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Session 18PD
Financial Restructuring

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Panelists: Meredith A. Ratajczak
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Summary: Over the last decade, the insurance industry has witnessed a flurry of financial restructuring activity. The big companies are getting bigger through acquisitions. Many large mutuals have demutualized and global ownership is increasing. In this session, panelists discuss:

- *Current financial restructuring trends*
- *The impact on the insurance industry as we know it*
- *Challenges for those companies that have recently experienced some form of financial restructuring*

MS. MEREDITH A. RATAJCZAK: I'd actually like this to be an open forum instead of a panel discussion. I am responsible for coordinating this session, and all my speakers except Duncan were unable to attend. I was called in as a last minute replacement. I've done a little work on this subject, so I can fill in.

We're going to talk about financial restructuring with two different focuses. Duncan is going to talk about it from the mutual company perspective: mutual holding company, demutualization, mutual mergers. I'm going to talk about financial restructuring through acquisition. I've done a lot of that kind of work over the last 14 years and a lot in the last year and a half or so.

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Note: The chart(s) referred to in the text can be found at the end of the manuscript.

The session description said that we were going to cover what's going on in terms of acquisition and mutual company activity? What will the impact of these trends be on the insurance industry as we know it? What's the impact on the company? I believe that is one of the most interesting aspects, at least from the acquisition side of things. As I mentioned, Duncan Briggs is my co-speaker. Duncan is a principal of Tillinghast-Towers Perrin, and is the manager of the firm's Atlanta office. He originates from England where he practiced as an actuary before moving to the U.S. in 1996. Duncan's consulting work in the past few years has been heavily focused in the area of mutual company restructuring—helping companies and state insurance departments implement or review plans to demutualize, to form a mutual holding company, or to merge. Duncan is also a leading practitioner in the area of embedded value reporting.

I have been a consulting actuary with Milliman U.S. in a number of different offices. Currently, I am co-manager of the life consulting practice in Hartford. My areas of expertise include statutory and GAAP valuation, cash-flow testing, and any sort of financial projections. I've done a lot of merger and acquisition (M&A) and demutualization work. I've also done a little bit of pricing and product development here and there. I'll turn the presentation over to Duncan.

MR. DUNCAN BRIGGS: Before I start, I'd like to know how many people in the audience are from mutual companies? How many are from stock companies? It's a pretty even distribution. For the people who are here, how many are with companies that have gone through some form of restructuring or currently are going through some form of restructuring? It's quite a large number.

I have to split the presentation into three parts. I'm going to start by giving an historical perspective and looking at what has been happening from a mutual company perspective over the last decade or so. Then I'm going to switch gears and look at companies that have gone through the demutualization process. What are some of the challenges that actuaries and nonactuaries have faced in the new stock company environment. Finally, I'm going to try to do a bit of crystal ball gazing and consider what some of these trends might mean in the future.

The first form of restructuring I'm going to talk about is certainly the one that has been most prominent over the last few years and the one with which people are most familiar: the full demutualization. What happens in a demutualization is that the ownership structure of the company changes from the policyholders to stockholders, so before the company demutualizes, the owners of the company are really the participating policyholders of the company. After demutualization, that ownership transfers to a new set of stockholders and the stockholders become the owners of the company.

Let's discuss predemutualization in the mutual environment. I think it's fair to say that the ownership rights are largely intangible. What do I mean by that? The membership rights include a right to vote on certain important matters. They also include a theoretical right to share in any divisible surplus in the unlikely event that a company should liquidate. This is not something that's expected, so for all intents and purposes, the financial benefits of the membership rights are intangible.

At the point of demutualization, as the policyholders relinquish those membership rights, they receive stock in the new stock company. The participating policyholders receive stock. That's not always true in all demutualizations. It happens in the majority of cases, but in some demutualizations, the companies haven't made a distinction between managing the company between par and nonpar, so it decides to distribute the value of the company to both par and nonpar alike. The value has gone to the par policyholders the majority of the time.

Typically, in most of the demutualizations that have occurred, there has been a concurrent initial public offering (IPO), so this brings in a new group of external stockholders. If you look at the profile of the stockholders at the point of demutualization, the mix is dominated by policyholders with a small number of external stockholders. What typically happens is that a large number of policyholders decide to cash out their stock either at the point of demutualization or through some commission-free sales program that companies typically offer. Over time, the mix of stockholders changes somewhat more towards the external versus the internal policyholders.

Nevertheless, for all of the demutualized companies, the mix is still heavily in favor of internal policyholders being the stockholders.

One variation on the plain vanilla demutualization is what's referred to as a sponsored demutualization. In this type of transaction, in addition to the policyholders being reimbursed for relinquishing their membership rights, an external corporate entity comes in and injects capital into the company in return for some stock interest. There could also be an IPO as well. You end up with stockholders that include policyholders, maybe some of the general public, and this corporate entity (the sponsor). There are a couple of examples of this. When Equitable demutualized back in 1992, AXA took a significant stake by way of a sponsored demutualization. A more recent example is the proposed demutualization of Provident Mutual. If that goes through, then Nationwide will own the demutualized company. The policyholders of Provident Mutual will receive stock in one of the Nationwide companies.

The most common questions that policyholders ask companies when they're going through this process are, why are we getting something, and what's going to happen to our policies? Policyholders think that because they're getting some cash payout or stock payout that they must be losing their policy. That's certainly the most frequently asked question, and it's often difficult for companies to explain how policyholders can get in this windfall and yet their policy benefits remain unchanged.

I'll give you an idea of the larger companies that have gone through the process in the last decade. When I put this presentation together, I thought it was quite interesting that there wasn't a huge amount of activity before 2000. Most of the large demualizations occurred in 2000 and 2001. When I put this together two months ago, Principal hadn't completed its demutualizations, but its conversion became effective in October 2001, so it is now a stock company. Although Prudential hasn't completed its demutualization, its plan has been approved by policyholders and the regulators.

So why have these companies chosen to demutualize? You can get a lot of information just by reading plans of demutualization. Most states require that the companies submit a plan. Those plans are in the public domain for the policyholders and the general public to review, and they have to contain a fair bit of information about why the company wants to go through this process. The foremost reason that's given is improved access to the capital markets. For a mutual company, access to capital markets is limited to debt capital. Of course, there's only so much debt capital that a mutual company can raise. Once you get into the equity capital markets, then, in theory, there's an unlimited amount of capital on tap.

Interestingly, there's not always a specific, immediate need for capital. I would say in most of the demutualizations that have occurred, there hasn't been a specific immediate reason or a need to get capital into the company. The companies have really wanted to put the structure in place. They have flexibility to raise the capital in the future when opportunities arise that require them to raise a significant amount of capital.

Another reason given for demutualization is to help finance acquisitions. If companies that are active in the M&A marketplace can use stock as acquisition currency, that certainly gives them a leg up on the company that has to use either cash or a combination of cash and debt.

Some of the more recent plans have actually listed the realization of economic value of membership rights as a reason, which is certainly a consequence of going through the process. The more recent plans have actually listed it as a reason in and of itself. I find that quite interesting, and if I consider the United Kingdom, there currently are only three significant mutual companies remaining there. All the other companies have gone through the demutualization process. However, those three companies have had a huge amount of pressure from the policyholders to convert to stock status. The policyholders are seeing the windfalls that other companies have given, and they want some of the same. There's an increasing bandwagon that's trying to get those companies to convert. I'm aware of one U.S. company where there has been some action in this area, but no others at this stage.

Incentive compensation is another factor that is often listed in plans. Some of the lure of this has disappeared over the last year or so. Throughout the 1990s, the benefit of having stock options was substantial, and a lot of companies believe that having a compensation package in place (one that includes stock options), will help them attract and retain the best employees.

When I put these numbers together, I was initially surprised by how small the drop-off is. Chart 1 shows the market share of mutual companies and how it has changed over the last decade. In 1989, the mutual companies' share of admitted assets was 41%. By the end of 1999, this had gone down by about six points to 35%. That's because the big companies had not yet demutualized at that point in time. I took the 1999 numbers and then backed out the companies that have demutualized in 2000 and 2001 (including Prudential, which is likely to demutualize soon). I ended up with 15.5%. On that basis, there really is a substantial reduction in the market share of the mutual companies.

The next form of restructuring I'm going to look at is referred to as the mutual holding company (MHC). This is a fairly recent option that has been available to mutual companies. What happens in this type of conversion is the mutual insurance company becomes a stock subsidiary of a mutual holding company. Typically, there are one or more intermediate holding companies in the structure. The insurance company sits directly or indirectly underneath the mutual holding company.

In contrast to the full demutualization, policyholders do not relinquish their membership rights. Instead, the membership rights are transferred from the insurance company to the new mutual holding company, so they are still there. They are just in a different company. They're still intangible, but for all intents and purposes, the policyholders have the same rights; they're just placed in a different part of the organization than they were previously.

Under the MHC structure, the mutual holding company retains a controlling interest in the insurance company, but it can go out to the capital markets and raise equity capital in the insurance company up to 49%. At all times, it's maintaining a controlling interest, but clearly this gives it a significant avenue to raise equity capital.

I have some examples of companies that have chosen this structure. This list is not complete, but there is still a significant number here. I think a couple of them are worthy of comment. AmerUs and Principal, both chose the MHC structure. With the benefit of hindsight, it was really an intermediate step, since both companies have now fully demutualized. In the case of General American, they demutualized in order to be acquired by Met Life. Essentially, they did the MHC and then went through demutualization as well.

Two others, Ameritas and Acacia, both independently formed mutual holding companies and then decided to merge. One of the benefits of the MHC structure is that you can fairly easily merge MHC groups together. You have all the operating insurance companies underneath and then you have shell holdings companies on top. You can fairly easily merge those companies together, which is what Ameritas and Acacia have done.

Not all states permit this type of conversion. In particular, New York does not allow New York domiciled companies to convert to an MHC structure. I think another point worth mentioning is that there has been a significant amount of opposition to this structure, mainly from consumer groups who, for one reason or another, don't view this structure favorably compared to the full demutualization. One of the arguments I hear is you're doing this conversion, but the policy-holders aren't getting any value. I never quite buy that argument because, in a demutualization, the policyholders are giving up their rights so they should be getting something. In an MHC conversion, the policyholders still have their membership rights, so why should they get any compensation? Nevertheless, the consumer groups have a strong voice. In one case, a proposed MHC transaction didn't actually go ahead because there was enough opposition from some of the consumer groups.

The reasons for choosing this route are very similar to the reason for choosing demutualization—access to capital markets and all the benefits that go with it. There is also structural flexibility. We've talked about the flexibility that the structure gives you to merge groups together once you've formed the mutual holding company. The MHC structure does have several key advantages over demutualization. It's certainly less costly and quicker than full demutualization. From an actuarial perspective, when a company demutualizes, one of the big exercises is figuring

out how you're going to allocate the money or the stock among the eligible policyholders. The way we do it in the U.S. involves a huge number of actuarial calculations and takes a large amount of time. In the MHC reorganization, there is no distribution of value, which does save significant cost and time. Another aspect is that none of the MHCs that have been formed have actually done an IPO at the time of conversion. The cost saving of not doing an immediate IPO is another significant consideration.

Recent IRS rulings have confirmed that, under this structure, the mutual company surplus tax does not apply. Again this is another consideration or reason that companies might give for wanting to form this type of structure. Despite its attractions, there are, nevertheless, some limitations to the MHC structure. As we've seen previously, some MHCs decided, after they had done the MHC, to fully demutualize. The structure is fairly complex. There are typically a number of intermediate holding companies in-between the MHC and the insurer. When you start merging these groups together, you can end up with a lot of legal entities. It's a fairly difficult structure to understand. It's not as flexible as a fully public company. There is this limitation on the amount of equity capital that can be raised.

The final form of restructuring I'm going to look at is the mutual company merger. This, without doubt, is more straightforward, and a lot less complicated than either demutualization or MHC. Nevertheless, it's still a significant exercise for a company to undergo. Let's say you have Company A and Company B, each with their own set of members and intangible membership rights. At the point of merger, the two companies come together into a merged company. From a legal perspective, that company is referred to as the surviving company and would typically carry the name of either Company A or Company B going forward. However, the members of both A and B become members of the newly merged company. They both have equal rights. There's no preference given for membership purposes; they're all members of the newly merged mutual company.

Some examples of recent mergers include Phoenix and Home Life in 1992, American Mutual and Central Life in 1994, Mass Mutual and Connecticut Mutual as well as Met and New England in 1996. Most recently, Guardian and Berkshire merged in 2001. The reasons why companies

consider mutual mergers vary from deal to deal. In some cases, the merging companies are very similar both in terms of size and also the types of business that the companies have. In those cases, a big reason for doing this is to gain scale and to be more competitive as a bigger company. The first three would be largely in that category. In other cases, the companies are very different in size and might be very different in types of business, but they are perceived to have some complementary expertises. The reasons for doing the merger are more strategic. For example, if we look at Guardian and Berkshire, Berkshire was a much smaller company than Guardian, but did have significant expertise in the DI market. This was viewed as potentially attractive when aligned with Guardian's DI distribution capabilities.

Now that I have covered the historical perspective, I'm going to take a quick look at some of the challenges and changes that recently demutualized companies have faced. To do some research on this, I actually spoke to quite a few actuaries and also nonactuaries in some of these new stock companies. I tried to get their perspective on what has changed and what is different about the new environment versus the mutual environment. Without doubt, the foremost change and challenge that was mentioned to me was the much greater focus on short-term earnings. While short-term earnings are still important for a mutual company, the actuaries that I spoke to said that in the mutual environment they had a more long-term focus, considering solvency and the ongoing financial strength of the company. In a stock environment, the analyst is king and the analysts live and breath GAAP earnings. It's not surprising that the focus of the companies has changed very much and is now heavily into short-term GAAP earnings.

Analysts don't like earnings surprises, so this has placed a great emphasis on clearly understanding and being able to explain short-term earnings and the impact of any actions that the company is considering. What impact will those actions have on future earnings?

The actuary's job has become more challenging. In addition to the new short-term focus, the actuary still needs to be the person who is considering long-term economic value. What's going to happen in the long term if we take some actions that we're now proposing. For this reason, tools like embedded value are coming into play more, and we're seeing more companies using

embedded value to help analyze the long-term impact of actions. They look at that on one end, and then look at the short-term earnings impact on the other end.

Another comment that I got from most of the people I spoke to was the actuaries feel more pressure in the new stock environment. This is driven by the earnings reporting requirements. The turn-around time for producing quality results is pretty tight, and there's also interim internal results that are required as well. Actually, the actuaries are working with more speed than they've been used to; however, they can't compromise in any way the accuracy of the calculations they're doing. They must get it done quickly and get it right the first time.

Another aspect that seems to be more pronounced in the stock companies is a greater communication between actuaries and nonactuaries, specifically between actuaries and accountants. This goes down to the whole issue of understanding the earnings. Most of the people I spoke to have found themselves working together a lot more closely and looking in detail at what the earnings are doing. They make sure they can understand what's going on, and they can adequately explain any fluctuations in earnings. As you know, a lot of earnings variability is driven by actuarial factors so the actuaries are getting heavily involved in this part of the operation.

In some cases, the actuaries are getting involved directly in communications with analysts. We all know the challenge of trying to communicate what can be highly technical actuarial concepts to nonactuaries. This has certainly been a challenge for those actuaries that have been involved in this aspect of things.

Another interesting point is knowing what not to communicate. This is also very important. In some of these companies, earnings information is much more tightly held immediately prior to earnings being reported than it would have been previously. This is done in order to minimize the risk of anything getting leaked out ahead of the official reporting date. In some cases, companies have had to go through fairly substantial internal education exercises so that all employees are fully aware of what types of information they should not divulge outside of the company.

The final point that was mentioned relates to more active performance management, which might have been the case previously. The company itself is under the microscope from the analysts and being compared to its peer group the whole time. That's acting to create more of a culture where each employee is really required to perform so that the company as a whole can perform. Some of the comments were things like clearer definitions of accountabilities and responsibilities. They needed more accountability than what exists for how people have performed against those responsibilities. They also want compensation that's more closely linked to the actual performance against the defined role.

I've covered recent trends and challenges. I'm going to finish off with a few thoughts about what some of this might mean for the future. I'd like to give a reminder of what we've seen from a mutual perspective. We've seen the market share in terms of assets drop from 41% in 1991 down to around 15% in 2001. Nevertheless, there are still around 70 mutual life and health insurers, 60 fraternals, and 15 holding company groups, so there's still a significant number. I think you can deduce from the numbers that the average size of the mutuals remaining is obviously a lot smaller than the average size ten years ago. Nevertheless, there are still several large mutual companies including Northwestern, New York Life, Mass Mutual and Guardian.

So what might happen to these mutuals as we move forward? I think one thing we can look at is what has happened in other countries and in certain other insurance markets around the world. The whole process of financial modernization and consolidation is at a more advanced stage than in the U.S. In particular, in Australia, the industry is heavily consolidated within a few very large financial services groups. There are no significant mutuals remaining there. As I mentioned, the U.K. has gone through the same process and is down to around three significant mutuals remaining. The large Canadian companies demutualized over the last two years or so.

Until recently, there have been obstacles or barriers to companies consolidating across industries. With banks and insurance companies working together with the Gramm-Leach-Bliley Act, maybe some of this will change. I haven't seen too much activity to date. Let's see what happens over the next few years and whether this does impact things.

The remaining large mutuals do appear to be pretty comfortable with their mutual status. They have strong brand names, and they are all pretty well capitalized. There doesn't seem to be a compelling reason for them to demutualize at this time. With some of the smaller mutuals, critical mass is likely to become more of an issue for them. The competitiveness of the industry, as we all know, is increasing day by day, so I think these companies are going to have to focus on expense levels and whether they have the scale to continue in their current form. However, the costs for these companies of going through a demutualization exercise are generally going to be prohibitive. Maybe this will necessitate the introduction of a simplified form of demutualization that companies can go through without having to do some of the very detailed calculations that the larger companies have done. MHC and the mutual merger are options that would be open to those companies. Some of the smaller mutuals could merge, and once they reach critical mass, then MHC or demutualization is a more viable option.

Being a consulting actuary, all the change that we've seen in the past few years has been pretty good news, so I thought I'd finish with my personal vision as to what I think might happen in the future.

MS. RATAJCZAK: What you need is a big loop: remutualize-demutualize.

MR. BRIGGS: That concludes my portion. I can answer any questions now, or we can move on.

FROM THE FLOOR: Why would that be your dream?

MR. BRIGGS: I hope that there's quite a bit of work so that I'm needed.

FROM THE FLOOR: I'm an independent consulting actuary, and I've been very involved in the restructuring process. In fact, as I looked at the list of companies, I realized that I have actually been involved with more than half of them. There's one more postscript that I would add to your list. I disagree with so much of what you said that we'd have to have a session where

just you and I fought for three days, so I don't even want to get into the discussion. I would say there's a tremendous amount of litigation following the restructuring. In fact, there are three suits already against Prudential and they haven't even demutualized. I know of two against the Hancock, and there are eight or nine against Met. Principal is also involved and has a lawsuit. The legal issues are very, very involved, and the lawyers are all confused. Half of the stuff that gets written is unintelligible, but what all of the dispute boils down to is basically two essential things. People aren't happy with the allocation of consideration. Basically, I just used it as an example. Prudential has 10 to 11 million policyholders, depending on how you define a policyholder. It has 616 million shares of stock. How those 616 million shares get divided up among the 10 or 11 million has led to a lot of litigation.

The other big contention in other lawsuits has to do with the preservation of contract rights. The granddaddy of them all is the right of a mutual policyholder to get his insurance at cost. That is, to receive a dividend that, in effect, gives him his insurance at cost. There are a lot of allegations in the form of court complaints regarding how dividend structures that are going to be payable after demutualization are a lot less than what they would have been prior to demutualization. That's an alleged breach of contract. The thought is that much of this value is being given to these newly created stock entities. In effect, a lot of work should be policyholder dividends through a very complicated actuarial recharacterization process, which now has become stockholder dividends. All of this is happening in court. The courts may fill it all out, and all the lawsuits might disappear. On the other hand, class actions take six to eight years to work their way through the system. It just may be that what actuaries are worried about now, and what management is worried about is that some of this litigation actually might mature. There might be some significant restructuring that people weren't counting on. In particular, I'm thinking of a closed block. A typical closed block might have $10 billion of liabilities and $8 billion of assets with a $2 billion shortfall. That $2 billion shortfall might suddenly become a $1 million shortfall. Perhaps $3 billion of stockholder equity will suddenly become redefined as policyholder equity. That's just a comment. I enjoyed your presentation, and I'll fight with you later.

MR. BRIGGS: I would just make one comment on the preservation of policyholder interest. The closed block, in itself, is intended to be the mechanism that would allow that to happen. I've done a lot of closed-block calculations. If the experience underlying the dividend scale continues, then you're going to get the same dividend.

FROM THE FLOOR: Closed blocks preserve the dividend scale as it presently exists, but the dividend scale is different from the contractual promise at issue. You get your dividends at cost, which means dividend scales in the early years of a policy are less than what an accounting provides for money's adequate surplus. In the later years, money is taken out of surplus. So you pick a particular dividend scale through the life of a block of policies and say that's it forever. That can be contested because if the company had not demutualized that scale for those policies that are already on the books, it would gradually increase over the years. It's that increase that's going to be missing that people claim they're contractually entitled to. A lot of future increase that would have happened to dividends has been taken away from current policyholders, and it has been given to stockholders. We're in the fight line. I agree that closed blocks produce the effect you want. Is the effect that you are producing what they're contractually entitled to?

MR. BRIGGS: The increases in dividends will happen. If it was an increase caused by the current scale, you're going to get increases in dividends. The funding calculation would allow for that increase, so they would come in. The management of a closed block is such that you fund for the dividend scale that's in place at the time the plan is adopted. If the company hadn't demutualized and interest rates go down, dividends would go down. The closed block is set up in exactly the same way. It's designed to maintain the policyholder interests and really give dividends in a similar manner to what would have happened without demutualization. Maybe expense issues would have come into play going forward, and they might get less if they hadn't demutualized. That's my view anyway.

MS. RATAJCZAK: As I mentioned earlier, my focus is going to be on financial restructuring through acquisition and divestiture. I spent 14 years doing M&A work. Over the last couple of years, I have been involved with several of the large transactions that have happened.

I'm going to talk a little bit about the trends and what's going on in the M&A marketplace today. I'm going to talk about what those trends mean in terms of impact on the U.S. insurance industry as we know it. Then I'll talk a little bit about what this acquisition and divestiture means and its impact on the company.

If you look at a list of M&A activity over the last several years, you could probably categorize it as dominated by several large transactions—AIG, American General, ING and Aetna Financial Services. There have been a couple of others, too. All in all, the big are getting bigger. Within the last few years, there have been fewer life transactions than in past years. There has also been increasing interest in foreign investment in U.S. companies. If you look at the list of the recent acquirers, like Allianz and the ING, you see a lot more interest in investing in U.S. companies from companies abroad.

If you look at the list of acquisitions and divestitures, I'd say they were strategic in nature. That's probably not a trend. You could probably point back to transactions in prior years that were strategic in nature. Specifically, for the two large transactions, it made the players that much stronger in the retirement services area.

There are a lot of companies that are interested in buying, but there are fewer companies that are selling that would have the quality and the characteristics that the buyers are looking for. There are a lot fewer companies out there that are desirable for a number of different reasons.

What does this mean to our industry? The big are getting bigger. You would think big companies could operate very efficiently and effectively. That has offered increased competition for companies that aren't so big. If you have two or three large players in the retirement services industry, it is a little difficult for the smaller insurers that might not have the same level of ratings as the larger insurers to compete appropriately or effectively. Also, with fewer companies, from the consumer's standpoint, the insurance buying population has fewer companies to choose from. We just know that with the level of M&A activity over the last decade, there are fewer and fewer companies for policyholders to choose from when buying contracts.

The increased interest in companies abroad investing in U.S. companies takes away from the "made in the U.S.A." feeling. It reduces our control on our industry. There are strategic transactions that have happened with companies getting rid of blocks of business. Many DI blocks have been sold recently, meaning that you have many fewer players in that marketplace. Strategic transactions that purchase large blocks of retirement services business change the nature of the environment that we're working in. It's a lot easier for certain companies to be a lot more competitive if they dominate the market share in certain product lines.

In general, ever since I started doing M&A work years ago, you'd go out and hire a consulting actuary to do an appraisal of a company that was interested in being acquired. They would get an investment banker to come in and go out and talk to ten companies. The person would see what a great company it is and buy it. That process is different. It's much more targeted. The American General transaction was targeted. The seller might still get the consulting actuary to do an appraisal. They might hire the investment bankers, but they have specific targets that they are looking at. As such, there is not the mass marketing effort to go out and sell the company. One company approaches another company. They sign some sort of an agreement to give them right of first refusal, and they go through this process and make sure that the numbers work. The process has changed. As I said, the strategic transactions have changed the competitive environment. You have fewer companies in certain lines of business, and it just makes for a different competitive environment.

It looks like a number of people have been involved in some sort of financial restructuring, but those of you who haven't probably don't appreciate the level of activity that goes on and what stress that puts on the actuarial resources. There's complete upheaval at the company from day one. It might not be completely across the company because, in a number of these situations, only a few people at the target company actually know that somebody wants to buy the company. There is a very limited number of individuals that can help answer questions. In one transaction I was involved in, the due diligence team had 100 people. We were trying to keep the transaction quiet so we brought in 100 people. You start by essentially going into the company and asking

for data. It's a relentless process. The person that looks at the business and does the due diligence needs to get information quickly so that they can report back to the company that everything looks good. We tell them how much we are willing to pay, which is subject to somebody making sure that certain things are as we see them. For a one-week period, you must have your resources. It might be your controller, your investment person, and your actuaries who gather up this information and are on call to come and meet in a secret room and answer questions about these data. The due diligence process is a daunting task. Take that a step further. Once you go through this process, you sign on the dotted line, and all parties are happy. The acquiring company comes in and wants to look at your models and how you do your actuarial business. Do they look okay? Maybe they're not granular. They might want you to make new models or do a better job of maintaining your experience. You might not have very good experience studies. On top of that, we do embedded value reporting, and we might want you to do that, too. We might say we want you to do that by year-end. If it is already July or August, all of this activity has to go on while you're doing your regular business. It's an amazing process.

The American General process started out when Prudential UK began looking at the company. Prudential UK looks at the business via achieved profits like embedded value. The whole time you're analyzing what the value of the company is, and you're doing all your work on achieved profits. Then AIG comes in and wants you to do appraisals and change all these assumptions. So there was a complete turnaround about how we were looking at the company in terms of value.

Of course, the company either loses control or gains more control. A gain in control brings additional responsibilities and a lot more headaches. There might possibly be some new reporting requirements. An international investor might come in and buy your company and ask you to do embedded value reporting because that's how it looks at business and does executive compensation.

Think about the acquisition process. Companies hire actuaries to value business. If you do a seller's appraisal, the buyer might look at the assumptions and say it can do things better and might want you to make modifications. When they arrive at what they're going to pay for the business, they have certain ideas in mind in terms of what the synergies might be between the two companies. It might be some excess capacity that's not used here. Maybe we can reduce unit expenses. They might just decide that there are some expenses they can get rid of, so there is emphasis on achieving those synergies. The party that bought the block of business or the company wants to achieve whatever return goals they had in mind when they came up with that purchase price.

Whether you are bringing in a block of business or buying a whole company, one of the biggest company impacts is the whole integration process, and that has a lot of different factors. It doesn't matter if it's two big companies or even two small companies. Each company has two, three, or four lines of business, so that might mean they have two, three, or four different administrative systems or a couple of different valuation systems. Management might want cohesive reports or to do cash-flow testing with one model. You must somehow integrate that data. You could take this company's business and move it to your systems, but that's not an easy thing to do. Everybody knows that when you set up your administrative systems, it takes a long time to make the modifications to deal with the business. In that sense, companies probably need good data warehousing facilities that they can use to get the data and use it.

In terms of actuarial processes and models, as I mentioned, you're probably not necessarily going to do cash-flow testing with two separate systems. Even though companies might be operating as two separate stand-alone entities, senior management probably wants to know what the shape of the world is. First of all, they want that shape of the world to be done on some kind of consistent basis. Say Company A has very granular models for doing its processing and actuarial functions, and Company B has varied simple models and not necessarily very refined assumptions. Then putting those two things together to give management data might create some issues that indicate that the whole actuarial process has the potential for big issues integration. Regarding

organizational integration, it's possible that one company likes the structure of the actuarial department that has a corporate actuary. That oversees the entire actuarial function. The other company has a structure such that they have different units where they have an actuary in charge of each unit. Maybe they want to make the structure similar so it's all about how you're setting up all the various departments in the company.

Another area is that the field is involved in one of these transactions. You've got the whole idea of field integration. Two companies probably have different philosophies in terms of field structure and compensation. If you take two companies, you have overlapping regions in terms of sales areas, and you have totally different agent compensation contracts. How are you going to integrate that whole process? It might even have a totally different focus based on what marketplaces they are looking at. The whole integration process is a daunting one. As consulting actuaries, we go in and do the M&A work. We do the appraisals, and give them the numbers. You don't necessarily experience all that goes on with integration first hand. It's such a big project that companies are finding that they need different kinds of resources to help them do that.

I think the trend will be fewer transactions. September 11 has put a crimp in the stock market, and that makes transactions that involve shares of stock a little interesting. I would expect that you're going to still see a lot of interest from international ownership in U.S. companies. There are fewer transactions and transactions that are very strategic in nature. There are also ones that are more targeted.

FROM THE FLOOR: I have two questions. I think Duncan mentioned the consumer group's influence over mutual companies or transactions. Have you seen similar trends in the overall industry restructuring in terms of their influence over such a deal. How do they exercise that and how do they change the structure of the deal? The second question I have is, in terms of the old restructuring trend in the industry, what do you see as the major impact on the actuarial profession as well as how we're going to prepare ourselves for it?

MS. RATAJCZAK: I guess the consumer's involvement regarding M&A type transactions is more focused on the approval process, if the policyholder is a shareholder. I can't actually say that I've heard of consumer groups going to companies and saying you really should be sold. I think that's more the case, and I think there's more consumer policyholder interest from the standpoint of mutual companies. If the policyholders are shareholders, then they do have a say about such things, but I think it's more mutual-company focused.

In terms of your second question, there is an impact on the actuary. There are possibly fewer companies that would need actuaries. However, I think the actuary is going to be called upon to do more in an acquisition or demutualization situation. The focus is going to be, in the case of acquisition, achieving the synergies and kind of making this thing work. From an actuarial standpoint, the actuary is the one who goes in and coordinates all the financial reporting, so they definitely have a hand in making sure that all the financial backing and work gets done. On the demutualization side, there's all this increased focus on short-term earnings. You have a whole bunch of different audiences now that are looking at the work that we do. The other offshoot is there are fewer companies; unfortunately, sometimes the end result of transactions means that certain people might lose their positions. They have two actuarial groups, and they find they don't need certain overlapping resources.

FROM THE FLOOR: You very clearly explained that the buy/sell process has changed, and, in a sense, that it is more focused. In your experience, to what extent are the buyers really placing any reliance on the financial projections that are being prepared for these transactions? Based on the two or three that I've been involved in, I'm seeing that they are basically ignored. I'm just curious as to what your attitude is. Second, what impact do you think the new accounting standards, 141 and 142, are going to have on the M&A activity in the future?

MS. RATAJCZAK: I'd like to say that they're always relied on. I was involved in a transaction in the early 1990s in which we did the seller's appraisal. We were sitting around the table with the buyers. They said, "We never even read this thing." They based their price on God knows what, but they didn't look at it.

I would have to say that the actuarial appraisal is the starting point of the majority of the transactions today. I think if investment bankers are involved, they want that document. That's my opinion and that comes from doing a lot of work and working a lot with people in our Chicago Office, who do much more of this than I do. I think it served as the basis upon which a buyer comes in and makes modifications to come up with a selling price, but I do believe it is a valuable tool. I would say, in most cases, it is viewed as the tool that is used to start to come up with value. That's my opinion, and that's kind of based on what I see and hear.

Regarding 142, one of the activities that you do as part of an M&A transaction is set up that balance sheet. Companies are very interested in what the mix is among the value of the business and the purchase price and the goodwill on the books. If there are changes in how you can account for goodwill, that's certainly going to change the company's thresholds in terms of value that they're going to place on a business. That's definitely a consideration.

FROM THE FLOOR: I have a question for Duncan. On one of your slides, you said that there were three remaining U.K. mutuals, and they were experiencing pressure to demutualize. Could you comment on where that pressure is coming from?

MR. BRIGGS: The one I'm most familiar with is Standard Life, which is the largest of the remaining mutuals, and the pressure is coming from policyholders. I think there's one guy, in particular, who has set himself up as an advocate for the policyholder group in general. He has a lot of support. I believe he even tried to get himself voted on the Board of Directors. He and his group did put together some pretty strong arguments to try and force the company to consider demutualization. I think it actually went to a vote, which was fairly close, so the company is still a mutual, but there is a lot of pressure. There have been some pressures on Mass Mutual to consider demutualization, but not at the same level as Standard Life in the U.K.

CHART 1

Percentage of Total Admitted Assets for U.S. Life-Health Insurers Attributable to Mutual Organizations