

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

CAPITAL-RAISING ISSUES

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- o How do the various alternatives work?
- o Reinsurance versus bank options
- o Regulatory news
- o Ratings agency considerations

MS. DIANE WALLACE: We're all voraciously looking for capital lately, so it is appropriate to discuss new thinking on creating innovative capital structures for the life insurance industry. We will focus on the theory behind some of these newer forms of capital and the impact on the financial security of the life insurance industry.

Traditionally, equity capital has been sufficient to finance growth needs in the life insurance industry. Occasionally companies would borrow money in a holding company and then infuse it as equity capital to the insurance company sub. But, over the last few years, companies have been thinking about maximizing returns on capital by using leverage. Some of these new ideas are very exciting.

All of these newer forms are driven by the intentional conservatism built into the statutory accounting system. In reality, fewer assets are needed to support future obligations than the amount determined by statutory reserve calculations. This leads to the desire to sell future profits that will emerge in the conservative statutory statements. Those future profits can be released in current statements if someone else is willing to assume the obligations of an insurance company in exchange for receiving assets less than the amount calculated according to statutory reserving principles. This is sometimes called "GAAPing" the statutory balance sheet.

For example, if you sell a single premium insurance policy for \$1,000 and pay 10% in acquisition costs, you've made the pricing decision that \$900 is enough to fund future obligations. However, under statutory accounting principles, you may have to set up an \$1,100 reserve. In other words, statutory rules require you to have \$1,100 of assets on hand to fund what you believe to be a \$900 liability. If you can convince someone else that \$900 is enough, then they might give you the \$200 now in exchange for the future

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statutory profits. Or, in a reinsurance transaction, you could pay a consideration of \$900 to the reinsurer to assume the \$1,100 of statutory obligations.

This restructuring leads to a very legitimate debate. Is this new form of capital seriously weakening the balance sheets of the life insurance industry, leading to a dangerous financial solvency situation? Or, alternatively, is this a beneficial transfer of risk to third parties, enhancing the risk profile of the company and bringing needed capital for growth? The debate will certainly continue, but a lot of excellent thinking has already been done. We have three speakers to give us their insight.

Bill Schnaer will review the variety of capital forms available, including traditional sources and new forms based on freeing up the conservatism in the statutory balance sheet. Bill is Executive Vice President of A. L. Williams Corporation, whose affiliate Milico has entered into a controversial commission financing transaction. Following Bill, we'll hear from Norris Clark, who is Chief of the Financial Analysis Division of the California Insurance Department. Norris has been at the forefront of the regulatory discussion on these issues and of the considerations on the proper accounting treatment. He will give us his thoughts about the true economic impact of these transactions and regulators' concerns generally about the solvency of the life insurance industry. Finally we have Weston Hicks, Vice President of Moody's Investors Service. Weston, who is responsible for insurance industry ratings, will inform us how the ratings analysis process looks at the true economic viability of insurance companies and the risks inherent in their forms of capital. I think we'll have a very interesting discussion, with thoughtful comment on both sides of the debate I mentioned earlier. I hope that you'll think about questions as the presentations are being given. A considerable amount of time will be left for questions and discussion from the audience.

MR. WILLIAM J. SCHNAER: As most of you know, our insurance company, Massachusetts Indemnity Life Insurance Company, has been involved with what has been called a levelized commission transaction. As it turns out, we are by no means the first, but certainly the most publicized, thanks to having antagonists who own a newsletter. The transaction has recently been studied by an NAIC working group. I plan to discuss it only briefly, but if you want to know more, I'll be glad to take questions. Instead, I'm here to talk about techniques of raising capital, with specific emphasis on what has been called securitization of assets and levelized commissions.

Capital raising techniques can be put into different buckets based on whether they're leveraged or nonleveraged. The classic definition of leverage is that the payback is relatively fixed. It doesn't necessarily have to be completely fixed, but in general, the dollars that the company will have to give up or pay back in the future is a relatively fixed amount. For nonleveraged capital, the amount is more or less at the discretion of the company. Certainly, you'll see there are some types that may not fall cleanly into either category.

Let's look at nonleveraged capital first. All of these seem to be fairly noncontroversial. First, stock companies can receive contributions from a parent or an upstream holding company. Similarly, a publicly traded company can sell common stock. Preferred stock

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is sort of quasi-leveraged, quasi-nonleveraged, but it is considered equity and, therefore, it should fall into the nonleveraged camp.

Mutual companies, of course, cannot avail themselves of any of these since they can't sell common or preferred stock. So, other techniques allow them to take advantage of public sources of capital. They can get into a joint venture with another company, where the other entity contributes capital into the venture, and the mutual insurance company takes some risk. A merger or pooling of mutual insurance companies has been talked about more than actually done, but it's also a way to match a company with excess capital with a company that wants capital to grow. We've seen recently some demutualizations turning a mutual company into a stock company. Someone who wrote an article about demutualization commented that you could count the number of companies who had done it on the fingers of a three-toed auk and have two fingers left over, but lately it's been happening more because companies want access to public markets. Mutuals have also used downstream holding companies for years.

Some techniques are available to both stock and mutual companies. According to a recent survey, almost 100% of companies surveyed are attempting to engage in an expense reduction program. No matter how lean and mean you are, if you take your eye off the ball for about six months, you end up getting a little fat. Another way to improve a capital structure is to sell marginal operations. Companies may have something worth more to someone else because of efficiency in volume. A number of companies have pared themselves down to single lines. A total or partial sale of a subsidiary has also been a favorite capital raising technique among many companies. Companies sometimes sell less than 20% of a subsidiary, so they don't give up control.

Surplus notes are another form of capital on the cusp between leveraged and nonleveraged types. Classification depends on the form of the note and the applicable state laws. There are some states that enforce a total nonleveraged nature, i.e., no funds can be paid back without permission of the State Insurance Department. A surplus note may even be worse than equity, since there are also some blanket restrictions on regular dividends. Other states have loose restrictions, such as repayment only out of positive earnings.

Finally, let's consider conventional risk transfer reinsurance. Here, the payback will be proportional to the direct company's profits.

Now let's talk about leverage, the more controversial kind of capital. Not all of these are necessarily controversial, and yet all of them have similar economic reality. The question then comes to mind, why are some of them more objectionable than others? Certainly financial reinsurance is very clearly leveraged. You get surplus today. If experience turns out as expected, you pay it back over a certain number of years in the future. When it's paid back, plus cost, it's all over with. Financial reinsurance is a little bit like the rap group that just got declared obscene in Florida. You can't really define it terribly well, but you know it when you see it.

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Another form is a sale leaseback of assets, such as home office equipment. Accounting treatment has varied from state to state depending on regulators' feelings about the strength and cancellation terms of the lease.

A fairly noncontroversial way to improve surplus is a sale of nonadmitted assets such as agent debit balances. Again, this is a leveraged transaction. You get a sum of money for which the payback is going to be fixed. This is a peculiarity of statutory accounting. An asset, which everybody agrees is an asset, is not allowed on the balance sheet. By turning it into cash, which is admitted, you can increase surplus. There are a number of companies selling agent debit balances, and if the sale is totally without recourse to the insurance company, it has been, and probably will continue to be, a fairly noncontroversial leveraged form of capital.

Another form is the sale and/or reduction of an overstated liability. For instance, property and casualty (P&C) companies buy structured settlements. They have long term claim liabilities that they're not allowed to discount at interest. By purchasing a structured settlement that discounts at interest, they can free up some capital. Another example that happened some years ago was the change in the standard valuation law to allow a general reduction of deficiency reserves. Bingo. To the extent that you may be holding net level reserves, or something higher than commissioners reserve valuation methods (CRVM) reserves, negotiation with the insurance department may reduce those and free up some capital. Cherry picking of capital gains is a favorite technique of a lot of companies. Again, it is a leveraged technique. It probably leaves you with a portfolio that's totally under water. When you have a capital gain, you sell it, and if you have a capital loss, you keep it. If you're never forced to sell, it can work out all right.

Another leveraged technique is a reduction of mandatory securities valuation reserve (MSVR) by asset swapping. I was reluctant to put this in the leveraged category, but I think it is largely leveraged. Some of this is totally noncontroversial. If you have bonds that are in the 20% category, and you exchange them for bonds that are in the 1% category, you free up some MSVR. There are other ways of packaging 20% bonds recently publicized that perhaps are a little more devious, but, in any event, it is a way that companies are freeing up surplus.

And now let's get to the two items, that although are economically very similar to the last six, have been getting a lot of publicity lately. One is securitization of future cash flows, which is a term I prefer to securitization of assets. And the second is leveled commission.

Let's talk about securitization of cash flows. What is it? A portion of future revenues is pledged in exchange for cash, purely and simply. You go to a financial institution of some sort. It could be the public -- by packaging and selling a security similar to mortgage-backed bonds. Or it can be a bank or credit company. Then, in exchange for cash today, you give up X% of future revenues. This method is widely used outside of the insurance industry for companies that need cash, such as retail companies. Companies that have huge receivables or predictable future cash flows can, indeed, exchange them for cash.

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I want to point out that this type of transaction is not the sale of assets. You must distinguish between companies selling future cash flows that are not already recognized as an asset on the balance sheet versus companies selling future cash flows that are recognized as an asset on the balance sheet, such as receivables. Sears has huge future receivables on their balance sheet, and they can factor them out in exchange for cash. On the other hand, other companies, such as a supplier to Sears, may have future revenues not reflected on the balance sheet. They have a contract with Sears over the next five years to supply them with dresses. They can pledge portions of those future revenues, which are not assets on their balance sheet, to a bank in exchange for the cash necessary to build their factory to supply dresses.

In the case of the widely publicized life insurance transactions by General American and Washington National, the portions of future revenues pledged were equal to the statutory loading. The theory was that the net statutory premium was already pledged and in use on the balance sheet in the form of the statutory reserves. The excess of the gross premium over the net premium was not used anywhere and, therefore, available for securitization. A counter argument was that certain expenses were also not recognized as a liability on the balance sheet, and the two went together. For example, future commissions, future maintenance expenses, future premium taxes, etc., are not recognized as a liability. So why should future loadings be claimed as an asset? The two go together.

The transactions under discussion had recourse beyond the specifically pledged policies. It was not a general obligation of the insurance company. It was a specific revenue-backed transaction. However, there was a question as to whether the claim of the lending institution (in both cases Citicorp) was subordinate to claims of policyholders in the event of an insolvency. I think the only reason a question came up was because it hadn't been thought about at the time the transactions were put together. The question is whether the bank could assert a secured claim ahead of policyholders or whether it was like any other creditor, which would put it behind policyholders. Citicorp was perfectly prepared to subordinate their claims to policyholders when push came to shove, but as it turned out, it didn't make any difference as far as the accounting treatment allowed by regulation.

Let's talk about the accounting issue. Since this is a transaction that is widely used outside of the insurance industry, it's instructive to think about what those companies do for their GAAP statements. When a noninsurance company securitizes future revenues that are not already recognized as an asset, the question becomes whether that company is entitled to immediate income recognition. In other words, are they allowed to increase their capital? In talking to our accountants, the answer is, as far as the SEC is concerned, almost never. It is a very rare instance where a company under GAAP is allowed to recognize income immediately as a result of the securitization of future cash flows. The answer is different when selling assets already recognized on the balance sheet such as factoring receivables. If you have an asset valued on one basis, and can get more cash for it than you were otherwise holding it for, then you can increase your capital. This is because GAAP allows carrying an asset at the fair market value. If a company with intentional conservatism manages to find somebody who thinks more highly of the asset than it does, there's no inherent reason why it shouldn't increase

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capital by selling the asset, since it was perfectly free to hold the asset at fair market value to begin with.

There is a controversy right now at the SEC as to whether the accounting to accomplish no immediate income recognition should be a deferred income account, deferred revenue account, or a debt. The SEC has proposed a number of criteria, although not yet officially. They have floated a trial balloon saying things such as a floor or a ceiling, recourse, etc., would have to be accounted for as debt versus deferred revenue. But, in this case, this is a line item question and not a capital question.

Now let's talk specifically about the statutory accounting questions that arose in the case of the General American and the Washington National transactions. Here the question becomes what is the proper analogy? General American maintained their transaction was analogous to the sale of a nonadmitted asset. In other words, the loading on future premiums was of the same character, say, as an agent debit balance, that under normal circumstances would be considered an asset. By turning it into cash, they could then turn a nonadmitted asset into an admitted asset. Again, the counterargument is that future revenues are not an asset. Reserve calculations may include, if you will, a reduction of the reserve for future net premium, but in insurance accounting, or in any accounting, future revenues are not an asset. They are future revenues, and you are allowed to bring them into income when they are due.

Missouri had a law passed specifically allowing the General American transaction. Also, the Illinois Insurance Department approved the Washington National transaction. However, the NAIC working group on the securitization of assets decided that this transaction was not in the nature of a sale of a nonadmitted asset, and that there should be no immediate income recognition. This is accomplished by setting up a matching liability.

Let's go on to levelized commissions. I may be beating a dead horse, because I think those of you who read the *Insurance Forum* understand this. A super general agent (GA) receives a levelized commission. The super GA pays the high first-year commission (my attorneys shudder when I say high, but we all know what I mean) to the lower-level agents. In the first policy year the super GA has a negative cash flow. In renewal policy years the super GA has a positive cash flow. That super GA borrows the money to fund the first-year deficit and uses the positive renewal cash flows to repay. Typically in these kinds of transactions there is no recourse for the debt beyond the super GA. Therefore, the insurance company's burden of paying the first-year commission has been shifted to another entity.

The elements of this transaction are very common: renewal commissions are paid by an insurance company and agents borrow from a bank on the strength of the renewals. This is something we learned about years ago as actuaries. And many of them can get loans that are nonrecourse.

As I go along, you'll have no doubt as to which side of this argument I'm on. The renewal commissions represent a deferral of acquisition expense. I think that's very clear. In fact, if you read the logic behind the original New York Section 213, the whole

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purpose of limiting first-year commission and prescribing renewal commissions was to limit the surplus strain of companies. And many people will say that the quality of business is enhanced by having renewal commissions. I think that is more theoretical than true. I think money that an agent gets next year is money that he doesn't think about at all. The personal discount rate of most salesmen is in the nature of 100%. You can achieve quality of business through immediate rewards and punishments much more effectively. In fact, our agents receive almost no renewal commissions. We reward persistency through first-year commission rather than renewal commission. If an agent has a choice between saving a case on which he can get 10% or selling a new case on which he can get 50%, I don't think it's any contest.

Let's talk specifically about things that make the Maple Leaf Transaction unique or perhaps slightly different from others. The business that is sold by Milico's agents is 90% monthly, preauthorized check, electronic funds transfer. Therefore, the super GA Maple Leaf had to assure itself of continued funding throughout the first policy year on any piece of business issued. Second, because we had commissions beyond the day of issue, every one of Milico's agents agreed in writing that Maple Leaf is the sole source of their commissions, and that they would not look beyond Maple Leaf in the event of a default. In addition, we have a collateral fund held by Maple Leaf funded out of commissions paid by Milico to Maple Leaf. It's used to supplement, if needed, or, if it is not needed, to replace when permitted the regular commissions from Milico. And, finally, the super GA is limited to breaking even.

As for accounting issues, there's no question about the GAAP treatment of the accounting in Maple Leaf. It's a debt. We had hoped initially for a sale treatment. We ran into the fact that you just don't get immediate income recognition when you sell future revenues. Maple Leaf has a bank debt and there's no recourse beyond Maple Leaf, and specifically no recourse to Milico. We had a question about consolidation with Primerica Corporation, which was an undesirable result from Primerica's standpoint. Primerica is the ultimate parent of Milico. Therefore, we created enough distance that at least under current SEC rules, the debt is not consolidated on Primerica's balance sheet.

The NAIC working group has now decided that allowing surplus relief from this transaction is contrary to statutory accounting principles. Obviously, that is a conclusion with which I disagree. Professor Belth, who had a spirited discussion on the issue of levelized commissions, made the same statement. He said it was a subversion of statutory accounting principles. Our belief is that there has been a true transfer of risk. In statutory accounting, the risk that we are forced to guard against is 100% lapse tomorrow. That is why all commissions and acquisition costs must be expensed when incurred. A company is not allowed to take into account the possibility of receiving premiums in the future. If it was, then you could capitalize and amortize, à la GAAP. If that risk has been transferred out of the insurance company, to another entity, we believe that we have eliminated the risk that statutory accounting requires us to account for. For any other insurance company, commissions are not required to be expensed until the premium on which they are paid is due, and we believe it should be that way for levelized commissions.

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Let's talk about the future. Another action of the NAIC working group is the establishment of an industry advisory committee. I understand this is in the process of formation. Perhaps Norris will have more information, since he may be closer to the group. They will be instructed to look at the total picture -- what sources of capital allow reasonable growth. I think it is possible to make an argument that trying to limit growth of insurance companies through capital raising techniques is inherently anticompetitive. Should the amount of leverage, or whether a transaction is leveraged or nonleveraged, be a criterion? Should lack of precedent? I think that has been one of the criteria. Should the relationship to policyholders' benefits be a criterion? I believe that was the criterion used by Illinois in its approval of the Washington National transaction. As long as Citicorp agreed that it came secondary to policyholders' benefits, it was considered a legitimate transaction. Finally, I think that this industry advisory committee, whether or not your company happens to have a member on it, needs input from the industry. They are going to be looking at all forms of capital, or certainly all of the leveraged ones. If you feel strongly, you should provide input so that they can get all points of view.

MR. NORRIS W. CLARK: After I listen to Bill talk, and I have heard him talk several times about levelization, I'm almost always convinced that he's right. However, I come to my senses eventually. As Bill has said, the focus of regulatory attention most recently has been on some of the newer leveraged types of surplus transactions. The securitization or sale of future revenues came about in the latter part of 1988. General American and Washington National got together with Citicorp and developed a way to sell their policy loadings, with the hopes that they would be able to recognize the revenue from the sale immediately and thus increase their surplus. In an unusual situation, regulators were brought on board almost immediately, as there was some hope that, working with state regulators and the NAIC, ground rules could be established to further develop the idea. In 1989 some other companies, including two California companies, entered similar types of securitization arrangements, although not necessarily related to their policy loadings. Also, Milico introduced their Maple Leaf commission levelization program.

Throughout what I say we'll talk about securitizations and levelizations because that's what everybody's been calling them. However, the securitizations that we've looked at have not really resulted in any securities issued, and the levelization transaction has not really created any level commissions. The agent still gets his high first-year commission.

The affected companies initially requested that the NAIC become involved in the review process, because they wanted a nationwide overview to avoid acceptance in one state and rejection in another state. The first group that really looked at the issue was the Emerging Issues working group, which is part of the Accounting Practices and Procedures Task Force of the NAIC. Subsequently, the NAIC formed a group, to which Bill has referred, to look specifically into the securitization and levelization issues. There was a need felt to have a variety of disciplines look into the issue. That group reports to the Financial Condition Subcommittee of the NAIC, and is called the Sale of Future Revenues, Securitization of Nonadmitted or Unrecorded Assets Working Group. I believe this is the longest name ever devised within the NAIC for a group. From now on I'll just call it the Sale of Future Revenues group. That group did look at the initial securitization schemes and recently preliminarily concluded its deliberations on

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commission levelization. During the course of the NAIC's review, a number of concerns were addressed. A quick overview previously presented by Terry Lennon of the New York Department of Insurance in an article entitled "Securitization of Premiums: A Regulatory View," summarizes the most basic background concern of regulators.

Mr. Lennon said, "A reconsideration of statutory accounting principles requires an analysis and understanding of the current environment. Such an analysis requires consideration of profit margins, management structures and the extent of leverage existing in the industry. It is no secret that in recent years the profit margins on new business of life insurers has shrunk at an alarming rate. As a whole the industry is probably not realizing even a risk-free rate of return. In addition, many companies, if not most, do not have adequate management structure to address today's problems. They operate under the structures and techniques of the past. Integrated management structures that set sound economic goals and have in place the means to monitor performance are not widespread. Finally, when considering the amount of leverage on the balance sheets of the industry, we must look not only at the reported numbers but also at what has been called the quality of surplus. The quality of surplus has, in past decades, largely been assured by statutory accounting, which has required a marked conservatism in the preparation of the balance sheets of life insurers. Over the last five years, however, the industry has waged an ongoing assault on that conservatism. Many of the liabilities are now approaching a market valuation. There are persistent attempts to report the maximum value of all assets. Regulators are seeing more transactions such as sale leasebacks of home offices and/or furniture and fixtures. In addition, there is more widespread use of techniques such as constant yield method of depreciation under which very little depreciation is charged during the average holding period of a property. One insurer has even proposed a transaction that represents the height of desperation and absurdity, a means to absorb all of its nonadmitted assets into its mandatory securities valuation reserve."

Mr. Lennon and others have continued to express those concerns about the overall financial health of the industry. Recently, in a White Paper report from IDS, it was argued that a severe economic downturn would threaten the solvency of up to 20 of the largest 100 life insurers in the country. An important point brought up in the report was that mismanagement of investment-oriented lines of business poses the greatest threat to life insurers. "Nearly 80% of the obligations of the industry represent guaranteed interest rate products with an emphasis on selling more guaranteed interest rate products," says the report. "Many insurers have assumed levels of business and investment risks that are too high relative to their ability to absorb losses."

With that basic background, let's examine what we've historically considered as surplus. Bill's description of the true equity type of surplus fairly well summarized that. We've got common and preferred equity for stock companies -- unrestricted surplus contributions either from new investors or from existing owners into companies. It's important to note that those types of equity require no continuing obligation of the insurance company to repay. This is real hard surplus.

We also have certain forms of surplus notes or contribution certificates. Depending on their form, these may or may not represent equity surplus as opposed to leveraged

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surplus. Historically, surplus relief reinsurance has also been considered as relatively safe surplus. Originally, that surplus was generated from what I call plain-vanilla-first-dollar coinsurance. Recently, more esoteric types of surplus relief have proliferated, which in reality are probably simply financing through instruments with minimal risk transfer. The contracts have been questioned and rejected more and more by regulators, particularly during the last five years.

Let's contrast traditional surplus with the new securitization/levelization-generated surplus. The first transactions, like General American's, were extremely transparent. It didn't take long for the regulators to determine that they were, in fact, debt. The banks' initial transfers or loans to the insurers were generously overcollateralized to the extent of about 300%. They essentially took historic lapse rates of the companies, which is the risk they were assuming, and multiplied them times three to determine how much they could loan. Although all of the language in the contracts relating to these securitizations talked about sales and transfers and never mentioned the word "loan," it was easy to see that the transactions were, in fact, debt. The surplus that the companies hoped to realize immediately had to be paid back to the banks with interest. The surplus of the company at the end of that payback period would be dependent on the profitability of the business that they had financed. The earnings that came off of that business would replace the initial surplus. It would not be added to that initial surplus. All other things being equal, the surplus of the insurer would be the same with or without the transaction at the end of the payback period. The company was only changing the timing of its earnings. It was not actually increasing its capital.

In this circuitous manner statutory accounting was, in essence, being converted to GAAP accounting. If statutory accounting allowed reflection of the securitization transaction as a sale, not as a financing, then regulators would, in essence, be allowing the recognition of deferred acquisition costs in statutory statements. If we, as regulators, thought that was okay, we might have simply said, "Why don't you companies start recognizing your future earnings now? We'll allow surplus to increase and save you the transaction cost related to the funding agreements." Obviously, we didn't do that.

I think I can show you with another analogy the basis for the regulatory treatment. If I sell the next five years' coupons on my bond portfolio, I'd get a lot of cash upfront equal to the present value of the future interest less some discount. However, would it be reasonable for me to recognize all of that cash consideration as income in the current period? The answer is obviously not, because I will not receive any interest on my bonds over the next five years, and the bonds that I now hold are worth less. To recognize income immediately rather than deferring that income over the five-year period would be an affront to any accounting system.

The commission levelization transactions, such as the Milico transaction, were, I'll admit, put together a lot better than the initial securitization transactions. I, personally, couldn't punch any holes in the logic or the concept of the levelization initially. However, it just wasn't passing the "smell test." The actuarial staff and I in the California department looked at the documentation, read it, talked about it. We couldn't figure out exactly what was wrong with it, but it just didn't smell correctly.

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The industry made some very good arguments, and you've heard a lot of those. They stressed that the transactions created no recourse against the insurance company, that they eliminated or reduced so-called commissions creep, that it was a relatively inexpensive method of raising capital, and that it shouldn't establish any bad regulatory precedents because the capital markets would impose discipline on the marketplace. Only those insurers that were already well-capitalized, with sound balance sheets, good business persistency, adequate asset liability matching programs, and returns on investment exceeding the cost of capital would even qualify for the funding that was being offered. As Bill said, it was purported to be an excellent source of capital for mutuals that did not have access to the capital markets. There was a strong argument made that since the company retained the cash, there were no future problems with reinsurance recoverables or offset rights. The transactions also eliminated the catastrophic lapse risk, probably did not reduce the existing profit margins, and defrayed the capital cost on new sales.

However, as we deliberated with the NAIC, we saw that when you stripped away the legal and technical structures that had been fairly carefully crafted to fit these transactions into the statutory model, the substance of the transactions appeared to create the same results as the initial securitizations we had looked at. The immediate surplus increase (the difference between the normal high first-year commissions and the levelized commission) had to be paid back with interest. There was, in fact, overcollateralization. Again, as with securitizations, only the profits from the financed business will eventually become earned surplus at the end of the payback period. So, the NAIC concluded that substantively statutory accounting was being converted to a GAAP accounting model.

That brings us to the current regulatory positions in certain states. In March 1989, the New York Department of Insurance issued its Circular Letter No. 7 that stated that immediate recognition of income or surplus pursuant to a so-called securitization was inconsistent with statutory accounting principles and that a liability must be established. In September 1989 the NAIC also decided that the original securitization schemes were financings. The language eventually adopted in the life, and accident and health accounting manuals states, "The immediate recognition of proceeds from certain transactions characterized as the sale of future revenues in income and/or surplus has been determined to be inappropriate for the purposes of statutory accounting. These transactions are sometimes referred to as securitization and are sometimes characterized as selling deferred acquisition cost. Accordingly, a liability should be established for the amount of the proceeds which shall be reduced as the proceeds are repaid."

On November 28, 1989, my department issued its Accounting Statement 89-3. That statement in part requires the following accounting and disclosure: First, it adopted verbatim the language that had been developed by the NAIC. Second, it adopted a concept that had been developed by the emerging issues working group in June 1989 relating to grandfathering. The California accounting statement said, "With regard to transactions which have been entered into prior to the date of this accounting statement, no exemptions from the required accounting will be allowed unless specific prior approval by the domiciliary state of the insurer involved was granted. Absent specific prior approval, such transactions shall be considered financing arrangements."

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The intent of that section was to require approval for the transaction prior to being effective, not prior to the date of the accounting statement. Since there had been no prior approvals of any of the securitization transactions, every life insurer licensed in California as of year end 1989 could not reflect surplus from any of the securitization transactions on their financial statements. Finally, the accounting statement specified that the liability related to the securitizations would either be reported as borrowed money or as a separate write-in liability in the annual statement. In either case a full disclosure was required. Just recently, as Bill noted, the NAIC concluded that the commission levelizations also had to be reported as financings. The exact NAIC accounting manual language is yet to be developed, and may be somewhat problematical, as Bill noted. The language will not be quite as simple as on the original securitizations. It's anticipated that a draft will be ready within the next two to three months.

Future activities of the Sale of Future Revenues Group include establishing the advisory group which Bill mentioned. There was some debate as to the need for an advisory group when it seemed that the NAIC is really opting towards forcing companies to look for traditional equity surplus. But, in the interest of being fair, which we do occasionally, we okayed the formation of the advisory group. It will be interesting to see what sort of ideas they come up with. The key is that the industry and the regulators work together to try to develop meaningful ways to generate additional capital for the industry. Regulators won't be in the position of just reacting to the transactions and schemes that come about.

During the course of the discussions of the group, some existing abuses were identified that had been tolerated previously. Those primarily relate to the accounting for surplus notes and financial reinsurance. Those two items remain on the agenda of the group. There is a certain segment of regulators who really believe that surplus recognition from the new forms of surplus relief are affronts, or at least ways around, statutory accounting. However, the NAIC group does realize that trying to change accounting for surplus reinsurance will be a lot more difficult than simply kicking out securitizations. It was a lot easier for insurance regulators to stomp on banks than it will be to stomp on reinsurers.

At a minimum, there is a strong groundswell to change the accounting for surplus relief, because we believe that it has the tendency to change the timing of actual operating earnings. There may be a change in accounting that will allow surplus to be recognized, but the surplus will be a below-the-line item. It will not flow through operations.

In conclusion, a number of other regulators and I believe that the key to building up the capital base and, hence, making the life industry stronger, is to write profitable business, not to engage in gimmicks or schemes to accelerate revenues and create illusory surplus. Maybe some product innovation and even better management instead of blind price competition in what are already saturated markets will be the key to renewed profitability in the industry. With profitable business, not only will surplus grow of its own accord, but the ability of the industry to attract real capital, not borrowed capital, may return.

CAPITAL-RAISING ISSUES

MR. WESTON M. HICKS: I'd like to talk to you about how Moody's looks at capital and to give you some context within which to evaluate how we might look at various capital-raising alternatives. I'll start by giving you a brief background as to our rating approach, so if you're not familiar with our rating activities, you have some sense of what it is we do. I'd then like to discuss how we think about the issue of capital adequacy in a life insurance company or, more broadly, in any financial institution. Third, I'll describe some of the specific techniques that we use at Moody's to evaluate capital adequacy and what it is we're trying to evaluate when we use these techniques. Then we'll look at some of the recent trends, including some numbers we've just finished for 1989. This is to give you a sense of how big the problem is. It's a difficult thing to try to measure in a short time, but I'd like to try to give you some sense of the capital position of the industry. Finally, I'll conclude with a brief statement of the outlook for the industry as we see it.

First of all, let me start with a very fundamental concept. Most investment grade life insurance companies have enough capital today in our opinion. It's something that's obvious to us, but it's not necessarily obvious to those who look at what we do. The key question we try to answer is how many of these investment grade companies are going to have adequate capital 10 years from now, or 15 or 20? The fundamental reason for this question is that our ratings attempt to predict long-term default in both the bond markets and in the insurance industry. By long term we mean that today, we want a rating which over time will be a reasonable predictor of the risk that an insurance company becomes insolvent. This is not just within the next five years, but over a very long period of time.

More recently we see what can be called a cycle of credit quality in the life insurance industry, and in the banking industry as well (Chart 1).

Simply put, a company's perceived credit quality is a function of its capital adequacy and its asset quality, among other things. As one or the other deteriorates, a downward spiral begins. We have seen this happen very recently. Poor-quality assets may require a company to pay more for its liabilities, particularly in guaranteed interest type markets. This in turn requires it to either have more leverage or take more risk on the asset side, and so the cycle goes.

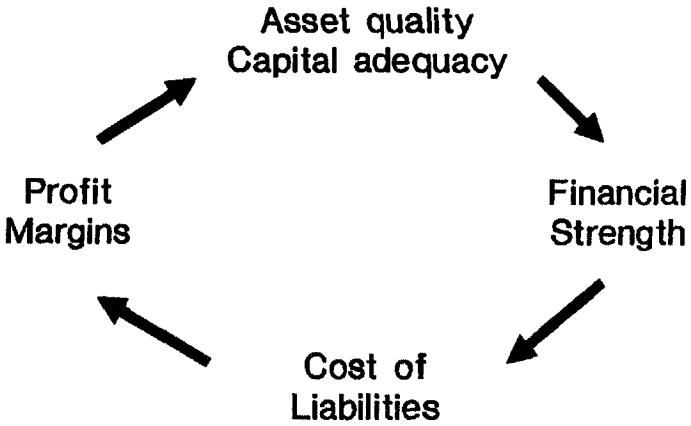
We use a mixture of both quantitative and qualitative techniques to predict long-term insolvency risk. The reason we do this is we believe that without looking at some of the fundamental analysis type aspects of a company and an industry, it's very difficult to predict long-run default risk (Chart 2).

The categories shown under quantitative analysis are what people generally perceive rating agencies are in the business of doing; that is, looking at a bunch of numbers and ratios, calculating profitability, looking at asset quality, measuring liquidity, evaluating capital adequacy. It's true, we do all of those things, but that's only part of what we do. The other part is to look at the fundamentals of a company. What is management like? What motivates management? Are they conservative or are they aggressive? What are the essential competitive strengths or weaknesses of the company's product portfolio and its distribution method?

PANEL DISCUSSION

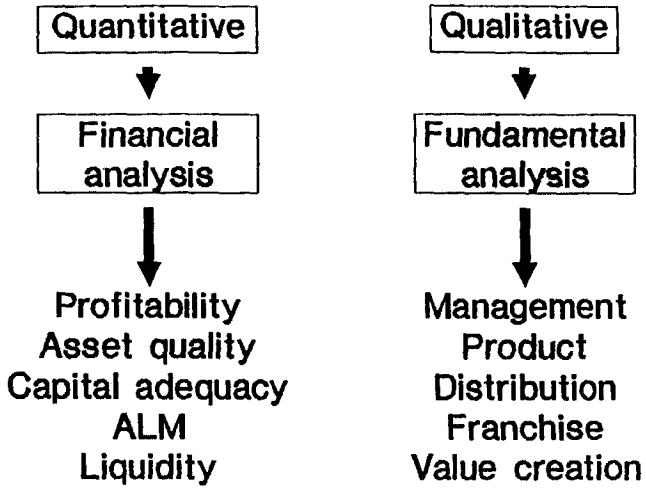
CHART 1

The Cycle of Credit Quality



CAPITAL-RAISING ISSUES

CHART 2



PANEL DISCUSSION

We found over time that those items tend to be more predictive of long-term default risk, certainly in the corporate bond markets, than financial ratios alone.

To give you a sense of our current view of the industry, this, as of late February, was the distribution of our ratings (Chart 3).

We don't rate every company in the life insurance industry. So, when I talk about the industry I'm really talking about a sample of the top 100 companies in the industry. Triple A, of course, is our highest rating. Triple A we define as an insurance company that offers an exceptional degree of financial security, and from that you can almost infer that it's an excessive amount. Double A we define as offering excellent financial security. Single A we say offers good financial security. And B-Double-A offers adequate financial security. Implicit in those definitions is a degree of uncertainty in the process. We fully admit that we don't have a magic answer, but we believe we can try to distinguish between degrees of relative financial strength.

Since this chart was done we have three more ratings that have been added to this list, including State Farm Life, which is rated Triple A, Safeco Life, which is rated Double-A-2, and Aetna Life & Annuity which was also rated Triple A. The point of this chart is that we see the industry, at least as we've narrowly defined it, in the Triple A/Double A range. This means that we don't see imminent solvency problems among the companies we rate. We certainly do see, however, long-term risks that keep the industry from being predominantly Triple A.

Now, let's go on to how we think about capital adequacy. The first point is that we don't believe there is any one particular measure that provides the answer to what is enough capital. This being an actuarial meeting, I'll say that reserves certainly go a long way toward making -- I believe the words are -- good and sufficient provision for the liabilities. But what is bad and insufficient? That, I guess, is what you need capital for, in addition to covering asset risks where the reserve is formula driven rather than as precise as many might like it to be.

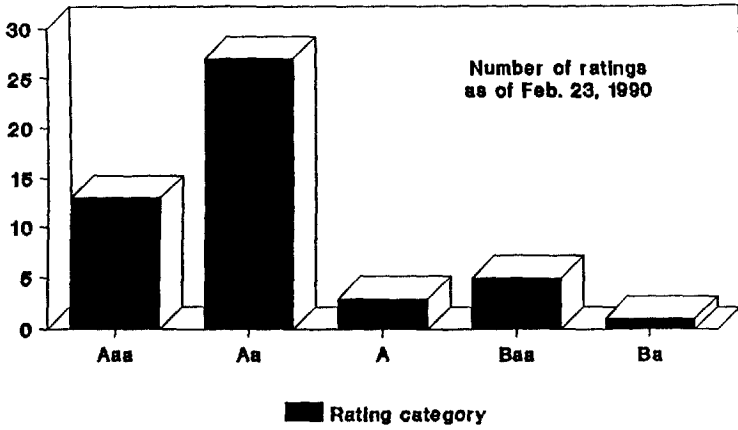
The second point is that we view capital as necessary to absorb economic loss. We think of a pretty bad situation when we put companies to this test. We look at historical defaults and make perhaps unreasonable assumptions about how bad it could be for bonds and mortgages and other asset types. We also assume that interest rate-related risks come home to roost at the same time, along with everything else. So, we really try to construct a fairly severe economic stress test of a financial institution.

Another aspect of capital that may be more important today is what we call perception capital. That is having enough capital to be perceived as a strong company in the markets in which you operate. We've seen this in the P&C reinsurance industry where you're not in business unless you have \$100 million of capital. It doesn't matter if you have \$2 billion of liabilities. You still need \$100 million of capital. In the life insurance industry there are clearly some time-tested benchmarks of financial capital standards for example, 5% capital to assets. Companies may be very viable but may not meet that test because of their mix of business. There is then a need for perception-related capital.

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CHART 3

Moody's Investors Service Financial Strength Ratings



PANEL DISCUSSION

We consider the potential effects of not having perception capital both in terms of how successful a company may be in its target markets and what consumers and agents may think of the company.

You can lay the elements of capital out on a continuum from more tangible elements of capital to less tangible elements of capital. Surplus, conservatively defined, is very tangible. Moving down the list are areas where the accounting assumptions determine the degree of implicit capital, such as asset valuation or the reserve basis. Moving down to the bottom, things like the value of future profit streams and, even softer, the franchise value are very intangible. What is it worth to have a company that sponsors the U.S. Open, for example? This tends to have a very strong franchise value.

Therefore, as we evaluate capital adequacy in the rating process, we try to look at different perspectives on capital, not just statutory perspectives. For example, a strong-growing company might have a 5% capital-to-assets relationship on a statutory basis, and a 10% GAAP capitalization ratio. In fact, valuing its future profit streams, it might have a ratio more on the order of 15%, and, the stock market may value the company at one and a half times GAAP book value. Just because it has a 5% statutory capitalization ratio doesn't necessarily mean it's a bad risk. Conversely, you can have the opposite effect. A company that is in a mode of liquidation may show very strong statutory ratios, but, in fact, its value is declining. The point is that we would look at all of those measures to try to get some perspective on the company.

Specifically, we look at four principal ratios. One is what we call a capitalization ratio. Second is adjusted capitalization. We also look at a risk-adjusted capital ratio or a benchmark capital type calculation. And more recently, we look at what we call an asset default stress test, which is intended to simulate losses that could result purely from asset risk. The capitalization number is simply statutory capital and certain reserves, including any real estate-related reserves, as a percentage of nonseparate account assets. The adjusted capitalization number adds a portion of the dividend reserve into the numerator and reduces the denominator by policy loans, since these can be considered contraliabilities rather than assets. This ratio also eliminates any investments in affiliates to take a more harsh look. That can be very punitive to some companies. Third, we look at a benchmark capital ratio that is based on actuarial work. We didn't invent it. We just stole it. In this ratio, we ascribe factors for asset risk. Following up on the earlier comment about the IDS study, they used this benchmark capital ratio. From our perspective, their conclusion was not necessarily plausible. For all these risks to hit at the same time, including default risk, insurance-related risks, and interest rate-related risks, things have to be pretty bad. The tables show the factors used to determine benchmark capital for asset risk, insurance risk, and interest rate risk (Chart 4).

The asset default stress test is an attempt to take a closer look at pure asset default risk. Moody's has a proprietary history of corporate bond default experience over the last 20 years. We used two standard deviations of the historical default rate by class of bond to come up with what might be considered a worse case default. We then made certain arbitrary assumptions about losses on default based primarily on information from investment banks that trade in defaulted securities. We used numbers like 40% loss of principal for a senior security and more like 50-60% for a junior security.

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CHART 4

Benchmark Capital: Asset Risk

"Yes" bonds	1%
"No*" bonds	5%
"No**" bonds	10%
Current mortgages	2.5%
Delinquent mortgages	5%
In process of foreclosure	10%
Common stocks	25%
Inventory in affiliates	100%

Benchmark Capital: Insurance Risks

Mortality	25%
Morbidity	10%

Benchmark Capital: ALM Risk

GIC/group annuities	1%
Individual life	2%
Individual annuities	3%

We made a similar assumption on mortgages. We then simulated an arbitrary stress period. We said all these losses will occur within a five-year period. We assumed a certain loss emergence pattern, and then discounted them back based on the earnings rates of the various assets to give some credit for the fact that high-yield bonds pay more interest than U.S. Treasury bonds. Chart 5 shows the capital factors that resulted from that analysis.

These are for information only. We do not endorse them in any way. Exposure in the chart is principal. Interestingly, for Ba bonds and Single B bonds we came up with numbers very close to 10 and 20% which is, after all, what the MSVR reserve factors are. We thought that was interesting. It is probably not a coincidence.

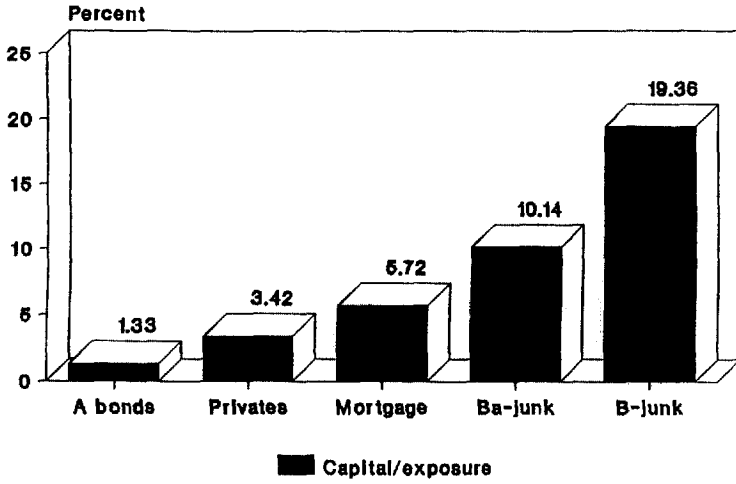
Let me turn now to median capitalization trends in the industry (Chart 6).

These are from our annual life insurance industry outlook, which this year is about a 65-page document. These medians are broad generalizations about the industry. In fact, we've seen that the trends are very different between companies that are predominantly in the individual life insurance business and companies that are in the pension and annuity markets, but here I've just summarized the total median. Within our peer group of companies there was actually an improvement in 1989 for the first time in, I believe, six years.

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CHART 5

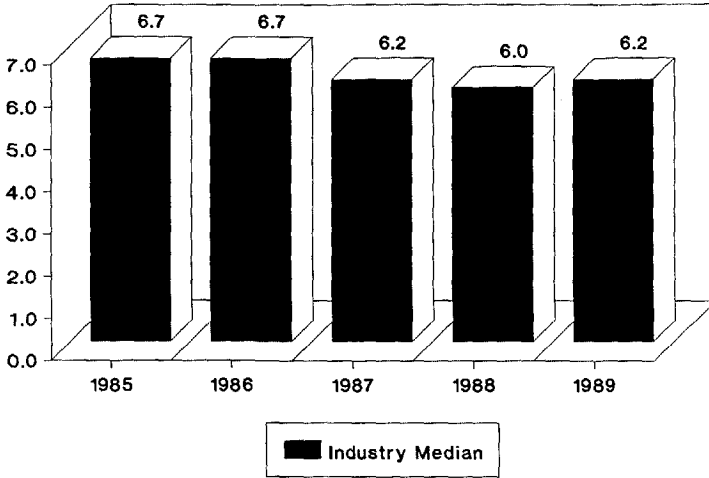
Asset Default Stress Test



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CHART 6

Capitalization Ratio



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We think that predominantly reflects some of the slower growth of the large mutuals and multi-lines that went early into some of the strain-intensive annuity lines. As those lines are beginning to slow, the statutory profits are beginning to emerge. We think another reason is that the quality of surplus is declining, which has been talked about in some detail.

Our risk-adjusted capital ratio, you can see, shows a reasonably steady trend (Chart 7).

However, there is quite a distribution around that median. Roughly, 20% of the companies that we follow have ratios below 100%.

Let's look at asset quality trends briefly, because we think this is one area where the industry does have some potential risk. We look at a group of companies that have above-average exposure to the commercial mortgage and agricultural mortgage markets. These are companies that have more than a quarter of their investment portfolio in this asset (Charts 8 and 9).

You can see from the bars at the bottom that for the industry as a whole, problem mortgages have crept up but are still at a relatively low level. But for the group of above-average mortgage investors you can see the number is quite high. This is, in our opinion, a disturbing trend. The decline in the last two years reflects, in part, some restructurings so they're not purely comparable numbers.

We also look at a subset of the industry that we call high-yield investors. These are companies that have significantly above average portfolio allocation to high-yield or below-investment-grade bonds (Charts 10 and 11).

You can see the industry's exposure to high-yield bonds. The bottom bars are very, very low. Even if you were to assume that there are a number of private placements considered below investment grade but classified as yes bonds, it's still a fairly low number. The high-yield bond investors, of course, are in a class by themselves up there at the top.

These two charts just look at the exposure relative to capital. Given that capital has been going down slowly, and that asset quality exposures have been going up, when you put the two together, you get a little more pronounced trend. Finally, let's look at what we consider below-investment-grade assets as a percentage of capital (Chart 12).

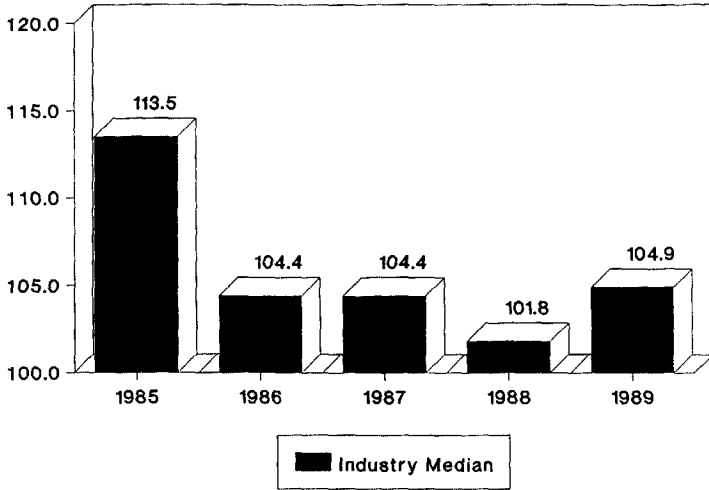
You can see that there's been a steady upward trend in the median until 1989, when it seemed to have reversed itself very slightly. We conclude from these measures that one of the principal risks to the industry is asset related. That is, having enough capital to absorb true catastrophe experience in asset performance. Hopefully, this will not happen in the near future.

Why is the industry's profitability and capital position weakening? First of all, lower profit margins have been driving this. We don't see that changing in the near future. Second, there's been a shift toward lower margin products in general.

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CHART 7

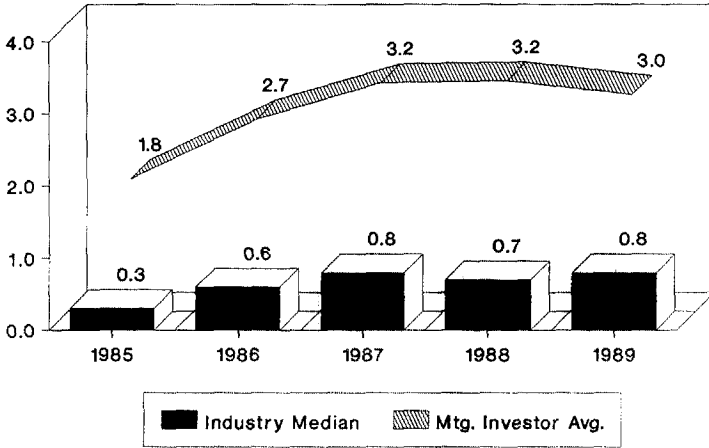
Risk Adjusted Capital Ratio



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CHART 8

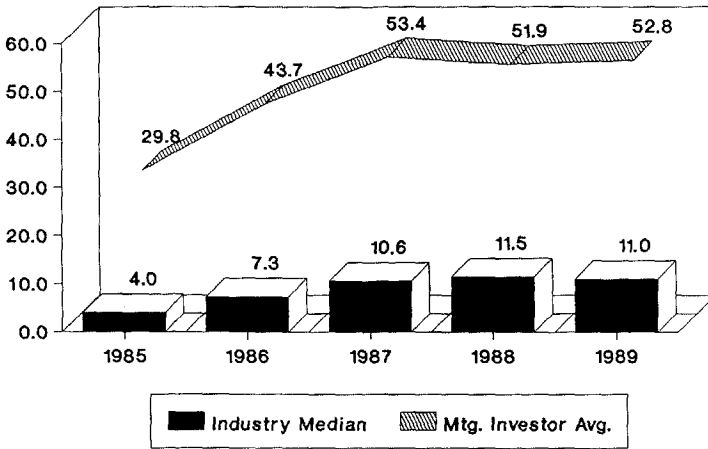
Problem Mortgages as %
of Invested Assets



CAPITAL-RAISING ISSUES

CHART 9

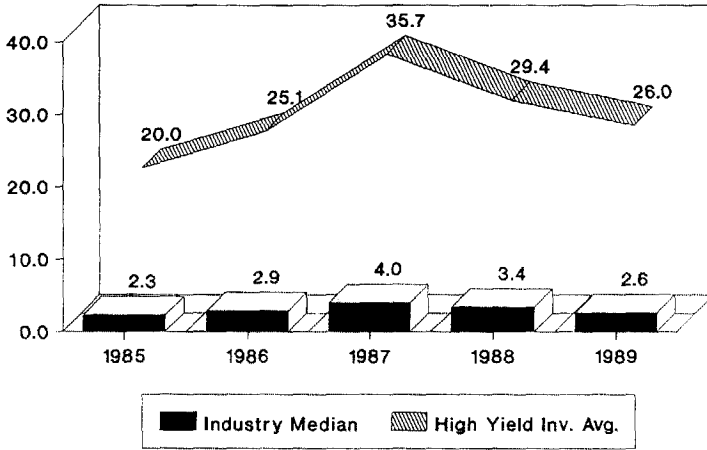
Problem Mortgages as %
of Capital



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CHART 10

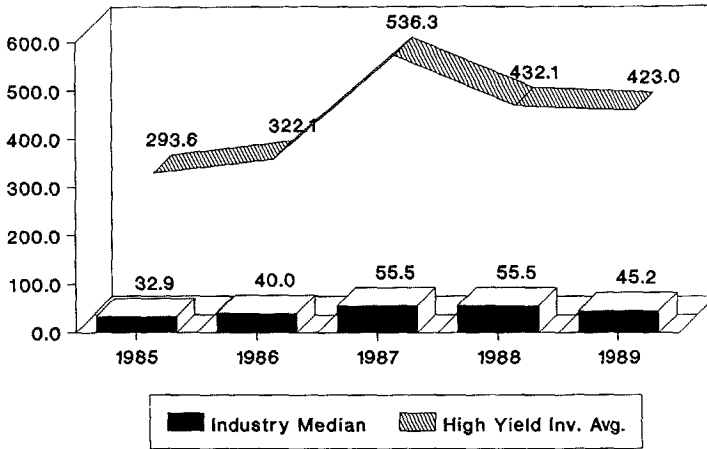
10% and 20% Bonds as %
of Invested Assets



CAPITAL-RAISING ISSUES

CHART 11

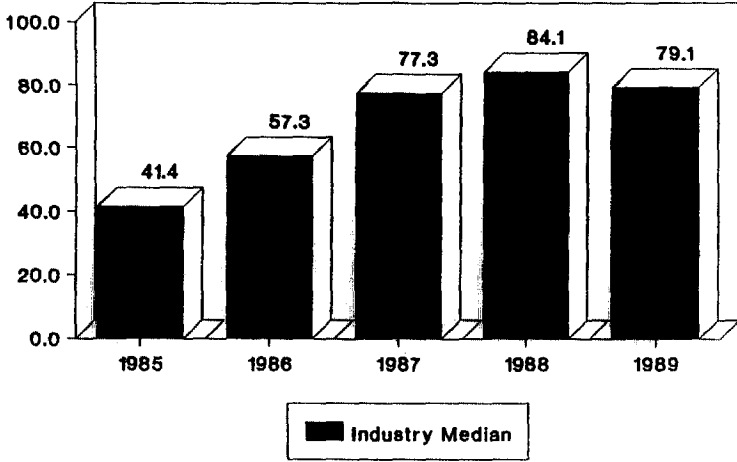
10% and 20% Bonds as %
of Capital



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CHART 12

**Below-Investment Grade Assets
as a % of Capital**



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It's not just that each of the products being written is less profitable, but that there is a change in the industry's complexion to annuity and pension related products. These products are sold through highly-competitive markets and are very competitively priced, especially on an option-adjusted basis. Also, there was a shift to higher-risk investments, which is now reversing itself. I don't think very many life insurance companies are putting money today into high-risk investments knowingly, but that certainly did happen in the mid-1980s.

In addition, existing assets are not performing as well as they should in both the high-yield market and the commercial mortgage market. The commercial mortgage market is perhaps the area which has yet to be tested in the industry. At least two companies come to mind that are losing money on an internal basis on their GIC business, primarily because of asset performance. That is, they are carrying the assets at a negative spread. That's a very disturbing sign in terms of the long-run creditworthiness of the industry.

Finally, investments in noninsurance activities have, in some particular situations, drastically altered the credit quality picture both positively and negatively. Several companies have very profitable, noninsurance subsidiaries, such as asset management companies which are throwing off fairly healthy profit streams. Others -- who shall remain anonymous -- have major investment banking subsidiaries that are having trouble. This element is very company specific as to its effect on credit quality.

As the outlook for the 1990s, we see a balance of factors acting on the credit strength of the industry. We're concerned about asset quality. I think that's clear from my remarks. Offsetting that is a renewed degree of conservatism in terms of new investment decisions and management of existing portfolios. That will no doubt mitigate to some extent the effect of past asset decisions. If companies are strong, they may perhaps enjoy some differentiation by consumers in terms of quality. We see that as another trend. Finally, the general economic uncertainty that could test the industry at some point in the next decade is a continuing concern. However, we do see some efforts toward more strict regulation, particularly in the MSVR and asset-related reserving. We think that's positive from a credit quality point of view.

In conclusion, I'd just like to make a couple of observations about how we look at capital and capital enhancement techniques. We ask ourselves a couple of questions. Are capital enhancement techniques being undertaken to allow a company to grow a successful business or are they more of a life support system? In the latter case, it's obviously not a very positive thing. What is the objective of a capital raising transaction? Is it to improve capital to absorb economic loss? If that's the case, many surplus enhancement techniques don't really work. They don't change the economic capital. If capital is being raised to support business growth, then very clearly there are benefits to enhancement techniques. But, we would want to evaluate the profitability and quality of the business being sought. Lastly, if the objective is perception-related capital, we certainly could understand the need to keep surplus ratios higher. It doesn't have any particular rating implication as far as we're concerned, if we're doing our job correctly.

MS. WALLACE: We've had some very interesting comments. Can I count on the audience to start some controversy?

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MR. DAVID N. INGRAM: Mr. Clark, how would you differentiate between levelization of commissions and a situation where one of our agents just goes out and gets a loan from a bank secured by renewal commissions?

MR. CLARK: One of the things we look at is the overall transaction and how much overcollateralization was required. I think what you're describing is different from the Maple Leaf Transaction in that what you're describing doesn't necessarily put a burden on the company to continue funding the repayment of the bank debt. The bottom line is does the present value of the future payments Milico agrees to pay Maple Leaf approximate the first-year and the renewal commissions or is it more? The total funds expended in the examples they presented represented in some instances 175% of what they would have paid out in actual dollars by simply paying the commission.

MR. INGRAM: I'm just trying to figure out whether some loan that an agent of mine takes can cause my company to set up a liability. I haven't understood where the line is.

MR. CLARK: I think what your agent does is totally independent. What we reviewed with Milico and Maple Leaf didn't appear to be independent actions. The overall concept was known by the company, the GA, and the lending institution.

MR. SCHNAER: I feel constrained to correct one impression. I think you've got the situations reversed. We had shown that under certain catastrophic lapse rates the amount that we would pay if we actually paid the first-year commission would be 175% of what we would be obligated to pay to Maple Leaf, not the other way around.

Let me make another comment. This is sort of a language lesson. What does the word statutory in statutory accounting mean? I think it means according to the statute. Therefore, the legal form of what you're doing is very important. What we were told is that they were looking at the substance, not the form. But, I think our lawyers will tell you that in accounting the form is very important. Statutory accounting, as we know with reserves, is primarily done by formulas in the law. It is only gradually that the regulators are bringing in the substance through valuation actuary requirements, etc. I think that it's a real worry, as Norris pointed out, that the language for disallowing commission financing is problematic. Certainly Milico doesn't intend to be the only company setting up a liability for renewal commissions. It doesn't intend to be the only company setting up liability for the loans of its agents. And to attack another one, we certainly don't intend to be the only company setting up a liability for the back yard barbecues that GA provide their agents out of their own pocket. This has to be something that's equitably applied according to the law, not just what people's opinion of the transaction is.

MS. WALLACE: Any other questions?

MR. KIN K. GEE: The whole issue of overcollateralization seems to me irrelevant in the transaction. Just as when we apply for a mortgage to purchase a house, no bank will lend more than, say, 80 cents on the dollar of the market value of your house. When the banks ask for 200 or 300% overcollateralization on future cash flow, this shouldn't be a relevant issue. The relevant issue is the fact that an insurance company is able to transfer a certain obligation without recourse. Under straightforward risk transfer

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coinsurance, a reinsurer has analyzed the profit potential of the business and is willing to pay a ceding commission on the expectation that it will get repaid with profits. It, too, generally seeks some kind of overcollateralization for that ceding commission. You need to look at the whole issue of transferring certain liabilities and risks.

MR. CLARK: When the issues were first brought up, an argument was made, and it's still being made, that the lender is assuming risks. To the extent that there's some *minimal overcollateralization*, I think that *might be a valid argument*. But what we were looking at in the case of General American, for example, was a seasoned book of business with a known lapse rate. Persistency was very good. The bank still required taking that lapse rate and multiplying it times three. Then they based the amount they would fund on the resulting flow. With regard to your reinsurance analogy, that's an issue that is coming back. When we require a securitization to be accounted for as a financing, is that inconsistent with what we allow for certain types of reinsurance? The answer is yes, but that doesn't mean that we're wrong on securitization. Perhaps what we're doing with reinsurance is wrong. That area will continue to be looked at.

MS. WALLACE: When we talk about transactions being overcollateralized, or talk about the risk to the lender or the reinsurance provider being minimal, we're actually saying that the statutory accounting rules for that particular product group or line of business are conservative. We really don't need reserves to the extent required under the laws. Historically, reserves have been conservative to protect against adverse fluctuations and poor economic environments. However, it's my belief that research is being done that will allow us to manage our businesses better, so we don't need the sort of margins that have been needed historically. If companies begin to do more sophisticated asset liability matching and asset based preservation of the type now in research phases, it's likely that pressure will be brought on regulators to liberalize current statutory accounting rules. This would eliminate the attractiveness of these alternative capital products. I'm curious how people feel about that. Will we, in fact, over a 10-year time frame be drifting towards GAAP type accounting as a result of better management of our risks? Does anyone in the audience or any of the panelists have any thoughts?

MR. CLARK: Well, as you and I have discussed before, if something is wrong with the rules, then I think it's incumbent on the industry and regulators to work together to change them. That issue has come up continually over the last five years as we've looked at more and more types of surplus enhancement transactions. I can only say that at this time, a lot ends up in the hands of the actuaries deciding what they want to do with the standard valuation law. I've asked our chief actuary if there's something wrong with current rules that he can concisely put together, and he's unwilling to do that. So, in the meantime, I guess we have to live and play by these rules, and that's what state insurance departments will enforce.

I might also comment that I don't quite agree with Bill's definition of statutory accounting. It's the perception of some people that as long as you can structure the form of something to fit within the law, you'll be able to account for it that way. I think that we are moving more and more towards accounting for substance and not form. And, as we do that, the rules will change. As you know, the laws in most states require insurance

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companies to account on the forms promulgated by their state or the NAIC. So, the rules change when we change the annual statement blank. One of the perks that regulators get is the opportunity to change the rules.

MR. SCHNAER: However, I think that there has to be some consistency between assets and liabilities. I agree with Norris that the overcollateralization issue is a red herring. If you feel that the payback of a certain amount is so virtually certain as to require liability, then the corresponding asset needs to be set up. It is difficult to imagine requiring a liability for, let's say, future premium taxes, even though they are certain to be paid if you collect a premium, without allowing an asset for the premium as well.

Let me back up and talk about "financial reinsurance." There have been some theoretical articles written that the problem, if you will, with financial reinsurance is that the risk transferred is at a mortality level above that assumed in statutory accounting, i.e., 1958 CSO or whatever mortality table you happen to be using. Therefore, the direct company really pays the claims and no reserve transfer should be theoretically allowed. When you're looking at the propriety of a transaction, you must first understand the risk that statutory accounting requires you to account for, and if that risk is transferred, then you have a legitimate transfer of risk. You cannot on the one hand say that because the collection of tomorrow's premium is uncertain, you cannot take that into account in your balance sheet, and on the other hand require a liability if a portion of that premium is pledged. Assets and liabilities must go together to have any rational form of accounting.

MS. WALLACE: It's really hard to talk about these transactions in light of how they fit into current statutory accounting rules. Any of us can sit here and poke holes at Norris's arguments on statutory accounting based on analogies to existing situations. Whether we agree with disallowing the surplus enhancement effect of these transactions because of statutory rules is not really the issue with regulators. Norris can correct me if I'm wrong, but I believe their issue is that a company which has promised future revenues to another party is less strong than a company which has not promised those future revenues to another party. It's more a question of whether the industry in general can stand to promise those future revenues to another party. In any particular case a company may or may not be able to, but regulators can't selectively apply rules. The regulator's motivation in disallowing these things is their concern about the weakening of the financial strength of the industry rather than any picky argument over whether this accounting rule or that accounting rule is broken. I really think it's almost impossible to fight these things by saying that they violate current statutory accounting rules. I just don't think they do. It's really another reason. Regulators are just saying that we can't allow this weakening of the balance sheets. Therefore, they're going to disallow it whether or not it violates statutory accounting rules. I'm not sure I agree with that position, but I can certainly understand it.

MR. GEE: I agree with you 100%. Ours is not to poke holes in the argument. What we are seeking is to have consistent treatment on transactions that we perceive to be similar. Also to follow up on one of Bill's comments. In his presentation, Bill said that one of the techniques available to raise capital is the sale of excess liability. He gave the example of the P&C loss portfolios. Certain reserve liabilities are not discounted. New York State promulgated Regulation 108 in 1984 which says that for P&C companies,

CAPITAL-RAISING ISSUES

certain transfer of loss reserves are treated not as income, but rather as appropriated surplus. This is slowly released into surplus and, therefore, not immediately available for dividends to shareholders and other similar purposes. The NAIC recently released an accounting proposal quite similar, and that's probably something not totally illogical for life insurance companies to consider.

MR. EDWARD H. COLTON: What I've heard Mr. Clark say is that he's got a job to do, and the tools in statutory accounting are not perfected yet to the point where they can do the job all by themselves. He needs to find other techniques to, let's say, protect policyholders. So, I don't hear everybody talking about the same issue. I hear people attacking the tools rather than getting at the issue. What I'd like to do is see if I can't crystallize the problem a little bit by setting up a model. Suppose a company sets up a subsidiary, and the subsidiary in and of itself is adequately capitalized. It looks good from every point of view, except it does one thing. It collateralizes or it levelizes the commissions in the same way as we've just seen. Therefore, only the business from which commissions are being levelized is behind the loan since you've got the subsidiary wall. Let's say that what's levelized is a third or a half of the commission, not the whole thing, so that you get some overcollateralization. But, it's confined to the same block of business on which the financing was arranged. Is that an arrangement that would seem cleaner than the original arrangements which involve a whole group of companies and policyholders, etc.?

MS. WALLACE: I guess there's probably no answer to that. It's just another variation on the theme.

