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THE DILEMMA FOR MUTUAL COMPANIES

Moderator: ALBERT E. EASTON
Panelists: HARRY D. GARBER
 JOAN ELIZABETH HERMAN
 THOMAS E. MOLONEY*
Recorder: ALBERT E. EASTON

- In search of capital
- Merger/acquisition considerations
- The demutualization alternative
- Profit crunch
- Joint ventures
- Lessons from other countries – Canada, Mexico, Britain

MR. THOMAS E. MOLONEY: This discussion will include why there is such a significant focus for insurance companies to increase capital. We will outline the limited ways in which mutuals can actually increase capital and touch briefly on how each of our companies may be striving to increase their profitability. We also will review briefly review the demutualization, merger, and joint venture alternatives. I cannot stress enough that this is a very small world that we live in and there is a much greater interdependency of global markets that impact all of us more than we might like.

Within the United States we are being "helped" from all regulatory fronts. The NAIC has instituted its own risk-based capital formula as a tool to monitor companies. I think it is fair to say that most of us support this early warning system. However, there is a concern as to how it might actually be used in marketing by the listmakers such as *U.S.A. Today*. We do recognize that the NAIC risk-based capital comparison ratios actually will, in the long run, prove to be a real benefit for us. Many companies are devising strategies to ensure that their capital levels are adequate given their business operations, their size, and their risk characteristics. The NAIC is also active in its accounting practices, codification, and state accreditation efforts. Not to be outdone, the Financial Accounting Standards Boards is looking at requiring market-value accounting and has just recently issued a statement on GAAP for mutuals. The market-value accounting changes as proposed make little theoretical sense, are not very practical, and will certainly create a noncompetitive situation with other financial institutions.

There also is much going on at the federal level. Health care reform was used as part of President Clinton's preelection cry for change. He has carried through on his election rhetoric by appointing the First Lady to lead the charge in this effort. This is coming at us like an avalanche. All of these items and other focuses will have an impact on the investment that insurance companies make in the financial marketplace.

* Mr. Moloney, not a member of the sponsoring organizations, is Chief Financial Officer at John Hancock Mutual Life Insurance in Boston, Massachusetts.

If we want to get a true appreciation for the capital dilemma faced by mutual companies, we need to further consider other environmental issues. We all are well aware of the fierce market-based interest rate competition and the tremendous impact it has had and will continue to have on our product offerings and resulting profitability.

The failure of a few high-profile companies, the flight to financial quality, and the growing importance of maintaining the highest claims-paying ratings has changed the insurance arena and justifiably caused many companies to focus more on profitability and capital growth. This becomes difficult while they balance improved or perceived-improved asset quality via a number of balance sheet transactions.

Consumers have lost some confidence in our industry. Rating agencies and regulators are concerned about maintaining their credibility, which adds fuel to the regulatory fire. The savings and loan (S&L) and banking failures also impacted us because of public relations and perceptions, and, at the same time, provided some companies with opportunities.

By some estimates United States commercial real estate has declined by about \$1 trillion since 1989. This is about twice what the United States stock market lost in October 1987. Banks and life insurance companies finance most of this commercial real estate. Insurance investments in mortgages and real estate have caused and will continue to cause some capital problems for the industry. The real estate problem is not over yet in many regions of the country nor is the attempt by regulators, accountants, actuaries, and many others to find the way to determine the "true value" of real estate for financial reporting purposes.

Also contributing to the mutual and stock insurers capital dilemma is the fact that for years we have been losing our market share of United States household savings. This is due mainly to increased consumer sophistication, a proliferation of alternative financial products, and changes in market level interest rates. We face regulatory battles at the state and federal levels. Consumers are more concerned than ever about getting their money back from insurers given some recent failures.

Showing the listmakers that you are able to meet your cash-flow needs is critical nowadays. Due to much of what we have discussed, profit margins are being squeezed and older, more profitable business is running off the books of many mutual life companies and being replaced by much lower margin products. Even though our industry was hit with an \$8 billion deferred acquisition cost (DAC) tax in 1990, we are still targets for increased federal taxation as more focus is building to reduce our country's budget deficit. The inside buildup for annuities and life insurance is an item that is highly visible to the Treasury.

Mutual life insurance companies need capital for expansion and growth to maintain ratings and to offset any unusually large losses from their investment portfolios or other adverse developments. We also have discussed that consumers are looking at financial quality more closely. Two measures of financial quality are the level and the absolute growth of capital from year to year.

Let us quickly review how mutuals may raise capital. First, they have to earn it the old-fashioned way; that is, they have to show it in profitability.

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However, many in the last several years, have been harvesting capital gains to raise capital as well, but the interest maintenance reserve (IMR) has intervened for interest rate gains. The FASB has issued *Financial Statement 113* which will likely be adopted by the NAIC. This new statement may restrict the benefits of financial reinsurance some mutuals have undertaken to increase their capital.

Similarly the NAIC has apparently made it more difficult for mutuals to utilize surplus notes to build their capital. We will have to see what will happen with the recently issued Prudential surplus notes as the State of New York and the NAIC review the transaction.

A mutual also may use a downstream holding company to bolster its capital. It may do this by selling interest in the holding company to the public or private investors or it may merge the holding company with another company. This is similar to what New England Mutual has just announced with their investment management companies.

Mutual companies also have been divesting themselves of unprofitable, low return, high-capital-needs businesses. Many companies are closely challenging their strategies and focusing more on their core competencies. I also want to mention here that, as we all know, mutuals clearly have restricted access to the capital markets. I want to cover capital-raising options briefly including increased profitability, demutualization, of course, and entering into joint ventures, mergers, and acquisitions. There also are some counterprevailing forces, such as profit margins being squeezed. Companies have been striving to be low-cost providers and truly emphasizing quality services. As an industry, we have a long way to go in the area of quality service. As mentioned earlier, increased federal and state taxes, tough competition, and increased consumer sophistication have all placed additional pressures on profit margins, all at a time when it is critical to increase our capital base.

Equitable and UNUM are two of the recent large mutual conversions, and we will certainly see more in the future. At least this is the rumor that the investment bankers keep pushing.

Why not demutualize? Some mutuals may consider demutualization and decide against it for certain reasons. I think the most significant reason for many well-named companies not moving ahead is the fact that it is not clear what they will end up with in capital at the end. The rules of the game are still not well defined.

John Hancock's Board and senior management are committed to making John Hancock the preeminent financial services firm. We are very focused on the businesses we want to develop and the markets in which we want to compete. We have no plans to demutualize in the near future. I would be wrong to say never. Never is a long time and things change very quickly in our business environment. However, we will continually monitor our capital and structural needs to determine if our organization's structure is the best one for us on a long-term basis.

Even though we are a mutual company, we prepare GAAP financial statements which are audited by external accountants. We use these financial results for internal purposes only. Our perspective would probably be similar to any company that was

considering demutualization. We would prefer to do it from a position of strength and not weakness, having had good financial results over a long history.

The market conditions would hopefully be favorable for an initial public offering (IPO), something you may not be able to choose at your own leisure. We would want to provide appropriately for our significant participating policyholder base. This is clearly the mutual company dilemma that many companies face. Our board and management would need to be very committed given the size and the cost of demutualization and the significant cultural changes involved. We also would have to have a well-articulated plan on how we would invest the IPO proceeds. We would need to improve some internal systems to better respond to many outside interests which are needed by a public company. This could be very costly at a time when we are trying to grow capital in the short term.

John Hancock has entered into various joint ventures as we have expanded internationally. We have chosen to do this to benefit from low-entry costs, use of partners' existing base and reputation, adding to the existing expertise and systems of our partner, not having to build from scratch, and using foreign nationals of local insurers.

Some weaknesses of joint ventures include some lack of control, questions of long-term commitment of partners, diluted returns, possible constraints on product development, lack of skills, lack of clarity, and certainly, in the international arena, cultural differences.

We all face more equal and diverse competition. There is a more open and competitive environment, and there is greater independence of global markets causing a shorter reaction time. Therefore, there is a much greater need for global intelligence, global strategies, and global consideration.

Let us first take a snapshot of the United States insurance market. We account for roughly 36% of worldwide insurance premiums, and we have the third largest amount spent per capita in insurance at \$1,900. Insurance accounts for 9% of our gross domestic product. These statistics, coupled with the fact that access to our market is not extremely difficult, make foreign competitors more attracted to the United States market.

The foreign companies' share of United States net premiums rose from about 4% in 1985 to 14% in 1990 and is surely greater today. We face a much bigger threat here at home from foreign competitors than most of us realize.

There have been tremendous changes occurring in global markets and they have had major implications on the competitive position and performance of all kinds of financial institutions as competition continues to intensify between firms as well as across international borders. This probably will not get any better in the near term.

In the late 1990s and into the turn of the century, we will likely see seamless markets for many securities and derivatives in much the same way as seamless markets in foreign exchange exist today. Some postulate that we may see a global modernization of financial capacity which in turn could help to lower the cost of

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capital and provide a basis for sustained world economic growth. All of these changes continue to put capital pressure on United States mutual companies as well as United States companies in general.

For the strategically focused mutual companies who have increased their capital, who have appropriate management skills, and who have decided to participate in a global basis, one would hope to see increased profits, reduced costs due to economies of scale, improved quality of service, and increased competitive leverage. Only a few of the strongest capitalized companies with a strong brand name and the best customer service will be able to play in these markets.

I want to reiterate that mutuals do face a dilemma today and into the next century if they want to play in the international markets. They may have to play if the competition attacks their particular markets. Unless a company is a niche player in a very specialized market and has a very strong hold on that market, it may be vulnerable to these new, highly capitalized competitors.

The real question is how do we increase capital? How do we make strategic acquisitions? We do not have the ability to do security exchanges at the present time or to do acquisitions at the parent level. Options include increased profits, demutualization, mergers, acquisition, and entering into joint ventures. We must consider how to increase capital in the context of all of the environmental and regulatory influences confronting us, and we need to carefully factor in the greater interdependency of global markets into our consideration. It will not be easy given the lack of traditional access to the capital markets. Only a few will be able to play. They will be the largest and the best capitalized: those able to offer the best services to their customers, and those that are innovative.

MS. JOAN ELIZABETH HERMAN: I would like to talk about why we decided to merge, the steps we took to effect it, and the results we have had.

The number one motivating force of our merger was to increase our overall competitive position. We felt that a merger offered substantial opportunities to reduce expenses, and hence, to better our competitive posture. We also saw it as a way to expand our distribution system at a cost that we could not otherwise achieve in terms of basically doubling the size of our career agency force. We also felt that in the long run, those factors would put us in better stead with the rating agencies. We felt that all things being equal they do put a premium on size. Given two companies with similar surplus asset ratios and other factors, size was an advantage, and, in that sense, it also would improve our competitive posture.

It was not strictly a search for capital, but a search for a number of things. We briefly considered demutualization back in the time period when UNUM was going through it. Basically both companies rejected that. There is a strong commitment to the mutual form of ownership and what that means for the participating policyholders. Basically, I think both companies would have considered demutualization as a last resort only if they felt there were no other options. The other issue was that there was a feeling that while demutualization could bring in capital, it did not immediately offer a lot of the other advantages that we saw in a merger.

Now we have, at times, made use of some of the other options that were previously outlined. For example, we have in the past taken a subsidiary public. We have a company Phoenix Re which is a property/casualty reinsurance company. A number of years ago, in order to increase its business, they felt they needed a substantial increase in capital. We did not want to send the money downstream and so we actually took it public, and that has been very successful for us. The stock has recently had quite a nice run up in price. Beyond capital there were other things that we were looking for, and we felt merger offered the opportunity to bring in those other things.

So how did we go about merging? We started with meeting of Phoenix Mutual's chairman, John Gummere, our president, Robert Fiondella, and the chairman and CEO of Home Life who was Bill Wallace at that time. Part of what was crucial to making this merger work was that there was agreement at that very first meeting on a number of issues. Most important, we had a similar outlook and corporate philosophy of how they felt about mutual life insurance and what that meant to both companies. There was also agreement on the company name. While that may seem like a small thing, investment bankers will tell you there have been mergers that have gone very far down the road and fallen apart over issues like this.

They agreed on the composition of the board of directors, specifically how many directors would come from each company. They agreed on a framework for the senior management organization in terms of the office of the chairman. They also agreed that on the individual life side, the company would sell predominantly Phoenix Mutual's products because at the time that was the broader, more competitive portfolio.

They also agreed that the state of domicile would not be an issue in terms of going forward with the merger. Home Life was a New York-domiciled company. Phoenix Mutual was a Connecticut-domiciled company. We realized that there might be a regulatory question in terms of having this merger go forward -- we might have to end up in one or the other state. This issue would not stand in the way, however, if we could get the regulators to agree.

There also was a feeling that if we could save \$45-50 million in annual expenses on an ongoing basis that it made sense to look at this option.

Then, we had a preliminary meeting in March 1991 with the Insurance Commissioner of Connecticut and the Superintendent in New York. We told them we were considering a merger and asked for a reaction. They said they would think about it and get back to us, but initially they were open to the suggestion. There also was an early meeting with the Governor of Connecticut. We talked to him about how he would feel about the merger, and we assured him that we did not expect employment levels in Connecticut to decrease. On that basis, he was very comfortable with us proceeding.

We then went to the rating agencies to get some preliminary read on how they might view this. This was taking place in 1991 in the midst of Executive Life's failure, and there was a very heightened sense of importance of ratings in the marketplace. We felt the rating agencies' view of this was very important. At that time, they were

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fairly noncommittal and said, come back and show us numbers and then we will talk to you.

In June 1991, we had another meeting with the insurance commissioners of both states and basically got a positive read. They told us under what conditions, in general, they would approve a merger. They told us that they were supportive of us going ahead and felt that mergers within the industry were probably a desirable thing.

With all that in place in June 1991, we basically announced to all the officers of both companies that we were contemplating this merger and outlined the rationale in terms of expense savings and expanded distribution, and, in the long run, the improved competitive posture that we thought it would bring us. We felt we had to tell everybody in the organization at that point that this was proceeding, because we were at the point where we had to bring a lot of people into the process in order to get the work done to see if this merger made sense.

Having done that, we then went ahead with all the work that has to be done in that feasibility stage. Work such as building an expense model to see what we could save on expenses. We had to do "stand alone" and "merged" financial projections going out ten years, both for the regulators as well as for our own boards, to show them that we felt that this merger would be in the best interest of both companies' policyholders.

We had to get investment bankers on board. We used First Boston and Morgan Stanley. We also had to begin to put all the human resources issues in place: communications programs, retention formulas, severance agreements, and all the other pieces that we were going to have to work on.

We began to line up lobbyists to help us get certain legal changes in place in both New York and Connecticut; changes that were going to be needed to legally effect the merger in terms of redomestication issues, etc. This, of course, was happening while Executive Life's and Mutual Benefit's problems were occurring. It really heightened concerns in the marketplace as to whether we were merging because we had to versus because we wanted to. This made it even more important to spend a lot of time communicating, not only with our home office employees, but also with our field forces. We told them why we were doing this and laid out the numbers and the rationale so that they were armed in the marketplace to talk about it. Of course, this further heightened the importance of knowing how the rating agencies might view this.

Having done all our financial work, one of the key things before going to our Board was to go back to the rating agencies again, armed with all the numbers, and see if we could get a read as to how they were going to view this. We felt it was very important to obtain an AA rating from at least one of the major rating agencies. That was our goal, but they would not give us a read. When we met in the fall with Standard & Poor's (S&P), they basically indicated an AA minus rating which we felt was acceptable for the merger to proceed.

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One of the other major things going on during this period of time was to work out a policyholder protection plan that would deal with the dividends that would be paid to inforce policyholders of both companies.

This was a period of intense activity that culminated in meetings in December 1991 (less than a year from when this all began) of the boards of directors of both companies. They agreed that we should go forward with the merger and signed a merger agreement. This was then followed up with meetings with all employees, meetings with our field, letters to policyholders and other customers, and news conferences with the media, all of which are very important. If you are ever contemplating a merger, remember to have scripts for the people who answer your customer service phones so they know what to say when they get policyholders calling with questions.

We then entered phase two of accomplishing the merger. We set a goal to effect the legal merger by July 1, 1992 (basically six months after the merger agreement was signed), and to have the operational side done as soon as possible. The goal was to get as much merged operationally by July 1 as was feasible, and then push to see if we could get it all done no later than a year from the date of the merger.

We set up integration teams. There were 22 task forces overseen by senior management. This was one of the most intense periods of activity most of the people at the companies ever went through. Everybody was working more than 12-hour days, and dealing with issues they had never dealt with before. The good news is that, as a result, we have an even stronger management team that comprises people who learned they could deal with the unknown, make the decisions, and have the authority to get it done.

We also proceeded to begin to merge certain functions in advance of the legal merger taking place. For example, we merged our data centers in May 1992 even though the legal merger was not going to take place until July. At the time we did that, there was still uncertainty from both a regulatory and a policyholder vote point of view as to whether this would happen or not. We felt that we would use joint service agreements to deal with that eventuality if it, in fact, did not come off as expected. The benefits of merging the data centers were so great and were so key to making the merger run smoothly that we decided we should not wait. We actually realized \$15 million in annual savings because of the merger of the data centers alone. This is one of the best areas in which you can save money.

We began to have people from the two companies work together. We had what we called merger transition agreements so that the head of Phoenix Mutual's Human Resource Department began to work at Home Life. The head of the Underwriting Department went to Phoenix Mutual to begin this real process of merging and working together.

In April 1992, again in advance of the merger, we began having the Home Life agents sell Phoenix Mutual's individual product portfolio. They could submit it directly to the home office without having to go through Phoenix Mutual's brokerage operation so they could begin to get the feel of what it was like to sell products and submit them to the Phoenix Mutual operation.

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We made it through all the regulatory hurdles. We had our policyholder vote in May. We had overwhelming support, and the merger went forward on July 1. In fact, by July 1, the data centers were already merged, and by the end of the summer, almost all of the home office departments were merged. Two areas took a little longer: one was our customer service operation. We ended up being a New York-domiciled company, although most of our operations are in Massachusetts and Connecticut. We had to open a new operation in Albany, New York for our customer service operation in order to fulfill our commitments to New York State in terms of employment levels. Obviously, this required a lot of training of new people. Since it was a new location we wanted to make sure customer service did not suffer so we phased that part of the operation in more slowly.

The other area that has taken a little longer to finish merging is field operations. We have some locations where we had both Home Life and Phoenix Mutual agencies in the same city. Some of these have already merged, and others will continue to be merged over the next year.

What about the results? How did we do as compared with what we said we would do? We are on target to achieve annual savings of \$70 million – that is on an overall expense base of about \$350-400 million. These are fairly significant numbers. As you can see, it is higher than our initial estimate in which we figured it would make sense if we could get about \$45-50 million in savings. As time went on, we felt we could do a lot more and that we should make sure we strove to get every penny possible. That is how we got to the \$70 million level.

We also have kept our individual sales growing. Our goal for 1992, the year of the merger, was to make sure that sales at least equaled the 1991 levels. We wanted to stay level during this period of turmoil. In fact, we exceeded that and now in 1993 are seeing our sales results pick up.

We also achieved what we hoped to in terms of retention of our field force. We had no meltdown in terms of losing career agents that we wanted to retain, and we were able to attract between 100-150 employees from the former Home Life to join the newly merged company. All of these employees had to relocate, so this was a decision that involved more than just deciding whether or not they wanted to work for a new company. Our goal was to make sure we got a core of people from the former Home Life to move to Connecticut or Greenfield, Massachusetts, and we have done that.

We think that in total, we have positioned ourselves to be a stronger competitor in the market's eyes. We have a better expense structure, one that benefits every single part of the company. Obviously, the biggest payoff has been to the individual line where we had the biggest merger of two operations, but everyone has benefited from the reduced expenses and staff savings. Our field force on the individual side has a broader, more competitive product portfolio to sell and a lower net cost going forward on which to compete. In our home office, in addition to the efficiency and expense savings, we have both a deeper management team and a management team that has been tested and risen to a challenge.

So, can this be accomplished? Yes it can. When you start the process it looks like a huge mountain that you have to scale, and it seems overwhelming, but it can be done. To get it done, however, you must have absolute commitment from the top. If the people at the very top of the merging companies are not in sync with what they are going to try to accomplish and who is going to have what role, you are going to be in trouble. But if you have this commitment, you can make a merger work.

You also have to drive the process and do it quickly. Everybody, including the consultants who deal with mergers, will tell you this. It is an intense period of activity, but the faster you get it done, the better off you are going to be. Communications are very key with everybody. It's important to communicate with not only your employees in the field, but also with regulators, the media, and often the legislators in the various states. You may well need the kind of enabling legislation we did, and it is very important to plan those communications well.

It is important that your employees feel that you are going to treat them fairly and humanely throughout the process. Obviously there is always a lot of concern about meltdown and losing key people. We did not have that, but I am sure we were helped in part by a tough job market. But a lot of it also has to do with how you communicate and how you treat people during the process. If you do it right and you are up front with them, giving them as much information as you can as early as you can, you will retain the people you need to get through the process.

In conclusion, if we had another opportunity would we do it again? The answer is, yes we would!

MR. HARRY D. GARBER: I am going to cover two subjects. One is the Equitable demutualization; the second is some general observations on demutualization as a subject.

Let me start with the design of the New York demutualization law which differs from the law in other states. We worked very long and hard to design the New York law. The "we" includes Equitable and many other New York companies. It is a law that is very detailed and specific, but with options for the company to use.

The New York Department made it very clear in the development of the law that they did not want to be put in a position of having to make value judgments on what a company is worth or other related issues. Therefore the law was designed so that the Department did not have to do that. This contrasts with the law in most states, such as the Williams-type statutes. Although these laws do not appear to call for value judgments by regulators, when these laws have been applied in Maine and elsewhere, the insurance commissioners have found it necessary to make value judgments.

In the end the New York law worked well for us. There was an immense amount of work up front in negotiations with the Department, but when we came down to the things where you usually have a problem (i.e., the hearing, the superintendent's decision, etc.), it was a piece of cake. The superintendent's decision was that we met the specific requirements of the law. Having done all the work on the various

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requirements, it went through very easily. We had only two lawsuits, both of which were settled before our stock offering.

One thing I have to repeat is that demutualization is not an actuarial process, it is a market-driven process. You need to understand this in order to understand this issue.

The circumstances of the Equitable that required us to demutualize are well known. We needed to build capital quickly, and, in fact, we could not wait for the completion of a demutualization action that was 18 months away. Therefore, we had to look for a private investor in advance of demutualization. Even if we had been able to wait for demutualization, I think we still would have sought a private investor since it was not clear that the funding required would have been available from an initial public offering.

We found ourselves implementing the demutualization process and seeking the outside investor at the same time. It took us essentially from the summer of 1990 through the summer of 1992 to complete the demutualization process. It might have run a little faster, maybe three months, had we not had to obtain the outside investor.

We had done some advance work. We had introduced GAAP accounting back in 1983, and it was a GAAP that conformed largely to the GAAP rules. The only difference was we were using a source of earnings form of accounting for participating business rather than what had been the traditional approach for stock companies. This approach was not accepted by the SEC in the end, and we had to adopt traditional stock company accounting for our participating business in the demutualization process.

In addition to GAAP accounting, we had participated actively in the drafting of the New York law and had done a number of trial runs at what I would describe as "tree-top level." The very valuable tool we had from these advance runs was a model of our participating business which we had developed with our outside actuaries. This model, when updated, was essential in the actual demutualization process.

We also identified most of the issues that would have to be resolved in a demutualization. This was very helpful in setting up the project plan.

Demutualization is an immensely complex management process. A company needs to involve a broad representation of various professions and functions: actuaries, lawyers, accountants, financial officers, administrative people, and others. The administrative people are extremely important. In addition, there are outside investment bankers, independent actuaries, outside attorneys, etc. The sales organization is very much involved along with the public relations people. It is a huge undertaking with many diverse interests and people important to its successful completion. There must be a project manager who can control all pieces, coordinate all the people involved, and keep things moving.

The regulatory process involved both state and federal authorities. The State of New York required the submission of a plan of demutualization. Agreement on the plan consumed most of the time required for demutualization. The requirements of what had to be in the plan was spelled out in the governing law. There was an advance

agreement with the department that we would discuss all issues and reach tentative agreements on all key issues in advance of the submission of the plan. However, there could be no final agreements until the superintendent approved the plan.

We had a mailing to policyholders about one month before the hearing. We had the hearing and the policyholder votes were counted in the period between the hearing and the superintendent's approval. We had a public offering a few weeks after the approval. It was an 18-month period from the time we started working with the department at the end of 1990 until we finally demutualized.

On the federal side, we had to deal with the IRS on both company tax issues and policyholder tax issues. The company tax issues had been fairly well settled by UNUM. There is no add-on tax after demutualization and a demutualized company is a continuing entity. In fact, in the year in which a company demutualizes, there is only one tax return and the add-on tax is prorated.

Policyholders do not have to pay any tax on stock received in a demutualization until it is sold. They have a zero basis in such stock so that it is fully taxable when sold. A complicating item is that stock cannot be given to contractholders under qualified plans. All annuities that are tax-qualified have to receive increased benefits rather than stock. On the other hand, this was different for my wife who is an agent and who has a Keogh contract where she is the trustee. She received stock as a trustee of the Keogh contract even though she would not have received it if she just had an IRA contract.

We needed an exemption for prohibited transactions from the Department of Labor to permit us to continue to manage the funds of those contracts that would be receiving stock from demutualization. It would not ordinarily have been a problem obtaining this exemption, but the complainant in one of our lawsuits was the ABA. They had terminated their contract with us, yet they thought they should get more money from the demutualization than was contained in the demutualization plan. What we found was that, while the ABA alleged that the plan was unfair, the Department of Labor found it difficult to issue the needed ruling. As completion of the demutualization hinged on our being able to get that ruling, we had to settle the suit for what we thought was an outrageous price.

The SEC reviews the material that is used in the company's S-1, which is needed for the initial public offering. SEC reviews all of your accounting practices including valuation of assets. Among other changes, we needed to establish a whole new process for valuing real estate as long as it expected to or could realize that value on sale within ten years. What was established in our process was that we not only had to realize the book value, but had to earn the cost of funds in the meantime. In addition, we had the whole question of reserves for bonds and mortgages.

The last issue was the GIC business which had been a well-known problem for us. We tried to set up a reserve for that business. The SEC would not permit that because of the precedent setting effects it would have had on the banking industry. We finally had to treat it as a discontinued business. We were not selling any GICs then so that was not a big deal from a business point of view. It required an immense amount of time and effort with the SEC before we came to resolution.

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I want to emphasize again that it is very important to settle litigation quickly. If there is any litigation outstanding, it is going to get in the way of decisions from any regulatory body that has to make a decision. Without being able to evaluate the litigation independently, regulatory bodies are afraid to make such decisions.

The New York law permits two approaches to demutualization. Under method one, the full value of the company at the time of demutualization (but before any new capital is brought in) is, in effect distributed to policyholders. The public offering of new capital establishes the value of the stock which has been distributed. This was the method that Equitable used. Under method two, a fixed amount determined by actuarial calculations is distributed to policyholders. The public offering then establishes the share price and the numbers of shares that policyholders would get. For example, suppose that under method two we determine that two billion dollars should be distributed to policyholders and how this amount should be allocated among policyholders. The initial offering price per share and, thus, the number of shares for each policyholder would be determined by market.

Most of us who designed the law believed that method two would be predominant. Having been through the process, however, I now think most companies will use method one. It is a lot easier for mutual company people to accept method one philosophically because policyholders will receive the value of the company whatever it turns out to be. The company issues new shares, the market determines the price of those shares, and the policyholder value is determined by the market.

When AXA made their investment in Equitable, they were willing to make an investment for an $X\%$ share of the company, where X was less than 50%. New York state required that the investment be made on a market-value basis. Their money came in and earned a return until it was converted into stock at the time of demutualization. It turned out that AXA received over 50% of the company as compared with the smaller percentage they had offered earlier. But New York was right; there was no way of establishing fair value in a large demutualization without reference to the market and the insistence by New York on that principal is the right answer regardless of the specifics of our case.

Most state laws do not call for a closed branch, but New York does. UNUM set up a closed branch. This is important. What a closed branch does is solve the problem of policyholder protection. Enough assets are put in the branch so that with future premiums they will satisfy contractual obligations and pay the dividends on the current scale if current experience continues. If current experience changes, the scale will be changed just as it would have been before demutualization.

The closed branch assures the continuity of dividend practices. More importantly, a closed branch makes it very clear to policyholders that they are not sacrificing policy or dividend rights for shares. This simplifies the policyholder communication process immensely.

One interesting facet of a closed branch is there will be more liabilities in it than there will be assets. This is because the premium/dividend structure will, in effect, be charging policyholders for the initial acquisitions costs which you have already incurred for future profits.

We had an issue of how expenses would be treated in the closed branch. The New York authorities did not want to be involved in future expense allocation processes. As a result, no expenses are charged to the closed branch except commissions, premium taxes, and other costs that were directly determinable at the time of demutualization. This decision further exacerbated the asset/liability difference in the branch because the premium/dividend structure provides margins to meet these expenses.

The next issue in New York was interesting. When we designed the closed branch as part of the law, we had said group business could be excluded from the branch. In the demutualization discussions, we found that because annuity contracts with a guaranteed interest rate and excess interest declarations and health insurance policies do not fit the individual life dividend mold, they should probably be excluded from the closed branch. We negotiated with New York to keep them out of the closed branch, but with the stipulation that, should there be unexpected future profits on these lines, the policyholder will recover additional returns.

The measure of expected profit for this purpose will be based on the future experience that was taken into account in determining policyholder values for the demutualization process. To the extent the actual experience is much better, there will be some return to policyholders. This agreement is part of the demutualization plan.

The plan required an allocation of policyholder shares. There is a fixed amount per policyowner which in our case we set at three shares. It was the compensation for relinquishment of membership rights. (We did it on an ownership basis not a policyholder basis.) For most policyholders, there was an additional allocation based on contributions to surplus, past and future. In this case, the contribution is determined as the accumulated surplus plus the present value of future profits. For policies in the closed branch, it is the amount of assets that have been accumulated on that contract minus the assets that are in the closed branch. These are algebraically equivalent expressions. Once we had determined these policyholder amounts, we allocated the available shares in proportion to those amounts.

Stock is tough to sell; it is a difficult business. People do not invest just because a familiar name or a friendly face. You have to go out and sell your stock as an investment that is going to do well for the pension fund, mutual fund, or other investors. The selling never ends. Even when the demutualization is complete, there will be a stream of analysts wanting to know what is happening and what is going to happen. Putting the company in a mode where analysts can understand it, where they can measure the performance, and have expectations is something that is tremendously important. It is not something mutual companies usually have to do, but it is a necessity for public market success.

Creating shareholder records from policyholder records, unless your company has a better set of administrative systems than we had, is a difficult process. We had several annuity systems, three life systems, a health system, etc., all of which had to be pulled together. We found that the Social Security numbers which we had been entering religiously since the 1960s were wrong in many cases. Having these

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numbers is very important because if you do not have the tax IDs for these policyholders, the IRS requires you to withhold 20% of any distributions.

With respect to internal communications, the clear necessity for us to demutualize and seek equity capital eased the internal communications process. Our people knew what we had to do, and they did not need a lot of education on why we were doing it. We also set up a group to deal with policyholders. We sent out a very large, complicated mailing to policyholders, and set up a special group reaching 100 people at one point to answer calls. In the end, about 40% of the policyholders voted and about 93% voted for the demutualization.

Let me spend a couple of minutes talking about general strategy. First, demutualization is not an end in itself, it is a strategy for a company. Timing and the company's circumstances make a huge difference in the result, and the company's and policyholder's interests are similar. You want to go to market at a time when there is a good IPO market to maximize policyholder and company value. The time will not necessarily be of your choosing, particularly if you are forced to demutualize for other reasons.

Second, it is very important to have a good story. Your strategy must make sense to people buying your stock. Your performance should be good, and your prospects should be bright. You do not want to be going to market at a time when things look glum, because selling the stock at a reasonable price can be very difficult. That means if you have losing businesses, you sell or discontinue them before you try to demutualize. If your asset profile does not match that of most stock companies, then you must either develop a good explanation for the difference or work to change the asset profile. The key is to be able to choose the time to demutualize.

The dilemma occurs because demutualization is a long process. It is regulatory driven with an everpresent threat of litigation. For these reasons, the demutualization schedule is hard to control. At the outset you need to plan for at least a year-and-a-half, and a couple of years would probably be normal.

The future cannot be predicted. Change is pervasive. My message is that some of those events happen with a 1% probability in your working lifetime. Worse yet, those adverse events to which you assigned no probability may also happen. If I were part of the management team of a mutual company, I would conclude that the company should think about and prepare for demutualization even though no decision has been made to demutualize.

Make sure your state laws are in place; make sure you begin to develop a company whose plans and strategy make sense to the market; and work towards having a record of good earnings results. This will help in raising capital and in providing value to policyholders.

Do your GAAP accounting. I think this will be required soon for mutuals in any event, but make sure GAAP is in place before the demutualization decision is made. (This also ties in with building the earnings record.)

Begin to look at some of the issues that you would face in the process of demutualization. Size is important in demutualization planning. This is a very complicated, expensive process and probably not one a small or medium-sized company can do economically. For these companies, mergers to increase size may be important to predemutualization steps.

MR. ALBERT E. EASTON: Before we get to the questions, I want to talk about the situation in other countries.

Mutual companies in the United Kingdom have been feeling for some time the constraints on growth that limited capital causes, and there have been several demutualizations there. This is particularly true of companies that concentrate on traditional with profit business, because of the fact that they have a much more levelized dividend scale than we have. Pressure has been relieved somewhat recently because companies have found that they can substitute unitized with profit for the traditional business. Unitized with profit is very similar to our variable life policies.

Under the new European Community rules, companies in the United Kingdom will probably be permitted to raise capital by use of subordinated loans. This is already being done in Norway and I understand that it will probably be available in the United Kingdom in 1994.

The surplus pressures on companies in Canada are similar to those in the United States. However, the new Canadian law which became effective in June 1992 has given Canadian companies the right to raise capital through the issue of subordinated debt. One large mutual company, Confederation Life, has already done so.

Confederation recently sold about \$200 million of subordinated debentures as a registered security in the European capital markets. Under the provisions of the new Canadian law, the extra capital raised by the sale of these notes begins to amortize linearly over the five years before their maturity date. Five years before maturity is the point at which it begins to turn into debt.

It also has been suggested that the new Canadian law would permit a mutual company to issue preferred stock which would not have the disadvantage of a maturity date. However, as far as I know, there have been no tests of the ability to issue preferred stock.

On the subject of subordinated debt, it is worth noting that the New York Law, Section 1307, provides the right for a mutual company to issue this kind of debt and increase its capital with the proceeds. Section 1307 not only requires the superintendent's permission before you do this, but the superintendent must approve every payment of either interest or principal on the subordinated notes that you issue. For that reason, this provision has not been used very much up to now. In general, subordinated debt or surplus notes are very rarely used in the United States; and mostly in distress situations. This does seem to be changing. There are rumors that several other mutual companies are currently considering this.

MS. AMY J. ABRAHAMS: My question is directed to the representatives from Phoenix Home Life and Equitable. I was wondering if you would share with us

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whether a specific event or a particular point in your financial status pushed you into taking the direction that you did? Also, in hindsight, do you have any regrets or was there anything you could have done to avoid the direction you took?

MS. HERMAN: First, for both Home Life and Phoenix, the possibility of merging had been something that both companies had considered in the past. For example, Home Life in 1986 almost merged with Pacific Mutual; in fact, it had a standing committee of its board. Phoenix, off and on, had merger discussions, a couple took place in the late 1970s, one in the mid-1980s, and two in the 1990s prior to the merger. These were more on an opportunistic basis rather than because there was any specific pressure to merge.

Part of the reason, in our mind, that more mergers of mutuals have not happened is that there is not a great pressure externally to do so, although the rating agencies in recent years may give more impetus to do that.

There wasn't a specific event. It was more a feeling that this might make sense if the right partner came along.

In terms of how it worked out? We felt it worked out the way we hoped, maybe better. When we first started talking we wondered if we could get it done quickly and whether or not we could hold onto all the people we wanted to keep in the company. We certainly felt that it was doable. However, if you had asked me whether we would be done as quickly as we were, my answer would have been, "I hope so." But, it went even better than we hoped, and we do not regret it at all.

MR. GARBER: We had looked at the concept of merger up and down in terms of people that were both larger and smaller than Equitable. We had actually entered into discussions in a couple cases. They had failed for all the traditional reasons that Phoenix Home solved up front so that was not really an option.

We made the decision to demutualize in the summer of 1990 shortly after Dick Jenrette became CEO. It was clear to us that the stock companies as a group were growing much faster than mutuals and that the GICs and poor management practices had decimated our surplus to a point where we needed to raise capital. We began working on demutualization quietly in the summer of 1990. We had hoped to delay the announcement of our intent to demutualize until mid- or late-1991. However, the announcement was moved up to December 1990 in order to provide the rating agencies with some support for keeping our claims-paying rating at the "A" level.

MR. BRANDT T. BROCK: How much did the merger actually cost? You mentioned that you are experiencing savings in the \$70 million range. What kind of payback time would there be? Also, is there still an "us and them" mentality? If not, how long did it take for it to change?

MS. HERMAN: The expenses that we actually quantified as merger expenses, not the soft staff time, were the costs of the investment bankers, the severance payments, the outside legal counsel, etc. We had about \$6.5 million in expenses between the two companies in 1991, \$27 million in 1992 (a lot of that was severance and retention and issues), and \$11 million in 1993.

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We are already experiencing significant drops in expenses in spite of this. Even when you add in the merger expenses, we are down from where we were in 1991 by about \$16-17 million in total, including merger expenses. Of course, there also is inflation and everything else going on. If you took out the merger expenses, in 1993 we were already down before adjusting for inflation by about \$20-25 million. By 1995, we will be getting the full impact of the estimated \$70 million. The staff reductions are taking place as targeted. We will then begin to get the full impact of the severance payments.

"Us and them" is basically gone. We had a field manager's meeting earlier this year of the two individual career forces. Part of the reason for that was to say that we are now one organization. Overall, things appear to be fairly well integrated at this point.

MR. FREDERICK S. TOWNSEND, JR.: If a company decides not to merge or demutualize, what use can be made of lines of credit to meet capital needs?

MR. MOLONEY: We have explored a large number of them over the years. The area of surplus notes is one that we have taken a look at, and they were certainly interested in seeing what was going on with Prudential. We have utilized credit in some of our expansion, but it is still, from a rating agency perspective and from many outside analyses, only a limited resource. It does not help much.

We have been exploring a large number of different alternatives. The best way we found over the years is continuing to focus on profitability, watching our expenses, watching how we grow, and managing our capital for strategic deployment from that perspective.