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SOURCES OF CAPITAL FOR INVESTMENT AND NEW BUSINESS

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Panelists: ARDIAN C. GILL
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Recorder: ANDRONICO LUC CASTILLO

- o Discussion of innovative ways in which capital can be obtained for investment and new business, including:
  - -- Collateralized mortgage obligations
  - -- Sale -- leaseback transactions
  - -- Sale of nonadmitted assets
  - -- Upstream and downstream affiliates
  - -- Reinsurance transactions
  - -- Debt and equity financing
  - -- Joint ventures

MR. JOHN H. FLITTIE: The last few years have seen an increasing realization among life insurance companies of the need to raise capital. This is a new development for many companies as they find that capital is needed to satisfy growth objectives: growth to take advantage of opportunity, growth to get critical mass in certain operations, and to finance external growth by acquisition. They've needed capital to finance new distribution systems, capital to finance new lines of business, capital to finance diversification, capital to finance technology, and maybe capital to finance demutualization in some instances.

This need for capital has certainly been fueled by the increased competition and product revolution that's gone on in the life insurance industry. It's been

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fueled in many cases by lower statutory earnings and rather erratic returns on equity (ROEs). It's been fueled by the tax uncertainty of the Federal Income Tax law in the United States where companies have had to be nimble on their feet in their capital planning. And perhaps, it's been fueled by the fact that there are many new players in the life insurance industry in the United States and Canada representing large overseas pools of capital or perhaps pools of capital that were developed from outside the insurance industry in the United States.

My company, Northwestern National Life, a medium-sized company with about $6 billion in assets, is typical of what has happened in the realization of the need to raise capital. We went the first 99 years of our existence without a trip to the capital markets. Suddenly in the past three years, we've taken nine trips to the capital markets: two public stock offerings in the parent company, a private stock offering in a subsidiary company, a commercial paper sale, a surplus relief agreement in one of the subsidiaries, and four sales of securitized assets through unit investment trusts. More trips to the capital markets are likely. Three major streets in the United States have come into our life: Main Street U.S.A., where our agents operate every day; Pennsylvania Avenue, where laws affecting taxes are made; and Wall Street.

We have two Wall Street investment bankers on our panel, both of whom had extensive home office life insurance company experience before getting their red suspenders and moving downtown. We also have a well-known reinsurance intermediary, who is also a merger and acquisition specialist. These three gentlemen will give you a variety of slants on our topics today. They may not always agree, and that's probably good. Bob Hogue is a Vice President, Corporate Finance at Prudential-Bache. He specializes in mergers and acquisitions and capital raising for both stock and mutual companies. Bob is Chairman of the Society of Actuaries Committee on Life Insurance Company Valuation, a member of the Committee on Valuation and Related Areas, and a member of the Organization Committee for the Investment Section of the Society. Charles P. Menges, Jr. is a Vice President and shareholder in Kidder Peabody's investment banking operations and as a senior investment banker, specializes for the insurance group in developing and executing new business opportunities in the insurance industry. Prior to joining Kidder, Charlie spent 20 years with the Equitable in a variety of investment and financial management positions, most recently as a

vice president in Equitable's Treasury sector. Charlie is a Certified Financial Analyst, a graduate of Fordham University and received his M.B.A. from St. John's University. Ardian Gill is one of the founders of Gill and Roeser, Inc., and its subsidiary company, G&R Intermediaries. These companies function as reinsurance intermediaries and merger and acquisition specialists in the insurance industry, both property and casualty and life. Since their founding in 1983, Gill and Roeser have transferred in excess of $3 billion of reserves between companies through reinsurance and recently completed a significant transaction on the sale of a life company to a nonlife insurance entity.

MR. ROBERT D. HOGUE: When John mentioned a number of reasons why life companies are going to the equity market, he took away most of my introduction. No good presentation is complete without an overview of the changes going on in the industry.

If you have read Jim Anderson's paper and the ten thousand similar papers that have been produced on the same topic, you won't find anything new. I will summarize those elements of change and the different kinds of impacts that are hitting life insurance companies of any kind these days that would affect their attitude towards capital. The things that we see that affect people's concentration on capital are questions on whether or not they have sufficient capital, whether they should raise capital, and whether they are managing capital properly.

1. The distribution system, especially the cost of it, seems to be concerning people.

2. People are concerned about the increased competition from noninsurance financial institutions. A number of equity and debt transactions have occurred that seem to be addressing this. The full financial service is impulse. If you're taking over my territory, I'm going to take over yours; and I'll do it with more money faster than you can do it.

3. Disintermediation: money is moving out a little more rapidly than companies want, they're losing their profit stream, and they're tending to replace that with capital.

4. The cost of product development, especially the systems: a number of companies look at their variable product or their registered products. They operate differently. They demand more capital to write. They are looking to capital specifically to write those kinds of products.

The results of all these are:

1. Loss of traditional savings dollars. This is going to be a problem. And also, the loss of the income that goes along with those savings dollars.

2. Reduced demand for pure life products. People are really in the investment business with the mortality overwrite. That's the kind of business you're in and it requires a different kind of capital structure to run a business like that.

3. Need for new investment products. You're competing with banks, S&Ls, other kinds of intermediaries that are selling those kinds of products.

4. Lower profit margins. I think it is very, very obvious. More and more companies are looking hard. Numbers indicate that the very profitable products are declining as a percentage of the portfolio, and the relatively unprofitable products are increasing as a percentage of the portfolio. And they're running against a kind of wall. When you can't depend upon high renewal profit streams, you tend to think more in terms of capital needs.

5. New distribution systems. Agent loyalty is probably a thing of the past. If you're going to compete for agent loyalty, you have to compete on product and price and expensive backup service. And that requires a higher investment. Many of those investments are intangible, but they are certainly higher.

6. Higher lapse rates. Business is not on the books for 15 or 20 years anymore. It's between 5 and 7 for most companies. Some companies are even talking less than 5 at this point. So the average life expectancy of the products you are writing is decreasing. You won't get the acquisition cost returned on a number of products that you're writing today.

Companies in the past, especially mutual companies, tend to look at defining a certain surplus ratio as being their central capital management philosophy. They depended upon a renewal profit stream to replace that ratio. They could write business. They could pay dividends -- do whatever they had to do. Or, they could have capital expenditures within the context of keeping that ratio between a couple of stated outer limits of their financial objective. I would hope that capital management for life insurance companies will not be this way anymore. Insurance companies will manage capital much the same way other financial institutions or the nonfinancial institutions manage capital. It is a resource. You'll have to spend a lot of your time as actuaries looking at the sufficiency of that capital. You're in a riskier business. More of that should be allocated to support the risk since statutory reserves are inadequate. More of that should actually be examined very closely for capital expenditure for expansions of some kind or another. I think John mentioned these things were already underway. People were already operating this way. We can take a look at that. I'm not sure I totally agree with John that that's absolutely true. I think we're seeing a start; but, to be perfectly honest, maybe the next speaker has a little more insight than I do, but I don't really see a pattern.

Table 1 is the amount of capital according to our data bank, which again might be a little different from someone else's data bank, since statistics on these things are not interpreted the same from company to company. But this is the amount of capital as raised by the industry over the last few years. As John mentioned, it's a very short time frame. This kind of activity has not been going on for very long, and I tend to look at it as beginning probably around 1984, when companies became very, very serious about capital.

What we saw in the life segment was a very phenomenal increase and it is fairly easy to draw a curve going concave upward very rapidly upon capital raising activities. Now bear in mind that there's a lot of different transactions here for different reasons. Obviously, we're talking about merger and acquisition currency. We're talking about a lot of debt raising which is really securitization, collateralization, leverage or arbitrage -- kinds of things which is an investment type of play rather than raising new capital for the company. But more and more of the new capital raising activity actually is going on.

TABLE I

CAPITAL RAISED BY U.S. INSURANCE COMPANIES[1] (IN MILLIONS)

	1984	1985	1986	1987	TOTAL
LIFE	$ 449	$ 1,522	$ 3,205	$ 1,824	$ 7,000
PROPERTY / CASUALTY [2]	212	4,043	5,367	604	10,226
ACCIDENT / HEALTH	12	30	65	0	107
MULTILINE [3]	435	1,794	1,358	1316	4,903
TOTAL	$ 1,108	$ 7,389	$ 9,995	$ 3,744	$ 22,236

(1) EXCLUDES ASSET REDEPLOYMENT.

(2) INCLUDES REINSURANCE.

(3) PROCEEDS TO MULTILINES WERE GENERALLY CONTRIBUTED TO PROPERTY / CASUALTY SUBSIDIARIES

The property/casualty (P/C) pattern seems to have been primarily to generate capital because of loss reserve requirements. On the life side, at least, I think we're going to be doing that same thing as statutory rules become more defined, as the committee that's putting together a new valuation law comes up with something, as people really look at statutory reserve standards and come out with something that's going to be longlasting and fairly firm. I think the reserve requirements are going to be more strenuous than they are; and I think a lot of companies are going to go out to raise capital to set up adequate reserves for the universal life business. So this is something. I don't think the casualty companies are alone in being caught short of reserves, although our problem won't be anywhere near as severe as theirs.

The kinds of capital that companies are raising (again there are a number of transactions) seem to be for different reasons (see Table 2). I tend to look at them in this way: I look at debt, I look at equity as being two extremes; and in between there's convertible debt and preferred stock. The pattern for the life companies seems to be very, very strong on the debt side, whereas the pattern for the P/C companies is very, very strong on the equity side. Again, I think the life companies are probably looking at a cycle that the P/C companies had gone through at one point in time. We may see more equity issues even from the mutual companies. Some of them are starting to talk that way in a very, very brief kind of way today. These numbers are here to kind of illustrate, to set the tone. The activity is there. I hold the activity is going to increase. I hold right now there's a mixed pattern that we don't know about yet. What I see (and it's probably very, very naive and simple) is "innovation."

Have we seen innovation? I've seen a few transactions that I would call innovative, but to date I haven't really seen a pattern of what companies are doing. I haven't seen companies be as creative in their capital raising as they have been in their merger and acquisition activity and that sort of thing. The same kind of strategic thinking doesn't seem to be formulated yet for capital raising, but I think the industry and the Society will move in that direction.

What I see is companies going after the lowest cost capital; in the U.S., in bonds, debt structures, playing to the market. If the market wants warrants,

TABLE 2

FORMS OF CAPITAL RAISED BY U.S. INSURANCE COMPANIES[1]

	1985				1986				1987			
	Debt	Convertible Debt	Preferred Stock[2]	Equity	Debt	Convertible Debt	Preferred Stock[2]	Equity	Debt	Convertible Debt	Preferred Stock[2]	Equity
LIFE	714	475	113	220	2,363	106	525	212	1,297	175	220	132
PROP. / CAS.[3]	465	160	1,025	2,393	1,450	371	305	3,241	250	0	210	144
ACC. / HEALTH	0	0	0	30	25	20	0	20	0	0	0	0
MULTILINE[4]	600	0	625	569	500	70	125	663	1,316	0	0	0
TOTAL	1,779	635	1,763	3,212	4,338	566	955	4,136	2,863	175	430	276

(1) EXCLUDES ASSET REPLOYMENT

(2) INCLUDES CONVERTIBLE PREFERRED.

(3) INCLUDES REINSURANCE

(4) PROCEEDS TO MULTILINES WERE GENERALLY USED TO INCREASE PROPERTY / CASUALTY RESERVES

they give the market warrants. If the market wants calls, they give them calls; or whatever -- going simply after the lowest cost. When Europe is cheaper, they go to Europe. When they don't want to do GAAP, when they don't want to get an S&P or a Moody's rating, they go to Europe. And I think a lot of activity is over there.

The other, especially on the debt side pattern, seems to be a lot of leverage. You hear the terms collateralization, securitization, the mortgage pools and these kinds of things -- simply leveraging on market conditions. If you can put money out at 10 and put it in something to earn 12, then you are leveraging. And there's a lot of this activity going on, especially with the large players. Large eastern mutual companies are doing a lot of this.

Into the future, I predict (this probably isn't worth very much) that companies will get into the capital management business. I think guaranteed investment contracts (GICs) are an emerging indication of a kind of security that the industry will get into. We're already talking about secondary markets for GICs. People are already asking about the formulation of GIC pools, securitizing GICs like we do mortgages. I think the industry is in a position to have instruments like that to do these kinds of things.

The other thing I think most companies will eventually be going after (and many are, right now in increasing numbers) are S&P and Moody's ratings. If you haven't done so, I would suggest that you think about that. You'll probably have to stand in line because those two agencies are very, very busy.

MR. CHARLES P. MENGES, JR: Bob spoke specifically about the capital raised in the insurance area. I think it would be well to set the tone and take a look at what's going on globally over the last five years in the capital markets. I'll take a look at both the debt and equity side on a public basis. Also, I've been able to gather some statistics on the private financing, which would give you a directional feel for what's going on in the private markets in terms of raising capital. I will just give a little overview and reinforce some of the themes that Bob shared with you on the insurance industry. Then, I can give you some thoughts and views on transactions that have taken place in the last two years, which are very significant. As John pointed out, he has been in the market some nine times in the last several years, and we see that trend continuing. In

sharing some of these transactions, I think you will get a feel for the scope and size of the challenge for the insurance industry and the challenge for us on Wall Street to help the insurance industry grow and raise capital. Today, capital markets are global in scope and have experienced unprecedented volatility and expansion. Also, many new financial instruments and vehicles have proliferated.

You can see in Graph 1 that this is all the public debt offerings that have been going on since 1982. You will see the enormous amount of activity going on in the last three years; in 1986, some $270 billion was raised in the U.S. capital markets for all industries. We see that trend, of course, continuing into 1987.

Similarly, see on Graph 2, on the public equity markets, 1986 was a record year. 1983 was similarly very high, again reflective of stock prices. Stock prices are at historical highs. I think the market was up $15 yesterday. The comment I would have on the public equity markets, and I think you are all familiar with that, either from an institutional standpoint or a personal standpoint, is the volatility. We see tremendous volatility going on in the equity markets. And, of course, there's the computerized training programs going on that sensitizes the market even more so. So going forward, I would say there are exciting times and challenging times in these public equity markets.

Again, Graph 3 gives you a feel for the private debt offerings. You can see that trend going up also. And on the private equity offerings, some $16 billion was done in 1986, a record year. (See Graph 4.)

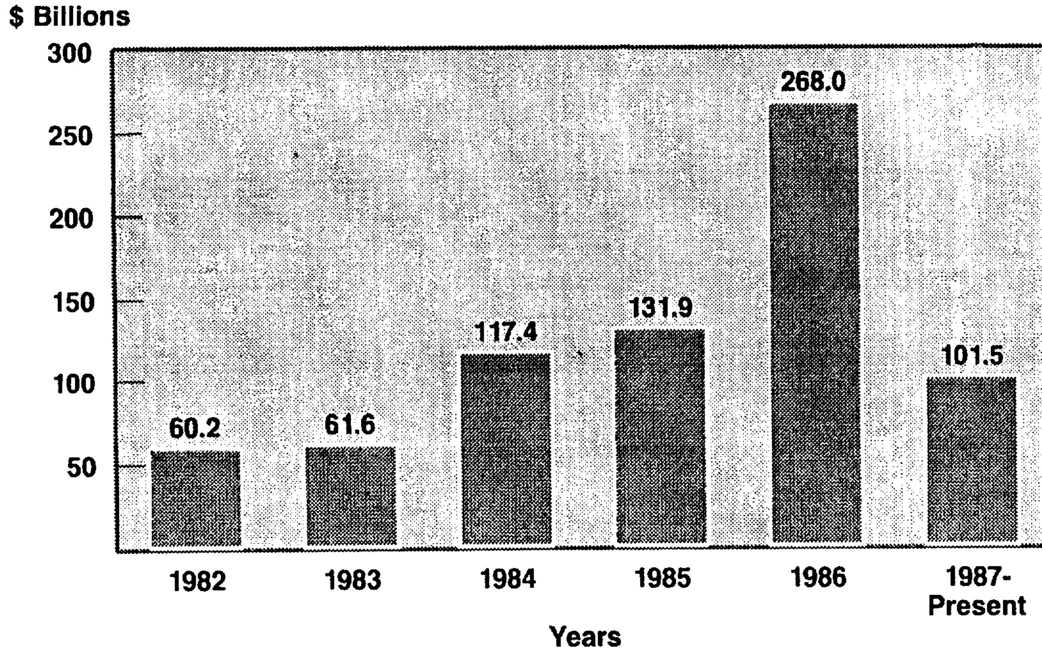
Insurance companies are no longer strangers in those markets. They regularly issue equity bonds, Eurobonds, commercial paper, and variable rate instruments, as well as securities backed by portfolio assets such as residential and commercial mortgages. The next series of numbers (see Graph 5) are some of the same kinds of numbers Bob shared with you, cut a little bit differently. Don't challenge us on the accuracy of the numbers. He takes different assumptions than we do. This is all of the insurance industry, and (I believe Bob's numbers probably were those as well) includes life and property and casualty.

On Graph 5, you can see that in 1986, we the insurance industry went to the markets for some $5 billion on the debt side and $3.2 billion on the equity side. Again, that trend is going up.

GRAPH 1

Expansion of U.S. Capital Markets

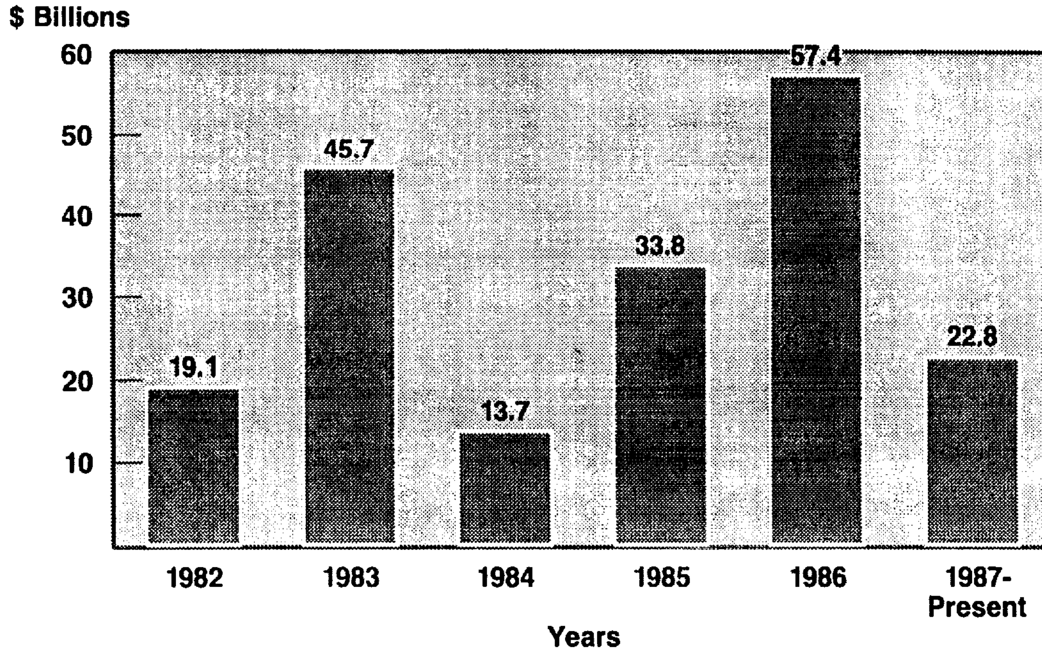
Public Debt Offerings



GRAPH 2

Expansion of U.S. Capital Markets

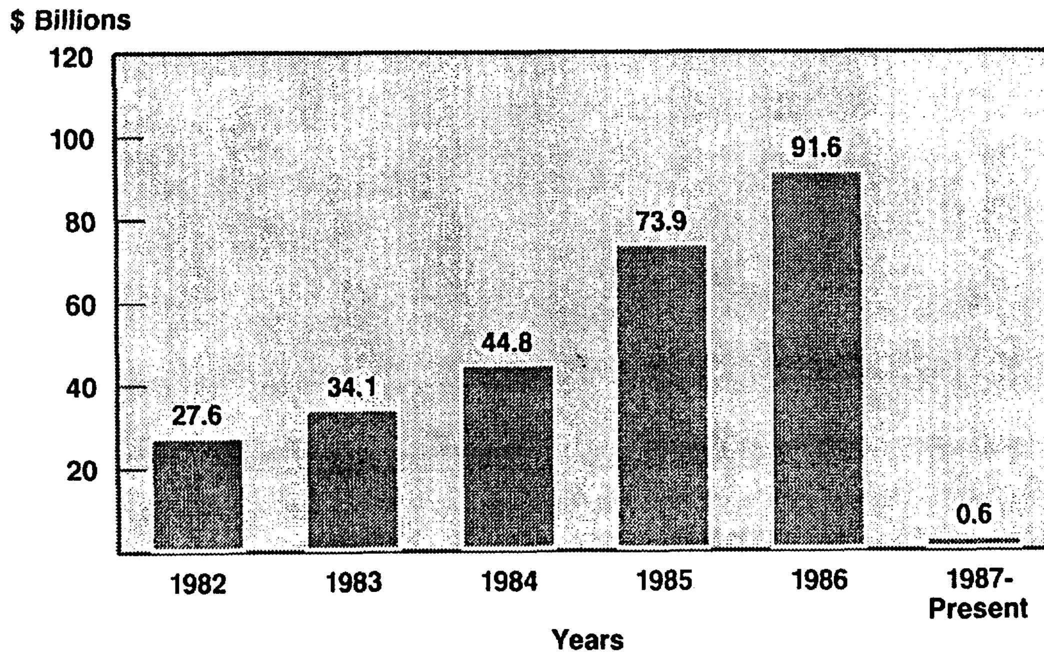
Public Equity Offerings



GRAPH 3

Expansion of U.S. Capital Markets

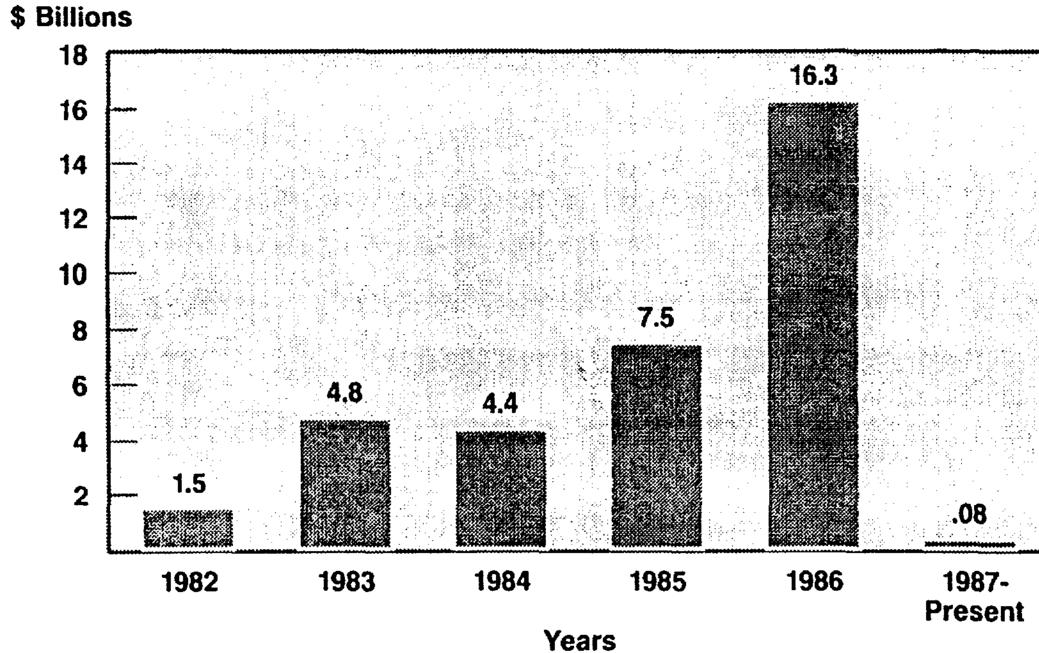
Private Debt Offerings



GRAPH 4

Expansion of U.S. Capital Markets

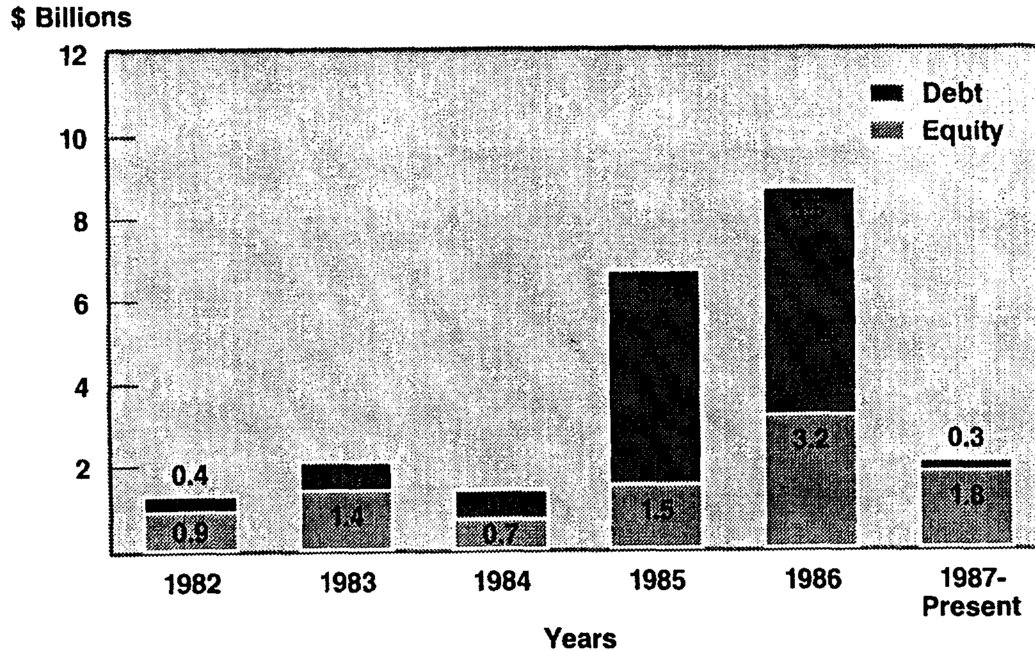
Private Equity Offerings



GRAPH 5

Insurance Industry Financing Activities in the Capital Markets

Public Debt and Equity Offerings



Bob did a very fine cut in defining the different types of securities as well. Graph 6 is your private debt and equity offerings, and you can see in 1985, there is an enormous amount of private financing done in the industry. John's company, Northwestern National Reinsurance Company, is in that statistic for some $30 million. We didn't see as much in 1986, and we don't have data for 1987.

Some of the following financings will give you a feel for the variety and size of transactions that have gone on in the last few years. One of the two down-stream financings that we're very familiar with is Allied Group Insurance, formerly called Aid Group, an Iowa based P/C company. I'll talk more about this later in terms of the structure of the financing. Basically, this was a mutual company whereby a holding company was set up. I think we got common stock for the company in the area of about 25% of the holding company's owner-ship structure. Similarly, Harleysville was a P/C company and we did set up a holding company for them as well. Some of you may be involved in setting up holding companies or have holding companies already. Plan on raising capital using that vehicle on a downstream basis, particularly from mutual companies. We have been helping several mutual companies in that area and regard that as a very viable alternative to demutualization.

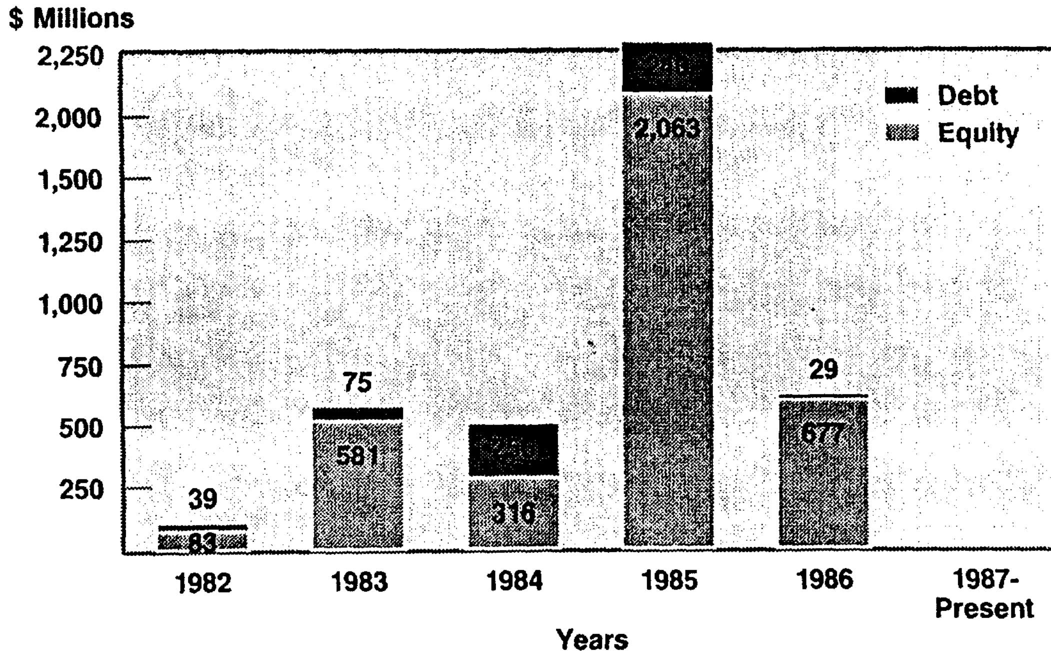
In terms of private equity offerings, we talked about Northwestern National Reinsurance Company. That was a vehicle that the parent, Northwestern Na-tional, felt they should use in terms of raising additional capital for that very exciting P/C reinsurance company, without having to raise the capital them-selves. That was done through private investors and as Bob mentioned, I believe about 60% to 70% was raised overseas with overseas capital. And that's a viable source of capital that we see and I'm sure Bob and his folks see as well.

In terms of large transactions, Fireman's Fund had two common stock offerings. The first one was in 1985, which was some $825 million and was followed up in 1986 with some $270 million of common stock offerings, with the historical largest insurance transactions ever. American Express still retained its 29% ownership in Fireman's Fund. So these are very notable transactions and of course is re-flected in our figures.

GRAPH 6

Insurance Industry Financing Activities in the Capital Markets

Private Debt and Equity Offerings



Last is the ICH financing. This was the debt offering of some $400 million of senior subordinated notes. There's been other leverage-type financings in the buyout opportunities that ICH got involved in.

That gives you a feel for the types of transactions that have gone on in the last couple of years, and I'm sure there are other interesting stories and later on we can chat about how these financings are structured. But, again, those are my quick comments on what's happening in the capital markets particularly for the insurance industry.

MR. ARDIAN C. GILL: I was glad that Charlie mentioned the alternative to demutualization. For years I've advocated what I call the "moribund mutual" scenario whereby a mutual company forms or buys a stock company and starts writing all its new business in that stock company. The source of capital for the stock is quota share or surplus relief reinsurance into the parent. And, of course, once the parent stops writing new business, the surplus will grow very rapidly and it will have the surplus to finance a more rapid growth in the stock company than it enjoyed in the mutual. An important factor here, of course, is that the future profits on the new business do not have to be paid out in the form of policyholder dividends.

I don't think any company actively adopted this strategy. There was a big tax advantage initially. At the moment I think it's neutral, but a number of companies are unconsciously doing it. The major example is the Union Mutual, now UNUM. The parent spawned a number of stock subs as subsidiary profit centers. The consequence of that arrangement was that the mutual company began to decline in terms of new business. Later, they wrote new universal life products in a stock sub, which, fortunately, was taxed as a casualty company. But, and oddly enough, UNUM, the one company that didn't have to demutualize, is the one that did. I think once you start thinking like a stock company you want to be one.

There are some other less extreme examples. The Guardian, for example, is writing very large amounts of variable life in a stock subsidiary and they will devote a lot of surplus to that I'm sure. The Equitable is doing the same. But, of course, the parent is so large you don't see it.

I'm going to segue into the reinsurance area. A while back, *Fortune* magazine discussing, I think INA and Fireman's Fund, defined reinsurance as a puzzle not worth solving. Of course the author is entitled to her own opinion; she's just not entitled to her own facts. Let's solve this puzzle with some fairly elementary stuff.

When an insurance company sells a policy, it makes an investment in the form of acquisition costs and the establishment of reserves. GAAP accounting gives you some of those acquisition costs back as a deferred acquisition cost asset. Statutory accounting does not; cash flow does not. The cash outlay is returned over time in the form of profits on the policy and, eventually, the insurer expects an appropriate return on its investment. So a life insurance policy looks something like a mortgage that is amortized. Just as mortgages can be sold to another lender, an insurance company can sell off some of its in-force business to another insurance company. The device is, of course, reinsurance. Just as a bank capitalizes its future profits on mortgages by selling them, the insurance company brings forward future profits on the business it reinsures, and there is a lot of flexibility in these transactions.

Reinsurance is a very powerful tool for raising capital for an insurance or reinsurance company. I'm going to discuss three ways of raising capital for life companies. There are others for casualty companies which in some ways are more interesting, which probably gave rise to that comment in *Fortune*. I will mention one or two of these which involve a crossover with a life company.

The first way is a simple surplus relief transaction on in-force business. Under this method, one life company cedes a block of reserves to another company, the reinsurer. The assets transferred may be less than the liabilities, the difference being the surplus relief, or the reinsurer may provide expense allowances equal to the surplus relief.

The surplus relief is repaid out of the future profits on the business. These surplus relief treaties are usually set up in a fairly conservative way so the reinsurer can expect to be paid back in a short time, say 3 to 7 years. The reinsurer receives a fee which is a function of the outstanding surplus relief each year-end or each quarter.

For a quality block of business with a payback within 5 years, typical annual charges are on the order of 2.5-3% of outstanding surplus relief. Any additional risk, from credit risk (say the company is not Best A-rated) to mortality and lapse risks, may require additional charges.

A simple example might be $25 million of surplus relief on a block of $100 million of reserves. In this transaction, no cash will change hands except for the risk charge. At inception of the treaty, several things happen simultaneously: (1) the ceding company pays to the reinsurer an initial premium of $100 million; (2) the reserves of $100 million are transferred to the reinsurer; (3) the reinsurer deposits the $100 million back with the ceding company as a mod-co allowance; (4) the reinsurer transfers the reserves back to the ceding company; (5) the reinsurer pays an initial expense allowance of $25 million to the ceding company; and (6) the reinsurer elects to withhold the expense allowance.

The reinsurer will have to credit the ceding company with interest on the funds withheld. The ceding company, since it kept the assets corresponding to the reserves, will have to credit the reinsurer with interest on those assets. The reinsurer also receives premiums, pays death claims, surrenders, and so forth. But these are generally done in bulk and netted out and the accounts are settled each year, with the reporting done quarterly. In this example, let's say there is $5 million of profit on the block each year. This can be modified by changing the interest rate credited by the ceding company on the assets deposited back by the reinsurer, called the mod-co interest rate. All that has really happened, when you collapse this transaction, is that the reinsurer has set up a liability "Funds due on Reinsurance" and the ceding company has set up a mirror image asset "Funds due from Reinsurer."

Assume the risk charge is 3% of outstanding surplus and it's paid in cash. For $25 million of surplus relief, then, the first year charge is $750,000, and the experience account starts with a negative $25 million. If the same interest rate is used for bringing forward the experience account and for interest on the $25 million withheld by the reinsurer, then the $25 million will be repaid in five years.

I've deliberately given a simple example with relatively low risk. We always build in a great deal more risk. It should be part of the reinsurance

transaction. Both the regulators and the accounting firms will require it to make it a legitimate transaction. The tax authorities also require it.

This is a sort of a do-it-yourself surplus note, but the taxes are different. If statutory and tax reserves are equal, and barring any IRS challenge, this transaction should result in $25 million of taxable income to the ceding company and a mirror image tax deduction to the reinsurer. If the company has net operating losses, carrying forward this is a great way to use them. If a company is taxable, however, the income in 1987 would be taxed at 40%, but the deduction of $5 million a year will be at 34%, give or take.

So it's a nice arbitrage for the reinsurer, but this transaction is most appropriate for a company with tax losses. If the ceding company has excess interest reserves or deficiency reserves, these, which are not tax items, can be coinsured with no cash, no expense allowance, no experience account or anything but the risk charge changing hands. This type of reserve should be ceded first. The reinsurer sets up the deficiency reserve on its books and the ceding company takes credit for it if it's with an authorized reinsurer. The reinsurer may, in turn, reinsure off-shore, where there are no deficiency reserve requirements. Therefore, this type of reserve often disappears into the Bermuda Triangle.

The second way to use reinsurance to raise capital is to look at your blocks of business as assets and sell some of them, just the way ARMCO might sell a steel mill or American Can (Primamerica) sold off its container business to get into insurance. Frequently, a company has a block of business of no strategic importance. Old paid-up business is an example. It can sell this block through assumption reinsurance and create cash to help implement other strategies.

Typically, an actuarial valuation is performed so that a statutory profit stream is projected. The reinsurer discounts that stream at whatever risk rate of return he thinks is appropriate. The reinsurer issues assumption certificates and does all the future billing and administration. It acts just as though it had issued the policies in the first place. The taxes here are the same as surplus relief for the ceding company, i.e., immediate taxable income. The reinsurer, however, must amortize the deduction over the life of the business, typically about 10 years.

If our surplus relief example of $100 million of reserves were handled through assumption reinsurance, and the agreed upon purchase price was $25 million, then the assuming company would accept $75 million of assets and would take over $100 million of liabilities. All this is doing, of course, is capitalizing income.

The third type of reinsurance does not so much raise capital as it reduces future capital demands. This is called quota-share reinsurance. The ceding company reinsures say, 50% of its new business. By this device, it relieves itself of acquisition costs and can write more new business than it might otherwise. This is more typical for the smaller insurers. The reinsurer pays the expenses on the portion it reinsures. It is repaid through profits on the policies exactly as the issuing company would be repaid if it did not reinsure. So why reinsurance? Well, the reinsurer does not expect as much profit. It hasn't, after all, marketed the business. Typically, he will make risk charges year to year (much higher than surplus relief charges) and will refund part of the profits when the experience account becomes positive. At a certain point, the ceding company may recapture and retain all future profits.

An example of casualty and life capital transfer would be structured annuities where the casualty company, instead of setting up the reserve, buys an annuity from a life company. In a way, it's a do-it-by-hand, I guess, discounting of its reserves. Life companies may also cede disabled life reserves to a casualty company, again transferring less in assets than in liabilities. This can work exactly like my surplus relief example, or this can be a true asset/liability and risk transfer.

There are many variations on the reinsurance theme, but it's an effective way to raise capital. It's especially important in structuring an acquisition. In a recent acquisition transaction, the projected statutory profit stream was too steep to support the amount of debt required. We proposed assumption reinsurance for a line of business the new owners weren't going to pursue. This sale of part of the company had the effect of reducing the purchase price. Then, we proposed a series of surplus relief transactions that would levelize the future profit stream. Finally, the profit stream was enhanced by a quota share treaty on the business to be written during the term of the bank loan. Anybody considering leverage in an insurance company acquisition should look at

reinsurance, probably in a combination of forms. The taxes are tricky, but it may be superior to debt as a way to finance an acquisition.

MR. HOGUE: Ardian mentioned one thing that was worth expanding on a little bit. In the merger and acquisition area, you see a lot of creative reinsurance applications. I saw a recent application of this kind of thing where a company purchased a life insurance company for X dollars, sold the in-force for Y dollars, borrowed X minus Y dollars, incurred a payment of a debt each year for I dollars, sold off the new business that it put on the books each year for Z dollars, and Z was much larger than I. So any of you who can run out and identify a company that you can set up those kinds of numbers for, and establish a line of credit with a bank downtown, should have a free insurance company before the sun sets.

So the point is that this kind of reinsurance that he referred to is very, very big in acquisition transactions. It's on the table in most transactions. At least the numbers there are for collateralization and securitization for some kind of deal, and they give comfort to the parties. How big that market is, I really don't know. But I've been told by one person who attempts to keep tabs on reinsurance transactions (which is much, much more difficult than public offerings, for example, because companies are so quiet about the transactions that they're getting into these days) that the market is still somewhere in the neighborhood of $400 or $500 million a year. That's the amount of money that's being passed because of that kind of thing. The options are always there. I don't think I've seen any life company acquisition situation where at least that wasn't a small part of it or a consideration of a small part of it.

I would like to mention a few things about reinsurance in terms of capital raising. I think surplus relief might become less of a source as time goes on. New York and California have very stringent laws. They're looking at transactions much more closely. They want certain characteristics present in the transactions before they allow reserve credits and all of these kinds of things that will make them work. Primarily, they want a real passage of risk. A lot of these contracts didn't really have that as part of the element. Illinois and Massachusetts, I think, are becoming as tough. Other states are moving on this issue also.
I'd like to ask Ardian about this off-shore activity. From what I've been told, the line of credit of off-shore businesses might be drying up a little bit.

MR. GILL: Well, it's drying up because letters of credit (LOC) are more difficult and expensive to obtain. An off-shore reinsurer would not normally be admitted in the states. So, in order to take credit for that reserve, the reinsurer has to post a letter of credit which says he's good for the assets and the bank guarantees it. Those LOCs have to be members of the Federal Reserve System. New York and other states have caused them to be what's called "evergreen and nonterminable." So, the LOCs have been more and more difficult to obtain. And that's really what's behind it. With regards to deficiency reserves, a funny actuarial animal that's been argued over for years and years, if the policy lapses, this liability disappears. But domestic reinsurers, if they keep them on their own books, are going to have to get 2-2.5% a year for these reserves. If you cede them overseas, then the price drops to the letter of credit plus .75%, somewhere in the 1-1.5% range.

MR. MENGES: I'll just make a few comments on the capital raising going on with reinsurance companies and give you some examples of that. We put a listing together of transactions that we knew were taking place over the last two years. I think the most significant are ones that you're aware of: General Re raising over $500 million in common equity in 1985 and 1986; NAC Re raising almost $100 million in common equity; NWNL's transaction, which I mentioned; and, of course, Beneficial's mergers and acquisition transaction selling its reinsurance business and paring its business down. I would comment just on one transaction we're familiar with but it is away from the life business: the U.S. Savings League. They have an inordinate amount of problems getting Director and Officer and blanket bond coverage. They made a decision to set up their own reinsurance company for those particular coverages. What they did was they set up a reinsurer and requested funds to be contributed by their 3200-member organizations. That offering went extremely well. They only expected to raise $20 million and got some $33 million. They will go to the member institutions for additional capital. So, that was a little bit of a unique transaction in terms of setting up a reinsurance facility for a special purpose.

Let me now turn to asset-type transactions. John wanted me to give you an overview on asset based transactions. I'll talk about three different types, and again, it will be on a treetop basis. I wouldn't represent that I know everything about leveraged buy-outs (LBOs) or collateralized mortgaged obligations (CMOs), but I'll give you a quick feel for that.

SOURCES OF CAPITAL FOR INVESTMENT AND NEW BUSINESS

ASSET RESTRUCTURING

Reasons for Restructuring include: (1) to build shareholders' value by putting assets to work; to realize borrowing capacity of an asset. (The bottom line is that either you recognize and use that asset, or someone else will use it for you.) (2) to change business environment; (3) to enhance earning power in the future; and (4) to streamline business operations.

Restructuring programs have been engaged by companies which include a tremendous range of techniques including: (1) plant shut-downs, (2) divestitures, (3) product line rationalizations, (4) sale of the company, (5) stock repurchases, and (6) leveraged buyouts.

The applicability of restructuring techniques is wide. Unless a company has a very narrow business focus and significant internal growth opportunities (a small percentage of companies), it is a likely candidate for restructuring -- voluntary or involuntary. The need to understand restructuring alternatives is important so as to make a better decision as to your company's need for such an alternative.

Variations on the LBO theme include:

1. "Plain Vanilla" LBO -- Investor group acquires the company using a highly leveraged capital structure. The majority of the funds are provided by banks, insurance companies, or the public markets. The investor group expects a 30-60% return and cashes out over a three to four-year time horizon.

2. Leveraged Recapitalization -- This was developed in response to hostile takeovers and is becoming an accepted, although often misunderstood method of increasing shareholder value. This is an option that allows management to retain benefits of the LBO concept and capture returns of the LBO firm for their shareholders, while avoiding the instability of a cash-out five years later.

3. Public Leveraged Buyout Holding Company -- A company sees itself not as a leveraged buyout candidate, but rather as an LBO firm forming a portfolio of businesses. This option works similarly to a leveraged

recapitalization. The differences are in the creation of a number of highly leveraged businesses, and the retention by a corporate holding company of a controlling interest in all of them. This variation offers increased flexibility and a source of cash for investment or stock repurchases, but does not address strategic growth by improving competitive position.

4. Leveraged Strategic Acquisition Program -- This uses LBO techniques to facilitate acquisitions both large and small. The company would provide all or most of the equity investment (approximately 10-20% of purchase price) and arrange the rest of the financing on a nonrecourse basis. The key to increasing value is to acquire companies with skills that build on your own skills base.

Developing a competitive position purely through internal growth is very difficult. It is not fast enough. LBO techniques, in turn, can be used to acquire large companies that will augment a company's competitive position on a much faster basis, as in the case of ICH.

An example of a life insurance company using asset restructuring would be beneficial selling insurance units, i.e., Western National Life.

Divestiture activities result from the following:

1. Regulatory guidelines/restrictions on type of business activities a parent company can be associated with; i.e., bank holding companies divesting of insurance activities and in turn insurance companies divesting themselves of nonbank banks.

2. Earnings losses in a particular subsidiary in which a parent company decides to sell off.

3. A new long-term financial strategy; an effort to streamline a business so as to concentrate on areas which have proven to be successful for a company; i.e., divest of activities not associated with mainstream of company.

Examples of insurance industry divestitures include: (1) Beneficial Corporation divesting of credit card division and property/casualty division;

(2) Transamerica selling its group life and health insurance operations to Provident Life and Accident; and (3) E.F. Hutton Group selling E.F. Hutton Life Insurance Group.

SECURITIZATION OF ASSETS

A CMO is a bond which is collateralized by mortgage-backed pass-through securities. A mortgage-backed pass-through security is an undivided interest in a pool of mortgages. Interest on the security is payable monthly. Investors in the security also receive a monthly pro-rata share of the principal payments on the mortgages in the pool. These payments include both scheduled and unscheduled (prepayments) principal payments.

The changes in prepayments are an important aspect of the securities because changes in prepayment rates may impact yield, total return, and average life. Faster prepayments shorten average life, decrease yield on a premium-priced issue, and increase yield on a discount; slowing of prepayments has the opposite effect.

Three major types of mortgage-backed securities are GNMA (Ginnie Mae), FNMA MBSs (Fannie Mae), and FHLMC PCs (Freddie Mac).

The issuer of a CMO is generally a special purpose financing subsidiary set up for the sole purpose of issuing CMOs.

1. Issuer purchases collection of mortgage-backed pass-through securities and places these securities in a trust administered by an independent trustee.

2. The issuer next issues several classes (or tranches) of bonds whose debt service will be provided by the cash flow from the collection of mortgage-backed pass-through securities in the trust. Hence, this collection of securities is called the collateral.

3. Because the timing of payments is different for the collateral than the CMO bonds, payments from collateral are reinvested short-term by the trustee between payment dates on the CMO.

4. On CMO payment dates, the cash flow from the collateral plus reinvestment income is applied first to interest on the bonds, and then to repay principal.

5. The bonds are retired sequentially. The first payments of principal are applied to the first tranche, while other tranches receive interest only. Only after the first tranche is entirely retired do principal payments commence on the second tranche. The process continues in this sequence until all tranches are retired.

6. The last tranche of a CMO is usually a deferred interest bond or Z-bond. While earlier tranches are still outstanding, no interest is paid on a deferred interest bond. The cash is used to retire bonds in the earliest outstanding tranche.

7. A CMO is structured so that even under the most conservative prepayment and reinvestment assumptions, the cash flow from collateral will always meet or exceed the cash flow obligations of all the tranches of the CMO.

Who issues CMOs? The first and largest issuer is the Federal Home Loan Mortgage Corporation (FHLMC). Securities firms have employed special purpose corporations to issue CMOs. Examples include: Mortgage Bankers Financial Corporation -- Kidder Peabody; Collateralized Mortgage Securities Corporation -- First Boston; Salomon Brothers Mortgage Securities -- Salomon Brothers; Paine Webber Programmed Amortization Term Securities -- Paine Webber; and Investors GNMA Mortgage-Backed Securities Trust -- Lehman Brothers. Home builders also have issued a significant amount of CMOs. Graph 7 shows the CMO activity going on.

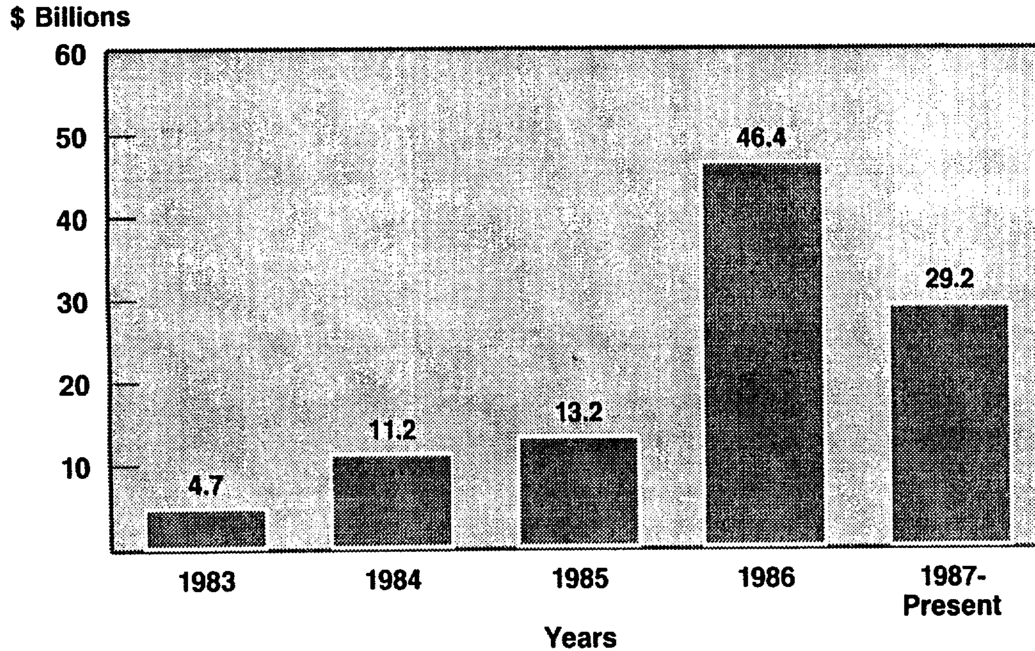
SALE-LEASEBACK

I will now point out some characteristics of a typical sale-leaseback financing structure. An established investor "lessor" will be recommended to purchase from and leaseback to the lessee a particular piece of property/building (primary lease concept) or a package of properties (master lease concept). There is a strong likelihood that the investor will utilize institutional financing for a substantial portion of the cost of property (i.e., issuance of notes which are secured often by first mortgage lien on investor's interest in property and

GRAPH 7

Collateralized Mortgage Obligations

Offerings



assignment of rents payable by lessee under lease of property). Typically, it will leverage its participation between 15-25% through a private offering to other institutional investors.

The cost of property is equal to current appraised value of property plus legal, administrative and professional fees, capital interest and taxes, and closing costs.

Rents are usually paid semi-annually in arrears. Rental payments, although paid in unequal amounts, are amortized over life of lease and charged against income for GAAP purposes. Renewal options often proposed by lessor are fixed renewal options to run in 5-10-year increments after term of lease is over. There is an option to purchase building/property back at the end of the lease.

The lessee is responsible for all closing costs. These costs are capitalized.

The lease is completely net (i.e., the lessee will agree to pay all taxes, assessments, maintenance and repair costs, etc., relating to the use and occupancy of the property). The lessee may sublet or fill vacancies in the building.

Examples of life insurance companies participating in sale-leasebacks:

Date	Lessee	Lessor
Jan. 87	Fred Meyer Real Estate Properties (Portland, OR)	Metropolitan Life Insurance Co.
Nov. 85	Security Pacific Bank	Metropolitan Life Insurance Co.
Jan. 85	First National Bank of Boston	Equitable Life Assurance Society of the U.S.

Why would an insurance company want to participate in a sale-leaseback?

1. Economically, in looking at the life of the lease, leasing a building/property costs less than owning. However, this does not take into account the possible repurchase of the building.

2. The concept of a sale-leaseback as an off-balance sheet transaction will reduce a company's assets which could increase the bottom-line return on assets (ROA). This is a very attractive aspect of the transaction.

3. The buyers for those transactions are usually large public companies who are better able to use the tax benefits from depreciation and property taxes because of their higher marginal tax rate in comparison to the lessee.

4. An insurance company is often the lessee in this transaction. This transaction offers a form of financing through the proceeds of the sale.

5. It converts nonearning assets into earning assets through the sale of the property.

Again, to summarize, we've talked about focusing on a company's needs. I think that's the important message I'd like to share with you rather than jump at one of these techniques. The issue is to really determine what your company wants to achieve in terms of raising capital. There are a host of alternatives that are available to you using your assets. I've talked about divestitures. I've talked about sales and leasebacks. But there are, of course, all sorts of combinations that you can devise once you achieve your strategic objectives in terms of raising capital.

MR. GILL: Can I interject something here? Charlie's really enunciated a pretty important principle. A company looking to raise capital should look first at its own balance sheet. The obvious items are the unrealized gains and its stocks, bonds, and real estate -- sell your home office, as he's mentioned.

But there's another item that's not so often recognized and that's the non-admitted asset item. For life companies, the major item that is nonadmitted is agents' debit balances, and they just kind of sit there year to year. You collect them but if they exceed the credit balances you can't admit the asset. These can be sold to banks and the banks will buy them for a flat fee. Look at your experience and decide what they'll give you for them. Our experience is that the banks have been a little less than aggressive in pricing these and we've introduced a wrinkle from reinsurance and that is the experience refund. If the collectibility is better than the banks have assumed (and they must necessarily be conservative), then the profit is shared in some way at the end. This works out well for both parties because the bank takes less risk in an area that it's not familiar with and the insurance company shares in the improved collectibilty that it can manage. It usually does manage to improve the collectibility because

it has a stake in it. If it does this every year, it has, in effect, a permanent addition to its statutory capital base. I emphasize statutory because that's where the action is in terms of usable capital.

Another item on the balance sheet that most employees don't like to hear about are the pension funds. These, especially in the big insurance companies, are pretty fat in terms of funding. In an acquisition, it's very common to just terminate the pension fund, release whatever assets you don't need for the vested benefits and start all over with a new plan.

MR. FLITTIE: Ardian, I think it's also worth interjecting that the use of the balance sheet to raise capital may be particularly applicable right now when insurance stock prices are rather depressed both in the life and P/C arena. A company should do anything it can to utilize its balance sheet to get statutory capital rather than go into the equity markets in fairness to its present shareholders and to hold down its cost of capital. Another good reason to use the balance sheet instead of borrowing is the fact that the more debt that you add, the higher your ratio of debt to capital goes and the lower your rating by Standard and Poor's and Moody's goes, and your cost of funds increases. I think your thought to look first at your balance sheet rather than at the public market is a very good suggestion.

MR. GILL: You answered a question I was going to ask Charlie and Bob. Let's see if I get the same answer. Is this a good time to go into the equity markets for a life company and a casualty company?

MR. MENGES: I would wait a few months. I think the prices are depressed. We haven't seen any significant activity in terms of raising equity capital in the last few months. I would be a little more patient.

MR. HOGUE: I'm always asked questions like this along with questions such as, what stock should I buy? I think I'm a little better at choosing stocks than I am in answering questions like this. Now would probably be an okay time to go for debt offerings as opposed to the end of the year, which is considered a fairly awful time. Life insurance company stocks, I think, are being touted by most of the analysts as being reasonably good buys now.

Firms have rating systems. It usually goes one to five: aggressively buy, buy and hold, watch, sell, run and sell. In general, the life stocks are nonaggressively buy and hold.

For P/Cs, the analysts seem to think that the double cycle is over. We're beyond the days of cash flow underwriting. The combined ratios are coming in line and many of the loss reserve shortages have been eliminated. Now is probably a reasonably good time to buy P/C stocks. I haven't seen anyone who's been really enthusiastic about P/C stocks yet. But actually I would expect those stocks will look better before the end of the year.

MR. MENGES: I just might add a couple of other comments. The discussions we've been having with insurance companies really are more in the area of restructuring and possible acquisition/divestiture activities over the last three to four months and companies getting positioned to raise capital on a public equity basis. But we haven't seen a whole heck of a lot of enthusiasm to do something currently.

MR. GILL: I don't see a change in the next few months. As a matter of fact, I think I see more negative forces than positive. For the life companies, I think AIDS is coming more and more to the fore. For instance, Mike Cowell's report will be out later in the summer. I think it's going to get a lot of attention and it's going to depress the life stocks.

On the casualty side, we see rates are softening. Reinsurance terms are not improving as much as a lot of people had hoped. More significantly, (and this hasn't seemed to hit the press) is the availability is declining. There's a lot more risk retention. The deductibles are much higher and the purchaser isn't buying as much insurance as he used to. So, I don't see anything in the next few months or even in the next year that's going to turn that around.

MR. HOGUE: We're going to talk a little bit now about corporate structure, vis-a-vis, raising capital. Primarily, we'll talk about upstream and downstream holding companies. John doesn't like me very well, so he has me introduce topics like this. Someone has to do it and you can't be right, so what you're looking at in Table 3 is not right. But, it's probably close.

TABLE 3

	STOCK	MUTUAL
UPSTREAM HOLDING COMPANY	C,P,D	
INSURANCE COMPANY	C,P,D,ARD	D,ARD
DOWNSTREAM HOLDING COMPANY		C
DOWNSTREAM FINANCING SUBSIDIARY		D
DOWNSTREAM INSURANCE COMPANY		
DOWNSTREAM NONINSURANCE COMPANY	ARD,ARE	D,ARD,ARE

C - COMMON STOCK
P - PREFERRED STOCK
D - DEBT

ARD - ASSET-RELATED DEBT
ARE - ASSET-RELATED EQUITY

SOURCES OF CAPITAL FOR INVESTMENT AND NEW BUSINESS

There are a number of ways to structure a corporation for any number of reasons and within that universe is a subset of doing so for capital raising purposes. Unfortunately, not all companies structure themselves solely for that purpose. But within that structure, there seems to be certain patterns and certain ways to proceed when you want to raise debt and equity capital.

For a stock company, an upstream holding company is there. Primarily, you want to get the insurance company away from the view of the regulators. So, when they look at the corporation, they do not examine the holding company when they essentially examine the insurance company. Some large stock insurance companies do not have such upstream holding companies. Very few are structured that way.

Some stock companies and all mutual companies that want to get into these plays form downstream holding companies of two types. One would be a general operating company and the other would actually be some kind of a financing company. You'll hear XYZ Mutual Funding Company. That could be a financing company that simply raises money and allocates money through the other subsidiaries of the parent. That's a popular vehicle for debt equity. There are some downstream stock life insurance companies. More of those are being considered, but not very many for strictly capital raising purposes. More of those are variable life subsidiary companies. At one point in time under TEFRA, they were universal life subsidiary companies. But since a number of those are sitting there, it's a good way to raise money (sell out part of the stock of that company). And then, there are downstream noninsurance companies: a lot of real estate investment trust, a lot of mortgage companies.

The pattern of transactions that companies get into -- under upstream holding company (common, preferred and debt) -- is probably on Wall Street. The largest number of transactions occur here. Now I know all of you remember all of the numbers that were on Tables 1 and 2. If you figure a common stock offering averages about $30-40 million and a debt maybe $100-125 million and divide into those numbers in your memory, then you come up with a number of different kinds of offerings made each year. The conclusion is there's not very many. When you separate the capital generation, that is, those transactions made to bring new capital into the company from the leverage or arbitrage transactions like the poolings, there's an even fewer number.

Predominantly, upstream holding companies of stock companies is where the action is. Most of that is acquisition currency; debt in equity to buy different operations. I can only think of three companies (one mutual and two stock) that raised capital at the insurance company level. This was entered mainly because of the ARDs (asset-related debt) and the AREs (asset-related equity). Those are really just pooled offerings, the CMO types of securities. They are not new capital at all but they are capital market transactions. We enjoy them because they are fun and profitable for us.

The New England Mutual did it again as they did in 1972, raising debt at the parent company level without filing a GAAP statement. This may change. They didn't go to Europe. They did it in the U.S. The SEC accepted the quarterly status statutory statements. This may change a pattern. I think that was probably some kind of watershed event. Some more mutual companies may look at that process as their option for debt equity.

Within the mutual company situation, the downstream holding company, and for the larger mutuals, downstream financing subsidiaries, seem to actually be a more common way. Under those items (see Table 3) you see C and D. Those could be C/Ds, actually under both. The pattern now is P/Cs are doing this route, primarily equity offerings, while the life insurance companies are doing a mixture. Actually, the mutual companies are doing primarily debt offerings through those kinds of subsidiary companies. I don't know why this pattern is true. It has to relate to the cost of capital. I think the P/Cs issued equity because they didn't think they could support the debt and because of the lack of earnings flow. They simply needed the money to support their loss reserves.

In the downstream insurance companies and the downstream noninsurance companies, we see some of these asset related offerings that are really investment arbitrage types of things. But at least I haven't seen that much capital being raised by those stock companies. I put them on the list because I think they will be very popular in the future, especially for stock subsidiaries of large mutual companies. This is a way for a mutual company to go to the public market. A GAAP statement can be generated for those companies. They will be protected. So either at the holding company or at the operating company level, I think this is the way that most mutual companies are going to go to the public market as the need to do so increases.

MR. MENGES: When Ardian asked me the question about the markets, he got me pumping. I had some other data that I know you'd want to hear regarding the P/C and the life business.

Remember the way price/earnings (PE) ratios are important indicators of value. I'll just share some numbers with you which would be important. In terms of the P/C industry, remembering the cyclicality of that industry, in 1985, when we had a host of activity in terms of financing in the P/C industry, we were seeing a cumulative multiple in the area of 22 times earnings. The relative PE to the S&P 500 then for the P/C industry was 1.5 times. Currently, in 1987 numbers, we're talking about a price/earnings ratio for P/C stocks of 8 times. This is a dramatic drop, again reflective, I believe, of the cyclicality of that business. The relative PE to the S&P 500 is .54, again a dramatic drop-off. As another indication in terms of the life companies, we're engaged in a very important project for one of the life companies, and I have a composite of selected life company PEs. Based on Street estimates and looking at price/earnings ratios, the average price/earnings ratios today of these seven stock life companies is about 10.5 times. They then trend downward to about 8 times, reflective of poor earnings estimates in that case.

Let me talk a little about downstream holding companies or downstream financing. My associate at Kidder has been very instrumental in working on these activities. There have been nine downstream financings done over the last few years; eight, as I mentioned, in Allied. The important thing in terms of looking at a downstream financing is to be able to tell a story to investors, and of course, with a right market timing. In creating a public equity vehicle, the characteristics of an attractive downstream financing are as follows: favorable industry outlook, reputation and name recognition, ability to demonstrate growth potential, ability to convince investors of predictability of future returns, and ability to evaluate business/financial risks. Of course, there are also all sorts of opportunities on the debt side. The three downstream financings that we're familiar with are Allied Insurance, Harleysville Group and American Reliance. These are all P/C businesses. We believe it works equally as well on the life side. We raised some $18 million for Allied. The parent retained some 78% of the holding company after the offering. Harleysville, a Pennsylvania based P/C company, raised $30 million and retained some 73% ownership in their holding company. American Reliance, a New Jersey P/C company, raised a little over

$10 million and retained some 60% after the offering. There have been smaller transactions of the other six that have taken place.

MR. GILL: I think one very successful example of downstreaming and going to the equity market is the Kemper companies. In effect, they demutualized by forming a downstream company and raising equity. The downstream route is a good one for a nonlife entity buying a life company. If you form a subsidiary life company and that life company borrows to finance the purchase of another life company, then you can consolidate the two life companies, and the tax return, in effect, gets the interest deduction against the life company earnings. Earnings from the life company are used to service the debt.

I would now like to move to joint ventures. At the beginning, one party has the money and the other has the experience. And at the end, the positions are reversed. The trouble with joint ventures is that they're pragmatically difficult to do right.

An example of one done quite successfully is the John Hancock/Century affiliation. It lasted well over a decade. The Prudential and Kemper entered into a joint venture for the same reason at the same time, and it lasted six months. The Century people, before they agreed to let the Hancock agent sell their automobile and homeowners' policies, insisted that the Hancock and Century people sort of live together for a while to get to know each other and see if they got along. They wouldn't agree to go ahead until that was done. They also insisted on complete underwriting and administrative control so the agents could not appeal an underwriting decision to the Hancock and have it jammed down the throat of the Century underwriters. Another element that caused the success in that situation was they shared the underwriting risk. I think it was reinsured to HANSICO, which I think Hancock owned most of, but there was some ownership on Century's part as well. This experiment has now ended and Hancock does the whole thing themselves. I don't know if their recent problems in this area have stemmed from their dissolving the venture or not. Otherwise, we found it rather difficult to get companies to agree to a joint venture. It's a long, hard process, and in the final analysis, they very often don't work.

MR. MENGES: I think the key point that Ardian raises (and I agree with his points) is there's some significant cultural differences when joint ventures are

entered into, particularly ones of substance. It's got to be a managed effort between the two parties. I clearly think in the case of Equicor a joint venture between the Equitable and Hospital Corporation of American (HCA), where Equitable is spinning off its group life and health business and marrying that to HCA business activities down in Nashville, this is a very significant step. I think the jury is still out as to the ultimate outcome of that marriage. We're talking about a combined entity of some $400 million in equity and some $2 billion in revenues -- very significant steps for both these entities. If it works, it will be a terrific situation. I know both entities are trying very hard to marry the cultures and getting a strategic direction together.

There's a lot of issues in terms of managing that process down the pike, and I think we can list off a host of joint ventures, as Ardian talked about. We know all the marketing techniques banks and insurance companies use, like selling insurance policies in bank lobbies, and those kinds of arrangements. Some have worked and some haven't. I think it comes back to managing the process and truly whether both entities want to make the venture happen. I think the bottom line is mixed. Some have worked, some haven't.

My closing comments would be sharing exactly what Ardian said. It's culture and it's an understanding to make these transactions work, and ultimately the people must get together and focus together.

MR. HOGUE: The three characteristics that were mentioned were very few work, you're dealing with different cultures, and there is some kind of a need sharing. It seems to be a product manufacturer and a distribution organization as being the key players. Most of the arrangements I've seen that have even been relatively successful were between those two parties where each one could not do what the other one was doing. A distribution system could not manufacture the products. In the group medical area, you hear a lot of triple-option agreements. Some of the hospital companies and the medical care provider companies are looking for insurance as that third option, so to speak. They have to go to the insurance company. That's why some of those ventures are successful.

The banks cannot manufacture insurance, so they look to the insurance companies in order to add that to their product line as a profit source. A few of

those have been successful, probably around a third of them. Some of the wrap-around annuities, of course, are more of a certificate of deposit (CD) or financial commodity product. Some of the S&Ls, have ventures that have been very successful. There are companies now, probably in increasing numbers, following what a few famous predecessors have done: supplying specialty insurance products to stockbrokerage houses. Under the current tax situation, that's going to be a very, very hot item for a couple of years. The moderator has much more expertise involving that. I look at joint ventures as being a continuous flow of experimentation because of that. I think it will have a low success rate, but I think there will be an increasing number of joint ventures made.

MR. SELIG EHRLICH: On the subject of looking to your own balance sheet, an item that was on the preliminary program but seemed to have gotten dropped, is the subject of policy loan collateralization. Is there anyone on the panel who can shed some light on whether this will ever come to pass?

MR. HOGUE: I've been approached by a few people. The firm I work with has a client that I was just working with. There will be a transaction definitely before the year is out, and the schedule now is probably within three months. I'm sure everyone will read about it. I don't know if I'll buy any of it, but probably so. It's a very simple concept. Anybody that has a large portfolio of low-yield policy loans would find a transaction like this worthwhile; worthwhile being that there are benefits other than just the securitization and trade-off and redeployment of assets. You end up in a slightly different tax position. There is tax implications. The downside, of course, is the administration. Unlike mortgages and whatever, there's a lot of administrative considerations. But at least there will be an example where these things have been resolved and done.

MR. EHRLICH: What's the motivation on the buyer's side? I mean, are they able to price this with the cash flows being very uncertain?

MR. HOGUE: They haven't done that yet. I don't know. There's any numbers of questions that haven't been resolved yet. I think to just wait and read the reports is probably the thing to do.

DR. V. MICHAEL SHANTE: I would like to follow up on the issue of securitization of policyholder loans. As Bob mentioned, we are presently working on a project to securitize the policyholder loans. The transaction has not yet been consummated, and as such we are not at liberty to discuss all the details. However, the basic objective is to restructure these assets into other assets which could be more readily marketed to other investors. The motivation from the seller's point of view is the same as that for selling any underwater bonds. The policy loans are basically very low coupon bonds and their book value exceeds their market value. Selling these assets at a book loss reduces the equity base of the company, and this could be desirable for tax planning purposes. It would also be beneficial for putting the assets to a more productive use. From the buyer's perspective, there are several benefits of buying these kinds of bonds. The tranching element adds value to the transaction. For instance, there may be four tranches in the bond structure with average lives of say two, six, ten and eighteen years. The cash flows of each tranche are better defined than that of the collateral, and each tranche is priced at a yield that is dependent upon the average life of that tranche. Because of the shape of the yield curve, tranching into a series of average lives can increase the value of the transaction. The other element that the holders of these bonds will appreciate, particularly in this group, is that the cash flows from these bonds are totally dependent upon the elements like mortality, lapse rates and maturities of life insurance policies. Thus, these bonds are ideal instruments for matching assets to the ordinary life liabilities. We have been approached by several insurance companies who have expressed interest in buying such bonds for asset-liability management purposes, and that gives us a feeling that eventually when the market for these bonds does develop, which I think it will, these new bonds will be in good demand from investors. There are about $50 billion of policy loans outstanding. Of course, not all of them can be securitized. However, even if only a half of them can be securitized, it could create an interesting marketplace. We can talk more about these issues when the transaction has been completed.

MR. JOSEPH A. SIKORA: I have a question about surplus relief. With the pending regulations, the ones that are already in place requiring additional risk on the assumption of the reinsurer, is there any feeling on how much the risk charges will increase? 2.5-3% has been fairly standard the last several years.

MR. GILL: Despite these new regulations, the cost of surplus has been going down not up. I think it's a matter of too much supply chasing too little demand. What the regulations have done is dry up the demand for annuity surplus relief. A very simple way of stating it, I think, is since the regulator says risk must pass on single premium deferred annuities, the major risk is an investment risk, then assets (or the investment) must pass. Well, most companies just don't want to give up their investment return to some other investment adviser. So, that's put a damper on that. I don't think the rates are going to rise very much at all. The risk has always been there, except in certain manufactured treaties which I think we're all glad to see go away, where there was no real surplus relief. If all the business lapsed then the ceding company had a problem and the reinsurer didn't. But those are gone, the major writer of those treaties is out of that business, and surplus charges are going down.

MR. FORREST ALLEN SPOONER: I wonder if one of the panelists might be willing to comment on the advantages of forming a funding subsidiary to provide the capital needs of other subsidiaries, for example, rather than doing it directly from the parent company.

MR. HOGUE: I think, Al, the only reason is the nature of the prospectus. The ones I've seen for those organizations have been quite small and they get into a lot of shelf financing. If you set up a funding subsidiary, then you do a shelf for $600 billion and then you just go back with the modification and application, take what you want when you want it. It seems to be an easier vehicle for that kind of thing.