flexibility is another key to capitalizing on those economic advantages. For instance, you should have a willingness to reengineer pricing structures, perhaps not to do underwriting but to get a share of the underwriting revenues, not to do servicing but to get a share of the servicing revenues. You also should be willing to reengineering the value chain and unbundle. Those are the kinds of things that need to be talked through, particularly in a long-range partnership. These are the things that are most on the minds of bankers when you speak to them.

Finally, there is execution risk. Banks are not particularly well-known for success in entering new ventures. It's taken them quite a while to get where they are in the securities industry. Many other endeavors have been notoriously unsuccessful. Most of these failures can be blamed on execution—jumping in with both feet before you have a strategy or understand exactly what it is you're doing. Most of the banks that already have an insurance business simply went out and acquired an agency and announced to the public that they were in the insurance business. I can tell you, if business did not triple in the course of two years after the bank acquired the agency, the bank is not in the insurance business. It may as well have bought a grocery store and held that as a subsidiary of the holding company, because it hasn't gained the benefits of combining insurance in a bank distribution environment. Banks that have been able to leverage their branch system and distribution capability have been most successful.

Mr. John D. Ladley: I'm going to talk about the evaluative techniques that can be used by an outsider in looking at a life insurer's product lines. Because product lines are the building blocks of life and health companies, valuation of product lines usually winds up being very helpful. I will touch on a number of techniques that have proven useful, but the bulk of this presentation will be about rating service data.

There are a number of ways a valuation can be applied. One is in product development. It may be essential for you to understand what your competitors are doing to rationalize your own product line, to remove yourself from the product line, or to recommend a more productive, rational product development and management process for your own company.

Second, it can be useful in acquisition and divestiture. Sometimes it comes up and sometimes it doesn't, it may help you understand what a competitor or target is doing and whether this is the way your company would do it. You may wind up with such things as reverse merging to recognize better ways of doing things.

Finally, it may assist you in line-of-business (LOB) strategic planning, suggesting, for example, product types and mix changes, volume expectations, market constraints in distribution areas, less-than-rational competition, and some of the critical success factors used by the top sellers.

Unfortunately, actuaries have traditionally been placed in a somewhat reactive mode. Usually, a chief marketing officer, chief investment officer, or your M&A leader approaches you with the concept of a new product or a potential target for acquisition, perhaps a small block of business. The challenges in evaluating the block of business—doing your due diligence and running your scenarios—generate plenty of work and little time in which to do it. I'm going to suggest some efficient ways to check your external sources to get better context for the work that you are doing. This is critical to doing a better job in any of those areas.

A market definition can be critical even to the point of helping you devise assumptions. I have a tennis partner who works in a plant. The plant makes plastic grocery bags and he tells me his company has a 100% market share. We all know that's never true in the insurance industry. You're always faced with a large number and array of competitors. Usually these competitors have unique strategic attributes, unless they're not entirely rational. They have strengths, but they also have weaknesses.

Once they are articulated, identified, and understood, strengths and weaknesses can be of great help in answering an important question: How are they doing this? That question almost always comes up late in the game. What problems do they seem to be incurring that we can avoid? The questions are useful, but I want to try to focus on the positive side. It's a challenge to find ways to get things done, not to discuss why you can't do them.

One particular information source available to nearly all of us, are the rating services—A.M. Best, Standard and Poor's (S&P), Moody's, Duff and Phelps, and others. They provide a wealth of information and knowledgeable ratings through their publicly available documents to provide useful insights into competitor market situations.

Let's set up a simple scenario. You're being asked to develop a small series of term and variable annuity products. To date, you've completed some steps for both plans. You first identified key competitors and the products you wish to emulate by referring to publicly available trade publications that provide product rankings and sales results. Product rankings through illustrations and premium comparisons are commonly available in approximately an annual cycle from a number of trade publications. In addition, Internet sites might provide product rankings for top companies, particularly for the term insurance market. As a supplement, you should have identified market leaders and their products using information from your own marketing department and possibly from distributor sources.

Next, you identified the other company key product features such as guarantee periods, underwriting classes, etc., through sources such as product announcements in the trade publications. You have also learned about the company products from Internet sites. Advertisements in trade publications often provide insight about how the product is marketed, how the distribution system is compensated, and who the expected target customer is. Again, you've checked with your own marketing department for supplemental information. You may have focused particularly on companies licensed or domiciled in the same states where you do business. This is particularly useful in New York, where regulations may affect the design of the product specific to your state. You want to see how they've coped with those regulations in their design and prices. They can be materially different.

In addition to these two steps, you identified product performance data, including rates charged, values illustrated, historical dividend treatment of policyholders, and similar indicators. This may tell you how a company has managed its in-force over time and how it obtains its profits margins after the product is sold. Such information may be found in consumer magazines and trade publications. For example, the standby is fifth- and tenth-year deferred annuity comparisons and various other comparisons in a magazine such as *Consumer Reports*. For participating policies you can refer to Schedule M, although that's likely to be of limited usefulness in our present scenario. Supplementing this, you can gain knowledge of rate determination and credit practices, also from publicly available data. You can refer to the annual statements of companies in question, your state insurance department, and the nonguaranteed elements filings.

We conducted a survey of about 20 companies, and the type of information they provided for nonguaranteed elements. If this were more closely monitored, there would probably be a lot more information. They were instances of companies not submitting anything at all, even though they answered some questions “yes.” In approximately 10–20% of the cases, there is a heavy amount of information in those filings, either on interest rates or mortality rates, and there may be other information as well. In general, you will at least see what types of changes have taken place and get a minimum amount of information from them.

Finally, interrogatories from annual statement information are often useful. You can get a good idea of the extent of reliance on reinsurance and who those reinsurers might be, which could be useful for our one-product series example. You checked where some states permit the illustration actuary filings to learn how companies may be dealing with expenses, although you recognize these filings are quite limited in what they tell you. You may have also done searches on the companies and products that you’ve targeted for attention, looking for announcements such as changes to term rates (increases or decreases, even for existing in-force), to reinsurance arrangements, and to bonus, rate, or conversion plans for large blocks of in-force. Finally, you can check product filing material and some of the illustrations. In a small minority of the cases, you may find additional attachments to those files, which are frequently useful and publicly available. As the last step in phase 1, you can establish rough sales volumes. All this provides a greater scope of data.

You now arrive at phase 2: pricing your own product. You’ll match your outcomes based on your assumptions with those of identified competitors. It’s a typical scenario. The term and annuity rates and values that you’ve determined have not matched up well with your competitors’ rates and values. You are ready to begin gap analysis, which is usually an iterative process of identifying procedures. You might emulate what competitors are doing, find ways to have your own corporate structure support those procedures, or conclude that there are just simply things that you can’t do.

As an example of this, you may realize that competitors in the small group you’ve looked at have an average yield significantly higher than your own. You can fairly readily learn the source of the higher yield and go through this with the investment department. You can also get into the kind of expense levels they are experiencing. However, be careful about assuming expense reductions in a product that may be dependent upon those expense levels.

On an annual cycle, either continuously or based on current events, rating analysts gather data and generate a significant amount of statistical analyses. In addition, through regular meetings and ad hoc discussions with the companies as part of their analytical process, these rating analysts review the performance of not only the company as a whole, but all of its key product lines as well. In fact, the rating services are highly insistent on receiving profitability by product line and information on specific key products within a product line. The information they access is in large part not available to the general public. However, they review the information, crunch it in great volume, and then comment on it. What could be better than that? They do your work for you in a way.

There's almost always an in-depth discussion and, at the same time, an evaluation of corporate management, almost always linked to product line data, as well as other data that they are providing. There are frequent updates, so the rating service information is usually, but not always, current. A good analyst will probably go into more depth, but raise many of the same tough questions you might ask.

The services evaluate this data, perform their analyses, and review their discussions within an industry and then within an LOB context. They arrive at tentative rating categories and then subdivisions within those categories. There is also a strong effort among all the top rating services to ensure a consistency of company ratings. There's a heavy use of committees, reviews, and so forth, so there is some commonality of rating, despite what you may believe if you are looking only at your own company situation.

Finally, the rating service summarizes all this information and issues a rating for the public. My focus here is not at all on the ratings themselves; it's far more on the information from the write-ups that support the rating. I should mention a couple of asides, being that there are many.

One is that two of the top services are much more oriented towards publishing views of their own technical analyses related not only to changes to their formulas and so forth, but also to specific product-line issues. For example, I was recently looking at "Funding Agreements," written by Moody's. Moody's, incidentally, also has conference-call and other means of disseminating information.

There are also rating services that focus heavily on expectations. The expectations are built on management goals and objectives gleaned from managements' meetings with the service. These give you excellent indicators about upcoming plans for product introductions and the critical success factors that the company has identified. Another example would be—and sometimes this goes down to the analyst level, depending on what rating service you're looking at—gaining insights on statutory and GAAP information.

There are some limitations to interpreting rating service write-ups. For example, while the rating services have common goals—that is, principally to express an opinion on the financial strength of an insurer going forward—not all the services arrive at their conclusions in the same way. Some use different techniques or different formulas to evaluate an insurer. Others see certain company attributes, such as mortgage-backed securities (MBS) or a collateralized mortgage obligation's (CMO) ability to raise capital for the significance of double leverage, as more critical than others.

Also, their industry outlook, while generally negative across all services on the life industry, may differ from service to service. Some services are particularly concerned about the annuity business; others are somewhat less critical. It is helpful to appreciate some of these differences if the rating service commentary is to be interpreted properly. A rating is not a performance report card, nor is it a report card on a product line per se. We know from studies that there often appears to be virtually no correlation between capital levels and rating or between profitability and rating.

Finally, the rating services often, but not always, use proprietary statistical analyses to gauge company performance. Some of these techniques are quite different from what an actuary might use. For example, returns on assets or expenses measured as a percent of assets for certain lines of business would not be our traditional approach. Statutory, GAAP, and value-added reporting generate some interest in the services as well.

One challenge in evaluating the rating service write-ups is interpreting the jargon or descriptive wording. Descriptors do have important meanings and can be compared from company to company. However, one rating service used more than 20 separate adjectives to describe earnings in a recent count we made. Some of the differences are probably too subtle to bothered with, though, for the kind of evaluation I'm talking about.

You should also note that ratings are developed using a total company perspective, including, most especially, its business strategy and all supporting information. There tends to be no single factor, including capital, earnings, or any other item that's predictive or directly linked. They are historically not ahead of key issues, but usually following or fast following them; therefore, in general, you should not expect to learn about emerging issues facing a product line from service write-ups.

Despite these limitations, I believe a great deal of information can be gleaned from these write-ups.

I strongly recommend referring to more than one and possibly three or four of the top services for any target competitors or market leaders to obtain a more complete idea of the way they do business. For best results, also look at several of these competitors' peers. Hopefully, you're one of them. This will give you more context to interpret what they're saying.

What kind of information might be obtained from these write-ups? Let's go back to the product development scenario. First, in looking at a competitor, you might discern whether it's term insurance or annuity line is a core LOB. If you were attempting to sell a product in a product line that is not central to your business strategy and, therefore, not a core line against identified competitors who are, you will be at a competitive disadvantage in almost every case. A noncore line receives relatively less profitability management, system support, and sales and marketing support than a core line will. This is an important first distinction to make.

Second, you might obtain information about the product's importance within LOB, its history, and the company's expectation for the product. Checking service write-ups over time may provide some information on a competitor's cycling of products, how fast it cranks them out, and whether it is the type of company that tends to get a jump on the market and gain market share. You can then identify whether your own philosophy and product introduction schedule is in sync with this. You might decide to take a longer-term view or expect a longer product shelf life instead.

Because all the major services are currently focused on growth and distribution effectiveness, you are likely to find useful information on the effectiveness of competitors' sales and marketing functions in a fair amount of detail. You should look for whether there are multiple distributors or single outlets, enabling techniques for distributors (such as lead generation), advanced underwriting, work site marketing techniques, or others. Are the companies with which you're attempting to compete holding a strong market position and are they well-known in the marketplace? It's not uncommon to see companies literally attempting to compete against trademarked products and companies. Market image and position can be very important in sales effectiveness. Does the distribution system appear to be one that will sell product only on price or on features as well? Does it appear cost-efficient? The agencies will usually comment on this because it is one of their true hot buttons, especially this year. How does your company's distribution system match up?

Besides annual statement risk-based capital (RBC), which is easily obtainable, you can obtain three more sometimes diverse opinions on capital levels and supplement this with rating service views of past and future competitive prospects for capital formation. Why capital is deemed high or low may be significant, and calculated ratios may not indicate this exactly.

ROEs by LOB may be provided and commented on using qualitative adjectives. Companies operating on thin capital, of course, can enhance ROEs, but you should be able to learn whether they have a risk profile that would be unacceptable to your company. A link to this would be the issue of leverage in these competitors. This would include reinsurance as well as other elements.

Clues to reinsurance retention or exact information on reinsurance retention will also be provided by the raters. Expenses are almost always mentioned these days and descriptives in this case are important to focus on. Compare these descriptives with your own company or with peers. Comparisons are very important in understanding the service's views and evaluations. These can also be put together with some of the quantitative analysis from annual statements.

Investment issues are typically dealt with in some depth, including commentary on asset/liability (A/L) management. It should be noted that, for A/L management, most companies easily meet minimum service criteria, and that's usually not a distinguishing factor. But information on the actual A/L matches are often useful.

I have used the rating service write-ups to help evaluate product lines in this way in the past. Prior to today's session, I reviewed the write-ups on four term writers, three of which also market annuities. Numerous insights could be gained, but I'll highlight just a few not in order of priority. Two of the four term writers had seen recent sales downturns. You could learn something from matching their product features with those of particular companies you identified. All were cited as having diverse term product lines and all but one had diverse distribution. The exception had essentially a captive distribution market. A good question would be, do you have these attributes?

All were name carriers, recognized or trademarked in the marketplace. Is your company in that position? Three were mentioned as being low-cost. Even the "highly efficient" terminology was used. What is the comparable rating service view of your company and why? Few companies receive this level of comment. Reinsurance retentions in proportions of new business reinsured were discussed at some length. None were credited with any exceptional A/L management function. All but one had high MBS and CMO concentrations. CMO classes were commented on in more detail. Two used derivatives, and one used below-investment-grade bonds. In three out of four cases, very specific proportions were provided. Again, how do you stand on this? Other commentary was provided about value to producers, producer services, new product introduction plans, underwriting, and persistency, which had comments on both good and bad levels.

There is usually much to be learned through these write-ups, especially if you can develop a broad perspective. It can help you sketch out a meaningful GAAP analysis and even provide specifics for your analysis.

Ms. Deborah A. Gero: I was asked to speak about evaluating life insurance companies from the outside using public information only. This is a task that sometimes befalls those of us who do M&A work if we're looking at a public company that has not announced it's for sale or perhaps even a privately held company that we think would be nice for us to own. This viewpoint is very different from the M&A world in which a seller provides an appraisal that's built from a microlevel. It has intimate access to the company's history of products and how much was sold in each year and can build a model from the ground up. Using only publicly available information, we can do some of that, but often the view is much more macro because company information on older products and details on investments, although available, are still best gauged by results versus some detail that a rating agency might look at.

In doing an analysis from public information, the first thing we do is gather 10Qs, 10Ks, and statutory filings. We might also have access to some reports that investment analysts have done. They may massage it and listen to press conferences, so they may have some slightly different insights.

To try and get a feel for how difficult or easy this task might be, think about your own company. If you were handed only the blue book, the other statutory filing, and GAAP filing, how easy or difficult would the job be to project the next three-year earnings? As you'll see, different companies approach disclosures in different ways, and you may be blessed with a company that's very easy to deal with.

The first issue that faces us when we're trying to figure out the earnings going forward is the quality of the earnings. Different companies account for things in different ways, both on a statutory and a GAAP basis. For statutory, one company might use continuous Commissioner's Annuity Reserve Valuation Method (CARVM), while another uses curtate, so the emergence of earnings would be very different for those two companies. On the GAAP side, quality of earnings might address how much acquisition costs a company defers and how long it amortizes them. Different companies will do different things. Goodwill is another example. How long is the amortization period?

An important thing to think about within that area is statutory adequacy versus what I call the "GAAP Big Bath"—taking a lot of write-downs in a year. Companies may have restructuring charges. Wall Street seems to be very forgiving of those write-downs, but they flag that there may be some more serious issues that they don't need to address quite so urgently on the statutory side because statutory adequacy is in the aggregate. GAAP might focus on Financial Accounting Standard *(FAS) No. 60* or *FAS No. 90* products and require some quicker action. Looking at what a company has done in terms of taking big write-offs on a GAAP basis may give you some insight about ultimate statutory earnings power. Those of us who are used to looking at appraisals think that statutory earnings power, distributable earnings, and capital from a company are really the only way to look at it. Still, you can look at GAAP to help you gauge the statutory.

Another item on the balance sheet is Interest Maintenance Reserve (IMR), a statutory concept only. One of the things you don't know when you look at a company's balance sheet is if the IMR is redundant, meaning they've just managed to sock away some nice total return profits that will amortize into income over the next few years. Is the IMR necessary? Have they sold a considerable number of, say, immediate annuities with long-term guarantees and, as assets prepaid, did they take capital gains and put them into IMR? It's needed to justify the total reserve level, so it's useful to try to ferret out.

The final item is tax. We can look at GAAP statements for deferred tax assets or liabilities to get some clues about the magnitude of these items, but it really only addresses timing differences between how they're reported in GAAP and what may ultimately be payable. It doesn't give you any insight about the aggressiveness or conservatism of the company's tax position. The tax year is not closed, so there could be some surprise in the future.

Do not overlook expense analyses. Some companies give you sound guidance about how much they feel is acquisition expense versus maintenance, but others don't. Some companies in a holding company structure will have expenses from the parent, but does not reflect what the company could actually be run for.

With respect to reinsurance, statutory statements have come a long way in disclosing and clarifying the types of reinsurance a company is using. Unless there's a vanilla type of risk transfer, it's very difficult to know the ultimate economic impact of many reinsurance agreements that might be on the company's books.

The next item is contingency prognostication. A couple of companies are superior at flagging when they're going to take big write-offs in the next two or three years. I don't know if it has created legal problems in the past with shareholders or it's just a management style, but often you can get clues about the next potential problem by looking at what the company talks about in its GAAP filings.

LOB analysis in a multicompany environment can be challenging in a couple of ways. Somebody mentioned Merrill Lynch already, so I'll use it as an example. If you want to look at Merrill Lynch's life insurance company, studying its GAAP statements isn't very helpful because the life company plays such a small part. Depending on the size of the company, you may find a lot or no information. It depends on the context within the holding company.

To elaborate, I will use as an example two unnamed but real companies operating in many of the same LOBs. Company A discloses a few basic items and Company B provides incredible supplements for each of its LOBs in very minute detail and enormous insight on how the income statement and balance sheet is put together for GAAP. It also discloses other very discretionary items, such the number people in each LOB, sales data, earnings spreads, and RBC, which you can get from the statutory filing, although statutory filings are in the aggregate. They have gone through the trouble of showing you the RBC for the particular line of business.

FASB allows and requires certain types of disclosure, but when we start seeing differences like this, in many cases, it's driven by what kind of relationship the company wants to have with its investors. When we get a situation like Company B, combined with all the product-type information that Jack talked about, it's almost possible for us build those very detailed actuarial models we know and love. If I'm supposed to be using actuarial definitions to be scientific and replace impressions and things like that, I'd have a lot more difficult time being a true actuary when it comes to Company A. Anecdotally, Company B's stock has done better, and there have been fewer earnings surprises.

To conclude, I'll quickly walk through some types of analyses that should be done once we get our earnings projections together. There is the Wall Street view, which applies to relative valuation; absolute valuation accounts for more of an M&A context. With a relative valuation you are looking at two companies, or maybe in Wall Street's case, the whole peer group of insurance companies, and figuring out which is overvalued relative to another company. Neither company has to be fairly priced in this model. It just means that one is trading more cheaply, given its merits, than another. When we look at a relative analysis or valuation from the company viewpoint, the usual result is relative. Will I make more money per share by doing an acquisition? Again, we're not necessarily asking if our target fairly valued, but if it is relatively undervalued compared to our company? There is a lot of this type of analysis going on.

In looking at Wall Street analyses, I list their price/earning (P/E) ratios and price/book ratios. Those look like absolute measures, but we often see them used in a relative way. Analysts will state that one company's P/E is less than another company's P/E, for example. I'm not trying to say that these are the only tools that analysts use. Often they look at the price ratios of one company relative to another from year to year.

Under absolute valuations, these are basically the free cash-flow analyses or actuarial appraisals. With Wall Street, we'll often find that, if a company is conducting an option, analysts will have put together their appraisals as well. These items are not gleaned from publicly available data, but are very detailed, hands-on, at the company data, so they differ a bit from using public information.

Many European analysts will look at a company's published embedded value, where the company has calculated its value of in-force, capital and surplus and come up with a goodwill number based on sales. In Europe, they're starting to see a lot more absolute valuations in the public forum. I hope that with this brief overview you can develop an appreciation of the difficulty, the degree of detail, and the different types of things that we can do.

Mr. Frederick S. Townsend Jr.: I'd like to ask the entire panel, do you feel that the proposed merger of Travelers and Citicorp will present the new Citigroup with a tremendous lead time in developing cross-selling opportunities? If so, do you think this will panic large life insurance companies into effecting M&A activity?

Mr. Overholt: Traditionally, banks have not done a particularly good job at cross-selling, and the larger banks, particularly some of the New York banks, have done a noticeably poorer job. I'm not sure that the notion of a merger of the two companies as it relates to increased cross-selling is going to get the kind of impact that I hear being talked about.

However, one of the best ways to get the kind of synergy they're looking for in this kind of merger is to own the distribution system. The cross-selling we have seen is not particularly well-done in banks, particularly banks in investment products and insurance. You may see a very different approach to that when the companies are merged, as opposed to acting as partners in the process, so it's far from a foregone conclusion. It will work well. I think it has a better chance of working than some of the more visible failed exploits in the past.

Regarding the second part of your question, it certainly has gotten everyone's attention. You hear it talked about a great deal, but I'm not sure that the trend relates as much to an outright M&A approach as it does to partnering up in some way, shape, or form. It certainly has accelerated this notion of banks and insurance. I'm not sure that it has accelerated the actual acquisition by banks of insurance companies or by insurance companies of banks. I think you will see frequent occurrences of it, particularly in the very larger companies, but I'm not sure that it will become an industry-wide phenomenon when there are, in many cases, better alternatives than actual equity investments. When you get to the regional banking level, probably some strategic partnerships could work just as well as an acquisition without bringing some of the nontraditional kinds of problems with it.

Mr. Ladley: I would agree with all of those points. It certainly has spurred much more talk, and banks and insurance companies are looking at each other. But I think there are a couple of levels to it. One, how many banks really want to underwrite insurance when they look at the relative ROEs in the insurance sector versus the banking sector? This diminishes their interest somewhat. It's a bit like building a house without a permit. Others aren't willing to be as aggressive as Citicorp and Travelers before legislation is actually passed.

Ms. Gero: Because SunAmerica is a variable annuity company, everybody came to us and said, "Oh, you must be next on the list or very high up on the list." One thing we started examining is the role of an independent insurance company. The targets that might be very attractive for banks are companies that have learned the bank culture and know how to work with them very well. Once an insurance company becomes acquired by a bank, all the companies it forged relationships with in the past won't want to do business with it anymore. It's interesting to look at how much value would be retained if it is acquired. That will start shaping which acquisitions take place. In the final analysis, these companies might do better left independent to maximize shareholder value.

Mr. Kimmel: I'll take the first part of your question first. Most banks, especially the large cap banks, are probably more concerned about who their next banking merger partner will be. That may mask the issue of getting involved in the insurance industry for a while. But eventually the only clear way for this to work is through a strong partnership. I don't think ventures are going to make this happen. It will have to be a true acquisition or a formalized financial partnership.

Over the past 10 years I have worked with a number of banks, including large money center banks, and they have peculiar ways of looking at insurance. Unless they get that expertise under their control, and, at the same time, allow those people to do what needs to be done to sell insurance, I don't think it's going to work.

Annuities are one thing, but banks have not really succeeded, either on the individual retail side or on the commercial side, in a consistent way to make the most of the insurance opportunity. A good portion of this involves bank culture and a need to control and understand that process. And it's not as simple as they expect it to be. Thus, there have been many false starts and moves by fits and starts because of the banking culture view of insurance. I'm not sure we would be much different in looking at banking, but that's the way they do it and it just doesn't work very well.

Mr. Bruce R. Darling: Another good source of information is the SEC's Web site, sec.gov, where you have the electronic data-gathering and retrieval system, Edgar, providing information for 10Ks. One of the problems with finding GAAP information about insurance companies and a conglomerate with other activities is that the 10Ks are consolidated for the whole enterprise and it's hard to find out what's happening with the individual insurance company.

By accident, while researching separate account prospectuses, I discovered the audited financial statements for just the insurance company piece of the company. That's a great little trick I wanted to share with you.

Ms. Osgood: What are the psychological factors involved in making a deal? I actually had the good fortune of participating in Session 51, which was a case study, Let's Make a Deal, Life and Health M&As. The session became a little nonfinancial and nontechnical at points. The facilitators actually said the same thing happens in actual practice. I was wondering if David could comment on that briefly.

Mr. Kimmel: I guess there would be a series of different psychological factors. One would be fear or desperation that, if you don't acquire this property, perhaps one of your competitors will. Perhaps for the last acquisition you looked at, you didn't quite get there, but that seems to be driving a lot of activity. There's also ego or deal emotion. People get caught up in the aspects of a deal and sometimes rational pricing isn't adhered to. Both of these factors have led to some mispricing in the marketplace and tend to be more pronounced in more concentrated markets. Look at the M&A activity that happened in the direct reinsurance market about a year-and-a-half ago. There was clearly a lot of deal emotion and a me-too mentality as well. If I don't buy it, somebody else will.

With some of the prices being paid, you can attribute some portion of the value to deal emotion. As you know, 10 or 15 years ago acquirers wouldn't pay for new business. In some transactions today, acquirers are not only paying for five to ten years of new business, but also paying more than the actuarial appraisal value. In part, you have to attribute that to deal emotion.

Ms. Gero: Watch the press releases. The emotional deals are the ones that are going to make the shareholders money. This is a gross oversimplification, but they do get very heated and a lot of value is placed on the future production.