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ALTERNATE METHODS TO RAISE CAPITAL

Moderator: DIANE WALLACE
Panelists: ROBERT ARVANITIS
LEANDRO S. GALBAN, JR.*
GAIL M. GOLIGHTLY**
Recorder: DIANE WALLACE

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MS. DIANE WALLACE: I hope we'll give you some new ideas about raising capital at your company. We have speakers who are both members and non-members of the Society, and in every case, experts in their field.

My name is Diane Wallace, and I'm moderating this session. I am Senior Vice President of Atrium Corporation, specializing in helping companies use reinsurance to raise capital. I'll be giving you a few comments later on in the program on this subject. Leandro Galban is Senior Vice President at Donaldson, Lufkin and Jenrette. He is an investment banker who has worked for many years in the insurance industry helping companies obtain capital. He'll speak to us about raising money in the capital markets. Gail Golightly recently became Vice President of Bankers Trust Company. She was formerly with Manufacturer's Hanover. Gail is an expert in reviewing the structure of bank debt, and she will speak on that subject. Bob Arvanitis was formerly with L. F. Rothschild and Moody's Investment Service. Bob is a financial analyst concentrating on the insurance industry. He will describe how the outside world looks at the capital structures of insurance companies.

MR. LEANDRO S. GALBAN, JR.: The process of raising capital is actually fairly novel for most insurance entities. I think the key issue to remember is

* Mr. Galban, not a member of the Society, is Senior Vice President of Donaldson, Lufkin, and Jenrette in New York, New York.

** Ms. Golightly, not a member of the Society, is Vice President of Bankers Trust Company in New York, New York.

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that the need for capital isn't always coincident with the worthiness of the project. We see a lot of deals looking for financing that basically shouldn't be. Just because you need the money doesn't mean you deserve to get it. And it's a very competitive market. But it's a big market. The life insurance industry over the last five years has raised about \$10 billion in new money. This doesn't include very substantial borrowing from banks, mostly to finance acquisitions. I don't have a firm number for bank borrowing, but it's probably several billions of dollars in addition to the \$10 billion raised elsewhere. A fair amount of capital has also been contributed by parent companies to subsidiaries, but the amount is very tough to trace.

Of the \$10 billion raised by the life business over the last five years, close to \$9 billion was raised in 1986 and 1987 alone. In a normal year, the life business raises less than a billion dollars in the capital markets. About three-quarters of the capital raised in 1986 and 1987 was in the form of debt, issued by a parent holding company. A lot of it was collateralized notes or certificates issued by large mutuals. The rest was either convertible debt or equity.

We attribute the strong investment support for these issues to general economic conditions more than to any overriding attraction in the business itself. We've been in a terrific bull market for both bonds and stocks. Industries of all kinds raised enormous amounts of capital, and the life business shared in that wealth. Many managements adhered to one of the principal dictums in capital raising, which is get it while the getting is good. That certainly was true during the last three or four years.

I'd like now to list a few points about how investors perceive the life business. The success of any investment from the standpoint of the investor is whether the return is commensurate with the risk. It's very clear that if you are in a business with a return of 10-12%, you really can't afford to pay much more than that for capital. And as a practical matter, most life insurance companies are issuing nonrated securities that should require a much higher return than 10 or 12% today. By the same token, the equity investor has to have a fairly positive view of your prospects if he is going to invest with enthusiasm, because he is looking today for a 15-20% return on his money.

I'm really saying that if we hadn't been in such a bull market, the life industry wouldn't have been able to raise nearly the amount it actually raised. Interest sensitive products are very, very price competitive and carry lower margins than traditional life and annuity products sold in the past. The required investment in new business for these products is at least as great as for traditional products and recovery of the investment takes longer, maybe as much as 10 to 12 years instead of 5 to 7 years in earlier days. The turmoil created by the new products has raised some question as to the persistency of the business and how much of the investment can be recovered through renewal profits. To some of us, operating expenses in the industry seem high, and we see this continuing unless the industry undertakes significant consolidation. Agents continue to influence product development and pricing to an extent that is often actuarially marginal. Finally, new accounting changes make it difficult for investors to assess the earning power of life companies with confidence, which is a big drag on any equity offerings that might be contemplated.

Of those companies in the health and disability business, the current results are also discouraging. While double indemnity (DI) may have good, long-term prospects, we don't expect much fundamental improvement in the group business

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until the resolution of the whole health care issue, including control on medical care costs. And this is a problem which has eluded the business now for 30 years!

External factors also affect investors' opinions. Financial institutions generally, and insurance companies in particular, are very sensitive to changes in interest rates. The growing consensus is that interest rates are headed higher and that, over the short term at least, this could impact negatively the margins of insurance companies. Investors are not convinced that the life industry today has the investment skills it needs to successfully manage assets in an interest sensitive product environment. Also, we expect encroachment into the life insurance business by other financial institutions. This raises uncertainties that give investors pause. And finally, further changes in tax laws will alter the still preferential character of life insurance. The impact of tax change is hard to assess.

Now, you may well ask in the face of these issues why we don't just pack it in and go home. There are several reasons. First, life and retirement income products are simply essential. We can't really do without them. Second, the life business is very critical to capital formation in this country. From a political standpoint, from a legislative standpoint, and from a policy making standpoint, it's hard to imagine how we could have a viable economy without the kind of capital gathering roll that the life business, and the property-casualty business to a lesser extent, plays.

In addition, most of the issues I've raised are really management problems. They are subject to management treatment, to improvement, to correction. The burden of change, of course, is on you and the rest of your management, if you want to remain viable and maintain the ability to attract capital.

Finally, I think the issues I've raised as dampeners are already reflected in the price of stocks. Investors have an uncanny way of anticipating negative trends. One reason stocks are so cheap is because these issues fester in the minds of investors. They will continue to depress the price of stocks until investors get distracted by something else, like a short spate of good results. (Our attention span isn't very long!)

There are three conditions for a successful offering. The first is a good track record in terms of growth and profitability. Always sell stock from strength. When you're looking for money, investors want to know why you need it. The best reason you can ever give is "we've got a super track record and we're going to continue to do this with the new money we're getting from you."

A second condition is pricing. A lower price can cover a multitude of sins in the eyes of investors, who are thoroughly greedy types to begin with. So, you can distract them from what's going on by just selling your stock cheaply.

The third condition is market timing. And, this may be the most important. Why try to sell a disinterested market when it does such a good job of selling itself from time to time? Patience and planning can achieve tremendous benefits in this game.

Now, I want to discuss briefly where the money comes from. It comes from everywhere. It can be obtained privately or publicly through a registered offering. That decision is simply one of market conditions and your own

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particular operating results at the time. Sometimes a private investor is willing to overlook short term problems when a public offering would never work because the problems would stand out too much in a registration statement.

In today's market, the domestic investors are typically institutional investors and, to a much lesser extent, individual investors. Foreign investors generally want to acquire or gain control at this time. But there are also foreign institutional investors who will just buy stocks and domestic pension funds, and mutual funds as well.

I'll cover one other topic, the financing of acquisitions through bank borrowing. In recent years this has been a growing phenomenon to a degree that really would have surprised us a few years ago. Some companies have been able to borrow two to three times their equity capital to make an acquisition. These transactions are really best suited to situations with seasoned books of business and little or no growth, so statutory drain from new business growth is minimized. The holding company borrows the money and then downstreams capital into the operating company as a surplus note. Repayment comes from the future earnings stream on the acquired business, through expense savings which can often be sizable, through sale of assets, through earnings of the acquiring company, and possibly through refinancing down the road.

This approach has changed the business of investment bankers because traditionally, acquisitions couldn't be made through borrowed funds to the extent possible today. I think the situation is a two-edged sword. I worry about the leverage in some of these companies, but I also see a healthy effect. The process of consolidation I described as necessary to the future health of the industry is facilitated by this type of financing. I don't expect everyone here to stand and cheer at the prospect of consolidation, but in macro terms, I think it will be good in the long run.

MS. GAIL M. GOLIGHTLY: I will start by talking about something that I know has been a really hot topic: the way a bank looks at a company's ability to raise capital. There are several methods for raising capital from a bank. First, let's discuss asset sales.

There has been a lot of publicity about what Monarch did with sales charges and about Prudential's policyholder loan sale. The Monarch deal with Chase is the first to use the concept of selling deferred sales charges. Everyone thought this could be the answer to interest sensitive problems. Interest sensitive products drain capital. If the company can sell the deferred sales charge, they may be able to mitigate some of that strain. However, the Monarch transaction was not booked as a sale. It was booked as a financing. The accountants and the lawyers couldn't agree on a particularly fundamental issue. Were the sales charges Monarch's asset? The deferred sales charges from products in a separate account may not be a sellable asset of the insurance company. Companies are now working to structure their products so that deferred sales charges will not be an integral part of the separate account, and therefore may be available for sale. But at the moment, nobody has a clear solution.

The policyholder loan sale that Prudential worked out actually cost it capital initially. Policyholder loans were sold at a discount. Prudential had to agree to guarantee the transaction in the event mortality was insufficient to meet the

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payment streams involved. Prudential's thinking was that, in the long run, the transaction bought them capital, even if it cost them capital in the short run.

Asset sales can also be structured around real estate transactions. The sale-lease back was made famous by most banks, who, in deteriorating economic times, chose that means to improve earnings. This approach may be particularly valuable to insurance companies, since they cannot write up the value of their real estate.

Demutualization has also been considered as a possible source of capital. However, it's expensive. It's tough. And, the valuation process takes a lot of time.

This leaves us with straight borrowing as a source of capital. And more life companies have become borrowers of late. This is really tied to Pedro's observations that there is a lot more acquisition activity going on. And banks have been willing to lend into that activity.

Now I feel that it's time for truth in lending. I have to tell you both sides of this story. Borrowing costs, and not just in fees and in interest. It costs in control. Because as a lender into an insurance company, I'm faced with the fact that you are part of a regulated industry. If you get in trouble, I have to wait behind all your policyholders before we sort out a solution. That makes you what we call a story credit. I have to feel comfortable that I know you in and out, and that I can protect myself. That usually means some very stringent covenants.

You may also sacrifice your future ability to do what you would like with your company. Because, as a lender, I will want to protect certain income streams. Pedro said that the ideal candidate to go to the public market has a track record. As a lender, I'm also looking for a company with a strong predictable cash flow. Bullet maturities don't work in insurance companies, because a lender is looking for a dividend stream from these insurance companies to service the debt.

Pedro talked a little bit about the structure of insurance bank debt. This is one of the few times that banks get over their inherent terror of lending to a holding company. Banks are afraid to lend to holding companies because there aren't any real assets. There aren't any boxes you can kick and say, "that's mine, I can take that." In an insurance company, there aren't any boxes to begin with. Even worse, the boxes belong to somebody else. So, if I lend into the operating company, I now have a partner: your state regulator. Anything I do to try to get myself in a better position, he will benefit from. As a result of that rather peculiar situation, banks lend at the insurance holding company level and permit the holding company to downstream capital in the form of a surplus debenture.

Surplus debentures are used because the repayment schedule mirrors the debt service. The bank will look at three sources of cash flow: the surplus debenture payment, the cash flow from normal dividend streams, and any management fees. Management fees are the least regulated cash flow of the three. That's not to say you can obtain \$40 million out of \$50 million that way. Regulators aren't that stupid.

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They do notice. However, it is a source of funds that permits a constant flow of cash to keep the banker feeling more secure that money reaches the holding company where the debt actually exists.

One of the problems with the fact that I prefer to lend to a holding company is tax. As you know, life/nonlife consolidation is only possible after a five-year common history. Therefore, a number of transactions like this involve a Texas life company to act as the holding company. Texas will permit debt well in excess of the equity base. This is a technique that has been used in a number of different transactions. It is simple, and we'll probably see a lot more of it in the future.

What kind of covenants are common in transactions of this sort? A favorite one of the bank is the material adverse change clause, called the MAC. It is a catch-all that says if you deteriorate, I have a right to accelerate my debt. Other covenants control how you may use the capital that I just lent. You can't move into products that I know won't give the return necessary to repay the debt. There'll also be limits on affiliated transactions. There'll be limits on reinsurance. And there'll be other techniques to try to pull cash flow up. There's something called an excess cash flow recapture which forces excess cash into the holding company even before debt payments are due. Then, if the company gets in a regulated situation where dividends won't be paid, something is still available for debt payments.

This is a broad outline of how debt works. The likely candidate for debt is evident from what I've said already. Interest sensitive products, because of their long break even period and interest rate vulnerability, create a great deal of problems for a lender. Group accident and health also creates problems because it is not a predictable line. Management is also a factor. How good are you at managing the risks around you? A bank is supposedly a more knowledgeable player than the public market, and therefore should be willing to take more risks than the common investor. But this is only true if we have understood how you got here and where you're going.

I would also like to discuss the issue of leveraged buyouts (LBOs). Banks have done a lot in the LBO market with insurance companies. However, I'd like to caution you that this is a slight misnomer. A LBO of an insurance company does not look like a LBO of a manufacturing company. Insurance companies can't sustain the levels of debt that are common in a manufacturing transaction. This is partly because of low cash flow, partly the problem of the bullet maturity. An insurance company has no assets readily available to sell. Breaking up a manufacturing company is a lot easier than breaking up an insurance company. Frequently you have distribution systems that cross over among a number of affiliates. Or companies have been stacked, creating difficult considerations if you want to sell a piece out. So before anybody beguiles you on the issue of an LBO, be aware that it's not very easy. Only a few closed within the last two years. And when they did close, they were not as highly leveraged as typical. Generally speaking, the leverage has not gone beyond 60%, which is very low for a traditional LBO.

MS. WALLACE: We'll cover the use of reinsurance for financing insurance company capital needs. Of course, conventional coinsurance has been used for many years as a financing vehicle. But in recent years another type of reinsurance labeled surplus relief or financial reinsurance, has emerged as a very powerful tool for use by successful, growing companies in financing their

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acquisition costs. Surplus relief should now always be considered as an alternative for raising capital in an insurance company. It won't cover all the needs, but it is certainly useful in some circumstances.

I will go over the basics of surplus relief, how it works, when it is appropriate, and give you a comparison of its use to debt and equity capital. Then, if we have time, I have a few comments about the current regulation of surplus relief. Let's compare surplus relief to conventional reinsurance. Surplus relief really isn't much different. It has many more similarities to conventional reinsurance than differences. In both, the reinsurer agrees to reimburse the ceding company's benefits in exchange for receiving premiums from the ceding company. The reinsurer also pays an allowance to reimburse the ceding company for its investment in the block of business. And in exchange, the reinsurer retains the right to keep renewal profits on the block until the reinsurer recovers its investment.

Although I don't want to spend too much time discussing the intricacies of this type of transaction, I would like to point out a few differences from traditional. In traditional reinsurance, the reinsurer competes with its rivals for the deal by offering the largest possible allowance to cover the investment in the business. In exchange, it retains the right forever to all the future profits on the block. If experience is bad, the reinsurer may not recover the initial investment in the business. On the other hand, it has a substantial upside potential if the block of business turns out to be very profitable. In surplus relief, on the other hand, the reinsurer usually promises to give excess profits back to the ceding company. Once the reinsurer has recovered its initial investment, all future profits go back to the ceding company through an experience refund. Since the reinsurer therefore has no upside potential, it wants to limit its downside risk. It does this by granting a fairly conservative allowance, which probably does not reimburse the ceding company for all of its investment in the block of business. A conservative investment is made by the reinsurer in exchange for allowing the ceding company to retain the right to excess future profits. In this way, the ceding company may be charged a fairly modest reinsurance cost on a use of capital basis.

I've just described two opposite ends of a spectrum of reinsurance. On one end, we have aggressive reinsurance allowances in exchange for the right to all future profits. This is *pure conventional*. On the other end, we have a more conservative investment on the part of the reinsurer and no upside potential. Of course there are lots of variations in between. The key to both is that the reinsurer only recovers its investment out of renewal profits on the block reinsured. Repayment is only due by the ceding company if the profits are there to pay it. The mechanism which shares any additional profit between the reinsurer and the ceding company determines whether it is more on the conventional end or more on the surplus relief end of the spectrum.

When is surplus relief an appropriate mechanism to raise capital? First, surplus relief is most commonly used to finance the investment in new business. In addition to acquisition costs, of course, business sold today generally has reserve strain. The required statutory reserve liability exceeds the assets the company has received in consideration for selling its policy. Surplus relief is a good way to support the strain. Occasionally, surplus relief will also help in another cost of investing in new business: required free capital and surplus. Best's and others use various formulas, but something like 5% of liabilities is generally necessary as free surplus to support the life insurance business.

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In addition to supporting investment in new business, surplus relief can also be used to assist in the financing of LBOs. Gail and Pedro have spent time talking about these types of financing. Remember what was described to you. The purchaser borrows money in a holding company and uses it to purchase a company or sometimes a block of business. Once owned, this new owner can use the in force business in the insurance company to raise capital through surplus relief. This increases the surplus of the insurance company, allowing it to make a dividend to its parent to service the debt. I've seen two types of structures. One type is where the company immediately reinsures virtually all of its inforce business, creating a big lump of capital to considerably pay down the debt. Alternatively, the company can enter a series of reinsurance transactions year by year, creating sufficient annual income to just service interest and principal repayments.

A third use of surplus relief is to handle temporary needs. Because of changes in strategy or temporary difficulties a company may need a one shot infusion. Surplus relief is a handy, fairly simple way to do it. As Pedro mentioned, one of the important keys in raising capital is market timing. If it isn't exactly the right time for a company to go out for equity or to borrow money, they may use surplus relief as a temporary method of obtaining capital until the timing is right for them to undertake a more permanent solution.

There are limitations on the use of surplus relief. It's not appropriate in every instance. First, the company must have an appropriate block to reinsure. The block has to be profitable so the reinsurer is willing to invest in exchange for the right to future profits. The block has to be cohesive enough to administer easily. A block with many different plans and products will not be administered easily. And the block has to be composed of products with a fairly common benefit structure, so the reinsurer isn't scared away. There are certain lines of business with lots of fluctuations where the reinsurer just won't be interested in taking the risk.

Another limitation is that you must have an alternative source besides the surplus relief. An insurance company cannot cover all of its capital needs with reinsurance. The reinsurer won't cover 100% of the investment in new business because it wants a high likelihood that renewal profits, even if worse than expected, will cover its investment. Also, reinsurance can't usually be used to cover most basic free capital and surplus requirements.

Another limitation is that a surplus relief agreement will usually be structured such that renewal profits will repay the surplus relief over approximately five to seven years. So, it's not a very long-term source of capital. Generally, the agreements are renewable if you've still got a suitable block of business, but they shouldn't be counted on as a long term solution.

What if you're making the decision between alternative sources of capital? What do you consider? First, surplus relief generally does not provide cash to the company raising the capital. The surplus is raised by reducing a liability item or increasing a receivable asset. So if the company needs cash, it shouldn't expect to get it from surplus relief. It will need to borrow money in the holding company or raise equity capital. Cash is possible, but not usual. This generally isn't a problem for most insurance companies, because insurance companies are cash rich. Their biggest expenditure is a noncash item, the increase in reserve, so they are generally not short of cash.

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Second, the price of surplus relief will generally be more than the cost of debt. To understand that, you have to think about the cost of borrowed money. If an insurance company receives an infusion of capital from a holding company which borrowed money, the cash may be invested in normally purchased securities. You will therefore earn investment income on that cash. The net cost of the capital to you is the difference between what the lender charges in interest and the amount of investment income you earn on the cash received. In today's environment, that cost may be a 1 to 2% spread charged by the lender. This is the number to compare against the cost of surplus relief. Surplus relief is usually priced as a percentage of the surplus provided and the numbers range from approximately 1 to 5%, depending on the circumstances. Cost of debt is generally less than the cost of surplus relief. It's cheaper to borrow money.

Even though surplus relief is more expensive, there are some advantages of surplus relief over debt. One of these is that payback is timed exactly to the emergence of profits.

Of course, debt must be repaid when the bank tells you to, regardless of the flow of renewal profits on the business generated from the capital. Surplus relief may never be repaid if the business doesn't produce profits. Surplus relief is only repaid when and to the extent renewal profits emerge. And if there are losses, the reinsurer covers those losses. So there is significant downside protection. Surplus relief is the only source of capital where the provider agrees in advance to give you more if you need it because of losses.

Another big difference in the methods is the look of the resulting financial statements after the transaction. This is, in my experience, the key factor which drives companies to use surplus relief in lieu of other methods. Surplus relief is the only method of the three which affects the income statement, as capital, or when you raise equity capital, the surplus on your balance sheet is improved but there is no effect on the income statement. Surplus relief, however, does boost the income statement, offsetting the expense associated with putting the business on the books.

Let me now just spend a few minutes on the regulatory environment. This is something you need to pay attention to if you are going to use surplus relief. Generally, you can work with your regulators. You just have to be aware of what's required and to recognize that your regulators will want to discuss this with you.

Reinsurance is generally regulated by the state of domicile of the insurance company. At times, you must consider the laws in other states where you are licensed as well. Regulation does not permit or prohibit any reinsurance agreement. You are free to enter any contract you choose. Regulation instead determines whether or not you will be allowed reserve credit for the reinsurance.

There are three major areas of regulation: risk transfer, security for reinsurance, and holding company laws. Risk transfer laws or regulations basically provide that if the reinsurer is not on the hook, the ceding company is not allowed to take the reserve credit. If you're obligated ultimately to pay the policyholders, you should hold the reserve. To determine whether your reinsurer is on the hook, look at the terms of the contract. Is the reinsurer obligated to make full benefit reimbursement, or just partial? Is there a permanent transfer of losses? In other words, if the business loses money, does the

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treaty provide that the reinsurer gets stuck with those losses, or does it have some alternative provision whereby the ceding company must reimburse the reinsurer for those losses?

Another factor -- is the reinsurer on the business for good? If the reinsurer has the right to terminate the agreement, then effectively the ceding company is ultimately liable for the benefits and must hold the reserve. The essence of the risk transfer laws is simply making sure the reinsurer is in fact obligated before the ceding company takes credit.

The second area of regulation is security for reinsurance. These regulations are set up to ensure that the ceding company can collect from its reinsurer when it's time for the reinsurer to pay. If the reinsurer is outside the jurisdiction of the ceding company's regulator, that regulator has no basis of knowing if the reinsurer is financially solvent and can pay its bills. Therefore, the reinsurer must provide security in the form of a letter of credit or trust account. This is essentially a mechanism where the ceding company may go to the reinsurer's bank to request money on demand if the reinsurer doesn't pay its bills. And this should provide fool proof security that the reinsurance will be paid when due.

Holding company laws apply if the reinsurance transaction is between affiliates. Most states' holding company laws require preapproval of reinsurance transactions between affiliates. In unaffiliated transactions no preapproval is generally required. The laws would be invoked at triennial exams to deny reserve credit if the risk transfer and security requirements are not in place.

In conclusion, reinsurance can be complicated, it can be more expensive than other options, and it is generally not useful to cover 100% of capital needs. But, in appropriate circumstances it's a very powerful tool. It's the only method of raising capital that improves the income statement in the year of the transaction. It's the only method that precisely times payback to occur when funds are available to pay it back, and it provides significant downside protection. So, surplus relief is something that should always be reviewed and considered in your total package of financing needs.

MR. ROBERT ARVANITIS: Today's panelists have given us an excellent overview of the mechanisms for raising capital through the equity, bank and reinsurance markets. From them you have heard the advantages and characteristics of each of those markets. I will try to provide a brief survey of the fixed income market place related to other financial markets, and to give some examples of the special adjustments that the life industry requires. We will consider the different perspectives of several outside observers of the industry, and along the way there will be analogies to other financial institutions.

Remember, in the fixed income markets everything is backwards. Low employment figures, strong growth in the GNP -- all the items we consider good economic news -- are interpreted as bad by the bond market. Even the pricing is reversed. People talk about high yield when what they really mean is low prices. And, of course, the best credit is one that never borrows, which is truly perverse.

In this vein, I will be counseling you that for a life insurer, the credit rating is very important. So important, in fact, that it should never be used; well, hardly ever.

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Of course it would be unfair of me not to mention an advantage or two of debt, which is where we'll begin. Next, I will lay out some of the financial measures used by investors along with important modifications to the life industry. Finally, I will try to clarify the special significance which the credit rating has for a financial intermediary like a bank or an insurer.

To put some perspective on the use of debt by the life insurance industry, I offer a very broad estimate of the industry position at year end 1987. It is the result in part of an informal survey of insurance executives. Total rated debt is from Moody's. Additionally, I have estimated that about two-thirds of that debt relates to life insurers or to the life insurance operations of health and life. To one significant digit, we stand at a 23% debt to equity ratio as an industry which is perhaps higher than one might have expected.

U.S. Life Insurance Industry -- 1987 (\$ billions)

Surplus	70
MSVR	16
Regulatory Capital	86
GAAP Factor	140%
Equity Equivalent	120
Rated Debt	40
of which Life...	27
Debt-to-Equity	23%

The classic advantage of debt is that it permits issuers to leverage up the return to shareholders. When the rate of return on assets is greater than the cost of the liabilities, the incremental gain is an additional return to the owners of the firm. A second advantage to the issuer is the availability of interest rate options in the form of call features. These call features often enable issuers to select against lenders. If interest rates rise, the borrowers hang on to the cheap funds. If interest rates fall, the borrower repays and replaces the debt with now lower prevailing rates. A third advantage of current notoriety is the value of a put option on the net worth of the firm itself. This is most clearly seen in the junk end of the market. Implicit in the bond covenant is the ability of the issuer to make the following wager with the investor. If the firm has a positive net worth at the end of the debt period, the debt gets repaid. If the firm ends up with a zero or negative net worth, the investors take ownership and are entitled to the residual value of the remaining assets. The issuer has, in effect, "put" the firm to the creditors.

These then are three of the advantages companies find in using debt. Firms will issue debt to leverage their return on equity just up to the point of increasing the riskiness of the firm. This riskiness relates to the need to cover the fixed charges of principal and interest with the variable returns from business operations. The perceived risk is likely to be a function of both the level of the fixed charges undertaken relative to income and to the volatility of that income.

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Dyed-in-the-wool believers in the efficient market tend to discount the advantages of leverage and the options which debt provides. According to the Miller/Modigliani theory, for example, the use of debt increases the riskiness of the firm from the first dollar. Rational investors immediately ask for a higher return on equity from the firm to compensate for the added risk which exactly offsets the extra earnings from the use of debt. Whether or not Miller and Modigliani are correct, the benefits of debt do have a cost.

The basic function of the bond analyst is to assess the credit worthiness of a firm. This in turn affects the cost of debt as investors demand varying risk premiums for different quality and maturity. Good analysis, whether of debt or equity, takes into account a wide range of factors such as historical financial measures, operating structure, market position and management strength.

I would like to focus today just on the financial measures, especially on fixed charge coverage and leverage. I believe these two measures and the suggested adjustments show the intimate relationship between debt instruments and insurance products.

The traditional definition of coverage takes the ratio of earnings before taxes and fixed charges to the fixed charges themselves. Coverage shows the degree by which a firm's income could vary and still meet the principal and interest requirements. It is a form of safety margin.

COVERAGE

Revenue	100
Expense	<u>80</u>
Operating Income	20
Bondholder interest	<u>10</u>
Pretax income	10
Coverage: $20/10 = 2.0$	X

For life insurers, an important component of operating expenses is interest credited to policyholders. This is most clear for products like guaranteed investment contracts. Although GICs may end up ranking senior to debt, they are debt-like instruments. Other concepts such as deferred annuities have explicit guarantees and implied or competitive requirements. Likewise, in a sense, participating dividends are a cost of doing business. Par dividends are partly a price discount to clients. However, par dividends are also partly a rent on the owner's surplus. In both functions, they are not easily reduced without consideration of the business consequences. I would argue that some

COVERAGE -- Life Insurance

Revenue	100
Expense (includes interest to policyholders of 50)	<u>80</u>
Operating Income	20
Bondholder Interest	<u>10</u>
Pretax Income	10
Coverage: $(50+20)/(50+10) = 1.17$	X

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portion of the par dividends ought to be viewed as a semi-fixed charge. When these additional costs are taken into account, a different and perhaps less favorable picture emerges. This consolidated view of fixed costs show relatively less margin for variation in investment income.

Fixed charges to be covered should include interest on GICs and other contract funds, tabular interest from page 6 of the Convention Blank, and some portion of policyholder dividends. The first concern about leverage is that it represents the margin for error available to absorb risks inherent in the insurance business. The SOA has set up a classification system for these risks and has with characteristic whimsy labeled them C-1, C-2, C-3 and C-4. As you are aware, these relate respectively to the asset default, insurance parameter estimation, asset/liability mismatch and general business risks. Now I don't want to seem like the Joe McCarthy of the financial markets, finding C-1 under every mattress, but in fact all four of the risks become the C-1 risk for the investor.

One adjustment to leverage requires netting out policy loans. Policy loans may be viewed as a prepayment of future benefits and as such are more of a contra-liability than an asset. If policy loans are securitized or sold off, a fair representation might be that the company is creating new debt rather than simply transforming one asset to another.

A second adjustment is to restore reinsured reserves and to create an explicit asset due from the reinsurers. Showing an explicit asset for reinsurance emphasizes the need to ask about the quality of that reinsurance just as one might ask about the quality and rate sensitivity of a company's bond portfolio. While reinsurance can decrease an insurer's C-2 risk, it may at the same time create C-1 risk.

LEVERAGE -- Life Insurance

<u>Assets</u>	<u>Liabilities</u>
8,500 bonds	10,000 policy reserves (net)
500 stocks	
700 real estate	
<u>800</u> policy loans	<u>500</u> surplus
10,500	10,500

Perceived leverage $10,000/500 = 20:1$

LEVERAGE -- Adjusted

<u>Assets</u>	<u>Liabilities</u>
8,500 bonds	14,200 policy reserves (gross)
500 stocks	
700 real estate	
5,000 reinsurance recoverable	
<u>0</u> policy loans	<u>500</u> surplus
14,700	14,700

Adjusted leverage $14,200/500 = 28.4:1$

In deference to our mutual colleagues, I have not put an explicit asset for deferred acquisition which would get us into GAAP considerations, but I do

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believe that a fair adjustment would be to increase surplus from its current tangible net worth aspect to a true GAAP equity.

A second concern about leverage, of equal importance to the bond holder, is regulatory. In the typical holding company structure, both equity and debt are raised by the parent. Funds are then invested downstream in the operating insurer to support the business underwritten. Insurance holding companies, along with banks, thrifts, and broker dealers, are at special regulatory risk. All those industries have to pass supervisory muster in order to pay up the dividends needed to support the debt. In hard times, insurance commissioners are quite likely to put policyholder interests ahead of those of bond holders or owners. A similar case pertains to mutuals. Debt service is more susceptible to restriction than payments to insureds.

In noting the difference in perspective between the rating agencies and the street, let me simply say that rating agencies tend to look at the long-term reality of a firm. When one considers the street perspective, it's as much an estimate of what future buyers will want as the true underlying nature of the firm. We have seen very vivid examples of how financial markets and the real economy can diverge!

Now, why should we care what the rating agencies or financial markets think? The reason is that the debt rating is, in a very important sense, our only product. The life insurance industry is special. All sorts of firms access the equity, bank and debt markets. Life insurers access a fourth market -- policyholder funds. As with the retail banks and thrifts, the credit rating is what we offer the public. The way various agencies in the bond market firms view the life industry is important not only because we may have borrowing needs, but because those views are a comment on what we sell. Our public responsibilities require that we maintain their trust.

MS. PATRICIA L. GUINN: I have a question for Diane and for Ms. Golightly. Diane, you indicated that surplus relief is the only one of the transactions that would affect the income statement. Isn't it true that it only affects the statutory income statement but not the GAAP statement? Secondly, can you address taxation for both the ceding company and the reinsurer on surplus relief versus assumption reinsurance?

MS. WALLACE: First, for most surplus relief transactions, it is true that only the statutory income statement is affected and not the GAAP income statement. The reason is that the GAAP statement, by its nature, spreads the profitability of a transaction over the life of the transaction under expected experience. In a surplus relief transaction, the company receives income initially, with the expectation of repaying it over a period of years if results come out according to GAAP assumptions. The simple sum of all of those years is zero, other than for the risk fee. When you GAAP this transaction, it should have no effect year by year. Another way of looking at this is to say that you haven't charged acquisition expenses against your GAAP statement, so it's not fair to take them back into income through the surplus relief. The whole basis of GAAP accounting is different from statutory accounting, where you charge all expenses and record all revenues when received. So it is true that surplus relief transactions will not generally affect the GAAP income statement.

The second question was on taxation. Let me just say that it is important to consider the tax effects, not only what they have been historically, but what

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they may be in the future. There is a lot of current activity on the taxation of reinsurance. On assumption reinsurance, which is a true sale of a block of business, it has long been held that the acquirer must amortize its purchase price over the life of the block. The purchasing price is considered an investment in an income producing asset, which must be amortized over the life of that income producing asset. Historically, in indemnity reinsurance, which is what I've been talking about with surplus relief, the reinsurer has treated its investment in the block of business as an insurance acquisition expense which is immediately deductible. The IRS is now challenging this position. Court cases are currently being heard to help establish whether a reinsurance allowance is actually an insurance acquisition expense and therefore immediately deductible, or an investment in an income producing asset which must be amortized.

MS. GUINN: Is the ceding company taxed in the year of the transaction in both instances?

MS. WALLACE: The ceding company is taxed on the income produced. Correct. Normally, however, a ceding company has losses they are trying to offset with this income. In that case, the income may not bring them to a taxable position. But if they are in a taxable position and they receive surplus relief, it will generally be taxable. However, there are ways to structure agreements which do not produce taxable income if that's important.

MS. GUINN: My second question is for Ms. Golightly. Could you expound a little more on the Texas life company concept?

MS. GOLIGHTLY: A small Texas life company is used as the holding company to distribute debt into the operating company. It, therefore, can file a consolidated tax return and the interest payments can be taken as deductions against the life company income.

MR. PAUL A. SCHUSTER: I have a question for the investment bankers. Many times surplus relief transactions will be \$2 to 3 million in size. Is there a minimum size transaction that an investment banker will look at -- is \$10 million too small, does it have to be \$50 million? Also is there a minimum size life company with which bankers would be willing to work?

MR. GALBAN: The banker obviously likes to do big deals because he earns bigger fees. There are some other practical constraints as well. In talking about an initial public offering for a young company, it's pretty hard to achieve any kind of decent marketability for that stock if the market capitalization after the offer is much less than \$50 million. That means the company has to have annual earnings of, let's say, \$5 million. In the private placement market, you will find any number of investors who will do \$10, \$15, or \$20 million deals split between one, two, or three investors. They'll each take \$5 or \$10 million chunks. In a nonrated bond issue, you really have to create some kind of liquidity. There's hardly a bond house that will touch a nonrated bond issue for less than \$50 to \$100 million.

MR. ARVANITIS: The important issue here is marketability, as Pedro says. Is there enough of a secondary market? Investors like to be able to get in and out of instruments as their opinions change.

MR. PHILIP J. BARACKMAN: I am interested in any of the panelists' opinions of the perceived impact on either the cost of capital or the availability of capital

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on account of the AIDS threat. Is the banking and investment community in general very familiar with the work that the Society of Actuaries has done in projecting the possible impact of AIDS on health and life insurance companies?

MS. GOLIGHTLY: I'm familiar with the work that the Society has done on AIDS. There is a certain amount of panic among people who do not understand the impact. From what I have read and seen about the statistical work being done, the life industry is going to be less hit than the accident/health side. It's not something that makes me run from the industry, but it's an additional factor to consider. We look at the life demographics a little closer, since obviously major cities are a higher risk factor. Certainly the work I've seen suggests that if we get to epidemic proportions, if it crosses over into the heterosexual population, we might as well all forget it and the cost of capital may be mute.

MR. GALBAN: Last year I lost a \$20 million private placement we were placing for a life company as part of an acquisition financing program. We were placing it with another life company, which in itself was unusual. After going practically to the closing, they turned us down because of the fear of AIDS. And my reaction was if they're afraid of investing in this company because of AIDS, can you imagine what they think about their own business. And it wasn't just a run around. They suddenly started to think about it as investors and said wait a minute. I think there's probably a little bit of head-in-the-sand syndrome right now among investors. Yes, they know it's a problem. They know there's a fair amount of literature and work trying to quantify it, but they really would just as soon not dwell on it too much. My feeling is that investor reactions to this problem aren't going to come until you really start to see it in earnings. It's probably a couple of years away.

MR. ARVANITIS: I think it would be useful to look back at the experience of our property/casualty brethren. They, too, had their own "A" word but in that case it referred to asbestos. It takes a little while, but eventually, that type of panic reaction subsides.

MR. THOMAS G. KABELE: I have a couple of questions for Ms. Golightly. Can you explain in more detail a "MAC" and an excess cash flow recapture?

MS. GOLIGHTLY: MAC stands for Material Adverse Change. It is a clause which appears in most standard bank documentation for not just the insurance industry but for most industries. It permits the bank certain rights of debt acceleration should a company start to materially deteriorate. It's a catch-all and is never defined more specifically than that.

An excess cash flow recapture affects your debt servicing. Usually, you've created a set of projections that shows a certain earnings stream. A banker will say if you do better than your projections, I'm willing to let you retain a portion of that but I would also like to get some debt prepayment from it.