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STOCK SUBSIDIARIES OF MUTUAL LIFE INSURANCE COMPANIES

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Reasons for having stock subsidiaries
- Impact of New York insurance law
- Use of subsidiaries taxed as non-life insurance companies
- Insulation of mutual parent from liability or regulation
- Different products, distribution systems or tax environment

Impact of TEFRA and Stark/Moore

Future developments
- Impact of possible changes in the form of life insurance company taxation which will follow STOPCAP
- Possible changes in New York insurance law, as suggested by the Heimann Commission
- Impact of subsidiary growth at the expense of the mutual parent
- Desirability and feasibility of demutualization

MR. HAROLD G. INGRAHAM, JR: We shall develop discussion of the subject through a series of questions and responses, and for each question that I ask there'll be an initial speaker, then other panelists will contribute. From time to time, we will invite audience participation. The first area we'll talk about are the reasons why stock subsidiaries have been developed and how are they being used. Question number one for Steve Smith is "Are there any significant reasons for having stock subs besides federal income taxes?"

MR. STEPHEN L. SMITH: Although many mutual companies have formed stock subsidiaries primarily for reasons associated with Federal Income taxes and the tax effects on certain products, there may be other significant purposes for having stock subsidiaries, although, I will readily admit that often the tax considerations overlap with them. This makes the determination of why stock subsidiaries are formed difficult to pin down in terms of a single reason. At my company, Union Mutual, our initial reason for forming stock subsidiaries back in the late 1960's was primarily based, not upon tax reasons, but upon a business strategy founded on two major premises: (1) management felt that many products, particularly Group Life and Health

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Insurance, were not perceived by the buyer or client as truly participating products, and (2) that the capital for starting group insurance operations came from the Mutual company participating policyholders and therefore they should reap the benefit in terms of investment return on any such ventures.

The first reason was primarily based upon the assumption that the group insurance buyer or employer was primarily concerned with premium rates or out-of-pocket costs on a year-to-year short-term basis. Therefore, "participation" in the traditional sense of the word in the surplus arising over a longer period of time was a feature not necessary within a group insurance product and certainly not worth paying any additional premium for. My company felt that this situation might, in some cases, give us a slight competitive advantage over other mutual companies. Certainly we would be able to pass on the expense savings arising from not having to do dividend type experience studies by class of policyholder and by not having to administer a dividend payment process. We were also one of the first companies to have group life premium rates with industry discounts and desired to have the lowest possible up-front rates without any dividend distribution based on experience. Non-par policies sold through stock subsidiaries was the most direct way for us to meet our objectives.

The second rationale flowed somewhat from the first although it really was a chicken and egg situation. Management felt that company funds - capital - from the participating Mutual company policyholders was used to start the Group Insurance and Indivdual Health businesses. Therefore, it was concluded that any investment returns from these enterprises should flow back to the providers of the "capital", those who took the risks of the new ventures. In the late '60's and early '70's the stock subsidiary structure allowed us to accomplish this result in the most direct fashion.

Another rationale that has been used by some companies prior to more recent insurance department approvals of asset segmentation approaches is that of establishing subsidiary companies in order to write products which are best served by having investment strategies dramatically different from the parent company. Again, taxes would be another major consideration. Pension business is a good example of this situation with some companies forming pension only subsidiary companies.

MR. JAY A. NOVIK: I have had contact with a number of mutual companies that have formed subsidiaries for various reasons and have learned some of their motivations. One that I've heard frequently is that a stock subsidiary allows a mutual company to do some experimentation that they'd be afraid to do in their own company--to try new products, to move into markets quickly, to experiment with underwriting, to test out procedures before trying to implement them on a broad scale. I hear that implementation of a new product for a large mutual company is a three year process; with a stock subsidiary you can get into new markets and work out the problems before you go through the effort of implementing in the Parent company. Also, if you want to get into an area that might be in conflict with your traditional field force, a stock subsidiary, especially one that has a name unrelated to the mutual, seems to have some political advantages. Going into mass marketing, which until recently was not a very political thing to do relative to your field force, might be easier to do through a subsidiary than through the main company. · Recently this seems to be less important. Many mutuals are getting into mass marketing and disregarding any of the internal political implications. There is also the possibility of regionalization. Although many companies have been able to regionalize some of their administration, there may be an attraction to regionalizing an operation and giving the regional managers actual bottom line responsibilities thorugh a wholly owned subsidiary. Of course, there are always the old traditional reasons for forming subsidiaries, such as avoiding regulatory problems. For many years companies have formed New York subsidiaries to do business in that state. Subsidiaries can be used to avoid states with onerous reserve requirement for a particular type of product and there are some miscellaneous tax benefits in the way of reduced premium tax on domiciled companies that can be additional motivation.

A subsidiary can also be utilized for specialized investment needs. One of the major business purposes for the formation of pension subsidiaries was the idea that their investment needs differed greatly from the investment needs of the general account.

MR. EDWARD N. WADSWORTH: I think that all the reasons that the other two panelists have mentioned are relevant. I do think that the different distribution system point is still quite important to a number of companies, particularly those with very strong general agency systems. The non New York company continues to be of some relevance. Many companies do find it much easier to deal in the 49 states with one company and deal only in New York with a special purpose subsidiary.

There are two new developments in the area that may have some impact. In a number of jurisdictions that up to this time have said that mutual companies cannot issue non-par business, the laws are now changing so that non-par business can be issued out of the mutual parent. Also in a number of the larger mutuals, there is a development to segment the investment portfolio to more closely emulate utilization of different subsidiaries from the standpoint of asset liability matching and appropriate asset composition. Perhaps to a certain extent this cuts back on some of the motivation for use of subsidiaries that existed in the past.

MR. INGRAHAM: What inherent limitations, legal and otherwise, are there in the use of life insurance company and other subsidiaries--such as limits on parent funding, surplus accumulation limits, diversification, ROI, so forth?

MR. WADSWORTH: As you all know, mutuals can only hold subsidiaries down stream. This necessarily means that the solvency of the mutual company can be affected by the activities of the subs. As such the primary regulator of the mutual parent, the insurance commissioner or superintendent of the state of domicile, has some interest in what goes on at a subsidiary level. I'll hit the various bodies of law and lore that impose some types of restrictions on the free utilization of subsidiaries.

The first one is legal. The laws of the state of incorporation control the ownership of subsidiaries. There are typically two general types of limitations on use of subsidiaries from a legal proposition. One is control of the type of activities in which subsidiaries can engage and the second is the size of the investments which the mutual parent can make in subsidiaries. Often there is a single sub limit and an aggregate subsidiary limit. For this purpose, I am discussing utilization of subsidiaries as a general matter. Life insurance subsidiaries are a subset of this and in some regards are treated more favorably. I will refer particularly to the law of two states--Massachusetts and New York. In Massachusetts, you can organize life insurance companies with no limit with respect to the amount of investment. This would include life insurance companies that are taxed as casualty companies. There is a limit with respect to non life insurance companies, casualty companies -- a limit of not more than 5%. There is also a provision that a mutual can own any other corporations whose activities are complementary or supplementary to the business of a Massachusetts life insurance company with the Commissioner of Insurance's approval. There are some limits. You can not invest more than 10% of your surplus in the voting stock of any single subsidiary. New York, up to about the middle of last month, had a very similar pattern of regulation. At that time, legislation became effective, which had been prompted by the report of the Heimann Commission of about two years ago. As you may recall the Heimann Commission was convened in New York in order to recommend changes in New York insurance law which would allow New York life insurance companies to become more competitive with insurance companies located in other jurisdictions and with other types of financial institutions doing business in New York and elsewhere in the United States. As a result of the Heimann Commission effort and the subsequent legislation, a mutual company in New York can invest in a subsidiary engaged in any lawful business with the exception of certain banking and retail credit activities. There are limitations that continue in New York as to the amount which can be put in subsidiaries, which are 2% of assets any one subsidiary, and 10% of assets in the aggregate in all subsidiaries. There is, however, no investment limit with respect to subsidiaries engaged in insurance activities in which the parent itself could engage. As a generalization not all states laws are as well formulated with respect to subsidiaries, nor are they as liberal with respect to life insurance subsidiaries as are Massachusetts and New York. For instance, although investment in life subs can generally be made in greater amounts than in non-life subsidiaries there are limits in some states. In some states, not more than 10% of assets can be invested in life subs. I think there's a liberalization going on in this area. I also think the Heimann Commission succeeded in liberalizing a body of law that was perhaps singularly restrictive. If a company has genuine interest in using life and other types of subsidiaries, I suggest that there be a review with the lawyers to see what the statute says and see whether some type of legislative effort may be required. There's a very excellent argument to be made that so long as a subsidiary is run reasonably autonomously there should be no limitations on the type of activity it can engage in at least within the financial service area, and that probably the only limitations on the amount of investment should be related to a concept of prudent investment practices.

There are a host of problems that develop when a subsidiary becomes large relative to the mutual and particularly relative to the mutual company's participating business. These are different than the legal restrictions which relate to the amount that the parent can put into the subsidiary. I think the most dramatic problem is the tontine problem. While this is way down the road for most companies, if you have a company that has been utilizing subsidiaries, and you see in the future that subsidiaries will continue to be used extensively, I think it could be a real problem. If you're subject to New York law or you're in another state that has statutory surplus limits you can start banging up against these limits. More fundamentally, as the surplus of the parent attributable to one or more successful subsidiaries becomes larger and larger it will become increasingly difficult not to distribute the value of the subsidiaries as dividends to your current policyholders. Beyond some point, surplus distribution would be required in order to appropriately benefit existing policyholders and to avoid genuine tontine problems.

Also, there is an investment risk diversification problem. This again is quite far down the road, and is probably not as relevant with respect to life insurance companies subsidiaries as with other types of subsidiaries. At some point it simply becomes imprudent for the solvency of the insurance company to devote more than a certain portion of the company's assets to a given enterprise. Obviously if the subsidiaries are in a high risk or cyclical industry, the insurance commissioner overseeing the solvency of the mutual parent could be expected to show some concern. Also, subsidiaries often are characterized by deferred returns. Unlike putting your money into a bond which has an immediate return, when money is invested in a subsidiary, there may be a drain rather than an addition to earnings of the mutual company for a number of years. At some point, this may be deemed an illegitimate investment simply because it reduces the return that would otherwise be available to the current generation of policyholders. Insurance company holding laws in a number of jurisdictions also have some relevance to subsidiaries. Basically, they impose very few restrictions on normal business activities, simply involving reporting for the most part. Material relationships between the parent mutual and the subsidiaries and also between the subsidiaries may require disclosure. From the standpoint of life insurance subsidiaries, the major constraint imposed by such laws is that they require Commissioner's approval before there is any extraordinary dividend payment.

MR. SMITH: In our case, we ran into insurance departments that had some limitations. In order to license our subsidiary in several states, we had to guarantee that a certain minimum amount of capital surplus would be maintained in those subsidiaries for some period of time. So in a sense that was a limitation and a guarantee of the parent. Also in New York, we happened to rehabilitate a company that was taken over by the New York insurance department and they did not look kindly upon our parent mutual company writing a similar type of product as the subsidiary. They've looked very suspect on that, so they've in many cases refused to approve for sale the new product unless it was only sold in either our subsidiary or a parent but not both. Another limitation would be dependent upon what name you use for the subsidiary. In our case we used the Union Mutual name on some of our subsidiaries initially when they were small companies as a marketing plus to say "look, we're associated with this parent". But that also may impose some moral obligations to bail out a subsidiary when in fact some companies may have established them to separate the liabilities.

MR. INGRAHAM: What are the potential advantages to mutual companies of offshore subsidiaries and are there many such subsidiaries.

MR. NOVIK: I'm currently uncertain about the potential tax advantages of subsidiaries, onshore or offshore, based on HR4065. Over the past years a number of major and minor industrial companies have formed offshore captives in various tax haven locations like Bermuda for a number of good business reasons. Many of them felt that they were overpaying for their property and casualty insurance coverages. They also believed that they could also get into the insurance and reinsurance business through an offshore captive without many of the onerous restrictions of U.S. domicile. They also looked to having access directly to reinsurers who, they felt, would be willing to give them a better price on their insurance than the primary companies. The major motivation was the advantageous tax impact of the offshore captives. The premiums paid to a captive were expected to be tax deductible by the parent company whereas self insured reserves to anticipate future claim costs would not be. The investment income on net amounts paid to a captive, depending on the location of the captive, could be accumulating tax free and eventually be repatriated through dividends or used to pay claims in the future. The after tax cost of an insurance program could be reduced by this approach. The captive could also be used to overfund an insurance tax program and be somewhat of a corporate IRA. Many of these anticipated tax advantages have not been realized.

The IRS has challenged the deductibility of insurance premium paid to a captive. The Carnation case, involving this and other issues, went to the Supreme Court. Much of the corporate IRA aspects of the captives have just not come to fruition. Looking at what this might mean for an insurance company, the advantage of being able to deduct the reinsurance premium is really not particularly meaningful to an insurance company. We can already set up reserves for future losses. Insurance companies have specialized tax treatment in this regard that other companies don't have.

The possibility of accumulating investment income offshore is intriguing and actually has been accomplished by insurance companies in the past. Quoting from the 1960 hearings before the Senate Judiciary Committee: "From testimony developed before the subcommittee it appeared that Life Insurance Company Tax Act of 1959 had triggered a new interest in tax haven insurance arrangements. The 1959 Act had taxed life insurance companies on a total income basis. Prior to the 1959 Act, life insurance companies had been taxed on an investment income base. Upon enactment, some life insurance companies began casting about to find new ways to eliminate the newly imposed tax on underwriting income." Companies looked to ceding business on a very profitable basis to an offshore subsidiary and allowed the profit to accumulate tax free. In response, the government enacted Section 953 which added the profits of these controlled foreign corporations to Subpart F income. Profits from a wholly owned subsidiary deriving its business from U.S. risks are included in the current taxable of the parent. This does not mean that there are no potential tax advantages from an offshore subsidiary. There are interesting possibilities utilizing non-controlled foreign corporations. A non-controlled foreign corporation in the context of an insurance company deriving more than 75 percent of its business from U.S. risks, is corporation which is less than 25 percent owned by U.S. taxpayers. A U.S. taxpayer is defined as a U.S. person that owns more than 10 percent of the company. If you own less than 10 percent, you're not included in the calculation. There have been many offshore corporations established where no U.S. person owns 10 percent or more. These companies are not considered NCFC's even if ownership is 100 percent by U.S. persons. Shippan, managed by General Reassurance, is one such company. There are many association captives set up in a similar manner. These companies can be used to accept U.S. risks, to accept reinsurance from their parent/owners and, possibly, to shelter and control taxable income until returned through dividends. I'm certainly not advocating or establishing a captive only for tax reasons. There are many business uses for an offshore subsidiary including advantages in writing foreign risks. Although I haven't had a chance to really look through the provisions of the Stark Moore proposal relating to doing business as a branch in foreign countries, there may be both business and tax advantages in doing business through a subsidiary in foreign countries. Probably the most frequent use of offshore captives for insurance companies has not been for tax reasons but for regulatory ones. An offshore captive may be utilized to access a more liberal regulatory environment. I've seen captives utilized to avoid setting up large deficiency reserves or excess interest reserves. This use may become more prevalent under HR4065 since holding deficiency reserves and excess interest reserves deplete surplus without reducing taxable equity.

MR. INGRAHAM: How is the investment in stock subs reflected in the investment returns of the parent? How is the investment income including unrealized capital gains or losses allocated by line of business and what is the business rationale for any particular approach used?

MR. SMITH: The return on stock subsidiary investments can be handled in various ways depending on company philosophy and regulatory requirements. For a company using a segmentation of assets approach for allocating NII, the investment in stock subsidiaries could be allocated to a specific segment. This segment could be subscribed to by a specific product line or product lines and/or company surplus funds represented by a corporate account or fund. For companies using Investment year allocation methods some special handling of stock subsidiaries would probably be called for perhaps similar to that used for other equity investments. Merely allocating the results to those products or company funds providing cashflow in the year that the subsidiary was formed or acquired or capitalized would most likely give less than reasonable results. Although some may disagree, it is likely that subsidiary earnings and financial performance will be much more stable than that of other common stocks or equities owned by an insurance company. This is particularly true in the case of wholly owned subsidiaries and those with managements in common with the parent. Therefore, it may be much more appropriate to recognize the change in value or unrealized capital gain or loss on a more current basis in allocating investment results to the various lines of business or Corporate account. This is most important from the perspective of internal measurement or performance measurement recognizing that statutory accounting may impose certain requirements on how this is to be done, hence producing less than realistic results. In summary, there is no "right way" to allocate stock subsidiary investment results. Certainly the business rationale for allocating investment income on subsidiaries by line of business will depend upon the business rationale for establishing the subsidiaries. However, whatever rationale is used will have to fit hand and glove with the allocation procedure filed with insurance departments in order to have the desired effect on the company's official records.

MR. INGRAHAM: What financing techniques are available with respect to life insurance subsidiaries, such as public offerings of minority interest?

MR. WADSWORTH: There really aren't very many independently significant techniques available to finance the activities of life insurance subsidiaries or other subsidiaries for that matter, as contrasted to techniques of financing the mutual parent. One of the often identified difficulties with the mutual form of organization is its limited access to the capital markets and its inability to raise money. Typically, subsidiaries are financed by equity or occasionally debt contributions from the parent. The basic debt capacity of the business organization, including the mutual company and its subsidiaries, is usually one figure and, typically, the use of subsidiaries does not increase the overall debt capacity of the entity. While a few subsidiaries have enough independent financial worth to support credit lines in their own right, typically any credit line of any substance is supported either by a parent's keep well agreement, by a parent guarantee of some type, or by an open-account financing arrangement with the parent. Accordingly, in the final analysis it is usually the parent's credit that supports any borrowing by a subsidiary. I know this is a matter of considerable interest in the case of our company which has an AAA debenture rating. We have a very definite idea on what our debt capacity is in order to hold our AAA rating. I will say, as a general proposition, that the debt capacity of mutuals has probably not really been tested, and there may be room for some relative increase, but I think that one can assume that it will end up being some relatively modest relationship to surplus.

There is one variant that deserves mention. A mutual company, at least a Massachusetts mutual company, has absolutely no ability to issue anything other than a debt type instrument. One financing technique that was used by a mutual casualty company with a number of second tier casualty company subsidiaries, was the public sale of a minority stock interest in the first tier holding company. The avowed purpose of the sale was to provide financing. There are several problems with this technique. Assuming that you wish to continue having, for instance, 80% ownership in order to be able to consolidate, or at least majority ownership in order to be assured of control, the ability to raise capital is limited. Obviously you can sell only so much without losing the amount of control that you want. I think one of the real problems, perhaps a more realistic problem, is how you guarantee to the people who buy the stock that there is any value supporting their investment. Obviously, you will be selling the subsidiary stock pursuant to a SEC prospectus and you know how pesky the SEC is as to requiring that all risk factors be set out. There is a significant risk factor present, it seems to me, when you have subsidiaries that continue to be controlled by the parent mutual management team. What are the assurances that there will be any continuing value in the subsidiaries? The way this issue was dealt with in the instance noted above was by means of a pooling agreement among all the casualty insurers involved whereby they simply spread the risks among all the companies, utilizing the underwriting capacity of the entire business organization. Just before the public offering, a new pooling agreement was entered into that simply allocated a higher percentage of the business to the subsidiaries. Also included in the prospectus were representations to the effect that the parent does not anticipate in any way cutting down the interest of the subsidiaries in the pooling agreement. By use of this technique, some reasonable expectation of profit was created. I think this is a very interesting technique. I also think, however, that it has a number of inherent limitations that make it feasible in a relatively few circumstances.

Mutual companies have been seeking access to the capital markets in recent years. There is the short term paper phenomena, going back for many companies no further than 1980. Many companies now have stand-by ability to issue commercial paper on very short notice. Because of the very nature of the SEC exemption under which commercial paper is offered, commercial paper can't be used for capital funding purposes. If you are going to fund a subsidiary you probably will want to do it on a more long term basis. For instance, New England Life sold debentures publicly in the United States approximately 10 years ago and the Hancock and Prudential, through offshore subsidiaries, have utilized the Euro bond market. Those are somewhat dramatic forms of financing.

MR. NOVIK: There have been other instances of casualty mutuals selling stock in downstream holding companies. Lumberman's Mutual followed this approach by putting enough earning power in a downstream holding company to sell stock, less than a majority, to outside investors. As far as proven profitability and the risks that you have to divulge in a prospectus, it's doubtful that many investors carefully read a prospectus. If you look at a prospectus for the least risky and the most risky ventures they look pretty much alike.

MR. INGRAHAM: What liability does a parent potentially have for the activities of life insurance companies subs? Please consider agent representations and guarantees required for licensing.

MR. WADSWORTH: Obviously there can be liability for the activities of subsidiaries at the mutual parent. There are basically two patterns as to how subsidiaries are named. Perhaps the most common is to seek some type of common identity with the parent. We have New England Life, the parent, and we have New England Variable Life Insurance Company, New England General and New England Pension as subsidiaries. Under this theory, you would utilize one common name such as "the New England Companies". The absolute opposite of this is to use a subsidiary the name of which in no way gives any indication that it is sponsored by or any way is affiliated with the parent mutual. This opposite tack is not at all unusual. For instance, when you're utilizing a different distribution system and there are sensitivities to that, or perhaps when you're offering totally different types of products aimed at a different market, this approach has value. There is both potential financial liability and exposure to regulatory censure at the parent mutual for a subsidiary's activities. When there is a questioned claim practice, for instance, is the parent going to be implicated? Is the regulator going to bring the parent's management on the carpet rather than the subsidiary's? Is the suit going to join the deep pocket parent rather than simply the subsidiary? In this day and age, if you market under an umbrella name, you must assume that the parent company will become implicated in many instances. Obviously, this doesn't always follow, and it depends on the circumstances and on the degree to which there are genuine efforts made to preserve autonomy at the subsidiary level. You have to accept the fact of potential parent liability if you are going to name subsidiaries in a way that leads to potential confusion with the parent, and if you're going to market products with the same field force. Take the case of an agent who has for years been representing a company that has the highest Bests' rating who finds himself selling an SPDA issued by a subsidiary that has perhaps a B or C rating. He may be expected not to emphasize the fact that the SPDA issuer is a corporate entity separate from the parent.

I confirm from my experience that a number of insurance departments have required a guarantee, typically in the form of a "keep well" agreement, of the parent before a new subsidiary will be licensed. New Jersey has imposed a ten year requirement that minimum surplus be maintained. While the minimum surplus is only a little over two million dollars, you can appreciate that the two million dollar cushion must be maintained even though the subsidiary may have lost many millions of dollars. That is, the guarantee is a fairly substantial undertaking. So long as the separate autonomy of subsidiaries is rigorously maintained, if a subsidiary gets into deep trouble, the parent can probably cut the knot and let it go under assuming no guarantee. Although there are many reasons not to allow this to occur, it is comforting that you could do so in extreme situations. Take the Chase Manhattan REIT situation. It had a name identified with the Chase bank. Chase was willing to spend millions of dollars in order to keep it going and keep the good will of the name, but at some point it became too much even for the Chase organization to support.

MR. INGRAHAM: I think we've come to a natural breaking point here where we can invite some questions from the audience on the category we've been exploring for the past 50 minutes or so, the reasons for having stock subsidiaries. Would anyone like to ask the panel questions on any of the points raised to this point?

MR. MICHAEL MATEJA: I was surprised by Mr. Smith's remarks to the effect that group products were not suitable for the mutual form of organization. Many mutual companies are very strong in the group area, and I can only conclude that they haven't got the message.

I spent fifteen or so years in the Group Division of Aetna, and during that time I always felt that our group products were essentially the same as those offered by mutual companies. Conceptually there is no difference between a stock company experience refund and a mutual company dividend under a group contract. Given the same experience and expense levels, the only difference between a dividend and an experience refund would be to reflect different profit charges (or perhaps FIT allocation). If in the par company the surplus required to support group business is provided by individual policyholders, it would seem reasonable to expect that the group business would be priced to achieve returns comparable to those achieved by stock companies on their group business. One of the long standing concerns of stock companies has always been that mutual companies do not price their group products to achieve realistic returns or do not allocate realistic levels of FIT to these products. This is the only way we have been able to explain how they could be so competitive relative to our own group products.

If, in fact, mutuals do not price their group products to achieve returns comparable to those achieved by stock companies, then there seems to be a serious question of equity in such practice. Individual policyholders would be subsidizing group policyholders.

MR. SMITH: Our company and its group insurance product area has almost exclusively been in smaller groups which we have not written on what we might call a retention, or a retrospective rating basis. That doesn't mean we don't do prospective rating. We obviously do or we'd be in as bad shape as a lot of other companies. We also did not have through the 1970's very much medical business. Most of our business was group life and long term disability which we did feel was much more suitable to the non par approach.

MR. ARDIAN GILL: I want to point out that equity accounting is not the only way to handle subs. While the accountants threw in the sponge on GAAPing mutuals, the same is not true of stocks and you may find it helpful to the Boards of your mutuals to present accounts on a GAAP basis. It's more familiar to them and in many ways more sensible. Also GAAP accounting can change the debt capacity of a company because in the stock sub, it's likely to be the GAAP surplus that will control rather than the stat surplus and you'll find finance companies owning credit companies for example. The credit insurance companies find it very attractive to do surplus relief because it may not affect the GAAP surplus, it does affect the stat surplus and the debt capacity is unchanged. Another reason for owning a stock sub is that you can sell the thing, and you can't sell your mutual very easily. Another is you can compensate your officers differently. You can use stock options and compensation arrangements that for example a New York department may not approve for mutual company offices. And if you're using your subs to diversify as opposed to merely doing insurance in another way, this type of compensation will probably be essential to attract talent.

MR. BRUCE E. NICKERSON: I was rather intrigued all last fall and this spring observing the debt capacities that arose out of the GAAP earnings of Baldwin United Corporation. However the question that I was planning on asking was in response to some discussion at the early part where I interpreted panelists' comments as indicating that the ability to create subs was anticipated to become easier over the coming years and I wondered whether they felt that the woes, while not involving mutual company subsidiaries of this famous corporation might be likely to cause them to revise that thinking or might cause regulatory authorities to revise it.

MR. WADSWORTH: Certainly some of the well publicized difficulties will create a sensitivity to anything that is deemed imprudent. I think in the area of subsidiaries of mutuals, there are many outdated restrictions. Many of these restrictions can be done away with without really inviting the horrors of the nature reported in the popular press in recent times. The inherent fact that subsidiaries of mutuals have to be downstream means that some type of continued oversight over subsidiaries is called for. Only a few years ago, mutual life insurance companies in a number of jurisdictions could hold no subsidiaries. Then there were statutory amendments which allowed insurance subsidiaries and, more recently, which allowed at least some types of non-insurance business.

MR. SMITH: There's no question that after the newspaper publicity from Baldwin United we got many inquiries from several insurance departments particularly aimed at transactions between the companies. I think that that area is probably going to get more scrutiny not just in mutual and stock subs but among any company that has multiple companies.

MR. JOSEPH W. MORAN: In the course of our efforts to get a newly created stock life subsidiary licensed in various states we've encountered two categories of questioning that I'd like the panel to comment on. The first idea of having a subsidiary to do a special category of business different from the category of business that's being done by other subsidiaries may be questionable. The second area in which questions have been raised relates to the intercorporate relationships under which the parent mutual company provides ongoing services to the subsidiary, in particular, the use of their data processing systems.

MR. WADSWORTH: At New England Life, we have received some questions as to why we need so many subsidiaries. As far as intercorporate relationships, we are in the process of forming a New York subsidiary now and we're running into many problems with respect to the proper relationship between the parent and the subsidiary. It comes back to the notion of the New York Department that you really can't set up a domestic New York shell subsidiary.

MR. SMITH: We've provided a lot of services out of Portland, Maine, which of course gets the New York Insurance Department all bent out of shape, but they have required us, to file with them something they call "a plan of operations" which specifically states what will be done, where, and how expenses will be allocated to that New York subsidiary.

MR. NOVIK: North American Reinsurance is a stock company wholly owned by a Swiss parent. We've recently formed a variety of subsidiaries. Most of the services of various operating insurance companies and of the special purpose subsidiaries are provided by a holding company that controls data processing and much of the administrative services. Effectively, the expenses are distributed among the various companies by a noninsurance entity.

MR. LEWIS P. ROTH: New York and many other states have prohibitions against making guarantees in a separate account, and I don't believe that the Heimann Commission report has changed in any way. Does anyone on the panel see any legal or other reasons why you cannot use a subsidiary to emulate a separate account with guarantees?

MR. WADSWORTH: Certainly under Massachusetts law, and I was under the impression that under New York law as well, you can issue guarantees out of separate accounts but you really have to run the separate account as if it were a general account. That is, the account would be subject to general account accounting and investment limitations.

MR. ROTH: Yes, that's right, if you make it look like a general account, but if you want to have some very specific investment philosophy which is not precisely what you would normally do in a general account, you can, I assume, use a subsidiary with specific investment objectives to emulate a separate account, and make guarantees?

MR. WADSWORTH: I think you could. You could set up a subsidiary that was properly licensed to be a life insurance company and issues guarantees. Another alternative, currently being used by a number of companies, is to segment the general account in an effort to break out pools of assets so that there may be effective asset-liability matching.

MR. INGRAHAM: Now lets talk a little about the tax law. Jay, what's the likely impact of the permanent TEFRA changes and the Stark/Moore proposal on special purpose stock subsidiaries?

MR. NOVIK: The Stark/Moore proposal is now H.R. 4065. It's through the House Ways and Means Committee. I think it's too soon for anybody to really be an expert on this act. I'd like to give you some perspective with a quote from Best's Review of March of 1983. "There are now 2,156 legal reserve life insurance companies in the U.S., 142 new companies were formed in 1982. The formations were the most in a year since 1965 when 174 new insurers began operation.

As usual, the plurality of the new companies were formed in Arizona. The formation of new companies has been prompted by tax, marketing, and investment considerations. During the past two years, a number of companies, primarily large mutuals, set up subsidiaries to handle annuity and pension business and other specialty coverages including Universal Life. Mutual companies can enjoy certain tax advantages in establishing stock subsidiaries to market nonparticipating products and to obtain the maximum deduction for underwriting income. Enactment of the TEFRA in 1982, however, should bring about a reevaluation of the formation of subsidiaries in light of tax planning under TEFRA or beyond." We're now beyond TEFRA, and a reevaluation is certainly in order. I'm sure all of you are aware of the possibilities under the 1959 act for affecting your tax burden by the use of multiple companies. The impact of a rapidly expanding pension business on a mutual company and the potential advantages of segregating it into a subsidiary are pretty well documented. Lines of business creating operating losses and investment income were more appropriately segregated to a separate company where there could be a tax offset as opposed to keeping them in a phase I parent company. Under HR-4065, companies will be able to fully deduct dividends so that the use of subsidiaries for either writing par business or reinsuring par business doesn't appear to be necessary. Most of the tax impacts of subsidiaries seems to have evaporated, as was intended by the drafters of the law. Are there any possibilities under the new law? It's certainly a little early to comment, but some of the possibilities that might be considered such as the use of a subsidiary to avoid the extra charge on surplus really won't work. Originally, the law was set up so that not only was the worth of the stock of the subsidiary included in the equity base of the parent, but also the subsidiary, if more than 80 percent owned, would be considered a mutual company on its own and have a second differential adjustment. This was effectively double-taxing the surplus allocated to the subsidiary. The latest version of the law eliminates the double impact by bringing the adjusted equity of this subsidiary of a mutual company that's more than 80 percent owned into the calculation of the parent mutual company. Therefore, a life insurance subsidiary really can't be utilized as a way of reducing the average equity base. Another possibility considered was reducing ownership by mutuals below 80 percent; regulations will be forthcoming to adjust for ownership less than 80 percent. There may be some potential in the use of a subsidiary that is either nonlife for tax purposes only or one that is licensed as a casualty company. The proration rules for tax exempt income under HR-4065 seem even more onerous than under the 1959 act and it's possible that the use of a nonlife company to hold tax exempts or preferred stock could be effective. To the extent that you dividend up to the parent, dividends that are otherwise not prorated (from a wholly owned subsidiary) will get into the proration formula to the extent that they arise from tax exempt or preferred stock held by the subsidiary. You can't completely avoid proration by using a subsidiary unless you never dividend income to the parent. The bottom line to the new law is that I don't see many prospective opportunities, other than general business opportunities, for the use of subsidiaries.

MR. INGRAHAM: What are the advantages or disadvantages of stock subsidiaries taxed as nonlife companies? What products are sold in these companies, and what methods are used to maintain a nonlife tax status?

MR. SMITH: Stock subsidiaries taxed as non-life companies, sometimes referred to as casualty companies, have several distinct advantages and disadvantages.

From a product and Corporate standpoint the taxation situation has been much more stable over the past decade than for companies taxed as life insurance companies. This situation may not continue for the future as I understand some comprehensive tax legislation is being proposed for non-life companies by some legislators. This stability helped improve the accuracy of pricing assumptions and overall company tax determination because there are relatively few unresolved issues in the non-life tax approach compared with life company tax treatment.

One of the major tax saving devices used by non-life or casualty companies is tax exempt investments. In recent years these could add a substantial amount of net income to the bottom line. This is because in the past couple of years tax exempt investments had yields in the neighborhood of 80-85% of fully taxable investments with similar risk levels. Therefore to the extent that a non-life company was profitable, tax exempts could make a healthy improvement in the gain from operations. Of course, there were some distinct disadvantages for life insurance products because the 818(c) tax deferral and non-par deductions were not available.

A more recent consideration with the proliferation of Universal Life type products and indeterminate premium products is the question of "what is a dividend". This is not an issue in a non-life company and therefore has been a significant advantage for companies in this situation.

All types of insurance products can be sold in a non-life company. The major considerations are the company's strategy and financial consequences, primarily in the area of taxation.

Non-life tax status is usually maintained by having a substantial amount of group health insurance which has reserves that are non-life reserves for tax purposes. In this regard, group LTD is most significant because of the substantial reserves which build up over time compared to other group health products. Another approach is reinsurance which can be used either to acquire more group health reserves or to cede life reserves as appropriate for the situation.

In the past five years, the non-life tax status has been a significant advantage to my company because of the ability to improve profits by using tax exempt investments and the more certain tax situation with regard to all products and particularly Universal Life. As I said before, however, it is not at all clear whether or not these advantages will continue in the future.

MR. NOVIK: One additonal comment about the bill. There's a continuation of an item that was included in TEFRA relating to reinsurance between affiliates that's somewhat an expansion. The new Section 811(d) provides for reallocation and recharacterization of reinsurance items among affiliates to "properly" reflect the reinsurance transactions. It also provides for reallocation and recharacterization if there are unrelated intermediary companies between the affiliated parties. So reinsurance to effect tax objectives among affiliates will be more difficult in the future.

MR. INGRAHAM: Thanks Jay. Now we come to a topic which up to a short time ago would have been almost unthinkable and that's one of demutualization. The question is what are the major reasons for considerating it? What are the major barriers confronting large mutual companies considering going the demutualization route? We're going to talk about alternatives, of difficulties and particularly industry efforts here.

MR. WADSWORTH: For years the mutual form of organization, which in some sense is a consumer cooperative, has been viewed as a perfectly acceptable form in which to conduct the life insurance business. However, there have been developments in the last several years to test this hypothesis. There are a number of areas where there may be perceived disadvantages to the mutual form. I'll list a few of them. One is access to capital and the ability to acquire other organizations by the use of stock. These are the traditional reasons to seek stock form. As noted earlier, a mutual company's access to capital, by means of borrowing, is both somewhat limited and is inherently quite expensive. Also, acquisition by means of stock is often beneficial from the seller's tax standpoint in that the receipt of the acquiring company stock incident to a merger will not trigger any immediate tax gain while a cash tender offer will produce immediate tax. This aspect may be quite important to the success of an acquisition. Additional capital, of course, may be required by a company to be able to afford new product development, to allow the efficient transition of a life insurer to a broader financial services provider, or for numerous other purposes.

There is also a notion that the stock form of organization lends itself better to the combination of various types of financial service organizations. The concept of a single holding company owning separate life insurance, casualty insurance, banking, securities brokerage and other financial service subsidiaries has its inherent appeal. Increasingly, federal and state regulation will be by activities rather than by industry groupings. Therefore, having separate and distinct first tier subsidiaries engaged in activities subject to different regulators and different schemes of regulation makes inherent business sense.

Regarding taxation, suffice it to say that if the Stark/Moore tax proposal, or any other tax proposal for that matter, results in a competitive advantage for stock companies, real or perceived, there will be continuing pressures to convert.

The fourth reason, I'll entitle "the mutual form falls apart". At some point, there are genuine tontine and dividend apportionment problems to the extent that more and more of the business is conducted on the subsidiary level. Obviously, this will come relatively rapidly to those mutuals that are determined to engage in business activities which cannot legally, or cannot prudently, be conducted by the mutual company itself. There is legislative and sometimes a regulatory preference to conduct activities other than those very closely related to traditional life insurance in subsidiaries. Those of us who wish to stray very far afieldof traditional life insurance activities really have to utilize subsidiaries.

There is something of an unfortunate legacy in the conversion area dating from the turn of the century. It is abundantly clear from a number of reported court cases that many conversions were carried out for the purpose of benefiting management at the expense of policyholders. Unfortunately, in a number of situations, such law as there was proved insufficient to protect the legitimate interests of policyholders. As a consequence, mutual life company conversion is expressly or impliedly prohibited in a number of states. For instance, in Massachusetts, a mutual life company cannot convert to or merge with a stock company. Moreover, in a number of states where there are statutory merger provisions, the form of the law would almost surely prove unworkable for a significant life company. In point of fact, these laws not only are designed generally for casualty companies, they also reflect far simpler times. There have, however, been some recent developments that I will report on very briefly. The Heimann Commission, appointed in New York in 1981, has recommended that New York law be changed to allow life company conversion. This legislation I understand has not been filed but is in the process of being drafted. I note that in the early summer, a law allowing the conversion of mutual life companies was enacted in California. I also note that there is some activity at the ACLI, where a working group has been established to review the area generally and possibly develop a model law for consideration by the NAIC. Finally, I understand that legislative efforts to enact workable conversion law are a priority matter on the agenda of a number of mutual companies in a number of jurisdictions.

I'd like to now briefly outline a number of issues involved in conversion. My emphasis will be a lawyer's emphasis. I'll briefly note the types of conversion techniques that are theoretically available and several alternatives to conversion. The purest form of conversion is straight conversion. You just take a mutual company and convert it to a stock form without the involvement of any other company. (Sounds simple, doesn't it?) A second form which has the same effect as straight conversion, is to merge the mutual into a stock life company. This could be done with a stock company shell set up for that purpose. A form that is theoretically available but has many real problems is bulk reinsurance. In Massachusetts, this is the only way theoretically available for a mutual life insurance company to convert. This route, however, also requires the approval of the commissioner of insurance. The bulk reinsurance laws, generally speaking, have no standards to guide an insurance regulator. Accordingly, it is quite doubtful that the requisite approval could be obtained in other than very simple conversion situation.

There are a number of other theoretical approaches which are alternatives to conversion. One would be building up your life insurance and other business in stock subsidiaries, putting the subsidiaries under a single holding company, and distributing the shares of the holding company to participating policyholders proportionate to their share in the parent. This has many of the same problems that straight conversion has. Another format could be utilized whereby you would essentially close off insurance sales at the mutual and establish a new management company having stock life subsidiaries. The management company, whose shares could be publicly sold, would have a long term service agreement with the mutual company to manage its insurance business. All new business would be written by the stock life companies and the mutual's business would wind down overtime. However, not only would this be ponderous, but it would probably violate the "management contract" restrictions found in a number of states. In short, there aren't very many easy alternatives to conversion. As discussed earlier, although there are a number of limitations, it is possible to conduct many non-insurance activities downstream of the mutual. In sum, a company would probably be willing to put up with a lot of the problems in using downstream subsidiaries before it would entertain a proposal to convert.

The relevant law of conversion is assumed to be that of the mutual company's state of domicile. There is, however, a genuine question as to what extent the laws of other jurisdictions would be applicable. This invites discussion as to whether federal preemption might be the only effective way to avoid jurisdiction being asserted by many regulators. This might or might not be coupled with federal incorporation of life insurers. This is a topic well beyond the charge of this panel.

There are a number of procedural steps that you would expect in any process of conversion. There would probably have to be the appointment of independent appraisors. You surely need the Insurance Commissioner's approval both of the appraisal and of the actual conversion plan. Finally, you surely need some type of policyholder approval. The most likely formula would be approval by some percentage of all policyholders. There is some thought that so long as adequate notice is given to policyholders, for instance, by mailing to all that can be found, approval of some percentage of persons present in person or by proxy at a meeting might suffice. Presumably only current policyholders can vote on the conversion. In some states there is a problem between policyholders and policyowners as to who has the inherent voting rights. A number of the existing statutes indicate that policyholders entitled to share in the proceeds are not only current policyholders but are also those who have some historic interest in the company. Under a "Williams Act" type of conversion statute, which is found in about 12 states, you have to go back three years in search of policyholders. Under the Wisconsin statute, you have to go back five years. This is of tremendous significance to a major mutual. You're not always sure you can find people who haven't been a policyholder for five years, and you have a tremendous amount of historic surplus that was not contributed by current policyholders. There are very considerable questions as to how a policyholder's ownership rights are to be reflected in the converted company. Are they going to be reflected by cash payout which would strip the ongoing entity of its operating capital? Are they going to be represented by common stock, by preferred stock, by some type of a debt type interest, or by some combination of the foregoing. Perhaps only preemptive stock purchase rights together with a liquidation preference is required, as in the case of federal Savings & Loan conversion. The statue would have to address the alternatives that will be made available rather expressly, and there may be some very strong feelings as to what is, and is not, appropriate. There are very definitely some constitutional issues involved in conversion. For instance, there is considerable question whether a policyholder's participating status can be taken away without individual consent. There are some cases that would indicate this is very difficult indeed. There are also cases that stand for the proposition that it is very difficult to remove the voting rights of a policyholder. As a consequence, you might end up with a hybrid entity which may have the worst of both mutual and stock worlds. The only hope might be that it would be a transitory state, and only last 50 or 60 years(!)

There is an issue that is near and dear to both actuaries and lawyers hearts, which is the method of valuing the equity of the mutual enterprise and the relative interest of the various policyholders. Presumably, a going concern valuation would be utilized. Under certain circumstances, i.e. when no public offering were planned, you might only have to come up with the relative value of the interests of policyholders; an absolute value might only be necessary if you contemplate a public offering at the same time. One of the reasons why there are so many investment bankers calling mutual companies from time to time now, is the expectation that there would be a public offering at the same time as the conversion. In order to appropriately price the public sale of the securities, the value of the entity would have to be established so that neither too much nor too little will be charged for stock publicly sold. I note that a number of the recent laws have made express provision allowing members of management, so long as they pay no less than the amount paid for the other stock being issued, acquire up to some percentage, such as 25%, of the value of the ongoing concern. This might be a realistic in a small concern, but I would doubt that management could afford 25% of the Prudential, for instance.

Another issue is whether there must be preemptive rights with respect to any public sale of stock. Such rights are calculated to preserve the % ownership of current owners, if they chose to exercise their purchase rights. Yet another very interesting question would be what should be the commissioner's standard of approval. For instance, there are two possible conceptualizations: (1) if the conversion is found to be in the best interests of policyholders, as contrasted to (2) if the conversion is not found to be contrary to the interests of policyholders. These are all issues that will have to be faced in drafting any model legislation and again at the local state level at the time such legislation is considered for adoption.

From a Federal standpoint, it is assumed that conversion to be feasible must be tax free to the company and to its policyholders. There are also questions as to what the tax basis of the policyholders' distributive share in the company's equity would be. One issue that is raised by the pending Stark/Moore proposal is the rather sensitive tax "segment" balance between stocks and mutuals. That is, conversion by even one major mutual life company could materially skew the segment balance.

There are also federal securities law implications. It may be that issuance of stock to current policyholders should be treated as an exempt issuance of stock, for SEC registration purposes, because it is accomplished pursuant to an exchange overseen by the Insurance Commissioner. There is a good argument for such exemption to the extent that stock is only issued to current policyholders. But this may all be somewhat moot, as I suspect that there will usually be a public sale of stock, and the same SEC material could be issued the policyholders. Also, state blue sky laws should not be overlooked. That is, there would have to be a review of state blue sky laws in all jurisdictions to make sure that the appropriate exemptions exist, or that local regulatory approval is obtained.

One of the most significant issues of all is something that comes under the general heading of "shark repellant". I suspect that a number of larger corporations would view with considerable interest the conversion of mutual life companies, unless some very strong anti-takeover measures are built in incident to the conversion. In all but the very largest mutual companies, the amount of equity, i.e., the aggregate market value of the stock of the converted entity, would be a fairly easy swallow for most Fortune 500 companies.

Also, there is a major government/public affairs effort involved in any type of conversion effort. The regulators have to be convinced that conversion is in the best interest of, or at least not contrary to the best interest of, the policyholders. Of course, local legislators have to be convinced of this before they will adopt conversion legislation. Finally, you have to convince your policyholders that conversion makes sense. In some respects, this is a particularly fortunate time because deregulation continues to be very much in the mode. I think that the idea of greater access to capital markets has considerable real appeal. Also, there is appeal to segregating into brother-sister corporations different types of financial services activities subject to different patterns of regulation. Finally, although all reports are not in on the form of company tax legislation which will replace the 1959 Act, in the event that it becomes demonstrable that the tax burdens of mutuals are substantially heavier than those of stock companies, there will be considerable motivation to convert.

MR. NOVIK: After all this discussion of demutualization I would like to say a few words for mutualization. Of all the major mutual life insurance companies domiciled in New York, only one started its corporate existence as a mutual company, and that's Mutual of New York. Equitable, Metropolitan and Home Life were all mutualized in this century. Prudential completed its mutualization in 1943 and has spent less than half of its corporate existence completely mutualized. I'd like to review some of the initial motivations for mutualizing to provide some insights as to why we might want, or not want, to demutualize.

Some of the mutualization arose as a direct or indirect result of the Armstrong investigation. In looking through the motivation for 26 different mutualizations of stock life insurance companies , three very major mutualizations resulted from the adverse public opinion arising from the Armstrong investigation and, more directly, the mutualizations occurred as a result of the measures put in to eliminate the nondividend return to stockholders. New York had limitations on dividends from capital stock of insurance companies. Prior to the Armstrong investigation, the stockholders had found many ways to circumvent these limitations by obtaining nondividend income from the insurance company. After the Armstrong investigation, the opportunities for the nondividend income were severely reduced and these owners were left with a stock that had a fairly low yield and wasn't very marketable. Mutualization allowed the stockholders to recapture their investment in the company with a substantial profit.

Another problem that caused the mutualization of some other stock companies was estate tax. Many of the life insurance companies were closely held. If a sale was necessary due to the death of one of the owners, the available price might be lower. Additionally, the possibility existed of the overvaluation of an illiquid stock for estate tax purposes. The above considerations created an incentive for the owners to mutualize and to essentially bail out with a profit which they might not have been able to achieve had they waited until the death of one of the owners. Also, through the mutualization, they were able to recover their investment but retain control of the mutual company.

There are five Canadian mutuallife insurance companies that became mutual to prevent alien takeover. There was a great interest among U.S. investors in taking over the various life insurance companies in Canada. Canadian regulators installed numerous restrictions, including restrictions on board membership, and also encouraged the mutualization of a number of these Canadian companies. There were three prosperous successful insurance companies that mutualized to avoid takeover, and this is something that might well be considered in demutualization currently. Six mutualizations resulted from various operational difficulties including loss of public confidence resulting from a parent's insolvency, management stockholder conflicts and stockholder dissension and other problems. In analyzing the possibilities for demutualization, I think we could gain from looking at these mutualizations especially the takeover problem. I think that many of the other problems are much better controlled by investment regulations, insurance regulation, but certainly the takeover problem is one that barring effective shark repellant, still continues.

MR. INGRAHAM: Demutualization has been much more common with property and casualty companies than with life companies. What can we observe and learn from this experience.

MR. NOVIK: Looking at the corporate records of a number of mutual casualty insurance company conversions, I observed three major motivations. One is to grow stronger and more competitive; second, to sell out, third is to achieve some special purpose such as the ability to have an upstream holding company to enable a group to get into other areas of business endeavor. Although profits for insiders doesn't appear in corporate records as a motivation, that seems to be a major motivation for some of the conversions. A questionnaire to a number of demutualized property casualty companies asked whether reorganization had hindered or improved their company in various respects. Of the 19 responding, five indicated that the conversion had hindered them because of some lost tax benefits as a result of a taxable transaction. Most of the companies reported improved employee motivation, improved relations with policyholders, agents, and regulators, and improved financial conditions. All indicated enhanced growth and expansion. This was cross verified by reviewing Best's Reports. They all had shown increased expansion. One lesson that we can learn by looking at the demutualized property motivation in some cases. One mutual terminated all the policies except for the five held by insiders and then demutualized, allowing the insiders to share in the value of the company. There have been other abusive situations. There are needs for reasonable constraints and for regulations.

MR. J. PETER DURAN: I think you alluded to the problem of existing surplus. To what extent would that have to be walled off for the old block of poliicyholders?

MR. WADSWORTH: From a standpoint of an attorney involved in drafting legislation to serve as a model, I note that we probably want to develop reasonably flexible conversion language. I think the extent to which you have to wall off surplus comes down perhaps to a resolution of the question whether or not you can genuinely terminate the participating status of existing par policyholders without their consent. If you can't, it would seem that a substantial amount of surplus must continue to be dedicated in some way to participating policyholders.

MR. HENRY RAMSEY: In regard to the particulars in the current tax bill and the negotiations in that settlement, the mutual companies argued very hard for the need to have a competitive playing field with regard to the subsidiary business in light of the fact that the products which were housed there were essentially identical to the products being offered by stock competitors. That position was held until the final hour, and at that time a compromise was offered. What the mutual groups sought was to have it taxed as a stock company, and to have the value of the subsidiary that was contained in the surplus of the mutual be cut out. The compromise that was offered to us was that a stock subsidiary would be taxed as a stock company, but that the value which was held by the parent related to the sub would not be eliminated from the parent. When the law came out, it was fairly different in that the value of the subsidiary would be redetermined as if it were a mutual company. This was not part of the discussion at all and we felt we really had been had at the last minute. The effect of this is identical to sawing your company apart and having two mutual life insurance companies with each subsidiary being treated as mutual life insurance company. You would get exactly the result which this law proposes, and that is now what we were offered. We feel therefore there was technical slip there which denied us at least some part of help, and it's particularly important in connection with deficiency reserves which are fairly prevalent currently in connection with the universal life products and others which inflate the surplus value related to that business and involve a tax. While we thoughtwe had a compromise that wasn't a level playing field but was at least more level than treating it fully like a mutual company, we didn't get it. We're seeking redress of that which we feel was a technical error in the drafting.

MR. NOVIK: I've heard that in at least one state, the special captive laws do not require deficiency reserves. This may provide an opportunity to alleviate deficiency reserve problems without going off shore. Reducing deficiency reserves in the parent will bring statutory surplus closer to tax equity.