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## **INSURANCE FINANCE REPORT**

### **AEGON N.V. BUYS TRANSAMERICA CORPORATION FOR \$9.7 BILLION**

In February, Aegon N.V., the large Dutch insurer, agreed to acquire Transamerica Corporation for stock and cash worth \$9.7 billion. In addition, Aegon N.V. will assume approximately \$1.1 billion of Transamerica's debt. With the acquisition, Aegon will become the third largest life insurer in the United States with \$98.6 billion in U.S. assets—trailing only Prudential and Metropolitan Life.

Although little known in the United States, Aegon is a leading international insurance group with its headquarters in the Netherlands. With over \$147 billion in assets, Aegon has a major presence in five markets: the U.S., the Netherlands, the UK (where it owns Scottish Equitable), Hungary and Spain. Transamerica is headquartered in San Francisco and is the second largest life reinsurer in the United States. Transamerica also has operations in commercial lending, leasing and real estate services which do not overlap with Aegon's activities.

The consideration for the acquisition is \$78 per Transamerica share to be paid \$54.60 in Aegon stock (70%) and \$23.40 in cash (30%). This represents a premium of 35.4% over the pre-announcement market price of Transamerica's stock. The exact number of Aegon N.V. shares to be exchanged will depend upon the average Aegon share price for the 20 trading days expressed in Euros (the European composite currency) on the Amsterdam Stock Exchange prior to the closing date of the transaction (converting the closing stock price based on the published exchange rate for U.S. dollars).

The exchange ratio for Aegon's stock remains fixed for a 20% increase or decrease in the Aegon share price. For the next 15% increase or decrease in the Aegon share price, the additional price movement is shared equally between Aegon and Transamerica shareholders. Beyond a 35% positive or negative change in the share price, the parties can fix the exchange ratio at the 35% level, renegotiate or decide not to complete the transaction. Aegon named its project "Operation Tony" and its acquisition subsidiary "Tony Merger Corp." in honor of singer Tony Bennett (who left his heart in San Francisco).

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Industry observers have commented that Aegon's acquisition of Transamerica is another striking demonstration of the trend toward globalization in the insurance industry. It also evidences the trend for companies to merge in order to achieve economies of scale and greater emphasis on particular products and lines of business. In this case, Aegon gains Transamerica's general agency distribution system, which focuses on high net worth individuals, its Canadian operations, and a major life reinsurance business. The combined operation will be much stronger in long term care insurance products, insurance marketed at the worksite, guaranteed investment contracts, 401(k) plans and other pension assets.

Aegon has been the world's best performing financial services company over the past five years, based on an index of shareholder value developed by Oliver, Wyman and Company, a financial services consulting firm. Aegon produced a 138% return for shareholders in 1998 alone. An investment of \$10,000 in Aegon shares in 1994 would be worth \$125,742 at the end of 1998. According to the same study, during the same period, more than 50 of the world's 400 largest financial institutions lost value for their shareholders on a risk-adjusted basis.

Vereniging Aegon (Association Aegon) controls a majority of the voting in Aegon N.V. through its significant ownership of common stock plus its ownership of all the issued voting preferred stock of Aegon N.V. Vereniging Aegon is a European version of a mutual insurance holding company and is far larger than its U.S. counterparts. The stated purpose of Vereniging Aegon is the balanced representation of the interests of Aegon N.V. and companies with which Aegon N.V. forms a group, insured parties, employees, shareholders and other constituencies of these companies.

The general meeting of members of Vereniging Association consists of twenty elected members. Of these twenty elected members, sixteen represent a broad cross-section of the Dutch society and the other four representatives come from Aegon N.V.

Vereniging Aegon is selling to Aegon N.V. approximately 20% of the common shares needed to fund the Transamerica acquisition and has also agreed to provide Aegon N.V. with a hedge to stabilize the purchase price. Immediately preceding the completion of the Transamerica acquisition, Aegon N.V. will issue new preferred shares to Vereniging Aegon so that it can maintain its majority voting control.

After completion of the Transamerica acquisition, Vereniging Aegon will buy common shares of Aegon N.V. in the open market to increase its holdings of common stock from approximately 30% of the shares immediately after the acquisition to 40%. The preferred shares issued to Vereniging Aegon as part of the transaction will be gradually repurchased by Aegon N.V. as Vereniging Aegon regains its 40% holding of common shares.

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For additional information, Aegon N.V.'s website is [www.aegon.com](http://www.aegon.com) and Transamerica's website is [www.transamerica.com](http://www.transamerica.com).

## **FORTIS AGREES TO ACQUIRE AMERICAN BANKERS INSURANCE GROUP**

In March, Fortis, a large Belgian-Dutch insurance, banking and investment group with over \$328 billion in assets, agreed to acquire American Bankers Insurance Group, Inc., one of the leading U.S. providers of credit-related insurance, for \$2.6 billion or \$55 in cash per share of American Bankers stock. The purchase price was a 19% premium over the pre-announcement closing price of American Bankers' stock.

Fortis, through its American Specialty Group based in Atlanta, already markets similar credit insurance products. American Bankers concentrates on marketing specialty insurance products and services through financial institutions, retailers and other entities offering consumer financing. American Bankers combined with Fortis' American Specialty Group will have annual gross premium earned of \$3.6 billion. The merger adds complementary products and distribution channels, particularly through the credit operations of major retailers and financial institutions that emphasize consumer financing. The acquisition will broaden American Security Group's product lines, improve cross-selling opportunities, and enhance marketing capabilities with a broader distribution channel. Fortis expects the merger to be immediately accretive to earnings and estimates that it will generate more than \$100 million in pre-tax annual synergies from operating efficiencies and economies of scale within three to five years.

The transaction represents a continuation of the global expansion by European insurance and financial companies in the United States. Since 1997, and prior to the American Bankers acquisition, Fortis had invested almost \$1 billion to acquire other insurance-related businesses in the United States.

American Bankers, within the past eighteen months, was involved in a takeover battle between American International Group and Cendant Corp. Although Cendant initially won the takeover battle for American Bankers by agreeing to pay \$67 per share, its own accounting difficulties forced it to abandon the merger and pay a \$400 million termination fee to American Bankers in the fourth quarter of 1998.

In the current merger agreement, Fortis is well protected against a hostile bidder, with a full array of deal-protection provisions. In the merger agreement, Fortis has the option to commence a tender offer for up

to 100% of the stock (or such lesser percentage that is a majority). The optional tender offer could presumably be commenced in the event another bidder appears. Certain officers and directors of American Bankers holding approximately 7.5% of the stock have agreed to vote in favor of the merger.

Fortis also has an option to purchase up to 19.9% of American Bankers stock at a cash purchase price of \$55 per share or, as an alternative, to be paid the spread between the higher of the purchase price offered by another bidder or the closing price on the trading day before an exercise notice for the option is sent. American Bankers amended its poison pill/shareholder rights' plan so as to prevent the Fortis acquisition from triggering the pill, but left it in place for another potential "acquiring person." Finally, if American Bankers accepts a "superior proposal" from another bidder, under certain circumstances, American Bankers will be required to pay Fortis a termination fee of \$85 million (approximately 3% of the total consideration to be paid by Fortis) plus up to \$5 million in costs and expenses.

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For further information, see Fortis' website at [www.fortis.com](http://www.fortis.com) or American Bankers' website at [www.abig.com](http://www.abig.com).

## DEMUTUALIZATION PLANS MOVE FORWARD

During the last few months, two mutual insurance holding companies—American Mutual Holding Company and General American Mutual Holding Company—have announced plans to study demutualization and one mutual life insurer, Standard Insurance Company, an Oregon mutual life insurer, completed its demutualization in an April initial public offering.

American Mutual Holding Company, the Iowa-based controlling shareholder of AmerUS Life Holdings, Inc., was formed in 1996 when AmerUS Life Insurance Company was converted into a stock insurance company. American Mutual was the first mutual insurance holding company in the United States. AmerUS Life Holdings was also the first subsidiary of a mutual holding company to issue common stock to the public.

Roger K. Brooks, chairman, President and chief executive officer of American Mutual commented: "The

mutual holding company served us well in the execution of our growth strategy. Since that time, however, many changes have occurred within our company and the financial services industry, and the board believes this is the right time to determine if a full demutualization would better serve the needs of the Company going forward."

AmerUS' use of the mutual holding company structure should facilitate a subsequent demutualization. AmerUS established a closed block on June 30, 1996. This is an accounting mechanism typically used in a demutualization or mutual holding company reorganization to protect the dividend expectations of participating policyholders holding life insurance policies. Since the mechanism has already been in operation for several years, AmerUS does not need to incur the time and expense to set one up if it demutualizes. Secondly, the demutualization may be structured in a way in which existing AmerUS shares are distributed to policyholders without an initial public offering (since AmerUS is already a public company).

In announcing its plan to study demutualization, Richard A. Liddy, chairman, president and chief executive officer of GenAmerica Corporation, the intermediate stock holding company established in April, 1997 under the General American Mutual Holding Company structure, stated that its financial performance over the past several years "has significantly increased the equity value of the company by approximately \$1 billion," derived largely from the stock market values of two of GenAmerica's majority-owned subsidiaries which are publicly traded, Reinsurance Group of America and Conning Corporation. "This makes it the right time to develop a plan to demutualize and unlock value for distribution to our policyholders," he added.

In April, Standard Insurance Company, a \$5.3 billion mutual insurer based in Portland, Oregon, demutualized by forming a stock holding company, StanCorp Financial Group, Inc. StanCorp Financial sold 13,920,000 shares to the public at \$23.75 per share with aggregate net proceeds of \$310.8 million. Standard Insurance became a wholly owned subsidiary of StanCorp Financial.

Consideration was distributed to the policyholders of Standard Insurance in the form of StanCorp Financial stock, cash or as an adjustment to their policy values (policy credits). Under the plan, Policyholders were entitled to receive at least a fixed minimum of 52 shares of stock (subject to adjustment) or the equivalent in cash

or policy credits. In addition to the consideration which was distributed, policyholders were also able to purchase up to 1,250,000 shares in the initial public offering in a directed share program which gave preference to policyholders. Since it is often difficult for small investors to purchase stock in an IPO, the directed share program was a potential added benefit to policyholders. In the early trading days following the IPO, the StanCorp Financial stock did not have a significant increase in value, unlike many IPOs of demutualizing insurance companies.

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For additional information, the AmerUs website is [www.amerus.com](http://www.amerus.com), General American's website is [www.genamerica.com](http://www.genamerica.com) and Standard Life's website is [www.standard.com](http://www.standard.com)

**U.S. SUPREME COURT UPHOLDS  
UTILIZATION REVIEW PROCEDURES  
BY WORKERS' COMPENSATION INSURERS**

In March, in the case of *American Manufacturers Mutual Insurance Co. et al v. Sullivan*, the U.S. Supreme Court ruled that insurers are not "state actors" under the Fourteenth Amendment and that the due process clause of the Fourteenth Amendment does not require workers' compensation insurers to pay disputed medical payments prior to a determination that the medical treatment was reasonable and necessary.

In 1993, Pennsylvania amended its Workers' Compensation Act to create a utilization review procedure under which the reasonableness and necessity of medical treatment could be reviewed before a medical bill is paid. If an insurer disputes the reasonableness or necessity of the treatment, it may request utilization review by filing a form with the Pennsylvania Department of Labor and Industry. Upon the proper filing of the form, the insurer may withhold payment to health care providers. The matter is then referred to a randomly selected utilization review organization, a private organization consisting of health care providers. The organization must complete its review within 30 days and any doubt as to the reasonableness and necessity of a particular medical procedure must be resolved in favor of the employee. If the employee wins, the insurer must pay the disputed bill immediately with 10% annual interest, as well as the costs of the utilization review.

Ten individual employees and two organizations representing employees who alleged that their benefit payments had been withheld under the law sued various Pennsylvania officials that administered the law, the director of the State Workers' Insurance Fund, the School District of Pennsylvania (which self-insures) and a number of private insurance companies that provided workers' compensation coverage. The plaintiffs alleged that the withholding of workers' compensation benefits without pre-deprivation notice and an opportunity to be heard deprived them of property without due process of law in violation of 42 U.S. §1983 and the Fourteenth Amendment. The U.S. District Court had dismissed the lawsuit on the grounds that the private insurers are not "state actors" and due process was not violated, but the Third Circuit Court of Appeals reinstated the complaint.

Chief Justice Rehnquist, with Justice Stevens partially dissenting and several other justices writing concurring opinions, pointed out that state action requires both an alleged constitutional deprivation and that the party charged with the deprivation must be a person who may fairly be said to be a "state actor." In this case, the state statute authorizes, but does not require, insurers to withhold payment for disputed medical treatment. He emphasized: "The State's decision to allow insurers to withhold payments pending review can just as easily be seen as state inaction, or more accurately, a legislative decision not to intervene in a dispute between an insurer and an employee over whether a particular treatment is reasonable and necessary... Such permission of a private choice cannot support a finding of state action."

The Court also rejected the claim that the withholding of payments without a prior hearing violated due process because the medical benefits were a state-created entitlement. In determining that there was a lack of a property interest in the payment of benefits, Chief Justice Rehnquist commented: "To state the argument is to refute it, for what respondents [plaintiffs] ask in this case is that insurers be required to pay for potentially unreasonable, unnecessary, and even fraudulent medical care without any right, under state law, to seek reimbursement from providers. Unsurprisingly, the Due Process Clause does not require such a result."

## “STATE ACTION” ISSUES IN OLD GUARD CASE DECIDED

In the case of *Crandall v. Alderfer*, Judge Clifford Scott Green ruled in March that neither insurance companies nor their directors are “state actors” and cannot be liable under 42 U.S.C. §1983 for converting a mutual insurance company to a stock insurance company pursuant to Pennsylvania’s Mutual-to-Stock Conversion Act. Several policyholders had filed suit against Old Guard Mutual Insurance Company, other affiliated insurance companies and several of the insurance companies’ directors in Federal District Court in the Eastern District of Pennsylvania. Among other things, the policyholders alleged that the insurance companies, acting under color of state law, had stripped them of their right to receive surplus distributions without compensation and that the insurance companies interfered with their contractual ownership rights.

Judge Green held that the defendants’ decision to adopt a plan to convert the insurance companies from mutual to stock form using the subscription rights method of demutualization was an action initiated and implemented by private entities and that the exercise by private parties of a choice allowed by state law does not make the actions “state action.” The court retained jurisdiction over plaintiffs’ remaining state claims.

While Judge Green’s decision does not mention the Supreme Court’s recent decision in the *American Manufacturers Mutual Insurance Co.* case, it is apparent that the Supreme Court’s views are consistent. As a result of these two cases, it is expected to be more difficult for policyholders to challenge actions taken by insurance companies to reorganize into stock companies, to withhold benefit payments pending review, or take other actions permitted by state insurance laws.

## EVOLUTION OF RISK IN THE INSURANCE INDUSTRY

Adam Klauber, CFA  
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**Thesis:** *Risk taking, the property and casualty industry’s core skill, has become a commodity. The eleven year property and casualty down cycle, therefore, is not really a cycle at all. A structural industry change*

*is underway, as the industry’s franchise value has been diminished by the loss of its proprietary competitive advantage — the ability to measure and incur risk. This transformation is akin to the shift in corporate banking from a credit to a fee based orientation and the life insurance industry’s move from a risk bearing to a savings oriented product base. The property and casualty industry’s shift away from risk will have material ramifications for the industry and its multitude of competitors.*

### ***Strategic Shift Within Corporate Banking, Life Insurance, and Property and Casualty***

The banking and life insurance industries achieved a wholesale shift in the 1980’s comparable to the transformation currently being experienced by the property and casualty industry. Corporate banking and life insurance previously had been businesses that focused on taking risk. In the 1980’s, their main products and core skills (measuring and taking risk) became commodity oriented, which allowed competition from outside sources to encroach on their respective markets. As a result, banks and life insurers were forced to shift into alternative businesses. From a strategic perspective, banks and insurance companies had to define their core competencies and reorganized their business around those capabilities. We believe that the property and casualty industry is going through this strategic realization and wholesale shift.

### **Corporate Banking**

The industry has effectively shifted from being compensated to take risk on corporate credits to providing fee related services. Banks still loan money to corporations, but in reality profits are made on the service businesses as opposed to the spread on credit. Throughout the 1970’s and 1980’s corporate credit spreads narrowed as the skill of taking risk became a commodity. The difference between the corporate loan net interest margin and the over three-year treasury notes declined from an average of 82 basis points in the 1950s and 1960s to -320 basis points in the 1970s and the 1980s. The underlying cause was simple — increased competition in a mature market. Too many competitors with similar skills (i.e. measuring credit risk and extending loans) were vying for a relatively stagnant client base. In addition, as credit risk became readily quantifiable, alternative forms of competition gained market share. The commercial paper market grew from \$48 billion in 1975 to \$674 billion in 1995 and now

comprises 49% of the overall corporate funding market. The banking share of the market dwindled from 80% in 1975 to 51% in 1995.

These competitive dynamics forced banks to shift their strategic focus. Corporate oriented banks moved away from emphasizing credit risk in the corporate market and focused on fee related items. The banks also moved down the credit spectrum (Latin American, real estate, and high yield), although these efforts have had decidedly mixed results. Service businesses, such as cash management, syndication, currency management, custody, and record keeping, have become corporate lenders' main sources of profits. Fee related business has increased from 20% of total bank revenues in 1975 to 35% in 1995.

### **Life Insurance**

The life insurance industry has shifted its emphasis from bearing mortality and morbidity risk to being a provider and processor of savings oriented products. Traditional life products, such as term and whole life, mainly provide protection against unforeseen events (i.e. death or sickness). Annuity oriented products, which have a modest level of risk protection, are primarily purchased and utilized for investment purposes. Profits from annuities have grown at a compound annual rate (1987-1995) of 19% compared to 8% for traditional life products. In addition, the profit contribution from the annuity segment went from being nonexistent in the middle 1980s to almost half of industry profits by 1995.

The disintermediation of the industry's client base was a major contributor to the shift from life to annuity products. Alternative distribution channels, such as banks and brokerage houses, developed products that supplanted the saving component of traditional life products. Capital markets competitors developed money market accounts and mutual funds and the banking industry promoted Certificates of Deposit in response to financial deregulation and the interest spike of the early 1980s. These competitive forces inspired the life insurance industry to focus on its most valuable skill to the marketplace. The result was a shift toward providing a variety of saving oriented products, annuities and variable life insurance. From 1983 to 1997 life insurance assets grew by at an average annual rate of 9% compared to annual growth rates of 34% for mutual funds and 14% for money market accounts during that same period.

### **Property and Casualty**

The property and casualty industry is migrating from a risk taking orientation into other core competencies. The main force driving this transformation is that the skill of measuring and bearing property and casualty risk has become a commodity. This has allowed alternative competitive channels to play a greater role in the traditional property and casualty market place. For example, alternative risk and self-insurance vehicles already comprise a significant 38% of the commercial market. The commodity orientation combined with the loss of market share have caused property and casualty returns to contract. The spread between the industry return on equity compared to the three-year treasury note has declined dramatically over the last five decades. The spread averaged 3.8% in the 1950s, 1.3% in the 1960's, 3.9% in the 1970s, .4% in the 1980s and .7% in the 1990s. Moving forward, other forms of competition, including banks, brokerage and marketing firms, are rapidly positioning themselves to become larger players in the insurance markets. Hence, similar to the corporate banking and life insurance industries, the property and casualty industry is being forced to reevaluate its competitive skill and strategies.

### ***Property and Casualty Evolution***

The property and casualty industry has increasingly displayed the major symptoms of an industry in the late stage of its product lifecycle over the last two decades. These signs include stagnant growth, over abundant levels of supply, diminished financial returns, and heightened consolidation activity. In particular, one major defining factor stands out. The industry's main product/capability (bearing risk) has become a fluid commodity. As this has happened, the industry has fallen into a perpetual down-cycle. The major factors that pushed the industry into the late stage of its life cycle include:

- Profitability has become dependent on investment income (i.e. cash-flow underwriting), as opposed to underwriting/risk taking.
- Technology has made the industry's proprietary capabilities, including measuring and managing risk, more of a science than an art. Standard industry underwriting techniques and statistical loss databases have become tools that are readily available to numerous competitors.

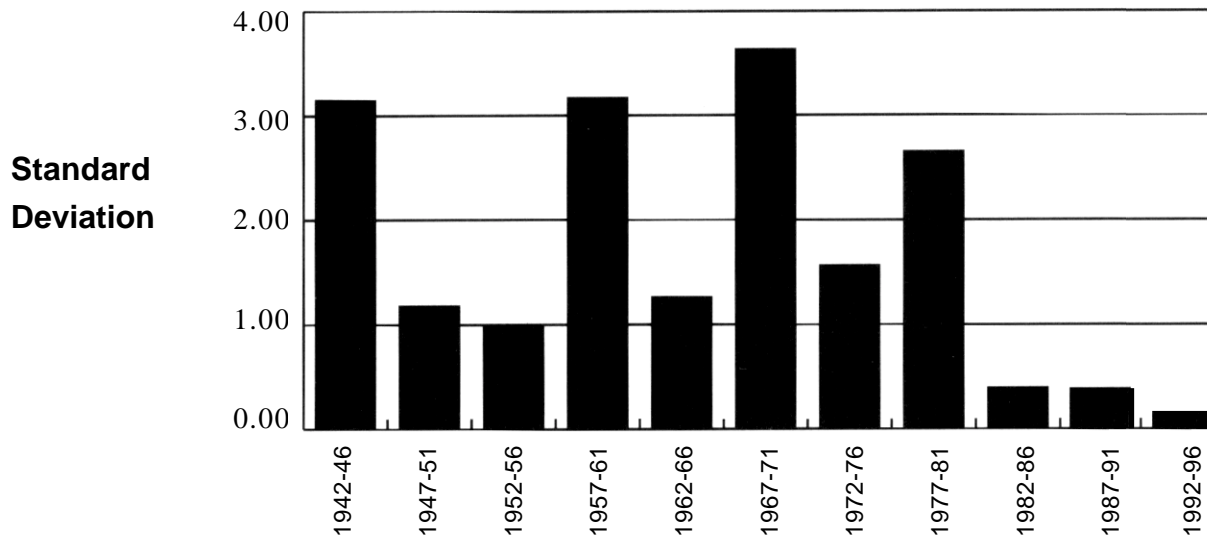
- The alternative risk market has gained market share. Risk has shifted away from insurers back to the entities that incur the risk.

From an industry perspective, the overall volatility of results has been greatly reduced. The standard deviation of the industry's earnings has declined materially since the 1970s. From the 1950s to the 1970s, industry earnings averaged a standard deviation from the mean of 2.2x. This means that on average for each five year period, industry earnings would swing one way or another by an average of 220% from the mean of that five year period. By comparison, the average standard deviation from the mean declined to 30% in the 1980s and 1990s.

While this sounds positive from an investors standpoint, it is not. At the end of the day, insurers are paid to manage risk/volatility. In other words, a reduction in the level of volatility is in essence a reduction in the demand for insurance expertise and capability.

Financial performance has deteriorated as the industry has matured over the last two decades. The industry has experienced material price increases in only two (1985 and 1986) of the last seventeen years. The industry has not produced an underwriting profit since 1979. From 1981 to 1996, the combined ratio has averaged an uninspiring 108%. To compound matters, premium growth has slowed. If the pricing upturn of 1985 and 1986 is excluded, premium has averaged only 4.5% over the last fifteen years. As one would expect, industry returns also have suffered. In the 1990's, the industry averaged a 9% return on capital.

**Volatility of Property and Casualty Earnings  
(1942-1996)**



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YES. Please send me additional information about Mutual Holding Company Conversion.

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