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Session 5PD
Buying And Selling Insurance Companies Internationally

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Summary: Over the last decade, many countries have opened their insurance markets to foreign interests. After the initial rush into many of these locations, a need for consolidation has developed. Players from North America and Europe are moving in and out of these markets, often competing with local companies for blocks of business. Attendees learn basic considerations and the process of an acquisition or merger.

MR. THOMAS A. JAROS: Welcome to Buying and Selling Companies Internationally. My name is Tom Jaros. I work with many companies both in Latin America and Asia.

One of the things I'd like to talk about today is the Las Vegas Principle. I am not sure how many of you have heard of the Las Vegas Principle. The first part of the Las Vegas Principle is that winners tell everyone. If somebody goes to Las Vegas, and they win big, they go tell everybody. Everyone is going to know about it, and hence, they're going to want to go to Las Vegas as well. On the flip side of the coin, for people who are less fortunate on their excursions to Las Vegas, they tend to be a lot less talkative. So you don't hear so much about the horror stories. I'm hoping that today we'll hear both about the good and the bad.

†Mr. Paolo Capaccione, not a member of the sponsoring organizations is a partner at KPMG – Financial Services in Milan Italy.

We have a series of very good speakers. Jim Toole, who has lived in Mexico for a number of years, will be our first speaker. For Europe, we have Bill Horbatt and Paolo Capaccione, and for Asia, we have Shu-Yen Liu.

Jim Toole has 15 years of technical and management experience in the United States, Australian, and Latin American markets. His background includes appraisal and due diligence work. He has done a lot of work related to mergers and acquisition activity, bancassurance, financial and strategic analysis, product development and pricing, cash-flow testing, demutualization of life insurance companies, U.S. GAAP conversions, and loss reserving. He is fluent in English and Spanish. He also has a working knowledge of Portuguese.

MR. JIM TOOLE: I am Jim Toole. My focus has been in Latin America. I've done over 15 transactions on both the buy and the sell side in Mexico, Brazil, Chile, Argentina and Colombia, which are the five major markets in the region, worth over $5 billion U.S. Frankly, these are quite small compared to transactions in the U.S. market. Put that in comparison with the Travelers, which is over $70 billion, and you can see that these are small. But these transactions are very important to each of their respective owners. A $50 million transaction is the smallest I've worked on. I have also worked on up to $1 billion most recently with the Adalgo transaction, and I can assure you each one of those thought it's the most important thing that you had to be doing, and you had to take care of the issues at hand.

Obviously it's going to be tough to capture a three-month process in a 20-minute talk. Although my focus is going to be on Latin America, most of what I say is applicable to any developing region. It's not as much applicable directly to United States, Canada or Europe, but if you're looking at Asia and other markets that are less mature, it is applicable. I will quickly shoot through what I see as an overview of the process, and part of what I am directing toward is more at the management level for people who aren't as familiar with the sale.

My personal favorite is the sell side. You build more relationships. Perhaps more people in this room do due diligence, and that is similar, but it's the flip side of the same coin. The issues are the same, but you have less time to deal with them. I want to talk about the role of the actuary, the sale process itself, for those of you who are unfamiliar with it, and why international M&A is different and why you have to be a little more alert, careful and cautious in doing international M&A. Finally, I want to address the more hard-core economic assumptions, actuarial assumptions and modeling considerations in doing different lines of business. How do you model a particular line of business? What's reasonable? What's not reasonable? And, finally, I'll address everybody's favorite, the determination of value.

What exactly is the role of the actuary? Why do you need an actuary in an insurance transaction? Why can't the investment banker just do it? Well, you need to build actuarial models to get that long-term nature of the cash-flow streams. Investment bankers deal with price to earnings ratios or price to book ratios. Most people don't feel that they're adequate to effectively capture the worth of an insurance company, and we, as actuaries, don't feel comfortable with it either, so we build a model trying to answer the question, "What is a company worth given a certain set of assumptions?" You have a choice of using projection software, spreadsheets, and given the timeframe and complexity of Latin American products, more than likely you're going to use both. You can't do everything in a TAS or PTS (two popular actuarial software packages) model. It's just impossible. So, you have to make choices based on the amount of time you have and how much money people are willing to spend to get it done.

It's also very important when you're building that model to do what we call a static and a dynamic validation. Those of you who do cash-flow testing know all about that. Your static validation is that at a point in time, your accounts, face amount, and reserves have to match up. You'd be surprised how hard that is in some of these developing markets. And then, going forward, even more difficult, how do you compare cash flows from the past period to the current period to a future period? What I like to do, and sometimes it happens, is if you can set a model date as of, say, 12/31, you can tie it to last year's cash flows, and maybe the next quarter's or the next two quarters'. So there's a way to get a really good anchor on where your model fit is.

The importance of the external actuary is not understood when people are purchasing actuarial consulting services. Why do we need somebody to tell us what our company is worth? Well, one reason is transparency, and another is that it's unbiased. Your external actuary presumably has done this numerous times, whereas your internal actuaries, although they've built a very good company model, won't be necessarily trusted by the buyers that are looking at your company. In my experience, the external actuary is, in fact, the most experienced member of the team. Your investment bankers are often fresh out of college telling you exactly what your company's worth. They don't know. You have a better sense of the market as the external actuary than the investment bankers. If this is your buyer's first foray into the market, they don't know a lot about it. So your job may, in fact, be to produce the first realistic multiyear planning exercise ever by your local management. And so the external actuary needs to provide a lot of guidance and leadership to try to bring the project to a successful conclusion, and that's hard to do.

Finally, the appraisal report is the summary of the work that goes out to buyers. It's a primary indicator of value, as well as of the assumptions backing all the values. It gives background on the market and company and distribution channels, as well as documenting the development of all the assumptions that go into the generation of the cash flows. And it should provide, in my opinion, enough information, like a good pricing model when you develop a product. You have all the assumptions. Pricing a company is not that different from pricing a product. All the same considerations are there. At the end of the day, you want to provide enough information to management so that they're comfortable that you've taken into consideration all the different elements, and they can more or less reproduce the results. Finally, your numbers need to tie back to the numbers in the investment-banking offering memorandum. Often, the investment bankers work independently from the external actuaries, and the numbers that don't tie in create a lot of confusion, and buyers don't like confusion. It creates uncertainty, which lowers price. So, keep consistent as much as possible.

As for the appraisal process, I can't emphasize enough that it's a team effort. You've got the investment bankers. You've got actuaries. You've got legal. You've got accounting. You've got HR. Everybody needs to be coordinated and focused. You've got to be able to present the story of the company in a consistent and focused manner. If your due diligence team goes through to different parts of the organization and gets different stories from different people, you're going to reduce price by increasing uncertainty.

I said I have a preference for the sell side just because you get to work longer with a group of people. On the sell side, the objective is to maximize the price. On the buy side, it's more to optimize the price while minimizing post-sale risk. And that's particularly with respect to the transfer of unfunded liabilities. So when you're going in on a due diligence, you're looking out for options, guarantees, things that perhaps the local company doesn't know are important, but you with your international or local experience have a better sense of. The sell side has a long time to prepare its case. The buy side does not. So, all things being equal, the seller is in a stronger position because they have theoretically perfect access to information. Theoretically, they don't know either. This increases the risk to potential investors because the seller could be hiding something. Inevitably, it decreases the price, and in order for the seller to maximize value, I believe it's in their interest to make the transaction as transparent as possible.

The sell side needs to anticipate what the buy side is going to want to look at and clean up any issues before they are identified. You also need to make provisions for any possible reserve deficiencies because the potential investor might discount those holes a lot more severely than you would in doing the work to quantify the amount. Finally, in order to encourage potential bidders to maximize their bid, there is a due diligence period afterward that allows them to go in and revisit everything in a little more detail with a larger team, and they get a chance to make adjustments to the bid based on any problems that might be uncovered during the course of review, not unlike a home inspection when you're buying and selling a house.

Only one party usually tends to due diligence, but I have seen situations where there's more than one. It's important in the due diligence process to look for not only undisclosed current liabilities, but to be aware of possible future risk. Fifty years ago, nobody thought of asbestos or environmental liabilities as being important, but they had these huge, long tails. There are contracts written in developing markets that aren't aware of things that we are now aware of through our own experience. Class action suits, while not common in developing markets, are a possibility in such familiar areas as sales practices in the United States and pension mis-selling in the U.K. You need to be aware that there are risks.

As to why international M&A is different, it's distance, communication and culture. You try to put 50 people on a plane and go to Thailand. It's hard work. Accounting, taxation, and reserving are all different from what you're used to. There are products and/or entire lines of businesses that you've never seen before. Your upper-level management doesn't have any idea what they are. And the buyers are not experts in local markets. So you've got all these hurdles to overcome to pony up the cash to make the purchase. The drivers of international expansion are different than the drivers of domestic expansion. What's going to make a fit and what's going to make a transaction work internationally are different than what they are domestically, and you have to take that into account when you're putting your offers together. And, of course, the lawyers and other predators are quite different in international waters than in local waters.

As for macroeconomic assumptions, typically the external actuary will rely on the investment banker to provide them, but everybody needs to buy into them. The investment banker, the external actuary, and the local company all have to say we're comfortable with that assumption. And in Latin America you need at least 20 years to calculate those present values, possibly more. In Latin America, macroeconomic projections of that duration are totally not reasonable. You're lucky to get three years on a Lehman report or something like that. So, you have to make something up. But you have to make something up that everybody can buy into. Typically what happens is you look for a curve that's going in the direction you're comfortable with for three to five years, and then you reach a long-term average over time.

The other thing you need to take into account is that there's a purchasing power parity (PPP) relationship between the local currency and the domestic currency. A fundamental assumption that I have seen in every transaction that I've done in Latin America is that PPP holds. It's something that I don't think has been written up effectively, but this is a fundamental relationship that allows you to make those currency conversions on the future cash-flow stream, making the assumption of PPP and the relationship between inflation in the local market versus the inflation in the domestic market. Then you have the additional complication of currency forward rates, that in some markets, they're different than PPP.

So what do you do? Well, you have to take into account either appreciation or depreciation of the currency in the timeframe that you're looking at. In Latin America, it's typically not more than a year. In markets like Japan, where you've got more data and more yield curves, you could look further into the future and take that into account in your projection. A depreciation of 10 percent in that first year would basically cut 10 percent off the value of your appraisal, so depreciations are things not to be taken lightly.

As for admitted assets and asset valuations, in developing markets they're very different in nature than those in developed markets. Most of the features that make assets difficult to value and project in developed markets, such as derivatives, asset-backed securities, and even simple put call options, don't exist in Latin America, but they have their own quirks, distinct character and risk profile. Everything that your classic asset tool and modeling system was built to handle for the United States doesn't work. You've got to find other ways to do it. Assets in inflation-adjusted currencies, or with yields linked to external indices, are among the simplest to model. Although trading volumes are thin, market values are usually available or can be derived from market data, but the volatility and inflation and trading ranges are more than domestic actuaries are used to considering.

Valuing assets for which the market is illiquid or does not exist poses much greater challenges. Large percentages of insurance company assets in Latin America are in illiquid real estate or in inter-company loans, some within very opaque corporate holding structures. You have no idea what the value of that is, and we're not just talking surplus, we're talking back in reserves. You can't do cash flow testing on stuff like that. Further complicating the issue is that reserves may be held on an inadequate statutory basis. So you might have to make a provision for increasing your reserves while decreasing your assets, which asks the question, "How much capital do you need to inject?"

There are reasonable approaches to incorporating existing assets and actuarial models. I have yet to see one in Latin America using a fully modeled approach in an asset modeling system. It just hasn't happened. Typically, people put them in spreadsheets and run them out. Asset durations in the region are very short. A couple years and they're gone, and everything is a new money rate.

Projections are almost always performed on a nominal basis in the local currency. I've seen them done other ways, but they don't always work. The values can be distorted. Modeling on a real basis can have a negative impact on the valuation if the model contains inflation-indexed products. If you're modeling on a real basis when these products are having increases in premiums and face, there's a lot of distortion that can occur. So, performing projections in local currency facilitates model development and reconciling the model to historic experience.

Risk discount rate is something that a lot of people get excited about and think you can prove that one is right. I've read everything I can in every industry from manufacturing to financial services to *McKinsey Quarterly*, and nobody has the answer on this. It's easier to do domestically, but internationally, forget it. You're basically coming up with a number that you're comfortable with and that gets you to the answer that you think is competitive. In theory, the risk discount rate is the risk-free rate increased by the risk premium necessary to compensate the investor for the risk that actual returns might vary from that expected. In practice, risk discount rates vary greatly between bidders based on strategic considerations of the use of capital and how much they want to enter the market—cost of funds, return expectations, internal hurdle rate, tax considerations and competitiveness of the bidding process.

You can justify this using capital asset pricing model (CAPM), but discount rates are, in effect, elastic and are influenced by far more mundane considerations than the calculation of risk-free rate, country equity risk, and industry data, which doesn't exist in the country you're buying in anyway. They've been falling in Latin America in recent years mainly because of the improvement and the linkage between the Mexican market and the U.S. market, but also because the number of high-end, high-quality properties available in the market is declining. As good companies are bought, there's less and less supply. Your risk discount rate declines, or that's a tool that you use to justify it.

As for discounting cash flows in Latin America, suffice it to say that real discount rates are used. Nominal discount rates are appropriate in a market where inflation is thought to be level, but if you've got an economic environment that you're expecting to improve, and your inflation is declining over time, starting with a nominal rate that's level over the period inappropriately penalizes earnings in later years. By using a real discount rate, you get a more even distribution of the present value there.

As for actuarial assumptions, you have to be very creative. The assumptions are developed in close coordination with the company you're working with. The external actuary has to balance the goals of the company with a realistic assessment of the chance of achieving them. It's your job to moderate, and you're trying to uncover hidden value while scaling back on aggressive targets to achieve a balanced and defensible end product. Your best data sources are pricing and budget, but in developing markets often pricing is not realistic and often budgeting doesn't tie. Tying reliable data at the level of detail needed that is internally consistent with the company's financials is, to put it mildly, a challenge, and more often than not the process is iterative. You've got to move back and forth several times to get to a point where you're comfortable. It takes a lot of time. Typically you want to rely on audited financial statements because that's your best bet. Quarterly financials are less reliable. A lot of times the numbers are just put in. So really end-of-year financials are the best ones to go with.

Premium projection is probably the biggest, most important driver of value that you're working with and also the most controversial. This has to do with your distribution channel. Basically the premium projection is a proxy for defining what your distribution channel is worth. It's something that's going to get a lot of scrutiny and is often not paid enough attention to. And then there are other quirks where you look at an existing distribution channel and imagine a new one.

Expenses are very challenging. They can be modeled in a number of different ways. It's difficult to establish appropriate expenses even at the line-of-business level because functional expense allocation is not typically done in developing markets or

Latin America. The challenge is to find measures that are appropriate and that everybody on the team is comfortable with and at some level match up to what you're modeling. The other problems that you have are dealing with overhead expense and Are ways to layer that into your model?

Many companies in the regions I work in are part of banks or manufacturing firms, and have cross-holdings. When you get these cross-holding structures, not only is your capital and surplus a mess, but your expense allocations are a mess—you don't know where your real expenses are if you're covering up for somebody else's losses. So it's very hard, and you have to make a guesstimate based on your best estimate and international standards.

And, finally, on the subject of buy-side expenses, be very cautious when you're trying to project future synergies and savings because typically you're adding layers of management and layers of reporting structure. You're not saving money, so be careful of that.

Commissions are much easier to deal with and are much better documented, but be aware that there are often multiple layers of bonuses and things like that that are more manageable than what is strictly in the contract. Talk to your distribution people.

Mortality in Latin America is not as important a factor, and in some countries, and in some products, mortality is 10 perent to 20 percent of premium. Your big costs are commission and expenses. It's not a number that your company necessarily has studied, and it might not even be that important. A 10 percent variation in your mortality means very little to your bottom line. So, it's not something that necessarily you need to get all bent out of shape about, whereas lapse and surrender is an important number. More often, on the mortality, you do have some company information on it, or you can get them to provide you the data to do a reasonable experience study. Year-end policy account extracts can do that.

You have to do technical reserves on the statutory basis of the local company. Notice that your assets are done on market value when you do a transaction, but your reserves are done on statutory. So there can be a bit of a disconnect, and fair value accounting is going to impact the way valuations are done in the future. Right now, any excess profits that are in the reserves come out over time, and it is hit by discounting anyway.

Dividends are not as big a deal in developing countries as they are in the United States. It is just not the focus. As for options and guarantees, be sure to look at the contracts to make sure you're not giving away something you didn't know. Reinsurance is typically not important in Latin America. There isn't enough mortality risk. So it's not as big a deal as in the United States.

Cost of capital is something people like to argue about. Typically the appraisal will present using the specific minimum capital of the country you're working in, and they let the buyer decide where they want to put it. There are arguments to go different directions, but that's what's done. As for taxation, you can provide profits on an after-tax basis using local market standards, but if your buyer is from an international perspective, and if they have a local subsidiary, they might be able to utilize loss carry forwards and other factors. There's going to be very different valuation of tax depending on the position of the buyer. In my opinion, it's better to leave that open and let the experts on the buy side decide. It's kind of a put option to the buyer.

As for modeling, suffice it to say in these markets you're going to see a lot of different things that you didn't see before. You're going to have to model them using spreadsheets. As for determination of value, there are basically three components. One is adjusted book value, and that is kind of an art. Look at your balance sheet and try to decide how to make those adjustments. Another is the value of the existing business, which is essentially your embedded value, but on an appraisal the discount rate that you're using is far higher. If you looked at an embedded value in England, they're using very low interest rates. But in Latin America you're using 10 percent, 12 percent, or 15 percent to discount, and there's that big difference there. Finally, there is the value of new business. You have your installed distribution capacity and your alternative distribution channels or the imagined distribution channels, but on the other hand there is a brand value to the firm that you're buying. The idea is that the alternative distribution channel is a way of capturing the brand value of the company, like Harley Davidson selling liquor now. Not that MetLife would want to do that, but they could. Then, finally, there isn't going to be a big difference between the appraisal value and the market value for a number of reasons.

Concluding, there's no cookbook. You've got to rely on experience, communication and teamwork. We haven't even touched on the post-transaction corporate form and its impact on your negotiations, on the risk of the transaction, on price. Is it a joint venture? Is it an acquisition? Is it a merger? Is it an alliance? All these things have a material impact. And then reporting bases—U.S. GAAP versus embedded value versus IAS. And, finally, the actual appraisal didn't even get to the issues of the integration, which is where your bigger risk is. Do you integrate effectively? Retention of talent, maintaining production and recognition of cost savings and synergies are all important considerations.

MR. JAROS: Our next two speakers are going to use a tag-team approach. Bill Horbatt has been practicing actuarial science for more years than he can count. He's been doing this before the advent of the personal computer, and he has most recently been working with the European market. We're also very fortunate today to have Paolo Capaccione from Milan, Italy. Paolo is not an actuary, but he has been working with insurance companies, and he is starting a practice for actuarial services in Italy.

MR. HORBATT: We want to focus more on the cultural environment and what's actually occurring in Europe. We have a reasonable presentation of what's happening in Italy, a bit of what's happening in Germany, a bit in the U.K., and we hope that perspective is what we'll share with you. It's not the detailed actuarial side, but as any of you know who have worked in M&A, the detailed actuarial side seems to get lost a lot.

Our focus to some degree is going to be on the Italian market because we've got is somebody who lives, eats, breathes and thinks Italy. If you looked at the top 20 M&A transactions worldwide, you would see that the European transactions really are significant, and they're significant whether you're thinking of the Europeans as buyers or as transactions occurring in Europe.

In Europe, they're basically selling savings products, starting out originally with endowment-type products. There's been a tremendous movement to unit linked, particularly in the southern European countries. All the products are being driven by tax subsidies. That's true in Italy. It's true in France where I worked most recently. It's true now in Germany where they've come up with a privatized social security complement, if you will. Cross-holdings are a way of life. Multinational branches are quite common. And embedded value has made tremendous inroads in Europe. It's taken for granted in the U.K. that you can't publish your financial statements without an embedded value if you want the analysts to take you seriously. As the continental companies are selling their shares in the London market, they're being put under that same pressure. So we're seeing more and more embedded values being produced, sometimes not too well. Do you recall that story that Federico was telling us about two weeks ago?

MR. PAOLO CAPACCIONE: The name of the Italian company was Alliaenza Assicurazioni, a group of Allianz, and they published the embedded value. When they made a mistake about the value, the stock price went down very quickly.

MR. HORBATT: They went down 20 or 30 percent in one day because they misstated their embedded value. Basically, the company calculated embedded value and published it. The more common practice is that somebody secretly calculates embedded value for two or three years. Once they figure out that maybe it's not too bad, then they publish it.

MR. CAPACCIONE: It's not very clear if it was just a mistake or something else.

MR. HORBATT: Good point. Paolo wants to talk a little bit about the size of the Italian market.

MR. CAPACCIONE: The Italian market is not very big, in terms of the number of the insurance companies that are actually publicly owned in Italy. The number of listed companies is much smaller than the number of insurance companies.

MR. HORBATT: Is part of that because a lot of companies are closely held in Italy, that they don't feel a need to be on the stock exchange to raise capital?

MR. CAPACCIONE: Yes. Old insurance companies were public not very many years ago, and the reason for the change is the emergence of mutual insurance companies. So, it's a market that is changing, but it's changing slowly. Of the top 15 insurance companies in Italy, Generali Assicurazioni is the only one that is a multinational. It's the only insurance company that's operating globally. The three largest insurance companies are in the same group. They represent 22 percent of the market, so it's a very concentrated market.

MR. HORBATT: An interesting thing about Generali is that the majority of their actuaries work outside of Italy, in foreign subsidiaries or branches.

MR. CAPACCIONE: Yes. The other interesting thing to note is that there are a lot of bancassurance companies. Seven of the top 15 insurance companies are bancassurance.

MR. HORBATT: That would be consistent with generally all the Mediterranean companies. Bancassurance is now the primary sales vehicle. It's true in France where I've been working most recently. It's true in Spain. It's true in Italy. However, I think bancassurance might represent only 20 percent of the business in Germany.

MR. CAPACCIONE: In Italy, property and casualty has been the most important business for insurance. This business has grown a lot. And the expectation is for more growth in the future.

MR. HORBATT: One thing you have to keep in mind is the aging of the European population. Countries like Italy are at a stable population just because of immigrants. I think Spain is expecting net declines in population because the births are not replacing deaths. So we're seeing in essence the baby boom generation maturing and putting money into savings.

MR. CAPACCIONE: What about the life market? Most of the products in the life market are financial products. Index and unit linked products are about 54 percent, 55 percent of the products. Ninety-five percent of life insurance policies are group policies and only 5 percent are individual policies. As for the distribution channels, the bancassaurance channel is 60 percent of the distribution. If you added financial consultants, who are about 10 percent of the distribution, you can see that most insurance products in Italy are from clients for financial products. Their expectation is for financial revenues, not for coverage.

As for the composition of the portfolio investment, 51 percent of investments are in bonds, which is less than in the past. In Italy, in the past, you could buy government bonds paying 12 percent interest, for example. The remainder of the investments is split up among equities, real estate, pension funds and other investments.

MR. HORBATT: That's an interesting thing. Another common characteristic of Europe is that historically companies have invested in government bonds, primarily their own government's bonds, of course.

MR. CAPACCIONE: What about M&A?

MR. HORBATT: What I thought we'd do is just throw out some interesting transactions. I picked them because they were interesting to me. I hope they're interesting to you, too.

Equitable is one of my favorites. It's basically a U.K. company, and they were going under the revolving capital principle. Being a mutual company, you could take two different approaches. One is that each policyholder contributes to the equity of the company. Under the other approach, once a block of business is gone you expect that block to have left no capital. So, Equitable was going along crediting real high interest rates on policies in terms of the bonus, and they knew they had a problem when the policyholders exercised their guaranteed annuitization rights. The mortality assumption was too high. Longevity had improved. The interest rate assumption was too high. Interest rates came down. So, Equitable said, "Well, we're a mutual insurance company. Let's just change our bonus formula. Let's give policyholders less cumulative bonus if they elect the guaranteed options." Unfortunately the courts in the U.K. didn't buy it. They said that if you gave somebody a bonus in the past, that's their bonus, and they can take that whole amount and apply it to whatever guarantees you've made. The net result was that Equitable basically went belly up.

Halifax just came in with its approach where, in essence, it did an asset purchase of Equitable instead of a company purchase. They fully reinsured on an assumption basis the unit-linked business that wasn't subject to this problem. They purchased the back office, and Equitable has one of the most efficient back offices in the U.K. They leased it back, of course, so they get reimbursed for it, and they purchased the goodwill, the right to market to those customers. They paid approximately half of what their ultimate price is up front. The rest is contingent upon the business working. I thought that was a pretty creative solution. We haven't seen it anywhere else, but it was interesting to watch.

Another interesting transaction involved the Lloyd's bank group. They purchased Abbey Life Insurance Company back before most of us were in the business, and just recently they bought Scottish Widows. The Abbey Life wasn't really a great operation, but it was their bancassurance insurer. So they said, "Well, we can run off the existing business. That'll be fine. But what are we going to do with this direct agency distribution force?" They sold it. A nice thing about this is that it gives you a feel for how things are being priced in the U.K. because they paid about the same amount as a purchase price as the annual premium volume or new business production of that direct agency sales force. They also disclosed that they thought the sales force would add 20 million pounds to their embedded value each year. Now let's return to Italy.

MR. CAPACCIONE: In Italy, there is a trend regarding M&A deals. The number of deals involving insurance companies is growing very fast. Most of the deals are insurance versus insurance, rather than insurance versus banking or insurance versus other financial companies. Also, very few of the deals involve foreign companies. Most of the deals are for inside Italy, in which both the buyer and the seller are Italian insurance companies. The deal normally is for the minority of the capital.

MR. HORBATT: So that means you're not getting control of the company. It's like a chess game, isn't it? You're buying a piece, then you're negotiating with somebody else to get another piece.

MR. CAPACCIONE: At the moment the market is very closed, and the technical elements are not necessarily that important for the pricing work.

On the list of the top 10 M&A operations between 2000-2001, one is Fondaria and SAI, which is closing just today. Commerzbank and Generali is a story something like a German M&A. INA and Generali is not a funny story in Italy with a merger. Monte Paschi Vita is one of the bancassurance companies listed in the top 15 and was acquired from MPS. And BNL Vita and Llnipol is something that is related to the story of INA and Generali.

MR. HORBATT: This is an interesting tidbit if you like to follow the soap opera that is Germany. I did a little research. I went back 15 years to see what was said in the press about the German market, and I love this statement: "Deutsche Bank will later today announce its long-expected move into the life insurance business." And here we are 15 years later, and what do we know? Deutsche Bank has sold every element of direct writing. No insurer can even negotiate a joint venture partnership with an insurer. What happened in the interim? Well, going into the soap opera again, it appears from the press that Allianz was supporting a merger of two banks, Dresdner and Deutsche. Deutsche Bank is the number one bank in the country and Dresdner is number two. Part of this merger deal was to create this Bank 24, which was going to be the merger of the retail networks. Now Allianz was worried. It was worried because they knew that in other countries like Italy, business moved over predominantly to unit linked, to equity products, and they knew that Germans were not buying equity products from their agents. So this was their hope. The hidden hand behind this merger was Allianz. And they were going to give up all their interest in Alliance and Deutsche Bank in return to get some Italian operations in Deutsche Bank's subsidiary.

In conjunction with this, Generali attacks and exchanges interest in Commerzbank. Generali believes in bancassurance, too, and they said they are not going to be knocked out of the German market. Meanwhile, following the same strategy, Allianz does some restructuring with Munich Re. As you remember, German corporate structure dates back to the Second World War, and it had a lot of interrelationships. Everybody owned a sliver of somebody else. Schroeder changed the German tax law to eliminate what I believe was a 50 percent tax on the capital gains that you would incur if you sold your interest in another German company. They eliminated it. As a result, a lot of companies started thinking about getting rid of their investments in other companies that were not core or strategic to them. Allianz and Munich Re cleaned up some cross-holdings. In two cases, Munich Re totally left Allianz of America, and, similarly, Allianz totally left Munich Re's United States non-life subsidiary.

Well, on April 5, 2001, the deal crashes. It seems that the investment banking arm of Dresdner Bank, which is the smaller of the two banks, was going to get gobbled up and basically disbanded by the Deutsche Bank investment bankers. For some reason, the chairman of Dresdner just couldn't deal with it, and the deal cratered. At the same time—this is really a quick reaction—Allianz announces a friendly bid for Dresdner Bank. They continue their restructurings with Munich Re, and they successfully complete it. Now, the interesting thing is their hopes were to increase bank life sales by a factor of five, and they've reported that they've actually achieved a factor of four so far. The independent analysts think they could increase non-life sales by as much as a factor of 30. We don't know what's going to happen, but they're progressing. Dresdner Bank, as I understand it, isn't doing too well financially, but then what bank is?

MR. CAPACCIONE: This is a story of the merger between INA and Generali. I don't want to say that this is the true story or an alternative story, only that it's just one point of view. INA is one of the oldest insurance companies in Italy. There was privatization in Italy because of a European commitment. So they decided to sell on the market part of the capital and start with privatization in terms of a style of management. New management came from a bank. And which bank? They came from BCI, which is a bank very close to Mediobanca, the very powerful merchant bank in Italy. Everything passes through Mediobanca in Italy—or it did in the past.

MR. HORBATT: It's as if they had a monopoly at one time. If you were going to do any M&A, you had to go through Mediobanca.

MR. CAPACCIONE: You don't want to go against them, and there is a strong relationship also with Generali. The general director becomes CEO after three or four years at INA. After the change, the business strategy of the company is that INA is becoming more of a financial institution, more like a bank than a traditional insurance company. They change the risk profile of INA. They do some deals on the market. They buy one of the most important banks. After three or four years, there is a spin-off of the real estate, and they sell part of the real estate to a big company that operates in Italy, so they get a lot of cash from this operation. In the same period, there are convertible bonds that are around. They don't know exactly who is buying these bonds, but the expiration date is very close.

At this point, Generali makes an offer. The offer is for cash and stock. At the beginning INA says no. Later, they say yes. The offer of Generali is strange. They offer a lot of cash in this operation, but everybody knew that there wasn't much cash in Generali, but they found the cash in INA after the acquisition, thanks to the spin-off of their real estate. It seems something was not built in a few months but probably years. The entrance of Mediobanca is very important. One of the points – of the story is that the difficulties in doing M&A internationally are cultural and political problems.

MR. HORBATT: Trust me, Generali's undue influence was because it was the flagship company, the only multinational in Italy. You'll see the same thing when it's a French electricity utility. You'll probably see the same thing in Spain. Maybe what we have to do is just set our sights lower. Don't go for the big targets because you know they're politically important.

MR. JAROS: Our last speaker today is Shu-Yen Liu. She comes to us from Hong Kong, but she's from Taiwan originally.

Shu-Yen has 19 years experience in Asia, and she's here to talk to you about a lot of things going on in Asia.

MS. SHU-YEN LIU: My session is really buying and selling insurance companies, but I wanted to focus on buying considerations for Asian business buyers. I haven't seen any Asian companies actually go out and buy business, especially in the insurance business. If there's any M&A, it's the western companies, including the Americans or the Europeans, coming into Asia to buy them up. So I'm just going to give you the view from the buyer's perspective.

How many of you would like to work in Asia some time in the future? Okay! That's good. That's encouraging because we do need a lot more actuaries to push forward for the Standards of Practice and actuarial education.

Let's take a look at Asia. Asia is actually quite big. If I segregate Asia into several sectors, in northern Asia we have Japan. It's a well-developed giant, but it's declining and being bought out by a lot of companies. Korea is a pretty chaotic country. Koreans are the toughest negotiators. You think you have the deal wrapped, but the next day they come back and say that they changed their mind. Everything goes back to ground zero again. So, that's the northern part of Asia.

The central part of Asia is more like Greater China. When we say Greater China we include three different areas: China, Taiwan and Hong Kong. These countries are mostly Chinese speaking, with Chinese cultures. As you all know, China is developing, and the recent WTO agreement is going to change the whole landscape in Asia. It's the only country that's really growing very fast. You see all the foreign investments going into China, and it's amazing.

In Southeast Asia, I would include Singapore, Thailand, the Philippines, Malaysia, Indonesia, Vietnam and some of the countries that are not yet developed, like Cambodia and Laos. And then you have India, Pakistan and Bangladesh. In the southern part, we can include Australia and New Zealand, but it's still debatable whether they are in Asia, even though Australians really would like to call themselves Asian.

The landscape of the whole continent is huge, and each country has its own regulations, development in terms of capital markets, insurance business and economic development. If you are ready to go to Asia, you'll see a lot of excitement in your lifetime, but it's also very difficult because it's very demanding if you want to do a good job.

Let's come back to buying businesses in Asia. I just did a study. It's research from January 1, 1999 through February 2002. You can see the grand total of sales (Table 1). The most significant piece was probably done in 2001. That was because in 1997 we had a financial crisis in Asia, and the deals didn't wrap up right away. It takes a little bit of time to catch up. I also segregated by type of company: insurance brokerage, life and health, multi-line insurance, mutual insurance company, property casualty and then total.

Table 1

	Target Company by Industry							
Year of Announcement	**Insurance Brokers**	**Life/Health Insurance**	**Multi-line Insurance**	**Mutual Insurance**	**Property/Casualty Ins**	**Grand Total**		
1999		10	3	3	4	**20**		
2000	2	12	3	2	13	**32**		
2001	10	20	6	4	17	**57**		
2002	1	6	1		4	**12**		
Grand Total	**13**	**48**	**13**	**9**	**38**	**121**		
	Target Company by Industry							
Target Company by Country	**Insurance Brokers**	**Life/Health Insurance**	**Multi-line Insurance**	**Mutual Insurance**	**Property/Casualty Ins**	**Grand Total**	**Deals Completed**	**Deals Terminated**
China		4	1			**5**	2	1
Hong Kong	1	2	1			**4**	2	
Indonesia		3		1	2	**6**	1	
Japan	1	6		8	16	**31**	22	2
Malaysia	9	4	2		6	**21**	9	1
Philippines		1	2		1	**4**	2	
Singapore		1	5		2	**8**	4	
South Korea		8	1		4	**13**	4	
Taiwan	1	12			5	**18**	8	1
Thailand	1	6	1		2	**10**	7	
Vietnam		1				**1**	-	
Grand Total	**13**	**48**	**13**	**9**	**38**	**121**		
Deals Completed	**6**	**22**	**8**	**8**	**17**	61	61	5
Deals Terminated	-	**2**	**1**	-	**2**	5		

By country, you can see that the country that has the most transactions is Japan. As you all know, Japan's low interest rate situation has been there since the early '90s, and it doesn't seem like it's going away. Part of the reason is because the government was trying to save the banking industry, and they didn't really understand that it's going to sacrifice the insurance business. All of a sudden, this giant company went belly up. Every year as we went through the fiscal year end of March 31, there were always a couple of companies in trouble. The Japanese government is not very active in terms of helping them to solve the problem. They'll let them go bankrupt, and then all the policyholders get a haircut. So that seems to be a problem.

Anyway, the western companies are better managed. They don't require as much of a consensus as the Japanese companies. You go to a typical Japanese meeting with them, everything is conducted in English, and everybody nods their heads.

When you ask them if they have any questions, they don't ask any. There is silence. And then they'll talk to each other. And you raise a question. They'll talk to each other, and they'll come back and say yes or no, and that's it. It's very frustrating, and it's also very slow. If you go through this consensus process, it takes forever because no one wants to be responsible for a decision, and I think it's holding the country back, even today, as we speak.

The second country with a lot of transactions is Malaysia. And then a third one is Taiwan. I also listed the deals that are completed already, and you can see that there's quite a bit of success. The majority of deals have been successful.

Let's look at the reasons for sellers in Asia. Why would they want to sell? If they're strong enough, why would they give it up, particularly because Asians are very, very conscientious about controlling things? It's very hard for them to give up their management control. You have to be very subtle with them because they may have built a company using a family name, so it's very personal.

In general, because of the 1997 financial crisis that hit Asia, a lot of companies needed additional capital to maintain company solvency. They needed insurance expertise because they had been tagging along on the economic growth, and the management didn't really need to do much. They grew by tagging along with the economy. They were not really accountable. They weren't really running the insurance business either. The local companies really needed foreign companies with better management style, more transparency, and things like that.

Because of the decline in interest rates and the financial crisis, they needed to shy away from all the traditional savings-type products, such as endowments, which have a huge investment risk for the insurer. They needed to create interest sensitive, unit linked, and variable products, and they didn't know how to do it. Also bear in mind that the capital market is not as sophisticated as in the West, which tends to be a problem.

Another reason was market competition. There were too many domestic players, and some of that came from the political development in most Asian countries. In the early '90s quite a few countries had made arrangements with the United States or a European country to open up to those countries to come in and build up the insurance companies. All of a sudden you have the foreign companies coming in. Hence, the domestic players felt that if the foreigners can come in and build the companies, so could they. All of a sudden, the political movement made the market open up. There were too many players and not enough market for everybody.

Traditional distribution channels tend to be a problem because agencies cost a lot of money. On top of that, the foreigners that came in and wanted to buy from somebody who was established. So they bid the price up per head. Anybody could just change their logo today, and the new foreign company in town would reward them. So that also distorted the market quite a bit in Asia.

Globalization and the entry of the WTO was another factor. The most significant one is China. China has opened up a limited approval process. It's quite painful also. I just visited the insurance authority last week before I came out here. They have quite a few different ways of going into China. A lot of local companies see foreign ownership as a positive movement to have because they want to work with somebody else who has the know-how. All of a sudden their price may go up if they're listed in the local market.

From the Asian aspect, a lot of it is quite similar to what Jim had mentioned earlier, because in any emerging market, you can't really expect the data to be there. You can't expect the transparency. I work for an accounting firm where we do audits. Sometimes it's just hilarious. You can't use your rational disciplined mind to judge them the way that we judge our business here in a very disciplined game-playing environment.

Now, let's take a look at the required capital first, local regulatory requirements versus prudent basis. They don't understand what's prudent. When you talk to any of the local companies, they say the government is taking the overall responsibility. If I go bankrupt, I'll go crying on their shoulder, and they'll try to find a way to help me because the government doesn't want to be embarrassed if they created the law. When we look at the actuarial audit and see the policy reserve, is it prudent? The local government has its own regulation. They may say you have to hold the reserve a certain way. It's all formula driven, but that does not mean the company is really financially sound. It's questionable.

In some cases there are additional special reserves, such as special claim reserve. Why do they ask companies to do that? In Taiwan, for example, you should be careful of the politics because it's not really a country in China's eye. Anyway, a special claim reserve is really considered like required capital. It's like a solvency margin. The solvency requirement varies from country to country. A lot of the British colonies actually inherited the European type of system, but when the European system moves into a risk-based capital (RBC)-type of required capital, I don't know what's going to happen in Asia. Quite a few countries, including Hong Kong and Singapore have been talking about RBC already. So that's on the horizon.

As for additional capital issues, there may be regulations that are different for a branch versus a subsidiary. If it's a branch, the local government actually thinks you've got a parent to pay it off, so you don't have to pay as much. But if you're a sub, the entrance fee is very high. There are restrictions. Normally, there is a 90/10 split between policyholders and shareholders. Policyholders get the 90. Shareholders get the 10.

Corporate law requirements exist, such as the need for a local partner in China. When you get a license in China, you have to find a local partner. As for currency controls, some countries don't let you take your money out. So there are a lot of issues and concerns that you need to watch out for before you go into Asia.

There are risk considerations, like currency risk. In Indonesia between 1997 and 2001, the currency really changed the whole insurance industry. Diversification benefits are another issue there. Economic assumptions are quite similar to what Jim mentioned. The most debatable assumption is the discount rate. I was involved in a transaction back in 1998 in Korea, and the Koreans said I should use 12 percent. The Americans said it's high risk, so I should use 18 percent or 20 percent. So that became a deal breaker. If you can't really talk to them about it, there's nothing you can do. And consider the correct risk-adjusted rate of return. It's in the beholder's eye, right? You're a buyer. You have certain standards you have to meet. The seller wants to have a certain price. So there's a lot of conflict.

As for capital markets, there is very much a lack of a local long-term bond market. Everything is very short. The longest one you can get is probably a three- to five-year government bond. So how do you deal with the long-term interest assumption? Company rating is not available. If you're buying into a corporate bond, there's no decent rating system. What do you do? Some are speculation-driven, like in China. In fact, most of the capital markets in Asia are very much speculative. It's not a rational market. Governments actually control the interest rate assumption, and they say you need to price the interest rate at a maximum of four, six or seven percent. You have to follow that rule.

As for heavier use of foreign currency investment, it depends on the country. Every country has a different limit on the investment. Greater use of equities is occurring because everyone is speculating. They need to lock in their gain, so they put their money in the market and then try to get out. If they unfortunately stand on some kind of a land mine, they're gone.

Withholding tax on investment income is occurring in some areas. I'm not going to go through experience assumptions very much because I think a lot of it is related to what Jim had mentioned—expenses, mortality, health claim costs, persistency and agent compensation. I want to mention policyhoder dividends very quickly. In a lot of cases, the government regulator actually stipulates them. In South Korea back in the mid-'80s, all of the companies were really stock companies. All of a sudden the consumer associations said, "You're growing a lot. Your surplus is quite high. We deserve some of it." All the non-par policies suddenly became par, but not even by legal document. You have a contract that doesn't say anything about the contract being par business, but yet they started to distribute non-par business as par business. So they were giving up. And they had all kinds of distributions, so it was pretty chaotic. Now there's a debate whether the stock company belongs to shareholders or to policyholders. If the company wants to have an initial public offering (IPO) to try to raise funds, it's literally impossible until they resolve this issue.

The current scale is not supportable. If a regulator stipulates it, they're a little bit behind already. So what are you going to do with your current situation on your investment rate of return? Other consolidation issues, like management control, minority interest, local account, U.S. GAAP, and actuarial appraisal value are mostly used on a local statutory basis. Some American companies actually use U.S. GAAP. Fair value accounting is not there yet. Solvency margin is mainly on an EU basis. RBC is not yet available. In Singapore, I think they're going to do it either later this year or early next year. Heavy financial reinsurance deals do happen, which distort the true financial picture.

Interrelated party transactions tend to be a real big problem because the companies were built by certain large conglomerates. If they need money, they take the money as a loan from the insurance company. There's a lot of that, too. On the subject of corporate governance, owner versus management decisions, a lot of the time managements are not accountable because the owner tells them what to do and that's it. There is a general lack of investment strategy in Asia.

There are a couple of questions that I wanted to raise from what I have seen related to the world of actuaries. In example #1, in Japan there was a case in which Company A bought a local Japanese company for $60 million in late 1999 and early 2000. They then contributed a capital injection of $40 million. Supposedly the company would be worth around $100 million, right? A year later they sold it to another company for $20 million. What happened? What is our actuarial credibility in a situation like that? You could talk about financial projections of this and that, but not within one or two years where the value diminished from $100 million to $20 million.

In example 2, what should be considered a reasonable price to embedded value and price/earnings (P/E) ratio in Asia? Canadian companies range from between 1.15 to 1.65 for price to embedded value. The P/E average is around 14. But what is it for Asian companies? We don't yet have an answer for that.

Example 3 is another case. A local listed company made a public announcement of their embedded value even though they only did one. Bill mentioned earlier that they probably looked at a couple of years and then decided to disclose it. This company was very brave in that they felt the value looked good. So they came out together with their actuarial consultants and made the announcement, and it fluctuated the price that day by 30 percent. What is our responsibility as actuaries?

In example 4, company statutory reserve meets minimum reserve standard on a local basis, but when we convert that into an international best estimate, the result is completely different. It could be insolvent. Is it our responsibility to say whether the company is solvent or not? Are we going to follow the local regulation or are we going to follow the international best practice?