FALLING DOMINOES: THE IMPACT OF CREDIT-TRIGGERED RISK
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By Tom Conway and Peter Davis

Value Drivers for Property/Casualty Insurers

Business mix, size, efficiency, concentration, and diversification all influence investors’ valuations of P/C insurers, an EY analysis shows.

By Perry Quick and Daniel Kahn

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In other articles, we update our analysis of the impact of demutualization on the market capitalization of the life insurance industry, explore the growing stature of Bermuda as an international reinsurance center, and analyze the findings from our latest transfer-pricing survey. We will also check out the International Capital Assumptions that will be featured occasionally in which we report on the first bulk sale of a portfolio of nonperforming loans in Asia. Please keep us informed about other topics you would like us to address in future issues of CrossCurrents.

Robert Stein
Chairman, Global Financial Services

An Unstoppable Chain of Events

If anyone still harbored any doubts on the subject, the repercussions from the Enron crash drove home only too dramatically the new world of credit-related risk facing property/casualty insurers. Credit defaults from the banks and triggers a series of related losses, forced restructuring and officers’ liability, to investment returns, magnifying greatly the overall impact on the bankrupt company’s insurers.

Our cover story examines the startling domino effect of these “credit triggered” losses, which demonstrates the need for risk management programs that take into account the interrelated nature of large credit exposures. And as insurers turn their attention to the need to measure, monitor, and mitigate the risks stemming from these multiple trigger points, the authors emphasize, they can learn much from the experiences and approaches used by commercial banks.

The implementation of international accounting standards (IAS), now under development, is another pressing challenge for insurance companies worldwide, necessitating a transition to fair-value, or “fair value like,” measurement of assets and liabilities, with all the difficulties this involves. But ultimately the authors of “IAS: Some Pain, Much Gain for Insurers,” this effort could yield substantial benefits by spurring insurers to enhance their operations in several areas, thereby positioning them to succeed in today’s more demanding business environment.

Increasing shareholder value is also a goal for publicly held insurers in today’s fiercely competitive capital markets. Following up on an earlier article (“Taking Stock of Life Insurers,” Fall 2001), Perry Quick and Daniel Kahn report the results of their analysis of the factors that influence the market’s valuation of property/casualty insurers. Some of their findings may surprise you.

Outsourcing, too, can contribute to company success, says Doug McPhie, author of “Thumbs Up on Outsourcing.” He notes that in their effort to save money and boost the bottom line, life insurers are becoming increasingly willing to outsourcing, once regarded as an oxymoron. As a case in point, he reviews the experience of several Canadian insurers who have outsourced policy administration and the factors that make these arrangements work effectively.

In other articles, we update our analysis of the impact of demutualization on the market capitalization of the life insurance industry, explore the growing stature of Bermuda as an international reinsurance center, and analyze the findings from our latest transfer-pricing survey. We will also check out the International Capital Assumptions that will be featured occasionally in which we report on the first bulk sale of a portfolio of nonperforming loans in Asia. Please keep us informed about other topics you would like us to address in future issues of CrossCurrents.
In the wake of Enron, property/casualty insurers must reassess their exposures to credit-triggered risk and how this risk is controlled.

By Tom Conway and Peter Davis

Enron collapse and the string of asbestos-related bankruptcies over the last 18 months have reopened the eyes of insurance company management to the risks presented by aggregations of exposure from credit-related losses. Like the wake-up call issued to the industry when Hurricane Andrew narrowly missed Miami in 1992, these events are driving home a clear message: to measure, monitor, and manage the interconnected risks that emanate from multiple trigger points.

The new world of risk has property/casualty companies facing what we call “credit-triggered risk.” In a traditional sense, credit risk usually implies the chance that a loss will occur on a financial instrument due to an obligor’s failure to meet its contractual obligations. Credit-triggered risk encompasses traditional credit risk but also a host of additional risks that arise when the financial condition of a policyholder, reinsurer, counterparty, or related third party deteriorates due to credit-related events. In a kind of deadly domino effect, the multiple losses from these exposures can sweep through a company, compounding the initial direct damage, in a chain of events that may be difficult to anticipate and impossible to halt.

The most recent example of the credit-triggered risk phenomenon is the insurance industry fallout from the Enron bankruptcy. In the days and weeks following Enron’s demise, property/casualty companies scrambled to quantify their losses. As they struggled to gather information, two things gradually became very clear: (1) that gathering the information was too difficult, and (2) that losses were emerging from multiple operating areas of each company.

The areas affected included investments (stocks, bonds), surety bonds, financial products (credit default swaps), directors and officers liability, and errors and omissions coverage. To date, total reported losses per insurer have ranged from $10 million to the hundreds of millions.

Driven by Major Trends
The fact that the insurance industry could be susceptible to such a large aggregation of exposure from a single bankruptcy should not come as a surprise, given developments over the last 10 years. Major industry trends such as globalization, consolidation, the introduction of complex new products, and the increasing structural changes within companies have all contributed to this problem.

Globalization has created farther-flung business operations, making it more difficult to provide corporate oversight at the level necessary to track risk aggregation. Consolidation has led to an increase in company size and to more diversified product offerings, making it more likely that an insurer will have multiple touch points with a single customer. The introduction of complex new products, such as collateralized debt obligations, has created the potential for companies to substantially leverage their credit exposure to a single counterparty or portfolio of counterparties.

Changes in management organizational structures have created specialized business units for the purpose of developing more focused, entrepreneurial operations within a company. While the business reasons behind these structures are legitimate, the effect in some cases has been to create silos that do not communicate and may be offering multiple products to the same customers.

The result of these developments is that prior to Enron, most P/C companies typically did not have the information to track aggregations of credit-triggered risk across operating units and product types. They simply had not focused on the need to assemble the necessary data and develop tools to manage and monitor credit-triggered risk.

This attitude is very similar to the insurance industry’s position on catastrophe risk prior to Hurricane Andrew. Insurers loosely monitored their catastrophe exposure, using out-of-date methods and models to monitor aggregations of...
Risk. Since then, the industry has done an about-face. Working with vendors, insurers have developed sophisticated exposure databases and catastrophe simulation models to measure individual risks and aggregations of risk. These efforts should serve as a model for the industry to follow in measuring other aggregation-type risks, such as credit-triggered risk.

Unlike the investment required after Hurricane Andrew, insurance companies can draw on the experience of other sectors within the financial services industry to identify how they can strengthen their management of credit-triggered risks. Over the past decade, commercial banks have continued to invest heavily in enhancing credit risk management. The challenges that P/C companies face in managing their credit risk have parallels within the banking industry, allowing P/C companies to leverage banks’ investments in this area.

These activities can fall into four categories: identification, measurement, monitoring, and management. Clearly, these activities build on each other, since credit-triggered risks must be identified before they can be measured or managed. These categories are also ranked by the increasing value that they bring to the organization. Risk identification, by itself, does not improve a company’s risk profile. Therefore, the challenge is to sufficiently invest in risk identification and measurement methodologies in order to build value through effective risk monitoring and management.

### Identification

As described above, there are two types of credit-triggered risks: direct and secondary. Direct credit risk is easy to identify at the product level, but not necessarily at the business-unit or enterprise level. Property/casualty companies take on direct credit risk primarily through their investment portfolios and financial products, such as surety bonds and credit guarantees.

In identifying direct credit risk at the enterprise level, insurance companies face two major challenges similar to those faced by banks. The first is to maintain the industrywide databases containing the organizational hierarchies for the companies the insurer has relationships with, so that all of the insurer’s credit exposures to the individual companies in the respective organizations can be aggregated up to the parent level or any level. Unless this occurs, single-customer risk concentrations may not be fully identified at the enterprise level of the insurer.

Second, exposure data must be collected from disparate systems across business units to allow for the aggregation of exposures at the enterprise and lower levels within the insurance company. Banks and others institutions with significant credit exposures have moved toward the creation of credit risk warehouses, or databases, that use middleware applications to collect exposure and risk data from diverse client interfaces and legacy systems. These credit warehouses, supplemented by market data and risk models, then support the measurement, monitoring, and management of their credit risk.

But beyond the challenges they face in collecting and aggregating direct credit exposures, insurance companies, unlike banks, also are subject to secondary — credit-triggered — risk exposures. (See Exhibit 1.) The challenge is not only to identify these risk exposures, but to place them on a level equivalent to direct credit risk exposures so that they can be aggregated up on a single-name basis. For example, an insurer may find that it has direct credit exposure to a given company, but also has secondary exposure through professional liability insurance sold to a service provider of that company.

As a second example, the insurer may also incur related losses from D&O insurance due to lawsuits against officers within the defaulting firm.

And finally, the insurer may experience losses from providing reinsurance to a company that provided coverage (e.g., a surety bond) to the defaulting firm. A large claim from the defaulting firm could result in a reinsurance claim when the reinsurer was unaware of the underlying exposure.

The scramble by insurers to assess their exposures after the collapse of Enron indicates that identifying credit-triggered risks, and developing systems that fully aggregate risk exposures on a timely basis, will require a significant investment of time and money. Insurers must assess the return on these investments in light of their current and planned credit risk exposures.

### Measurement

In recent years, banks have made considerable progress in quantifying their credit risk exposure. Insurers can leverage this expertise.

Banks have focused on the enhancement of their internal ratings systems, improving the ability of these systems to effectively rank-order credit risks on a consistent basis across product types, and to link credit ratings to default probabilities and resulting estimates of loss severity. Particularly for credit exposures to public firms, banks have introduced forward-looking models to obtain the market’s view of the credit quality of individual firms, allowing banks to identify potential credit deterioration prior to a ratings downgrade.

For example, Exhibit 2 shows the default probability for Global Crossing — which filed for bankruptcy in January 2002 — as estimated by KMV, a leading vendor of credit risk models. As compared with its credit rating and associated historical default probability, for similarly rated firms. In this case, the KMV default probability, which reflects the market’s view of the altered value of the firm, shows a deterioration in credit quality well in advance of the credit rating downgrade.

Banks have made similar advances in developing portfolio models that allow companies to measure their potential losses at a certain confidence interval, given the credit risk correlations within their portfolio. The information is crucial to the enhancement of early-warning systems, allocation of credit risk capital, and refinement of risk-based pricing.
While adopting the new international accounting standards will be challenging for insurers, the ultimate gains could be substantial. The IASB initiatives have been endorsed by the International Organization of Securities Commissions (IOSCO), which supports the use of international accounting standards (IAS) as an alternative to national GAAP in local capital markets, including the United States.

The U.S. Securities and Exchange Commission (SEC), a member of IOSCO, has not clearly stated its position as to whether and how it will recognize IAS as an acceptable basis of reporting for U.S. purposes of foreign securities filings. Instead, the SEC has preferred to participate in the dialogue and monitor developments, withholding its ultimate decision. The proposed IASB reporting framework would be radically different from current national reporting practices in many countries and would thus pose serious challenges for insurers and other participants in the capital markets. At the heart of the proposed standards is the concept of fair value — or a “fair value like” — measurement of financial assets and liabilities. Some observers believe the movement of global capital markets to a fair-value standard will eventually force U.S. GAAP to follow.

Accounting for insurance is a top IASB priority because at present there is no international financial reporting standard covering insurance contracts. To address this issue, the IASB is currently reviewing a Draft Statement of Principles — Insurance Contracts (DSOP) that will likely form the basis of an International Financial Reporting Standard (IFRS) for insurance contracts. The DSOP would apply to all forms of insurance (life, property/casualty, reinsurance and health) and presents a set of principles upon which an IFRS can be built.

With its requirement for fair-value (or “fair value like”) accounting, the DSOP represents a major departure from current accounting practices. As a result, putting the new reporting framework in place will be a tremendous challenge for insurers, surpassed in difficulty only by the need to explain reported earnings after the new principles have been implemented. The global business community is responding quickly to the IASB’s efforts to develop uniform global accounting standards. In Europe, many non-insurance companies already report under international standards. Furthermore, the European Commission (EC) has mandated that by 2005, all companies with shares trading on stock markets within the European Union (EU) must report using IAS standards. In addition, it is expected that companies with listed debt in the EU will be required to report IAS results by 2007. This requirement may be extended to all companies operating in the EU, even those not listed. The tight timeframes stipulated for IAS implementation compound the challenges facing the insurance industry.

Key Challenges Raised IAS 39 and Proposed Changes. The DSOP scheduled for completion in late 2003, will fill a gaping hole in the current international financial reporting framework. At this point, under IAS, the majority of an insurer’s assets (as well as some of its liabilities — specifically, “investment contracts”) are governed by IAS 39, Financial Instruments, Recognition, and Measurement. However, insurance contracts are excluded from the scope of this standard.

IAS 39 permits certain securities (those classified as trading and available-for-sale) to be carried at market value, with changes in unrealized gains and losses reported through income. As an alternative, a company may elect to report unrealized gains and losses for the available-for-sale securities through equity. Financial liabilities that are not insurance contracts and are not held as trading must be measured at amortized cost.

Unless these IAS 39 requirements are modified, insurers will find themselves in a quandary. On the one hand, most of their invested assets will be carried on their balance sheets at fair value. On the other hand, investment contract liabilities would be carried at amortized cost, and investment contract liabilities would be carried at fair value or something similar to fair value (i.e., entity-specific value). In this situation, the classification of contracts as “insurance” would have a significant impact on the level and volatility of reported earnings. To address these potential problems, the IASB is considering a number of changes to IAS 39. One proposal would permit companies to measure any financial instrument at fair value, with changes in value...
reported through income. If this revision were made, most insurers would likely opt to use fair value for both assets and liabilities in order to make the accounting consistent with insurance contracts reported at either fair value or entity-specific value.

**Contract Classification.** The DSOP applies to insurance contracts, not to insurance companies. Moreover, the definition of insurance contract requires the presence of “insurance risk.” This definition is similar to that for U.S. GAAP in FAS 97 and 113.

The intent is for similar contracts to be recorded at similar values in the balance sheet, but this may be difficult with the DSOP and IAS 39 in their current forms. For many contracts with large investment elements, judgment will be required as to whether they should be classified as insurance or as investment contracts. This decision will affect their carrying value and the pattern of earnings recognition (in the absence of the proposed changes to IAS 39 described above).

Furthermore, the DSOP requires that contracts be reclassified from non-insurance to insurance (but not vice versa) under certain conditions. For example, deferred annuity products in some countries might be reclassified from investment to insurance contracts as they approach the annuitization date, and the mortality risk rises to significant levels.

**Basic Measurement Principles.** Under the DSOP, a single approach to measurement applies to all insurance contracts. This differs from some current practices, such as U.S. GAAP, for which accounting varies by product type. The DSOP specifies that invested assets deemed to support liabilities should not be taken into account when valuing insurance liabilities, except where the liability cash flows are directly dependent on the assets, such as in a variable annuity, unit-linked, or other “performance linked” contracts.

Two possible ways to measure insurance contract liabilities outlined in the DSOP are fair value and entity-specific value. If IAS 39 is amended to require fair value treatment for the “substantial majority” of financial assets and financial liabilities, then insurance assets and liabilities would have to be measured at fair value, defined as the amount an insurer would need to pay a third party to assume the liability in an arm’s-length transaction. Without this amendment, insurance assets and insurance liabilities would be measured at entity-specific value. The DSOP is silent on the liability measurement approach to be used if fair value is permitted but not required under IAS 39 for financial assets and liabilities other than insurance.

**Adjusting for Risk and Uncertainty.** Under the DSOP that is done by adjusting the cash flows (the preferable approach), the discount rate, or both, without double counting.

The risk adjustments are referred to as “market value margins” and should be consistent with market-risk preferences. The market-based adjustment for risk and uncertainty effectively acts as a market mechanism for pricing uncertainty and will have an impact on liability valuation levels. However, there is no guidance in the DSOP on how these margins should be determined.

**Valuation Options and Guarantees.** The DSOP requires that options and guarantees contained in contracts, such as minimum interest-rate guarantees, guaranteed annuity rates, and guaranteed death benefits on variable or unit-linked products — be valued. In such cases, option-pricing or stochastic valuation techniques will be required, forcing many companies to undertake costly upgrades to their existing financial measurement and modeling systems.

**Estimating Cash Flows and Adjusting for Risk and Uncertainty.** Liability valuation begins with projections of expected cash flows under an insurance contract. The present value of those cash flows, discounted at the risk-free rate, is the liability value before any adjustment for risk and uncertainty. Both fair value and entity-specific value should always contain a market-based adjustment for risk. Under the DSOP that is done by adjusting the cash flows (the preferable approach), the discount rate, or both, without double counting.

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**Market transactions and product pricing typically employ embedded-value techniques.** Embedded-value calculations include asset returns in excess of risk-free rates and typically adjust for risk by means of allocated capital and use of a discount rate based on the cost of capital.

If the rules for setting market-risk adjustments are not consistent with established product-pricing techniques, there is the possibility of reporting material gains or losses when products are issued. Furthermore, the DSOP sets limits on the projection of some income that would be anticipated in pricing, which may lead to losses at issue even for products that are priced profitably. Specifically, returns in excess of risk-free rates on assets backing insurance contracts may not be taken into account. In other words, the standards for calculating fair value are not necessarily consistent with actuarial practices.

**Financial Statement Disclosures.** The proposed DSOP disclosure requirements are voluminous and burdensome. Companies will be required to disclose expected earnings based on prior-period valuation assumptions, together with the effects on current earnings of new business written, release of margins, deviations due to differences between actual and expected experience by source, and changes in assumptions.

**Major Implications for Insurers.** The timetable for converting to IAS is extremely tight. For companies reporting in multiple territories, it will take years to implement a full conversion, and all companies will need to apply the standards for several years before they will be able to comprehend and explain their results. Therefore, IAS adoption and analysis are recommended well before 2005.

The business implications of the DSOP reporting framework are far-reaching. Among the most significant are the following:

**Increased Financial Statement Volatility.** Reported financial results will be more volatile under IAS, making it more difficult to understand results and explain them to senior management, boards of directors, investors, and other stakeholders.

**Investment Management.** In the effort to reduce earnings volatility, assets and liabilities may become more tightly matched, and assets backing surplus may be invested in less risky instruments, causing policyholders and investors to lose the potential upside gain. For countries such as the U.S., there will be fewer constraints on managing asset portfolios on a total-return basis, because current disincentives to realize gains will be diminished.

The credit quality of the fixed-income portfolio will become more transparent, because changing credit spreads may materially affect reported income. These changes may not be offset by corresponding changes in liability values, due to the separation of liability discount rates and asset yield rates. To some extent, however, a fair-value system that provides for the recognition of a company’s own credit risk in the liability discount rate would alleviate this problem. As investible asset-quality spreads increase or decrease, the company’s own credit-quality spread related to valuing liabilities would tend to increase or decrease as well.

**Pricing and Product Design.** Products may be designed to take advantage of the new accounting environment. For example, performance-linked contracts appear to receive more favorable accounting treatment than other life insurance contracts. Companies also may be reluctant to readily offer guarantees and options in contracts as their true economic costs become known. If they do offer such guarantees, they may choose to hedge the risk to more effectively manage the volatility of results.

In addition, back-end guarantees and loyalty bonuses may be introduced to show that a product contains valuable options. This would allow companies to consider future premium renewals when valuing the contract, which would tend to reduce the liability.

**System Challenges.** To meet the new reporting requirements, insurance companies will have to undertake a massive retooling of existing systems and may have to introduce new global
In determining how best to resolve these outstanding issues, the IASB is taking a holistic approach. This approach involves considering a wide range of factors, including the potential impact on financial reporting, user understanding, and the need for comparability.

**Disclosure and External Relations**

The new, more onerous IAS disclosure requirements will require insurance companies to adopt a completely new way of communicating with the public. For example, the balance sheet may change materially from the valuation date to the date of the IFRS statements. The IASB has taken a different approach to presenting earnings analysis, forecasting, and risk management. The IASB is considering whether the prospective disclosure framework will involve some pain; insurers stand to realize substantial gains from their efforts as well. Ultimately, the adoption of international accounting standards should help insurers adapt to, and succeed in, the more demanding business environment.

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However, despite the demonstrated linkage between outsourcing and share-holder value, life insurance companies historically have lagged banks and other sectors of the financial services industry in the extent to which they engage in outsourcing. The banking industry accounted for 35% of the total value of outsourcing contracts for business processes in the UK, one study found, while the life industry represented only 5% of the total.

Picking Up Speed
Now that may be about to change. Over the past year, the trend toward outsourcing in the life industry has been growing, with major deals occurring in North America, Europe, and Asia. Since the beginning of this year, Manulife Financial, Canada’s largest life insurer, has announced the outsourcing of its North American IT infrastructure management to IBM, and Sun Life of Canada has agreed to have Marlborough Stirling handle the policy administration of its 800,000-policy UK business. Last year, Abbey Life announced a similar deal with Unisys for its 1.5 million life policies.

John Mather, chief information officer of Manulife, cites four main reasons why the insurer has entered into its partnership with IBM: to provide IT depth and flexibility for future mergers and acquisitions, to provide resource flexibility that will allow the insurer to respond to the peaks and valleys of IT demand resulting from the rapid development of new products, to create a top-flight IT back office, and to drive cost savings.

Outsourcing is often viewed as falling into two categories. The first category, information, communications and technology outsourcing (ICT), encompasses IT operations, development, infrastructure, and networks. The second, business process outsourcing, can include back-office operations for group, individual, finance, investments, human resources, and other operating areas. Providers such as Cap Gemini, CGI, EDS, and IBM all offer solutions in both of these areas for many industries, while other companies specialize solely in the life industry.

Historically, North American life insurers have used outsourcing only for minor business processes, or for new processes that lack an existing administrative infrastructure. However, as the recent announcement by Manulife and others suggests, the trend is shifting. And while IT is often the first place where life companies outsource, the bigger opportunity may lie in the area of business-process outsourcing. The incremental gains that come from internal management of business processes may be neither big enough...
Outside providers typically have the systems and processes to support the most complex products and can provide seamless interfaces back to the life company’s in-house systems, supported by real-time, daily, weekly, or monthly connections.

Fortis believes its provider is successfully managing the complexities of its products, according to Donivan. Interfacing between systems is not an issue, he says, because there is a seamless interface back to the insurer’s own accounting, reserving, and investment systems through extracts between Liberty’s systems and those at the insurer.

However, multiple products and interfaces, together with the long life of policies, result in another major complication: system conversions. The process will need to go through several systems conversions throughout their life cycle — an expensive and risk-prone process.

Adding to the complexity is the acquisition of companies or blocks of business that can result in a life insurer’s maintaining multiple systems and processes. Outsourcing removes these issues, and outside vendors claim that they often can complete conversions more quickly and at less cost than the company would incur in doing a conversion itself.

Substantial Cost Savings

There is some skepticism in the industry about an outsourcer’s ability to provide services at a cost lower than the life company itself can achieve. However, Manulife’s John Mather reports that the savings his company realized from its outsourcing deal with IBM exceeded what the company anticipated when it first began examining outsourcing opportunities. He estimates the seven-year deal will result in a 30% savings on the $1 billion CDN it would have cost Manulife to continue to manage ICT itself.

Sun Life of Canada reported a $50 million savings from outsourcing policy administration in one business unit. Abbey Life and Fortis also cited savings resulting from their policy administration outsourcing arrangements.

According to Bruce Powell, senior vice president of Liberty, its customers have realized an average of 25% to 30% savings in annual policy administration expenses, and a one-time system conversion typically costs between 30% and 50% of the initial annual cost. The savings result from economies of scale, process innovations, and the provider’s ability to spread its investment in new technologies — for example, new universal life systems applications, imaging, work-flow and call-center operations — across many companies, reducing the costs to each one.

Another benefit of outsourcing, says Donivan, is that previously hidden costs are now visible and are better managed. For example, when Fortis maintained its own billing processes, it was inevitable that the products would need to go through several systems conversions throughout their life cycle — an expensive and risk-prone process.

Adding to the complexity is the acquisition of companies or blocks of business that can result in a life insurer’s maintaining multiple systems applications. Insurers often elect to maintain multiple applications rather than incur the costs of conversions. However, multiple applications mean multiple support processes, such as reprogramming each application for a change in tax law. Outsourcing removes these issues, and outside vendors claim that they often can complete conversions more quickly and at less cost than the company would incur in doing a conversion itself.

Core Versus Noncore Processes

Our study found that financial services firms increasingly view outsourcing as an integral part of their strategy to save money and boost the bottom line. As a result, they are now willing to outsource activities once regarded as sacrosanct. Is policy administration one of those activities?

Most of the life companies we have spoken with say they have not given serious consideration to outsourcing some or all of their policy administration processes. They question whether outsourcing policy administration can reduce costs. They also maintain that insurance products, systems, and interfaces are too complex for outsourcing providers to manage effectively, and that policy administration should not be entrusted to a third party because it is a core business process. How valid are these concerns?

In the life insurance industry, we believe that product design, marketing and distribution, policyholder service, underwriting, and risk management are the key areas where life companies compete through differentiation. While many life companies attempt to differentiate themselves through outstanding policy administration, the marketplace recognizes only a few. Policy administration does touch the customer, but for many companies the goal is to deliver service at the lowest cost while meeting a minimum base line of quality. This makes policy administration a prime candidate for outsourcing.

Liberty Insurance Services, a U.S.-based third-party administrator owned by Royal Bank, currently provides policy administration outsourcing services, from underwriting to claims adjudication. Among those companies is Fortis Family Life, which decided to outsource the administration of its more than one million policies some years ago.

Doug Donivan, senior vice president, notes that Fortis uses Liberty for most of its policy administration activities, from initial application to claims payment. Other processes, including the product development, distribution, actuarial, and corporate reporting, are still handled in-house. Essentially, the policy administration process has been changed from being a back-office operation at Fortis to being a front-office operation at Liberty.

Policy administration in its broadest sense covers all stages of a policy life cycle after the policy design, marketing and sale processes (see exhibit). Routine internal transactions are obvious candidates for outsourcing. More sensitive are those with a customer interface, such as the call center. Can a provider’s call center deliver the depth of knowledge needed to handle what can be a large portfolio of highly sophisticated products, and can the provider be given the right empowerment to resolve customer problems appropriately?

Product Complexity and System Interfaces

Policy administration involves complex products and systems, and complicated interfaces between these systems. Products can range from simple term policies to sophisticated variable universal life policies. Systems interfaces include linkages between underwriting, policy maintenance, commission, reinsurance, call center operations, cash management, claims adjudication, billings and collections, reserving, and accounting.

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Can the provider be given the right empowerment to resolve customer problems appropriately?

Financial services companies are now willing to outsource activities once regarded as sacrosanct.
In the immediate aftermath of September 11, property/casualty executives were scrambling to meet liquidity needs, fulfill their policyholder commitments, and handle other fast-breaking crises. Next came a need to focus on underwriting, pricing, and legislative proposals for protecting the industry from events that many consider uninsurable. Now, although these issues have not been completely resolved, P/C executives should begin to return to the broader strategic challenge of how they can position their companies to increase and sustain shareholder value in today's fiercely competitive capital markets.

Academics, consultants, and management gurus have advanced various, and often contradictory, value-creation strategies for P/C companies — for example, to diversify and share risk lines of business. And to measure companies' progress in meeting their goals, financial analysts and others often benchmark P/C insurers against traditional performance measures, such as loss and combined ratios, although the evidence linking these measures to shareholder value is usually anecdotal. Now, although these issues have not been completely resolved, P/C executives should begin to return to the broader strategic challenge of how they can position their companies to increase and sustain shareholder value in today's fiercely competitive capital markets.

A recent analysis undertaken by Ernst & Young provides some answers. This analysis, which extends the analysis of life and annuity companies we conducted last year (see “Taking Stock of Life Insurers,” Fall 2001), confirms some long-standing value-creation and rules of thumb for the P/C industry, while raising some questions about the veracity or relative power of others. Here are some of our major findings:

- A P/C insurer’s GAAP book value, rather than current earnings, cash flow or any statutory financial measure, is the best single benchmark to explain relative differences in P/C insurers’ market values.

- Companies that keep expenses in check (i.e., lower expense ratios) and asset returns high are rewarded with market-to-book ratios that are higher than the industry average. Some traditional closely watched performance measures, such as statutory loss ratios, did not show statistically significant correlations with market valuations.

- Investors favor higher levels of business-line concentration over broad diversification. In an era when many companies perceive a need to expand their books of business beyond lines traditional for them, our analysis confirms that concentrating on one’s core products is important to success.

- Geographic concentration is viewed negatively by investors, as is undue concentration in hurricane- and earthquake-prone areas.

- High percentages of personal auto and reinsurance lines generally tended to boost market-to-book ratios in recent years, while commercial auto, personal homeowners, medical malpractice lines, and asbestos coverages have been viewed negatively by investors.

Research Approach

Our analysis was based on 37 publicly traded insurance groups principally engaged in property/casualty business. We used cross-sectional and time-series, multivariate regression techniques to track the historical relationships between company stock market values and a number of financial and nonfinancial variables.

Statutory filings provide a rich source of data regarding business lines, geographic coverage, and other attributes of the company that are not revealed by GAAP reporting or disclosures. Therefore, we began our analysis by collecting both year-end GAAP and statutory data for the years 1997 through 2000. The data was taken as of the last week of February 1998 through 2001, when year-end performance reports generally are available.

By using a regression analysis approach, we were able to explain much of the variance in market valuation for the companies over the four years studied, gaining insight into the factors that contribute most dramatically to favorable and less favorable perceptions in capital markets — that is, the P/C industry’s value drivers.

Two different measures were chosen to characterize market value assessments: total dollar market capitalization and market-to-book ratios.
The regression results reveal some implications for insurers.

- Revenues positive
- High Leverage
- Concentration Index positive
- Assets positive
- Business Lines positive
- Catastrophe Risk positive
- Geographic Regions positive
- Debt/Equity positive
- Investment Return
- GAAP Book Value positive
- Statutory Surplus positive
- Efficiency
- Combined Ratio
- Loss Ratio
- Dividend Ratio
- Value

Two variables were above our 80% confidence level over the four-year period as a whole and for the years 2000 to 2001, but were less significant in the earlier 1998 to 1999 period:

- On the strategy side, the markets are telling P&C insurers to diversify across regions in order to spread risks efficiently, but to “stick to your knitting” when it comes to business lines. This is not surprising, given the unique and rapidly changing knowledge and skill sets required in underwriting different P&C lines.
- Larger size also seems to produce an advantage, and leveraging debt does not appear to be disfavored.
- The market appears to consistently reward companies whose business lines are more weighted to reinsurance and personal auto, the latter being less stable from year to year in the P/C business than is true for the life companies, the capital markets do not rely on a single year’s results to project differences in future earnings among companies and hence, in relative market values.

Our analysis provided empirical confirmation of the view expressed by some Wall Street financial analysts that balance-sheet measures — especially book value — are more consistent drivers of market value than earnings or cash flow. For example, GAAP book value alone explains 93% of the variation in market cap — a somewhat better result than for GAAP assets (80%). These GAAP variables have much greater explanatory power than statutory balance-sheet measures like policyholders’ surplus (65%) and net admitted assets (62%).

Market-to-Book Analysis

Having established a robust relationship between market capitalization and book value, we were then ready to explore how the capital markets weight companies’ business-line and geographical choices and recent performance in assigning valuations. The results of the P/C company analyses were generally consistent with our findings in the earlier life analysis, namely, that company business mix and related performance measures help to explain market valuations. These results also provided empirical support for many of the industry analysts’ views and rules of thumb, although some results were at odds with conventional wisdom.

We ran many different regressions, using various combinations of drivers over different time periods, in an attempt to explain the historical pattern of differences in P/C insurers’ market/book (M/B) ratios. Since many of the potential value drivers were highly correlated with one another, great care was necessary to sort out the underlying relationships and to ensure that the systematic relationships between drivers and market values were not spurious and were robust over time.

Results of the Analysis

Certain performance variables (e.g., size, leverage, business line concentration, and various business-line reserve categories) consistently appear to be statistically significant in explaining differences in M/B ratios. In particular, nine variables showed a confidence level greater than 80% and with fairly stable magnitudes over both the entire four years studied and for the shorter subperiods (2000 to 2001 and 1998 to 1999). These were:

- The market-to-book value explains 93% of the variation in market capitalization. For example, GAAP book value alone explains 93% of the variation in market capitalization and book value. We were then ready to explore how the capital markets weight companies’ business-line and geographical choices and recent performance in assigning valuations. The results of the P/C company analyses were generally consistent with our findings in the earlier life analysis, namely, that company business mix and related performance measures help to explain market valuations. These results also provided empirical support for many of the industry analysts’ views and rules of thumb, although some results were at odds with conventional wisdom.

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finding may surprise some industry experts), while penalizing companies with commercial auto and asbestos exposures. Some other lines (namely, personal homeowner and medical malpractice) appeared to be in disfavor during the 1998 to 1999 period. But these lines and relationships became less pronounced in the more recent years, suggesting that business-line preferences can change over time.

3. On the performance side, companies are rewarded for keeping expenses under control. Maintaining a strong return on assets is also a plus, but our regressions imply that realistic variations in ROA among companies do not lead to economically significant differences in market/book premiums.

4. Finally, P/C company executives and potential company investors may want to listen to the capital markets for “the dogs that didn’t bark.” That is, a number of variables that are often used by analysts and others to evaluate performance and assess relative value actually showed no statistically significant relationship to M/B ratios. This lack of statistical significance does not imply that these measures should be ignored, but they appear to be less important in explaining differences in market value differences across companies than has been assumed.

The list of such variables includes:

- Loss Ratio
- Gross/Net Premiums to Surplus
- Change in Writings or Surplus
- Investment Yield
- Liabilities to Liquid Assets
- Agent Balances to Surplus

Among the measures that were not statistically significant indicators of relative M/B ratios, the most surprising item may be the statutory loss ratio. Many might wonder how the loss ratio, considered the best single measure of a company’s ability to select, underwrite, and price risks (arguably, its most important business activity), could not significantly influence the market’s assessment of a company’s value. Loss ratios are, of course, notoriously volatile, and one year’s historical results tell an investor little about the company’s ability to achieve a sustained level of performance. This interpretation is consistent with the relatively higher importance of book value compared with earnings or income measures in explaining differences in total market caps, and with the statistically significant, but economically minuscule impact of ROA on M/B ratios.

In the volatile world of the P/C insurer, this points to the importance of the expense ratio as a measure of the efficiency with which the business can be conducted. While investors may favor volatile loss ratios, which so often seem to be beyond management’s control, they appear to place significant weight on the company’s ability to run an efficient business. Perhaps the market is saying that an efficient company will do well when industry loss trends are favorable, while an inefficient player will underperform even when market conditions are right.

In summary, our review demonstrates robust and significant relationships between P/C companies’ market values and certain measures of their strategic choices and operational performance. These statistical patterns shed light on which aspects of the insurance business may present the most promising opportunities, and should help insurers and other companies interested in investing in the P/C industry to identify the business lines, concentrations, and business behaviors that may prove most rewarding.

Plans are now under way to enhance both our life and P/C analyses in several ways. These enhancements include expanding the list of companies reviewed to cover the largest insurers that have substantial businesses in both life and P/C; considering both life and P/C insurers together for all companies, including measures for significant asset management operations; and adding other new business decision and performance variables that were not considered in the previous studies. For further insights, stay tuned for the results of these analyses.

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The Bermuda Class of 2001

<table>
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<td>Chubb</td>
<td>Arch Reinsurance</td>
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<td>Marsh</td>
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<td>Arch Reinsurance</td>
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<tr>
<td>Meilheuser Reinsurance</td>
<td>Arch Reinsurance</td>
</tr>
<tr>
<td>White Martins, Reid &amp; Co.</td>
<td>Arch Reinsurance</td>
</tr>
</tbody>
</table>

Re's very disciplined use of proprietary risk modeling in underwriting, which has set the standard for others to follow. Similarly, at Ace and XL, two survivors from Bermuda's “Class of the 1980s,” solid analytical work forms the basis of disciplined underwriting. This is based on a culture and regulatory environment that allows for the development of capital to write lines of business where the rates are most attractive. As further evidence of their increasing market influence, Bermuda companies are among the participants in a corporate capital group that is now developing recommendations designed to help Lloyd's redefine its role in the international market. Indeed, concern has been expressed in some quarters that the London market has been unable to attract the type of capital now flowing to Bermuda — smart capital that bears little resemblance to the naive capital that flooded the reinsurance market from Australia in recent years. Bermuda's consumption-based tax system and pay employment and payroll taxes — part of the cost of doing business on the island. They also pay taxes in the countries in which their subsidiaries operate. However, Bermuda does not tax earnings and is therefore tax-neutral on earnings from Bermuda company operations in other countries. Meeting Buyers' Needs. At the World Insurance Forum held in Bermuda in February, risk managers from large corporations such as Delta Air Lines and Verizon noted that despite the new capital that has flowed into the market, they face increased exposures because of the industry's current inability to fully cover aviation liability, terrorism, and surety risks. The insurance industry will, no doubt, address these concerns, and Bermuda will surely be part of any solution that emerges. The Bermuda market will never be the whole solution to global insurance needs, because its small size restricts its growth. But its role will continue to evolve. Just as it has proven in the past that it can provide global capacity when needed, Bermuda is sure to take a leadership position in demonstrating how smart use of technology, ongoing innovation, and disciplined underwriting can change the way insurers do business.

Jan Spiering, jan.spiering@ewy.com, is chairman of E&Y’s Hamilton, Bermuda, office. Jonathan Reiss, jonathan.reiss@ewy.com, is a reinsurance partner. They can be reached at (441) 236-2046.
is no more important economic issue currently facing Asia than eliminating the nonperforming loans (NPLs) that are dragging down the financial system and impeding economic recovery. Across Asia, problem loans have reached crisis proportions, accounting for more than $2 trillion in distressed or impaired assets.

Every Asian country has acknowledged the severity of this problem and has established special-purpose agencies to address and monitor the situation. This is an encouraging sign, because no economy in the world has been able to achieve a sustained economic recovery without taking action to deal with problem loans — as demonstrated by the past experience of the United States, Mexico, Canada, Sweden, and many other European countries.

Many Asian countries have opened their financial markets and banking sectors to foreign investors, and foreign enterprises have acquired failed banks in Japan, Korea, and across the region. Countries like Thailand have modified their bankruptcy laws to accelerate the judicial process and strengthened the rights of creditors. And Beijing has made remarkable progress in reforming Chinese state-owned banks and enterprises by making them more transparent and embracing international best practices.

But governments cannot do the job alone. Private capital is needed. With Asia’s banks and other capital sources cutting back on business lending and investing, global opportunity funds and other international investors are injecting key sources of capital by purchasing distressed debt, real estate, banks, insurers, and other operating businesses around the world. Such sources of capital promise to play a key role in the one remaining obstacle to economic recovery in Asia: the identification and removal of bad debts from banks and insurers and the disposal of these loans to the private sector.

Huarong: A Groundbreaking Transaction

In China, the groundbreaking Huarong transaction marked the first successful bulk sale of a portfolio of problem loans to the private sector, offering a striking example of how NPLs can be tackled effectively. In the fall of 1999, China — beset with problem loans that were weakening its four state-owned banks — established four asset management companies (AMCs) to purchase and manage the banks’ large portfolio of nonperforming loans. A total of US$7.34 billion of NPLs was transferred to these independent agencies: China Great Wall, China Orient, China Cinda and China Huarong. Since then, the four AMCs have made tremendous progress in resolving NPLs, achieving recovery rates that are among the highest in Asia, often approaching 50% of book value.

China Huarong, the largest of the AMCs, has taken the lead in opening up the market to U.S.-style bulk transactions. By the end of 2000, Huarong had resolved nearly US$967 million of nonperforming assets, primarily distressed assets it had acquired from the Industrial and Commercial Bank of China.

Then, in November 2001, Huarong succeeded in attracting 12 of the world’s most prestigious financial institutions, as well as six highly respected domestic companies, to bid on China’s first-ever bulk sale of a portfolio of nonperforming loans. This competitive bidding auction resulted in the sale of US$1.9 billion of NPLs to international investors, including Morgan Stanley, Lehman Brothers, Salomon Smith Barney, and Goldman Sachs. Huarong expects to recover approximately 21% of the outstanding principal balance of the loans from its participation in a joint venture with these investors.

This transaction marked a new plateau in the development of China’s free-market economy. Ernst & Young acted as financial advisor to Huarong, and the observations made here about the success and importance of this transaction are based on our participation in this effort.

Huarong’s Commitment to Success

The goals of the Huarong transaction were to:

- Maximize the recovery value of the nonperforming loans.
- Provide world-class seller due diligence to enhance asset value.
- Employ several disposition strategies in the transaction.
- Encourage participation by experienced and qualified international investors.
- Maintain a transparent, fair, and efficient auction process.
- Complete the transaction on schedule.

Success Factors in the Huarong Transaction

- A fair, transparent, and orderly process
- Thorough, high-quality due diligence
- No reserve prices (minimum bid price)
- Logical pooling of assets (five pools)
- Structured bidding
- Combined participation of international and domestic investors
- Seller (Huarong) informed about investor needs
- Equity joint venture to allow Huarong some upside in the recoveries
- International Finance Corporation (World Bank) financing

Huarong committed itself to transparency and to closing the transaction. It helped investors overcome the difficulties of purchasing nonperforming loans in China and communicated the regulatory and legal concerns of investors to the relevant government agencies. The enthusiastic support of the People’s Bank of China and the Ministry of Finance also proved beneficial. Statements made by these agencies on the “road show” undertook to explain the transaction helped to clarify the foreign exchange needs facing investors in Europe and the U.S. as a result of the liquidation of the NPLs. Huarong also sought advice from the Korean Asset Management Company on the success of Korea’s loan sale initiatives, another transaction where E&Y had served as financial advisor.

Going forward, Huarong plans to employ several strategies for resolving its portfolio and is seeking input from the international community to that end. New regulations on the drawing board will strengthen the rights of creditors and the ability of foreign investors to use the legal system to resolve nonperforming assets. Huarong plans to offer additional assets for sale in the near term, including other portfolios, asset-backed securities, and equity joint ventures.

The Huarong transaction represents the first step in dealing with the difficult NPL problem facing Asian countries, which is of such magnitude that it will take many years to resolve. The pain resulting from taking action will be great, but the pain that would result if the situation is not resolved will be even greater. There is opportunity for all players — governments, banks, and investors — in resolving this crisis, and we expect to see many NPL transactions similar to the Huarong sale as this challenge is tackled more aggressively in the years ahead.

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THE first phase of the major life insurer demutualizations is over, with Prudential successfully completing its initial public offering in December. But it would be premature to label Prudential as the last big company to shed the mutual form. The pending conversion of Provident Mutual and its simultaneous acquisition by Nationwide Financial, for example, probably signal the beginning of a new wave of sponsored demutualizations.

Typically, in sponsored demutualizations policyholders are issued shares of a larger, already public life insurer into which their former mutual company is merged. Sponsored deals are attractive to companies that lack the size and breadth of operations to be a successful IPO candidate. We estimate that there are 20 to 30 mutuals or mutual holding companies that could benefit from this alternative demutualization route, and several of them are likely to follow Provident Mutual’s lead in the near future.

Moreover, the larger holdouts — including Northwestern Mutual, Massachusetts Mutual, New York Life, and Guardian Life — are not prohibited from changing their minds at any time and converting, with or without an IPO. Still, it is unlikely that future demutualizations will resemble the highly concentrated period of activity that has led to such a massive increase in the market capitalization of the life insurance sector in recent years.

Another indicator of how the structure of the industry will continue to be influenced by the demutualization phenomenon is the sale of Clarica to Sun Life in Canada. While they remained mutual, these companies were imperious to the forces of consolidation so evident in the stock company world. We can expect a similar level of consolidation activity among the former mutuals that are now public companies, although most companies that demutualize have a period of time, generally three to five years, during which they are protected from hostile bids.

The Numbers Tell the Story. The dramatic impact of the recent demutualizations becomes apparent when we look closely at the amount of new capital on the drawing board in the U.S. alone. As it turns out, this prediction was uncannily close to the mark.

Global Warming. It is instructive to recall that the generally positive outcome of the initial launches of the demutualizing companies was initially in some doubt. In the summer of 2000, the market was giving newly demutualized companies a cool reception, with the prices of most U.S. life insurer IPOs below book value. Equity investors were worried that large numbers of life company shares coming on the market, and the even larger number coming into policyholders’ hands, would depress prices long after issue. Moreover, the returns posted by life insurers looked pretty bland at that time, compared with what investors had been seeing on the tech side.

That was then. This is now. By the beginning of 2002, all the new equity had been absorbed, with no apparent problems. With the bursting of the tech bubble, investors had a much heftier appetite for the stock of financial services companies — even with lackluster returns — and the predicted indigestion went away. MetLife and John Hancock joined the S&P 500 Index. So, probably, will Prudential. Aggressive share-purchase programs by most companies kept the upward pressure on prices. The end result of all these factors is a market capitalization that exceeds our 1998 estimates, and is nearly double its value at issue.

Don’t Get Too Comfortable. The warm market reception accorded life company stocks is not unanimous, though. Despite the good stock results, the analyst community remains adamant about returns. Cost reductions are occurring, but not as quickly as analysts might like. The returns from variable products are down because of drops in market levels, while those of fixed products are sagging because of low interest rates. September 11 and resulting conditions in some reinsurance markets have taken their toll as well. The underlying economic forces for consolidation have not gone away, and the first of the “first wave” demutualizers are now being swallowed up.

A few short years ago, demutualizations were a powerful force in reshaping the life industry’s structure. Now, sponsored transactions and acquisitions of the earliest converters are likely to play heavily in the ongoing reformation of the sector’s capital base. The likelihood is that mutuals and former mutuals will continue to hog the spotlight on industry restructuring for several more years to come.

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### Growth in Market Capitalization as a Result of Demutualizations

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<th>IPO PRICE ($)</th>
<th>CURRENT PRICE ($)</th>
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FALLING DOMINOES: THE IMPACT OF CREDIT-TRIGGERED RISK

(continued from page 5)

As property/casualty insurers look to enhance their management of credit-triggered risks, they should assess their ability to consistently rank-order risks across products and business units based on forward-looking views of credit risk. They should also assess their ability to measure the correlations among their credit (and other) risk exposures in order to assess how much could be lost in a worst-case scenario. Where credit exposures are modest, insurers will want to develop approaches that cost-effectively capture the credit risk within a contract, among the need to undertake a costly assessment of the specific credit exposure.

Monitoring
Credit-risk monitoring is largely driven by a company’s ability to identify and measure its risks. The more advanced the identification and measurement, the greater the potential to monitor shifts in credit quality and the potential impact on related exposures. Credit-risk monitoring should allow management to focus on the largest exposures and highest risks. The largest exposures (based on direct and secondary exposures) and the lowest-quality credits should be monitored more frequently. In recent years, many institutions have turned to vendors’ market-based models to develop early-warning systems that monitor their riskiest customers and “biggest movers,” or those customers with the greatest deterioration in credit quality from period to period.

Management
The management of credit-triggered risk can take three forms: (1) limiting the risk accepted, (2) demanding adequate compensation for the risk accepted, and (3) transferring or mitigating the risk either within the transaction or at a portfolio level. As shown in Exhibit 3, credit-triggered risk should be managed at all stages of the credit cycle.

Effective credit risk management begins with a clear definition of the firm’s credit risk appetite, which then drives the controls and limits on the types of credits accepted. Common limit structures limit risk exposures by single customer, credit rating, geographic location, and/or product. In recent years, commercial and investment banks have revisited their limits structures, which were originally judgment-based, to set more risk-based exposure limits. For credit-triggered risks, P/C companies must develop a consistent framework that allows them to identify their strongest lines of business and reposition their operations in order to control losses and provide stable returns during high-stress periods.

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BY KATHRYN O’BRIEN AND EMMA PURDY

Transfer Pricing Is Top Tax Issue, Survey Finds

services companies view transfer pricing as the most significant international tax issue they will face for the next several years, according to a survey conducted by Ernst & Young. Double taxation and foreign tax credits are the two next most important issues cited by the 69 banks and insurance companies participating in our annual Global Transfer Pricing Survey. Curiously, however, none of these respondents sought the relief from double taxation that is available through the relatively inexpensive mutual agreement process.

Many companies assume that they can take a foreign tax credit for a foreign-initiated adjustment without filing for competent authority assistance under the mutual agreement process, thus mitigating the impact of double taxation. Actually, to be eligible for a foreign tax credit, the institution must first have exhausted available administrative remedies, one of which is the mutual agreement process.

Documentation Woes. When respondents were asked which countries’ transfer-pricing documentation concerns were most troublesome, the six countries mentioned most frequently were the U.K. (cited by 54 respondents), Poland (41), Canada (13), Australia (12), Germany (9), and Japan (6). Most of these countries are financial centers that either impose tough penalties or are active examining jurisdictions. The U.K., however, was the only country to result from the fact that Poland requires companies to produce documentation within one week of being asked to do so, and can impose a penalty of up to 50% of the tax owed.

More than three out of five financial services respondents stated that they prepare documentation on a country-by-country basis, with limited coordination between countries. With the increased ability to identify and measure their exposure limits, P/C companies must develop a consistent framework that allows them to identify their strongest lines of business and reposition their operations in order to control losses and provide stable returns during high-stress periods.

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FALLING DOMINOES: THE IMPACT OF CREDIT-TRIGGERED RISK