RECORD OF SOCIETY OF ACTUARIES
1987 VOL. 13 NO. 3

STRATEGIES FOR INVESTING SURPLUS

Moderator: ROBERT D. SHAPIRO
Panelists: JOSEPH FAFIAN, JR.
RICHARD K. KISCHUK
BRUCE J. NICHOLSON
Recorder: AKIVA ZOHAR

- How should surplus be defined?
  - Target surplus versus free surplus
  - Statement surplus versus obtainable surplus
  - Assets assigned to surplus
- How should investment policy relate to surplus?
- *Investment strategies*
  - Target surplus versus free surplus
  - Statement surplus versus obtainable surplus
- What are some of the alternatives utilized for "investing surplus"?
  - Diversification
  - Existing line expansion
  - Reinsurance
- What is the effect, if any, of rating agencies such as A.M. Best, Standard & Poor's and Moody's? How do their ratios and ratings reflect surplus investments?

MR. ROBERT D. SHAPIRO: We are here to talk about making money. If we use return on invested capital as our measurement standard we observe: (1) companies generally expect to make more money (i.e., a higher return on investment) on invested excess capital than on required capital, and (2) excess capital is generally invested in higher risk assets.

Ideally the risks involved in excess capital investments will be reasonably related to the expected return; the higher the risk, the higher the expected return.

Each company seeks to achieve its target overall return while maintaining an acceptable overall level of risk. For example, an organization with a 15% overall target return might plan to achieve its goal with the following package of investments.

	(a) $10 billion of normal insurance business assets earning 15%
plus	(b) $2 billion of invested excess capital earnings 20%
plus	(c) $2 billion of required capital earning 10%
equal	(d) $14 billion of total assets earning 15%

It is often difficult to meet return objectives while at the same time keep investment and business risks within reasonable levels. Increased consumer awareness and competition has put pressure on profit margins in many products and lines of business. In addition, we no longer have large mortality and interest spread margins to buffer our often costly marketing and administrative operations. The resulting financial pressure has forced us to reexamine our view of profitability, performance measures and acceptable risk levels.

Our focus will be on excess surplus or free surplus. Mathematically we can define excess surplus in this way:

Excess Surplus *Equals* Total Capital *Less* Target Surplus

Although this equation is easy to write down, precise definition of its terms is not so easy. Are we talking about statutory capital, GAAP capital, management-defined capital or obtainable capital? How should the definition of total capital reflect items such as the value of subsidiaries or the profit imbedded in existing blocks of business? How should we reflect statutory investment restrictions and rating agency concerns? How might a mutual company's perspective differ from that of a stock company?

However difficult, each company must grapple with these issues and establish its definitions of total capital and required capital. These definitions will ideally be anchored in the company's particular mission, objectives and general view of the world. The amount of excess surplus will flow out of this effort.

Once we've determined the amount of excess surplus, how do we go about developing strategies for deploying these monies? The process followed should be closely linked to the strategies and organizational capabilities of the company. For example, some organizations are financially driven and will target opportunities in terms of meeting financial return objectives. Other organizations are looking to enhance their marketing or administrative capacity and will seek to strategically invest to achieve these objectives. Most companies seek to add long-term value that is related to core businesses or basic skills. Only rarely will new core businesses or pure investments be sought.

What is the right approach to investing excess surplus for your company? Although the answer to this question obviously involves extensive analysis, one helpful perspective is to examine the amount of excess surplus and the strategic fit of a particular investment opportunity.

If a company has substantial excess surpluses, it will create maximum value if there is high strategic fit. If there is low strategic fit, the company may be able to upgrade the return on excess surplus, but the value-creation capability is not as high. If a company has limited excess surplus and finds an investment with excellent strategic fit, it may want to borrow money to make the investment.

Excess surplus is an important resource in implementing an organization's strategic plan. Our speakers will address the key factors that must be addressed in defining and deploying excess surplus.

MR. BRUCE J. NICHOLSON: My role is to "set the table" for the two other panelists.

To arrive at excess surplus, we first need to define how much surplus is required to support the company's business plan. This is most effectively done by developing a target surplus formula and incorporating it into one's financial models. Surplus is defined as statutory surplus, with some adjustment for the peculiarities of statutory accounting. Mandatory securities valuation reserve (MSVR) would probably be included. For example, the statutory net gain from operations can be thought of in two pieces. One would be the net investment income that is earned on statutory capital and surplus funds. The other is the statutory book profit that flows from the business in force and the new business that is written during the year. The statutory book profit is used at the cell level in pricing using Anderson's Method. In the calculation of statutory book profit, net investment income is earned on the reserves held, and there is a deduction for the increase in statutory reserves. The statutory net gain is effectively added to statutory capital and surplus funds at the end of the year.

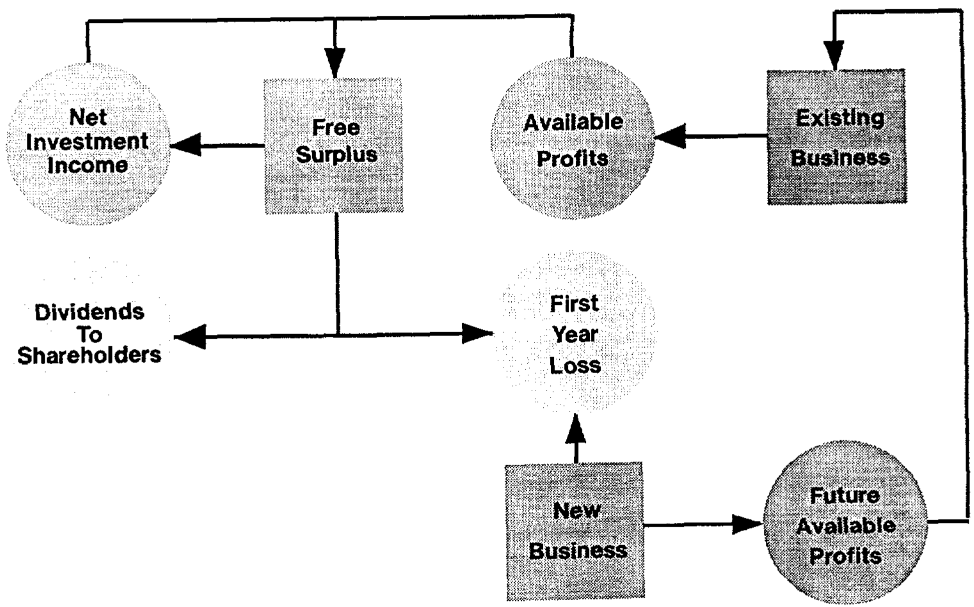
Now let's modify the definition of statutory book profit for a target surplus formula. If we add the net investment income earned on target surplus funds held at the beginning of the year and deduct the increase in target surplus required during the year, we get something I am going to call "available profit." These funds are available since they truly represent the amounts which are available to the company to be invested in new business, redeployed elsewhere, paid as shareholder or policyholder dividends, or accumulated as free surplus. This approach takes into account not only the required statutory reserve amounts, but also the additional amount of surplus funds that are needed to support the company's business plan. The required surplus needs of the company are automatically provided for in the calculations. Note that the adjustment made for target surplus is similar to the statutory book profit entries for reserves. In fact, you might consider this to be an additional required reserve.

A depiction of the flow of available profits during any year for an insurance company is shown in Chart 1. The amount left after target surplus is subtracted from total capital and surplus is what, I've chosen to call free surplus. Free surplus generates net investment income, which is added back into free surplus. Business in force generates available profits, which are the statutory book profits adjusted for the target surplus formula. The total of free surplus, the net investment income earned thereon, and the available profits from business in force represent total available funds. Two options for the use of these funds are shown in Chart 1: one is to pay dividends to shareholders and another is to invest in new business.

Writing new business generally creates a loss, the statutory book loss increased by the amount of target surplus required to be established to support that particular segment of business. You might wish to refer to this first year loss as the available loss as opposed to an available profit. However, future available profits will be generated presumably in succeeding years. You may have several different lines of business, strategic business units, or products that you might wish to invest in, depending on how you're organized. Each of these

CHART 1

FLOW OF AVAILABLE PROFITS



would use some of the available funds in any one year. One key feature that you might look at is the relationship between that first-year available loss and the future available profits which will be realized in future years. If the internal rate of return, calculated using available losses and available profits (as opposed to statutory book profits) exceeds the required risk rate of return, then that would seem to be a good investment of available funds.

When viewed in this way, target surplus requirements play an interesting part in the calculation of internal rates of return for different lines of business. For example, statutory book profits have been used in profit testing for individual life insurance because surplus requirements for individual life insurance are not considered to be nearly as significant as they are for some other lines of business. In Chart 2, let's examine the relationships of the typical first-year commission and target surplus required to first-year premium for different lines of business. For universal life you might have $75 commission for a $100 premium for universal life and be required to put up surplus of $10 in the first year. For a single premium deferred annuity, the commission might be $5, and the target surplus might also be $5; the amount of surplus required and the selling cost are very close together. On group health, the commission might be $10 and the target surplus might be $20, twice the level of the selling cost. You may find a similar relationship for property casualty insurance: $15 commission and $33 target surplus.

CHART 2

RELATIONSHIP OF COMMISSION AND REQUIRED SURPLUS TO FIRST YEAR PREMIUM

	Universal Life	SPDA	Group Health	Property Casualty
Premium	$100	$100	$100	$100
Commission	75	5	10	15
Required Surplus	10	5	20	33

Let me briefly summarize this financial model before I discuss target surplus formulas. The financial model just described is based on projections of available profits, which are nothing more than the statutory book profits adjusted for a target surplus formula. By projecting these available profits in future years, both from existing business and from future business, the financial model can tell you a number of things. If the projected amount of free surplus over the next few years turns negative, the need for future capital infusions is indicated. On the other hand, if the projected amount of free surplus is growing larger, it indicates that excess capacity exists. The company probably ought to look at redeploying that capital elsewhere. If you examine the available profits and losses from each line of business, you can determine whether the line of business is, in fact, a capital user or a capital provider. The value of the company can be determined by discounting the cash flows from both free surplus and existing business, and return on equity measured on a "value added" basis.

Of course, the effectiveness of this whole system depends on the development of a meaningful target surplus formula. One approach to developing this formula is to carefully analyze the various contingency risks C-1, C-2, C-3, C-4 against which surplus is being held. To do this, you're going to need the services of the corporate actuary. His skills could be used to analyze the risks in numerable detail, particularly the C-3 risk, which is more qualitative than quantitative.

We have moved into an era of scenario dependent profit testing with dynamically linked variables. If you ask the corporate actuary for a target surplus formula, he'll generally say, "No problem, I'll give you forty or fifty of them. We'll just run 40 or 50 scenarios randomly generated."

At the other end of the spectrum are the target surplus formulas developed by rating agencies such as A.M. Best company. A.M. Best's target surplus formula for large companies was reproduced in Don Sondergeld's paper, "Profitability as a Return on Total Capital," which was published in the *Transactions*, Volume XXXIV, p. 417. There are several things to keep in mind when you look at this formula. It is reproduced on Chart 3.

CHART 3

THE A.M. BEST TARGET SURPLUS FORMULA
(FOR LARGE COMPANIES)

Individual Life	3% of Reserves
	\$4.80 Per \$1,000 of Permanent Insurance
	\$2.40 Per \$1,000 of Term Insurance
Group Life	3% of Reserves
	\$1.20 Per \$1,000
Annuities	3% of Reserves
Health	24% of Premium

The formula above is applicable to a large company; generally higher amounts would be required for a smaller company. How much higher? Well, it's been suggested that you might divide these parameters by 0.6, for example, to get the factors that are more applicable to a small or medium-sized company. However, it should be remembered that these numbers are not cast in concrete, but generally used as guidelines in establishing a company's overall rating.

In the calculation of actual surplus which is compared with a target, surplus amount losses in a line of business as reported on page 5 of the Annual Statement are deducted from actual capital and surplus in the year the test is applied. This suggests that you might employ an accountant who is sufficiently creative and flexible in matters of allocating net investment income and expenses to avoid that result.

Just because you hit the target in the A.M. Best formula in one year, doesn't necessarily mean that you'll automatically receive a high rating. I think most companies have found that A.M. Best is looking for consistent results over a period of time, and this is generally the key to higher ratings.

While the formula works reasonably well at the macro level, it has real problems when applied at the micro level. Applying it in pricing work and applying it to specific lines of business can produce unusual results. For example, the percentage of reserves used is the same regardless of the line of business. Because it is recognized that a little bit higher amount is required for individual life, a $4.80 factor per thousand of permanent insurance is added while only half that amount is used for term insurance. So, for example, on a universal life policy, if the target annual premium is $9.60, the target surplus required at the end of the first year, as determined by the A.M. Best formula would be at least 50% of the premium. Most actuaries would view this as an excessive amount. If an internal rate of return calculation is made on that basis, I think you'll find it would be difficult to meet one's required risk rate of return.

For annuities the A.M. Best formula is 3% of reserves. A single premium deferred annuity product or single premium whole life product with a sufficient mismatched risk, sold in a market that is highly sensitive to changes in interest rates may find that 3% of reserves is not enough.

It's my belief that for most companies the proper target surplus formula is established with an eye towards both the theoretical contingency risk and also the practical requirements of the rating agencies, such as A.M. Best.

Chart 4 is the target formula of a large mutual company that was reproduced in a paper published by Lincoln National Life people several years ago. This formula was volunteered by the actuary of a large mutual company and was developed more in line with what generally were to be the surplus levels of peer companies at that particular point in time. I would suggest that this is the general type of formula that's most appropriate in most companies today. The actual numbers might be different, but the way in which they're stated (the percentage of individual life reserves, an amount per thousand of term insurance, a percentage of individual health premiums, a percentage of annuity reserves, a different percentage of group pension reserves, etc.) is more in line with the type of formula that would be used by a company in its financial models. The formula is developed by considering a number of factors, including the size of the company, the nature and extent of the contingency risks that are faced, the level of reserves held, the importance of an A or an A+ rating from A.M. Best (which could vary from company to company), and the cost of capital that is willing to be incurred. Holding target surplus amounts of any level have a cost associated with them and they should be recognized in pricing.

CHART 4

TARGET SURPLUS FORMULA OF A LARGE MUTUAL COMPANY

7% of Individual Life Reserves
$1 Per $1,000 of Term Insurance
33% of Individual Health Premiums
5.75% of Individual Annuity Reserves
3.25% of Group Pension Reserves
2% of Separate Account Reserves
15% of Group Life and Health Premiums
5% of Supplementary Contract Reserves
3% of Other Reserves

Practically speaking, the large mutual companies probably spend more time examining the theoretical C-1, C-2, C-3 risks and don't worry as much about their A.M. Best rating. On the other hand, small to medium-sized companies are very concerned with their A.M. Best rating, and, in fact, want to make sure that an A or A+ rating is obtained. They tend to hold relatively larger amounts of surplus for that reason.

Now that you can determine a target surplus formula under an approach such as this, you can define your target surplus amount and determine how much free or excess surplus you have. And, if you're fortunate enough to have excess surplus, Joe Fafian can probably tell you how you might redeploy it.

MR. JOSEPH FAFIAN, JR.: Let me begin my defining my assignment. I'll leave it to the others to define a methodology for calculating *surplus surplus* or *free surplus*. I think Bruce did a super job of discussing that issue. Let me define what I mean by surplus surplus or free surplus or excess surplus or whatever you want to call it. It's surplus not required to implement a company's current strategic and operating plans, whatever they may be. What are some alternatives for utilizing what I call surplus surplus or what has been referred to earlier in the program as free surplus or excess surplus? In some of the industry's more aggressive companies, what I describe as strategies for investing surplus surplus, may very well be included in a company's current strategic plan. But for most companies, what I'm suggesting, are some alternatives to be considered to supplement the typical strategic plan.

Why might a company have a different investment strategy for its surplus surplus than its other funds? As Bob said earlier, and I totally concur with him, there is only one reason. The goal of any alternative investment strategies for surplus surplus is to accelerate profit growth. A company must be convinced that it can obtain a higher return from alternative investment strategies than it can from its normal investments. Otherwise, it should not consider investing its surplus surplus in any different fashion than it invests its traditional funds.

With that as background, let me turn to my basic assignment. What are alternative strategies for investing surplus surplus? I'll focus on three basic questions. First, what are some of the alternatives for investing the surplus? We'll look at about a half dozen possible alternatives. Second, why should all these alternatives be considered? In other words, why should we expect that these alternatives will produce better results than traditional investments? And, third, what are the pros and cons of each of these alternatives? What are alternatives? What are the potential extra rewards that one can expect to receive, when you go ahead with one of these choices? Let's begin by looking at the alternatives we should consider.

STRATEGIES FOR INVESTING SURPLUS

At the risk of oversimplification, alternative strategies for investing surplus surplus can be divided into three broad categories: expansion, diversification, and what I refer to as venture capital. There are two basic ways to either expand or diversify. Either can be done through acquisition or through internal development.

Expansion can be accomplished through the acquisition of other insurers, the acquisition of other businesses, the acquisition of blocks of insurance in force, or through the acquisition of distribution systems. Expansion can also be achieved through internal development. You can develop your own distribution systems. You can certainly develop your own products. And, you can have internal development via geographical expansion or market expansion.

When it comes to diversification, you can diversify though acquisition or through internal development. You can diversify through the acquisition of other insurers. Acquisitions can be used to diversify either into new product lines or new markets that you're not currently in. You can certainly diversify through the acquisition of other businesses. Acquisitions can be used to diversify totally outside of the life insurance area. You can diversify through the acquisition of other distribution systems, either through the acquisition of marketing companies directly or businesses that utilize different distribution systems than you currently do. In theory, whatever you can accomplish through acquisitions, you can accomplish through internal development. You can start other businesses, you can start other distribution systems, you can enter other markets.

The last alternative is you can view your surplus surplus as venture capital. You can invest these funds in something other than your basic business, or businesses that you want to diversify into. So those are the fundamental alternatives that I see for investing surplus surplus.

Let's turn and see why each of these alternatives should be considered, and let's also look at the pros and cons of each alternative. The first alternative is expansion or diversification through the acquisition of other insurers. As I see it, there are at least five reasons why you ought to consider the acquisition of other life insurers with your surplus surplus funds.

One reason to acquire companies, is to acquire new distribution systems. If you examine the life acquisitions of USLIFE, you'll find that most of them were motivated by expansion rather than diversification. Most of the companies that were acquired were selling individual life insurance. They were selling in different parts of the country than the other USLIFE companies were, and in some instances they were selling through a branch system rather than general agent (GA) system. But, the acquisition resulted in bringing new distribution systems to the group.

If you examine the acquisitions of Associated Madison, which is American Can's financial services holding company, you'll find that in each acquisition, a new distribution system was acquired. These acquisitions were more diversification oriented than expansion oriented. Each acquisition brought a new distribution system to the group. In most cases the new distribution systems sold products that the other companies in the group did not currently sell.

In today's rapidly changing world of life insurance, does a company want to bet its future on any one distribution system? I suggest not. Acquiring distribution systems can be an important objective to be achieved by an acquisition program.

The second reason to acquire companies is to enter new markets. You may want to expand by acquiring new markets for products you are already selling. As I indicated, that's basically what USLIFE did. Or you may want to diversify by acquiring completely new product lines and markets. That's basically what Associated Madison did. So, entering new markets is an important objective that you can achieve through an acquisition program.

The third reason to acquire a company is to achieve expense savings. Some companies have done an outstanding job of reducing unit expenses through acquisitions; companies like ICH, American General, and USLIFE in the old days. This has enabled the companies to expand their markets by being able to be much more competitive in their product offerings. So, achieving expense savings through consolidation is an important objective that you can achieve through an acquisition program.

The fourth reason to acquire a company is because of the added value you can bring to the company. Added value comes in a variety of different ways. You may be able to expand by selling your product through their distribution system. You may be able to expand by selling their product through your distribution system. You may be able to increase the company's investment income through redeployment of their assets. You may be able to reduce future income taxes through tax consolidation and you'll certainly be able to eliminate unprofitable lines of business. Thus, added value means that you can bring something to the company that it cannot, or will not, bring to itself. Eliminating unprofitable lines of business sounds like a very easy thing to do, and yet it's amazing how many companies would be reluctant to reverse their own decisions. When you acquire those companies it's a fairly mechanical thing.

The fifth and final reason to acquire companies is to acquire or expand management capability. Do you want to diversify with a management team that is not familiar with your new market or new product? Do you want to begin selling in a new geographical area when your people are not familiar with all the bandits that are in the field? Acquiring management can be a very important objective that's achieved by an acquisition program.

Now that we've discussed the reasons to consider expansion or diversification through acquisitions of other insurers, what are some of the pros and cons of such a strategy? The price of an acquisition can either be a positive or a negative. Companies are sold for more than they're worth. Companies are sold for less than what they're worth. Why does this occur? I think for openers, what does worth really mean? In my opinion, very often potential buyers and sellers do not focus on what a company is worth to them.

Let me use an example from my personal experience. In the early 1970s, USLIFE acquired Eastern Life, a New York company, and merged it with its own New York company. The merged company did not have any more staff positions than United States Life did prior to the merger. The merged company retained most of Eastern Life's general agents. The merged company discontinued the Eastern Life's unprofitable group line. And, the merged company kept many of Eastern Life's more capable executives.

Obviously, this company was worth a lot more to USLIFE -- the buyer -- than it was worth to the seller. In a way this represented an ideal acquisition. The price paid by USLIFE was more than the company was worth and yet they made out. So everybody won, yet USLIFE overpaid. So price can be a pro or con.

The next thing to consider is what I refer to as culture shock. Again, this too can be a pro or a con. The personnel from a newly acquired aggressive company can bring a new culture to the acquirer and make it more aggressive. Again, the best example I can think of is based on my personal experience. The first acquisition in the financial services area by American Can was that of Associated Madison. At that time, Gerry Tsai was the Chairman of Associated Madison -- today he's Chairman of American Can.

Just this week they announced their latest acquisition, the acquisition of Smith Barney. So he basically transformed the company from a manufacturing company to a financial service company. Recently, they sold their basic business -- their can operations -- and renamed the company. The reward to the shareholder was super -- stock prices have gone up almost fourfold. So clearly, a new culture came to American Can because of that acquisition.

In some cases, the personnel from the acquired company go into culture shock when they begin to interact with their new owners. This is particularly a problem when an entrepreneurial company is acquired by a staid, traditional, conservative life insurance company. Such culture shock can be either a plus or a minus, as I've said, but it's something that you have to evaluate if you decide to invest some of your surplus surplus in acquiring other insurers.

Last, but not least, you must consider due diligence. At the risk of oversimplifying things, the purpose of due diligence is twofold: (1) Before you close an acquisition, you want to send a team to the company and "kick the tires." You want to make sure you're really getting what you thought you were buying. And, you want to verify that the price you're willing to pay really makes sense for you. (2) You want to get to know the people. Will culture shock result in losing the people you were counting on to get the results? Or will it be a positive influence?

If done well, due diligence assures you that the objectives you've set out to achieve by the acquisition will in fact be accomplished. The only negative of a well-planned, executed due diligence program is that it is a tremendous drain on a company's resources. If due diligence is not planned and executed well, you're liable to have a real negative -- you bought a company and you didn't get what you expected.

We've discussed the acquisition of other insurers; let's turn now to the next alternative, the expansion or diversification through the acquisition of other businesses. In theory, you can expand your sales by acquiring new distribution systems for existing product lines.

Again, let me describe some personal experiences with this type of acquisition. At USLIFE we acquired consumer finance companies in part to get additional outlets for our credit insurance subsidiaries. This worked well -- we substituted USLIFE's products for those that were previously being sold.

We also acquired savings and loans with the view of utilizing their branches to sell life insurance. This didn't work at all. We were never successful in selling life insurance products through the S&L branches.

From my experience, I think it's fairly easy to acquire a business that is selling a product you offer, and substitute your product for that of a competitor. But, it's much more difficult to acquire a distribution system that is not selling your product and expect to achieve success by training and motivating them to do something new and begin selling your product.

Another objective in acquiring other businesses, is to acquire new products for existing distribution systems. Again, let me relate two personal experiences, ironically both with the same product, mutual funds.

In the late sixties, USLIFE along with many other companies in the industry, decided that life insurance products were no longer viable. We all had to have a mutual fund companion product. The package would keep pace with inflation, at least that was the theory. So to meet this perceived need, USLIFE went out and bought a mutual fund management company. That acquisition was basically a failure. Our field force didn't sell enough mutual funds to cover the costs that we incurred on setting up a broker dealer.

Now let me tell you a success story with the same product and that was at Associated Madison. We felt that the A.L. Williams sales organization was leaving a lot of change on the table. When they replaced a permanent insurance policy with term, they didn't have a vehicle to capture the cash value that made economic sense for everybody that was involved. So, we also bought a mutual fund management company. The results were sensational and the acquisition was very successful. Recently, American Can sold about 20% of the company to the public and received about three times what they paid for the whole company just two years prior, in large part because of the success of this operation.

So my feeling is that there are a lot of opportunities to acquire new products for existing distribution systems. However, the ones that work don't depend on creating a sales need that didn't exist before. Instead, the ones that work involve bringing their product to satisfy a sales need that already exists.

The next reason for acquisition of other business is to acquire a source of counter cyclical earnings. This was the theory behind the conglomerates of the sixties and seventies. I once had a fellow define diversification for me. I was told that diversification is where you take money that you made in a business that you know something about, and lose in a business that you know nothing about. Now that might be the real world, but at least theoretically, acquiring businesses should give you counter cyclical earnings, and it's an option that's available.

Another objective of acquiring other businesses is to expand management capability and technical expertise. For example, one of the benefits that was derived by many life companies that acquired mutual fund management companies was that a new perspective was brought to the investment of the life insurers' assets. Trading, investing in lower quality issues, etc., were notions that came to many companies in the life industry as a result of acquiring money managers, or in some cases of a money manager acquiring them.

Those are the reasons to consider acquiring other businesses, now what are some of the pros and cons? My comments with respect to price, culture shock and due diligence are essentially the same whether you buy other insurers or other businesses. However, there are two things I'd like to add.

If you think culture shock is a problem when you buy another insurer, you should see what happens when you buy another business. The people from both companies all speak English, but when it comes to business issues, it's very tough to communicate. You'll find compensation practices that absolutely shock people from the life insurance industry. You'll find nitty-gritty stuff like what we refer to as Exhibit 5 expenses, they refer to it as something else. You'll find a totally different regulatory climate. So culture shock takes on very many additional facets.

When it comes to due diligence, most life companies think they can assemble a team that can do a decent due diligence job on another life insurer. For the first acquisition that a company makes, I would strongly urge them to retain people that have been there before. I look at USLIFE again using a personal experience, and by the time I left the company we had developed perhaps the best acquisition checklist in the business. But let me tell you, in our first acquisition we really didn't know what we were doing. Without some help from Peat, Marwick, I think we would have been lost. We were fortunate that it all worked out well. When it comes to acquiring other businesses, it's highly unlikely that a life insurance company has the expertise to perform adequate due diligence. So they have to rely on outside help.

Expansion through the acquisition of other blocks of business is another option. There are two basic reasons to consider this alternative. The first is to reduce unit costs. If a company has a halfway decent data processing system, they can usually add a significant number of policies to their system without increasing their staffing costs.

Again, using a personal example -- when I was at USLIFE, the New York Company acquired the Northeastern block of ordinary in-force involving about 10,000 policies and we didn't have to add a single person to the staff. So obviously this reduced unit expenses.

The next reason to pursue this alternative, is that the acquisition of blocks of business can represent a potential source of additional sales. Someone has to service these policy holders and sell them additional insurance as their needs change. What are some of the pros and cons of this alternative?

The major pros and cons are price and the displacement of the business. As with an acquisition of a company, you have to determine what the block of business is worth to you, not what some actuarial valuation says it's theoretically worth.

The potential negative you have to consider is the displacement of the business. If you acquire a block of orphaned business, chances are lapses won't accelerate after you acquire the block. You can assign this business to your field force and provide them with, at least theoretically, a potential source of additional business. On the other hand, if you purchase a block of relatively new business, particularly if the field force doesn't come with the in-force, chances are terminations will accelerate and you have to consider that in your pricing.

There are two basic reasons to consider expansion or diversification through the acquisition of distribution systems.

The first is to increase sales and profits by acquiring a quasi-captive source of business. I say *quasi-captive* for a couple of reasons. First, if you buy a distribution system, you want to structure a portion of the sales price on an earn-out basis. Once you do that, you'll have to give the seller some freedom in running his own business so he may on occasion do business with other carriers. Second, the distribution system you acquire probably has some strong ties to their prior carriers, so again, it's quasi-captive. And third, I don't think any companies are left today that want to be all things to all people and so most companies don't offer every product that a distribution system might need.

In addition to acquiring distribution systems to increase sales, another objective is to retain a portion of the selling profits. When you look at what's gone on in our industry in the last several years, I sometimes think there's a lot more profit in selling life products than in manufacturing them.

In any acquisition of a distribution system, you have to make sure there is a match between the company and the distribution system. Are the distribution system's sales practices consistent with the acquiring company's philosophy?

How does the acquiring company's field compensation practices compare with what the distribution system is accustomed to? How much home office support does the distribution system receive from its current carriers?

You also have to worry about the stability of personnel. When you acquire a distribution system, you're in large measure acquiring futures. Will the principals that made the past results happen leave you? If they do, those futures are going to evaporate overnight. In addition to expanding or diversifying through acquisition, in theory, you can accomplish the same thing through internal development. You can develop new distribution systems. You can develop new products. You can expand geographically. You can enter new markets. You can start other businesses.

Whether you decide to expand or diversify through acquisitions or internal development is very much a company-by-company decision. I've seen both fail. I've seen both succeed. I used to have a boss that had a great phrase. The only time you're sure someone can accomplish something, is if they've done it before. Very often, that's where internal development efforts go astray. I consider myself an excellent life insurance executive. But every time I've ventured into the property and casualty business, I've totally failed. And I think diversification has that potential problem with it.

Let's look now to the last alternative for investing surplus surplus. There are many opportunities to utilize surplus surplus in the venture capital area. There are many people with excellent track records, and good ideas but no money or limited money. Certainly in the high-tech area there are numerous examples. But even within the life insurance arena, there are many companies that are capable of profitable growth, but they lack capital.

There have been two attempts that I'm aware of at starting a venture capital fund for insurance ventures. I participated in one -- but we just didn't raise enough dollars to make it interesting. Conning and Company participated in another and my impression is they got a small fund going. So there are plenty of opportunities to finance new ventures in the life insurance industry and the return is quite dramatic, and venture capital within the industry or outside the industry is another alternative.

Let's see if we can summarize. There are many ways in investing surplus surplus. Surplus surplus can be used to expand through acquisitions and internal development. Surplus surplus can be used to diversify through acquisitions, as well as to diversify through internal development. And last, but not least, surplus surplus can be used to invest in venture capital deals. Remember no matter what option you select, returns should be expected to exceed returns from traditional investments.

Let me suggest you get a copy of the March issue of *Best's Review*. There's an excellent article that Bob Shapiro wrote that I commend to all of you. It's right on the mark of a lot of issues facing our industry.

MR. RICHARD K. KISCHUK: Bob has given us a good strategic overview, and Bruce has shared with us his perspective on how to define and determine excess surplus. And then finally, Joe has defined a whole array of alternatives for utilizing excess surplus. I think at this point you might wonder what's left to be said. What I'd like to do is to try to put some of these concepts together and describe an integrated approach to the problem of how to invest excess surplus.

First, I'd like to say that I am somewhat troubled by the approach taken by many companies. You seem to see a lot of companies saying, "Gee, look at all of this excess surplus. Now what do I do with it all?" What I would suggest is, if companies are following that approach, it reveals a real weakness in the approach taken to both financial and strategic planning. Those companies are really putting the cart before the horse.

In light of our topic, I am going to suggest something pretty radical although it's right along the lines of what Bob suggested earlier. That is that the company should first forget completely about the whole issue of excess surplus. Instead, management should focus on developing a sound strategic plan.

In developing a strategic plan the company should focus on such questions as: What businesses are we in? How attractive are they? In each business, who are our competitors? What is our competitive position in each business? How will we sustain a competitive position? What businesses should we expand?

STRATEGIES FOR INVESTING SURPLUS

As Joe suggested, we need to look at the flip side of the coin, what businesses should we contract or get out of? (That's usually something that's tough for companies to face up to.) What goals and objectives do we have for each business? What strategic issues do we face? What are the appropriate strategies for each business? Obviously, none of those are easy questions to face; but, you really can't even approach the question of investing excess surplus until you've looked at each of these questions and answered them all.

A key element of the strategic planning process is to set an objective for return on equity. This is something you've probably heard over and over again, but it really is of fundamental importance. One reason for that is that return on equity is a very major determinant of the growth rate that a company can sustain with internally generated funds, without looking outside the company. Everything else being equal, the higher the return on equity, the higher the growth rate a company can sustain without looking outside for sources of capital. Of course, there are other factors that are relevant to that growth rate. Those can include things like the level of dividends paid to the owners of the company, whether they be shareholders or policyholders, and the level of capital gains that are generated from the company's investment strategy. Obviously, those could be more or less depending on how aggressive the investment strategy might be. But, a company should have an idea of what growth rate it can fund without looking to outside sources. This provides a very important perspective in evaluating the financial aspects of the company's strategic plan.

For example, suppose that a stock life insurance company is earning a 12% return on equity. Let's say that it's paying shareholder dividends of 5% on equity, and that it's earning capital gains of 3% on equity on average, due to an investment strategy of investing in real estate and common stocks. What long-term growth can this company finance from internally generated funds? While you have a return on equity of 12%, you also have capital gains of 3% on equity, for a total of 15%. And then you're paying out dividends of 5% on equity. So you take 5% off of 15%, and you have a sustainable growth rate of 10% over the long run. Now you look at the strategic plan. If the strategic plan implies a growth rate of less than 10%, let's say 7%, then the company will be building excess capital at the rate of 3% a year. If the strategic plan implies a growth rate of more than 10%, let's say 15% then the company is going to have to seek outside capital in order to sustain its strategic direction. It's important for a company to know which side of the coin it is on. This is an oversimplification, of course, and the actual task of determining the sustainable growth rate can be considerably more complex. In determining that, a lot depends on the accounting basis that the company is using for internal reporting. Some accounting bases lend themselves more easily to answering questions like that than others.

Why is it important to go through this exercise? It is critical because management needs to understand the difference between the company's long-term financing situation, as opposed to the position it may find itself in in the short run. For example, we've focused primarily on excess surplus in the positive sense. I think it's pretty obvious, algebraically, that in comparing actual surplus to target surplus and subtracting target surplus from actual surplus, you can end up with either a positive or a negative result. Obviously, it's easier to deal with a positive result but the result can be negative and then you can have a deficit surplus position.

Again, at the risk of oversimplification, we can define four basic situations that a company might find itself in. We'll first take the best situation and then we'll look at the worst situation last.

First, a company may find that it is overcapitalized currently, and that the company will be building excess surplus for the foreseeable future. This is a pleasant problem to have. Still, there is a real danger in this situation. Management may be tempted to invest surplus in ill-considered expansion and diversification strategies, thinking that if this year's investments don't pan out, there will always be more money to invest next year. This can work for a while but in time, if a company pursues this kind of approach this will result in declining returns on equity. Eventually it will cause a company to move into one of the other three situations, which are a little tougher to deal with.

Second, a company may find that it's overcapitalized currently, but that its growth rate cannot be sustained over the long run from internally generated funds. Here, the company has to be very careful in determining why this is happening. This is neither good nor bad, but in this case the company is consuming its excess surplus, and it's important to know why. The most desirable situation is where the company is earning good returns on equity in its existing businesses and it needs to find money to fund a number of excellent strategic opportunities. In this case, as long as management is reasonably sure of good returns from these growth opportunities, excess surplus will be returned to the company in due course. But, I think management needs to spend quite a bit of time making sure that's true and that it's not rationalizing bad investments. It's important that these investments are made pursuant to a sound strategic plan and that there's a good strategic fit for the company. Otherwise, it's too easy to rationalize poor investments.

On the other hand, a company may be consuming its excess surplus because it's earning poor returns in its existing businesses. Here, before considering what to do with excess surplus, management needs to take some corrective action to increase return on equity from the businesses it is in currently. A real pitfall, in this case, is for management to attempt to increase return on equity through a large acquisition, for example, rather than addressing the strategic problems in the company's basic businesses.

The third basic situation is where a company is in a deficit surplus position; that is, actual surplus is less than target surplus, but the company will be generating excess capital for the foreseeable future. If the deficit surplus position is not too severe, then management may not have to do very much in terms of corrective action. On the other hand, if the deficit is serious, then management may have to take a number of actions to try to bridge the gap between where they are now and the time down the road where the excess surplus that will be generated will cover the current short fall.

The most difficult situation to deal with is where a company is in a deficit surplus position currently, and the projection is that the company will be generating negative available capital. In this case, a company is not only in a hole, but it's digging itself deeper. I'm not going to go into a lot of detail on how a company might try to get itself out of that hole, except to say that corrective action is obviously going to be needed on a number of fronts.

I think life would be simple if it were obvious which basic situation a company is in. As I indicated, the type of management reporting system that a company is employing can make this easier or more difficult. And, unfortunately, a number of factors can conspire to mask the underlying situation.

For example, a company may be generating large capital gains in the short run, and it may feel that it's in a good situation even though the underlying situation is that it's eating into excess surplus. This might result from liquidating large investments at a capital gain, or from large stock market gains in a bull market, or from selling a business that the company is in. A company may be generating large capital gains from operations in a cyclical business that is at the top of the cycle. When a business is at that point everyone likes to think that that's the way things should be and a lot of times there's not a recognition that the bad times will come again. Or a company may get a temporary boost in its surplus from a decision to leverage or increase its debt-to-equity ratio. This provides a lot of capital to invest in the short run, but obviously, there's a limit to how far you can leverage a company.

In these situations, and you see this quite often, by the time management realizes that it's in a negative long-term situation, it may be too late to correct the problem. So it's obviously better to recognize and determine the basic situation the company is in well in advance and determine how a company should be managing its excess surplus position.

The key points that I want to make here are that company management should be driven by a well thought out strategic plan and that surplus is one of the key resources needed to implement a strategic plan. The evaluation of a company's excess surplus position is obviously a key aspect of evaluating that resource. However, management should consider both the company's current excess surplus position and its sustainable growth rate in making decisions about what to do with that excess surplus position. This is not an end in itself. Management should never put the cart before the horse by evaluating its excess surplus position and then backing into a strategic plan.

MR. FREDERICK S. TOWNSEND, JR.: I'd like to thank the speakers for preparing their presentations today on what's a very technical subject. One thing may have escaped my attention, but I didn't hear anybody mention investing surplus surplus and buying back their own stock, which is an option today for publicly held stock companies. The life industry is being battered by a number of factors to include sales being down in recent months, higher tax rates in 1987, very punitive guidelines coming out from FASB, from GAAP accounting, and the AIDS cloud overhanging the life industry. We have a number of major life insurance companies selling at 70%-80% of their GAAP book value. So, it's an ideal time for companies to achieve reward in returns by buying back their own shares in the marketplace and a number of major capitalized companies have programs authorized by their boards of directors, to include Mr. Fafian's ex-company, and Mr. Kischuk's previous employer, which I think is authorized to buy back up to 115% of book value.

MR. KISCHUK: I didn't mention that in my remarks, although that was certainly in back of my mind. One perspective that I have is that that alternative is really a benchmark alternative that should always be considered. I would generalize it to include returning capital back to the owners of the company in any form, whether you're paying dividends to policyholders or paying dividends or increased dividends to shareholders or buying back stock. The key question is where is the money better off -- in the hands of the company or in the hands of the owners? I think that is something that should always be looked at. The other thing I would mention is that there has been some emphasis in the past on buying back stock for stock companies but the alternative of increasing dividends has become a lot more attractive under the new tax reform act. I think we may see some more of that, but it amounts to the same thing.

MR. SHAPIRO: If an organization is thinking of diversifying into unrelated businesses, I believe it should consider returning the money to shareholders (or policyholders) as an alternative. Many would argue that the shareholders can make this kind of investment as well as the company; at least they should be given the choice.

MR. E. PERRY KUPFERMAN: Joe, you mentioned some bad luck in trying to diversify from life into casualty. Does anybody have any successful experience in bringing casualty and life together? Also, could you elaborate on why you think companies and/or yourself have not had great success in bringing life and casualty together? I also was wondering if anyone on the panel might comment on the subject of utilizing surplus for reinsurance.

MR. FAFIAN: As far as property and casualty (P&C), my reference is more to a personal failure although it happened to be a corporate failure as well. At the sales level I can think of one success story, where I've seen the Life and P&C sold by one organization successfully. That was the most unusual arrangement you ever saw in your life. You walked into their operation and they had a common reception area, and one brother ran the P&C side and the other brother ran the Life side. If you look at most of the Life -- P&C marriages, they don't seem to work at the sales level. If they don't work at that level then you ask, if you are you really marrying two businesses or if you are in two fundamentally different businesses. If you think of all the multiline companies, they didn't seem to have had the outstanding success distributing either one of the products from the other distribution systems. Some have succeeded at both games, but for some reason they appear to be two different games.

MR. KISCHUK: I'll say a couple of things about the second question (using surplus for reinsurance). I think, from the strict financial standpoint, one might evaluate that in terms of what return you can get versus alternative uses. The main comment I would make is there are obviously a lot of pitfalls, and it really revolves around the question of whether you have the expertise to enter that arena or not. Certainly, it is not a business you'd want to dabble in, especially with the wrong people. And, I think, especially on the property and casualty side, we're now hearing all kinds of horror stories emerging from what went on during the recent period when a lot of companies were dabbling in reinsurance. They got involved with a lot of the wrong people managing general agents, brokers, and so on. Some of the losses are just horrendous. Another real issue is, if you get involved in reinsurance, who do you retrocede business to? You need to make sure that those are people who are going to pay their claims. Again, that's a problem that has come back to haunt people in the property and casualty business.

MR. SHAPIRO: The other side of the coin is that, even if successful in a financial sense, using surplus for reinsurance avoids the real issue of how to strategically deploy available excess capital. Management time is diverted from businesses with which management is familiar. When the surge of profits comes back in future years, the company may not yet have the needed plan for deploying the now larger excess surplus.

MR. SOLOMON GOLDFINGER: Mr. Fafian, I was wondering if you could clarify the process of comparing the rate of return for investing free surplus versus what's available from what you call a traditional investment of surplus. What's troubling me is that most traditional investments don't involve any investment of surplus and that if you buy a bond, say, a normal investment, it's an investment of cash but it involves no reduction of surplus. So, what are the traditional investments of surplus? Also how do you compare an investment that involves a reduction of surplus versus one that doesn't?

MR. FAFIAN: The basic premise I was dealing with was surplus surplus, whatever that means. So the notion of reduction of that surplus having any intrinsic value, would be foreign to the notion that implies you don't need that surplus, but you would like some alternatives on what to do with it. If you look at the return notion, certainly in acquisitions or diversifications, it's just a yield calculation, if you will, over the long term, whatever period you choose to use long term. (It was interesting that at USLIFE five years was long term, while at Associated Madison three years was long term.) What kind of returns can I expect from this acquisition and how does that compare with what I can get just in a normal market?

MR. GOLDFINGER: What do you mean by the normal market?

MR. FAFIAN: Normal market might be bonds, mortgages, etc.; the traditional types of investments.

MR. GOLDFINGER: How do you calculate that in return on a surplus? One involves reducing your surplus the first year, or some number of years and getting it back, and the other involves not reducing your surplus. It seems to me that you're looking at one thing that's free in terms of surplus and one thing that's not free. That should be taken into consideration, the fact that it's free surplus. Therefore, it's not important that it uses up the surplus.

MR. FAFIAN: In my mind, if I look at surplus surplus, these are not funds that I need to run my business, to have whatever rating I need or any other consideration. This is a pile of gold that's left over. If I put it in a traditional investment, a mortgage, a bond, what have you, etc., I expect to get some kind of yield and I have some risk depending on the quality of that investment. If I put it into an acquisition or diversification effort or an expansion effort, I can project out what I expect the revenue stream from that to be, again with some associated risk to it. How do the two compare?

If you're dealing with part of your basic surplus then I think that that's a different ball game. You have this fantastic return but the insurance department is going to close you down next week because you don't have enough statutory surplus. For surplus surplus that shouldn't be an issue, in my opinion.

MR. HENRY B. RAMSEY, JR.: I just want to point out that Rick's commentary applies very well to mutual life insurance companies as well as to the stock companies. In particular, since they don't have any other way to get capital, your commentary is right on line. But to do that, you have to make the kind of analysis that Rick talks about, which is really determining what your capital investment is in your business and what kind of return you are earning on blocks of business. It's the kind of analysis that a number of companies are really starting to make now, but haven't in the past. But, if you're going to do that kind of planning, you have to do it and it's just as applicable in a mutual company as it is in a stock company.

MR. ROBERT L. SPIES: We've had some discussions recently in our company with the investment people on how to invest the target surplus. I'd like to hear comments on the two schools of thought that we've discussed. Number one, invest it the same way you chose the assets that are appropriate for the liabilities. Number two, target surplus is to cover those unexpected occurrences; they can happen any time, so you ought to be fairly conservative, in shorter term paper. We haven't resolved it yet, and I'd like to hear your comments.

MR. NICHOLSON: I don't think there's an easy answer to that one. If you look at target surplus inside your pricing formulas and are trying to establish sufficient internal rates of return on your invested funds, you need to get as high a yield in those funds as you possibly can just like you're trying to achieve on your invested assets. Because, in fact, the difference between the rate of return that you're able to achieve after taxes on your target surplus funds is being discounted at a required risk rate of return considerably in excess of that. I would be more of a proponent of investing to achieve as high a yield as I possibly could, consistent with my strategy on the liability side.