

# **RECORD, Volume 24, No. 3\***

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New York Annual Meeting

October 18–21, 1998

## **Session 119IF**

### **A Game of Jeopardy: Smaller Insurance Company Survival for \$200**

**Track:** Smaller Insurance Company/Financial Reporting/Product Development

**Key Words:** Financial Reporting, Product Development, Smaller Insurance Company Issues

**Moderator:** JOHN E. WADE

**Panelists:** KEITH A. JENSEN<sup>†</sup>  
CRAIG F. LIKKEL  
THOMAS STODDARD<sup>‡</sup>

**Recorder:** JOHN E. WADE

*Summary: Panelists (the “contestants”) present the following topics utilizing the Jeopardy game show format:*

- *Consolidation trends—demutualization, upstream holding companies*
- *The characteristics of candidates for merger or acquisition*
- *Company positioning, niche markets*
- *Survival strategies: predator versus prey*

*The moderator (the “host”) solicits active audience participation to cover each topic and determine the depth of the discussion.*

**Mr. John E. Wade:** Our first panelist is Craig Likkell from Milliman & Robertson (M&R). Craig spent 12 years of his formation period with Merrill Lynch Life as vice president and actuary and then was employed by M&R. He joined GE Capital as their chief actuary during much of their acquisition period. When GE Capital moved their offices to the East Coast, Craig chose to remain in Seattle and return to

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M&R. He has considerable experience from both the company side and the consulting side.

Next is Tom Stoddard, who is a senior vice president with Donaldson, Lufkin & Jenrette (DLJ), an investment banking firm in New York City. Tom has been involved in a number of important acquisitions in the industry, focused on the insurance and finance areas. He's been involved in Aegon's acquisition of Provident's life operations and the demutualization of New York Life and Canada Life. Actually, he and Craig were both involved in GE Capital's acquisition of Toho Mutual's assets, although I guess they didn't know each other at that time.

Keith Jensen, the next person, is a senior vice president from the American Annuity Group and has worked on several acquisitions for the American Financial Group organization, on both the buy and sell sides. Prior to that, Keith was partner with Deloitte & Touche for 22 years and has experience in mergers and acquisitions, due diligence, and various other aspects of the accounting area. Keith is with my company's prior owner, and he and I have worked together when ownership was transitioned from the American Annuity Group to Service Corporation International, which was our major client.

**From the Floor:** What are small companies doing to resolve the Y2K issue?

**Mr. Keith A. Jensen:** The Y2K issue, both from an operating perspective and from a mergers and acquisitions (M&A) perspective, is obviously a hot topic. There is much being written about it. Some small companies have approached us with respect to our ability to actually be a third-party administrator (TPA) for them in lieu of their having to go through the expense of getting this resolved. It's becoming an increasingly difficult issue because of the scarcity of resources and skilled people. We're finding that we're in heavy competition for adequate resources to just get through our process.

I think many people, as the time comes closer, are looking for TPAs. There have been a few enterprises, in particular Hanover Re, that have actually circulated a letter to existing and prospective clients asking whether the clients have noncore blocks of business that they are concerned about from a Y2K perspective, that they would be interested in having somebody sell. This is another opportunity for blocks of business, or perhaps even for small companies, to become a trigger for acquisition or TPA-type activity.

From an M&A perspective, Y2K is a major issue, and we're looking at opportunities right now. There are a couple that we've taken a pass on because we just didn't think we could deal with the Y2K issue in time. It's a motivator for transactions, but

it's also a bit of an inhibitor. I suspect, as the time draws closer, that it'll become more of each.

**Mr. Thomas Stoddard:** From an investment banker's perspective, in looking at M&A and the Y2K implications for clients trying to make acquisitions, we're seeing that Y2K has been a deterrent, both in terms of trying to get deals done and in the price that clients are willing to pay. As people think about synergies and cost savings, one of the things they're factoring in is a longer period of time to actually make systems conversions. At this point, I think people have concluded that you really can't interrupt what people are doing in terms of resolving their own Y2K problems. Because that can't be interrupted, you have to let them complete their process and delay any kind of conversion onto the consolidator's system. So when people think about synergies, they're naturally postponing them.

If you look at deal activity over the last year, while dollar volume of transactions announced in the life insurance sector is up because of the number of big transactions, the actual number of sizeable deals that have been announced is actually down quite markedly.

**Mr. Craig F. Likkell:** We faced that issue from a different perspective. Some of the clients of M&R are asking us to certify that our systems are Year 2000 compliant. This process of documenting, testing, and compliance is rather pervasive these days, and the issue is obviously critical to ongoing successful operations.

**Mr. Wade:** That's a good point that the individual company has to deal not only with their own systems but also with the systems of all the suppliers that are part of their network.

**From the Floor:** How much M&A is really the result of market perceptions, perhaps fostered by investment bankers, that this is really the thing to be doing, as opposed to finding real value in this process?

**Mr. Jensen:** We're going to let the investment banker answer that one.

**Mr. Stoddard:** It's interesting when you look at targets. It's very easy to see that, from a target's perspective, there are benefits of being able to sell your company if you're publicly traded at a premium to market, or if you're a private company at a fairly high valuation.

As we've looked at M&A valuations over the last couple of years, disregarding the recent market break that we've had in the stock market, we've seen valuations increasingly moving skyward. Acquirers are competing to pay the highest price,

and they are paying most of the synergies to the targets. However, when we've taken a look at some of the very active consolidators in the life insurance sector, such as American General, Jefferson Pilot, GE Capital, and some of the others, to see how their stock prices have performed relative to the rest of the industry over a long period of time, and in particular over the last three years, in general, they've outperformed the broader life insurance market. So it appears that the stock market is rewarding these strategies.

When we've looked at individual deal announcements and the stock market reaction to those announcements, the results have been actually very, very striking. If you look at the banking sector as a comparison, typically those transactions are priced so that the earnings-per-share impact is relatively neutral by the second year. At least that's the way they're announced. The stock market tends to be very skeptical of those transactions, and by and large, the stock market reacts negatively to an acquisition announcement. The typical reaction of the acquirer's stock is to trade down 3 or 4%. Obviously it varies from deal to deal, but if you look at it on average, that's sort of the typical reaction.

If instead you look at the life insurance sector and see what's happened to Consec, American General, and others, with the exception of Consec's Green Tree acquisition, you'll see that generally there's been a positive reaction. Stocks will trade up 2, 3, 4, or 5% and, in some cases, much more than that. We represented Aegon on the Provident acquisition. On the day that transaction was announced, Aegon's stock traded up by 10%, and they added \$2 billion in market value. That's on top of the added market value by issuing new shares to Provident shareholders. So from a consolidation perspective, the stock market is clearly saying that deals are good for acquirers. The acquirers are becoming successful companies.

I think that the reasons are several-fold. First, we can look at back-office expense savings and synergies. There's a question as to whether these companies are really achieving all that. There are costs of integration, and it's very difficult to achieve those operating synergies.

There are also capital factors that are driving deals. Larger companies are being assessed a lower cost of capital in the markets. Their stocks are trading at higher price/earnings (P/E) (ratio) multiples. Their ratings are better, and their borrowing costs are lower. So when you look at their pure cost of capital, it's less. When you then look at the amount of capital that they have to hold to support their business, the rating agencies are clearly saying that larger companies can sustain the ratings with less risk-adjusted capital than smaller companies. As a result, when pricing a deal, a larger company assuming that they need to hold less capital or can run a business at a lower risk-based capital (RBC) ratio than other companies is able to

access that capital in the capital markets cheaper than their smaller competitors can. So natural factors are driving towards consolidation.

If you look at P/E multiples of small companies versus large companies, the stock market is clearly saying that the earnings of small companies are better suited on the chassis of a larger company, so there's sort of a P/E arbitrage. As we look at it, I think in the insurance sector maybe more than other sectors, there are rewards to making acquisitions.

**Mr. Likkel:** Is there a real bias in the marketplace that bigger is better?

**Mr. Stoddard:** There clearly is. Even with the recent volatility in stock prices, you've actually seen more of it, particularly on the annuity side. People are really seeing the life insurance and annuity sectors as a scale game, where stability of earnings and good credit ratings are important. It's put much, much more pressure on small companies.

**From the Floor:** Is the Penn Corp. situation going to change any of that, or make people look at things differently?

**Mr. Stoddard:** Penn Corp. is an interesting example, because when they tried to make the Washington National acquisition, they tried to do a number of things. People looked at them and said, gee, they're paying high prices. We don't think they're that successful in consolidating acquisitions. Sooner or later some of these people paying high prices are likely to come to tears, and I think that's one of the first examples of an active acquisition strategy that's not working.

There are a few other companies out there that are similar examples. Some of the acquisitions made by larger companies have been more or less successful than others. Frankly, GE Capital is still working to integrate all of the acquisitions that it's made, but its cost of capital is so low that it can actually afford to be a little less successful in some of its acquisitions from an operating perspective, yet still create value for shareholders.

**Mr. Likkel:** When you can borrow at triple-A rates at an after-tax basis of around 4%, and you leverage that borrowing-type capacity with a purchase transaction that realistically may produce only an 8, 9 or 10% return, that leverage works a lot of magic in terms of how you report ROE to an organization like GE Capital.

**Mr. Wade:** Would you all say that the benefits work both ways for a viable small company that really has a good operation going? If they can make themselves

attractive and it's a stock transaction, can they gain from their stock going up with the acquirer?

**Mr. Stoddard:** Yes, from a small company's perspective you can look at this from both sides. From the acquisition side you can point to some companies that were small that have become much larger and have been successful in acquisitions. Protective has made successful acquisitions. It has consolidated lots of small companies and blocks of business. American Heritage has a very successful work-site business, and has been very active in expanding through acquisitions. Selectively, you can find companies that have been successful at carving out good niche strategies in the acquisition mode.

From a seller's perspective, and because the industry is in consolidation, you really need to be skillful at consolidation. The consolidators are all competing for deals. They're using the benefits of their cost of capital and their back-office operating efficiencies to be able to pay as much as possible.

From their perspective they're getting earnings growth. The stock market is rewarding them for doing deals, and so they are incented to pay high prices and to pay as much as possible in order to get the same deal that someone else did. That's benefiting the targets substantially.

**From the Floor:** From a consolidation point of view, do you find more companies are merging now? So many companies seem to be just absorbed.

**Mr. Wade:** This is the top management team thing.

**From the Floor:** That's right. If you have a small company that is viable and has something to offer, it seems that frequently the small company's not there anymore. It's been consolidated into the bigger company. It just seems as though that's happening more often nowadays.

**Mr. Jensen:** Let me address that from both a buyer's and a seller's perspective. We'll use John's company as an example, because we both bought and sold it within the last three years. His company did remain autonomous within our organization. The reason it remained autonomous was that it was a strong niche player with a unique capability that was not directly synergistic with many of the capabilities of the rest of our organization. As an observer of both what we've done and what others have done, I think that's not unusual. In a situation where you have a unique specialty, where you have a unique market that you're serving, you tend not to have some of the consolidation synergies. The synergies we looked for were more the cross-selling synergies than the typical back-office crunch-the-

expense synergies. The flip side is that when we've done transactions with enterprises that had product lines that were very similar to what we had, then we were pursuing the expense consolidation, which results in a more stereotypical consolidation.

**Mr. Stoddard:** I think if you look at deals, you can group them into consolidation transactions and expansion transactions. Many companies are disappearing, but many companies are becoming part of bigger companies because of an expansion rationale. If you look at what GE Capital has done in most of their acquisitions, they've been looking for good management teams and providing them with more resources and better capital in order to move forward. If you look at what they've done in Japan, for example, it's not a consolidation play from GE's perspective, it's an expansion play. If you look at ING's acquisition of Equitable of Iowa, that was really ING being motivated to find an annuity platform that would give them cross-selling opportunities and allow them to expand.

If you're a manager at a small company, you want to think about the factors that are driving consolidation. If you can create value in your distribution or in your strategy, some people will be willing to keep you operating either as an autonomous entity or within the context of a larger organization. The difficulty is for people who are more in the commodity lines of business who have expense issues. They're the ones who will receive acquisition interest from a consolidation perspective.

**Mr. Likkel:** Yes, I'll echo that with my experience at GE Capital, which runs the range of the spectrum. On the side of autonomous, GE Capital acquired AMEX Life, the long-term-care operations that grew up underneath the ownership of AMEX. They isolated the long-term-care business and sold that in 1995. GE Capital regarded that as a successful niche, and a growth niche. They consolidated some of the corporate finance functions, the investment functions, but basically left them as an autonomous operation at their location in San Raphael, California. It's really been one of GE Capital's most successful acquisitions in their series of acquisitions. On the flip side, they acquired the Harcourt General insurance group based in Orlando, and that office is basically shutting down completely this year and consolidating to Richmond, a combination of Richmond and Lynchburg, Virginia.

**From the Floor:** One of the problem areas that you listed is mixing cultures and calming employees. Would you care to comment on that?

**Mr. Likkel:** There's no question that calming employees should probably come first in that topic. Whenever there's a transaction or even a rumor of a transaction, some people get quite upset, and there's a potential loss of productivity and a potential

loss of good people. It's a difficult call as to when to share the story and share the rationale. But communication—as much communication as possible—generally works the best in the long run. Obviously there's a phase where things need to be kept confidential until the point is reached where a deal is imminent or it's going to happen. You really need to tell the truth, but sometimes that's a conflict with the need for confidentiality. It's a tough issue to balance.

The key is that people need to recognize not only their concern for ongoing employment, but also that employees are going to look at the potential change in the situation critically and evaluate the alternatives. All of that is going to create some stress. As a deal approaches or, in fact, gets done, then the communication issue really needs to be emphasized. Communication of the vision, the rationale, and the strategy is very important down through all layers of the organization.

Beyond the transaction, when you're moving to, I think, what GE Capital refers to as the "integration phase," you need to involve people—key managers from both sides—in the process of integrating two different operations with different systems and different approaches to managing the business. There needs to be clear communication of the time frame of that integration phase, the key objectives, and the key accountabilities. Regardless of whether all those steps are done well, you're typically going to lose some good people in the transaction.

For example, I know that the majority of people at Life of Virginia with the title of senior vice president and higher are no longer with the firm. There is going to be a clash of culture, and GE Capital culture has some unique aspects. There are all sorts of pluses and minuses with some of the big consolidators such as Conseco, American General, and Aegon. People, either with a small company background or even a very large autonomous company background, don't always see where they themselves fit into a large organization, but that's the reality of the marketplace.

**Mr. Jensen:** We've had two fairly significant transactions this summer, and I think when you get to this thing of calming employees, strategies are really nice. What they want to know is, Do I have a job? What are my benefits going to be? If I stay until the end and I lose my job, how much of a cushion do I have so I can find a new job? It really gets down to the basic survival instincts.

We actually took that approach this summer on a transaction where, on day one, we pulled all the employees together, literally, at the same time the press release was going out so that nobody would learn about it other than in the meeting, and we dealt with those survival issues. On day two we brought in the people who were going to run the business to talk about strategy and the grand plans over the long run. Right or wrong, we concluded that nobody would listen to that until they



had processed the questions, Do I have a job? Do I still have medical benefits? and all of those kinds of things.

I would think that if the owners are exiting the business, then the economics are probably numbers one, two, and three on their consideration list. To the extent that there is a desire on the part of owners to stay involved in the business, or to give some reasonable weight to employee continuity, certainly the selection of a buyer can play an important role.

In the companies that Craig mentioned, there is a series of different philosophies as to whether people can expect to have a job six months later, and all of that plays into the selection process. I think, in terms of calming employees, it really is about the basic issue of still having a job.

**Mr. Stoddard:** I think those are some really terrific comments. As an investment banker I advise people primarily on M&A, and I spend a lot of time talking about synergies and cost savings in the abstract.

It was interesting to have the tables turned on me a little bit late last year. I used to work for Union Bank of Switzerland (UBS) before coming to DLJ this year, and I was part of the buildup in investment banking at UBS. In early December last year they announced a merger with Swiss Bank, which really was a sale of UBS to Swiss Bank, although UBS was the larger institution. It was very interesting for us to be on the other side of the coin saying, "Gee, we thought we were takeover-proof." Now after finding out that we had been acquired, there was a completely new management team involved and a completely new strategy.

I think your comments were right on the mark in terms of the things that you need to hit on. I think one of the failings of Swiss Bank's strategy in integration was that they didn't get to everybody in the organization. They had certain strategic points that were driving them. They had their priorities, and they focused on the priorities, thinking that they would follow up on some of the other things later. In the grand scheme of things it was probably a rational thing for them to do, but in terms of actually managing the merger it meant that they didn't get to everyone, and they didn't communicate with everyone. This was not just on the first day, the first week, or the first month. It meant that my colleagues and I, 23 investment bankers in total, our entire group decided that it wasn't an organization that we were willing to work for. Even though we were asked to stay, we decided to leave. That's an example of good people leaving in part because of a communication strategy, their business strategy, and some of the basic things that you talked about.

**Mr. Wade:** I think that's a very good point. When acquiring somebody, spending some time finding out who will be able to contribute on a long-term basis should be a part of the due diligence. On the other hand, I think about the people on the side of the company that's being acquired. Some people will take a package to leave and make a change. It's fine. That's the right time for them to do that. If you can get out of your mind what titles are and who does certain things, you can instead look at it from this perspective: How can I make myself useful to this new organization? How can I show, by my knowledge of the history of my company and my situation, that I can be a contributor to the bigger organization? Things will sort themselves out, and you'll find yourself a part of the bigger group.

**Mr. Likkel:** Yes, I'm also, depending on what day you ask me, either a victim or a beneficiary of a consolidation. While the headquarters of GE Capital's operation was in Seattle, they decided, with the acquisition of Life of Virginia and First Colony Life, that the center of gravity was much more highly weighted to the state of Virginia. They announced, basically, a year and a half ago that they would consolidate the headquarters to Richmond. I had a tough decision to make, and it involved many things in my personal and professional life. I chose to stay in Seattle and rejoin M&R, and I'm fairly happy with that decision. It is a difficult issue to wrestle with when it becomes personal.

**From the Floor:** Could you comment on the expectations versus the realities in terms of the effects on the distribution system and service to policyholders, through some key examples?

**Mr. Jensen:** I think that there are examples going both ways. I'm not going to pretend that I've done an in-depth study, but by reputation one of the issues that Penn Corp. has had to deal with is that they've consolidated and left many people, a lot of expertise, and a lot of distribution behind.

Our organization has been the beneficiary within the last year of hiring a group of refugees from a consolidator. Essentially, a consolidator bought a company that was in our town and then announced that everybody would not have a job, because their company was being moved elsewhere. We hired about 85% of the people who were in that company and said, "Why don't you just re-create your company, and we will supply the capital?" They brought along their entire distribution, which was an independent agency, a national marketing organization-type distribution.

We are nine to ten months into that endeavor. We will be writing about \$40 million of life premium this year through that distribution. We have 2,500 producers this year. That's an example to me of a consolidation where somebody forgot to think about how to bring not only the people along but also the

distribution. They concluded they wanted to take care of the runoff business, and they weren't focused on the ongoing business.

On the flip side, to use a close-to-home example, when we acquired the American Memorial group of companies we think we did a quite decent job of identifying some synergies. We're associated with a property and casualty company as well, and American Memorial's distribution was through funeral homes. We were taking property and casualty products and some other services into those funeral homes. It's hard because you have the issues raised around mixing cultures, and you're bringing in a distribution that approaches life differently. You get channel conflict, and it's really easy to have the "not made here, the way we did it is right" mentality. I think that requires some real intellectual integrity in the management process. Management must be willing to say, "Maybe we didn't do it right, or maybe we ought to reexamine what we did." I think that the willingness and ability to get that done is going to vary from company to company.

**Mr. Likkel:** Another example would be some of the things that are going on in the GE/Toho transaction in Japan. When you get down to it, it consisted of an acquisition of a distribution system. Toho Mutual is a company with some significant problems on its balance sheet, which many companies in Japan are experiencing right now. GE looked at the opportunity to acquire on a tremendous scale a full-blown distribution system in a marketplace and a culture where insurance, life insurance in particular, is held in high regard. The distribution system GE acquired included about 6,000 agents. It's going to be a while before that is deemed a successful transaction, but GE has invested a lot in terms of effort and people at some considerable expense, when you think about moving people to Japan and living there for a two-to-three-year tour of duty. I think that's a good example of the importance and value of distribution and perhaps the ability to separate that from existing companies.

**Mr. Stoddard:** Among our client base, we regard distribution as the key area where senior management is devoting a lot of time focusing their strategic thinking. If consolidation opportunities are great, everyone knows who does exactly what they want to do. Given the right opportunity, they'd be happy to consolidate their neighbor. However, they're really spending a lot of time thinking strategically about what distribution networks they need to deliver the product. When companies get larger, their ability to repeat on capital is somewhat constrained. Profitability is not being driven by underwriting better, by being more efficient on an expense basis, or by being bigger. Those things are taken for granted; the real competition is taking place based on the distribution networks.

If I'm a big insurer, should I be buying a securities brokerage network, or should I be like AIG and try to buy SunAmerica, in part for their products, but also in part for their distribution? The interesting point is that distributors are now realizing this, and we've had a couple of opportunities recently where groups of agents or distributors have banded together. They've taken either their loose affiliations or their agencies and they've decided to incorporate them and then put themselves up for sale. This raises interesting issues because they're basically coming to us saying, "We generate x amount of business for ABC big company. We think we can reproduce that, and we think we should get paid for that today. Therefore, we would like to put ourselves together and sell ourselves to someone else, and then attempt to move that business." This puts us as bankers in conflict because those are our regular clients. I think distribution will become a key trend and the distributors themselves are going to try to capture more of that value for themselves.

**From the Floor:** I happen to be one of Keith's refugees. I've been telling the story of Great American Life with \$6 billion in assets and annuities having a strategic plan that included getting more into life insurance with American Memorial and Loyal American Life, a couple of niche areas. You very often see where you have an opportunity. There isn't a marketplace, but an opportunity develops to bring in a new group that's been mostly operating together and become operational quickly. Keith has said how well this operation is going. It does make me wonder how long it might be before it becomes a candidate for sale, and I'm not sure I want an answer to that one.

**Mr. Wade:** That might relate to the diversification question. We touched on it a little bit earlier; the idea of companies growing themselves by either creating another line of business that they're not really in, or by acquiring a company to broaden their base. I think A.M. Best, in its ratings process, is currently looking for companies to be really broad-based and diversified in their operations.

**Mr. Stoddard:** From a banker's perspective, diversification is something that we have mixed feelings about. To the extent that diversification stabilizes earnings and enables big companies to be in more places, we think the rating agencies like that. The capital markets are willing to give people credit for being big and for having some stability in their earnings. We also have some concerns, though, about management's ability to be all things to all people and to be good in many different areas. I think there are examples of people who've expanded into the asset management business or other areas of insurance, where a number of the multiline companies have not been very successful. A diversifying acquisition that gives them distribution, gives them products, and allows them to sell outside the United States in ways that they haven't done here. I think that can have benefits, but I think

there are also some very significant risks to diversification that sometimes get short shrift.

**Mr. Jensen:** I guess I have to start by saying the life division's not for sale. We feel that diversification is critical from a couple of perspectives.

I think most of my colleagues in the senior management of our company believe that over the long run narrow product-type silo operations are not going to be successful. We need to go to a customer and offer a broad base of financial services in order to be competitive.

In the last three or four years we have really embarked on a very conscious diversification program, the life division being only one of those efforts. We have embarked on it from both an acquisition perspective and from a capital deployment perspective, bringing in expertise and essentially building a company and having them replicate the knowledge that they've gained elsewhere.

Perhaps it's because our core business has traditionally been fixed annuities, but we're finding, from a rating agency's perspective, that our sole focus in the fixed annuities, the absence of diversification, is an inhibitor to increasing our ratings. We're finding a more receptive audience as we diversify. One of the things they're telling us about the life division and other things is, "Let us watch it for a year or two, and if you pull this off, that'll have positive rating implications." Obviously that starts building on itself, because it'll give us access to markets with some of our traditional core businesses that we currently cannot access.

**Mr. Likkel:** I think diversification makes sense as a risk management tool. With the thin margins you have on many products these days, you can't really hedge a single premium deferred annuity (SPDA) portfolio and make a decent return. You combine SPDAs with structured settlements, with a successful life product operation. There are some offsets to the inherent risks in those products, and that makes sense.

Diversification historically seems like one of those things that, whether in favor or out of favor, is almost like a fad, especially with respect to noninsurance company owners. I think of Aegon selling off some of their operations. Weyerhaeuser had a financial services division, sold most of it off, and said, "We're a wood products company, and we're going to go back to our core strength, our core foundation." Is that something you see today or in the 1990s as an overall trend or are those just isolated examples?

**Mr. Stoddard:** I think there's less sort of willy-nilly conglomerate formation today than there was in past decades. I do think American Annuity Group's strategy of selectively building products that can be delivered to customers, in a customer-focused approach, is the right one. I don't think that's very different than AIG adding SunAmerica to their portfolio.

I'm more concerned with acquisitions that step a little bit further to the side. For example, I'd point to Northwestern Mutual's acquisition of Frank Russell this year at an extremely high multiple of goodwill at a peak of the market. You ask yourself, "Frank Russell, terrific franchise, but what does it really bring Northwestern Mutual that they don't have, that they really need to have right now?" There are a number of strategic initiatives that would have made more sense.

I think you can look at similar acquisitions. Either the deal structure should have been different to mitigate some of the risks, or the whole strategic thinking behind it should have been different in terms of whether they were the right buyer for that company at that price. Again, this is all a matter of degree, and we spend a lot of time critiquing transactions afterwards. I think selective diversification in areas that extend a company's core competencies makes sense, but some of the bigger steps are much more questionable.

**Mr. Robert C. Tookey:** I'd like to add another reason for mergers and acquisitions. It may belong in diversification, but frequently a company will buy another company because of its state licenses. It wants to expand into virtually every state in the country because it has developed a new product or a new distribution system that requires that. The deal issue would probably just be the retention of the state licenses and whether any special moves are required to get into the good graces of the insurance commissioners.

My question on discounted cash flows is a nitty-gritty question. What rate or rates of discount do you use for the cash flows and what is the rationale thereof?

**Mr. Stoddard:** That's an interesting question because I think you'll get three very different perspectives from the people on the panel here.

In terms of discounted cash flow, we're seeing a wide disparity of approaches in M&A today, and I think it's getting increasingly divergent. In the past I think most discipline acquirers focused on discounted cash flow. Today, with more public transactions, people are focusing much more on earnings per share, accretion impacts, and incremental GAAP ROE. There are many more buyers today who are motivated based on the GAAP implications of transactions rather than the cash implications of transactions. I think ultimately those companies fall back to cash,

but in terms of their near-term hurdles, it's much more GAAP oriented than it was in the past.

The first time I worked for GE Capital was during its run at Kemper. We thought there were some issues with the real estate portfolio at Kemper, and we wondered about the cash implications. Frankly, the GE Capital people came back to me and said, "Don't worry about the cash. We print cash. We mint cash. What we care about is what's going to happen to our GAAP earnings. If you can find a way to manage the GAAP earnings going forward, we'll make the deal work if otherwise it strategically makes sense."

In terms of the companies that are focused on cash-flow valuation, I point to Aegon as one that's very, very focused on that basis. Aegon is a Dutch company that trades at a very high P/E multiple. Because under Dutch accounting principles they can write off goodwill in the year of acquisition, virtually any deal they can do at almost any price looks good from an accounting perspective. They are, by necessity, forced to go back to statutory principles and to real discounted cash-flow valuations.

Generally, as we look at public companies until the recent stock market break, we would say that the cost of capital for those companies, on a weighted average after-tax basis and blending both debt and equity, had decreased from about 12% a few years ago to below 10% as recently as June or July. In June or July it was probably more like 9.5%, and for some of the bigger companies it was below that. For a company like GE Capital, which leverages their common equity 10 to 1, it was below 5%. In terms of what we see people using to pay in discounting actuarial valuations in acquisitions, we've seen numbers that have moved to 11% or less.

Everyone used to be looking for a 12% return and there are some that still say that they're trying to get a 12% return. When you actually get down to the numbers, you'll see that they're tricking the cash flows with tax benefits or other things that are really extraneous to the transaction but that they are somehow attributing to the transaction. If you really look closer, the more aggressive acquirers are discounting deals at closer to 10% more in the 10–11% range. I would guess that Met Life's acquisition of Security First probably was priced nearer the 8% range.

I think the other interesting question is, What cash flows are people discounting? I think the acquirers are willing to give lots of benefits of the synergies to the seller, and the cash flows that they are discounting include those discount rates.

**Mr. Jensen:** I'm really glad to hear you say that about Security First. I was a little worried while he was talking about having it move down to 10%, because we

looked at that. In our assessment, we thought we bid rather aggressively, and we were in single digits. We were not at 8%, and we just scratched our heads at where people were coming from.

**Mr. Stoddard:** I think 8% may be charitable.

**Mr. Jensen:** I do too. Right or wrong, we have not gotten ourselves onto the accretion bandwagon as the primary measure. Our primary measure is still the discounted cash flow, and if we can survive a return hurdle, then we look to make sure that we're accretive. Having spent 22 years in the accounting profession, it frightens me (though I recognize it as a reality) when the accounting drives the transaction. That strikes me as the tail wagging the dog.

From our perspective the discounted cash flow that we look at is whatever we've concluded our hurdle rate to be. Ours has declined over the last couple of years, but we basically take a hurdle-rate approach. Tom did mention that it's very easy to get the answer we want to receive. You get into the spreadsheet, and you give yourself more expense savings or more cross-selling benefit credit. By plugging that number you can make the thing come out any way you want to, which really says that you have to have some intellectual integrity around that.

I don't think choosing the discount rate is all that difficult. I think the difficult thing is determining what you are discounting and what components you have plugged in. Can you really achieve those? I'm not sure that there have been any really good empirical studies done to see how often people accomplish those wishes and hopes and dreams in terms of the synergy benefits. Yesterday I had the chance to sit in on a conference where Larry G. Mayewski from A.M. Best said that A.M. Best is going to embark on such a study and print a paper. An analyst from DLJ, as well as one of their competitors, both stood at the microphone right after he said that and just said, "We wish you luck. It's a valiant undertaking, and there's no way you'll be successful."

**Mr. Stoddard:** I have a number of clients who insist that their internal management requirements are returns that are in excess of the discount rates we've been talking about. One of them in particular has been told by their senior management that they have to get 16% returns on life insurance acquisitions. We responded, "You're not in the M&A business." Frankly, what they do is assume very, very rosy scenarios, and rather than discounting cash flows in perpetuity, they grow things at a rapid rate and then apply high terminal multiples. They end up with returns that look like 16%. When we do the real math, we come out to 10 or 11%. I think there's intellectual honesty and integrity and a disciplined acquisition strategy, and then there are other ways to simply justify doing the deal.



**From the Floor:** I'd like some comments about looking at the ability of a smaller company, whether a mutual company or a stock company, versus a larger company, that's trying to put a deal together where the smaller stock company's P/E ratio doesn't justify making the stock a currency. For the mutual company, certainly, there is no currency unless they're a neutral holding company fighting against a larger company that can leverage their stock into very cheap currency and do a deal.

As a side comment, I was recently involved in managing an unsuccessful/ successful acquisition process. I say unsuccessful because we didn't get the deal, but successful because we didn't get the deal for the right reason. We applied a discipline to the acquisition of a block of disability insurance (DI) business, and we sliced and diced that thing every which way but loose. We knew more about that company's block of business, literally, than they did. At the end of the day when I put my bid in and I put it in on two different bases I found that the successful bidder was more than twice what we bid. When we got into the post-mortem on the due diligence process, we found out that of the four companies that were involved, we asked the most questions, and the successful bidder asked the fewest questions. It's an interesting commentary, but I'm really interested in small company versus large company.

**Mr. Stoddard:** We've done post-mortems like that on a number of transactions ourselves. In some cases you'll find that the successful acquirer was just frustrated with other acquisitions, felt like they had to be aggressive, and paid up when maybe they didn't have to. In other acquisitions, because there is a larger acquirer, they can price a deal holding less risk-adjusted capital, and they can price it at a lower discount rate than other companies can. You'll be astonished by the price they can pay. However, by looking at it in a disciplined way, from their perspective the deal still makes sense, and they're being rewarded by the stock market for being aggressive.

In terms of how smaller companies and mutual companies compete, I think the answer is that there is no easy answer. One of the things that's motivating many of the demutualizations today is acquisition activity. I'm advising Canada Life right now in Toronto, and they've done nine acquisitions in the past six or seven years. We've worked with them in the U.S. in trying to do big and small acquisitions, and they just can't compete. They're an example of a company that's trying to hold to a disciplined cost of capital benchmark at something like 12%.

Other companies like Protective or GE Capital, who can access the capital markets on a moment's notice, can go out and borrow very cheaply, can issue their equity very cheaply, and simply can afford to price deals more aggressively. One of the

main reasons why Canada Life will demutualize is to put themselves on a better footing.

I think what you need is an active acquisition strategy where you very carefully identify who the key targets are for you. Then you spend time proactively wooing those management teams and talking to those management teams. It may take a period of years before something actually happens, but you want to put yourself in a position where you get the first look or an exclusive look.

I'd use UNUM's acquisition of Colonial as a good example. UNUM and Colonial, over a period of time, developed fairly close management relationships at the senior level through a proactive strategy that UNUM undertook in soliciting Colonial and talking to them. When Colonial decided to sell, the only party that they spoke to was UNUM. Although UNUM didn't get the company at a cheap price, they were the only party that had a shot. They put up a reasonable number, and they won the transaction. With some hard work, small companies that don't have as good access to capital and mutual companies can be successful in transactions.

**Mr. Likkel:** Just a quick comment from a person in the consulting business whose business it is to put together actuarial appraisals. It is good to hear there are still factions within some of these acquiring companies that do want to look at the long-term ROI, the return on invested capital on an after-tax, after-the-cost-of-capital basis. Obviously, the impact of leverage and the GAAP profile are becoming much more prominent in the analytic work involved.

The key comment that I'll throw out is that the quality of your underlying model is still very critical to the quality of the analysis of accretion or dilution of earnings. Obviously we spend a considerable amount of time working with a seller to understand the profitability and the risk profile of their business and to put together a quality actuarial appraisal and calculate numbers at whatever discount rate the seller wants. Those tend to be moving from an historic 12–15% to more of a 10–12% range. The interesting thing is that we spend as much or even more time working with the model after the original appraisal report in order to construct purchased GAAP scenarios. We work with the buyers and their analytics of alternative scenarios from a distribution and a sales standpoint, from a cost savings standpoint, and from a purchased GAAP accounting standpoint.

**From the Floor:** This is a follow-up question to the valuations section in terms of discounted cash flows and cost of capital. When you are valuing a block of business and you generate the cash flows, do you use a stochastic approach, or are you looking at two or three different deterministic scenarios? A second question is, I noticed that the discussion on cost of capital and discounted rate has been in the

order of the use of an absolute number: 10%, 12%, 16%. In view of the drastic changes in the Treasury rates we've seen lately, doesn't it make more sense to use a spread off the Treasury rate or off the term structure instead of using an absolute number in terms of arriving at a cost of capital or a discounted rate?

**Mr. Stoddard:** In answer to your second question, I think we talk about fixed numbers, but it's shorthand because there is more analysis that goes into it. People tend not to redo the analysis every time they do a deal. The way we look at it is that a properly leveraged life insurance company probably has something like a 25% debt-to-capital ratio. When you look at specific companies, you may see more or less. You may see some tax-deductible preferred stock in the capital structure that allows them to have more leverage.

One of the things that's benefiting the larger companies is that they're able to get away with more fixed-income instruments in their capital structure than other companies. The other component of the capital structure is the common equity, where we look at the dividend policies, the dividend growth rates, and what investors are expecting. We look at the capital asset pricing model, we look at dividend discount models, and we look at other models to back into a number of measures of what a company's cost of equity is on a current basis. We'll occasionally do a cost of capital study for our publicly traded companies. By reference we'll say to private companies, "You're similar to this company, or this is what other people are paying. These are sort of the target returns you should be looking for." We think there's not that much disparity in the life insurance industry from one company to the next in terms of what investors want. What investors are giving credit for is success, stability of earnings, and size. Those are some of the key differentiators in terms of cost of capital.

That means that a smaller publicly-traded company probably needs to earn something on the higher end of that, something more like the 12% range today. The larger companies with more leverage will come out being able to price things more aggressively. Then you get back to particular management teams having target rates. I, as an investment banker, can walk in saying that your cost of capital under my calculations is 8.5%; therefore, you should be willing to price this deal with all these optimistic assumptions at 9.5%. However, you're going to look at me and say, "Well, that's nice, Mr. Investment Banker. I have a business to run, and tomorrow when I go to the capital markets I may or may not be able to raise capital at those rates. I've also got to pay you a fee that you probably haven't factored in. I'm not sure whether I'm really going to be able to achieve that plan or not, so I want to build in a buffer." All of that drives to using round numbers in terms of how people are pricing things.

**Mr. Likkel:** I'll quickly address this. In response to his first question, the majority of appraisals that I've seen or worked on worked from a base case. It was a deterministic base case with a sensitivity analysis for key areas of risk or of potential divergence of views. When you do have a heavy emphasis on interest-sensitive business, I've typically seen a "New York Seven" or some variation of a set of interest rate scenarios. I've also seen a stochastic analysis in an appraisal consisting of 50 random scenarios, but my limited exposure is that's still in the minority in terms of the typical appraisal report.

**Mr. Stoddard:** Yes, I think we agree with that. We see people asking for that data, looking at them, and recognizing that there's an implicit cost. When it gets down to being aggressive in bidding, people just go with the base case.

**From the Floor:** I wanted to follow up on the second question the gentleman asked because I think it's a good question. One of the things that we had to do in our process, after the fact, was to look back at what the successful discount rate was and see if we could justify or rationalize a way to get down to it.

Depending on the risk profile of the business that you're trying to buy and the capital structure or the RBC structure of the company that's doing the acquisition, it seems logical to look at the cost of capital, including RBC, in the following way.

If I'm buying a block of health insurance or if I'm buying a block of life insurance, I'm looking at where discount rates have come from. I go back a little bit further because I remember when discount rates were 18 and 20 and purchase-to-GAAP ratios were 2 to 1. You may say that my risk-adjusted cash flows for the given block of business that I'm buying are  $x$  because the risk-adjusted nature of this line of business (whether it's interest-sensitive life or DI or whatever it is) is 11%. So I discount my cash flows irrespective of RBC at 11% when I build in whatever synergies I can. Then I look at the required RBC, and my company says that we need, for example, 250% RBC. I look at those discounted cash flows and I say, "If I don't employ that capital, and I don't deploy that capital, I'm probably going to earn no more than 8%. So if I earn 8 plus delta on that money, I'm doing better than I would have done if I'd let it sit fallow. Then I take a weighted average of the cost of capital discounted at 8 plus 50 basis points and 11 on the risk-adjusted cash flows, and I get a different profile. Now, if my company's RBC requirement is 300% or 275 or 190, I get a different answer. Is anybody using that approach?"

**Mr. Stoddard:** Absolutely, people are using that approach. One of the things that you, as a small company, have to compete against is people who, like Gary Wendt, can leverage their company 10-to-1 debt-to-equity. He can look at minuscule RBC and still maintain the triple-A rating at GE. People will look at things like that, but

they'll look at those things much more aggressively than you can, and that puts you at a disadvantage.

In terms of other companies, we work with Aegon very frequently, and I can tell you that Aegon, because of its ratings and because of the capital position, assesses lower RBC to acquisitions than most other acquirers do. They can be very conservative and disciplined in discounting the earnings off the in-force and the new business properly. When they get down to how much capital they need, it ends up being less. Because their cost of capital is really much cheaper than where they're discounting things, they can do deals like the Providian transaction and make a lot of money.

The problem for mutual companies like Union Central is being faced with that choice of how to deploy capital or whether or not to employ it at a marginally better rate than whatever it's earning now. If you were a publicly traded company, you'd have another alternative for that delta that you're talking about, which would be to buy back stock. The capital markets like that, because they like companies that are buying back stock. We're seeing a great amount of that in the banking industry now. We're starting to see more of it in the insurance industry.

Some of the very active acquirers, companies like Conesco that manage the capital markets extremely well, are issuing equity to do deals. When they've got excess capital sitting around, they buy back their stock to return that capital to the market. The market appreciates that discipline and, in general, is willing to reward companies like that with higher P/E multiples.

You may have a problem because you have capital and you have the choice of either using it or allowing it to sit fallow. Meanwhile, other companies have the choice of getting it whenever they have a good reason to use it, or not getting it or returning it when they don't.

I think the problem you'll face is that ultimately, if you ever decide to demutualize and go public, the public markets will mark to market your entire book of business. If you've priced your book of business to get 11–13% returns, you'll come public at GAAP book value or better, depending upon your growth rate. If you've placed your business so that you're getting 8% plus returns, the capital markets are going to say, "We assess a cost-of-capital charge to these companies at higher rates." You're going to come out at a discount to book value less a further discount because you're a mutual and you've got lots of policyholders and all those impacts.

That's what we're seeing right now with Mutual of New York, which we're taking public beginning this week because DLJ's their advisor on the demutualization and

a co-lead on the initial public offering. In the offering materials we've illustrated a discount to book value, and when people ask why, I think it's attributable to the ROE they're getting on their business the way their business has been priced historically. Now, many years later, the capital markets are bringing that to task, doing an implicit mark to market, and coming up with the real cost of capital for the company.

**From the Floor:** I can appreciate all of these issues. One that doesn't apply directly to us interests me, and that is the ratings issue. You've all alluded to it but not directly addressed it, and I'd ask you to directly address it, specifically that A.M. Best has been accused of having a negative small-company bias. Is this true from your perspective, and do you find this to be a fair assessment if it is true? If it is true, what can be done to mitigate it?

**Mr. Jensen:** One of the things that I do in our organization, other than do transactions, is manage the rating agency process. If somebody from A.M. Best were sitting here, they would probably respond with at least a no and maybe a qualified no to your question. My perception is that the answer to your question is yes, and I'm not sure that it's totally irrational. I think A.M. Best has modified their thinking over the last couple of years to focus more on financial security, and I think they have a perception that there is more room for shock absorption in a large organization than there is in a small organization. As a general principle that might be true, although I think we could all think of examples where that has proven not to be true.

A.M. Best has clearly rewarded some of the consolidators. The questions that we get asked as we talk with them about acquisitions focus on what the real synergies are. How are you making this any better than the two of you separately would have been? I think there are some acquirers who have a very good story to tell with respect to that, and it appears to us that A.M. Best is rewarding them. A.M. Best, I believe, has done a couple of other things over the last few years. They've really tried to not grade inflation out.

If you track ratings over the past five or six years and look at the proportion in various rating categories, it's quite clear that there has been a concentrated effort to find reasons to downgrade companies, and I don't think that was as true several years ago. They have also de-emphasized some of their quantitative analysis, and they're looking at the qualitative analysis. They talk to us in terms of "value-added." How do the things we're doing add value to the various stakeholders, policyholders, employees, equity holders, and so forth? All of this is a long way of saying yes, I believe there is a bias towards the larger companies, but much of the conversation we have with them has moved away from

the quantitative to the qualitative how good the synergies are within the organization. How much can you demonstrate that acquisitions, in fact, make you better than the two of you would have been on a stand-alone basis?

**Mr. Likkel:** There are some quantitative aspects. The cost of doing business today versus 10 or 20 years ago is different in terms of the baseline economies of scale. There are the valuation actuary, the illustration actuary, the whole market conduct compliance arena that's grown in the last five years or so, along with a plethora of asset management issues with the derivatives and the variety of asset risks that you face today.

There is some justification for managing all facets of the life insurance company well. My personal belief is that the key thing is whether you have a viable business in which you can demonstrate growth, and whether you can demonstrate operating your business within your expense allowances. I don't think there's enough credit given to a well-managed smaller company.

**Mr. Stoddard:** I agree with the comments of my colleagues. I'd point to one additional example, American General, at the opposite end of the spectrum. Earlier this year A.M. Best either downgraded them or put them on watch for downgrading based on their acquisition activities. A.M. Best's comment was that they didn't think that American General was going to be able to keep running on the treadmill as fast as they had in the past. Furthermore, A.M. Best said that American General's ability to get earnings growth from their core operations was less than satisfactory, and their ability to continue to go out and manufacture earnings by doing deals was subject to some doubt. I think we're going to see A.M. Best be skeptical of small companies but take a renewed critical look at acquisitions.

**From the Floor:** I had a follow-up question on the ratings issue. I'm curious as to how the capital markets react when A.M. Best either upgrades or downgrades. Do they typically validate what A.M. Best does, do they ignore it, or is there any kind of trend or statistical study that anyone's done?

**Mr. Stoddard:** I don't know that anyone has done a statistical study. I think it really depends on whether the business is ratings-sensitive or not. There are a number of companies that have strong ratings or weak ratings where the business is not as ratings-sensitive. If the research analysts have concluded that having an "A" or an "A+" from Best is important or that some of the annuities lines having an "A+" or an "A++" is important, or if they look at the Standard & Poor's (S&P) ratings, I think the rating agencies take that as a comment on the operating success of the company and their ability to generate new business going forward. They can look to it as one of the ingredients of success.

I don't think it otherwise provides that much information to the capital market, so we tend not to see big reactions unless it really conveys news about the operations or about something that the market didn't expect. For example, I think the American General downgrade I just mentioned was a surprise to people. It was a surprise to me, and I think people took note of that.

**From the Floor:** Here's a follow-up question. We have a perception that, when it comes to the capital markets, our S&P and Moody's ratings are the relevant factors when it comes to the distribution. The A.M. Best rating becomes a relevant factor, for example, if you're qualifying to make a proposal to a potential new school district. I'd be interested in your thoughts on that.

**Mr. Stoddard:** Yes, I think that's consistent with what I'm saying. I think most of the capital markets investors don't really understand A.M. Best's scheme all that well. They don't know how to translate a Best "A" into a subordinated debt rating, so they really want to focus on the S&P or the Moody's rating and probably a little bit more on the S&P rating at least that's been my experience. That's why I mentioned the research analysts when I was talking about the A.M. Best rating, because it's the equity research analysts who will look at the Best rating and translate that into the impact on the distribution. If the distribution can sell with whatever rating they have, then there's no impact. If it's going to impact the distribution, then the equity research analysts will factor that into their thinking about earnings estimates on a go-forward basis. Otherwise, I think the capital markets are much more focused on S&P and Moody's.

**From the Floor:** I'm a consulting actuary and I'd like to get some comments from the panel on the Y2K issue. It seems to me that many people who can profit from this are blowing it out of proportion. I'd like to hear from the panel on that particular issue.

**Mr. Jensen:** I don't really think people are blowing it out of proportion. From some of the due diligence that I've been on, I think that there are a number of subsidiaries of companies, or maybe even whole companies, that have not really come to grips with all this. I worry about our own government and how much they've really done. From looking at due diligence, I think there are some acquisitions and some companies that are going to unravel. I think the Federal Reserve and the banking system is very worried about some of the smaller banks. I don't think it's going to be the end of the world, but I think there are some very serious issues out there. Given all the companies in the world and all the different computer systems, I think we're going to see some surprising results even when 1999 rolls around and then when the year 2000 hits.



**From the Floor:** Can you tell me what is involved in the process of due diligence?

**Mr. Likkel:** Typically, the process involves the seller working with an investment banker and putting together a data room, sometimes in response to a request from a potential buyer. Other times, with the knowledge of the investment bankers, a very exhaustive set of documents needs to be assembled as part of this process. A due diligence team typically is put together for a potential buyer that involves all of the key disciplines financial, actuarial and legal. The mission is really to go in for a three-to-five-day period and review the information in the data room. At the same time you want to spend good quality time with the senior management team to really understand their perspective on the key issues and their ability to articulate the strategy. You try to absorb all of that information and come out with some confidence that you won't find any big, nasty surprises if you buy this company. The idea is not to determine whether the overall product has an 8 versus a 10% return. What you really want to look for are any big surprises that may take your 10 or 12% return to a negative return for a period of time.

**Mr. Stoddard:** As users of the due diligence, we would rely heavily on both bankers and actuaries, as well as our own people from various disciplines. What I really want to know is what I should pay, what deals with the economic side, and what other contractual issues do I want to deal with that may or may not have direct economic impact. You look at corporate kinds of issues. Are there contingent liabilities that I want the seller to keep or just a whole variety of things. The real challenge is frequently to make sure everybody understands that they don't have to do the full integration plan in the course of the due diligence, and that the real task is to find out how much is reasonable to pay and what other contractual issues we need to flag. And that is a challenge, to keep that balance, because people naturally will try and drill deeper than necessary to answer those questions.

**From the Floor:** Are there some areas that are more important today than in the past, such as the market conduct or 7702 compliance? I was in the 7702 Session (75 PD) yesterday, and we were discussing whether people really know whether they're complying with 7702 or not. That seems like it could be a very big issue. You don't want a \$400 million class action suit brought against you with some kind of market conduct problems.

**Mr. Stoddard:** The real difficulty is identifying the risks that people really haven't thought too much about yet, like some of those tax issues. There are gray areas and different kinds of solutions in terms of who bears the risk, how comfortable you are with the due diligence, and how strong the reps and warranties and indemnification will be in the contract. The real challenge is to spot issues like that when they're not apparent or when they're not on somebody's checklist.

With declining interest rates, I'm beginning to worry because we're starting to see more companies getting closer towards guaranteed minimums in bonuses, in annuity business, and in other sorts of interest-sensitive business. We've seen that in some acquisitions, not as much in the U.S., but in particular overseas. I'm aware of at least one company that's botched an acquisition recently and will have to announce a big charge to reflect some interest guarantees. My concern is whether we're going to see that kind of thing in the U.S. over the next couple of years. People today, even though it's not on an acquisition checklist, need to be alert to developments like that that may come back to bite them.

**From the Floor:** What level of interest rate guarantee would you consider important to worry about?

**Mr. Stoddard:** Again, it depends on the annuity business that you're looking at, the products, and where the low rates are. Given the high level of investment that's occurred internationally over the last several years, our current interest rates, and all of the trends in the capital markets, I would not be surprised if interest rates continue to decline another 100–150 basis points over the next 12 months.