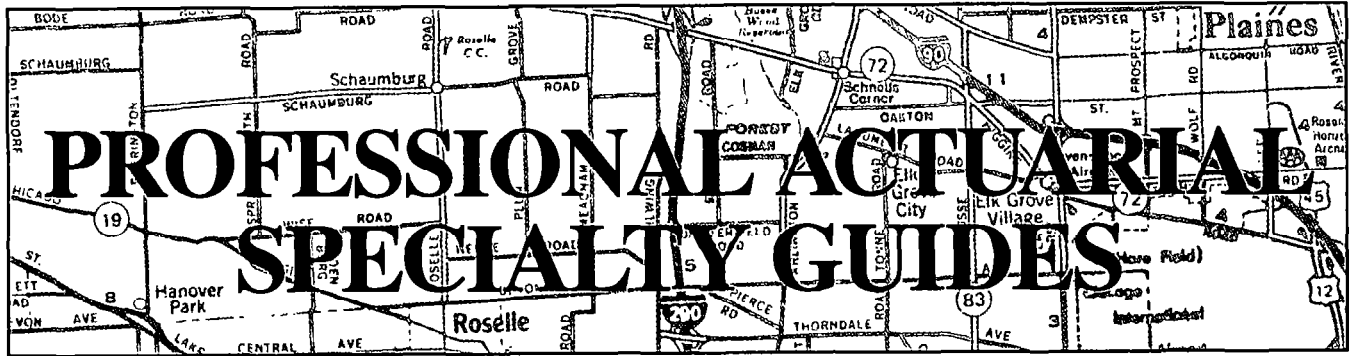


## SOCIETY OF ACTUARIES



## COMMITTEE ON CONTINUING EDUCATION

## MERGERS AND ACQUISITIONS—LIFE INSURANCE

**The Actuary's Role**

The actuary working in the field of mergers and acquisitions needs much specialized knowledge, in addition to the basic skills common to all actuaries. When serving as an adviser to either a buyer or a seller of an insurance enterprise, the actuary is naturally called upon to evaluate the soundness of reserves and pricing margins in existing business. But, in addition, the actuary, working alone or with other specialists, will have to form a judgement about the margins that can be achieved on future new business in a competitive market, future growth of the business, and the impact of external forces on the particular business involved. And then there are specialized actuarial techniques that are used to put all of this information together into an appraisal of a company that can be used by buyer or seller in their decision-making process.

In order to operate effectively, the actuary doing this work ought to have at least a passing knowledge of some very important non-actuarial areas such as strategic or synergistic considerations; the principles used in asset valuation; the techniques of providing a capital structure for the transaction; and the tax implications to both buyers and sellers of a proposed transaction. In addition, the general experience of other companies that have gone through a similar process would be helpful, as would knowledge of problems that can arise in such areas as human relations, information systems, and marketing.

But there are some particular areas where the actuary's skills are basic to the process, and where the actuary must take a key role. One of these is the establishment of "purchase GAAP" values, which might be quite different from the historical GAAP accounting basis that is then in place. Analysis of reinsurance contracts is another important area. And finally, there is the analysis by the actuary of the impact and cost of employee benefit plans.

**Introduction**

When it happens that a corporate acquisition turns out to be unsatisfactory to the acquiring company, or a merger fails to produce the expected benefits, it often is the case that the initial investigations and financial analyses were not well done. It is important first of all that the strategic rationale be well understood. This means thinking carefully about the kind of "fit" that can be expected. The significance of the particular market niches of each company have to be examined. Strengths in terms of various skills and capabilities must be assessed.

Financial projections of the impact and value of the merger or acquisition often suffer from unjustified optimism. Hoped-for economies of scale must be carefully examined, and growth potential and profit margins realistically evaluated, often in an atmosphere where time pressures are severe and data is incomplete.

Mergers and acquisitions of insurance companies have led to the development of specialized techniques especially appropriate in an insurance context. Typically, the valuation of an insurance company is done in three parts: the value of surplus, the value of business already in force, and the value of future business. Resulting values are significantly different from the value that the stock market may place on a company. This is due not only to the different purposes of the two kinds of valuation, but also to the principle that in merger or acquisition work the analyst should pick up facts and insights that are not available in published information.

Because so much is at stake, it is important that workers in the field explore every source of data and be sure that no obtainable information was missed. This is known as "due diligence" and, as the term implies, means that it can later be demonstrated, if necessary, that everything appropriate to the task was thoroughly done.

## BACKGROUND MATERIAL

The material in this section is designed to give an overview of the field of mergers and acquisitions. It will be particularly helpful to the actuary who is newly entering the field or who has only worked sporadically in it. As befits such material, it is less technical and often less specifically "actuarial" than what follows in subsequent sections. Items in this section include two references which, taken together, give a good picture of what mergers and acquisitions in insurance are all about. There are also some accounts of particular merger experiences and how they worked out. Finally, there are some suggestions for keeping up with current developments, and for texts from outside insurance that may contain some useful background.

### Actuarial Background

1979 Panel Discussion on Mergers and Acquisitions of Life Insurance Companies (*Record of the Society of Actuaries*, Volume 5, Number 4, p.969)

This discussion offers a broad view of the overall subject and some of the actuarial considerations and approaches. The discussion also includes: (a) The effects of an acquisition on a company; (b) The legal aspects of takeovers, including board and management responsibilities and liabilities; (c) Structuring and evaluating the financial considerations in a takeover.

Level: Intermediate Pages: 14

1984 Panel Discussion on Corporate Diversifications, Mergers, Acquisitions, and Joint Ventures (*Record of the Society of Actuaries*, Volume 10, Number 3, p. 1497)

This gives a good background on life company acquisitions and corporate diversifications as well as spelling out the reasons why mergers and acquisitions take place. It also includes a good case study of the implications of a merger with emphasis on the management considerations and also speaks of some of the possibilities of demutualization.

Level: Intermediate Pages: 42

### Experience In Mergers and Acquisitions In Life Insurance

1977 Panel Discussion on Acquisitions, Mergers, and New Evaluations (*Record of the Society of Actuaries*, Volume 3, Number 1, p. 191)

Two good case studies are included herein, and they provide a good overview of the merger and acquisition process. The topics addressed include: Evaluation of the reasons for and against mergers and acquisitions, profit objectives and projections, legal considerations, and development of an actuarial appraisal.

Level: Basic Pages: 19

"Moving Ahead With Assurance", by Rod McQueen (*Canadian Business*, June, 1985, p. 110)

This summary of a Canadian insurance merger discusses many of the nonactuarial aspects of mergers, including the legal barriers and work force problems.

Level: Basic Pages: 4

"Merger Means Disaster for Some", by Alfred G. Hagerty (*National Underwriter*, May 23, 1988, p. 1)

This is a subsequent view of the same merger as was discussed in the McQueen article; the viewpoint is somewhat different, and the great difficulties encountered in the transition process are stressed (although the merger is judged by the author ultimately to be a success).

Level: Basic Pages: 2

"Anatomy of a Company Merger" (*National Underwriter*, April 6, 1985, p. 17)

A generalized description of a U.S. life insurance acquisition. The emphasis is on marketing and on consolidation of computer systems.

Level: Basic Pages: 3

**NOTE:** Knowledge of recent actual transactions and their relative values is vital to the practitioner in the mergers and acquisitions field. The following periodicals are recommended as sources of news in this area:

Best's Insurance Reports (A. M. Best Co., Ambest Road, Oldwick, N.J. 08858)

The Insurance and Financial Review (Philo Smith & Co. 2950 Summer Street, Stamford, Conn. 06905)

(Also, The Actuarial Digest publishes at least annually a summary of M&A activity; e.g., the Aug/Sep 1989 number)

For the actuary who wishes to have at hand for occasional reference a general text about mergers and acquisitions from a non-insurance point of view one of the following two books might be appropriate:

Salter, Malcolm S. and Weinhold, Wolf A.; *Diversification Through Acquisition: Strategies for Creating Value* published by the Free Press

Lee, Steven J. and Colman, Robert D. (Editors); *Handbook of Mergers, Acquisitions and Buyouts* published by Prentice-Hall

## CORE MATERIAL

In this section we come to the central part of what an actuary who wishes to practice in this field ought to know and what represents the most important part of what an actuary is expected to contribute to the process. The section is divided into two topics: Actuarial Appraisal, which is the process of analyzing the experience, products and prospects of the company in order to set a value on it; and Purchase Accounting, the changes in accounting that take place as a result of the purchase.

### Actuarial Appraisal

"Setting Standards", by Patricia L. Guinn (*Emphasis Magazine*, Number 1, 1990)

This article summarizes the steps in the actuarial appraisal process and discusses some of the key issues involved in setting formal actuarial standards for appraisals of life companies.

Level: Intermediate Pages: 4

Actuarial Standard of Practice: "Actuarial Appraisals of Insurance Companies and/or Blocks of Insurance Contracts" (Actuarial Standards Board, 1990)

Should be read in the exposure draft form or, if available, the final form. When the standard goes into effect it will delineate the process that the actuary in the U.S. should go through, the reports that should be made, and some of the criteria for choosing assumptions.

Level: Intermediate Pages: 10

"Actuarial Appraisal Evaluations of Life Insurance Companies", by Samuel H. Turner (*Transactions of the Society of Actuaries*, Volume 30, page 136)

This is a thorough discussion of the appraisal process. It describes and critiques current approaches to appraisal and proposes a new approach. It calls for more meaningful disclosure in connection with the process and examines the nature of differences between appraisal value and GAAP shareholder equity; it also contains a valuable list of references for further background.

Level: Advanced Pages: 32

### Purchase Accounting

Interpretation I-D on Purchase Accounting (Financial Recommendations and Interpretations, American Academy of Actuaries, 1977)

This interpretation relates to computing policy reserves for individual life insurance policies acquired in a transaction which is to be accounted for under the purchase accounting rules described in Accounting Principles Board Opinion Number 16. It discusses several aspects of reserve development including tax considerations.

Level: Intermediate Pages: 2

"Accounting Principles Board, Opinion No. 16 (Business Combinations) and Opinion No. 17 (Intangible Assets)

Opinion 16 gives rules for treating business combinations either as purchases or as pooling of interests, and opinion 17 sets rules for goodwill and its amortization.

Level: Intermediate Pages: 29

Accounting for the Purchase of a Life Company", by Gary Corbett (*Transactions of the Society of Actuaries*, Volume 27, p. 313)

A thorough discussion of the considerations involved in accounting for an acquired block of inforce business. Nine methods are described and analyzed by use of a simple model office. (However, it does predate the Academy Interpretation I-D).

Level: Advanced Pages: 62

"Purchase Accounting: A Fresh Look", by Douglas A. Eckley (*Transactions of the Society of Actuaries*, Volume 32, p. 449)

This paper builds upon the Academy's Interpretation I-D to develop a "best" method determined from the two general approaches identified in the Academy's Interpretation. It develops the basis for the method and discusses considerations in setting actuarial assumptions to be used for purchase accounting. The accompanying discussions should also be read; a number of dissenting opinions are contained therein.

Level: Advanced Pages: 35

1979 Panel Discussion on Purchase GAAP versus Historic GAAP (*Record of the Society of Actuaries*, Volume 5, Number 1, p. 205)

This deals with GAAP accounting for mergers and acquisitions and presents an overview of APB 16 and some guidelines. It outlines specific methodology and also deals with the subject of purchase restatements.

Level: Intermediate Pages: 16

1985 Panel on Accounting for Mergers and Acquisitions (*Record of the Society of Actuaries*, Volume 11, Number 2, p. 1029)

This is a detailed discussion of the objectives and practices related to purchase accounting. It requires considerable background knowledge about accounting and tax issues.

Level: Intermediate Pages: 22

## NOTE

Where one (or both) of the companies is located in Canada, reference may also need to be made to the accounting principles set out in the Handbook of the Canadian Institute of Chartered Accountants.

## SPECIAL TOPICS

In this section of the guide are collected topics which are of great importance to the transaction and which could often be useful knowledge to the actuary, but are not considered "Core Material". These references generally emphasize the point of view of experts in other fields. In particular, most of these references have to do with the financial aspects of mergers and acquisitions, such as capital structure, minimizing taxes, etc. Also included are two references on employee benefit aspects. They are included here for completeness, and this is certainly an area of endeavor where the actuary should expect to exercise some expertise, but it is often considered an entirely separate area of study.

"Acquiring a Life Insurance Company", by Thomas W. Walsh (*Price, Waterhouse Review*, Volume 27, Number 2, p. 25)

This is a useful outline of the considerations in making a life insurance acquisition from an accountant's perspective. It is non-actuarial and general in nature. It touches on each of the major considerations in the acquisition process and also includes some additional information regarding accounting for the purchase.

Level: Basic

Pages: 8

"Structure Considerations in a Leveraged Acquisition", by Robert L. Beisenherz (*Actuarial Digest*, Volume 6, Number 1, 1987)

A very thorough discussion which deals with maximizing interest deductibility, the effective use of capital, and ways of creating cash for debt service, as well as touching upon relationships with banks and regulators.

Level: Advanced

Pages: 7

"Analyzing Employee Benefit Costs in Mergers and Acquisitions", by Everett Wong (*The Actuary*, October and November, 1988)

This article was written from the point of view of the actuary advising the buyer in acquisition (not necessarily an insurance acquisition). There is some good advice on how to work within severe time and data constraints, and also there are extensive lists of "things to watch out for".

Level: Basic

Pages: 5

1979 Panel Discussion on Mergers and Acquisitions (*Record of the Society of Actuaries*, Volume 5, Number 2, p. 327)

The discussion relates to pension plans in mergers and acquisitions. It addresses the concerns of the plan participants as well as the financial considerations from both an actuarial and an accounting point of view.

Level: Intermediate

Pages: 25

**NOTE:** At the time this Guide was printed the forthcoming text by Fagerberg and Tiller on *Reinsurance* was not yet published, but it is expected that this might be a useful reference for the reinsurance aspects of mergers and acquisitions, and that the chapter on "Assumption Reinsurance" might be particularly relevant to the subject matter of this Guide.

This Actuarial Specialty Guide on Mergers and Acquisitions – Life Insurance was developed under the auspices of the Professional Actuarial Specialty Guides Committee on Continuing Education by

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