TRANSACTIONS OF SOCIETY OF ACTUARIES
1968 VOL. 20 PT. 2 NO. 56 AB

PANEL DISCUSSION

THE HOLDING COMPANY STRUCTURE AND THE LIFE INSURANCE COMPANY

1. Purpose, scope, and function of the holding company.
2. Activities more easily engaged in by the holding company than by the life company.
3. Activities available to the holding company but not available to the life company.
4. Reasons why a holding company may be inappropriate in a given situation.
5. Effect on the future of life business
   a) organization,
   b) earnings,
   c) taxation.
6. Usefulness for mutual companies.

Philadelphia Regional Meeting

CHAIRMAN GORDON E. CROSBY, JR.:* In the spring of 1966, those of us who were charged with the responsibility for the long-term management of our corporation started doing some soul-searching and planning in much more detail than we had ever done before.

We found ourselves with a life insurance company in its one hundred and sixteenth year of operation—the oldest stock company in America, the largest stock life insurance company domiciled in New York, a company that ranked in the top 4 per cent (based upon insurance in force) and that had just completed a decade during which insurance in force had more than quadrupled. Our annual rate of sales had more than doubled, and our statutory earnings had increased in excess of 185 per cent, so we had a fairly good platform from which to start our programs. However, as we looked five, ten, fifteen, and twenty years into the future, we concluded that we might not be able to "get there from here," and this was a rather dismal conclusion at which to arrive.

In analyzing the situation, we took a complete inventory of our current status, personnel, field organization, insurance in force, and the tools with which we had to work, and we attempted to study the trends which were on the way, not only in the life insurance industry but in the business community at large. We analyzed these trends and

* Mr. Crosby, not a member of the Society, is chairman of the board and president of USLIFE Holding Corporation.

tried to interpret what their impact would be upon our operation in this future span of years.

We made definite some long-term corporate goals, not only taking into consideration the obvious things, such as earnings and compound growth rates, but also trying to look into a crystal ball, which, hopefully, was shining and accurate, to determine what the consumers' objectives or desires might be. So, having completed this work, we concluded that there was, in fact, a need for a different corporate structure. It might be of interest to you if I emphasize just a few of the major reasons for desiring corporate change.

As we looked at the horizon, we concluded that there was probably going to be, for the first time in a number of years, not an increase in the number of life insurance companies but a decrease, a very dramatic decrease in small as well as medium-sized companies. We foresaw attractive opportunities for the merger of smaller companies into a larger insurance company. You are aware of the impact on earnings if some very substantial erosions can be made in the general expense line. However, since we are a New York–domiciled life insurance company, this was an avenue that was for all practical purposes closed to us. In this same general area, we viewed some excellent opportunities for the acquisition of companies that could operate attractively as free-standing regional affiliates, providing the opportunity to share personnel and facilities and to maximize our human and capital resources; but, once again, under the statutes and regulations of the authority who looks over our shoulder, this was practically precluded.

Upon looking at the consumers' interest and the trends that were occurring in the financial community, we were concerned because of the prohibition against our ownership of nonlife insurance affiliates. I jotted down a few to give you an idea of what we thought we might have in mind: mutual fund management companies and mutual fund sales organizations, a subject which has received a great deal of interest in the past year or so; diversified investment banking companies; fire and casualty companies or, perhaps more important from our point of view, the ownership of fire/casualty sales organizations; commercial banks; savings and loan banks; finance and/or factoring companies; leasing companies; title insurance companies; and various kinds of corporate service facilities, such as EDP, printing, advertising and sales promotion.

If you have five or six life insurance companies, you do not have to duplicate many types of service for each. These can be blanketed in one vehicle and the services made available to each through manage-

ment service fee agreements, very frequently with a broadened scope of operation, improvement in the expertise, and reduced unit costs.

There was no opportunity for diversification in the nonfinancially oriented business, but, when we looked twenty or twenty-five years into the future, we thought that diversification might not only be desirable but might perhaps be necessary. For these reasons, then, we concluded that it would be desirable to determine a change in our corporate structure.

There are some technical limitations that have disturbed us. We were unable to use senior securities in United States Life. You are familiar with the accounting rules limiting the utilization of nonadmitted assets. We had a limitation on the percentage of assets that could be invested in common stocks, because in New York there is a limitation of 5 per cent.

Although we had been competitively oriented, we were becoming increasingly concerned with the extra-territorial control of the state of New York in the other forty-nine states in which United States Life was admitted. This had pretty well restricted us, but at the same time we were finding it necessary to compete in our home state with foreign companies being admitted to New York through a wholly owned subsidiary; they were having the best parts of both worlds and we were not.

Then we looked at the entrance into "our business" of fire and casualty companies, mutual funds, industrial corporations, and even the conglomerates and decided that there was a changing scene of which we should take cognizance.

That is, in a way, the background for why, in December of 1966, we chose to form USLIFE Holding Corporation. This was a very arduous technical procedure. We spent hours in conference informally with the New York Insurance Department preparatory to obtaining their approval. It required SEC registration and its approval of our prospectus. In January, 1967, what we now refer to as the "infant parent" was born. We had an exchange program of one-for-one, United States Life for USLIFE Holding Corporation, and, despite the fact that the exchange period was very short, at the time we closed off our exchange offer to enable us to move into our acquisition program we had 98.34 per cent of United States Life owned by USLIFE Holding Corporation.

I would like to emphasize that USLIFE Holding Corporation is a general-purpose, New York business corporation and not a shell. It is truly an operating company, and during this past year we have created an organizational structure of officers and employees. Many of them

have been transferred from our affiliates to the parent company, and others have been employed from the outside to join the parent company. We now have a staff which includes investment officers, actuaries, attorneys, CPA's, marketing specialists, advertising- and sales-promotion specialists, and management personnel, who have their own internal line organization insofar as the holding company is concerned but stand in a staff relationship to the chief executive of the affiliates. This enables the affiliates to have a level of expertise which perhaps they could neither attract nor afford. We think the people factor, or the human element, of the holding company is the real nuts and bolts of what will assure its success.

As we brought the holding company into being, we identified three specific areas of operation for initial consideration.

1. This area we captioned the "Insurance Division," of which United States Life Insurance Company is a part. Despite the fact that United States Life was admitted to all fifty states, our marketing penetration was heavily concentrated in our own area, which is the northeastern territory. We thought that, as we moved forward with the expansion of United States Life, we would intensify its activity in that geographical sector, continuing to use the company's fifty-state entrance because of its effectiveness in the group, pension, and mass-marketing areas.

Our first acquisition after the formation of USLIFE Holding Corporation was South Coast Life Insurance Company of Houston, Texas domiciled in Texas and in eight contiguous states. This was an excellent vehicle for us to use for the development of the southwestern market.

In August of last year, after some very interesting negotiations, we bought Commonwealth Assurance of San Francisco and Independence Life Insurance Company of Pasadena and merged them into a new company—Commonwealth Independence Life Insurance Company, with headquarters in Pasadena—which gives us our California company.

We think that we have a great opportunity for accelerating the rate of growth of these companies, not only on their own but by a merger of smaller companies into these companies. We are in the process of doing this now with Southern Provident of Dallas, a small company which will be merged into South Coast Life Insurance Company. The consolidation of those two home-office staffs and field organizations and the improvement which we will be able to make in their level of general expenses will make a very important contribution to the statu-

tory earnings of South Coast and its capacity to pay dividends to the holding company. It will certainly move South Coast several years down the road in its own growth program in comparison to what it would have been able to do otherwise.

2. The second area that we considered was the equity area. I have made speeches over the years about the good property concept of life insurance and about all the dastardly things that the mutual fund business was doing to us; but the world has changed, and I think we have to be realists, particularly as we look at that segment of our population under the age of twenty-five and that segment over the age of fifty, which accounts for a good percentage of the total. We concluded that we could best move into these marketing areas if we could somehow "package" mutual funds and life insurance. We did not know anything about the mutual fund business but thought that, if we were going to get into it, we should associate with professionals.

In January of this year we consummated the purchase of Distributors Group, Incorporated. We think that with the programs we now have under way we will very substantially enhance the operations of Distributors Group on its own and that as a result we will have a facility that will enable us to move into the marketing of mutual funds and variable annuities with the field organizations of our life companies. To accomplish that step, we formed 125 Equity Corporation, a wholly owned subsidiary, which is a NASD-registered broker-dealer. Through this corporation we will license our 10,000 life insurance salesmen with NASD.

3. We were concerned with the maximizing of capital resources. Notwithstanding the relief which seems to be forthcoming in increasing the amount of our assets that can be invested in common stocks, we thought we would have to go even beyond that, particularly since the profit margins of the product lines which we sell in life insurance companies continue to decline.

South Coast Life Insurance Company had a wholly owned subsidiary—South Coast Investment Corporation—which basically performed the investment division functions for that life insurance company. We paid this company up to the holding company as a dividend, changed its name to MID Services Corporation (a wholly owned affiliate), had all the investment division personnel of the three life insurance companies resign and simultaneously re-employed them with MID Services Corporation, and entered into a management service fee agreement between MID Services Corporation and each of the life affiliates whereby it provides all the investment divisions' functions up to the

point of a recommendation to the finance committee and the appropriate officers. This very substantially reduces the unit expense of our investment division functions, puts us into a prime position with regard to the size and quality of the loans which we can handle, and, in addition to our being an investment diversified banking firm, lets us get into the development of investments and equity positions.

These are some of the things in which we have been involved in USLIFE Holding Corporation for fifteen months, and we continue to be optimistic.

MR. GEORGE W. YOUNG, SR.: Connecticut General's motivation in changing to the holding company setup was a little different from that of the United States Life. Before going into the reasons why we approached the problem as we did, perhaps I should go back to the time when we acquired the Aetna Insurance Company through an exchange of stock; this exchange took place in 1962; after the exchange, the life company owned 98 per cent of the Aetna stock.

We realized that a life company was not, and still is not, a suitable type of corporation to own a subsidiary because of the operation of the Life Insurance Company Federal Income Tax Act. In this connection, let me quote from the "Plan of Exchange" sent to our stockholders and the stockholders of the Aetna Insurance Company in 1962:

> The Life Insurance Company Income Tax Act of 1959 imposes a tax burden beyond normal standards on any life insurance company which owns a subsidiary. Hence, the ownership by Connecticut General of the Aetna stock will result in an increase in Connecticut General's federal income tax substantially beyond that normal to ownership of subsidiaries. While legislation will be proposed to correct this inequity and to remedy other obvious defects in the law, there can be no assurance that the Congress will pass remedial legislation.

As I am sure you realize, the tax on a life company increases as its assets and surplus increase, even if the income is constant. Because of this situation and for business reasons, we wanted to rearrange our corporate structure so that the life company would not own the fire and casualty company. The obvious solution was to form a holding company; but, for a number of reasons, this did not appear desirable in 1962. After the Congress, with Treasury approval, passed enabling legislation in 1962, we went to what is called a "stapling" arrangement.

Under this plan, the life company distributed the fire company stock to a trust company, which held the stock in trust for the owners of Connecticut General stock. In other words, the Connecticut Gener-

al stockholders were the beneficial owners of the fire company stock. However, they could not sell this ownership without selling their life company interest at the same time; hence the term "stapling," to indicate that, although the two corporations were separate, their stock was, in effect, stapled together; and, every time a stockholder bought or sold a share of Connecticut General stock, a proportionate interest in the Aetna went along with it.

I mentioned that there were a number of reasons why the holding company did not appear to be a desirable setup at that time. First, we could not complete the transaction during 1962, and this would have cost us almost $2 million in federal income tax, resulting from the additional assets and surplus held over the year end. Second, there would have been a federal stamp tax on the newly issued holding company stock certificates, and this meant another $1 million. Third, there was a tax each year on 15 per cent of intercorporate dividends, which meant over half a million dollars a year in tax; and, in practical effect, those who refused to exchange their Connecticut General stock for holding company stock would get higher dividends. Fourth, under the laws then in force, the exchange would have been voluntary and would have involved large brokerage fees to persuade stockholders to make the exchange. Also, we felt that holding companies were not well regarded by the investing public.

By 1967 all these objections had been taken care of. There is no longer a tax on intercorporate dividends when the parent company owns more than 80 per cent of the subsidiary. The federal stamp tax on newly issued securities has been eliminated. Appropriate charter amendments have been passed by the Connecticut Legislature which made it possible to force any holdouts into the fold if the shareholders voted in favor of the exchange. Also there was now greater public and stock market acceptance of the holding company concept. In other words, in 1967 it became feasible to change to the holding company setup at a small cost and rid ourselves of the stapled arrangement, admittedly cumbersome.

Most of the other reasons for going into a parent-subsidiary relationship have been given by Mr. Crosby in his thorough coverage of the subject. There is one difference which I might mention. As Mr. Crosby indicated, most companies changing to the parent-company structure do so largely for flexibility reasons. This is true in the case of the Connecticut General, except that at the present time we are interested in flexibility only to the extent that we might venture into other types of insurance and related businesses. Although it is possible that

at some future date we may want to get involved in unrelated ventures we have no plans for doing this at the present time.

In considering the kind of corporation the parent company should be, we came to a different conclusion from that of the United States Life; we decided that, instead of a general-purpose corporation, we should have a fire and casualty insurance company as the parent. You may be interested in some of our reasons.

First, as I have just indicated, it is our current plan to stick to the insurance business and related activities. We also felt that our stockholders had invested in the Connecticut General because it was an insurance company and that presumably they still wanted to own stock in an insurance company. Also, the title is descriptive of our principal business; if we simply called ourselves the Connecticut General Corporation, it might give the impression that we planned to become a conglomerate type of operation. Just the fact that the word "General" appears in our name was a factor in our decision. This would not, of course, apply in the case of most other companies.

The second reason had to do with regulatory problems. Rightly or wrongly, we felt that an insurance company would probably become less involved with federal regulation than would a general corporation —or at least we hoped this would be the case. We had been dealing with the Connecticut Insurance Department for some time, and we felt that our life might be simpler if this continued to be our principal regulatory authority.

Mr. Crosby mentioned one factor which influenced their decision to organize the parent company as a general corporation. This was the fact that an insurance company in New York could not issue preferred stock or bonds. This is not the case in Connecticut. In Connecticut an insurance company can issue preferred stock—the Travelers has done so in exchange for the Phoenix Insurance Company stock.

The exchange of Connecticut General life company stock and the Aetna Insurance Company stock for the stock of the parent corporation took effect in December, 1967, and now Connecticut General Insurance Corporation owns 100 per cent of the stock of both the Connecticut General Life Insurance Company and the Aetna Insurance Company. We had our first annual meeting a few weeks ago, and I would say that the transition from the stapled setup to the new holding company was uneventful. I would like to point out, however, that a tremendous amount of planning by our own lawyers and outside counsel was necessary in order to accomplish this. Whereas most of the problems were anticipated in advance, we have a few which are

still unsolved. We also must anticipate some new regulatory problems to come up in the future, both in Connecticut and at the federal level; and we can expect that the New York Legislature will probably pass some kind of restrictive legislation based on the recent report of the Special Committee on Insurance Holding Companies.

MR. WALTER L. GRACE: The basic organizational nature of a mutual company is that it may hold but it may not be held. Also, since a mutual company cannot issue stock, it must make its acquisitions with cash. There is a very practical problem in the purchase of a business by a mutual company because of the IRS's treatment of mergers. Corporations generally acquire control of other corporations through a tax-free exchange of stock. If a mutual company pays cash for the stock of a corporation it wishes to acquire, the purchase may result in a capital gain to the stockholders of the acquired corporation. This makes it difficult to purchase a company with any significant growth.

There is also a fundamental difference in philosophy between mutual and stock companies on the subject of acquisitions. For a mutual company to acquire another company, the transaction basically should be of benefit to the company's general body of policyholders. This benefit could be due to (1) enhanced investment earnings or capital gains potential, (2) reduced expenses of operation, (3) broadening product lines, or (4) expanding market penetration.

Last year we saw the willingness of one state—Massachusetts—to liberalize its legislation by permitting mutual companies, in addition to their owning life or variable annuity companies, to own certain types of subsidiary corporations previously prohibited:

1. An insurance company other than life or variable annuity.
2. A data-processing or computer-service corporation.
3. A real estate holding, developing, managing, or leasing corporation.
4. A corporation providing investment, advisory, management, or sales service to an investment company.
5. A corporation whose business has been approved by the insurance commissioner as complementary or supplementary to the business of a domestic life insurance company.

Already we have seen specific actions taken by some mutual companies in Massachusetts to acquire corporations under the new legislation. Undoubtedly this trend will spread throughout the country if the interest indicated by the Special New York Committee Report is any indication of things to come.

RUSHMORE MUTUAL LI
LIBRARY

There is one other device, akin to the holding company idea, which is available to mutual companies. I will merely mention it, without commenting on its pros and cons. This is the device of "affiliation," that is, a working agreement between two mutual companies to conduct part of their operations jointly, usually accomplished by some interlocking of the boards of directors of the two companies.

The actuary of a mutual company must, of course, be directly involved in any acquisition situation. The list is long, but some of the topics that he considers are (1) determining the worth of the company being acquired, (2) expense-allocation problems, (3) federal income tax problems, (4) consistency of product line if the acquisition happens to be another life insurance company and many others of a similar nature.

CHAIRMAN CROSBY: In answer to the question of why there is this sudden rush of interest toward holding companies, the reason seems to lie in the fact that, when one looks twenty or twenty-five years into the future, there is cause for concern in profit margins and the continuing erosion of profit margins of the products sold by a life insurance company. Our studies indicate that, with the exception of a very few, the profit margins in individual accident and health are very low, perhaps the notable exception being the disability income or loss-of-time coverage. Insofar as group is concerned, companies seem to be quite content if they can earn 2–5 per cent of their claims net after tax. Insofar as our ordinary products are concerned, we only have to look at the reduced average premium per thousand over the past twenty-five years, which has only been offset ever so slightly by the increased average-size sale.

Well-managed companies probably have their operating expenses down about as low as they are going to go as a percentage of premium or investment income. Barring some breakthrough, which would be wonderful but is not on the immediate horizon, we are probably doing as well in mortality as we are going to do; we have been fortunate to have had the net yield on our invested assets in recent years, which none of us anticipated as short a time ago as five or ten years. It is within the realm of possibility that, if we accept an isolated block of new ordinary business not supported by prior old blocks of business in force, the profit margins on that might leave something to be desired.

I think that some members of the Society of Actuaries and the Special Committee of Analysts are doing yeoman service in trying to achieve an improvement in adjusted earnings per share. The unfor-

tunate thing is that it is almost "too little, too late," because analysts are now changing their points of view, and they very frequently say to us, "Don't tell me about your net gain of insurance in force. Don't tell me about your percentage increase in sales. Don't confuse me with your adjusted-earnings formula. How much money did you make?"

At one time they felt that, if you obtained a 10 per cent return on stockholders' equity, that was a very creditable performance. The ante has gone up. They now want 15 per cent before you are put on a recommended list. They can get 15 per cent in other types of investment—true, they are not as stable or as long-term as ours. If you are charged with the responsibility of managing a company with your investors' interests at heart, you must take this point into consideration. This area is one of many which has contributed to the formation of holding companies.

A second point is in our distribution costs, our agency system. After World War II we looked at the progress that we were not making in manpower development and figured that we would change that trend in the opposite direction through use of agent-financing, which did not make a very creditable impact but very significantly increased our distribution costs. We said, "Well, that didn't do it. What we have to do is to improve our agent selection, training, and supervision." This added very substantially to our marketing costs but did not significantly improve the results. We then said, "The real answer is to do a better job with the general agent and manager." This added to the distribution costs but did not significantly improve the results either. Therefore, we have, on the one hand, the decline in profit margins of our product lines but, on the other hand, a very substantial capital investment in the formation of a field force, from which we are clipping very few coupons.

It used to be that any agent of mediocre success would sell one hundred lives a year. Now the sale of fifty lives is rare. It used to be that a couple of closing interviews a day was par for the course, but now two or three a week are considered adequate. We have the manpower and we have the establishment, from which we are not clipping the coupons, so perhaps by having these allied financial services—be it mutual fund or something else—we can obtain an enhanced return on the investment which we have already made. We have had our tuition expense, and this might come back and have a healthy effect insofar as the consolidated earnings of the company are concerned.

Finally, it seems to me that I have noticed a dramatic change in the past few years on the part of management who now are doing some

really serious, conscientious, in-depth, long-range planning. I do not mean planning for 1968 in 1967; I mean really long-range. The United States Life is 118 years old. What will it be when it is 218? And what will it be when it is 318? I think that managements are assuming this responsibility more seriously, perhaps, than they have in the past and that this has contributed to the sudden rush of interest in holding companies.

MR. KENNETH R. MACGREGOR: What is the nature of the income of the USLIFE Holding Corporation, and who pays the staff?

CHAIRMAN CROSBY: We have dividends which come up to the holding company from United States Life, South Coast Life, and Commonwealth Independent. We have dividends which come up which are in effect the total earnings of Distributors Group, 125 Equity Corporation, and MID Services Corporation. Those are the sources of income of the holding company.

With regard to the fixed expenses of the holding company staff, which are significant to be sure, these are handled by management service fee agreements, approved and supervised by the New York Insurance Department. It is the same kind of indirect allocation which you do divisionally within an insurance company. If we go on with some of the further expansion steps to which I have alluded, you can very quickly see that this will have some significant impact on other sources of income.

MR. MELVIN L. GOLD: Do you think the need for parallel companies exists outside New York?

CHAIRMAN CROSBY: We obviously think that it is an advantage, particularly with companies such as South Coast, which has its own board of directors, its own officers, and its own identity in that particular market. Its *modus operandi*, insofar as its agency plan is concerned, is quite different from that of United States Life, so we can do some things in South Coast which we may be unwilling or unable to do in United States Life. Then in Commonwealth Independent we have entirely different things. We think, therefore, that having these different operations adds significantly to our flexibility.

MR. GERALD A. LEVY: Would you go into specifics with regard to the problems that you ran into with the SEC and with regard to cost? If you had it to do over again, would you do anything different?

CHAIRMAN CROSBY: I would say that the word "problem" or "difficulty" is not applicable with reference to the SEC, where you must do what they want you to do, the words have to be their words, the financials have to be their financials; really though, other than the time required to do these things, we had no difficulty with the SEC.

As far as the New York State Insurance Department is concerned, we started meeting with the then Commissioner, Henry Root Stern, in the summer of 1966, since we recognized that this was a departure from the type of operations which we had had in the past. We felt fully responsible to the insurance department, realizing that what we did would perhaps establish some kind of precedent; so we worked this out together over a period of time. From our point of view, we think that we may, in some small way, have contributed to the appointment of the Blue Ribbon Holding Committee of New York. We think their report is excellent. We also think that the legislation being designed for presentation to the New York Legislature is excellent and that we are all going to benefit from these changes, which, unfortunately, are long overdue.

The time spent with respect to the SEC was forty-five to sixty days, and, although it is hard to break the cost up since a prospectus which includes audits must be prepared and a special stockholders meeting held (which is not solely for the SEC), I would say that the total exercise came to roughly $150,000 to $200,000.

MR. ELMER BILLMAN, JR.: When you get the several companies into the holding company, do you expect to fire all your actuaries and immediately rehire them?

CHAIRMAN CROSBY: We did not fire anybody. This was all part of the master plan. I might say that, as a result of the formation of MID Service Corporation, the investment division officers of the three life insurance companies that moved over benefited substantially in title, salary, and, in my view, maneuvering ability for further personal growth.

I think it is within the realm of possibility that such a holding company as USLIFE Holding Corporation could take all the actuaries of all its affiliates and put them in one company which, under the management service fee agreement, would provide the actuarial services for all the affiliates and, if there were time and staff left over, become actuarial consultants as well.

Los Angeles Regional Meeting

CHAIRMAN DANIEL P. KEDZIE:* The insurance and financial press and students of the business keep telling us that we are in a new insurance era—the age of the holding company. We have seen formidable evidence to indicate that there are reasons to take note of what is happening:

1. We know that about forty holding companies have been formed or were planned in the year 1967.
2. The *Insurance Advocate*, in a fine article by Chandler Currier Jordan entitled "Insurance Holding Companies and Other Fiscal Fauna," provides us with a listing of *373* corporations operating in the United States as insurance holding companies or as financial complexes, industrial conglomerates, or non-insurance parents with insurance company subsidiaries. (See especially the January 20, 1968, issue.)
3. The state of New York's Special Committee on Insurance Holding Companies recently released a report which should generate legislation of a controversial nature for insurance holding companies.
4. The NAIC currently intends to draft model legislation on the subject.
5. The American Management Association expects to draw *hundreds* of participants to its seminar on insurance holding companies next month.
6. As a last and very important reason, your Society has scheduled "The Holding Company Structure and the Life Insurance Company" for its General Session at each of its three regional meetings.

There are other indicators of the importance of this subject. In our shop, as in yours, we are constantly asking each other, "Have you heard about Over Reserve Life Insurance Company's forming a holding company?"

Let us assume that your company, like our life insurance company (Continental Assurance), has now given birth to a brand new baby, which we have christened a holding company. I would like to suggest that, if you find yourself in that position or are approaching the "conception" stage, you will find yourself with the need to answer rather quickly a series of *very* important questions. You will have to determine, for example, whether your holding company will confine its activities merely to planning, controlling, and acquiring additional subsidiaries or whether it will become an operating company engaged in buying, selling, and the like. The choice you make will determine the size and complexity of the organizational task ahead of you. You will be better able to decide whether you need *hundreds of employees* at the holding company level or very *few em-*

* Mr. Kedzie, not a member of the Society, is vice-president and executive assistant to the president of CNA Financial Corporation.

ployees, having the great bulk of them in the subsidiary companies. (CNA Financial has two full-time male employees.)

We are all faced with the question of how to organize a subsidiary relationship where more than one exists. For example, American General Insurance Company has at least six life insurance companies; CNA Financial has two. How should they be organized for maximum effectiveness? Will one write group and the other individual? Will one operate in New York State and the other elsewhere? How shall we structure the relationships between them, and those between the subsidiaries and the parent? What about the fire and casualty insurance companies which may be part of your group at the present time or are contemplated for future purchase? And what will you do about the health insurance being written by both your life insurance company and your casualty company!

Let us also give some attention to your need for income, since for the first few years you will be almost solely dependent upon your insurers. It is imperative that you predict amounts that they can generate. Shall the holding company turn to other types of businesses, besides its insurance subsidiaries, to generate needed income? Or shall it use its own unique power of leverage by employing financing techniques, such as bonds, preferred stocks, and other financing instruments foreign to the insurance companies?

What will be your policy with regard to the amounts of *earnings* that the subsidiaries will direct as upstream dividends to the holding company? How large a *surplus* will you now maintain in your insurance companies?

Once you have determined the source and amounts of funds from the subsidiaries, you will then have a better idea of what actions are necessary to realize the potential you have established for your holding company. To do this, you will have to decide if yours is a "growth" company or if dividends to shareholders are more important. And how *fast* do you wish to grow?

You might set your goals in terms of earnings per share or return on investment. This is always an interesting exercise. It is very much like the life insurance agent who uses the "needs" approach to sell his product to a client. Once you, as a client, have established an amount for a clean-up fund, a mortgage-clearance fund, an educational fund, and a life annuity for your widow, you then discover that a mere $450,000 of additional ordinary life will fix everything.

So it is with your holding company! Once you have determined the amount of dividends to be generated by the subsidiaries and contrasted them with your expectations of an increasing earnings per share, you find

that the gap can be filled merely by the purchase of a medium-sized mutual fund and a large property and casualty insurer.

This obviously oversimplified and facetious commentary is merely illustrative of another series of questions you must answer. One of the principal ways to fill the so-called planning gap is through acquisitions of other organizations. But what type of acquisitions will *your* holding company make? Will you confine them to businesses similar to the one in which you now operate? Or will you become the LTV of the insurance industry, and buy anything reasonable in sight? And, by the way, how will you pay for them? With cash? Common stock? Preferred stock? A new financial security?

Once you decide upon an acquisition strategy and buy your first company, you then must give attention to how you will integrate this company with your current operations. Hopefully, you can produce synergistic effects that make the whole greater than the sum of its parts.

"Well, Kedzie," you say, "Will all those questions *really* have to be answered?" Unfortunately, gentlemen, yes—sooner or later, and probably sooner. The best way that we at CNA have found to handle them is by planning ahead. If you were to visit me at CNA, you would see evidence of a massive effort to generate data for answers to these questions and others. These activities are all pointed toward what Howard C. Reeder, president and chairman of CNA Financial, calls "planning for the college education of our new baby"—the holding company. We have enlisted the best talent within and without the companies to help us array these data for management decision.

We believe that the stakes are *so high* and the potential rewards *so great* that we must concentrate our efforts on a planning system that enables us to maximize the advantages of the holding company mechanism. We hope that those of you with holding companies, or plans for them, will agree. All of us then can be properly prepared for an unprecedented era of service and growth.

MR. ANDREW DELANEY: In answer to the first part of Question 1, Webster's unabridged dictionary defines a holding company as "a company that owns all or part of one or more other companies for purpose of control." Before proceeding, I will pose and answer a question of my own. With the insurance business well over one hundred years old, why has there been such a stampede to form holding companies in the last two or three years? In addition to the reasons that I will give in answer to Questions 1, 2, and 3, there were two fundamental changes in business conditions in recent years that provide the essential backdrop. The first, psy-

chological in nature, relates to the lack of esteem that the financial community generally has had for holding companies. The second, more tangible in nature, is the change in the Internal Revenue Code in 1964.

The above-mentioned lack of esteem existed from the thirties to the sixties, certainly due in part to the predepression activities of Samuel Insull, the Van Swearingen brothers, and others who used holding companies as a device to pyramid control, with the resultant bust of the early thirties. This lack of esteem is illustrated by holding company shares selling at prices lower than could be calculated from the market value of their holdings.

The tangible reason relates to the tax the holding company paid on 15 per cent of any dividends received from its subsidiaries. This was a proximate cause for holding companies to sell at a discount.

The two essentials for the present extension of holding companies were a gradual change in the investment community's regard for holding companies and the change in 1964 in the Internal Revenue Code. This change permitted a holding company to have a 100 per cent dividend exemption, provided that it owned 80 per cent of its subsidiary and that the dividends earned by the subsidiary and paid to the parent company were earned at the time the subsidiary was a part of the holding company group. An additional tax change permitting the filing of consolidated returns converted the situation from a disadvantageous one to one which is advantageous because, in filing a consolidated return, the operating losses in one corporation can be offset against the profits of another.

There is an exception in the case of life insurance companies which cannot be consolidated with other companies in the group, even other life companies, except where one life company owns another.

The first and perhaps most important reason that insurance companies are forming holding companies is their desire to diversify. They no longer feel that they are in the insurance business but that they are in the money business; they are, therefore, looking at mutual funds, commercial banks, and other financial services.

The second reason for forming a holding company is flexibility. Insurance companies are severely restricted in the amounts that they invest in other companies and are not permitted to use debentures or convertible debentures in raising new capital. The holding company can do so.

The third reason is the increase in federal income tax in 1959 on a life insurance company owning a subsidiary. One way of avoiding this increased tax is the "stapling arrangement" used by Connecticut General. This ingenious arrangement is not a very durable vehicle, and the holding company is a more constructive way of avoiding the taxes.

A fourth reason is that under the laws of most states two life insurance companies can affiliate only by merger. By using a holding company, both insurance companies can be continued indefinitely until the merger can be effected most expeditiously.

A fifth reason is that the holding company can show as assets items which would be nonadmitted for an insurance company and thus present a fairer picture to its shareholders.

The sixth reason for forming a holding company is merely to stay abreast of the competition.

MR. ROBERT C. TOOKEY: I have been asked to play the devil's advocate role and comment on Topic 4, "Reasons Why a Holding Company May Be Inappropriate in a Given Situation."

A most interesting example of the herd instinct is the headlong rush of the stock life insurance companies in this country to form and become a part of a holding company. To be sure, a great many life insurance companies have valid reasons for going the holding company route, and there are some holding companies that have long held insurance companies—such as Transamerica, one of the granddaddies of them all. While the generalized recommendation "Form a holding company" may be sound advice in many cases, I think that in other cases it is 90 per cent sound and 10 per cent advice.

In the past a "pure" life insurance company which is owned by thousands of stockholders has normally sold for a higher price-earnings multiple than the same entity contained in a holding company. A good example is a holding company that owned 46 per cent of a large life insurance company. It owned nothing else, and yet its shares sold for 15 per cent less than the shares of the life company on the open market. How can this be? A holding company is usually in a position to acquire other companies, and, when this happens, the investor who is primarily interested in having a position in life insurance stocks may end up owning more than he bargained for. Another reason holding companies have sold at lower price-earnings multiples is that it is sometimes difficult for a securities analyst to ascertain the true worth of the stock. He then becomes reluctant to advise his client to pay the same price-earnings multiple that he might recommend for a straight life stock. Though this trend may be changing, it is too early to be sure that it has. Someday, perhaps, the situation may be completely reversed, but today, when all life stocks, in and out of a holding company, are depressed, one is inclined to reserve judgment.

For the typical company that has mastered the technique of marketing life insurance and serving the public, a concentration of its executive effort in doing a better job in its specialty makes more sense than diluting executive effort and becoming involved in many other activities. Perhaps the day may come when there will be so few publicly held life insurance companies that have stayed out of a holding company that the agents of such a company could enjoy an advantage over agents from other companies. They can point out that the company they represent deals only in life insurance and is not mixed up with a lot of other stuff, the result of which could be a reduction of safety from the policyholder's standpoint. Though not necessarily accurate, such oversimplifications are quite often used by salesmen. Maytag manufactures only washers and dryers and makes quite a point of this.

Institutional investors may, because of investment policy, be unable to take a strong position in insurance companies that are merely a part of some corporate conglomerate. It is demand by mutual funds that helps support these stocks of life companies.

One also wonders whether the trend toward conglomerates which involve life insurance companies interrelated with totally unrelated businesses can someday lead to unpleasant consequences. I should like to quote from an article, in a very well-known business magazine, describing a holding company which owns a life insurance company, along with a very large defense contractor:

> This clever leverage is only half the story. The other half is that the merger creates the certainty of far greater earnings potential. This is because the life company has tremendous unrealized capital gains in its common stock portfolio. As an insurance company it can count these security gains as income in the year they are taken. In addition the solid insurance earnings make the defense contractor's earnings mix more attractive to the bankers. There are also tax advantages. Insurance companies pay taxes at about half the rate of industrials and this advantage can be spread over the whole merged company. In addition, new methods of insurance accounting allow the expense of new business to be written off over a few years rather than the year incurred. This could increase reported insurance earnings and should be useful in making further acquisitions.

Though this article is for the most part misleading, inaccurate, and incorrect, one still wonders how helpful such talk is when we are asked to justify our present federal income tax formula. Here an industry which is designed to protect widows and orphans justifiably receives special tax treatment (a deferral, not reduction of taxes), and now we see the begin-

nings of a trend where the industrial conglomerates could attempt to use that tax advantage in the pursuit of growth and diversification goals totally unrelated to the fiduciary responsibility to policyholders and beneficiaries.

While it is true that the state regulations have been unduly strict in many cases, the recent New York Insurance Department report on holding companies indicates that they recognize this fact and are prepared to suggest remedial measures. In effect, the department has recommended that life and casualty companies be given greater latitude in the formation and acquisition of subsidiaries. When it is an insurance subsidiary, such latitude should be of the broadest nature. On the other hand, noninsurance subsidiaries should be restricted to such functions which truly supplement the simple goal of providing the public with insurance. Naturally, the department prefers that such subsidiaries be wholly owned by the parent company if they have their own subsidiaries, otherwise majority owned by the parent. It was recommended that insurance companies be able to invest a larger percentage of assets in common stocks.

As to the problem of capitalization, the report recommended that insurance companies be permitted to raise capital through sale of senior equities and securities convertible into equities. It was further recommended that both stock and mutual companies in both the life and casualty fields be permitted to obtain the capital required to support insurance and appropriate ancillary operations through debentures.

Most insurance departments are quite apprehensive about the additional workload resulting from the obvious complications arising from the holding company concept with its family of subsidiaries. This makes effective regulation more difficult and expensive. However, a typical insurance department might logically seek to extend its regulatory powers to regulation or some form thereof of the other enterprises associated with the insurance activity. Holding companies might find this attitude somewhat burdensome.

The question "Is the insured public better off in view of the proliferation of life insurance holding companies?" naturally arises. It would depend on the ability and integrity of management and the soundness of the organizational concept in each case. In many cases the public is much better served because of the spectrum of financial services that are thereby made available. On the other hand, insurance company managements should avoid dilution of their efforts and diversion from their primary objective, which is to sell insurance and to service policyholders. The more an executive allows his time to become fragmented, the less effective he

becomes. Thus the holding company will normally be faced with more difficult staffing problems if it is to prosper equally in all its endeavors.

The example of the marriage of the insurance company and the defense contractor that I mentioned earlier points out a paramount danger, namely, a shift of emphasis from insurance to noninsurance operations and the attempt to utilize the tax advantages applicable to the life insurance industry for the benefit of other pursuits which take precedence over the insurance operations. This pointed objective of "maximizing profits" by being in all businesses, and by utilizing all possibilities of an intercorporate shell-and-pea game, may not serve the best public interest.

In summary, let me say that the holding company concept, in my opinion, is in special situations fully justified. I feel, however, that proliferation of holding companies implies that many companies are doing this to no advantage, acting only from the self-preservation instinct. Finally, I believe that the subsidiaries in such a holding company should be in those businesses providing financial services that would facilitate the sale of life insurance. Rare is the case where the inclusion of an insurance company designed to operate in the general market would be justified as a small segment of a large industrial conglomerate.

MR. JAY C. RIPPS: Mr. Delaney mentioned the advantage that a holding company is flexible and is able to circumvent certain state laws regarding limitations on common stock investments. One purpose of these laws, I think you will agree, is to prevent undue economic concentration. How justifiable is the insurance company's position in trying to circumvent these laws? Do you think there is any danger of increasing economic control by insurance companies?

MR. DELANEY: We are not attempting to circumvent any law. There is no prohibition against the issuance of securities or the investment in various types of securities by a holding company. I think the primary purpose of most insurance investment laws is not financial concentration but the protection of the policyholders. I do not think there is a danger of increasing economic control, but perhaps the Department of Justice would have a different view.

MR. TOOKEY: Some of the state laws have not kept up with the times and have to be revised so that the insurance industry can compete in the general market. I wonder, however, whether it would be a good thing for a holding company which owned the stock of a life company to borrow against those shares to invest in a different industry when the purpose of the insurance company is to provide protection for its policyholders?

MR. DELANEY: The policyholders of the insurance company would be just as well protected if the shares of the insurance company were pledged to buy something else. It is the stockholders who would be at risk, and, if they do not wish to be stockholders in that kind of company, they can sell their stock.

MR. THOMAS K. PENNINGTON: I feel that the holding company structure provides more protection for the policyholders of a small insurance company. If the over-all complex is not profitable, the life company can be sold to new ownership with minimal disturbance to the policyholders in contrast with the forceable reinsurance of a failing company.

MR. TOOKEY: I feel that the dividends to the policyholders might be affected in a situation where the holding company had borrowed against the insurance company's stock for an unsuccessful venture. I think that more exacting, complicated, and expensive regulation will be required for this reason.

MR. JOHN C. WOODDY: What impact has the Report of the Special Committee on Insurance Holding Companies to the New York Insurance Department had on the general movement toward holding companies?

MR. DELANEY: There is no law expected in this term of the legislature. It seems clear that the New York Insurance Department is going to assert its authority over the holding company, for example, by determining the amount of dividends that can be paid from a subsidiary to the parent, and I suspect that there is going to be very little advantage in the arrangement.

MR. WOODDY: The report suggested that, if the holding companies did not watch their step carefully, they might be faced with a statutory requirement that the holding company be an insurance company. Has this suggestion affected any holding company planning?

MR. DELANEY: We like the all-inclusive charter and bylaws in case we wish to engage in other businesses. Many of the larger holding companies feel that their stockholders are in the insurance business and that the parent holding company should be an insurance company.

MR. MORTON D. MILLER: Mutual companies also have an interest in the potential of holding company arrangements or, more particularly, subsidiary company possibilities as a means whereby the kinds of diversification of services that many people feel the industry must have in order to stay in the market can be achieved.

MR. TOOKEY: In California we are attempting to follow the Massachusetts approach, so that the company may own 51 per cent more of a subsidiary in certain lines. These include:

1. A real property holding, developing, managing, or leasing corporation.
2. A corporation providing investment, advisory, management, or sales services to an investment company or separate account.
3. A data-processing or computer service corporation.
4. An investment company or companies as defined by the 1940 investment company act.
5. A corporation acting as administrative agent for a governmental instrumentality performing insurance-related functions, or for private health and welfare plans.

MR. DELANEY: Mutual companies will be at a disadvantage, because they can only pay cash, whereas the shareholders of a company that has acquired a large book profit may be interested only in a tax-free exchange for other shares.

MR. KEDZIE: A couple of mutual companies have formed stock holding companies which in turn, since they are stock corporations, can buy things by other than cash transactions.

MR. TOOKEY: The mutual company which wishes to expand by the acquisition route, purchasing other life companies, should consider demutualizing and forming a holding company.

MR. DONALD J. LEAPMAN: So far all the discussion has concerned the fiscal aspect of the holding company. Has the panel any views concerning the use of a holding company for removing from the operating life, fire, casualty, and mutual fund companies the common elements—for example, for removing the E.D.P., marketing, investment, accounting, and legal elements—in order to avoid bias? These common elements would then have no special relationship with any one individual operating company and would also be better placed to make their services or advices available to outside clients.

MR. KEDZIE: CNA has formed CNA Realty Company so as to have the ability to hold equity positions in real estate. The staff used will be our regular investment staff. Consideration is being given to the possibility of combining computer operations within the two Continentals and possibly making the operation available to others.

MR. DELANEY: In our holding company we have one finance committee, that makes investments basically for all companies in the group; one

computer installation, which services all in the group; and one payroll and personnel department.

MR. BERNARD RABINOWITZ: Several years ago, in South Africa, a holding company supplied services to an insurance company which it controlled and charged exorbitant fees. The insurance company was soon in financial straits. This led to much tighter control by the authorities.

MR. KEDZIE: The New York Insurance Department report makes it clear that the relationships between the holding company and its subsidiaries will be fair and equitable and that allocations of expenses will have to be very good.

MR. TOOKEY: The report indicates that irresponsible management would have more opportunities for abuse under the holding company arrangement and that a catalog would be drawn up of potential abuses.

MR. RANDALL M. LUZADER: Suppose that a company formed a subsidiary corporation whose sole assets were the furniture and fixtures of the insurance company and took the full value of this as an asset. Is this legal? If not legal under the one-fifth of 1 per cent rule, is it legal under a leeway clause? How does it pertain to the taking of the nonadmitted assets into a parent corporation in a holding situation?

MR. DELANEY: We had a similar situation in Texas and the department wrote down the value of the stock of the subsidiary corporation to zero.

MR. PENNINGTON: Since the data-processing operation of a company could easily become worthless, I would think that the owning of the data-processing company by the holding company would leave the life policyholder better aware of his true surplus protection, since the now worthless subsidiary would not have been included in the surplus relied on for protection.