RECORD, Volume 25, No. 1*
Atlanta Spring Meeting
May 24–25, 1999

Session 71PD
Use of Reinsurance in Mergers and Acquisitions

Track: Financial Reporting, Reinsurance
Key Words: Corporate Strategy, Financial Reporting, Mergers and Acquisitions, Reinsurance

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Summary: Mergers and acquisitions are often financed through reinsurance. Panelists discuss the advantages and disadvantages of the different types of reinsurance used as a financing medium.

This session includes:
- *The various uses of reinsurance to facilitate mergers and acquisitions transactions;*
- *The advantages and disadvantages of using reinsurance;*
- *The recent activity relating to the use of reinsurance.*

Mr. Jeremy Starr: On our panel we have Tim Gaule. Tim is here as a seller who used reinsurance to exit a line of business. Tim is currently vice president at Security Benefit Life where he serves as the appointed actuary. In 1997, Tim coordinated the sale of Security's individual life block to Kansas City Life. I'll represent one buyer's perspective. I'm vice president of reinsurance at Guardian Life. I head up Guardian's mergers and acquisitions (M&A) operations. Our last speaker will be presenting not only as a buyer but also as a matchmaker. He helps two companies seeking to enter into a transaction get the most efficient result. Jim Dallas is currently vice president of business development and the research actuary for RGA. He is responsible for oversight and development of all financially motivated reinsurance transactions, including assistance with M&A activities for RGA's clients.

Mr. J. Timothy Gaule: What I would like to do today is to provide an overview of the process we used to sell our life block in 1997. It was definitely my key project for a good part of that year. What I plan to do is to provide an overview of the transaction, provide some background information regarding Security Benefit, and describe the block of business as well as our reasons for selling the block. This block had become a relatively insignificant part of our in-force business, so selling this block wasn't as much an issue of "parting with our lover" as it was how to deal with a problem child. I also intend to discuss how we went about marketing the block, the interaction we had with the potential buyers, and ultimately why we decided to sell the block using coinsurance.

The block consisted of 100,000 universal life (UL) and traditional life contracts. The total statutory reserve was approximately $300 million. As already mentioned, we divested the block using 100% coinsurance. The reinsurer was Kansas City Life. The effective date of the

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transaction was September 1997. Security Benefit actually continued to administer the block until year-end 1997.

Security Benefit is a Kansas-domiciled company located in Topeka. At the time of the sale, Security Benefit ranked among the 25 largest variable and flexible premium annuity companies and had assets of approximately $6 billion. Our strategic emphasis within the last few years has been the retirement plan market, selling qualified annuities. We've been very successful in this area and have achieved a substantial amount of growth. In fact, at the time of the sale, the life block based on total in-force reserves represented less than 5% of our total block. We also market a family of mutual funds.

The traditional life block consisted of 65,000 policies, approximately $105 million in reserves, and a face amount of just under $1 billion. It included a variety of coverages, including term policies, which were issued primarily in the late 1980s and early 1990s. These term policies tended to have high average sizes. The traditional life block also included a variety of permanent life plans, including whole life, limited pay life, and endowment plans. Our product actuaries must have been very busy in the 1960s and 1970s, because there were definitely a lot of variations in these contracts. This presented a challenge in preparing the actuarial appraisal model because there were many plans that had just a handful of in-force policies. I'm sure that at one time the marketing people had great expectations for these products, which unfortunately didn't pan out.

The UL block consisted of 38,000 policies. The total amount of reserves for this block was approximately $200 million. The total face amount in force was approximately $3 billion. This block consisted of both flexible premium and fixed premium interest-sensitive plans. The flexible premium plans were introduced in the early 1980s. The fixed premium plans were introduced in 1986. The fixed premium plans also included a block that had been assumed from another company. There were many administrative issues associated with this assumed block. These administrative issues required a number of modifications to our administrative system, and in some cases the only way to correctly administer certain policy provisions was through manual processing. The fixed premium plans also contained many of the usual provisions offered with these types of contracts, such as vanishing premium and premium redetermination options.

As I mentioned previously, Security Benefit has achieved considerable success in the variable annuity (VA) marketplace. We felt that the disposal of our traditional and interest-sensitive life blocks would enable us to focus on our core VA and mutual fund business. The sale would also allow us to reallocate capital to those lines.

In preparing to market the block, our first step was to develop an actuarial appraisal of the block, and to do this we engaged Ernst & Young, LLP (E&Y). My staff was heavily involved in the preparation of the actuarial appraisal model. The actuarial staff at Security Benefit assisted in the development of assumptions and in-force files and the creation of the model on TAS™. The consulting staff from E&Y provided overall direction and support to the model building process. We used our existing cash-flow testing model as a platform off which to build our appraisal model.

We felt that we needed to use an outside firm, such as E&Y, to oversee development of the actuarial appraisal in order to give credibility to the numbers. In addition, the existing cash-flow testing model did not include many of the older traditional plans because they represented an insignificant portion of our total reserves. We therefore needed E&Y's expertise on how to best fit the older traditional life plans into the appraisal model. E&Y also provided guidance regarding the appropriate assumptions to use in the model. For the most part we used assumptions

based on company experience. In some cases (e.g., expenses) we used industry experience. Whenever we used assumptions based on industry experience, we relied on E&Y's recommendation as to what would be considered the appropriate assumption.

We retained the firm of Donaldson, Lufkin & Jenrette (DLJ) to market the block. One of their steps was, with the assistance of the staff at Security Benefit, to prepare a confidential information memorandum. This memorandum described the company, why we were selling the block and our ratings, as well as our financial position. This memorandum also provided summary information regarding the block that was not contained in the actuarial appraisal document, such as in-force statistics, descriptions of the major plans, distribution of the block by size, issue age, and issue year. The actuarial appraisal document, which was prepared by E&Y, described the results of the appraisal, summarized the key assumptions, and also provided in-force statistics for the model plans that were included in the appraisal.

We received preliminary bids from 23 companies. In soliciting preliminary bids DLJ indicated that companies submitting bids should provide information regarding their current ratings and financial position. That information was a key factor to us, and I'll mention again later. Price was not the most important issue, although it wasn't unimportant. We asked that any initial bidder provide us with an initial range for the estimated price they would be willing to pay for the block.

Prior to submitting their preliminary bid, the initial bidders had access to both the actuarial appraisal report, prepared by E&Y, and the confidential information memorandum, prepared by DLJ. Bidders were also asked to indicate how they would obtain the capital needed to support the acquisition. In addition, we wanted to know something about their track record in acquiring other blocks of business. We definitely intended to give a preference to companies that had done this before. Bidders were also asked to provide a description of their ability to provide quality and ongoing administration. We're proud of the customer service that we provide at Security Benefit. Our VA staff has received a number of awards for their customer service, and it was important to us that whoever purchased this block continued to provide quality ongoing administration.

In the offering letter DLJ indicated that Security Benefit expected that the transaction would be structured as a 100% coinsurance agreement. DLJ further indicated that the company intended cash to be transferred as the supporting asset. It was expected that the purchaser would create a trust into which supporting assets would be placed. The reason for the trust would be to protect Security Benefit in the event the purchaser got into financial trouble. The purchaser was required by the terms of the trust to put assets in that trust equal to the reserves.

Since we wanted to expand our annuity business, we did indicate a willingness to swap blocks of business. We indicated that we would give preference to a buyer who was willing to swap blocks. None of the 23 buyers offered to do that. I guess this demonstrates that everyone else wants to buy annuity blocks of business.

As I mentioned, there were 23 initial bidders. Once all the initial bids had been received, our next step in the process was to work with DLJ to select the final bidders. Final bidders were selected based on their financial position and rating, our perception of their ability to quickly transfer the administration, our perception of their ability to provide quality ongoing administration, and the amount of their preliminary bid. The seven final bidders were not the seven highest bidders, but their bids were definitely in the upper end of the range.

Once we identified the seven companies that had made it to the second round, the next step was the due diligence visits. Those visits occurred over a two-and-a-half-week period. It was definitely very time-consuming for many of us at Security Benefit. Our focus was to be as open and as cooperative as we could be. We felt we didn't have anything to hide and we dedicated

resources from marketing, actuarial, legal, administration, and the systems area to assist with these visits. Each visit lasted anywhere from one to two days. These visits were definitely a significant strain on internal resources. My day job at that time was to coordinate the due diligence visits, while my night job was to handle my regular duties as valuation actuary.

It's interesting to note that the buyers had a wide range of perspectives. There were definitely those buyers who were more interested in the appraisal results. In fact, six of the seven buyers used the same actuarial modeling software (TAS™) as my company. We were able to provide these companies with electronic copies of the actuarial appraisal model. I believe this was a real advantage to them because they could then run the model using the assumptions they believed were appropriate.

Some companies were very interested in the administration of the block. These companies wanted to fully understand any modifications that we had made to the system as well as any processes that were not automated. As I'll discuss later, we were interested in the buyer assuming any market conduct risk with the block. As a result, companies bidding on the block also wanted to meet with our marketing and compliance associates to discuss how the products had been marketed as well as any compliance issues.

There was a considerable variance in the size of the due diligence teams. Some companies brought in very large teams—as many as 14 people—and visited for a couple of days. The team that impressed me the most, although they weren't the final buyer, had only five people on their due diligence team. Their visit lasted only one day, and it is my perception that they probably learned as much or more than anyone else. This company had acquired other blocks of business and it was obvious that they had their act together and knew exactly what questions to ask. I really felt by the time they left that they knew as much as anyone else did about the block. There were some teams that were very detail-oriented. We had one team in particular that got into a lot of details about reserves. We spent a considerable amount of time explaining reserve calculations for relatively insignificant supplemental benefits.

During the entire sale process our philosophy was to be open and cooperative with the potential buyers. We did, as I previously mentioned, share electronic copies of the actuarial appraisal model. Working with E&Y in advance of the visits, we tried to anticipate the questions that we might receive from the potential buyers. In anticipation of these questions we prepared a number of displays that supported our assumptions. I believe these displays were very helpful and demonstrated that we had nothing to hide.

We tried to use each visit to prepare for the next visit. If there were questions that came up that we hadn't anticipated we developed additional displays so that we would be better prepared for the next visit. Any new information was also shared with companies that had already visited. In addition, we set up what we called a data room. In the data room we had copies of the policy forms for the major plans, actuarial statements of basis, lapse studies, mortality studies, expense studies, as well as documentation regarding our mainframe administration and administrative procedures. As I mentioned previously, we committed a lot of associates to this project, who all recognized this project as a top priority. Definitely there was a strain on internal resources. As these due diligence visits were going on, it was not only necessary to spend time with the team that was currently visiting, but to also answer questions from the teams that had visited previously, as well as to answer advance questions from teams that had not yet visited.

When it finally came down to selecting the purchaser, price was important but it was not the most important factor. Actually, the purchaser was not the highest bidder. The financial position

and ratings of the buyer were critical. The ability to provide quality, ongoing administration was also critical, as well as the buyer's willingness to accept the market conduct risk. We really wanted to be out of this line of business. You can't completely get away from it with a coinsurance agreement, but at least by the buyer's willingness to accept the market conduct risk, we knew that market conduct issues related to this block would not be an issue going forward financially.

The company we selected, Kansas City Life, is a Midwestern company. They're located in Kansas City and have a similar corporate culture to Security Benefit. An important advantage that Kansas City Life offered, as a buyer, is that they are located only 60 miles away. There were a few of our associates who were displaced as a result of this transaction. Kansas City Life actually hired a number of these associates. Being able to hire the former Security Benefit associates was a real advantage to Kansas City Life. Kansas City Life was able to bring people on board who were familiar with the products, especially the older whole life plans, which contained unusual features.

We also thought it was important to maintain good relations with our agents. Some of these agents are significant annuity producers. We recognize the importance of maintaining these relationships and try to work closely with Kansas City Life to resolve any issues. We feel it's to our mutual advantage to resolve any issues involving our former life agents. If these issues aren't resolved, quite possibly the agent will move not only the life business, but also the annuity business.

Kansas City Life also agreed to place the assets supporting the block in a trust. The trust agreement dictated what kind of assets could be placed in the trust. I know, for example, we wouldn't allow any Internet stocks to be placed in the trust. The trust agreement also specified that the amount of assets in the trust should be equal to the sum of all the reserves and liabilities required to be maintained by the company. The trust further specified that reserves were to be calculated consistent with the reserve requirements, statutory accounting rules, and actuarial principles applicable to the company under the law of each state in which the policies were delivered.

Prior to submitting the final bids, each of the seven final bidders were given a preliminary copy of the proposed coinsurance treaty. As part of their final bid, each company was asked to identify what issues they had with the proposed treaty. Once we identified Kansas City Life as the buyer, we needed to sit down with them and go through a series of face-to-face meetings to write a treaty that was acceptable to both sides. This was one more advantage to Kansas City Life's close geographic location. It made it pretty easy for us to schedule face-to-face meetings to work out the final details.

You might ask, why did we divest this business using coinsurance? I think one of the reasons was that we had previous experience with assumption reinsurance.
It was a small block of business of just a few hundred policies, and all that we were trying to do was to move these policyholders from a subsidiary company up to the parent company. The parent company was more highly rated. We couldn't get everyone to agree to do that because this block involved more than 100,000 policies. We just didn't see any way we could get everyone to agree to the assumption agreement. We also felt that by placing the assets in the trust that would provide the company with protection in the event the purchaser experienced financial trouble. Again, the trust provisions required that assets equal to the reserves be placed in the trust. We also had agreement from the purchaser to accept the market conduct risk.

The disadvantage of the coinsurance agreement is the fact that these policyholders are still Security Benefit policyholders. From the policyholder's standpoint, all that has happened is a transfer of the servicing address from Topeka to Kansas City. From the policyholder's perspective, any administrative problems were caused by Security Benefit. If this policyholder also owns a Security Benefit annuity policy, then there is a risk that the policyholder not only terminates the life policy but the annuity policy as well. This is why we feel it's important that both companies continue to work together. Our close geographic location makes it easier to work out any potential issues that arise.

In summary, the sale of our life block was a very involved process and caused a significant drain on internal resources. A large portion of my staff was involved with this project for almost a year. In addition, heavy human resource commitments were required for a number of months from many other areas in the company.

It was important to have a third party involved in the process, which is why we used both E&Y and DLJ. You need a third party to lend credibility to the numbers, plus, as a result of their previous experience with these transactions, a third party can bring experience to the table that the home office staff just doesn't have. It's also critical to commit dedicated resources to the effort, especially to the due diligence effort. Finally, in a coinsurance transaction, I believe the buyer and seller need to continue to work together after the sale.

Mr. Starr: My part of the presentation will focus on the whys and hows of doing a sale using reinsurance. Tim gave us a good primer on how one particular transaction worked. What I'm going to do is broaden that view by discussing many alternative ways to structure a sale of a block or company. A divestiture is really the end of the process. The process really begins with a company's planning process. This process can be thought of as having four major legs to it. First, the planner needs to get a view of the environment outside of the company. This would include not only financial industry-specific issues, such as HR-10 and the movement towards megamergers (e.g., Citigroup, Aegon/Transamerica, etc.), but also changes in purchasing habits of consumers and demographics.

The next phase relates to an internal review of your company operations. This review should include an understanding of not only what you do, but also how each particular operation compares to industry benchmarks. A planner should include a study showing not just administrative efficiency, product development prowess, investment capabilities, and marketing efficiency, but also how these interact to give competitive advantages in the different lines in which the company is involved. This review should give the planner a good picture of what the company does well and what it does less well. Combining these two analyses is one of the planner's toughest, yet most important tasks. In this phase planners must combine their view of the outside world with their view of what the company is most proficient at. The task is to find those niches where the company has clear competitive advantages and where it can take advantage of these characteristics.

Once that is accomplished, the next step is to figure out how to transform the company from what it is now to where the combined analysis dictates the company needs to be in the future. The problem is that while this analysis shows where the company should be positioning itself from an ideal perspective, the company is not starting out with a clean slate. The company has in-force business that it has been writing, which means that there are' potentially some blocks of business that do not quite fit into this ideal picture the planner has developed. This is where divestiture comes in. Divestiture is a potential answer to the question of what to do with those parts of the company that do not fit into the planner's vision. I will address how to accomplish a

divestiture and will wrap up with a couple of ideas that take a different perspective on how to use reinsurance and M&A.

The planning process is complete, and it is found that there are, in fact, either blocks of business or a subsidiary of your company that do not fit your vision of the future. Before deciding what to do with these entities it is useful to determine why they do not fit. One possibility is that this particular subsidiary was in a specialty line of business. For example, the plan calls for your future business to be geared towards the high-end market and the company currently has a subsidiary that's selling credit insurance. Since credit insurance typically is geared more toward the mass market, it is decided that this company does not fit with your vision of the future of the company. The decision is made to divest that subsidiary. The question now becomes how to divest.

Divesting a company or a block of business can take several forms. One possibility is that you can disincent your field force to sell the product. This could be done, for example, by lowering commissions or taking away club points to disincent them from selling a product. That will certainly reduce sales. The problem with this approach is you will still have new business being written and transacted in situations in which the agents are potentially antiselecting against you. In addition, management must still dedicate time and attention to dealing with these discontinued products. This may be an acceptable outcome in certain situations where alienating key agents is to be avoided at all costs, but in other situations the downsides cited above are greater than having goodwill with the agents.

Another step might be to stop writing those products altogether. That's fine, except the company must still manage the in-force business and deal with the agents who must service this business, and you still have to deal with the administration of this in-force business. This latter issue may not be a disadvantage if you're still writing policies with similar administrative characteristics to the discontinued line. For example, the company has two different UL products. One product is aimed at the mass market and the other at individuals with high net worth. The business plan calls for focusing the company totally on the high-net-worth market. If you continue to hold onto the administration of both UL lines of business, it will help keep the company's unit costs low. Thus, to stop writing the business but retaining the administration could be beneficial. This still leaves the company with many of the problems cited in the previous situation (e.g., diverting management attention away from the ongoing business of the company). Thus, while keeping the administration would be a desirable feature, in our example of a potential solution it does not solve the other issues cited.

One possible way to deal with this situation is to sell the block of business or subsidiary to help you both raise capital and get management's attention directed away from the lines of the past and on to those key niches that are to become the company's future. How are you going to divest? There are several different forms. One of them is through a merger. An example of how a merger can be thought of as a divestiture could be where a company would like to maintain certain ties to a line of business, but the company does not have all the right tools to be an efficient competitor. The company could then approach another company who has complementary capabilities. The two companies could then form a third company, which would be the survivor of a merger of your subsidiary and the other company. The resultant company could be set up to allow your company to still participate in this market, but on a basis where the new company is thought of as more of a passive investment rather than managed as an ongoing business. Sale of subsidiaries is another form of divestiture. Recalling the credit insurance example mentioned earlier, the parent simply sells the subsidiary.

While a significant amount of information could be developed on the above two concepts, I will focus on assumption reinsurance and indemnity reinsurance. Assumption reinsurance is possibly one of the worst terms in insurance. Assumption reinsurance is not really reinsurance—it is actually an outright sale of a block of business. In this transaction the policyholders are no longer the policyholders of the sellers but are now policyholders of the acquirer, and they are told that explicitly. The seller, in exchange for parting with all future rights to the profits/losses of the sold block of business, receives as compensation the present value of after-tax cash flows.

Indemnity reinsurance is an agreement between two insurers—the policyholders have no claim against the reinsurer. In fact, they usually have no idea that anything has transpired. The exception to not knowing that anything has occurred was discussed in Tim's presentation. In that case, the policyholders were told that there was a new administrator. Even in this situation, however, there is still no liability established between the administrator/indemnity reinsurer and the policyholder. Indemnity reinsurance, when used in divestiture, behaves similarly to assumption reinsurance. The seller in both situations receives the present value of after-tax cash flows and can get rid of the administration. Indemnity is different because: (1) the policyholders do not know that a transaction has not occurred (nor do your agents) and (2) there is a difference in how the two transactions are taxed (see below).

TABLE 1
COMPARISON OF FORMS

	Merger	**Company Sale**	**Assump. Reins.**	**Indem. Reins.**
Capital Received	Low	Low	Medium	High
Ongoing Liability	None	None	Near Zero	Full
Visibility to Agents/Phs	High	High	High	None

Before explaining the features of Table 1, there are certain assumptions the reader must keep in mind. First, assume that there are no synergies in the transactions being illustrated. If in one of the transactions synergies do exist, then the relationship to the other transactions will change. Also assumed is that there are no special tax elections made during any of the various transactions. With that in mind, the capital received by the selling company is the highest with indemnity reinsurance (that is due to some tax efficiencies discussed below). The capital received is the least under the selling-a-company scenario. This is caused by nonblock liabilities that arise, such as market conduct (usually not passed in a block- only situation), real estate in the target company, litigation against the company not related to the block of business being sold, tax inefficiencies, etc. In an indemnity policy, ongoing policyholder issues are typically retained by the seller(Tim's example is an exception). Assumption reinsurance is somewhere in-between.

Clearly when you sell a company, all the liabilities related to those policyholders are moved to the acquirer. In indemnity reinsurance these liabilities typically stay with the seller. With assumption reinsurance, most of this liability moves to the buyer. The only piece that does not move is in the case of some states that require that if something happens to the buyer (e.g., insolvency), the business will revert back to the original selling company. In these cases, there is some potential ongoing liability.

With respect to visibility, clearly all the transactions, with the exception of indemnity, are highly visible both to your agents and policyholders. Thus, if it is desired to have a situation where the transaction is invisible to your policyholders and agents, only the indemnity reinsurance

transaction provides that characteristic. This characteristic is most important when the selling company wants minimum disruption/adverse publicity with its publics (agents and policyholders). One example of when this would be true is when a company is selling a line of business but is going to continue using the same sales force for those businesses it intends to write in the future.

As with anything in life, there is no free lunch. Each of these transactions has certain issues that need to be considered when deciding which one to choose. With regard to assumption reinsurance, the fact that insurance is a 50-jurisdictional environment with 50 different sets of regulations makes this form of transaction a challenge to complete. There is an NAIC model on assumption reinsurance, but very few states have adopted it and even those states that have adopted it have added their own little nuances to it. The range of assumption reinsurance regulation goes anywhere from a state that requires preapproval of the transaction (Once the state regulators approve the transaction there are no further approvals that need to be obtained. A company only has to send out a certificate to the policyholders telling them that their new insurance company is X-Y-Z; attach this endorsement to your policy form) to a state that will require that both the state regulators and the policyholders explicitly accept, in writing, the new insurer.

Thus, there is a wide range of things that have to be planned. As a buyer, assumption reinsurance results in new direct policyholders. These new policyholders have all the issues that any direct policyholder engenders. This ranges from policyholder service to agent servicing and expectations. The policyholder expects crediting rates and cost of insurance (COI) rates that are in line with historical changes. These expectations also need to be managed in a manner consistent with the way the buyer calculated the purchase price; otherwise, results will differ from those anticipated. Managing these items consistently will not guarantee achievement of anticipated profit margins, but not doing so just might.

Assumption reinsurance also has tax inefficiency. Congress was heavily lobbied back in the mid-1990s by general industry to allow for the deductibility of goodwill in an acquisition. Congress responded by passing Section 197. Prior to Section 197, goodwill associated with an acquisition was not deductible for tax purposes. Under Section 197, general corporations were now allowed to deduct the goodwill over a period of 15 years. That was the good news. This new code section was passed in an era where any new tax benefit had to be balanced with an equal tax increase. The bad news is that the insurance industry is one of the areas of tax increase.

Prior to the passage of Section 197, the insurance industry was required to amortize the part of the acquisition price represented by the deferred acquisition cost (DAC) transferred. The entire acquisition price, in excess of that amount, was deductible at the time of the acquisition. Section 197 required that any purchase price in excess of the DAC piece would have to be amortized over 15 years. Assumption reinsurance is a purchase and therefore requires the use of purchase GAAP. How one deals with the various issues surrounding what assumptions to use in purchase-GAAP calculations can greatly influence the profitability of that block of business on an ongoing basis.

Indemnity reinsurance has issues that need to be addressed also. On the plus side, if the correct quota share is chosen, and correct varies from state to state, there are no explicit regulatory approvals that are needed. Also, because it's an agreement between a ceding company and an insurer, policyholder notifications are not required. Section 197 applies to assumption reinsurance. It does not apply to indemnity reinsurance; therefore, part of the purchase price will be immediately deductible up-front. The key concern with indemnity

reinsurance relates to coordination; for example, coordination of investment policies, coordination of setting the COI rates, and coordination of setting interest rates. Coordination is key because the direct writing company is still the one that is legally required to set all those items, even if the buyer is the one who economically owns the risk. This means that a mechanism needs to be developed so both sides can equitably meet their needs.

Both forms of reinsurance, assumption and indemnity, have two key issues in common—administration and investments. Administration can be thought of in Shakespearean terms: To keep or not to keep. The choice is there with either assumption reinsurance or indemnity reinsurance, as evidenced by Tim's company having an indemnity coinsurer take over the administration. Why would a seller want to retain the administration? One reason is to keep unit administrative expenses down. For example, if the seller is still selling similar products and the administration moves to the buyer, then the seller will have that many fewer policies to spread fixed administrative costs over. In turn this would raise your costs and make your ongoing products economically unappealing. Retaining administration could keep these unit costs under control and preserve your competitiveness on your ongoing block of business.

Another reason to retain administration relates to your agency force. If the sales force who sold the product being reinsured is one that the company is going to be maintaining, it may be easier to do so if you maintain the administration. Disposing of the administration is attractive if you have no similar products or if the agency force that sold this product is one that is not selling your ongoing business. Another example of why a seller would want to dispose of the policy administration is if the company has Y2K problems that have not been resolved. Being mid-1999 already, getting rid of the administration is probably a good idea.

Another issue is related to investment issues. If the block is assumption reinsurance or if you sell the company, then the buyer has to deal with investing in such a fashion that the expectations of the policyholders are maintained. In indemnity reinsurance there is the question of how to control the investments to the satisfaction of both parties. How do you reconcile the fact that, on the one hand, the direct writing company sold off all or a substantial portion of their economic interests in a policy, but, on the other hand, they are also the ones that legally have to set the crediting rate? To further complicate matters, whoever holds the assets is negotiable. Either the agreement could be structured so the buyer receives all the cash, or the seller could withhold the funds. In either event, the parties need to develop a method of investing so that the interest rate being credited to the policyholders meets or exceeds their expectations, but also meets the buyers' profit margins.

There are several ways it can be done. One way is that an investment team is created to make all the investments. This team would consist of investment professionals from both the buyer and the seller. This team would form a committee and jointly make the investment decisions. A second way of deciding how to invest for the sold policies would be for the seller to retain the buyer as an investment advisor. The investment advisory contract would set out the investment criteria that has to be met. Another approach is for each party to invest independently. As part of the reinsurance agreement, guidelines are established relating to the kind of assets each can invest in and how the crediting rate is going to be set. In that way the parties jointly decide how to move forward.

Up to this point our focus had been on divesting a noncore block of business or company—one that the company no longer wants to be involved in. What happens if the company needs to raise cash, and the company's plans envision all the lines of business that are currently being written as key to the company's vision of the future? Unfortunately, part of the company's vision is that policyholder service must be enhanced; that the company must have a presence on the

Internet and rebuild several other parts of its operations in order to better establish the company's niche position. What are the company's options?

One way of accomplishing these goals is to go out in the capital market and issue stock, bonds, etc. While this is a very accepted method, it can be time-consuming, expensive, and subject to the whims of the marketplace. Another way of raising capital is using reinsurance. You divest one of the company's strategic lines of in-force business via a quota share, indemnity reinsurance agreement.

There is no impact on the company sales force because they do not know of the transaction. The company has sold off the future profits on the portion reinsured, but has not otherwise impacted how the line is operated. Capital is raised in a relatively quick and discreet manner. Because the company is only reinsuring a portion of this business, the capital is raised and the company still maintains a share in the ongoing profits of the business.

What if selling a portion of the in force does not raise sufficient capital? One solution would be to then turn to the capital markets, but this time for a much smaller amount than the company would have needed had it gone to the capital markets without using reinsurance first. A different approach would be to divest ongoing business. As with the in-force block, this can be done by using indemnity reinsurance of a modest quota share of the company's ongoing business. Further, by structuring the reinsurance agreement to shift the bulk of the tax burden to the reinsurer a company can gain real tax savings. The agreement can also shift a significant portion of the impact of acquisition costs to the reinsurer. These types of agreements can be structured with either the reinsurer demanding the full profits on the quota share that has been ceded, the reinsurer demanding a very modest share of the profits, or something in-between.

In the case where the reinsurer only demands a modest portion of the ongoing profitability of the product, the ceding company has an agreement that actually increases the profitability of the product being sold. The company could use this enhanced profitability to either go straight to the bottom line or to increase the competitiveness of the product. The latter route could enable a company to maintain the level of profits demanded by management, while increasing sales with a more competitive product.

Mr. James W. Dallas: Before I get into my presentation, I wanted to mention one of the things that Tim addressed. He mentioned Kansas City Life as the reinsurer of the block. I think most of us would not consider Kansas City Life historically as a reinsurer, but because of the nature of the assumption reinsurance regulations that Jeremy went over, a lot of companies that we would not consider to be reinsurers are reinsuring blocks. The true meaning of the term *reinsurance* has gotten a little bit hazy. I like to think of RGA as a reinsurer. My part of the presentation is how reinsurers can help buyers who are reinsuring blocks through 100% indemnity reinsurance or assumption reinsurance, or whatever the structure might be.

Here's a little background on the current consolidation going on in the life insurance industry. Companies are positioning themselves to find a competitive advantage in the financial services marketplace. They're positioning themselves either as consolidators or strategic purchasers, or for growth for survival. Consolidators are companies that are looking to gain massive scale. They typically are going to look for blocks that are in runoff mode. Strategic purchasers are companies that are looking to add complementary businesses to their core lines of business. The companies that are just looking for growth to survive are looking to add existing business primarily with an eye on new sales.

Companies that are active in the M&A marketplace, at a minimum, form informal teams that analyze the potential transactions and execute those transactions. They typically partner with investment banks and consulting firms and specialized attorneys. But one specialist we think that is often overlooked is the professional reinsurer.

A reinsurer has three primary roles in supporting a company in an M&A transaction. There is the traditional role of managing risk, there's the role of helping to finance the transaction, and then there's the role of serving as an additional resource for the potential buyer. Let me go through all three roles.

Purchasing a block can lead to unforeseen risks. There's always the possibility that the block has lower-than-expected returns and there could be an' increase in the volatility of those earnings. Traditional reinsurance can help companies manage these risks. Here are three examples that help illustrate what I mean.

All these examples, by the way, focus on life insurance, but they can easily apply to annuities or property and casualty situations. The first example is a purchase situation where the seller may have had a higher retention limit than the buyer had. For example, the seller may have had a $2 million retention limit, but the buyer has only a $1 million retention limit. Through the use of reinsurance, the buyer can carve out the policies that are in between $1 million and $2 million and go ahead and put that into their bid, therefore maintaining their $1 million retention limit. And that can happen on both the in-force quote, on the block of business that's being taken over, or on a new business basis.

The second example is one where the seller's appraisal may be viewed to have some aggressive assumptions in it. In particular, mortality is often looked at as one of the more aggressive assumptions. By using reinsurance to get an outside view from a reinsurer, the buyer may be able to purchase or use reinsurance to lock in all or a portion of the mortality assumption that's being used. That way, the buyer becomes more comfortable with the assumption, and it's going to make the returns a lot more predictable.

These first two examples have very simple structures. In the first reinsurance treaty, there's a transaction from the seller to the buyer. Under most situations it's going to be a 100% coinsurance transaction or it could be assumption reinsurance, but I'm assuming that all of these transactions are 100% indemnity coinsurance. Then behind the buyer, you have a simple YRT transaction. Again, it can be on the in-force businesses being reinsured or on new business going forward.

The third example is where the seller may have four of the five lines of business they may be selling off. Maybe it's all life business, but all different markets or different marketing focuses, and they want to sell the entire package all at once. They don't want to carve it up, but the buyer may be only interested in, say, two of the four or five pieces. There may be one that the buyer just can't administer on an ongoing basis, so they want to try to get rid of that piece. The buyer could solicit a reinsurer to act on a retrocession basis to reinsure those unwanted pieces. This allows the buyer to go in with one package deal. In that way, the buyer's bid is going to be comparable to the other buyers, who are also giving a bid on the entire deal. If the buyer goes in with an offer on two out of the four pieces, but three other companies are offering a bid on all four pieces, the buyer's chances of getting even those two desired pieces are reduced. Use of the retrocession is going to be transparent to the seller. The buyer simply takes the reinsurer's quote, wraps it into the quote, and then gives the one entire bid to the seller.

Under this structure, the buyer doesn't have a YRT agreement standing behind it. It's going to be a coinsurance agreement from the seller to the buyer. Behind the buyer is going to be a coinsurance or modified coinsurance or cofunds withheld transaction—whatever can be worked out between the buyer and the reinsurer.

The second primary role of using reinsurance in an M&A opportunity is that of helping to finance the potential transaction. We believe that reinsurance can be used as an alternative or a complementary tool for financing a transaction. It offers flexibility that you may not have with other forms of financing, and reinsurance can be used to customize a situation to a company's particular needs.

To understand how financial reinsurance can be used to support an acquisition, I probably should give a brief discussion of the different costs and types of financial reinsurance that would be appropriate. The cost of financial reinsurance can occur under a wide spectrum. I like to think of what the cost would be for a financial reinsurance transaction as how much collateral would be involved in a given purchase price and where the collateral is the quota share that is reinsured to the reinsurer to support the initial ceding commission. In a reinsurance transaction, all of the risks have to pass between the ceding company and the reinsurer: mortality risk, lapse risk, and investment risk. Renewal expenses have to be provided for in the treaty as well. So what is solved for is the initial up-front ceding commission that the reinsurer is willing to pay to the ceding company. The spectrum can range from a high-collateral transaction to a low-collateral transaction.

For example, let's compare two different financial reinsurance transactions. Both of these transactions are going to give a $10 million ceding commission to the ceding company. However, an alternative one is going to require a quota share of 80% ceded to the reinsurer to support the repayment of that $10 million, whereas transaction 2 is going to require only a 40% quota share. The same ceding commission is provided under both transactions. To compare the cost and the impact of the two, the ceding company looks at how much of a renewal string of profit it has to give to the reinsurer to repay that $10 million. Because the 80% quota share is the higher amount of quota share, I would call that a high-collateral transaction, whereas the low-collateral transaction would be the 40% quota share.

Neither the high-collateral nor low-collateral transaction is going to be best for every situation. A high-collateral transaction may be preferred to a ceding company, and it primarily will provide statutory capital to finance the acquisition. Of course, all statutory risks are transferred, but the payback of the up-front ceding commission is going to be more predictable, and that's going to result in a lower cost charged to the ceding company for the business ceded. A low-collateral transaction may be preferable to a ceding company who is looking for long-term financing, and it will impact both statutory and GAAP capital. If a buyer uses a retrocessionaire to support an M&A activity with a low-collateral transaction, the ceding commission provided by the retrocessionaire will probably be equivalent to the price that the buyer of the block is paying to the initial seller of the block. The total ceding commission provided by the retrocessionaire will be adjusted for the quota share that is ceded to the retrocessionaire.

A combination of both high collateral and low collateral can be used to finance an M&A activity. It's possible to customize a reinsurance solution around any given company's needs.

Next, I'd like to compare reinsurance to the two primary alternatives of raising capital: debt capital and equity capital. Reinsurance can be used as an alternative or complement to debt and equity. A well-structured financial reinsurance program offers the following advantages to conventional financing.

In general, reinsurance has a minimal impact on a company's balance sheet because it is not viewed as a primary source of a company's capital. The reinsurer's collateral is going to be limited to the future profits of the reinsured business and not the general assets of the company. Therefore, it is viewed usually as the less risky tool. In addition, the reinsurance payback schedule may offer more flexibility than debt or equity.

Reinsurance designs can be built with very flexible recapture schedules. As an example, a company purchasing a block of business may be offering, let's say, a $100 million purchase price, but they may have access to capital of only $50 million at the time. Over the long run they'd really like the profits for most of that $100 million purchase. The buyer may be able to structure a reinsurance transaction where, up front, the reinsurer provides the other $50 million, but portions of that $50 million can be recaptured by the buyer over a two- to five-year period. That way the long-term profitability of most of that purchase will remain on the buyer's books. Usually there's a permanent layer of reinsurance. The reinsurer may require that 25%, or half of that initial 50%, remain on its books, so over the long run the $100 million purchase price really becomes, let's say, a $75 or $80 million purchase price.

Reinsurance may offer some flexibility with regards to size. A $1 million or $2 million transaction, as far as the amount of capital to put into a transaction, is not too small for a reinsurer to look at or to consider. On the other hand, debt or equity may have minimum size perhaps in the $100 million range to make it worthwhile to do an equity offering or a debt offering. By using reinsurance, a company can better match the financing of a transaction to their investment and it may eliminate the necessity to raise excess capital.

Again, reinsurance offers flexibility with regards to structure. Reinsurance transactions can offer coinsurance, modified coinsurance, YRT, coinsurance with funds withheld, or whatever it takes to transfer the risk to the reinsurer and satisfy the buyer's needs for keeping assets on their books, moving RBC around, tax efficiencies, whatever it may take. You avoid the capital market timing risk that you might have with debt and equity. Once you decide to go out with an equity or debt offering, it's difficult to pull back. You may have your equity offering the day the market drops or a debt offering the day that interest rates spike up. With reinsurance you typically don't have that kind of risk.

Last, compared to debt and equity, the transaction costs are usually a lot less for using reinsurance. External attorneys and investment bankers are usually not needed. Probably the biggest investment is giving the reinsurer some information and data, which will require an investment of time from your staff. This way, the reinsurer can do its own analysis of the block of business.

The third and final role that a reinsurer could help with an M&A activity is to provide an independent appraisal of that block. Typically, as Tim mentioned, the seller of the block will hire an outside consulting firm to perform a valuation on that block of business. There might be some aggressive assumptions in that valuation. The seller will want to try to get as good a price for the block of business as they can, so they're going to put some aggressive assumptions in there and try to get as much from the bidder as possible. The initial bids will usually be based on that initial valuation.

The reinsurer can help provide an independent opinion on the assumptions in the valuation. For example, the reinsurer could give an opinion on whether the mortality assumption is not aggressive enough or 'too aggressive. The reinsurer may have seen other blocks of business that are similar to the block of business being sold. Therefore, they could give some insights into

the mortality or the lapse assumption, and even give insights into the proper investments if the company is unfamiliar with the particular block of business and how to do a better asset liability matching of it.

And I'd like to add that using a reinsurer to help in an acquisition is basically free. The reinsurer's interests are going to be aligned with the buyer's because the reinsurer will only be compensated if the business is successful. There is usually not any kind of up-front commission or up-front commitment fee paid to the reinsurer in order to have the reinsurer take a look at the block.

To summarize, reinsurance can play three primary roles: that of traditional risk management, that of helping to finance the transaction, and that of an additional resource.

From the Floor: Because of the difficulties in assumption reinsurance, most transactions now are coinsurance. One element that you didn't really talk about in your transaction was the counter-party risk; that is, a credit exposure to the reinsurer that you have in a coinsurance transaction. Maybe you can comment on that.

Mr. Dallas: That's why you have the trust.

Mr. Gaule: That is why we have the trust. As I mentioned previously, the trust gave my company protection in case the reinsurer ever got into financial trouble. In addition, we specified the assets that could be placed in the trust. The assets included in the trust had to be cash, cash equivalents, certificates of deposit, publicly traded bonds rated A or better, preferred stock with an overall average quality of A or better, and commercial mortgage loans not in default.

From the Floor: OK, did you have marked-to-market and true-up provisions in the trust?

Mr. Gaule: No. The aggregate book value of the assets in the trust was required to be equal to required balance (policy reserves) as defined in the coinsurance agreement.

From the Floor: I think it's a general question: How do you handle the credit risk of the reinsurer under a coinsurance structure? If they fail, you're still on the hook for the benefits.

Mr. Dallas: I think what you're getting at is, what other assurances, beside the trust, can you put in the reinsurance transaction? Should it be' a market-value or a book-value trust?

From the Floor: The issue of overcollateral, frequency of marked-to-market, investment guidelines—all those things need to be considered.

Mr. Dallas: Right. Maybe requiring assets of 105% of reserves, which would be the overcollateral. I think those are issues that you can certainly work out with any buyer.

From the Floor: Tim, in your presentation you elected to go through the coinsurance route rather than the assumption route because of the probability that our policyholders would elect to do so. But once the coinsurance route had been satisfied, could there not have been a move to assumption by Kansas City Life at that point?

Mr. Gaule: That's true, but as far as I know they've elected not to do that.

From the Floor: From your point of view, were a lot of the policyholders who went to Kansas City Life also annuity holders?

Mr. Gaule: There were some. I don't know the exact percentage. I would estimate that it was under 10%.

From the Floor: So from a commercial point of view, you're probably better off keeping your brand name with those policyholders?

Mr. Gaule: That's true. Again, that's why it was important to my company to find a reinsurer that would provide high-quality, ongoing customer service.

From the Floor: Jim, there's been conversation about securitization for life insurance companies. This is not a reality currently in our marketplace, but do you have any comments on it vis-à-vis reinsurance? I know in the U.K. there's been some securitization of life companies.

Mr. Dallas: The difficulty with securitization, as I see it in the U.S., is the desire to raise capital without having it appear as debt on the books. You have to complete a risk-transfer reinsurance transaction first. That transaction has to be to somebody who is willing to take on those risks and then carve up those risks in such a fashion that the investors in the bonds are almost assured of getting their payback. Whoever is issuing the bonds either is comfortable with having debt on their books or can make it appear that there is no debt on their books. I'm not sure if that's what you're asking Joe, but that's where I've seen the difficulty in securitization.

Mr. Starr: I've heard of those kinds of transactions also. The way I've heard them being structured was for the U.S. ceding company to reinsure with an offshore company. The offshore company does not have to deal with our regulatory issues, so they are freer to take in risks and, in turn, repackage them into securities. I haven't heard of any actual transaction occurring on a U.S. life book of business, but there was an article on the subject in the *Reinsurance Newsletter*. I suspect that where there is securitization there must be a transaction not that far down the road. And, yes, that would be a great subject for a new presentation—securitization in an M&A transaction.