

**RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 3**

SURPLUS MANAGEMENT

Moderator: JAN L. POLLNOW
Panelists: GLEN M. GAMMILL
HARRY D. GARBER
ALLAN D. GREENBERG
Recorder: FREDERICK L. DAVIS

- o Consumption and creation of surplus (GAAP and Statutory)
 - Projections
 - Relation to reporting and pricing
 - Monitoring
 - Cost of capital
- o Organization and structure
 - Stock versus mutual (demutualization)
 - Holding companies
- o Upstream
- o Downstream
 - Allocation to strategic business unit
- o Sources of capital (availability, cost, regulation)
 - Reinsurance -- surplus relief
 - Issue stock
 - Debt
 - Securitization
 - Surplus notes (debentures)
 - Joint venture
 - Divestiture
 - Merger

MR. JAN L. POLLNOW: In my current position as corporate actuary, I need to stay in touch with all aspects of surplus management, from the product pricing process through the financial reporting, to monitoring of surplus and agency ratings.

Surplus management certainly seems to be a hot topic. Everybody's concerned about it: company officials, regulators, agents, policyholders, and the employees. Due diligence seems to be the operative word. Everybody seems to have a little different outlook on it. Certainly the regulators want you to have lots of surplus. Maybe you don't want to have so much if you're management and you want to get a good return on equity. When I was thinking about this I thought that everyone has different outlooks, and perhaps it even depends upon which generation you grew up in. I was listening to a videotape the other day by Ken Dykewald. He's written a book called *The Age Wave*, and in his presentation he talks about how people look differently at their finances and savings. For instance, those who grew up during the Depression tend to be quite conservative and put a lot of money aside because something very bad might happen. The next generation came along more oriented towards spending, but still in moderation. Now we have the young adults growing up today. They probably don't have any money in the bank,

PANEL DISCUSSION

but as long as they've got two credit cards that aren't over the limit, they think they're in good shape.

I've noticed that several surplus management seminars have been given in the past two years, including one at this meeting. These agendas are becoming more and more specialized. With our expert panel we certainly plan to give you some expert insights into the world of surplus management.

Earlier this year Investors Diversified Services (IDS) published a paper in which it indicated that 20% of life insurers are at risk of insolvency if there's a major economic downturn or if there's a decline in the major investment markets. That's pretty scary, but I don't think it's cause for panic. In fact, there was an article, written by Ian Rolland, CEO and President of Lincoln National, "No Cause for Panic," published earlier this year in *Best's Review*. In his article Ian agreed that there must be concern over these negative trends that are going on in the industry, for instance, surplus ratios going down, asset defaults going up, and some heavy emphasis in particular areas on junk bonds. But he also indicated that these do not alone justify any alarming conclusions about the solvency of the industry. In other words, we're not yet into a savings and loan type crisis. However, he did point out that surplus is a scarce commodity, and it must be managed effectively. In fact, productive use of capital is synonymous with survival. Speaking of survival, we have a company out there called Executive Life. We might think of how it manages its surplus. A few years ago it had too much surplus, or at least it appeared that way. The management people were having difficulty investing the surplus effectively and getting their return on equity up. Now, entirely due to their concentration in the junk bond market, they're fighting for their life. I'm not here to tell you that they did the right thing or the wrong thing, and I think that they are going to survive. Maybe one of the reasons that they will survive is they did have enough surplus to take on the junk bond risk that they did.

I'm going to turn the podium over to our distinguished speakers and let them discuss what surplus management is all about. The first speaker is Glen Gammill. Glen is a partner in the Dallas management consulting department of KPMG Peat Marwick, where he specializes in financial reporting and surplus management. Glen is both an FSA and a CPA, and is Chairperson of the Society of Actuaries' Financial Reporting Section Council. Glen is going to provide us with an introduction to the capital management process. He's going to discuss some of the objectives of a structured capital management program, the rationing of capital, and the barometers you might use to measure the financial strength of a company. Our second speaker, will be Harry Garber who's Vice Chairman of the Equitable. He's also on the Board of Directors of the American Academy of Actuaries. He has been actively involved in the federal, legislative and tax arenas. He mentioned to me that he was getting more involved in the insurance part of the operation again. Harry's going to discuss surplus management issues that are related to the difference between a stock and a mutual company, and maybe he'll even let us know if he wishes the Equitable was a stock company. Our final speaker is Allan Greenberg. Allan is Chairman of Greenberg & Ficus, which is a Stamford, Connecticut, company that specializes in mergers, acquisitions and reinsurance. Prior to forming the company in 1988, Allan was Chief Actuary and on the Board of Geneve Capital Group and was Executive Vice President of its subsidiary, Standard

SURPLUS MANAGEMENT

Security Life of New York. Allan is going to give us a brief overview of some of the sources and the costs of raising capital. So, with that, I'll turn it over to Glen.

MR. GLEN M. GAMMILL: As Jan mentioned, my job's to set the stage for the panel discussion by describing a financial process that we believe will undoubtedly play a major role in increasing the financial manager's ability to assist his or her company in meeting its overall financial objectives.

That process is the capital management process. Following my conceptual description of that process, Harry will discuss how that process is impacted by the company's organization and structure, and Al Greenberg will discuss the various sources of capital and comment on their availability, cost and any associated regulatory constraints.

From my perspective the capital management process is a decision-oriented process which supports the systematic use of existing and emerging financial principles with the objective of meeting the company's financial objectives. One of the major themes underlying my presentation is that financial managers should be held accountable for managing their company's capital such that the company's value is enhanced. By systematically managing the company's capital structure to minimize its cost of capital and by selecting and managing those business opportunities whose financial returns exceed that cost, the financial manager can be successful in this value enhancing role. To assist the company to achieve consistently profitable growth the financial manager will have to increasingly rely on a systematic and disciplined process for financial decision-making. While such a decision process doesn't guarantee financial success, it does enhance management's ability to ensure that each deployment of capital receives a consistent level of scrutiny by management.

Jan mentioned the words "due diligence" a moment ago, and at a meeting several months ago I used that term in a presentation to several senior managers in a midwestern mutual company. The CEO at that meeting questioned my use of the term by saying that it carried a lot of excess baggage. While the expression "due diligence" generally relates to a wide range of activities often associated with mergers and acquisitions, I believe that its use is most appropriate when describing the decision process used by the company's senior management in deploying scarce and costly capital resources. The owners of an insurance company, whether stockholders or policyholders, have every right to expect that senior management will exercise the utmost care when deploying the company's capital. The execution of a structured process in connection with managing that capital is a strong indication that senior management is attempting to be diligent in discharging its financial responsibilities to the company's owners and policyholders.

While there are many ways to describe the capital management process, one could view that process in three distinct but interrelated decision areas: capital structuring, which Harry and Al will refer to in a moment, capital rationing, and asset management. By capital structuring I mean the process by which the company's capital needs are assessed and the process by which sources of available capital are identified as to amount, incidence and cost. Al will be discussing the various sources of capital, and Harry will be discussing how corporate structure and organization impacts the cost of that capital. I'll

PANEL DISCUSSION

concentrate the remainder of my remarks primarily on the decision areas involving capital rationing and asset management.

By capital rationing I'm referring to a process by which competing business opportunities and/or investments are chosen by the company for financial support assuming scarce and costly capital resources. Capital rationing will rely heavily on projecting the cash flows underlying each competing business opportunity presented to the company for capital commitment. The allocation of capital to such opportunities represents what I call a first order investment decision.

In March 1990 the Insurance Accounting and Statistical Association (IASA) mailed to its member companies a survey questionnaire concerning the capital management process. This survey was sponsored by IASA's research section and included life, health, and property and liability insurers. The survey was designed by Dr. Joan Lamb-Tenent, a professor at Villanova University, and me. The survey responses were sent to Joan at the College of Commerce and Finance at Villanova, to be tabulated and were then reviewed by both of us. The results of this survey were recently presented at IASA's annual conference in Anaheim, and I'll be referring to the survey throughout the rest of my remarks.

In the area of capital rationing the IASA survey questions were broadly grouped into two major response categories. The first category, focused on the use of financial projections in evaluating alternative business opportunities competing for potentially scarce capital resources. Survey objectives were to highlight certain characteristics of these projections, as well as to assess internal consistency both at an intracompany and interfunctional level. For example, are each business unit's projection assumptions consistent with corporate expectations? Are the assumptions used for capital rationing internally consistent with those used for product pricing? The second category of questions in the rationing area focused on techniques used in conjunction with developing financial projections to compare various business and/or investment opportunities competing for scarce resources, and the extent to which reliance was placed on each of these techniques.

With regard to the financial projections used to assess capital needs, a company may anticipate capital constraints beyond covering early negative cash flows and minimum statutory reserve requirements. IASA's survey participants were asked if their company recognized capital commitments beyond statutory requirements when evaluating insurance businesses for investment purposes. Approximately 60% of the respondents indicated that capital management beyond statutory constraints were recognized. Although only a modest difference in response was noted between the stock and mutual insurers, it appeared that large companies were much more likely than their smaller counterparts to recognize such additional capital commitments.

For those recognizing additional constraints, the survey asked which forces influenced their decision to do so? Internal forces were identified by 75% of those respondents, whereas external and/or other forces accounted for 19% and 7%, respectively. This response indicates that, while rating agencies and other external constituencies appear to

SURPLUS MANAGEMENT

be influencing these IASA respondents, the major impetus for recognizing such additional requirements appears to be from within the companies themselves.

Financial theory would expect that the business assumptions used to assess capital needs for capital structuring decisions and the assumptions used to evaluate competing opportunities for capital rationing decisions would be internally consistent with those assumptions used in pricing the company's products. Accordingly, survey participants were asked whether or not the assumptions used for such decisions were reconciled with product pricing assumptions. Of those responding, 44% indicated that such reconciliation wasn't, indeed, made. Those insurers performing such reconciliations were more likely to be stock rather than mutual, large rather than small, and life and health rather than property and liability. So much for capital rationing.

By asset management I'm referring to the process by which assets supporting each business unit or investment opportunity are managed to meet the company's financial objectives. Considering capital rationing as the first order investment decision, asset management can really be considered as a second order investment decision. From one perspective, asset management decisions include allocating investable funds by asset class, selecting assets within each such class, and using performance measures to manage those assets selected. With regard to asset allocation the IASA survey asked respondents to rank how various characteristics impact their company's allocation decision, from most important to not considered. Of those characteristics, insurance cash-flow estimates received the highest proportion of those indicating most important. This response, coupled with the response to the survey's final question indicating that 60% of the respondents considered asset management as the decision area likely to be emphasized by their companies over the short term, corroborates that the industry is focusing primarily on the asset liability management area at present.

While the asset allocation component of the asset management decision is important, the ability to monitor financial performance and to take corrective management action is essential. Currently, there are honest differences of opinion among actuaries, accountants and the users of financial information as to the accounting model best suited for management's financial statements. Major issues in this regard include which accounting model (1) facilitates the communication of financial results to senior, nonactuarial managers in a relatively straightforward manner; (2) allows for the comparison of the company's financial results against the results of peer companies published in the public domain; and (3) reconciles with other financial information, most notably the company's own statutory financial statements? Today, GAAP is the accounting model predominantly used in the industry for internal management financial statements, although each company must make its own decisions in this regard.

Finally, it's my understanding that the various rating agencies and services do consider the effective implementation of a capital management process by management as an important indicator of that company's ability to successfully achieve the short- and long-term financial objectives that it set. Recently, in reviewing a successful presentation made to Standard & Poors by a major insurer, I noted a substantial portion of that presentation was devoted to demonstrating that management thoroughly understood the capital management process relative to the company's major product lines. The

PANEL DISCUSSION

importance of employing an effective capital management process to achieve consistently profitable growth is readily apparent. Meeting the competition requires that successful companies make every effort to ensure that an appropriate level of due diligence is employed whenever deploying capital resources is an issue.

Now I'd like to turn the podium over to Harry Garber who will spend some time talking about the structure and organization of the company and how they impact the surplus management process.

MR. HARRY D. GARBER: Organization and management structure was something that no one talked much about in the insurance industry until 25 years ago or so. I'm going to concentrate on the effect of organization and structure on surplus management, and I'll start with a little, simplified Chart 1 description of a mutual company and a stock company. I would say these are sort of typical organizations. The mutual company will have one or more downstream holding companies with subsidiaries underneath. For a stock company there is a holding company above the life insurance company. That will be an upstream holding company. Mutuals always have to have downstream holding companies. Stocks can have upstream or downstream, but the typical organization would be upstream. Mutuals, for those of you who don't think a lot about these subjects, have no shareholders and are operated in the interest of their participating policyholders who have certain ownership rights such as voting for directors and receiving ownership interest in liquidation. They are not technically or legally owners, however. Stocks are owned by shareholders, both legally and really.

Let me just spend a second on subsidiary companies because they're an important aspect of organization. There are a lot of reasons for organizing activities in subsidiary companies. Some of them are legal. For example, the insurance law requires this activity be conducted as a separate organization.

One aspect of organization with subsidiaries is the name of the business. The activity may have a name that is better known in its area than the parent's name. Equitable has an investment management subsidiary called Alliance Capital. Alliance Capital, in its field, is much better known than Equitable, and so it's better to operate it in subsidiary form.

Another aspect is the question of risk. If you establish subsidiaries, you have limited liability in case they get into a lot of trouble. That works as long as your name isn't on the door. If your company name is on the door, then you're going to be held responsible for it regardless of form.

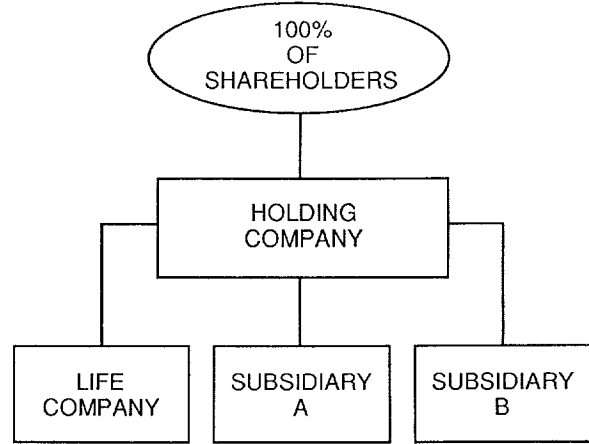
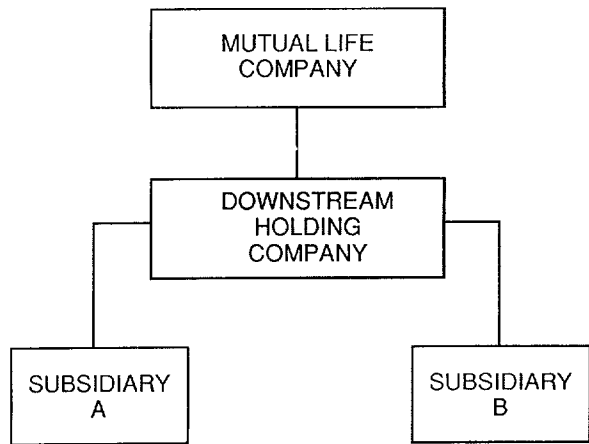
A third aspect of organization is history. You may acquire a company and just continue it in existence as a separate company.

A fourth aspect is the need to establish a track record. You may have a company that you wish to invest in or eventually sell, and you want to establish a track record in that business. A few years ago we spun our group operations out into a joint venture, established a record with it, and eventually sold it. Because of its established track record, it was a lot easier to sell than if it had remained in the parent company.

TODAY'S MUTUAL

VS.

TODAY'S STOCK



1761

SURPLUS MANAGEMENT
CHART 1

PANEL DISCUSSION

Now, let me go through some of the effects of having an upstream company or a downstream company, particularly the effects on the surplus management of the insurance company.

The first difference is raising capital. Stocks can raise capital at the holding company level or at the subsidiary level. They can raise both common and preferred equity. They can raise debt in several forms through banks or in the private and public markets. Finally, and very importantly, debt raised at the holding company level can be contributed to the subsidiary as equity, increasing the available surplus. Mutuals can raise equity and debt at the holding company level, but it really doesn't help a lot. Debt doesn't increase surplus at the insurance company level up above the holding company. Equity does not increase the capital of the enterprise. Selling equity in a downstream holding company is essentially the same as selling any other asset. All you do is exchange one form of paper for another. You may realize a capital gain on it and get some surplus out of the result of doing that, but you would do the same thing by selling a piece of real estate. So, in fact, raising equity at a downstream level is not enhancing the equity of the enterprise. It may be very hard to raise equity at any level unless a subsidiary is self-standing, unless it has its own sales distribution organization, or unless it has its own administrative organization. The relationships between that type of subsidiary and the parent get very complicated, and shareholders are probably reluctant to get involved in that kind of a situation.

I would call the second issue one of potential deregulation. When the time comes that banks and insurance companies can operate in the same corporate framework, undoubtedly, one of the things that will be required is that the insurance enterprise and the banking enterprise be separate in an ownership sense. Now, on the stock side, you can have the life company, and then Subsidiary A could be a bank, and, in fact, they are separate entities. When you get to the mutual side you will say, suppose subsidiary A is a bank. It's still owned by a life insurance company, and that's probably not going to be permissible. That will be a problem for the mutual entity.

For reporting purposes, stocks use GAAP and mutuals use statutory accounting. That's not really relevant, though, for the surplus matter. When dealing with surplus management, the accounting issue between the two entities is in the area of acquisitions. If an insurance subsidiary is acquired by A, that is, if subsidiary A becomes another insurance company, it never really affects the surplus of the main stock company. However, if a mutual acquires an insurance company of Subsidiary A, then it's got to immediately write off the difference between the acquisition price and its statutory book value. Even if you acquire a company at GAAP book, you're going to have an immediate write-off equal to the difference between GAAP and statutory surplus. Second, if you acquire a noninsurance subsidiary, there are limitations on the amount of goodwill you can carry on your balance sheet. In New York, for example, the limit is 10% of surplus. If you are already at that limitation because of previous acquisitions, then, in fact, you'd have to write off the full difference between GAAP and statutory, i.e., the full amount of goodwill. That is a problem in acquisitions.

Taxes are an issue I don't want to spend much time on because a lot of other people are spending a lot of time on it, but, there is an additional tax on the mutuals relative to

SURPLUS MANAGEMENT

their earnings. This represents another hurdle that they have to go through in the process of building surplus.

The mandatory securities valuation reserve (MSVR) is another accounting problem. Since Subsidiaries A and B, don't come up through the stock insurance company, their results don't affect the MSVR of the insurance company. In the mutual structure the MSVR is back up at the mutual life level. To the extent that earnings are accumulated through noninsurance subsidiaries, they can't go into the surplus of the mutual life company but have to go into the MSVR. You can avoid that by paying dividends out, but that, in effect, decapitalizes those companies. That would get to be a very complicated situation if you did have any outside owners in your downstream holding company.

In summary, the downstream form which the mutuals must use has a lot of disadvantages: raising equity capital, deregulation, acquisitions, federal taxes, MSVR, and accounting. It does not affect surplus management directly but, in the cases of deregulation and acquisitions, may affect the health and competitiveness of the enterprise. These are only theoretical differences and don't make any real difference in operations.

Let me quickly run through some statistics. Chart 2 deals with the number of companies. Over the period 1950-88 the number of stock companies grew, but the number of mutuals declined. Chart 3 looks at the worldwide relationship of companies in terms of capital and considers the top 20 companies in the world measured by capital. In 1960 there were 10 companies in the U.S., five mutuals and five stocks. By 1970 there were only eight, five mutuals and three stock. In 1980, there were but five, two mutuals and three stock. And in 1988 there were only two stocks. We were one of those 10 companies in 1960 and probably were there in 1970. Clearly insurance companies have been losing ground, and mutuals have been losing more ground than the stocks.

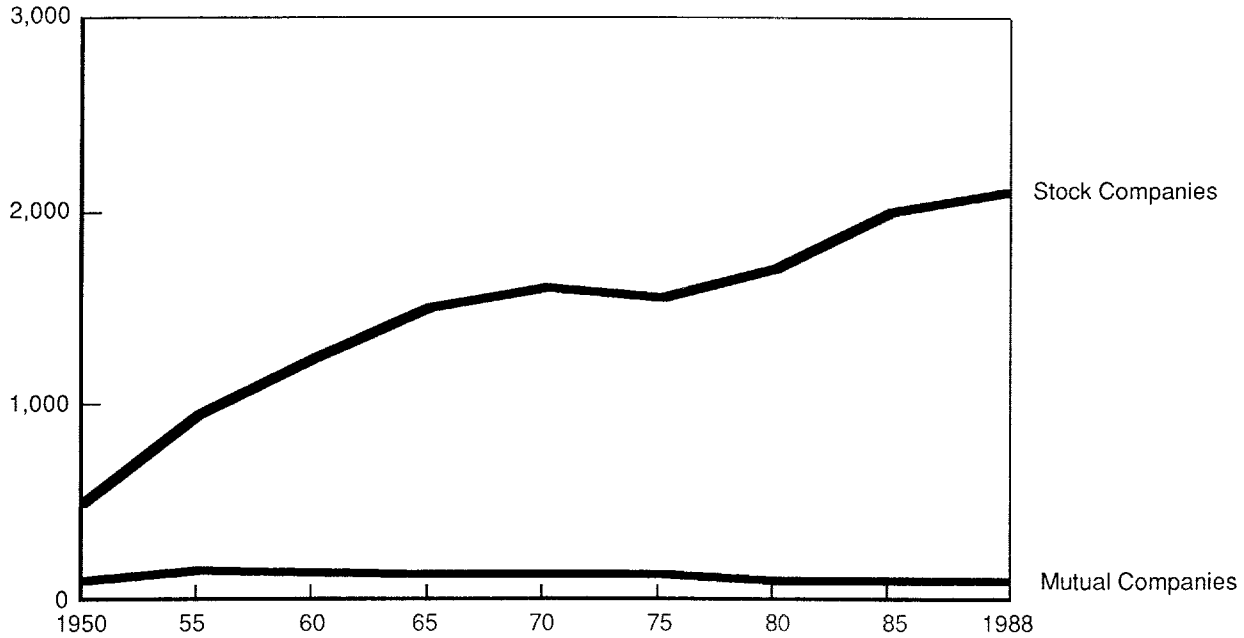
Finally, Chart 4 shows ratios of capital to admitted assets. Stocks have run throughout this entire period at the 10-11% level; the mutuals at roughly 6%. Chart 5 shows total capital of stocks and mutuals; stocks have increased around 75% over this four-year period, while it's been about 50% for mutuals.

While this doesn't prove that the structural differences are undermining the mutuals, there's little comfort in these statistics for those who would argue that structure doesn't make any difference at all. The rating agencies were mentioned earlier; they have added an additional imperative to surplus management, particularly of mutuals. Up to a few years ago Best's was the only rating that was important to mutuals. Today, the claims paying rating of Moody's and Standard & Poor's have achieved at least equal prominence for large companies. In addition, Moody's annually publishes what's called capital adequacy ratios, which are eagerly gobbled up by all agents and competitors. These ratings are of increasing importance to brokers representing companies and in GIC placements; they're also being used more and more in competitive individual life sales. For mutuals having sufficient capital and earnings, organizational structure limitations are not major problems. For others, however, change in organizational structure offers a way to raise upstream equity capital for safety, ratings, or for business growth. There are two possible approaches here.

U.S. LIFE INSURANCE COMPANIES 1950-1988

In Business in the United States

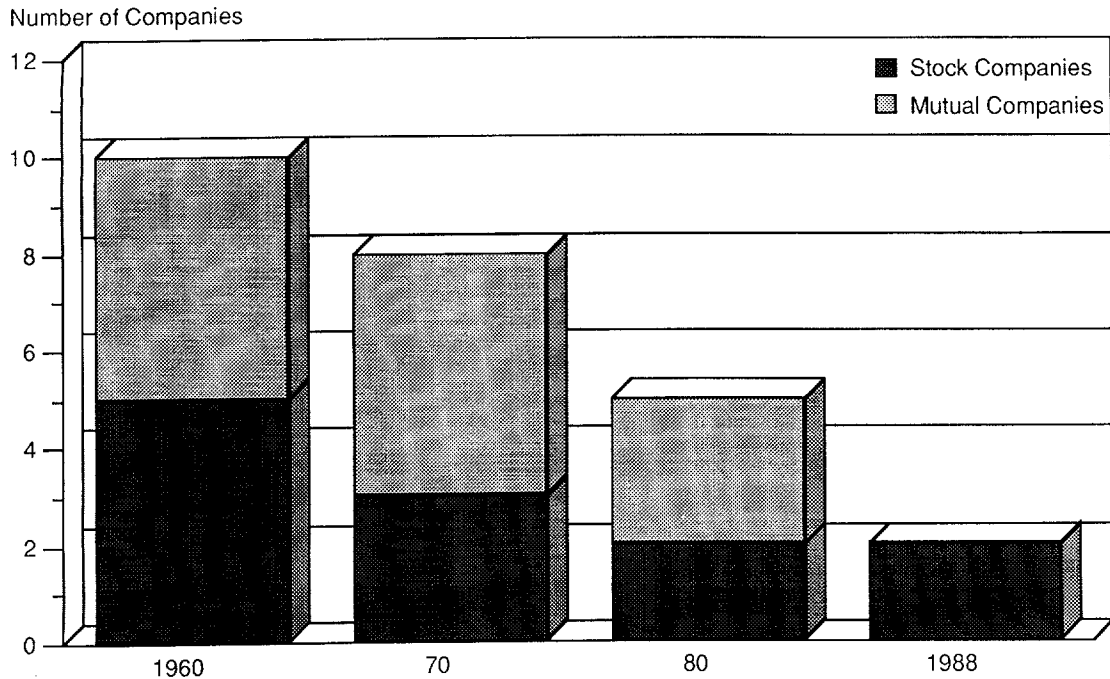
1764



PANEL DISCUSSION
CHART 2

Source: Data from American Council of Life Insurance

NUMBER OF U.S. INSURANCE COMPANIES INCLUDED IN TOP 20 WORLDWIDE FINANCIAL COMPANIES 1960-1988

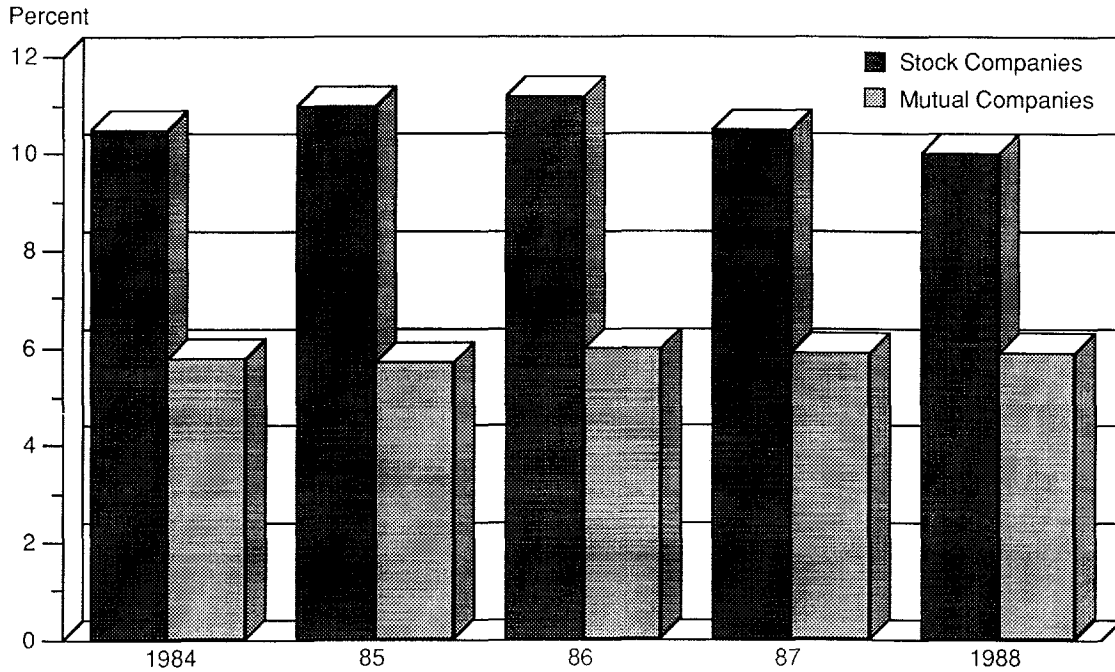


1765

SURPLUS MANAGEMENT
CHART 3

Source: Euromoney; Moody's International Manual (Annual Reports)

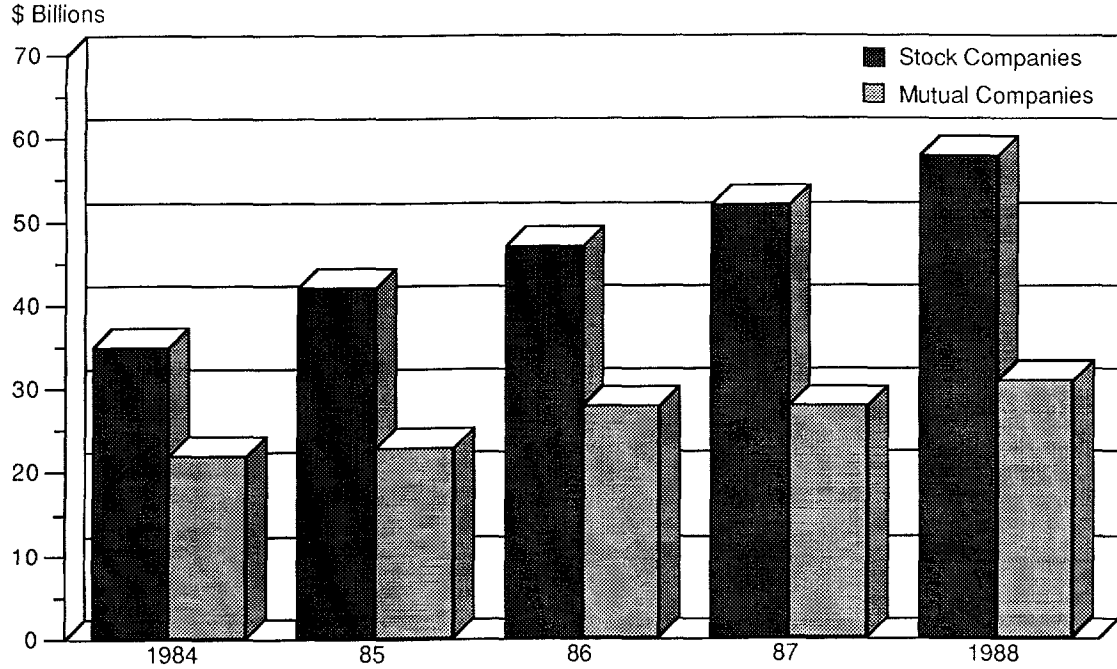
LIFE INSURANCE INDUSTRY
Capital Adequacy
(Ratio of Capital & Surplus to Admitted Assets)



Source: *A.M. Best Database*, adjusted for affiliates

LIFE INSURANCE INDUSTRY

Capital & Surplus



Source: A.M. Best Database, adjusted for affiliates

1767

SURPLUS MANAGEMENT
CHART 5

PANEL DISCUSSION

Demutualization is a process of converting a mutual company into a stock company (Chart 6). I will describe a maximum timeline because all the background analysis, including GAAP conversion, would be done before you'd ever make a decision to proceed. This is the process in the New York law. I want to discuss that because, if a company operates in New York, the New York Insurance Department is going to apply certain parts of that law to your plan regardless of whether you're converting under another law.

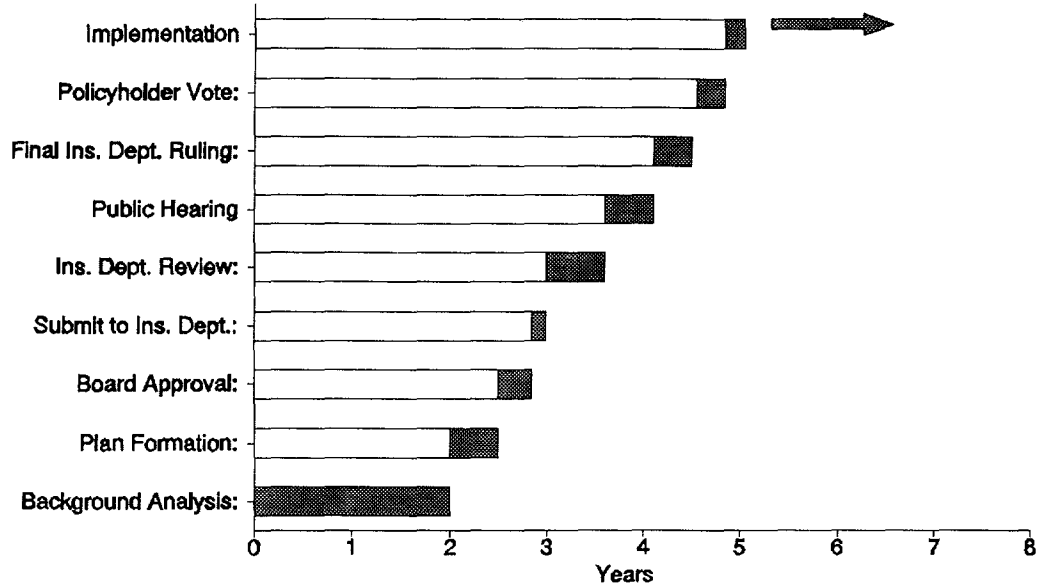
First you must deal with background work and plan formation in demutualization: GAAP conversion is a particularly important element of that. Second, the company's board of directors has to adopt the plan, and that will require three-quarters of the board approving it. The board is also required to opine that the plan is fair and equitable to policyholders and to indicate the reason for selecting the particular method involved. Your plan clearly has to include a description of the reorganization, the company charter, company bylaws, plan of operations, and the reasons for selecting the method. The plan also has to specify the amount, form, and allocation of any consideration that is due policyholders as part of your plan. The plan is then submitted to the Superintendent of Insurance, and policyholders have to receive notice. There is an Insurance Department review with all of its consultants, after which there would be a public hearing. The Superintendent then has 60 days to find that the plan does not violate the law, is fair and equitable to policyholders, not detrimental to the public, and that the demutualized insurer has sufficient capital and surplus. You then have a policyholder vote, needing approval from at least two-thirds of the policyholders voting.

If you start with a background analysis all done, you're probably dealing with it on a two to two-and-half-year time frame. No one has gone through it in New York yet, so we have yet to find out what is required. Demutualization will require that each policyholder's account be set up to assure the continuation of dividend payments. The amount of assets set aside for that purpose has to assure that the current dividend scale could be continued if current experience continues. You don't have to continue the scale if experience deteriorates, but that amount must be set aside. Interestingly enough, the tests that have been done would indicate that the amount of assets to be set aside is less than your statutory liabilities. This has some interesting results when you do statutory accounting and put together your GAAP books.

There are two methods under the New York law. Method 1 requires that all equity interest be immediately distributed to policyholders and that the sale of stock by a converted company to outsiders must be disclosed in your plan and approved by the Department.

In Method 2 the aggregate policyholder consideration is defined as the assets accumulated by the company from the current policyholders, less the assets you've set aside in the closed branch, so that, in fact, the assets which have been contributed by the current policyholders will be received by them either in the form of stock, cash or future dividends. Typically, this calculated amount would fall somewhere between statutory surplus and GAAP surplus.

Sample* Demutualization Time Line



* Actual procedures and timing will vary and overlap based on company involved and relevant state laws.

PANEL DISCUSSION

As a practical matter, Methods 1 and 2 are equivalent if the calculated value policyholder consideration in Method 2 is less than market value of the company. If the reverse is true, where the market value of the company is less than this calculation, you can't do a conversion under that method. You reduce the amount of Insurance Department discretion by following one of these two methods, and as experience has shown, the less discretion the Insurance Department has, the better off everyone is in these processes. When you get all finished, the converted company will look like the stock company described before and will get the benefits of the upstream holding company.

There are a number of concerns for the mutuals which have converted. Companies that need to demutualize may not command an attractive market price. On the other hand, if you've got a company that is restructuring and has relatively low values, that may be a good reason to buy stock at a low value price and look for the upside potential. The process of demutualizing will be costly and time-consuming, and setting up records for hundreds of thousands of shareholders is a challenge. The effect on corporate culture can be traumatic: one company went through 15 years of trying to change the corporate culture before it went the demutualization route. Finally, when you end up, you have a public company with all the SEC reporting and disclosure requirements and with the threats of hostile takeover. Given all these concerns, mutuals are looking for alternatives, and in recent months the concept of the mutual holding company approach has emerged. There are mutual savings banks in the northeast that have set up holding companies under state law, and there is one life insurance company in Quebec that has also set up a holding company structure.

In a holding company you take that membership interest which policyholders had, their ownership interest, and transfer it to the holding company. Then you convert the mutual company into a stock company (Chart 7). The stock company can raise capital, or the mutual holding company can sell some of the shares of the participating policyholders. The only thing is the policyholders have to retain, under this structure, voting control which would mean at least 50% of the votes. A mutual holding company is operated on behalf of the participating policyholders; the formation of the mutual holding company has separated the policyholders' interests from the member interests. Its policyholder interest stays in the life insurance company. Its member interest now transfers up to the mutual holding company. If we were to go around organizing mutual companies these days, this is probably the way in which it would be organized. What we've done now is to create a parallel structure with the stock companies. (See Chart 8.) You need some legislative action. There has been a bill drafted in New York and is under discussion with the New York Department. One significant advantage over demutualization is, you don't have to determine what the individual policyholder's interests are because you've got those interests held as an undivided amount in the holding company. This clearly speeds up the implementation and approval process. It can be a way station on the road to demutualization because, in the end, you could dissolve that holding company, distribute the shares to policyholders, and that would effectively then create a pure stock company.

MR. ALLAN D. GREENBERG: There were several areas that I would like to talk about, but I want to concentrate on two. If there's time at the end, I'll get into some

SURPLUS MANAGEMENT

CHART 7

MUTUAL HOLDING COMPANY CONVERSION

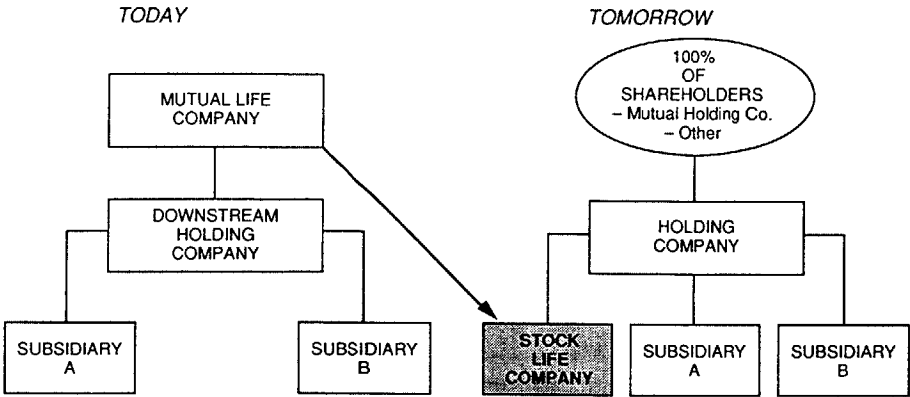
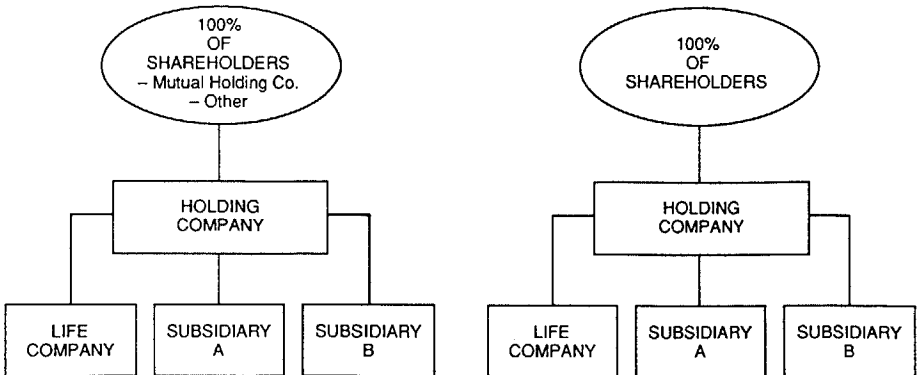


CHART 8

MUTUAL HOLDING COMPANY

VS.

STOCK COMPANY



PANEL DISCUSSION

other issues. I want to talk about these issues because there have been so many changes in the environment today relative to these two areas of raising capital for insurance companies.

In the last two or three years the movement of banks into the insurance industry as a source of capital has been nothing short of phenomenal, and several companies arranged to increase their capital through utilizing bank debt in a way that would increase their equity. This is not a new concept. Many people have had experience with agents' balances. Agents' balances tend to be a known quantity. The percentage of agents' balances that tend to eventually be paid off and realized as earnings by the company become an admitted asset, cash, after having been a nonadmitted asset, agents' debits/balances due. What banks have done is accelerated this process by lending money to the insurance company with the agents' balances as collateral. What is very new is that banks have devised ways to take the loadings on gross premiums as collateral for these loans which then becomes capital for insurance companies. Last year the NAIC determined that this was not acceptable. Earlier NAIC statements promulgated that any financing produced this way was fine. There was nothing wrong with a company borrowing money from the bank and increasing its capital by getting this capital secured by loadings on its premiums. The NAIC did, however, say that since this money has to be paid back to the bank, a liability should be established for it, so the net gain to capital was zero. Last year the NAIC followed this, and as a result, what probably would have been a torrent of activity ground to a halt. There are some companies that were able, through their state commissioners, to have activity they had engaged in up to that time be grandfathered.

For practical purposes the environment has radically changed, and what seemed like an unlimited source of capital for many insurance companies has dried up. However, an area that Harry alluded to, with various statutory problems that accompany it, is the idea of a downstream company as a way of increasing the capital of an insurance company. The problem is that in many downstream companies you have goodwill, and in the case of a mutual company, there are limitations on the amount of goodwill that can be carried at the parent company. What the banks have now done -- and I think it's very creative because it eliminates some of the problems in earlier bank attempts to supply capital through loadings -- is to lend money to downstream companies to pay commissions front-ended to agents. The insurance company pays to the bank commissions for various numbers of years. In doing so the insurance company is effectively contractually obligated only to pay the level commissions. The major source of surplus strain for most companies today, the writing of new business, is substantially mitigated.

There is some question as to whether or not this method of raising capital through bank financing will continue. It should be mentioned that the most successful attempt at this method of financing is from a company that sells products with substantial margins. Given the banks' normal conservatism -- they tend to be more risk averse than almost any insurance company -- the amount of collateral they want in order to support the subsidiary setup for financing commissions to the agents is substantial. In today's pricing in much of the insurance markets, there is some question as to whether a rational level commission can be paid contractually by the company to this bank that pays the agents the commissions. There is nothing to prevent this from happening right now, but it is

SURPLUS MANAGEMENT

hard to believe that an Insurance Department would permit a life insurance company to contractually be committed to pay commissions on premiums which clearly in a defined number of years would bankrupt the company. If there are not sufficient margins for the company to be able to demonstrate that it can support these commissions, I think that this seemingly golden source of capital may be limited to a few niche companies that still have suitable margins on their products. If we have time later on, I do want to talk about some of the other ideas that companies can use for downstream companies to improve their capital situations.

The second thing that happened in the past year is a complete turnover in the reinsurance marketplace. I remember speaking at a Society of Actuaries meeting a year ago about the possibility of reinsurance capacity being drastically affected. There was great concern as to what would happen in the Supreme Court in the Colonial American case, and I made the statement that, if the decision is unfavorable, I think it bodes very ill for people who want to obtain surplus in their companies using reinsurance. This, to me, was so obvious that everyone should see it. What happened next was the decision on Colonial American was unfavorable, and there was a slight spike in the cost of reinsurance.

In 1989, Steve Ficus, my partner, and I had devised a way to provide surplus through reinsurance at what we considered an incredibly low rate, possibly under 2%. Coming just after the Colonial American decision, it was like a license for us to print money. Those of you who were involved in reinsurance last year probably saw the most amazing phenomenon in the history of financial reinsurance. By the last two weeks of December 1989, reinsurers were trying to give surplus away, and companies were saying that the price was too high. The price went down in various cases to less than 1%. Fortunately, we had all our commitments for this brilliant idea well ahead of this development.

There were several external factors that really caused the reinsurance surplus, and I believe it would have happened no matter what. There was a drop in demand. In the past couple of years Equitable had been a major user of reinsurance, but any reinsurance needs in 1989 was done earlier in the year, and there were no reinsurance needs in the latter part of the year. Executive Life, which also had been a big user of surplus, was not a big user of surplus at the end of 1989. More players came into the financial reinsurance marketplace, and all of this caused a glut of surplus that drove the price down 75-80% in a matter of about six weeks. I know people looking for surplus last year got quotes they couldn't believe, and before they could go to the senior executives and do the deal, they got another phone call from someone else cutting that rate by 15 or 20%. This went on for weeks at a time.

I don't believe this is going to continue. The surplus of available surplus, if you will, I believe was a one-time event, and people made certain decisions based on an expectation of getting certain rates of return on that use of capital. I believe very strongly that if providers of surplus, a normally scarce commodity, foresee that they are going to receive a 1% or less-than-1% premium for lending other companies their surplus, they're going to put that surplus to other use. I believe that in 1990 reinsurance still may be a very viable way for companies to increase their surplus on a short-term basis. I do believe that the party is over, and you're going to see rates again back at 2.5% or 3%,

PANEL DISCUSSION

perhaps even higher. There are always special situations, for those companies that are really observing the marketplace, there still will be opportunities to obtain surplus relief reinsurance through normal methods at a substantially more favorable cost than the rest of the industry. I don't think any of you should set your goals for obtaining surplus this year at less than 1%, nor below 2%. Those who are creative and see opportunities will probably be able to obtain surplus much cheaper than the average in the marketplace.

One of the simplest sources of capital and surplus I've always thought would simply be to retain earnings. However, right now we have a strange tax system. This can be a painful way to accumulate surplus for mutual companies because, for every dollar of earnings they retain, they're going to have to pay additional tax on that dollar going forward. Mutual companies are in the very strange position of needing surplus and wanting to keep their surplus at the lowest possible level because of the tax consequences. Although I grew up at a very large mutual company, most of my career I've been affiliated with stock companies. I don't think that I could ever be classified as a mouthpiece for the mutual life insurance companies, but I do think there has to be a better way to tax earnings on deemed equity on the part of policyholders than to tax that equity directly.

Other ways for mutual companies to demutualize or get the benefits of demutualization without doing it. The idea of a mutual holding company probably is an example, and I think we are going to see a lot more capital be raised through this methodology.

The final thing I want to talk about, is something that has not been sufficiently used in the past -- joint ventures. There are many companies both in and out of the insurance industry that have very, very specific strengths. There are other companies that could utilize those strengths because they have the capital to invest but don't have a specific strength to invest in. We were involved in a venture recently whereby we were working with a mutual company to increase its operation by 40-50% virtually overnight, but it did not have to make any material capital contribution. The reason was this mutual company had some very obvious strengths that the other organization could use to its profit. In return this mutual company obtained extremely strong marketing without having to make a large investment. We are talking about an investment of \$400 or \$500 million if the only way the mutual company could have done it was by making an acquisition. As Harry said earlier, there's a very limited amount of goodwill. There are virtually no companies around that can make acquisitions with goodwill in the hundreds of millions of dollars and not suffer extreme statutory hardship.

MR. ABE C. OLSHEN*: Would your comments be the same with regard to the demutualization and the question of the distribution of so-called equity surplus under a federal Public Law 15 situation rather than just New York alone?

MR. GARBER: Let me just say that the effect of whether you repeal Public Law 15, which is the McCarran-Ferguson Act, is really the question of what happens when you repeal it. What do you substitute for it? Saying it's the feds or the state regulators is one thing, deciding among the federal regulators is another. Then there is the question

* Mr. Olshen, not a member of the sponsoring organizations, is the retired President of Olshen & Associates in San Francisco, California.

SURPLUS MANAGEMENT

of whether the feds are going to deal only with financial matters or whether they're going to approve policy forms and so on. My guess is that eventually the feds will take a piece of it and leave the rest to the states, and so that, if they're going to do anything, they're probably going to do the financial side.

With respect to demutualization, state law has been developed here recently, and it's been developed in a fairly uniform manner. I would doubt that if the feds got involved in that they would change what exists in any significant degree in that area. I think the demutualization law in New York was one that was developed after long and careful study with the companies and regulators. It conforms very well to the Society of Actuaries' task force report, although the two were going on simultaneously, and, in fact, the law part was finished before the report. So, it comports fairly well with the realities in the world. I would say that, if Public Law 15 were repealed, most of my comments wouldn't change at all.

MR. GREENBERG: Again, I think there's nothing inherent in Public Law 15 that precludes anything that Harry said. Much of what I said involves transactions that I don't think change if there were no Public Law 15.

MR. POLLNOW: Allan, when you mentioned all the surplus out there, does that mean there's a lot of excess capacity out there? Is this going to get the insurance industry into trouble by cutting rates?

MR. GREENBERG: I think the excess capacity developed at the end of last year almost as a result of a fluke of several things happening together. I will now categorically state that there is no question in my mind whatsoever that the impact of the Colonial American decision and the elimination of any tax benefits on the part of the providers of surplus to do so will result in an increase in cost of doing reinsurance to develop surplus for temporary needs.

MR. POLLNOW: The other interesting comment you made concerned whether there are sufficient margins in the products to support the obligations if you front the commissions and then have to pay them back on a level basis. Does that mean that companies are not taking this into account properly in pricing their products originally?

MR. GREENBERG: I think that most people would agree that there already is a problem in the pricing of insurance that has been around for many, many years now.

There is a little bit too much of "things have improved, and they're going to continue to improve" in the pricing. I think that margins wouldn't be deemed excessively prudent in mainstream insurance today. Let's look at a scenario where you have a high front-end loaded commission and some small renewals, and you replace that with renewal commissions substantially in excess of the value of the other commission stream so that you, in fact, are adding a substantial contractual obligation to the insurance company. If you look at any major stock or mutual life insurance company and took its commission structure, and if the average weighted commission level on its current assumptions were 18% a year, and it contractually guaranteed to pay to another company 30%, I do not believe it has margins sufficient to do that.

PANEL DISCUSSION

MR. GAMMILL: Harry, this is a question for you. Generally, the cost of capital is impacted a great deal by the strings that are attached and the subordination of the funds. In this downstream mutual holding company structure is there any additional regulation that would be present, versus that in a normal upstream stock holding company, where that subordination would increase the cost of capital to the mutual holding company?

MR. GARBER: You would have established your participating policyholders as a closed branch. The legislation that we have talked about would permit the fees for management of assets and administration and so on to be pulled out of that closed branch. So, there will be some profit that branch would be producing. The company buying into that holding company below the mutual holding company might very well be one that's interested in getting into the business and wouldn't mind owning less than a 50% share.

MR. GREENBERG: I think one of the issues you have to be very careful of with that structure is there are potential tax consequences that could be devastating. Although the idea of keeping this 51% ownership is important long term, on a short term you can go nowhere near 51% without such catastrophic tax consequences that the enterprise would not be viable. So, it's really important in doing some of this to be very careful how you structure outside ownership. If it doesn't meet certain parameters over certain periods of time, you'll have opportunities to examine different careers than the one you have right now.