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PRODUCER OWNED INSURANCE COMPANIES

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Allowing participation in underwriting gain to compensate large producers:

- o Agents
- o Banks
- o Savings & Loans
- o Direct Marketing Sponsors

Topics include:

- o Participation in strain
- o United States (U.S.) or international structure
- o Type of stock ownership
- o Tax implications

MR. MELVILLE J. YOUNG: General Re has been involved with several producer owned insurers over the years including one of the more successful ventures, Integrated Resources. If Intergrated Resources, a precursor of the equally well-known "M Group," were a typical example of what an insurer could expect to result from producer owned insurance companies, there would be very little for us to debate today. In fact, these early successes have led to a surge in interest from both producers and insurers. And, as the concept becomes widespread, some questions arise:

1. If the justification for producer owned insurers (from the insurer's viewpoint) is improved experience, the producers will place the cream of their production into the deal in which they share the profits. Who gets what's left?

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2. Does the whole of the production improve, or do we end up with the same experience in total, since we will share some of the cream but probably still get our share of the balance from someone else's captive producer? In the latter case, we've accomplished only lower profits by increasing our acquisition expenses.

3. Many of the producer owned insurance programs provide a five-year buy out for the producer. What happens to the experience once the quality incentive has been removed?

4. From a tax standpoint, Section 845 of the tax law raises significant tax avoidance issues in reinsurance arrangements. Is it possible the IRS will attack some of these producer owned reinsurers, saying that there is significant tax motivation or tax avoidance involved in their formation?

We have an impressive group of speakers assembled today to address these and other questions. Our first speakers is Mr. Joe Fafian who heads a new management consulting firm, Fafian & Associates. Prior to that he was President and Chief Operating Officer of Associated Madison, American Can's Financial Services Holding Company, and Chairman, President and Chief Executive Officer of National Benefit Life.

Our second speaker is Mr. Joe Kolodney. He has been with General Re for sixteen years. As of January 1, 1985, he was appointed President and Chief Operating Officer of a subsidiary of General Re, Fairfield Life. During his tenure with General Re, he was an Account Executive in the Northeast marketing area and was responsible for putting together several of these producer owned reinsurance companies.

Mr. Dennis Van Mieghen is with Peat, Marwick, Mitchell & Co. He has been there for about twenty-five years, a partner since 1972. Currently, he is the firm's National Director of Insurance Taxation. Those of you who attended the previous panel discussion know that he's involved in the American Council of Life Insurance (ACLI) subcommittee group hoping to write some regulations on Section 845.

MR. JOSEPH FAFIAN: My role on the program is to review where we have been and to discuss the trends that will result as producer owned companies become commonplace in our industry. To accomplish this, I will briefly review the trends in the industry and the industry's competitive climate. I will discuss why I believe these trends will result in a change in the fundamental relationship between agencies and carriers. I will then review the historical precedents for producer owned insurance companies and conclude with my opinions regarding the future.

The first major industry trend in life insurance is that stock company dominance has accelerated in the last five years.

> In 1977, mutual and stock companies each had about $35 billion of total premium income. Stock companies now account for about two-thirds of the industry's $100 billion of premium income.

> In 1977, stock companies had 37 percent of the industry's assets. Currently they have about half of the industry's $700 billion of assets.
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> In 1977, stock companies had slightly more than half of the industry's new individual life sales. Currently stock companies account for approximately two-thirds of the industry's individual life sales volume.

If you consider that these figures were for 1977, you'll realize that the stock subsidiaries of mutual companies had not had a chance to be reflected in them, so they represent real differences.

The second industry trend is that investment yields are still climbing, but overall yields are still below today's new money rates despite the latter's recent decline.

Third, expense ratios are generally stable or declining. The impact of inflation has been offset by a combination or larger policies and less staff due to automation.

Fourth, mortality continues to improve, although I wonder how long that will continue. Equally important, the improvements in mortality for the larger amounts continue, and people who would be candidates for the agent-owned company tend to operate in the bigger case market.

The fifth and final item is the only bad news in the industry in recent times. Persistency in deteriorating. While the A.M. Best lapse ratio is not the best indicator of persistency, it is valid as a crude measure. If you look at that overall lapse ratio, it has gone up about 50 percent in five years, which is incredible. In some companies the impact of this adverse persistency has offset the benefits of all the other good things that have happened: improved mortality, the rise in investment returns and the stable expense ratios.

Clearly, at least in the near term, persistency has become the largest variable in individual life insurance profitability. Companies that can recruit and retain production sources with above average persistency will have an edge over their competitors.

What are the trends that I see for producer owned insurance companies? First there has been a temporary increase in field compensation due to replacements. We hear phrases such as "internal replacements," "external replacements," and "guaranteed issue replacements." Replacements have enabled people in the field to provide their long-term clients with a better product and receive new first year commissions for it. Hence they are making a lot more money than in the past.

While this has been happening, a second trend has continued. First-year compensation, as a percentage of first-year premium, has been reduced. This is a result of several factors.

> The cost of insurance has declined ever since I have been in the business and I entered the business in 1959.

> Commissions have been reduced to reflect emerging persistency trends. For example, term insurance commissions have been reduced or leveled by many companies. Universal life has become about one-third of new sales and many companies have adopted a low target premium philosophy.

Because of all the replacement activity, the typical agent's pocketbook has not been seriously hurt by these reductions in first-year compensation.

Nevertheless, I am starting to see a third trend emerge--concern about field compensation for the longer term. More and more you hear agents express concern about Federal income taxes. More and more you hear agents express concern about the impact of these lower first-year commissions. As one person I know put it: "When all my in-force is replaced, what do I do then?" So we have people accustomed to the better life styles that these replacement activities helped provide, who are now concerned about their ability to maintain these life styles over the long term.

Some other developments have been going on in the field for some time. Companies no longer believe they must be all things to all people. Agents no longer believe that one company can meet all their needs. Today virtually no one represents one carrier. But multicompany representation creates problems for the field.

> Problems are created for the field when companies change philosophy on anything from underwriting to service and marketing support.
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> Problems are created for the field when companies are forced to restructure their products or compensation. Most recently, the new tax law has required some companies to modify those products priced assuming that the benefit of an 818(c) election would continue. Withdrawal of reinsurance support has forced companies into product or compensation changes.

So overall, multicompany representation has not proven to be the panacea that a lot of people in the field thought it would be. On top of that, a lot of general agents have found that the cost of maintaining supplies for several companies' products, mailing material to their brokers and so on, has proven to be a much more expensive proposition than many people thought it would be.

Let's go on to one other trend. Inflation and the change in producer compensation have changed the relative profitability of personal production versus sales force development and management. When I first went into the business, everybody wanted to build a shop. Today, many producers have no desire to build a large shop. They are very content to remain in personal production if the economics work.

I have talked a little bit about changes in the industry and in producer owned insurance companies. But what has happened to competition? It has gotten tougher on all fronts. There are new entrants in the

marketplace, including banks and financial services companies. Industry annuity reserves have doubled in five years and now approach $200 billion. Many of these sales were made by brokerage houses, not insurance agencies.

We have seen the emergence of new distribution systems. Direct response has become an extremely effective way of reaching the lower-income market. The distribution systems of financial services companies have become a major factor in the upper-income insurance market.

There is a greater consumer awareness about product distinctions. The FTC report, the various state publications and disclosure requirements have all had their impacts.

As discussed earlier, there has been an acceleration of replacement activity. Five years ago the increase in the industry's individual life insurance in-force business was about 55 percent of the industry's sales for that year. I have not seen the 1984 figure, but for 1983 it is less than 50 percent. We have also seen new products emerge, interest-sensitive products and a whole variety of universal life products and deferred annuities. We have also seen tax loopholes closed. For example, the old Section 79 sales have disappeared, and the impact of what I call the 818(c) term products is disappearing. So the competitive climate continues to get tougher both for the carriers and for the agents in the field.

Looking at all these trends, I view five as being the most important:

1. Persistency is now the key issue in the profitability of individual life insurance business.

2. Agent compensation per dollar of premium has declined.

3. Agent income has temporarily increased due to replacement activity.

4. Multicompany representation is no longer viewed as a panacea by most people in the field.

5. The competitive climate has worsened over what it was a couple of years back.

To me, these trends suggest we ought to be figuring out ways to make the agent in the field our economic partner. What better way than to have him share in the underwriting profits and losses of the business he writes? However, the industry has two historical precedents it ought to consider before finalizing a judgment on the merits of agent-owned companies.

In the 1950s, increasing yields and improving mortality resulted in accelerated life insurance earnings. Also during the 1950s, Wall Street discovered life insurance stocks and many general agents at that time formed their own insurance companies. A return to the P/E ratios of

the 1950s could once again lead general agents to form their own companies.

The other precedent we ought to look at is mass marketing. In order to compete, some companies work very closely with their clients, and reinsurance companies were established for mass marketing accounts. Arizona Credit Insurance type companies have certainly become commonplace, so that banks and auto dealers can share in the underwriting profits of the business they generate, without having to worry about caps on compensation. Companies like Ford Life or JC Penny Life were established by mass marketing companies in order that the parent company could share in the underwriting profits of the business written on the parent company's clients.

So we have precedents in our industry for sharing underwriting profits when it makes economic sense.

There is a benefit to the carriers in establishing agent-owned companies. There is a benefit for the agents, at least for those who produce large volumes of profitable business. There is historical precedent for sharing underwriting profits. In my opinion, the companies who have established agent-owned companies will be viewed as pioneers ten years from now. Other companies will follow suit to retain and attract quality production sources. To me, the only unresolved question is who these other companies will be. Will they be the traditional writers of large volumes of individual life insurance, or as was the case with credit insurance and other mass marketing forms, will these companies be the aggressive young companies that will take market share away from the giants? Only time will tell.

MR. JOSEPH KOLODNEY: As mentioned earlier, I was the Account Executive for General Re who helped put together the first major producer group effort catalyzing the relationship between the people at Integrated Resources and about four carriers that were ultimately involved in the process: Security-Connecticut, Security Life & Accident of Denver, Trans World in New York and Fidelity Bankers Life in Richmond. The carriers, in effect, financed the development of the business and provided the forum for these producer groups to get together, grow and expand. I am going to cite some observations, in a non-technical way, on how these deals should be constructed, what some of the motivations are and what the interests are in them.

Mr. Fafian has already touched briefly on some of the advantages. Theoretically, producer groups could represent a consistent predictable source of profitable production. Everybody is scrambling for business. This is one way to at least try to control the fountain of business that one is able to access.

But there are certain minimums involved. The deal has to be worth the time it takes to put it together. A lot of people are going to be involved. It's somewhat speculative as to whether they can perform or not. The companies have to conduct very serious evaluations of these people and must also understand what the motives of the parties are. Everybody is in the business to make money, but where is the

proprietary interest? Is it in the interest of the producers to say only that this is a way to increase their compensation? Or, is there a more serious interest in constructing an alternative vehicle that they can use for other purposes? Perhaps they feel that, at some point, they themselves want to get into the life insurance business. This is a nice block to start building with. One can help them by retaining some influence over their future decisions. The President of Security Life and Accident said: "This is a partnership," and if someone accepts it in that philosophy, he has to be sure he understands what his partner wants.

Producer group marketing has a lot of practical, but at the same time ephemeral, advantages. You in the audience are all knowledgeable professionals. You know that producers do what they do best, and that's produce. In dealing with them, you are dealing with entities who are motivated by the same goal as the carriers and the reinsurers, the goal of making money. But you are not necessarily negotiating with a knowledgeable party. If you are serious about making these deals work, and not being perceived as trying to take advantage of the producer's lack of knowledge, sophistication or even naivete about the nuances of the primary business, I think it is very important that you bring a high degree of good faith to the table. Be sure that each of the parties has a clear understanding of what he is required to provide, what he is providing and even what he may have to give up or defer to make the arrangement successful. You can't sell something to the producer that he doesn't believe in. There must be an investment and a risk position for both parties. The deal is no good if one party is going to benefit unduly at the expense of the other.

Another interesting thought is the homogeneity of the group. There are a lot of brokerage groups around the country who, together, generate a lot of premium. But after you explain the concept to a group of say fifteen producers, several of them will quietly come up to you and say that, within this group of fifteen, there are probably only eight who can really deliver the kind of deal you are talking about. Business from the other seven you wouldn't want.

The elements of profitability remain the same: mortality, persistency, expense savings, excess interest earnings. Other elements may have a bearing on the attractiveness to the producer group of entering into a reinsurance-driven arrangement: personal taxes, capital gains consideration and genuine expectation of significant future profitability of the business they are producing. This last element, as a matter of practical consideration, can't be recognized immediately, simply because all the economic risk of success is then transferred to one party and that would not be fair, that would not be a partnership.

Make sure the producers have a bona fide third party in whom they are investing their money, to make sure that their interests are reasonably secure. It is inadvisable to have the company and a producer negotiate just between themselves. You want to give these people, and they probably should insist on it, an opportunity to have impartial advisors or paid consultants representing their interests. Then they will know that the deal is being handled in a very proper and businesslike way.

You should have a consulting actuary involved, an accountant or a reinsurer who can perform in an intermediary role and simultaneously contribute to the partnership. It is beneficial for both the carrier and the producer to have the professional reinsurer involved in an objective check and balance role, to avoid what may emerge from time to time as unfortunate, blatant self-interest on the part of one party or the other.

The producer supplies a distribution system, product ideas and markets. Carriers supply the vehicle to maximize producer strengths plus support units and structure to maintain production momentum. Carriers also supply underwriting, accounting, policyholder service and, while it is almost taken for granted but should not be underestimated, money. Money can take the form of commission income to the producer, and most importantly, surplus investment to help carry the product to market by willingness to defer a statutory return (real money) on its investment. The reinsurer provides a forum where the two parties can negotiate more successfully on critical issues. The reinsurer is also an independent underwriting reviewer, an independent positive auditor of business and a resource for claim assistance. Finally, the reinsurer is an additional source of investment capital (that is, surplus) to help the primary carrier support the new business strain generated by the producer group's efforts.

One of the contributions General Re made back in 1975, with the Security Life & Accident deal, was to effectively finance the development of that company's whole Section 79 program.

Let me just quickly recap the benefits of these arrangements. For the company, these are: lower unit costs, increased production, quality business and consultation benefits. The producers can provide more competitive products, get a piece of the action, and there is often a cross-fertilization of ideas, which is very positive. There are some disadvantages however, to this relationship as far as the company is concerned. The relationship becomes an agent/consumer one. The agent, in effect, may own the book of business. The agent asserts a great deal of control and there is always a potential for losing the production group to a competitor. So when you structure these deals, make sure that all these little items are checked off your list and you provide as much protection as possible. I think, maybe simplistically, that the quality of the relationship the life insurance carrier develops with the producer group will be one of the things that carry the day.

The reinsurer's role can accelerate the profitability of the producer's business in a couple of ways. It can maximize the producer's company contribution by paying allowances on business going into the producer company in its negotiated share. It can "clean up" the writing carrier's statement by being there as an "approved/accredited" reinsurer, thus obviating the need for the carrier to involve itself in Mod-Co, letters of credit and regulatory questions or shareholder questions, policy loan security, and so on.

Everybody is going to be talking about what he can bring to the table, how neat the product is going to be, and what terrific compensation schedules are going to be paid. Then the first piece of business is

written and somebody says: "What do we do with it?" How does it get to the reinsurer, the producer company? Don't underestimate the importance of administration. Agents don't understand its true importance until it is explained to them. The company often needs better understanding of what it is obligated to do to make it work. It's a lot different doing one of these deals, even with a reinsurer's expertise to help you over the hurdles, than keeping as much of the business as you can for yourself and then buying some yearly renewable term (YRT) reinsurance or, in the interest-sensitive product area, co-insuring the mortality cost. Computerization is a big advantage if it's handled right. Quota share is probably the most efficient way even if you have to produce the reports layered by face amount. But don't forget about the accumulated risk in the producer company. Don't forget about the catastrophic exposure inherent in group salary savings and risk concentrated areas.

No one knows more about a person's business than the person doing it. That's true in your relationship with your marketers. They know more. It is true in your reinsurer's relationship with you. You know more. That's why a transaction such as we are discussing here has, at its core, the rockbottom foundation on which any successful partnership is built, the highest good faith. Sure, decide what it is going to take to work for the producer and for yourself. Negotiate to come to a profitable arrangement and make sure that it is consistently honored. That last will continue to strengthen, enhance and insure the continuity of a deal you wanted.

As a closing comment, I would like to mention an example that arose when I was talking with one group of producers. Its business was regarded as highly profitable. Upon analysis, one could determine that it was minimum deposit business. The carrier said it was highly profitable, because they looked at it one way. But the producer looked at it another way. The carrier said: "I priced this product so that I could support a 60/40 ratio of loaned to unloaned business." The carrier was delighted with the producer's production, except that 100 percent of the business he produced was all loaned. So you have to try to think about how these things work out when you are structuring these deals. Perceptions are important. Reality is also a significant consideration.

MR. DENNIS VAN MIEGHEN: I am going to be covering tax aspects, and I will get somewhat detailed. Producer owned companies have been around for a long time. That's especially true in the credit area. There have always been companies controlled by the producers of credit life insurance, which normally are either finance companies, auto dealers or banks. So the structure that ordinary life writers and possibly annuity writers are getting into, has been looked at before. What is changing is that other types of business are now being put in a company that's controlled, or partially owned, by the producers of the business. In addition, there are other analogies where a number of users of insurance have banded together in various structures to minimize their insurance cost.

First of all, I am going to make the assumption that all the business we are talking about relates to U.S. insurance risk. There are

different rules for foreign risk, which are beyond the scope of this discussion. So we are talking about policyholders that are located in the U.S.

One way to structure an organization is to start with a foreign corporation. Then divide that into two sub-groups: controlled and noncontrolled. I will define those terms later. Further divide it into "doing business in the U.S." and "not doing business in the U.S." Later on, I will also comment on some miscellaneous considerations, such as new reinsurance rules, compensation vs. capital gain, accounting and the impact of the Carnation case, if any.

Now let me go back and start at the beginning about foreign corporations, because having a domicile offshore is a possibility to consider. The location is usually Bermuda or the Cayman Islands, but lately the Turks, Caicos, and Virgin Islands, have been looked at. The reasons for looking at a foreign jurisdiction, other than taxes, are low capital requirements, very little regulation and the ability to combine life and casualty products in one company. In the U.S., there is a requirement to segregate life and casualty business into different companies. For example, you may see auto warranty insurance and credit insurance come from the same producer. The producer goes offshore so that it has to have only one license, because the offshore jurisdictions normally let you put both in one company. If you want to sell both those lines in the U.S., you would have to have two separate companies.

Probably the most appealing setup from a tax point of view is a foreign, noncontrolled corporation. Noncontrolled basically means that the particular shareholder you are talking about has less than a 10 percent ownership interest in the company. That's usually measured on voting rights. If you are noncontrolled, the producer's share of the profits for that corporation is currently not taxed. That's assuming you are also not doing business in the U.S., another key criteria. If the structure is noncontrolled and not doing business in the U.S., then the money is the premium dollars that flow into the foreign corporation. If you are in a jurisdiction like the Caymans or Bermuda that do not have a current income tax, that money will accumulate tax deferred. The earnings on investment income, and if there happen to be underwriting profits, will accumulate without current tax and then, if distributed in the form of a dividend, would be subject to ordinary income rates at the time of distribution. The idea is to let it accumulate for a long time, then get redeemed out. Hopefully, from technical reading of the law, that redemption will be treated as capital gain. So the objective, if you structure it as a foreign noncontrolled corporation not doing business in the U.S., is to accumulate the funds tax deferred. Then, when you finally cash out, you do so at capital gains rates, which as you know are substantially lower than ordinary income rates. The term that is normally used for that type of situation is an "exotic."

A "preference share" structure is the way the exotic situation is usually set up. If you have thirty different producers in a company, they will each have separate share of stock that are unique to them. You will have Class 1, Class 2, Class 3 stock for instance. Usually, the fronting company or the sponsor will also have a percentage of

ownership in the company. What you tend to do in that type of setup is segregate the accounting, so that Class 1 stock might belong to an auto dealer in Chicago, or Class 3 stock to a producer of ordinary life. The redemption value of those shares and the dividend rights on those shares will be dependent upon the profitability of each producer's particular business. There normally is not a pooling or a sharing of all the producer's profits or losses in that situation. It is hoped that this corporation, having many different shares of stock, will be treated as one corporation and not as many corporations. If it is treated as many corporations, each of these preference shareholders would then be a controlled foreign corporation. So you get a big umbrella and hope that it will be treated as one corporation. Since there are many owners of that one corporation, it is noncontrolled and, therefore, there is no current taxation. That is the most prevalent setup lately, especially for the auto dealers, and the concept is being discussed for those companies that are now looking into what to do with individual ordinary life producers.

Again, you would become a controlled foreign corporation based on regulatory and capital considerations. In some foreign jurisdictions there is just less regulation and less capital required. In a controlled corporation you have an owner or a particular shareholder who owns more than 10 percent, and usually, in this case, there is one who is truly in control and holds 100 percent. If the income that is earned in that controlled, offshore corporation is all related to U.S. risks, both the underwriting income and the investment income are currently taxed in the U.S. They are taxed as a dividend to the owner of that foreign corporation. These rules are found in Subpart F of the U.S. Internal Revenue Code. It is not particularly advantageous from a Federal income tax point of view. The reason you would go controlled is primarily regulatory, not tax motivated per se, because you are taxed on that income as earned and not as distributed.

This again presumes that the foreign corporation is not doing business in the U.S. Normally, what companies do to increase their ability to argue, should it be questioned, that they are not doing business in the U.S., is keep a complete set of accounting records offshore, sign all reinsurance agreements offshore, hold all director's meetings offshore, and have an investment advisor offshore. If you reverse the process to argue that you are doing business in the U.S., you just do things in exactly the opposite location. You don't keep records offshore, or you make sure you keep a complete record in the U.S. You sign your reinsurance agreements in the U.S. and you don't have director's meetings offshore. You might even get an office in the U.S. just to make it look like you have a permanent establishment and are actually doing business in the U.S. There has not been a lot of controversy so far on doing business versus not doing business in the U.S. I would expect that question will come up more in the future. The guidelines for answering that question are somewhat vague. There are not a lot of specifics in the area of doing business versus not doing business in the U.S.

Recently, I have seen a trend for companies to still go offshore, but to argue that they are doing business in the U.S. This would be the

situation of a controlled foreign corporation, but doing business in the U.S. Why do they want to do that? Because under the new life insurance tax law, if you are a small company and you qualify as a life company, your maximum tax rate on earnings is around 14 percent. It could be lower with surtax exemptions, if those apply. Also, if you are doing business in the U.S., you are not subject to an excise tax. If you are offshore and not doing business in the U.S., and handling a U.S. risk, you've got to pay an excise tax that tends to be 1 percent for all reinsured risk. The tax cost of being classified as doing business in the U.S., in many circumstances, could be less if you say you are subject to U.S. taxation, because 14 percent of net income might be less than 1 percent of gross premium.

The offshore jurisdiction that looks the most favorable is the Turks and Caicos Islands. However, there are some problems with that because there are no surplus requirements and no regulation. There, if you want to argue that you are doing business in the U.S. and be taxed as a life insurance company, a special set of rules applies. There are also regulations for determining the amount of your income that has to be reported if you are a controlled foreign corporation not doing business in the U.S. If you don't have any reserve requirements or reserve laws in a foreign jurisdiction, the regulations say that you are deemed to come under the reserving laws of the State of New York so that you use New York insurance requirements for purposes of computing profit or loss. There are no such regulations that apply to foreign corporations doing business in the U.S. That raises the question, can a foreign company say it is doing business in the U.S. and qualify as a life insurance company? The life insurance company rules say that reserves must be required by law but if you are doing business in the Turks and Caicos Islands, no reserves are required by law. Therefore, how can you ever qualify as a life insurance company and meet the requirement that the reserves must be required by law? You probably can't. It is a very technical point, but one that is very important right now in terms of how some of the producer companies feel they can minimize their taxes. I don't think it can be done without a change in the law. It is hard to overcome this reserve required-by-law requirement.

Let's move on to U.S. corporations. There are controlled and noncontrolled U.S. corporations. Noncontrolled companies have been around for awhile. They tend to be the Arizona exotics that we've seen for auto dealers in particular. Some auto dealers can't afford the Arizona capital requirements so you do this umbrella again. You have a number of preference shares that are segregated in terms of their values. The only difference between the offshore and the onshore is that the onshore company is subject to U.S. taxation as a U.S. corporation. These days that isn't so bad because the tax rates are lower for U.S. life insurance companies, as was previously mentioned. It remains to be seen whether that will be the case in the future because Congress is considering doing away with the small company exemption (the 60 percent exemption) and the 20 percent taxable income adjustment. Those two adjustments get a small company down to about a 14 percent tax rate or lower.

You could have a controlled corporation in the U.S. This becomes important in dealing with the fronting company, especially with ordinary life, because of the fact that ordinary life business tends to produce statutory losses in the beginning. If you are setting up a new company, it may produce tax losses. If you're not able to use those losses, because there is no other income to offset them against, especially in the short run, it's not efficient. You want to get the most efficient tax answer possible, not only at the agent's level but at the corporate level.

I have seen one case now which has been set up in the beginning as a controlled corporation. It will be controlled voting-wise and value-wise by the sponsoring insurance company, so that the sponsor can include this company in it's consolidated return. That's very important in the earlier years so that the losses that will be produced just because of statutory accounting can be offset immediately by the sponsoring company at a 36.8 percent tax rate. The controlled rules basically are that in order to be able to file a consolidated return, you have to be 80 percent or more owned both in voting rights and in value.

We have a new value test in the U.S. Before there used to be only a voting rights test. It was very easy to control or decontrol or consolidate or not consolidate by just moving ownership around, by having a number of classes of stock or by changing the voting rights on those stocks. You can't do that anymore. Now there is a dual test of value and voting.

Another troublesome point will also have to be clarified, especially with agent-owned companies where the agents are at least participating. That's the treatment of options. In many instances, the agents will be given options to buy stock. The right to exercise an option will be dependent upon the volume of business that the agent produces, and upon the persistency of that business. An agent won't be given the stock immediately. He will have the right to purchase stock if certain events happen, and that raises a question on this control test: In measuring this 80 percent value and ownership rule, do you count options where a producer has the right to buy stock in the future? That's an open question. It's probably yes, but there are no regulations out for answering it. It's a brand new law that could cause problems. The point I am trying to make is this: The fronting or sponsoring company may want to be in control in the beginning for tax purposes, because losses are produced in the beginning. However, that may be difficult to achieve if options granted to agents are counted, since the sponsor may not then meet the 80 percent test. That's a gray area right now.

Let me discuss some other related questions. Will the new reinsurance rules apply to agent-owned companies? Just to digress a second, the new reinsurance rules under Section 845 of the U.S. Internal Revenue Code are effective for risks reinsured after 12/31/84. Accordingly, they are currently effective. Any time a reinsurance agreement has a "significant tax avoidance effect" the IRS now has substantial powers to rearrange, if you will, reinsurance agreements to produce a different economic answer or a different tax answer as to the timing of

deductions and who claims the deductions. My feeling is that it will be difficult for the IRS to apply these reinsurance rules to producer owned companies. Since this business is produced by the agent, the purpose or intent is to have a portion of the economic profits actually reside, via reinsurance, in this captive or downstream company. It is its business and it does have a right to those profits. I think that it would be very difficult for the IRS to rearrange that transaction in those circumstances. I qualify that, because there could be many different circumstances. Maybe you are trying to delay the time when those profits or losses get passed down. You know what the ultimate answer is going to be, but you are trying to affect the timing. If you affect the timing of the profits or losses down at the agent-owned company, the IRS may very well attack the transaction under the new insurance rules. I don't think the new reinsurance rules apply, but in certain circumstances they very well could apply if the intent is to delay the timing of recognition of income or expenses.

Next is the question of compensation versus capital gain. Clearly, agents want to increase their after-tax rate of return. Compensation income, as you know, is subject to ordinary income tax and the capital gains tax is a lower rate. I think it's dangerous if the agents are cutting the commissions that they otherwise would have received, and are having those lower commissions flow into their share of the value of company stock in the agent company. If that is done, the reduced compensation could possibly be recharacterized by the IRS as ordinary income.

Another consideration is accounting. There was one case back in the late 1950s, dealing with the accounting for an agent-owned company. This was a situation where the agent held preferred stock and his cash-out rights and dividend rights were essentially dependent on the value of that business and the profits it produced. The company, in doing its financial statements, showed the value of the stock as a liability. The company did not show it as an integral part of one corporation. The amount that this shareholder would be entitled to was shown as an expense, not as a potential dividend. The court said the company wasn't treating this agent as a shareholder. It was treating the stock as an expense on the statutory financial statements. Therefore, the court said that this was not a stockholder relationship, it was really a commission arrangement. So I think it is very important that this reinsurance company, if you will, having a number of shareholders, treats the financial statement as one corporation. You might have internal records that segregate everybody's rights, but don't do that on the published financials. Show it as one integral corporation, otherwise you will jeopardize its status as a corporation for this purpose. For the person who has rights, are those rights in the form of a shareholder? It is very important that they be shareholder rights. So watch the accounting.

One last point. Will the Carnation case apply? I don't think so. Carnation is a case that dealt with a controlled corporation where the insured and the insurance company were related. That case, and a number of others since it, said that an insurance relationship did not exist. I don't think that the rationale of Carnation applies in the case

of the agent-owned companies, because it's not the agent's risk. He may be producing the business, but he's not the insured. So I don't think the rationale of Carnation applies.

MR. OSCAR ZIMMERMAN: Given that you are in the consulting business, would you comment on some typical start-up costs? You brought up the actuarial consulting component, the accounting consulting component, the legal consulting component and setting up your administration in dealing with reinsurers. Do you have some ball-park numbers for each of those start-up costs and how they might be split between the producers and the insurance company?

MR. VAN MIEGHEN: I'll just give you my impressions from the ones I've worked with. The direct writer is bearing almost all the costs for legal, accounting and offering circulars. Usually, you see a thick circular. My understanding is it may not be subject to SEC jurisdiction if you have less than 35 people involved, but nevertheless you see thick documents which are expensive. What does it run? Estimating, without breaking it down between legal, accounting, and printing: \$20,000-\$40,000. That's leaving out questions of financing by the direct writer: Does he take surplus notes back? What capital if any does he put into the company? Does he make direct loans to the insurance agent to get capital in the company? Those would all have hidden costs that may or may not be quantified as such.

MR. ZIMMERMAN: After the start-up costs, would you have a guess as to what resources you need to maintain it every year? You may need half an actuary, a quarter of an accountant and so on just to do the bookkeeping and the ongoing administration. You know, you bring up new products and then you have to do agreements and all that.

MR. VAN MIEGHEN: I think those would be mainly hidden costs. You are not going to hire additional people to do this, it's just that the people that you have work harder. You have fixed costs, but they are hidden. You are taking some people away from other work that they may have been doing. Your total payroll may not increase, but nevertheless I think that is a hidden cost. I really don't know how to quantify that.

MR. YOUNG: There are others in the audience who are better qualified and have fresher knowledge, but I can tell you a little bit about what I recall of my experiences, with the Integrated Resources situation. When that first started up, we the reinsurers, as part of our price for what we were getting out of it, did a good deal of the back office work for the agent-owned reinsurer. They had an accountant and a secretary for the first few years until it became a substantial operation.

MR. HENRY KUNKEMUELLER: This is just a nuts and bolts question. How much should a share of stock cost these people? How much should a producer put up? Is there any rule of thumb, or are there any ranges we can talk about?

MR. PAUL CARMODY: We are actively in this producer-sponsored insurance market. Our criteria is that the producer put up \$1 million

before we enter into the transaction. So we are at a very select end of the market. Only with the very largest of the producers will we even discuss this as a possibility.

MR. YOUNG: I know that other companies are taking different approaches.

MR. HAROLD INGRAHAM: We are asking for a lot less than that and are taking some of it in cash, some in promissory notes, and the balance out of deferreds. The total is $100,000, not $1 million.

MR. VAN MIEGHEN: I'll comment on what another company is going through. It has the agent-controlled company with one large producer, but that producer has subproducers. There is a lower-tier program between the agent and the subagents. That gets interesting too, regarding the involvement of the company in the subagents' program. The involvement of the sponsoring company has been mainly in structuring the subagents' rights. In a way, that is almost another topic. If insurance companies have programs for their large agencies, the large agencies might also find that they have some rather large agents within their group who feel they also should have a part in this program.

MR. YOUNG: I don't know if anyone in the audience is from Executive. I know it has that kind of setup. I don't know either if there is someone from Security who could talk about the M-Group, but we welcome comments on those as well.

MR. TIMOTHY FITCH: Is this type of agreement a way to get additional profits to the producers, and thereby increase their allegiance to the company, or is it a way to shift commission money into capital gains as a result of selling their stock?

MR. YOUNG: I think you know in the Integrated Resources arrangement with Security-Connecticut there wasn't a significant reduction of commission income, so that issue didn't come up. Mr. Fafian probably has some comments on your question.

MR. FAFIAN: If you look at the fellows that are in the field, they talk about giving up maybe five or ten points in return for that on a compound interest basis and on a capital gains basis. If you looked at it from the company's vantage point, everybody is fighting to get the few producers of large volumes of profitable business. Companies recognize that "the sizzle sells as much as the steak." From my dialogue with these people, they really don't get into the details of the arithmetic, but do get into the conceptual notion of "if it's capital gains, that's great."

MR. FITCH: In our situation, one of the things that eventually led to a breakdown in the agreement was the agent's desire to have money sooner rather than later. This desire came to outweigh their willingness to wait for some capital gains, or the potential for some profits down the road. Eventually, they started looking for some type of second-year bonus. The only way to squeeze money out of the product

for that was to get rid of the reinsurance. When given the option, they took the second-year bonus over the ongoing reinsurance. Now maybe you could avoid that in the way some of the other deals are structured, but that's basically what we ran into.

MR. BRUCE NICKERSON: I had the experience of working very closely with some agents, and those of us who have a home office orientation need to be aware of the difference between the broad intention of the agent and what his instinctive behavior, after years of training, will turn out to be. The broad and honest intention of the agent may be to end up with capital gains in the long run, but it is also very common that those people who are very successful as agents are also very successful at spending money and developing cash needs. That tends to undermine the ongoing viability of these programs. Similarly you will hear an honest, in terms of intent, expression that one of the benefits the agent brings to the arrangement is that he will place only his good cases in it and will find other carriers for the other business. But, when the heat of the sale gets on, his concern turns out not to be whether this is a case he ought to put with another company, but how he gets it sold and how he gets it placed. Again, the heat of battle does away with good intentions.

On the subject of just where the moneys can come from, one source that is potentially more fruitful than a direct reduction of commission is future bonuses. With agents who are heavy producers and business not involving reinsurance, that is a much more fruitful area for elimination. I have seen a lot of contracts that are 90 percent, but the bonus can add another 30 percent if you do enough business.

As far as the question of turning compensation from ordinary income into capital gains is concerned, one factor which Mr. Van Mieghen did not address is the question of whether, in the process, the receipt of this compensation is now made considerably more contingent. I would expect that if the agent were giving up the certainty of commissions for the potential of future profits and those profits then emerged, that your issue of whether that was capital gains or not would be considerably diminished.

MR. VAN MIEGHEN: It's a good point. I agree.

MR. NICKERSON: I am thinking that if the agent's return out of the reinsurance company is not merely a pass through of some sort of compensation, but involves the potential for the agent to receive the benefits or losses of his business, then he is genuinely putting himself in an entrepreneurial risk-taking situation. If his business has poor mortality experience, he may never get the commission that he would have gotten if it were a normal life insurance sale. I would then argue very hard that he is entitled to a capital gain.

MR. VAN MIEGHEN: Some of that may be appearances. You mentioned maybe a 5 or a 10 percent reduction. That's a lot better than a 40 percent reduction. I think this could be a gray area. But, I would tend to agree that if you take a 5 or a 10 percent reduction, and that

is subject to the risk of never getting it, you may very well have capital gains. I agree.

MR. YOUNG. At General Re, we've seen situations where the quality has been better than we normally would have expected. In those situations, the agent clearly selected in our favor. We've seen situations where that didn't happen, and an earlier comment about selecting quality producers to put into the program should be kept in mind. Since "casually presented is casually received," how this program is sold to the producers is of prime importance. I have seen instances where producers involved in producer owned insurance companies have been very careful about the quality of business that they put into those situations.

MR. FAFIAN: We have seen a precedent with the various persistency/productivity bonuses. There will be people in the field who will very much want to direct their business to maximize their bonuses. They will even approach you and say things like: "Can I get this case under another contract number and not have it count towards my persistency bonus?" Others might have the same arrangement, but it doesn't seem to have any impact. I don't think, whether it's agent-owned reinsurance or any other scheme of compensation, we are ever going to make agency selection foolproof. You still have to do your homework.

MR. INGRAHAM: I have a question for Mr. Fafian. With respect to the producer owned company, what kind of person should be in charge of day-to-day operations? Should it be a person who is willing to produce for himself? Should it be somebody with a marketing background, or some other background? Would it be a managing partner trying to set up with an equity interest? I think it would be a very tough job in the sense that you would have to command the respect of some very tough independent-minded producers, and at the same time you have to deal with the home office. I wonder if you could share some of your perceptions on this role.

MR. FAFIAN: You are going to get a very biased opinion, because I will tell you what I view as the optimum solution. I am basically trying to have someone like myself run the reinsurance company and that whole activity. As Mr. Kolodney said earlier, let the sales people do what they do best, sell, and do not get them into the loop of administration, paper shuffling and so forth. In support of this, look back at the companies that were formed in the 1950s by people from the field. Unless they brought some other ingredient to the arrangement, the companies were in administrative mess, had financial problems and so on because the people didn't have the backgrounds to cope in that environment.

MR. ZIMMERMAN: If you are using an offshore reinsurance company, does that imply the fronting company has to put up more capital because it doesn't get any credit for its reinsurance reserves? It's just an extra cost of doing business.

MR. VAN MIEGHEN: In the offshore companies, I guess I have seen it done two ways. You have either had the letter of credit, or funds are held back in an escrow or a trust account, to make sure the company gets the reinsurance credit for unauthorized reinsurance.

MR. YOUNG: I would say there are several ways to go in that situation. Mr. Kolodney gave a plug for having a professional reinsurer in-between. That eliminates the problem from the primary company's viewpoint. It is possible that the agent group will have difficulty providing a letter of credit at a reasonable cost. The alternatives are, at least initially, to set up the arrangements on a Mod-Co basis or even a YRT basis. This is possibly less attractive, because there is no asset accumulation in the agent's company, but it does get around that problem.