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CURRENT TOPICS: U.S. INSURANCE

Moderator: ROBERT D. SHAPIRO. Panelists: HARRY D. GARBER, MADIE IVY, JOHN STUDZINSKI***

This session will discuss current U.S. life insurance issues, and will focus on innovations and critical changes occurring in such areas as:

1. Corporate structures
2. Marketing strategies
3. Distribution approaches
4. Product design
5. Management techniques
6. Federal income taxation
7. Reinsurance

MR. ROBERT D. SHAPIRO: The panel we have assembled has broad actuarial and nonactuarial experience. Madie Ivy is a tax partner in the New York office of Peat, Marwick, Mitchell and Co. Her practice is largely life and property and casualty.

John Studzinski represents the investment banking firm of Morgan Stanley in New York. In recent years, John has had considerable experience involving mergers and acquisitions of insurance companies, both life and property and casualty.

Harry Garber is the Executive Vice President and Chief Financial Officer of Equitable Life. He has been with Equitable for 31 years. Harry directs Equitable's strategic planning and is currently chairman of the dividend philosophy committee of the Society of Actuaries.

My name is Bob Shapiro. I am the National Director of Life Insurance Consulting for TPF&C.

The goal of this panel is to cover issues of current origin in the life insurance industry. Our approach will be to focus on major issues, and particularly how the outlook and strategic prospects for life companies have changed over the last year.

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**Mr. Studzinski, not a member of the society, is a representative of the New York office of Morgan Stanley & Co.

We will begin with each of the panelists giving a brief discussion of where they believe the life insurance business is going, how they anticipate changes occurring in the environment, and how they see those changes affecting their strategic planning.

MR. HARRY GARBER: First, I think that we are clearly in a period where the consolidation of a financial services industry is now beginning to happen. Under the pressures of inflation, high interest rates and increasingly volatile economy, the pace of the consolidation is accelerating. Along with it, there is a clear and rapid erosion of the legal structure which has both protected and restrained the major subindustries within the broad business spectrum that includes life insurance companies, commercial banks, thrift institutions, casualty insurance companies, insurance investment, real estate brokerage services, etc. As has happened in the case of other industries in which consolidations have occurred for basic economic reasons, we can expect that the results of this consolidation will reduce the aggregate industry profitability, will create pressure for price decreases and performance improvements and with these, increased customer satisfaction. As the consolidation process proceeds, there will be a substantial reduction in the number of companies in this industry as the weaker firms (which do not have the market position, capital and other resources to compete effectively) are either absorbed by stronger or larger firms or go out of business.

At the other extreme will be a group of winners who have found the strategies to increase their market share and profitability during the consolidation.

The financial services industry, if you look at it in its totality, is huge. At the end of 1980 it encompassed about five trillion dollars in assets under management. It had about 230 billion dollars of capital and it was growing with the U.S. economy. It had a very low level of concentration with the leading firms having less than a 3 percent share of these industry totals both in terms of assets and capital. If you take the aggregate of the 20 leading companies, they total about 20 percent of these totals. So it will be some time before leading firms can achieve a dominant position, either individually or in the aggregate.

In my view, there is no clear road to success in the financial services industry. It seems clear that distribution success and effectiveness will be the key factors. The recent moves several leading companies have taken with the objective of enhancing their distribution capabilities are indicators of this. But no one is sure what combinations are needed or which will provide the desired improvement of distribution synergy and effectiveness.

I think one-stop shopping is a fairly discredited theory. The average consumer now deals with a couple dozen or so vendors of the various types of financial services and he is quite prepared to continue to do so. However, the consumer, individual, or company is predisposed to use multiple services of a company with which he is pleased on the basis of past performance or relationships. The essential strategy, then, is to increase the number of individual, business and corporate customer relationships and to obtain distribution efficiency by enhancing these relationships through the sale of other services. The question is how to do this most effectively and profitably.

In addition to distribution effectiveness, a key issue in the financial

services industry is the availability of capital. At the end of 1980, the financial services industry had about $4.70 worth of capital for every $100 of assets under management. This represents a very high degree of leverage - even considering the fact that many of these assets do not involve financial risk to the managing companies (They are essentially managing them for a fee.)

The ability of companies to expand will depend upon their ability to build capital and achieve rates of return commensurate with the business growth and the risks undertaken. Also, the financial services world of the future will be more technologically based than in the past, thereby requiring more capital for investment in computers and communications equipment. Accordingly, the need for increased access to the capital markets and greater need to maintain or build profit margins will be crucial factors to individual companies in this consolidation process.

Although financial services consist of many diverse types of services, I think it's clear that the leaders which emerge in the industry will continue to emphasize the products/services on which they were founded. Life insurance companies will remain, principally, as life insurance companies, etc. The reasons are simple. Each company will seek to build on strength and every company that has built itself to being a leading company today, must by definition have been quite successful in the segment in which it operated. Beyond this, each of the major segments of the financial service industry offers necessary services and ones for which there is usually a growing market. Furthermore, entry from one segment to another is impeded because of both legal barriers as well as the need to establish segment expertise.

When an industry has no patents or no trade secrets and there is little that can be protected very long, success is going to come from one of two things: either becoming a low cost producer or building a more efficient distribution process, and probably both. And companies may not have a lot of time to do this because I think things are beginning to move very quickly.

I think you can get an example of what's happening if you look at what Merrill Lynch has done to banking margins. Whereas, traditionally banks might have wanted to earn 100 basis points or 50 basis points for a service, Merrill Lynch money market accounts are providing it for 10 or 20. The only way to build margins is to achieve a unique position somehow. Either a particular niche in the market, a particular area in the country, or something that gives you unique characteristics.

Finally, the question of capital is going to become a paramount question. We cannot assume (and particularly mutual companies cannot assume) that all the capital that will be required can be developed from internal earnings.

MR. JOHN STUDZINSKI: I would like to begin by saying that I am very excited to be here today. I think that a representative from Morgan Stanley in the mergers and acquisitions area is really very relevant at this type of gathering. The most active, exciting area of mergers and acquisitions today is in the insurance and financial services area. All of the things which were just mentioned by Mr. Garber are all being seen in our shop and in the other shops on Wall Street. Recent acquisitions, such as Dean Witter/Sears, Shearson/American Express, are examples of what is going on in the industry.

Clearly, there is an evolution, almost a revolution taking place. We are

seeing a lot of nonfinancial, blue chip and foreign buyers who are going to be taking over in the financial services and life insurance market in the United States. The decisions they are making are to go after small, quality companies, companies that can provide them with either a distribution system or a specific market segment.

Strategically, and historically, people have looked at life insurance on a product basis. They made acquisitions on the basis of what type of ordinary life product they were going to obtain, what type of accident and health product they were interested in pursuing. This approach has changed significantly today. The first strategic question any large company asks concerns distribution system and market segment.

With respect to the old make or buy decision, most of the large companies seem to be buying. A good example is what the Lincoln National has done through acquisition. By associating themselves with Associated Madison, they have moved into mass marketing; through their recent acqusition of First Penn Pacific, they have moved into the Universal Life product; and with the acquisition of Security Connecticut in 1979, they purchased an entirely new distribution system -- the brokerage distribution system.

With respect to how the tactics in acquiring these companies will affect the industry, it is very possible that there are going to be a lot of hostile takeovers and media sensationalized tender offers that are all going to fall in line with companies diversification objectives. This will have implications with respect to management and geographic diversification.

Lastly, I think the mutual companies in the United States will undergo some change in the near future. A number of mutuals are seriously contemplating mergers. I believe the feeling on Wall Street is that once one major company goes through the mechanics and the logistics of trying to decide how to handle the surplus, how to handle the policyholders, how to do it in a fair and equitable way, there will be a domino effect in many other companies. Many other mutual companies will expand their market and geographical presence through these types of transactions.

Another type of transaction which we have been looking at closely in the life insurance area is demutualizations. There are some feelings that there are a number of advantages to being a stock company - access to capital markets, access to growth and opportunity through acquisitions.

MS. MADIE IVY: I am also glad to be with you this afternoon. My business is taxation and I would like to discuss Washington's thinking on tax policy as outlined in the General Accounting Office (GAO) proposal. The GAO report is a 216-page report to Congress, dated September 17, 1981, which basically said that life insurance companies are extremely favored and major tax reform is needed.

The GAO report discusses why the life insurance company taxation needs revision. Specifically, it states that mutuals are no longer the dominant factor in your industry. It describes the shift from whole life to term, the dramatic increase in pension lines, and identifies policy loans as being a serious cash flow concern. The economic changes that were identified as having an impact on the life insurance industry were increased rates of inflation and interest, and the overall awareness of the general public regarding the interest rates and the earning on their investments.

The GAO's report to Congress had three specific recommendations: the 10 for 1 rule, the deferral of 50 percent of underwriting gain, and the 818(c) net level adjustment.

The GAO had three alternative suggestions for dealing with the 10 for 1 rule:

- revalue reserves using the actual adjusted reserve rate;

- replace the 10 for 1 formulas with geometric approximation; or

- substitute a 4.5% maximum for the adjusted earnings rate with either the arithmetic or geometric approximation. The GAO felt the 4.5% maximum would give the best result of the three alternatives.

The GAO recommended that the deferral of 50% of underwriting gain be phased out over five years for companies in existence 15 years or more. They recommended that the deferral be continued for new companies until they had been in existence for 15 years, then phased out over five years.

The GAO recommended that the 818(c) net level adjustment for non-term business be reduced from $21 to $12 per thousand. They made no recommendations for changing the $5 per thousand for term business.

The report listed six additional areas which should be reviewed by Congress: 1) Deferred annuities: Here they felt that consideration should be given to the appropriateness of allowing the investment type contracts to take advantage of the high interest deduction to the company and have a favorable tax treatment to the policyholders. 2) They felt the life insurance company definitional test be tightened to exclude credit A&H companies. 3) They wanted clarification of life reserves and the definitions thereof. 4) Clarification as to what investment expenses are deductible in determining your investment income. 5) They wanted clarification of definition of assets, specifically due and deferred premiums and escrow funds. 6) Modified coinsurance under Section 820 to avoid taxes requiring legislation to stop abuses.

The government's response to these proposals - this is one government agency talking to the other. The Treasury concurred with the elimination of the deferral of 50 percent of your underwriting gains but felt that the 15 year provisions for new companies with a five year phase-in would still allow excessive deferrals. The treasury feels the current $21 per thousand approximation reevaluation under Section 818(c) is excessive but did not agree with the $12. They felt it should be eliminated altogether. They also felt there were serious deficiencies in the GAO analysis of the 10 for 1 rule. They felt that the GAO only focused on the higher marginal rates that the life companies were paying; not the overall tax burden. They were very critical of the GAO's treatment of modified coinsurance, feeling that they were superficial and uncritical, even though it was listed as an area of concern. The Treasury Department also believes that the deferred annuity area needs special attention.

For those of you who are not accustomed to working in Washington, the Treasury deals with policy while the IRS deals with strictly administrative aspects of tax policy. (They are your auditors.) The IRS felt that the GAO's report gave insignificant attention to many of the controversial areas. They state in one of their reports, "The tax free build-up of earnings on life insurance

products, especially deferred annuities and universal life products, should be studied. These are often more of an investment vehicle than a life insurance product". Another comment was, "modified coinsurance represents a major area of tax avoidance and should have been more developed in the GAO report". That is the Washington climate today for your industry.

I think that as we progress through the next few years and you see the refinements of your industry, you will come away with the same feelings that I had about six months ago. I was in Washington for a White House briefing and talk with David Stockman and several key tax reform congressmen. They were asked many specific questions about the Savings and Loan industry. I came away with a strong feeling that the Reagan administration's overall policy is industries should stand on their own and not receive favorable tax support if they were not economically viable.

MR. SHAPIRO: I'd also like to make a few comments about where I think the industry is going. It seems appropriate to start with corporate strategies and structures. I believe there are at least six possible strategies for life insurance companies. These brief comments will be too oversimplified to really amount to anything more than a discussion base.

One strategy is to "bury your head". The structural needs of that kind of strategy include a long neck and a lot of luck.

The second strategy is to diversify. Diversification is often thought of in terms of the full financial services concept. The structural needs to diversify include corporate flexibility and financial strength, two elements that are difficult to mesh successfully.

The third strategy might be described as "to manufacture products". Such a company must be quick to develop new and competitive products, and must be very efficient.

The fourth strategy is to target market. Colonial Penn is an obvious example there. Some of the structural requirements here include direct response marketing expertise, the ability to develop sponsorship from third parties, and a high level of creativity.

A fifth strategy might be to evolve as a "boutique", providing a limited number of products or services generally focused toward specific markets or distributors.

A sixth strategy is to develop agents. What is needed structurally to develop agents depends on the market focus. The upper income market is different than the middle income market ... in fact it is difficult to find many good current examples of successfully using agents in the lower income markets.

The place to start is with mission and fundamental strategy definition, <u>not</u> with product or other structural elements of the strategy. Structure follows strategy. If strategy is properly developed it will be clear that not everyone has to sell universal life and the full complement of financial services to upper income markets through stockbrokers to succeed in the 1980's!

One of the questions that was brought up was: "If the IRS rules unfavorably on excess interest questions for single premium deferred annuities, how might

affected insurers utilize reinsurance to overcome that?"

MR. GARBER: IRS rulings are not law and I would not take an adverse ruling from the IRS as being definitive in this case.

MS. IVY: Many people think this will be litigated.

MR. GARBER: That one will definitely be litigated by us if by no one else. I think we will have a lot of company.

MR. SHAPIRO: The question on the modified coinsurance tax savings is really two-fold: First "Are companies thinking of distributing the tax savings to their in force where they have developed mod-coinsurance tax savings?" Second, "Are companies thinking of reflecting such savings in the pricing of new products?"

MR. GARBER: We have not at the Equitable chosen to do either of those at the moment, but we have begun to think about them. Until the present situation develops a little more, I think modified coinsurance is a weak thread on which to develop a long term pricing strategy. Bill Harmon said yesterday at the tax session that he feels very comfortable with the existing agreements. Though the IRS may challenge these agreements in court, he believes that most of them substantially comply with the law. To say that the situation in Washington is confused probably understates it. I think the President is getting a lot of advice not to move ahead with his tax package. Whether he will take that advice or not, I do not know.

If a tax package is proposed, my judgment would be that most likely the repeal of modified coinsurance will be in it. Whether the repeal of modified coinsurance would pass the Congress is another question. Insurance companies are not all that favorably thought of in Washington, but I think our case is pretty good. I would hesitate, however, to build a long term pricing strategy on maintaining modified coinsurance. Current dividend distribution policy must depend a lot on really how you view the future. Will high interest rates continue, and, if they do, what will happen to old business. Depending on your cash situation, it is easy to write some scenarios where assets must be liquidated in order to cover withdrawals on existing business. It might be very nice at these times to have these reductions in tax to fall back on as a way of supporting your situation. From our point of view, we are going to sit tight and not distribute until the whole situation and our understanding of likely future trends becomes a lot clearer than it is today.

MS. IVY: Just another comment on Modco. There is a feeling in the IRS national office that they could do away with Modco abuse strictly through revenue rulings and tightening up of interpretations. I have had several people ask me recently about what would be an effective date on Modco if we have a legislative "repeal". That is a congressional action which cannot be predicted. You are not home free on Modco contracts that you might be considering today. Generally, the IRS is administratively very critical of Modco transactions and should expand their audit activity in this area.

MR. GARBER: Even if they do not like it, they will not be able to get your money back for the eight or ten years it takes to go through the court system.

MS. IVY: However, they are going to charge you 20% interest starting February 2, 1982.

MR. SHAPIRO: In terms of the merger activity characterized for example by Prudential and American Express, what do you see in the future in terms of noninsurance companies looking at insurance and other financial service companies.

MS. IVY: There was a saying at one time in Texas, that everybody should have their own bank. I think there is now a saying that everybody should have their own insurance company.

MR. STUDZINSKI: I think a little history here might be helpful. In the end of the 70's there was a movement among a lot of the large oil companies to develop for tax and some investment reasons, strategies to purchase a life insurance company.

The best example many of you know of is the purchase of Southwestern Life by Tenneco. I think that took place in 1978. Right now the picture has changed significantly. In terms of the nonfinancial people who are interested in life insurance, large companies are becoming interested.

Let us pick a general company that manufactures "widgits". Historically, their profile has been that that they have been involved in three or four different manufacturing areas. If you look closely at each one of these companies now, you will find that they are going out and they are hiring from the major life companies or major actuarial consulting firms individuals to develop their financial services operations. I think among the fortune 200 companies, 20-40% of those companies who have not historically had financial service arms are now moving into those areas. I think the primary reason is that over the next decade and perhaps all the way to the year 2000, the life insurance business is going to be a significant high growth industry.

In many respects in terms of investment, people feel the life industry will replace the high technology industry in terms of prices that people are willing to pay to get into this industry. For life insurance, a buyer usually pays two times book on a GAAP basis and 15 times earnings. Prices very rarely deviate from that unless the transaction is extraordinary. At times, people will pay closer to 17-18 times earnings for companies that have established a market position, or that have certain products which are appealing from a future profit margin standpoint, or which will enable a large industrial, a large nonfinancial company to make a significant investment in the financial service area.

MR. SHAPIRO: Do you agree with the observation that 50% of the life companies will be merged or acquired in the next 10 years?

MR. STUDZINSKI: 50% plus or minus what, is the question. I am surprised the person did not say 50% plus or minus 10% or 5%. If we assume it is 50% plus or minus 50 I'm home free.

It is really an alarming question and the person who wrote it obviously knows that this is something that we are more and more concerned about. I think that we need to look at companies today on the basis of size. On the basis of premiums written, the number of companies ranked between 350 to 700 in size could well disappear and be merged or consolidated.

Many of the small mutuals are probably in liquidation right now -- or at least over the next 10-20 years. From a standpoint of Wall Street, everyone makes fun of us because our fees are paid on the basis of how many transactions we supervise and consequently, we do not have an incentive to encourage the amount of transactions in the life insurance industry. We do believe that our clients are moving in the direction of consolidating and significantly decreasing the number of companies -- primarily from a unit cost efficiency standpoint.

MR. SHAPIRO: Although 50% of the current life companies may disappear in the next 10 years, there may be a formation of a number of new ones for different kinds of strategic reasons. An example is the stock subsidiaries being formed or acquired by mutual companies.

Virtually every mutual company has looked at the question of a stock subsidiary. The larger the mutual the harder the look. Over the long term, I think most large mutuals will either form or buy a stock company. If it is for defensive reasons there may not be a lot of immediate activity in the subsidiaries. Strategically, many mutual companies believe they cannot afford not to have that stock vehicle available, even if they are not yet quite sure strategically how they are going to use it.

This topic raises a whole series of questions. One is the make vs. buy question. It is very easy to say "We will go out and buy a widely licensed clean shell in order to have it available". But there are not many widely licensed clean shells out there! Those that exist are demanding and obtaining pretty high prices. One of the approaches we have observed is to continue to look for that clean subsidiary while forming one or more of one's own subsidiaries. If a company is lucky enough to find something in the meantime, great, but the odds are becoming less and less, at least for purchase of a reasonable price.

Another alternative is to approach some of the owners of life insurance companies that may not be enamored with them anymore or that probably do not have the available management time to devote to the life company. Possibilities here would include noninsurance company owners or property and casualty owners of life subsidiaries.

I want to make sure we have Harry Garber cover the current activity of the Dividend Philosophy Committee (it has a new name now), addressing the future implications for dividend philosophy and the philosophy of managing nonguaranteed premium products.

MR. GARBER: We have not submitted any formal report this year and I wanted to appear on this panel (in part) to bring the membership up-to-date. The committee has been in existence for 5½ years. We started by looking at the problem of dividend illustrations and the concerns that were being expressed around the dividend illustration process. We sought to deal with illustrations alone and found that, in fact, we could not do that. We found it was necessary to include illustrations as a subcategory of the whole dividend process. Once we took that direction, we produced a proposed opinion in '78 and a proposed set of recommendations in '79. These have been circulated, and many of you, I am sure, have read them and commented on them. The recommendations then went on to the Academy to initiate the implementation process. The Academy has also received comments from members and has now issued a formal set of recommendations.

The original recommendations did not cover either individual annuities or the question of stock company dividends. In addition there were a lot of things happening under the titles of excess interest, indeterminate premiums and Universal Life which are certainly not traditional nonparticipating business and look very much like dividends. The society officers considered these developments and concluded that the charter of the Committee should be enhanced to enable it to look at them as well.

With respect to stock companies, we took a survey of current practices. The results of the survey confirmed our worst fears. We know there was an immense diversity of practice in payment of policy dividends by stock companies, however, we didn't imagine what the diversity actually was. It became clear that the "standard deviation" of this diversity was much larger than the same measurement would have been among mutual companies. Furthermore, it was clear that most of the current stock company practices did not conform to the recommendations of the Committee.

This left us with a couple of choices. One is to weaken the principles so that they can be applied broadly to the participating business of stock companies and the other is to retain the principles but not seek to apply them to existing business soon. The Committee has not reached any firm conclusions yet, but I believe we will conclude that it is most important to retain, or perhaps, to enhance our principles. We will leave to the Academy the task of deciding how they should be applied to new and old business. Certainly, they ought to be applied fully to business written sometime in the future, but when and what is done with existing business requires consideration by the Academy.

There are a couple of other important issues on this general subject. One deals with the question of separation of accounts. I think we have concluded that the principles should include a separation of accounts between par and nonpar business. We believe this concept should apply to mutual companies as well as stock companies, although that is not in the current recommendations.

The other issue that we are wrestling with is how much the shareholders should be able to draw from the policyholder account. Should this be covered explicitly in the principles or just be a matter of disclosure. That is an open issue with us now.

With respect to annuities, we have decided that traditional annuity contracts (including excess interest type business) should be included in the recommendations without any change in the principles that we are using.

Next, I would like to discuss the subject of nonguaranteed benefits. This category includes excess interest on annuities, indeterminate premiums, Universal Life, etc. We believe that there should be some professional principles applicable to these contracts in which the results are not guaranteed. And, to the extent that those principles are not followed, there should be some disclosure of that practice on the part of the actuary.

Remember that the principles that the Committee has developed are broad, general principles. We have not made them mandatory for anyone to follow. However, to the extent they are not followed there should be some disclosure of that. We would expect to recommend that this approach be applied to nonguaranteed benefits as well.

The basic principle of the dividend recommendations is that differences in treatment of different classes of policyholders should be based on actual or anticipated experience. I think it is fair to say that the Committee believes that this principle used for excess interest, undetermined premium and universal life products should be reasonably consistent with this dividend principle, recognizing that dividends tend to be a backward looking process while there is a forward looking process in the case of premiums and excess interest. We will be drafting recommendations. I would hope that within the next year we will have something for you to comment on before we pass them on to the Academy.

MR. SHAPIRO: Let me ask a couple of questions of our other panelists. This is for John. Is it possible synergistically to integrate an insurance company and a financial service company (like a bank or brokerage firm) or do they have to be operated separately?

MR. STUDZINSKI: I think the answer is yes. The best example I can site is the merger or the proposed merger of American Express with Shearson, Loeb, Rhoades. I think the unit we have to focus on here is not the management but the actual individual who is going to be offering the service, whether it be a brokerage service, a credit card service, or offering a number of different types of insurance policies.

MR. GARBER: Is not the main problem the people? If you buy a brokerage company, you have bought a group of people and some customer lists. These people, for the most part, would not want to be integrated into an insurance operation, if they have any other choices.

MR. STUDZINSKI: That is a very good point. When one looks at a brokerage operation, you find a group of people who are all paid on the basis of their individual performance. These people tend to be very independent, entrepreneurial types. If you try to take that group and force it into a structure where there are a lot of organizational goals, there are problems. I think the other problem is that brokerage firms compensate their agents differently and probably much higher than you find in many life insurance companies. If you have a broker distributing life insurance and you have a life insurance general agent distributing a brokerage product, the compensation decision is unclear.

MR. SHAPIRO: Historically, there have not been many examples of successful synergy or integration, even with combinations as seemingly alike as a life and a casualty company. Hence, the integration has often not resulted in successful results.

MR. STUDZINSKI: That is why you now have a lot of P&C companies very willing to sell their life subsidiaries.

MS. IVY: However Shearson-American Express seems to be working from the employee morale standpoint. The brokerage people I have spoken with, are delighted with the computer systems and back office potential of American Express, so they both have something to bring to the table.

MR. SHAPIRO: A question that concerns many is how best to preserve a company's existing block of business. For example, how can large mutual companies, with their large blocks of traditional in force business, protect

themselves from the current replacement opportunity that new money products such as Universal Life offer to their customers?

MR. GARBER: I would like to say, first, that the only difference between a large life insurance company and a savings bank these days is the question of inertia. In fact, individual policyholders have been less active in demanding that their money get current rates of return than the people who leave their money with thrift institutions. I do not know how long we can live on inertia. Among very sophisticated people, not very long, I am sure. In fact, I think the funds of larger policies are flowing out very fast in policy loans or in surrenders.

We may quickly reach a position where we have two unsatisfactory choices: one is to let that flow continue, sell the assets to meet it, and then become insolvent right away; and the other one is to pay higher rates to keep the funds and hope that interest rates go down before you run out of money.

The second is clearly the better choice. I think you can make distinctions between those groups of policyholders that are more likely to move and to begin to convert those over at the early part of your program. We have to recognize that a fundamental change is taking place in the country. People know the value of their money now and they demand that their money get a fair competitive return. I don't think we can hide any more behind the obscure sort of pricing that we have relied upon in the past.

One way of saying it is that although the FTC lost the battle, they won the war. What the FTC said should happen is going to happen; not because they decreed it, but because people understand and appreciate the value of their money. If our companies do not figure out how to do something about it, other companies will. For us to sit back and assume that this will not happen is a "head in the sand" sort of philosophy.

MR. SAM TURNER: I really would like to draw an analogy. I think going back for several years you will discover that we have a demand liability matched with long term assets. That has come to the forefront very clearly as interest rates have gone up.

I have the pleasure or misfortune of also serving on the board of a major bank in Virginia. I think our industry faces very much what the banking industry has faced. If you look at the banking industry, what has happened is a remarkable internal disintermediation; a dramatic flow of funds from regular checking to interest checking, a dramatic flow of funds from regular passbook to savings certificates. I think as an industry we are faced with two choices: either we do it to ourselves or somebody else will do it to us.

The banks have already gone through this period and I am surprised there is a reluctance for all of this money to shift quickly. I am continually amazed at how much regular passbook savings and regular checking there is still around. I think you will find the same forces at work in the life insurance business.

It is not going to happen one hundred percent overnight no matter what happens. I think we have two choices: one is to go through this period and come out of it preserving your customer base, and then go forward from there, or somebody else gets your customer base. That is exactly what has happened in the S&L's and banks.

MS. IVY: I believe we are dealing with a changed environment. How many of you have read Vogue Magazine lately? Why don't you pick it up and turn to that page right next to how to "redo your makeup". You will see financial advice -- analyzing universal life, analyzing investments in money market funds. Look next to Dear Abby in the woman's section of your local newspaper. You are going to find a column that says "Personal Finances". That is a changed environment. I happen to have become involved with the early stages of a magazine called Money. Money magazine didn't exist ten years ago. It is directed toward lower level consumers and is making them smarter about such things as policy loans, and their net after-tax income on various investments.

MR. STUDZINSKI: This trend is going to exist to a greater extent once people can walk into Sears and get basic financial advice -- something they were not able to do historically. Over time, there will be a trend toward disseminating that type of information to an even broader group of people.

MR. SHAPIRO: One technique that has become of more and more interest is direct response marketing. Kiran Desai will cover what changes have occurred over the last year in direct response marketing and what those implications mean for the future.

MR. KIRAN DESAI: During the last year, the direct response business is being forced to operate more productively and is required to go from "Ready, Fire, Aim" to "Ready, Aim, Fire". The four C's are leaving their indelible mark on the direct response environment of today.

The first C is Cost of Capital.

A direct response company spends capital up front to acquire the business. The direct response insurance company itself takes the risk of inflation, unlike an agency company where some of the acquisition cost is being paid after the receipt of premium. In an agency company, inflation decreases the present value of the real income of the agent, requiring the agent to take some risk of inflation. With the significant rise in capital, the bottom line impact on a direct response company can be as great as a decrease in profits of about 5 to 10 points. In a highly competitive environment like ours, this may even wipe out any profit that one may have. It certainly requires us to focus more closely on optimum use of capital resources. The use has to be productive and we have to cut down the ratio of acquisition costs to premium by about 25 or 30 points. This can be done primarily through either increase in average premium or by refined segmentation and targeting to more select groups.

The second C affecting direct response is Competition.

The insurance sector's share of disposable income has decreased, as Harry pointed out. The battle for the disposable income is becoming more intense. The competition for direct response comes from the outside and from the inside. From the outside we are now in the big league. Many noninsurance companies like Merrill Lynch, American Express and City Corp. are entering the direct response insurance field, and some are saying that 'if Merrill Lynch is here, can Mobil be far behind'? Noting, of course, that the profitable segment of Montgomery Ward is their insurance operations. Increased competition within the industry comes from various segments. As you all know, old line mutual giant companies like Prudential, as well as

Firemen's Fund, and Allstate have acquired brokerage houses and are likely to embark on targeted response business.

The third C represents Cost of Doing Business.

There is nothing unique here for direct response. We all are experiencing an increase in unit expenses. Unlike direct response, however, the other forms of insurance have experienced some commensurate increase in average premium. There is an unseen threshhold of premium that is hard to cross for direct response business. This means that the ratio of expenses to average premium has risen much faster than the industry. Over the last five years the general expense ratios have gone up as much as ten points. This has been aggravated by higher cost of capital. The problem of reducing the expense ratio by either severely reducing the expenses or by increasing the average premium is now receiving the highest attention of the management.

The fourth C affecting direct response is the Customer Profile.

I must have read over 1,000 articles and newsclips on "the graying of America", "the forgotten generation", "the other generation", or what the Europeans call "the third age". The older generation has captured the marketplace attention. Since this business is what I term "small premium" business, direct response is one of the logical alternatives. You have all undoubtedly heard about the $33 million war over the senior citizen health market that has brought the biggest insurance company into the direct response health insurance market! There are many other changes in the customer profile and the demographics impacting direct response targets. The second big one that affects us all is the advent of two-income families. This brings more disposable income to the family, but leaves less time on their hands to make the decision. This may bring some form of one-stop financial services and changes in the distribution system that would let your friendly stockbroker/bank collect your insurance premium, or your good neighborly insurance agent pay all your insurance and other bills and invest the balance for you in a segregated tax free account. I can't remember which, but you bet everyone listens when he talks, and you know you are in good hands.

All of this sums up as one big C - Change. As Chinese characters correctly convey, this sign represents both an opportunity and a danger. One must balance these two forces, and for direct response people this means test, test and more test.

Let me briefly review how the changes in direct response affect the items listed in the program. As to corporate structure: we may be moving from traditional insurance companies towards financial service centers, with a keen eye towards tax changes and changes in the bank holding company laws.

Changes in the marketing strategy for direct response is likely to translate into innovative ways to increase the average premium of the existing block to compensate for increased dollar amount in expenses and to find a suitable stream of new products for the existing marketplace. The second marketing strategy area is innovation, namely new markets. We now have the unique opportunity to use some of Uncle Sam's money to finance the project by using R&D credit. Growth in direct response will come from increasing the average premium threshhold and finding new needs to be fulfilled.

The changes in distribution systems will probably bring, as everyone has

been talking about, one-stop financial centers and storefront offices. Use of telephone and multi-media and two-way communication where both AT&T and RCA, in conjunction with their cable TV, may be very active.

Product design changes will require the direct response industry to make products more widely available, with underwriting criteria that permits innovation. Age and sex-related products may become a way of the past. This may happen soon in auto, but it will probably come to life insurance in the near future. Those who may have looked forward and tested some of the alternative underwriting criteria may be in a better position to look at the future where that may be a requirement. Direct response marketplace may offer ways to test the products on some grounds where they are underwritten based on biological age rather than chronological age, or some other criteria that does not require age/sex rating or meets some consumer expectation.

With all of the factors listed earlier, cost being primary among them, management in direct response would have to be more focused and dedicated. Direct response is a long-term proposition; it is not a business where rewards come immediately. Proper assessment of basic items like risk charge, proper cost of capital, as distinct from accounting item of cost of capital, are important. An approach that segregates trim operating budget from optimized acquisition budget and a long-term optimal opportunity budget is likely to bring you better direct response products that weather the future forces of the marketplace.

MR. SHAPIRO: How do mutual companies rationalize redeployment of policyholder funds to other businesses?

MR. GARBER: Let us start with the proposition that mutual life insurance companies are corporations that, though they are owned by their policyholders, have an important need to continue operations - I contend that this is in the interest of the policyholders because it is not possible to dissolve the operations of a mutual life insurance company in a graceful way. In fact, once you begin to go downhill, you will go very fast. You won't be able to distribute surplus in the fashion which theory tells you you should be able to.

The only way you can live is to grow and be successful in the marketplace. I think that it is incumbent on the management to assure that the company does continue, that it is successful, and that that should not be inimical to the interests of the continuing policyholders.

I think the case that Bob spoke about earlier where the number of policyholders gets to be very small because most of your business is being conducted in some other way is an awkward sort of problem. If you study the charters of mutual savings banks, you will find that the only people considered owners are those that have passbook accounts. People who have certificates of deposit are not owners. Thus, you can see that mutual savings banks will quickly get to the point where you have no owners left. Presumably, however, there will be legal ways found for these institutions to continue.

So, if you accept the belief that you do have to grow and prosper, then I think as long as expansions take the form of serving the interests of the company in growing and prospering, that should be of as much interest to the continuing policyholders as the distribution of excess interest or excess surplus.

Mutual companies are not, as a group, strongly capitalized. If you look at all the financial services companies, including banks, life insurance companies are losing ground. They have a much smaller share of the capital in this industry than they had ten years ago. They used to have about 20 percent; they now have about 15 percent. They are growing at a slower rate. Unless that gets reversed we will grow ourselves out of existence. We won't have the capital to conduct the business in times when the margins are a lot thinner than they are today.

The margins on the life insurance companies are much higher than for almost any other company. These are going to get shaved down. What Universal Life does is to disaggragrate the price and slice the margins very severely. We are going to have to get larger in order to be able to sustain ourselves. I do not think there is any company that wants to continue in business that has excess capital sitting around.

MR. SHAPIRO: Mutual company mergers comes up more and more in discussions today. As of this meeting date, two mutual life companies are in the process of merging. There are several situations where mutual life companies have expressed intent to merge and have not carried through.

There is considerable precedent for mutual mergers in property and casualty companies, as well as in the savings and loan industry.

I believe we will see a number of mutual company mergers and/or demutualizations in the 1980's. The critical issues that must be resolved in successfully completing a mutual company merger are:

1. What are the advantages of merger?

2. What is "surplus"?

3. Who owns the surplus (as defined above)?

4. What are the policyholders' rights?

5. How will the merged company be organized and managed?

Let us talk in a general way about the tax, purchase accounting and other items that are critical in life company mergers.

MS. IVY: Some fairly fancy tax structuring has been used in several recent acquisitions primarily using a code Section 334(b)(2) liquidation. Assume you wish to acquire a target company for cash. Two options the shareholders have are: (1) they can vote to have their company sell its assets; recognize the ordinary income internally in the corporation; then pay dividends to the shareholders or (2) they could sell their stock. If the shareholders sell their stock, they normally receive capital gain treatment. If they have the company sell its assets, generally they end up with ordinary income. Therefore, the objectives of shareholders selling a company for cash, are generally best met with a sale of stock.

If you have paid $10 million, it is normally desirable to assign that $10 million to the individual assets. For example, to buildings, computers, so you can take depreciation based on the purchase price.

A 334(b)(2) liquidation allows you to, in effect, give both parties what they want. The purchaser buys the shares of the corporation; the shareholders have no future liability for that corporation; they take their capital gains and go home. Now the purchaser owns the corporation. If the corporation liquidates within two years, it will be able to treat the transaction, for tax purposes, as if it bought the individual assets.

The keypoint in the life insurance industry is when you paid say $10 million for the life company, and a review of assets acquired shows the major part of your value is in the insurance in force. When you allocate your purchase price assigning a value to the book of business, and then write that value off over its useful life for tax purposes, the acquiring corporation has very nice tax deductions to offset future earnings.

MR. SHAPIRO: In a typical acquisition situation, using a classical actuarial appraisal approach, the evaluator sums three items: adjusted book value, a value developed for the existing block of business, and a value for the company's future marketing capacity. One of the difficult tasks is to attach reasonable disount rates to the streams of future profits from each of these three items. Another difficult task is to attach reasonable tax rates to the projected profit streams.

One of the implications of 334(b)(2) is that it often defers taxes. It defers taxes long enough into the future so that potential purchaser will look at present values before tax as a reasonable starting point for measuring the after-tax present values! In other words, if no taxes are expected to be paid for ten years and a 20% discount rate is being applied, the future taxes are often not a meaningful percentage of the before tax earnings on a present value basis. This is one of the reasons why the purchase price for many life companies may appear to be high relative to the apparent after tax future earnings of the company as it exists today. Once liquidated under 334(b)(2), the company develops and additional "value" in terms of the future tax shelter.

MS. IVY: This area is fairly complex from a tax standpoint and can have some traps in it. There can be downside risks to doing a 334(b)(2) liquidation. It is not always advisable. If you have a large net operating loss carryforward and you liquidate the company, then that carryover is lost. This would be one example of a situation where you might find that the net operating loss carryovers or tax credit carryovers were worth more than the 334(b)(2) liquidation.

MR. SHAPIRO: John, if you had a stock life insurance company come to you that wanted to sell themselves at the highest possible price today, what kind of process would you recommend following to obtain the optimal value?

MR. STUDZINSKI: There are a number of things one does to prepare a company for sale. Some people prefer the term affiliation, particularly if the company is going to remain completely intact ... the management is going to remain, the location is not going to change and essentially the only thing that is going to change is the ownership.

The first thing we recommend that the company does is to retain an investment banker. We suggest this from the standpoint of not only giving them broader exposure to the market, but enabling them to understand the number of parties

that are involved in an effective selling program. Those parties include an actuary or actuaries, who will be responsible for assembling the information on the value of the inforce with respect to any tax liquidation or purchase accounting adjustments that a prospective buyer may want to analyze.

One would also involve the accountants to make sure both the company and the prospective purchasers fully understand the company's historical tax position as well as its likely tax position over the following ten years.

Those three parties - the accountants, the actuaries and the investment bankers - will work with the company for a number of weeks in developing a package of information that will describe the company from a financial standpoint, from a tax standpoint, and from a market standpoint. In terms of getting top dollar, our feeling is that we need to present the material accurately and completely. We also need to give the management who will be running that company after it is acquired a good deal of visibility and a good deal of involvement in the selling process.

After all, a buyer is really going to want to buy management: a management that understand its products and markets; a management with a certain sensitivity as to where that company is going to go over the next ten years.

The company will need to put together projections. In the course of this business, I have come to learn that even the most well-regarded, well-known, and supposedly well-controlled companies do not, as a regular matter, put together projections. It is an academic process, but it's important if you are going to pick your company as something that needs a larger affiliation and a larger capital base. That's what I would call Step 1, the preparation phase.

Step 2 is the actual marketplace. The most effective way to do it in the mergers and acquisitions area, if the buyer is satisfied with all the prospective purchasers, is to do what is called the competitive bid. A competitive bid is a situation where we have ten people who are interested in the company. Over a series of weeks, the management decides that there are eight of those they find particularly interesting. We ask those eight (our objective is to get the number to five) to submit final bids. Generally, we pick a number and ask anyone who wants to submit a value view (say we are talking about a $200 million company) in excess of $180 million to do so.

These value views are based on a preliminary assessment of values. By values, I mean adjusted book value, value of the in force, and value of the new business, plus whatever premium you wish to add for such thing as distribution systems. I know for a fact that companies today will pay a premium for direct marketing or for brokerage opportunity because these are considered the two most desirable distribution systems.

So you package all those numbers together and if they can get beyond $200 million, we may include them in the final pool of five. Then we would say "all five of you are going to submit final bids. You are all going to sign stock purchase agreements or merger agreements so we can iron out all the legal issues with respect to a transaction prior to the final bid". The only number that is left to determine, then is the final bid. By doing this, we

can guarantee to the client and the company, and most important to the shareholders, that we did not leave any money on the table.

As a fiduciary responsibility to the board of directors and shareholders, that is the best way to get the best price for the stock. It is also the best way to direct a live company to an affiliation with an entity which it itself chooses to affiliate with.

There are a number of different variations of that but that is essentially the process that one would go through if one wanted to excite the marketplace, market a particular company, and attract a buyer who is going to be a good buyer -- not only in the present, but with respect to the continuing ownership of that property over time.

MR. PAUL YEARY: (Western and Southern Life): In 1954 Western and Southern merged with a small mutual company called Pennsylvania Mutual. In 1958 W&S merged with a California company called Guarantee Mutual that had business in four states.