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SURPLUS MANAGEMENT

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MR. DANIEL J. KUNESH: I am a Principal and Vice President in the Chicago office of Tillinghast, a Towers Perrin company. Harris Bak is Vice President of Chase Manhattan Bank in New York. Finally, Dick Stenson is Senior Vice President and Deputy Chief Actuary at the Equitable Life Insurance Society of New York.

At a recent conference that I attended, Mr. John Flittie of Northwestern National Life Insurance Company outlined what he believes to be keys to winning in the 1990s in the life insurance industry. I couldn't agree more wholeheartedly. Let me outline them for you. A company must exhibit marketing effectiveness, investment expertise and expense control. Also on this agenda for a winning combination is the availability of needed capital at a reasonable cost. This is the topic of our discussion -- the management of capital and capital resources available to the life insurance industry.

Surplus and capital has indeed become an increasingly scarce resource. Let me state at the outset that it is my opinion that the insurance industry as a whole is rapidly becoming a surplus-poor industry. Let me offer as an example, a comparison to the small island nation of Japan. In a recent Tillinghast publication, Jim Anderson states that he believes the total capital and surplus in the U.S. life industry approximates $100 billion. By comparison, the entire industry in Japan aggregates $500 billion. Indeed, one company alone in Japan, the largest company, has more capital and surplus than the entire U.S. life industry.

There has been a steady and continuous downward trend in the overall level of capital and surplus of admitted assets in the life insurance industry. This is true both before and after adding mandatory securities valuation reserve (MSVR) to the capital and surplus

base. This is true for both stocks and mutuals. The relative level of mutual company surplus is less than that for stocks. Two things widely contribute to these differences.

1. By necessity, separate account assets are included in the denominator. This depresses the ratio of surplus to assets. As a whole, the mutual segment has more separate account assets than the stock segment.

2. The mutual segment has a larger portion of total pension funds in the industry. Generally, the required level of capital for pension funds is believed to be less than for life and health products.

A considerable amount of attention recently has been on a subject that just won't go away. The subject is target, or benchmark, surplus. Many believe that target surplus standards will be established by the NAIC and insurance departments in the not too distant future. Free surplus, available for expansion, joint ventures and other investments, can be defined therefore as total surplus plus MSVR minus target surplus.

We recently completed a study of target surplus requirements for the industry as a whole. Using the Moody's formula, we found that for the mutual segment, target surplus requirements have averaged somewhere between 4.8-5.3%. While we did not quantify a similar value for stock companies, it is our belief that the stock ratio would be somewhat higher. This is a considerable portion of the total average surplus available at the end of 1988. Thus, it is clear that capital and surplus is becoming an increasingly scarce resource and it is management's responsibility to establish an effective program of conserving, gaining access to, and managing surplus.

What are the objectives of an effective surplus management program? I submit that there are at least four:

1. A good program will maintain or at least seek a position of financial strength for all the stakeholders in the company; that includes policyholders, shareholders and employees.

2. A good program should be designed to enhance financial flexibility; that is, the ability over time to react favorably to a reasonable set of financial alternatives available to the company in a timely manner.

3. An effective program will allow the company to acquire capital or surplus when needed at the lowest possible cost. This assumes the company will have available to it a series of alternative options from which to choose a surplus enhancement action which best fits its current needs.

4. The fourth objective goes without saying, that is, to maximize shareholder/ policyholder values in the company.

A company will have available to it, at any given point in time, a different set of alternatives by which it may enhance its surplus position. The trick is selecting the best alternative at the lowest possible cost. Unfortunately, "best" and "cheapest" is seldom a

combination available when needed. There are a series of considerations that a company should make when evaluating capital raising alternatives.

Senior management must consider the ultimate deployment of capital -- that is, how it is to be allocated, to whom, and why. Many companies employ a corporate account to access and deploy capital to the company's various lines of business. The corporate account, in effect, becomes a profit center by itself. A second approach is known as the "distributed" approach, wherein surplus is accumulated in each respective line of business over time and decisions about the deployment or raising of additional capital are made by senior management at the line of business level.

Another important consideration involves the form of capital that is required; that is, cash versus noncash. An example of a cash situation is where monies are needed to finance rapid growth in new business with high acquisition costs. A noncash example would be to meet additional reserve requirements such as deficiency reserves or excess interest guarantee reserves on annuity products.

It is also important to identify alternative capital raising opportunities and compare them against each other using criteria based upon the company's current need for capital. Needless to say, cost is not always the best criterion for a final decision on any alternative. And speaking of cost, while not always the single most important criterion, it is important and must be studied carefully to determine the economic impact on the organization. This includes the impact on the company's GAAP and statutory financial statements.

The company must also consider the long-range impact that a capital raising alternative may have on its shareholders and/or policyholders. "Quick fixes" such as those used by many companies through the use of financial reinsurance may be short-term answers and may disguise real problems that ultimately can destroy an organization. For example, the decision for a company to finance growth in the annuity marketplace through the use of surplus relief reinsurance may not be wise if sales are to be achieved through high long-term interest guarantees and junk bond investments; unless, of course, adequate consideration is given to C-1 target surplus.

Each capital raising alternative must be evaluated in terms of its impact on the financial statements and the company's book value. Some capital raising techniques will not be recognized as improving GAAP shareholder equity. An example is financial reinsurance. Accordingly, substantial disparity may occur in the company's GAAP-versus-statutory book values. A company may be well advised to measure the impact on its total economic value of varying alternatives by using a value added approach.

Management must also consider the impact on the company's operating and financial leverage. Abrupt changes will be carefully monitored by regulators. Additionally, management must consider the expectations of the various providers of surplus. These include cost, collateral and how much of a piece of the action the provider of capital or surplus will demand. Of course, these expectations will vary, depending on market conditions and the overall strength of the company and the industry.

Another important consideration is the impact that the capital raising alternative will have on rating agencies such as A.M. Best, Standard & Poor, Moody and other debt and claims-paying-ability rating services. Companies will go through great pains to avoid a movement in their Best rating or other rating, and will kill otherwise fabulous capital raising ideas to maintain these ratings.

Serious considerations must also be given to the reaction of regulators, investment analysts and agents of the company. Regulators will often be involved in the decision making process, such as in situations involving surplus debentures, securitization and programs to finance levelized commissions. Investment analysts will review with scrutiny any major capital raising efforts of a public company. Agents' concerns relate to the continuing strength of the company, their continued access to competitive products and markets, and favorable ratings from Best and the other rating services discussed earlier.

Finally, the company must consider both the legal and tax implications of the alternative. Certain capital raising techniques such as levelized commission financing may involve a mountain of legal paperwork and regulatory involvement. Similarly, corporate reorganization efforts, such as through the formation of a downstream holding company either internally or in tandem with a joint venture partner, can have substantially different federal income tax implications, given form and structure. These and other considerations are all important before a decision can be made on the selection of a capital raising alternative.

Harris Bak will discuss some of the trendier approaches being used by companies to raise capital and surplus today. But first, let me outline for you some techniques that companies can use without going to the outside. I call these internal streamlining techniques.

I will be discussing the results of a surplus management survey that I conducted in preparation for this meeting. The most popular means of streamlining internal operations is through cost reduction programs. Practically everyone believes that they can save money by reducing expenses by an appreciable amount.

A second approach used by some companies is to streamline their product distribution practices. This includes such things as market segmentation, wherein the company analyzes its total market base and only allocates resources to those segments that have the greatest promise. Another technique is to have better control over the time spent by the field force. This includes effective training programs, sales brochures, and guidance in seeking prospects. Many companies are also making greater use of technology in distributing products, through the use of hand-held computers, automated field underwriting and facsimile machines.

In a similar strain, some companies are looking to diversification. Diversification may be selective, such as through the restructuring of products and services, or it may be geographic or demographic, such as increasing sales in overseas markets such as the Pacific rim or catering more directly to the growing segment of young female executives. Many other companies are looking to reduce their distribution costs by dealing with banks and other financial institutions.

It should be noted that many of these internal streamlining techniques do not have an immediate surplus impact. However, they do comprise a more effective use of capital by reducing total distribution costs, increasing sales effectiveness and shortening the timeframe over which to recover the surplus invested in new business.

An increasingly popular technique used to generate surplus quickly is to sell segments of the company's business which no longer meet its overall strategic plan. These include loss operations, business segments which are just plain outdated and do not fit the current marketing structure and business segments which appear to be too small to be profitable; in other words, where profits are being eaten up by the expense of operations.

Another popular technique is to realize unrealized capital gains from the sale of assets where market values exceed statutory book value by a fair amount. Under this technique, timing is of the essence and capital gains taxation is an important element. Examples could be the sale of investment real estate and mortgage loans with equity kickers.

Other companies will sell certain nonadmitted assets such as agents debit balances. The idea is to circumvent the restrictive statutory requirement that such assets have no carrying value in the statutory financial statement.

Another technique is to sell and lease back home office real estate and data processing equipment. The concept is similar in that the value of the home office generally exceeds its current carrying value in the annual statement. Often, such sale or leaseback arrangements result in a larger overall cost over the lifetime of the asset, but it does free up surplus.

The destrengthening of reserves is a technique that has been used by companies over the years. It is my belief that most companies have gone about as far as they are willing to go in weakening reserves in their statutory financial statements. This approach obviously was heavily used in the early 1980s, when tax reserves were defined and reserves in excess of tax reserves were no longer a tax-deductible item.

Our list of internal streamlining techniques also includes the sale of overstated liabilities such as undiscounted claim reserves. Obviously this technique is more popular with property and casualty companies. Finally, the age-old idea of effective tax planning should never be forgotten. While the tax law revisions of the 1980s largely stripped opportunities to plan effectively, there are still opportunities involving alternative minimum taxes, the effective use of net operating losses and various forms of corporate consolidation.

Harris Bak will now talk about levelized commission financing and some other new ideas.

MR. HARRIS N. BAK: I'm going to be speaking about levelized commission programs, and especially about some of the discussions and concerns that we've had with state regulators and the NAIC.

I will first give a brief overview of how a levelized commission program works. The reason we need something special is that companies would like to pay commissions as a level percentage of premiums, but agents are used to getting commissions up front.

It's probably impractical to expect most agents to accept a level commission program, so we need a mechanism that will convert a level commission payment into a lump sum or a heaped pattern of commissions to be received by the agents. The way this can be accomplished is through the formation of an independent marketing company. This company could be a general agency or some other organization. When I say independent, it is not a subsidiary of the life insurance company.

Let me give the example of a company that pays more or less standard general agency commissions of 96% the first year and 10% renewal. It would like to spread this pattern out. It can't realistically spread it out over 20 years, but it would like to spread it over five or six years.

Continuing with our example, the insurance company agrees to pay the general agent, the independent company, 25% of premium for each of the first five policy years. Instead of being compensated directly from the insurance company, producers now get two forms of compensation. They get a level annual 10% from the insurance company directly. In addition, the intermediary -- the producers -- receive 96% the first year and 10% in all renewal years. This is what they've been receiving all along. The insurance company's promise to pay the independent marketing company is in the form of a general agency commission agreement.

If the policy terminates, there is no obligation of the insurance company to the marketing company. We would expect the 25% to be accounted for like any other commission as expense when incurred.

Of course, the independent marketing company now has an asset, which is the receivable of 25%. This has a value, but is somewhat indeterminate. The marketing company's balance sheet is fine on a GAAP basis. It has an extreme cash flow problem, however, which it meets from an external source. It could also meet it from equity capital. In our example, cash flow needs are met by funding from a bank.

Traditionally, a bank would not lend to this independent marketing company because it's not a creditworthy institution. It has no real capital and surplus. What it has though is an asset which we feel has real value. And in this case, the bank would lend us 61% and take a security interest in the receivables. If the independent marketing company had other creditors, the bank would have the first rights to receive those commissions. It would be like a secured loan, like a mortgage. It's not treated as an off-balance sheet item or as a purchase. The security is in the promise of the insurance company to pay commissions at 25%. It is very clear that there is no connection between the loan and the insurance company. The number one concern of regulators is whether or not the banks have a hook into the insurance company for this loan.

In order to convince the regulators that there is no recourse, we overkilled the issue. First, there is no recourse because of corporate structure barriers. If the bank lends

money to a general agency or any other corporation, there's no way an insurance company can be liable just because that agency is an agent of the insurance company. Second, the banks will make an explicit disclaimer in the agreement.

There's been one very large transaction which probably most of you know about, called Mapleleaf, the Massachusetts Indemnity & Life Insurance Company (MILICO) deal. MILICO, a large life insurance company operating out of Georgia, entered into a $500 million arrangement. A new company was formed called Mapleleaf. Mapleleaf agreed to finance up to $500 million of new commissions to MILICO's agents. And Mapleleaf did so by securing an agreement with a group of banks led by Chase Manhattan. The banks, in their loan agreement with Mapleleaf, exclusively state under no circumstances will the banks have a right to go after MILICO or any of its affiliates. Even though this clause was unnecessary, it was put there specifically to remove concern.

The last thing concerns extra legal liability. There is a concern that even though the agents are getting paid by the intermediary, something could happen down the road. After all, the intermediary is a very thinly capitalized company. If it doesn't complete it's obligation to pay the agents, the agents (who have just completed a service for which they won't get compensated) may go to court and sue the insurance company. Concern still exists, even though the agents have agreed to accept compensation from the third party.

This concern is muted by structuring the financing to cover only excess first-year commissions. Agents will receive renewal commissions directly from the insurance company like they always did. However, they will receive the additional first-year compensation from the new intermediary company. There is some risk in the first policy year, but because most companies are annualizing first-year commissions, the policy is issued as soon as it is sold. The agent gets his check and the obligation to him is extinguished. So there is really little concern for any recourse by the agent.

I was trying to think of a unifying theme for the talk. The only thing I could think of was they all start with "C" -- commission creep, commissioner's concerns and cost of capital.

Let's talk about commission creep first. It is analogous to tax bracket creep. Tax bracket creep, of course, is the idea that if your income goes up 10%, your taxes may go up 20% even though the tax rates are the same. You just creep into a different bracket.

We have the very same thing with commissions. Companies are paying basically the same commission percentages now that they did in the 1950s. However, the percentage of the premium dollar that's going to cover sales expense has gone up very dramatically, almost double. And companies fail to recognize it, which may be one of the reasons why our profit margins have been reduced. The reason they fail to recognize it is, to the extent it is financed internally by company surplus, it is a hidden cost. It's an insidious cost. To the extent that you have to pay the independent third party to finance those commissions, the real cost will be recognized directly in asset shares. We believe it will have a positive effect on twisting.

Consider the classic scale of commissions again, that is, 96% the first year, 9% years two-ten. Under New York law, it drops to 6.5% in most cases. Let's use a scale with a 2% service charge. That's pretty typical for a whole life general agent (GA) scale in the 50s. If we take the present value of a dollar of compensation at 3% interest and divide by the present value of $1, we get the percentage of the premium pie needed to cover sales expenses.

What happens if we keep the same 96% and 9% and just change the lapse rate, and the interest rate? Let's assume the lapse rate goes from 11-26%. The result is more than a 50% increase in the cost of financing the sales expense. Again, if someone independent is financing it, he will charge over 26%, depending on his assessment of risk. If it's financed though debt, it might be 26% plus 10%. And that's eventually what has to be passed on in the premium.

Table 1 is a summary using different lapse rates. Now why did I use interest rates as high as 21%? The prime rate did get to a 21% peak at one time, but what is an appropriate interest rate to use? Well, if a bank finances it, you could use the lending rate which, for larger companies, may be 10 or 11%. One could argue that if the company finances internally, the true cost to its stockholders or its policyholders (if a mutual company) is at least a foregone interest rate.

TABLE 1

Lapse Multiples

Interest	1.0	1.5	2.0	2.5	3.0
3.0%	17.0%	18.7%	20.7%	22.9%	25.4%
5.0	18.3	20.1	22.1	24.4	26.9
7.0	19.5	21.4	23.6	25.9	28.5
9.0	20.8	22.8	25.0	27.3	30.0
11.0	22.1	24.1	26.3	28.8	31.4
13.0	23.4	25.4	27.7	30.1	32.8
15.0	24.6	26.7	29.0	31.5	34.1
17.0	25.9	28.0	30.3	32.8	35.4
19.0	27.0	29.2	31.5	34.0	36.7
21.0	28.2	30.4	32.7	35.2	37.9

If the company could have taken those commission dollars and invested them, they would have earned, let's say, at least 9%. In addition, it's using up surplus. So it's really 9% plus the cost of surplus. If the cost were to be measured as the marginal expectation of shareholders in terms of return on equity, you would get something in the high teens as an appropriate interest rate.

If this internal cost is financed through debt, I believe it will have the lowest cost. One can't say debt is better than equity, but it does have different characteristics, generally lower risk and therefore lower cost. If you expect an investor or your policyholders or anyone to take risks, they're entitled to a higher return. The financing of commissions or

any other costs for that matter makes sense if the return on investment of business sold is greater than the cost of capital.

A company could say, "Well, I don't need surplus. I've got more than a benchmark surplus." If this company can take the extra surplus it generates and purchase blocks of business, agencies, other insurance companies, or do anything useful, and get a return on investment greater than the cost of capital, then the cost of the borrowing is worth it because it will make the company more profitable, with a stronger balance sheet. It's not an accounting trick, it really will improve the company. If on the other hand the company's products are so competitive that its return on investment is only 7% or 8%, it doesn't make sense.

This goes back to what Dan was talking about earlier, when he talked about all the different techniques companies are using to raise capital. I basically break everything into debtlike or equitylike. Equity instruments are where the investor takes a substantial risk and expects a substantial return. Debt instruments are either overcollateralized or in some way have very little risk and a relatively low cost.

Let's take a look at common stock. If a very strong, highly rated stock life insurance company seeks capital, the parent company could issue commercial paper and raise money at a cheaper rate than bank borrowings. However, the life insurance company cannot issue the debt because it won't help surplus. If the holding company assumes the debt and then downstreams it as capital, the life company now will be under pressure to return an equity-type return to its parent. So though the parent company may be able to borrow money from the public at 8% or 9%, the life insurance company will be required to produce at least a 15% return on any surplus it gets from the parent company.

Surplus notes, if they existed, would be in the same category. In most states, the surplus note laws are so restrictive that no independent investor would invest in them. In many states, no payments can be made, principle or interest, unless the state commissioner approves it under whatever ideas he has at that time. Surplus notes are used frequently between parent and subsidiaries. Some states, such as Texas, allow surplus notes to be preapproved as long as surplus stays above a floor. In this case, a bank or an investment firm may consider investing in surplus notes because risk can be evaluated. Of course, the cost would be similar to that of the equity-type investments.

Securitization is also something Dan talked about. To a great extent, securitization has been hampered by the New York circular letter and the NAIC ruling. It involves turning nonadmitted assets into admitted assets by selling them for cash, or by selling the rights to them. In the first category are nonadmitted assets, sale/leaseback of the home office and the sale of agents' debit balances. These sales are usually done on a cash basis. The cost would be net investment income plus a spread, let's say a bank spread or investor's spread of usually 0.5-2.5%, depending on the creditworthiness of the company.

The next thing I have is "cherry picking" capital gains which I guess is a pejorative expression. Dan spoke about selling off appreciated assets. Well it makes sense particularly if your home office value has gone up three or four times.

Why have hidden surplus? Now the states may say it's good to have hidden surplus; it makes the industry more solvent. But it makes companies less comparable because some companies own their home offices and some don't. However, if a company went through its entire bond portfolio and half of the bonds had a market value above cost and half had less and they sold off all the bonds that had a higher market value, obviously that would be the cheapest way to increase surplus because the company could take the capital gains and reinvest. It wouldn't cost anything above the reinvestment rate. However, it would distort the financial statements.

As Dan mentioned, any program like levelized commissions which involves setting up a new agency, new commission agreements, and legal agreements has a very high fixed legal cost. It's inexpensive for a $50 million or a $200 million program. It's not at all practical, however, for a $5 million program.

From a regulator's point of view, one of the benefits of programs like levelized commissions is that it leaves the cash with the company. So rather than transferring reserves, the company actually gets the cash in hand. There hasn't been much of a problem on the life side, but on the property and casualty (P&C) side there's been tremendous concern about amounts recoverable from reinsurers.

In fact, the NAIC has required that recoverable reinsurance due over 90 days has to be treated as a nonadmitted asset in certain cases. And there's no question about "right of offset." We know some of the regulators are going to court to fight the reinsurers' right of offset because they feel this right reduces the recoverability of surplus relief.

One difference between levelized commissions and securitizations is that the former doesn't shock surplus. A company can't take all its margin in such an arrangement and get a one-time $50 million infusion. The day a company signs a levelized commission agreement, nothing happens to its balance sheet. But as new business is sold, there is no surplus strain, or there is less surplus strain. So as new sales are made, the cost of the surplus strain is reduced.

Another benefit is that it equalizes mutuals. Many of the capital-raising alternatives previously mentioned were available only to stock companies. Mutuals don't have a holding company that can borrow and contribute surplus. The mutuals have a bad competitive disadvantage in the capital markets. Any method which tends to increase capital internally, i.e., directly from the value of the business sold, is available to both mutuals and stocks. Levelized commission financing is an alternative therefore to demutualization.

I just want to point out that under levelized commission financing, the largest risk a company has aside from the asset risk, aside from the risk of junk bonds or duration mismatch, is the expense/lapse risk. If lapses go up, the expense is charged to policyholders and the current premiums go up. If some outside party has financed this, the insurance company will absorb the affect of worse lapses. However, if lapses are catastrophic, if they triple or quadruple, the company will not have paid the upfront commission and the investor will lose money. So that's one major risk eliminated from the insurance company.

A number of questions have been raised about the impact of levelized commissions on reserves. First, if a company pays a relatively high renewal commission, say 25% a year, should it set up a deficiency reserve? After all, if it's a stock company, the gross premium less the commission may be less than the valuation net premium. If no commissions were to be charged against the net premium, then there is no deficiency reserve. There is some inconsistency in the computation of deficiency reserves, under the current law, and that's a broader issue than what we're talking about.

Another example is if you have two companies and one has a gross premium equal to the valuation net premium at a very high renewal commission, there is no deficiency reserve. If another company has a gross premium a dollar less than the net premiums but no commissions (i.e., a direct marketing sale) a deficiency will result. So there is already some inconsistency, and this would have to be addressed.

A second question is about the propriety of commissioners reserve valuation method (CRVM) reserves. CRVM reserves are less than net level reserve by the amount of the unamortized expense allowance. If first-year expenses are reduced, should CRVM in the statute now make no differentiation between companies that have high first-year expenses and companies that don't? The allowance is a fixed amount and is the same even to companies that have lower expenses. So under current laws, the CRVM reserve would be equally available to anyone. There are a number of companies that sell through direct marketing and still use CRVM reserves.

There is, however, a good and sufficient provision in the valuation actuary's opinion. What prevents a company from paying or promising very high renewal commissions or any other deferred contingent amounts involving more than the company's margin? We're working toward having valuation actuaries, but in the meantime most states require a statement of actuarial opinion that reserves and actuarial liabilities make good and sufficient provision for all future obligations of the company. This includes benefits, expenses, commissions, etc., and would include the higher renewal expenses under a levelized commission program. It effectively places a limit on how much commission a company finances. In fact, in our previous example, if the commissions come out to a level 26%, the margin before commission better be 26% in renewal years or else the actuary will have to require additional reserves.

One benefit of having an outside party finance commissions as opposed to doing it internally is that the capital markets create discipline. As much as the regulators do not want companies to get in over their heads and possibly become insolvent, the banks have at least as much interest. They never make loans expecting to have any provisions for loss. In order to qualify for bank financing, a company will have to have a sound balance sheet, a good persistency program and an asset/liability matching program. In every proposal we've done at Chase Manhattan, before we would consider doing the financing, we have required that the company have in place an adequate asset/liability matching program. Companies financing their own surplus from internal sources are limited by the total amount of their surplus.

One of the points raised by regulators is that if the states do allow securitization or levelized commissions, it may be okay for really good, sound and profitable companies,

because they need surplus to grow. But there are other companies in trouble that maybe shouldn't grow and that are too aggressive. The states say, however, that they cannot discriminate in accounting rules. They can't have a different rule for Prudential than for a small company that's running irresponsibly.

Unlike the states, banks, Wall Street firms and outside investors can discriminate. Banks can and will lend money only to companies that they perceive are strong, well-run companies. And this I believe will eventually force capital towards stronger, more conservative companies and away from the high-flying companies. This can only ultimately result in a stronger industry. So we do discriminate. We require that the return on investments be higher than the cost of capital. We believe this will eventually weed out bad agents and bad management.

The last question raised was, "How about the banks?" Are there banks that should qualify for this and those that should not?

For example, the NAIC has rules about what types of banks can qualify to provide letters of credit. And letters of credit are more of a problem because they tend to be "one-year evergreen." So if the bank is not able to renew its pledge in future years, the company has a problem. In the case of levelized commissions, as far as existing business is concerned, the banks usually fund it up front and there's no real concern about where the banks will be in a few years.

Insurance commissioners are concerned about what types of insurance companies should be eligible for special financing programs. And they ask the question, "Are banks in the insurance business?" I'd say "Yes, banks are in the insurance business. Banks are in the auto business. They're in every business because every business requires capital." Do banks control the way insurance companies operate? No, of course, not. And I believe that the states should be concerned that banks, through covenants or through any other technique, do not tell a company when or how to pay claims, what types of policies to sell, etc. These covenants generally state under what conditions a bank will lend money to a company to do a certain type of business. If the company wants to change and go into perhaps riskier types of business, the bank may not be obligated to finance those new types of business. But the banks will not tell the insurance company how to run its operations.

MR. KUNESH: Next we have Dick Stenson who will give you the perspective of a mutual company.

MR. RICHARD M. STENSON: As Dan said, I'll be commenting from the perspective of a mutual company. What I'm going to try to do is run through the program outline, recapping some of the things you've heard so far, but as both Dan and I said, to try to do it from the perspective of a mutual company operation.

First, let's discuss the need for surplus. The first need for surplus, in my judgment, is for risk. Thus, we define "assigned risk capital," "target surplus" or whatever words that we use to describe the cushion that insurance companies need to protect against possible

unexpected loss. This includes all the C-1, C-2, C-3, and C-4 risk analysis that we in the actuarial profession have spent so much time discussing and writing about recently.

It's the pure risk-driven element of insurance, and it's deeply connected to valuation actuary issues and to levels of surety or conservatism and reserve levels.

The valuation actuary should set reserves at a "good and sufficient" level to one where *it's probable that together with future cash flows they will be adequate for future benefits* and other charges. I've heard a lot of discussion of what "probable" means. Can you put a probability around it, say 90%? Maybe it's 65% or maybe it is higher. Do we get into statistical testing or scenario testing or judgment? All of these are issues that could and have occupied whole discussions in the Society. I'm going to pass over these, other than to comment that surplus is what's left after plausible risk levels have been provided for.

The point I want to make is that no matter what approach and formulas a company may decide to use for the level of target surplus it wishes to shoot for, management needs to be comfortable with that level in terms of the risk analysis involved. In practice, public perception and rating agency reactions come in very strongly. They could, in my judgment, be even more important, particularly if you are a fairly conservatively managed mutual company with a big portfolio and a lot of dividend margins and you actually feel the need for target surplus might be less than what the rating agencies or others might look for. Nevertheless, such a company would want to work toward those goals and would want to build acceptable levels of surplus in the eyes of rating agencies and the public. This is a very important consideration.

A.M. Best has been in the business for years and has been reported to use various formulas that you've all read about and that are tied to amounts of required surplus for various businesses. S&P uses various leverage criteria. Both of these rating agencies also do additional analysis and consider a number of other factors. Moody's is very interesting in that they are moving much more toward a direct assessment of benchmark capital, using factors for C-1, C-2, C-3, and C-4 risk analysis. I think there is a very interesting link between the actuarial work that's been going on in this area and the perception of the rating agencies. You need to know where you want to be in terms of a target surplus level and try to build toward it or make sure it's maintained.

Next you get into other needs for capital. And we're getting into strategic needs. Companies may want to get involved in new lines of business that in the long term will benefit the company and its policyholders. New products, new distribution systems, expansions to new markets, domestic or foreign, systems renovation costs -- these all could involve a growth strategy that fits in the longer term with policyholders' needs, but that with existing products and markets nevertheless do require some additional capital.

Now I'd like to comment a bit on the subject of capital budgeting. Capital budgeting in a mutual company is a question of who gets what -- lines of business, product lines, ancillary businesses, functions within the company. In looking at this issue, I think you have to consider not only the ongoing amount of target surplus necessary to go with the total block of business, but also the statutorily hidden costs of acquiring new business and expenses that the company writes off that in fact are there because management

anticipates that future margins will pay these back and provide for the ongoing continuity of the company. This implies the need of a management accounting process (modified statutory, GAAP, value added) that somehow takes into account these costs so that they can be looked at internally.

All this starts with the simple allocation of statutory capital needs by major lines of business in a manner which appropriately parcels out risk capital requirements on a business-by-business basis. We try to do this at the Equitable. These procedures can induce, at least on a management basis, a corporate account to hold these required amounts or to hold excess amounts or simply balance out aggregate results between businesses. Dan commented about some of those possibilities.

We segment assets in our general account by major line of business. We do establish a corporate segment, but it's an internal segment. We use it for such investments as investment companies and enterprise wide-type assets. It gives us a base in our management reporting system for seeing how we're doing, with capital allocated among the various major lines of business. But it's not a part of formal statutory accounting.

There is a fairly new regulation in the state of New York that would require companies to file, with the Department's permission in accordance with a plan of action, a formal corporate account or surplus management account. This new corporate account would show up on the statutory blue blank as one of the lines of business. So that possibility is now there.

I'd like now to talk about providing for surplus needs. The first source of capital for any mutual company is earnings. That's obvious, and we've heard that before from the earlier speakers. Dan has commented on streamlining and expense control that improves earnings. He commented on the orderly sale of assets that develop substantial unrealized capital gains such as real estate. And those are earnings. That's really an attempt to manage the business efficiently to provide for maximum statutory earnings to fund future growth, of course, after providing for appropriate dividends to policyholders.

Stock subsidiaries of mutuals can tap equity markets by offering stock in the public market or by otherwise taking on partners. I think Dan is going to talk about some possibilities later on. These are somewhat limited for mutuals, however. There are tax considerations that need to be made. At least an 80% ownership of any stock subsidiary is generally required for that purpose. There is a very real difficulty of a mutual company dealing with an outside owner of a portion of the company's business, if it has a subsidiary stock corporation that is particularly publicly owned. Otherwise equity markets really can't be tapped by mutuals, short of demutualization.

Demutualization has been a path taken by only a few companies in the life area as far as I know, and hasn't been used extensively. Of course, it is available now in many jurisdictions, including New York by special legislation. I think one of the problems with it so far has been complexity and the time involved, and whether it really fits what a company might want to be doing at a particular point in time.

Later on, I will comment on a modified concept of a mutual holding company organization that some of the New York companies are trying to put forward as a possibility for the future. There are other ways of providing for surplus needs, including securitization, commission factoring and the sale of nonadmitted assets, as discussed earlier.

One approach I'd like to touch on briefly is the sale of insurance subsidiaries. Over the last couple of years, because of a change in strategic direction, my company has sold subsidiaries that renew two things: (1) a focus on distribution channels outside our own agency force and (2) a joint venture with another corporation dealing in the group life and health (manager care) business. In both cases, a substantial amount of statutory capital was raised by the company, although I add that it really was a strategic repositioning of our company to deal primarily with our own agency force in the individual life and annuity areas. I mention it in this context because it can and does raise capital because the costs of developing new business have already been expensed in prior statutory results.

Another interesting thing I'd like to mention is that, when we were dealing with some of these companies, we did use some of the ways of tapping equity markets that a mutual can use through a subsidiary. As I mentioned, the group health and life operation was a joint venture with another company. Another one of our outside venture partners used an investment company whose sales force sold single premium annuities. That company was a part owner of the company. It purchased that company from us. So they are examples of the ability of a mutual company to partially tap outside equity markets, but only partially indeed. And as I say, we are not using these techniques now. We currently own all of our life insurance subsidiaries.

I'd like to talk a little bit about reinsurance. Reinsurance is really a time-honored and efficient way for insurance companies to raise capital from other insurers with excess capital. It can include the sale of an interest in a block of business -- up to a 90% portion for New York companies -- with all risk and future statutory profits on the reinsured business going to the reinsurer. In other words, such reinsurance represents a true sale of the long-term interest in the business to somebody who either has a better strategic interest in it or who has the capital that can support the business. So-called financial, or surplus relief, reinsurance in past years in some cases *sometimes* did not pass significant risk and might have had escape hatches for the reinsurer if bad times befell the ceding company. However, current versions of this form of reinsurance do pass an appropriate level of risk, as has been addressed by regulators in a number of states, particularly New York. Under current arrangements, the reinsurer does take on a full downside risk of the business with an upside return limited to recoupment of the relief and a fee. If properly executed, these arrangements can and do appropriately balance risk and capital among life insurers. Capital flows can be provided to companies where it can be used most efficiently and where the industry can therefore be a healthy industry.

Now, I'd like to return to the original outline and talk a little bit about holding company structures. Largely, I'm going to leave comments on that to those that Harris has already made and what Dan I believe will make later. The more glamorous versions of holding

company structures are difficult in a mutual environment. Dan will offer a few possibilities that are very interesting and that involve stock subsidiaries in various configurations.

However, in a mutual environment, you always end up with the top layer being the mutual company. As Harris commented, one source of capital that's not available to mutual companies aside from direct access to equity markets is direct access to the debt markets through a parent holding company. In a stock environment, a nonlife parent company can pump capital down to the life subsidiary through the vehicle of a downstream holding company. As I mentioned, mutual companies can demutualize and can then play by the rules that apply in a stock environment.

I'd like to take a moment and comment on a development that's received industry support; that is, a New York provision that would permit domestic mutual life companies to convert to a mutual holding company operation with a stock life insurance subsidiary. This idea is already present under law in New York. As I see it, an in-between effort would be permitted to sell up to 49% of the stock of its life insurance subsidiaries to others, thus permitting the company to raise capital from equity markets without going to the full step of demutualization. Of course, the organization is still a mutual owned by policyholders of the mutual life company.

In such a situation, the reorganized insurer would have to allocate assets to a mutual account in an amount which, with future revenues and after future claims, expenses and taxes, would support the continuation of current dividend scales, if experience underlying that scale continues in the future. This is very similar to the closed block of operation that's part of a folding mutualization approach, spelled out in New York law, where a closed block is set up for the participating policyholders at the time that the company demutualizes. In this case, however, the reorganized insurer would continue to issue par policies which would fall into the mutual account.

In this proposal, there is also a provision that would allow the new insurer with $50 million or more in surplus to be considered a "larger size operation." In this case, the mutual policyholders at the time of reorganization would receive benefits of some type and value equal to 10% of the net proceeds of any sale of common stock to an outsider that takes place within five years of the reorganization. Therefore, existing policyholders at the time the holding company operation was set up would be able to benefit from a piece of the equity raised in the sale of stock to the outside. So that's a new possibility.

I'd now like to spend a few minutes talking about alternate financing techniques that are available to mutual insurance companies. First, I'd like to mention what isn't available, because it isn't available to anyone. The securitization of future insurance revenue streams as a capital-raising tool is the best example. The New York circular letter and various NAIC actions prohibit this as a source of cash. They call for a liability to be posted for the amount of the cash raised. In my opinion, although there was a flurry of activity about these and a few securitizations were actually done as I understand it, I don't see them as future possibilities, certainly not for a New York company.

I would like to reinforce something that Harris said. The actuarial profession has been working with regulators in an attempt to draft a proposed new valuation law and cash

flow testing procedures, thus, a mechanism that would provide safeguards if securitizations were to have been okayed. Such mechanisms would have safeguarded against the taking down of reserves that are really needed, or the failing to post additional reserves that are really needed. It seems to me, as Harris commented on the levelized commission approach, that the actuary is expected to show that reserves are adequate. His work might involve a gross premium valuation which projects expected future revenues. If securitizations were to be permitted, such work should go on as well and future revenues would have to include any required pay-back under the securitization deals.

I don't believe the concept of levelized commissions has any difference in approach between stocks and mutuals. One thing that might in fact be very important for a company to consider, however, is the type, organization and structure of its distribution force.

I'd like to make a few brief comments on surplus notes. In New York, there was an effort a year or two ago to try to adopt a proposed change in the law that might have permitted surplus notes to be used extensively. At the moment they've got a reputation of being used only as a last device, and certainly for a New York company as well as for many other states, the payment of interest alone or even just principle has to be okayed by the insurance department. The recent attempt tries to set up a series of ground rules with advance approval from the department. Such approval could have permitted an investor to at least be able to evaluate a set of circumstances under which there could be reasonable surety that they would get their money back, both the interest and the principle if the insurance company has proceeded to earn appropriate required levels, with appropriate minimums. And I gather that those ground rules are in place and permitted in some states where surplus notes are a tool. But at the moment I don't see surplus notes as something that would be useful in New York.

In summary, I've tried to comment from the point of view of a mutual company. A mutual company has to earn its capital. There are a number of devices that are available to mutuals during periods of change. It's been an arena that's occupied a great deal of attention in recent years. There have been a lot of new ideas and some have stuck, some have not. I think there is a shortage of capital in the entire insurance industry today. Rapid environmental changes in the industry, the evolution of products and differences in the ways companies do business are all going to keep this issue in the forefront over the near future.

MR. KUNESH: I would at this time, like to outline some additional ideas that companies might explore in their search for additional capital and surplus. I will talk a bit about reinsurance, surplus debentures and a sampling of techniques that mutual companies can use and have used in recent years. Finally, I will present to you the results of my surplus management survey.

Reinsurance can be used in a number of ways as a source of surplus to a life insurance company. My hope is only to identify these for you. The most popular form is financial reinsurance, also known as surplus relief reinsurance. It is used (1) to help companies feeling the strain of rapid new business growth, (2) in tax planning, and (3) in the entry to new markets. The beauty of financial reinsurance is that almost any type of business

can be used in the design of the treaties, including both existing and new business. Current laws, however, require that there be some risk transfer in the transaction.

Reinsurance has also been a valuable tool for financing acquisitions, at least in part. It is used in structuring joint ventures, and as a means of cleaning up the balance sheet. An example of the latter might be the cession of certain reserves that need not be backed by asset cash flows such as deficiency reserves. Finally, many companies are looking to reinsurance with international organizations as a means of promoting synergies with overseas countries in an effort to broaden their market base. Some believe that this will become increasingly important after 1992.

Recent activities at the regulatory level have placed certain restrictions on financial reinsurance. Let me mention a few. There is an NAIC model regulation which places some rather severe restrictions on surplus relief treaties. Then there is New York Regulation 102 and California Bulletin 89-3, both of which are similar to the NAIC model. The New York extraterritorial provisions make these laws very important today. Finally, there is New York Regulation 20 which relates to the mirror imaging of reserves. This topic remains hot because many actuaries believe that while reserve mirror imaging is a nice concept in theory, it is impractical and unenforceable due to the complex design of financial treaties today.

Let me round out my comments on reinsurance by pointing out some typical provision in today's agreements. As stated earlier, there must be some real risk transfer in the contract. Second, a financial treaty cannot have a forced payback of losses to the reinsurer. Third, the payback of surplus can only occur from the profits of the business involved. Fourth, the reinsurer's income cannot exceed that of the ceding company. And finally, the reinsurer does not have unilateral right of termination. There are, of course, other restrictions that are outlined in the NAIC model and the New York and California regulations.

Over the past six to eight years, there has been an increasing amount of activity with surplus debentures. In fact, by the end of 1988 there were over 83 life insurance companies involved with outstanding indebtedness of approximately $2.3 billion. Twenty-four states have laws that either regulate or authorize surplus debentures directly. Other states, such as Illinois, have approved such surplus enhancement instruments.

What is a surplus debenture? In a nutshell, it is a debt instrument with a conditional obligation to repay. It is subordinated, in terms of claim on assets, below most other forms of debt and most issues of preferred stock. Generally, a surplus floor is defined such that as long as the company remains below this floor, no interest and principle payments can be made. In effect, a surplus debenture is a "nonadmitted" liability since there is no real liability until the surplus rises to the floor. Historically, surplus debentures were used by mutuals to provide initial surplus in the organization. In the case of stock companies, they were used to raise surplus in periods of growth or loss situations. More recently, surplus debentures have been used to finance acquisitions. ICH is a good example where surplus debentures have been used to help finance the acquisition of a number of its companies in recent years.

SURPLUS MANAGEMENT

Let's take the simple example of a holding company which owns Life Company A. A wishes to purchase Target Life from its current parent at a price of 100. Let's assume for the moment that the statutory capital and surplus of Target is 40. If Life Company A bought Target directly, it would have a surplus hit of 60, because it could only record Target on its statutory books at the statutory carrying value of 40.

For the moment, let us assume that the holding company borrows 100 from a third-party lender. It then issues a surplus debenture for 100 to Life Company A, which in turn acquires Target at the price of 100. That transaction by itself increases Life Company A's surplus by 100, which in turn is reduced to purchase Target. The net effect is an increase in Life Company A's capital and surplus of 40 as opposed to the 60 hit without the surplus debenture.

I should say that states are beginning to look very closely at the wisdom of this approach. Many departments believe that if a surplus debenture is really a debt instrument, then it should be treated as debt in the statutory financial statements. As you heard a moment ago, the issuance of a surplus debenture, in effect, creates something out of nothing. It creates surplus on the life insurance company's books out of the holding company's debt. Generally, debt service costs are paid from profits of the life company subsidiary. There is an indirect tie of the original debt between the holding company and the third-party lender to the amounts that must be contributed upstream by Life Company A to service that debt. Michigan is one state that is closely reevaluating its position on surplus debentures.

Let me quickly explore some additional management enhancement techniques for mutuals. The first technique is demutualization, known to most actuaries today. Simplistically, the mutual changes its organizational structure through a long involved approval process with the various state insurance departments to become a stock company. Generally, shares of stock are now owned by the former participating policyholders plus new investors who inject new capital into the organization. Questions of appropriate levels of distribution to existing and prior policyholders is of major importance. There is also the risk of a hostile takeover when it becomes known that a company wishes to demutualize.

Another form of demutualization is called a "sponsored demutualization," much like the one that was done by the Maccabees with the Royal Insurance Group. In this situation, a company would pick its parent in advance. The sponsoring group could be any number of organizations such as a U.S. insurance group, a U.S. noninsurance group or a foreign insurance or noninsurance group. The sponsor acquires all the shares from the participating policyholders at the time of demutualization and supplements existing surplus with additional new capital. The questions of a fair distribution of the value of the organization to current and prior policyholders becomes even more important in this situation.

Companies may also merge. Reasons for mergers may be to gain economies of scale and critical mass. Matches are more likely if companies are different from each other in terms of their size, distribution systems, base of marketing operations and lines of business. Similarities must generally exist in management style and corporate focus.

An even "spiffier" idea may be the merger of two mutuals with a leveraged buyout (LBO) spin-off. Let's take the example of two mutuals which each have a stock life subsidiary. The two mutuals merge and then spin off one of the two stock life affiliates to the management of one of the mutual companies. This situation generally fits if one company has entrepreneurially-oriented managers while the second company's management prefers to run the merged mutual company operations.

Joint venture can also be used successfully by mutual companies. One example is where the mutual company enters into a joint venture with an outside partner and forms a holding company, which may be owned 50% by each party. They then go out and acquire a life insurance company or shell. The next step involves the sale of a specific line of business in the mutual company to the acquired stock life affiliate of the joint venture holding company. In effect, the mutual company contributes the line of business to the joint venture and the unrealized capital gains in the business; that is, the value of the business being contributed becomes surplus to the mutual company. The joint venture partner then contributes cash to finance growth in the organization.

Another variation of this is where the mutual company contributes one of its downstream stock life subsidiaries to the joint venture holding company. The joint venture partner again contributes cash to fund the internal and external growth of the combined operations.

A final idea for mutuals that I want to talk about involves first forming a downstream holding company and then making a public stock offering. Under this situation, the mutual contributes either an existing downstream stock subsidiary or a line of business to the holding company, and then additional shares of stock are offered to the public via an initial public offering (IPO) to raise capital to either acquire other companies or finance growth.

It might be interesting to note the changes in the status of the mutual segment during the last ten years. Changes in the entire insurance industry, including property and casualty companies, include 13 demutualizations, 13 mergers with another mutual company and two liquidations. Only two new mutuals were formed in this period for a net change of minus 26 companies. Certainly this supports the idea that many mutual companies are concerned about their futures in the 1990s.

At this time I want to move on to the surplus management survey. I sent out approximately 90 surveys to 90 different companies representing companies of all sizes and types. There were 60 respondents, all the way from the largest mutuals and stocks to smaller and medium-sized mutuals and stocks. Thirty-eight were stock respondents and 22 were mutuals.

The first question on the survey was, "Does your company have a formal surplus management policy?" Approximately 56% said yes and 44% said no. More mutuals responded "yes" (64%) than stocks (53%).

The next question was, "Does your company have a corporate account?" Responding companies were split about 50/50. Of those that do not have a surplus account, 56%

said they allocate surplus by line of business. Only 36% of the mutuals said they have a corporate account. Sixty-one percent of stocks by comparison said they have a corporate account. I think this is somewhat reflective of the focus on corporate surplus that stocks have had over the years.

I then asked the question "How are line-of-business allocations made where a line-of-business allocation is made?" In almost two thirds of the situations, it is done by target surplus or benchmark surplus. An historical accumulation approach, which is the old traditional approach, is still being used by approximately 24% of the companies and reserves by 7%. There are some companies that use a combination of reserves and in-force.

On the subject of target surplus, I asked the question "Does your company calculate target or benchmark surplus?" I was surprised by the response because I thought the percentage responding "yes" (70%) was high. If true, this is very favorable.

Of course, it is the direction we need to be heading as an industry. It is also interesting to note that of the 70% responding "yes," 91% of mutual companies said "yes." Almost everybody in the mutual segment said they are doing something with target surplus. Only 58% of the stock companies said they were. And of course, most companies are addressing all risks, particularly C-1, C-2, and C-3.

Another question asked was "Does your company use a formula approach or a stochastic model to derive target surplus?" Maybe the responses were obvious to some, but they weren't to me. That is why I asked the question. Eighty-five percent said they use some form of formula approach. Only 5% use a stochastic model. It might be interesting to note in conversation with Asutosh Chakrabarti of the New Jersey department, that his model is stochastic in design. Approximately 10% of the companies reported that they're trying both. I don't believe I have a split between the stocks and mutuals.

The next question was, "If your company uses a formula, is it unique to your company or is it a standard formula?" Well, 55% said it's a unique formula. Perhaps different companies have different definitions of "unique" which fit their business. Some companies said their formula is unique except they try to tie into the A.M. Best or similar standard formula. I don't think the A.M. Best formula is very good for measuring risk surplus needs. It's not detailed enough. Yet, 47% using a standard formula say that they're using the A.M. Best formula. And 12% use Moody's. I happen to think Moody's is a bit more representative. It covers more of the various types of C-3 risks, although I think it produces the highest reserves of any standard formula. Perhaps the main reason companies reflect the A.M. Best formula is to obtain (retain) a rating from the agency. This alone is not a valid reason for establishing risk surplus.

Another question was, "Does your company use target surplus in pricing decisions and return-on-equity (ROE) analysis?" You tell me if you believe it. Sixty-six percent or two-thirds said they use it in pricing, 71% in ROE analysis. I do not have a stock/mutual split on this question. I think the results are surprising. If true, it's wonderful.

Next, "What are your investment objectives for free surplus?" Remember earlier I defined free surplus as total surplus plus MSVR minus target surplus. Well, one-third said they don't have a goal and only 15% said their primary objective is to maximize return on investment through capital appreciation on common stock, real estate and similar investments. Eight percent said, "We don't have any free surplus. We don't have to worry about it." And 24% did a number of things including long-term investment, short-term investment, and buying companies. So it's all over the map and it boils down to the fact companies haven't really given a lot of attention to the issue of what to do with free surplus. I thought more companies would have as their objectives the development of new business, new lines of business and so forth.

Next, I got into some of the more "think"-type questions. "Has your company found it necessary to enhance surplus over the past five years by means other than accumulated gains from operations?" Forty-eight percent said "yes." To the question "What are the means of surplus enhancement that were used over the past five years?" of the companies that responded "yes" to the prior question, 52% said they have used financial reinsurance, 21% said other reinsurance, such as risk-sharing coinsurance, and 28% said holding company debt (of course, only available to stock companies) or infusion by the parent. A lot more companies than one might think used asset sales for capital gains (28%). Open capital markets have barely been tapped (10%) at least in this sample. Securitizations, before they closed the door on this technique, were used by 17% of the respondents. Surplus debentures were used by 10% of these respondents. Less than 10% responded to the use of joint ventures, demutualization, levelized commission financing, sale of nonadmitted assets, collaterized mortgage obligations (CMOs), accounting changes and other fairly elaborate ideas.

Then I asked the question, "What do you believe will be the top means of enhancing capital and surplus over the next two to five years?" On this question, I tried to isolate mutuals so the percentages would only apply to the respective segment where necessary. As I stated earlier, everybody thinks they can save money on expenses. The question is, "Can such savings be appreciable?" Many have already done so successfully.

Regarding contributions from parent upstream holding companies within the stock segment, 77% said this is where they're going to look for money. Sixty-one percent of all companies said they might sell marginal operations. You are continually hearing about blocks of business for sale, companies streamlining, etc. It's much more important than one would have imagined five years ago.

Other results are as follows: Levelized commission financing, 56% of all companies in the survey are going to look at it. Financial reinsurance and risk transfer coinsurance, 53%. Joint venture partners, 53%.

Some of the other techniques in the top ten are to improve the balance sheet, sell off a subsidiary, and form a downstream holding company. There was also some response to downstream funding companies, etc.

The next question was "What do you believe to be the major threats to maintaining desired levels of surplus in your company?" I don't think it's surprising that 78% said they're growing too fast. The question is, are they?

Deteriorating profit margins are also very realistic. Two-thirds responded that this is a threat, and that's obvious. On the rising cost of operations, only half think it's going to be a problem, perhaps because inflation has stabilized. Other results follow: Volatile investment markets and volatile lines of business, 35% and 33%, respectively. Capital losses or write-offs of investments, such as mortgages or junk bonds, 18%. This is probably a more significant percentage than it seems because many companies do not even enter this ballgame. Asset/liability mismatches, less than 10%, a lot lower than I expected.

And I believe the final question that I asked on the survey was, "Which of the following are expected to place demands on your surplus in the next two to five years?" The previous question was a general "what do you think?" question about the industry as a whole. This question asks the respondents about their specific companies. The answers were by far the most important. Many said, "We're going to grow, but we have no way to finance growth." That was 73%. Expanding existing or related markets, which is really related to growth, captured 47% of the responses. Target surplus is scaring 43% of the respondents. They're saying, "I don't know where we're going to find it." I think it's a very real concern, and some of the percentages cited earlier are indeed true. Enter into new markets, plan acquisitions, pay shareholder dividends, service existing debt, pay back debt -- these all are much more significant than the percentages mentioned earlier. For example, not every company in the survey has reached out to debt as a source of capital. I would say almost every company that has reached out to debt is concerned about this. As I indicated, the survey results expand on some of these issues.

Before we go into the Q&A session, I believe Dick wants to add a comment on rating agencies and the position of regulators.

MR. STENSON: When I commented on rating agencies, I said that I see them as using a risk-based approach. They want to make sure that the companies that they're evaluating have adequate surplus to avoid problems. My comment on the regulatory side is that although I can certainly see regulators being concerned about things beyond reserves, which has been a primary emphasis, their concern is that companies "get too close" to minimum surplus levels. They are after all worrying about ultimately regulating solvency. I would like to express a concern though that if they move too deeply into regulating target surplus, we could end up with a doubling up effect if we're not careful. Capital is a little too scarce to worry about that.

By that, I mean that if set formulas were used to define absolute minimums, and if rating agencies wanted to make sure that you have surety on top of that, then companies aren't going to come close to those set minimums. You might actually end up with a doubling effect. I don't think that is something we need when we already have a fairly short supply of capital.

MR. KUNESH: Let me make one final comment. Asutosh sent me a document which scares me. It is a publication called *Failed Promises: Insurance Company Insolvencies* by the Subcommittee on Oversight Investigations of the Committee on Energy and Commerce of the House of Representatives. While the Dinghall Report relates mostly to the property and liability industry, there are references to the life insurance side too. It's scary because it seems more and more likely that there will be a continual invasion of insurance company regulation by the federal government, particularly in the area of insolvency. It points out six weaknesses, and I'm just going to mention some of them.

Included areas are delegation of management authority, reinsurance, unreliable information, insufficient regulation, and poor enforcement practices at the state regulatory level. It goes into some depth about three property/liability insolvencies: Mission Insurance Company, Integrity Insurance Company and Transit Casualty. Then it says certain issues to be addressed include adequate capitalization, reinsurance -- some of the things we just mentioned -- reporting requirements, holding company structures and affiliates, state regulatory enforcement, and of course, what level of federal rule should exist. The report calls for a self-regulation of the industry, something like in the securities industries. The focus would be heavily centered on solvency standards. Perhaps one of our state regulators in the crowd may wish to comment. At this point, I want to open it up for questions.

MR. ROBERT F. LINK: Dick Stenson and I have known each other for many years. There was a session on this subject, I think it was in Boston, about 12 years ago. I was one of the panelists, and said something very much like you, Dan. For 15 years, the surplus percentage of a list of large mutual companies had been declining steadily. So I think we're now up to 27 years or something like that, if I remember correctly. We had a stochastic model for developing target surplus at The Equitable. It was a very elaborate model, and I don't really recall that management ever established targets based on the model. There were a variety of reasons for that, having to do with the nature of the model itself, and possibly also that it produced answers that were different from what management wanted. So, "that's baseball."

We had another model which was a linear model of an extremely simplified insurance company where you could spend your money developing the agency force, or spend it pushing a premium-intensive product such as term insurance, or an asset-intensive product such as annuities. We were able to run that model through a linear programming process to search for the best strategies based on management objectives. Of course, management likes to see premiums grow. The one most interesting thing that we found was that if you ran the model with a rolling five-year plan -- that is to say, you start in a given year, search for the strategy that will maximize your premiums five years out, and then go forward one year and do the same thing all over again, and then see where your premium has gone in 15 years -- you get a certain answer. If on the other hand, you run a rolling five-year plan with the objective of maximizing surplus, you will end up not only with more surplus, but also with more premium income. This is sort of an interesting commentary, for what it's worth, on the interplay between short-term objectives and long-term objectives.

MR. JEFFREY GLENN STEVENSON: I couldn't resist making a comment, Harris. I believe the conclusion was that the capital markets will impose discipline. I certainly hope so. As a taxpayer, my bills have gone up daily, it seems.

You mentioned that they would provide adequate reserves for losses. I guess that was one of the things that I was unclear on, because we've got all these formulas and sometimes they're backed up by modeling to tell us what target surplus ought to be. If we shift some liabilities around, then presumably someone has got to be setting up some reserves and target surplus on top of that. I get the impression that you wouldn't be setting up the same surplus that an insurance company would have to in that business.

MR. BAK: Are you talking about banks?

MR. STEVENSON: Yes, risk equity provision for loss.

MR. BAK: Banks are required to set up capital. They have different tiers of capital based on the amount and types and riskiness of the loans they make up. So for example, if a bank made a ten-year loan to a certain insurance company, you might have to set up capital equal to perhaps as much as 10% of the loan. If it was a short-term loan, the bank may set up capital equal to 1% of the loan. So banks are required to maintain capital.

MR. STEVENSON: Right. So it ends up being weaker. I get the impression that's a thinner margin than the insurance company is holding.

MR. BAK: Well, they're comparable. In other words, if a bank makes a loan to an insurance company, the bank has to set up some capital. The insurance company may or may not get capital for it. If it goes directly to an insurance company, there's no increase in the company's capital. If it goes to a holding company, which in turn downstreams it, there's a dollar-for-dollar increase in capital to the life insurance company. In addition, it's actually riskier for the bank because the bank has to depend on the insurance company not only to be profitable and solvent, but also on its ability to pay dividends to the parent company in an effort to service the debt. There are two levels of risk there. If the bank is making loans or if it is making other financing directly, it has limited recourse. It can't look to all the assets and surplus of the insurance company, but it benefits from not having to worry about the dividend payments. I hope that answers your question.

MR. STEVENSON: It's getting there. Could you comment on the disclosure requirements for that? Perhaps in the annual statement or say, for a regulator or rating agency looking at the solvency of the company?

MR. BAK: There is some talk at the NAIC. One of the things that was proposed or discussed was that if a company did use a levelized commission program or if they did securitizations specifically, it should be noted in the annual statement in the footnotes. We have no particular position on that. Regarding rating agencies, Standard & Poor's put out a rating update on MILICO after the levelized commission program was

implemented in which it noted the favorable benefits to the company in terms of a reduced lapse risk. And it says it favorably impacted the company's rating.

MR. ROBERT J. CALLAHAN: The views that I express are strictly my own personal views. You mentioned the Dinghall Report. Perhaps the Dinghall Report does level a lot of criticism against the current regulation of solvency of insurance companies. In the beginning of the report, it criticizes the National Association of Insurance Commissioners as setting forth model laws and model regulations, but not having the authority to enforce them. It relies upon the states to enact those laws and regulations in their individual states.

There are many company people as well as regulators who will privately tell you that federal regulation is coming in five years or 10 years. I'm one of the few who will say state regulation is inherently discriminatory, both on the basis of the fact that various state laws differ from one state to another. And while you mentioned that, at the end of the report it seemed to recommend that any regulation be similar to that of the SEC, I think it is only fair to state this was only one of several possibilities that were outlined at the end of the report.

The regulation of insurance is currently done by states, although it is interstate commerce. Because Congress gave the authority to regulate to the states, Congress could thus rescind that act and give the authority to either a federal agency or to any other entity. Or the federal government could, as the report mentions, set forth minimum standards for the states to administer and execute. It could have established, at the other end, a federal agency to take over the regulation of insurance.

Now there's one big practical difficulty in all this. Where is the federal agency going to get the personnel, the expertise to take over? Another thing it mentioned was perhaps dual state/federal regulation, letting the individual companies choose as to whether they wanted to be regulated by the federal government or regulated by the state government. Now in spite of all the criticisms of the NAIC and its inherent weaknesses, the report does mention as you noted, the possibility of the federal government authorizing an association of life insurance companies and regulators to enforce solvency. There is that possibility.

The National Association of Insurance Commissioners originally was just that, an association of insurance commissioners funded by levies against state insurance departments. But in recent years, the Insurance Regulatory Information Services (IRIS) has grown up and companies, both property and casualty companies and life insurance companies, submit their financial data in their annual statements on diskettes to the NAIC central office in Kansas City. This part is funded by direct assessments against the life insurance companies submitting those diskettes. The NAIC central office runs a number of ratios using this financial data. It publishes the ratios it uses. This year it will also publish a list of companies that fail four of more tests. As a matter of fact, I think the list it intends to publish will be a list of all companies, giving results of each of the tests for all companies.

In turn, the NAIC central offices, while it has certain software programs and hardware, has also established networks with the state insurance departments. One of the things you did mention was an organization something along the lines of the SEC. In fact, this may be doable because you do have an existing network today which can review financial data. If the federal government were to authorize that group, it would be like an association of insurance companies and state regulators. In fact, the life insurance industry would be what many people have said for years -- a self-regulating industry.

MR. KUNESH: Bob, for a much clearer summary than I gave earlier, I can only think of the federal government's recent experiences with the savings and loan industry. And it could happen again. I think your comments about appropriate cooperation between the NAIC and an industry association could be workable.

MR. RICHARD S. ROBERTSON: I was shocked with that list of the ten leading ways of raising surplus. With the exception of the first one, expense reduction, they all involve various forms of either increasing leverage or sales of assets. I'm skeptical of expense savings. I kind of feel like I'm watching the "David Letterman Show" where you put these up in reverse order and we laugh after each one. Then you put the number one up and it gets the biggest laugh of all. Where on that list were such things as increased profit margins on insurance, or the elimination of money-losing operations, or the reduction of policyholder dividends to levels that can be supported by existing profitability? I think until we look to strengthening income statements as the primary way of strengthening balance sheets, we're going to find that our balance sheets are going to continue to get weaker and weaker.

MR. KUNESH: I want to say that number three on the list was to sell marginal or losing operations.

MR. STENSON: Dick, I just want to comment that I couldn't agree more with you. We point out the fact that the fundamental value of any artificial or natural program is that the return on investment is greater than the cost of capital. If the business is not profitable, if it's not earning an adequate return to policyholders or stockholders, theoretically you're better off not doing the business than to try and raise capital to support it. I agree with you.