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THE DILEMMA FOR MUTUAL COMPANIES

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- In search of capital
- Merger/acquisition considerations
- The demutualization alternative
- Profit crunch
- Joint ventures
- Special problems at mid-sized and small mutuals

MR. SIDNEY A. LEBLANC: I plan to make a few introductory remarks and turn it over to the panel. Given the caliber of the panel, my interests are best served by getting out of their way.

We're in three primary fields in the 1990s. We're in the stagnant individual life market. We're in a health market that is threatened by state and federal regulation, and we're in a low-margin annuity market. They're all very competitive. That's the good news. It's a dog-eat-dog world and vice versa, and someone said this is the number-one profession. The result is that problems are normal. At a typical company, there is no sales growth, increasing expense rates, and reducing profit and expense margins. Problems are usually a little tougher for smaller companies.

We're talking about mutual companies. We're only interested in the evil stock companies as they impact on our problems here. Mutual companies have all the problems I've talked about before, plus they don't have an access to capital and there is a less sense of urgency to solve their problems. The last point is an important point; they need to arrange their long-term destinies while their companies are still strong. There's a tendency for a company to say it has good surplus and won't worry about the other problems. Not to worry is an old Irish expression, and it kind of means the same as mañana, but without the sense of urgency.

If a company does have these problems in anticipating its surplus, it's not serving the policyowners well, and it's also not serving management well. Management really has a big stake in this, and it needs to be in a position to negotiate from strength, when it still has some control over the options that it can pursue. The panel is going to talk about options.

I would like to mention one option that Pan-American went through. On September 1, 1992, Charlotte Liberty Mutual merged into Pan-American. The way we did it resulted in a win/win/win situation. That's important because that's the only way you can have a merger. These things have to be voluntary. They have to be good

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for both parties or they won't happen. They're complicated enough if both parties want to merge. They're impossible if they're not interested in merging. The impact that merger was that the policyowners received substantial dividend increases. The employees received job offers, and they received generous severance pay if they declined the job offers. The remaining surplus was satisfactory to Pan-American as a surviving company.

Since that time, we've made a formal proposal to merge with a second company. The company narrowed it down to us and one other company and wound up merging with the other company because it was a local company. If any of you are interested in merging, give me a call at 1-800-LET'S-MERGE, and I'll be glad to talk about whatever issues or concerns you have. One important point in merging is the human resources issues and I'd like to touch on that.

If the best deal for current and future owners of a company, is a merger with a larger company, which would imply increased dividends, a more secure company, and a viable company, to accomplish this management must eliminate its current jobs and its current location. That would typically be the case, although maybe less so with larger companies. If management has control, then management should be generously compensated for the loss of security. Now, management shouldn't be paid like it owns the company, but it should be paid beyond normal or generous severance for employees and beyond receiving a finder's fee for the owners.

The panelists are all partners of prestigious firms. Keith Gubbay is a partner with Tillinghast. Hugh McCormick is a partner with Le Boeuf, Lamb, Leiby, & MacRae, and Dan McCarthy is a partner with Milliman & Robertson. LeBoeuf, Lamb is a big law firm with about 500 lawyers who are primarily in New York. It operates in a number of other cities in the U.S. and in other countries, and about a fourth of its business is insurance business, so it is a significant player in the insurance field.

Dan McCarthy is going to talk primarily about large companies and their issues. Keith Gubbay is going to focus more on small companies. Hugh will cover the regulatory, legal, and tax aspects.

MR. DANIEL J. MCCARTHY: Many conversations about mutual life insurance companies and their needs and problems tend to begin and end with discussions about capital and their need for it and their difficulty in accessing it. I might well end there, but I'm not going to start there. I want to start by talking about operating costs. By the way, to give you a framework for different sizes of mutuals, Keith and I have adopted a convention (see Table 1). If a mutual has assets of more than $25 billion, we'd call it a giant or a mega. If it has $4-25 billion, it's large to mid-size. Keith will talk about mutual companies with less than $4 billion in assets.

I want to start by talking about operating costs. Our firm does an annual study focusing on operating costs in the individual life business, in which many mutual and stock companies participate. We get transaction counts for each company in effect, number of new policies, number of policies in force, amount of insurance sold, death claims, surrenders, lapses, and that sort of thing. We put standard costs on each one of them so that we can calculate a standard cost for each company then we look at their actual cost in relation to that.

TABLE 1
Profile of U.S. Mutual Life Companies

Category		Number
Mega	$25 billion and above	7
Large	$4 million to $25 billion	15
Medium	$250 million to $4 billion	40
Small	Below $250 million	48
Total		110

Because I'm going to be looking only at relativities, it doesn't really matter whether our standard costs are right, or too high, or too low, as long as they're reasonable in relation to each other. That gives us a benchmark to compare companies. We have looked at mutual and stock companies of different sizes year after year during the period 1987 through 1991. Focusing essentially on the top 20 mutual and stock companies, which means that we're talking about companies with $4 billion and up on the mutual side and a little more than that on the stock side because we combined companies of common ownership, we found a few things.

First, at the end of 1991, while there was a little bit of difference by size, the relationship between actual cost and standard cost to the mutuals basically translated into a statement that their operating costs were, in relation to their in-force, 20-25% higher than for stock companies of roughly comparable size.

Second, looking year by year at 1987 through 1991, the unit-cost multiple on the mutuals, what you could describe as the effective inflation on these standard costs that we held constant during that period of time, was in the range of 4-5% per year. For the comparable stock companies, it was absolutely flat. It was the same at the end of the period as it was at the beginning. Then we went back and looked at growth of these companies in the individual life business. You never have the measure you'd like to have. We could all think of reasons why there's no perfect measure, but individual life insurance in force was as good as any, at least as a relative measure.

The average growth rate of the stock companies in the study was about 4% higher than the average growth rate of the mutuals in the study. It was, roughly speaking, 10-14%, or numbers in that range. There was higher growth in the stocks and flat expenses in the stocks. There was lower growth in the mutuals and expenses were creeping up in the mutuals. I think that's the beginning of a story. Capital is near the end of the story and we'll come around to that. That's point one. We need to focus on this issue because it is key to these companies.

I can't prove point two, so I won't spend a lot of time on it. I think the issue is somewhat different for the giants: the seven American and two Canadian companies who have more than $25 billion in assets. By the way, there's a distinct cut at that point. When you draw a line at $25 billion, you have trouble finding folks right below that line. You drop down quite a bit before you get to the next group. The reason I say I think it's different and more solvable in theory, at least for the giants, is that they've already got scale. Even without significant growth, they've already got scale.

There are some very unpalatable things that some of those companies would have to do to get their expenses more in line, but I believe they have the scale from which to do it. Does that mean they could survive without growth forever? No, but it means that they are big enough, in my judgment, and their expense issues are different than the issues of the companies at the next level down that don't have the scale. They have to make the same kinds of investments in systems and all kinds of operating things that larger companies do and, without growth, they have great trouble financing those kinds of investments.

From the decade 1981 to 1991, if you take the 20 largest mutuals, the giants and those at the next level down, their asset growth was between 8% and 9% per year compounded. It doesn't matter very much whether you take the top five or the bottom five in that group. That's generally much across the industry in that category. If you take the top 20 stocks, the average growth rate in assets is almost 15%, and it's higher once you get past the giants, particularly because once you're past the giants, you don't have to deal with the anomaly that TIAA is technically a stock, which kind of distorts all the numbers when you look at the top few. So asset growth was significantly higher for the stocks than for the mutuals.

Interestingly, 1992 presents a different picture. I think it's important to understand that picture as we go into the next step and talk about capital and capital needs and capital needs in relation to size. Let me give you a few numbers for 1992. The seven U.S. giants (the seven large mutuals) grew in asset size by 7% in 1992 over 1991. If you take the 13 mutuals just below that, they grew at an average of 2.6% in 1992 over 1991. It isn't good to make too much of one year, but it's important to look at these things. By the way, the four largest Canadian companies, of which two would qualify as giants and two would not, fall in the middle of that. They grew at about 5% in 1992.

What does that tell us? You can't look just at overall growth. You need to look at mix of business. In 1980, the insurance industry in total, if we separate life insurance on the one hand and annuity and pension on the other and leave separate-account business out for the moment, was about 50/50. That is to say about 50% was in life insurance reserves, 50% was in annuity and pension, and there were small amounts of health and miscellaneous. By 1991, that had turned to about 70/30; 70% annuity and pension and 30% life insurance. The swing was at least as dramatic for the mutuals as it was for the industry as a whole.

There's a serious question then that companies are having to confront, mid-size companies in particular, concerning the identity of their core business. Most of the companies in this category would identify individual life as a core business, and they would similarly identify their annuity business to the extent that it's agent-sold. Most of these companies also have very sizable blocks of group pension business, and a number of them are letting it run off at the moment to fundamentally get their assets and liabilities down, to get them back in better balance, improve their ratings, and give them the ability to redeploy their capital for what they would perceive as core business.

In particular, when you look at the mid-size mutuals for 1992, you see a puny growth rate. That growth rate is different between their life insurance reserves and their pension reserves, with life insurance being higher. What does that mean? It means that mutuals are indeed capital constrained. You are well aware of the axiom that if you've got capital equal to your required target, however you measure that, you can't grow faster than your underlying rate of return on your products. This is true, but that growth can be redeployed and, in fact, is being redeployed in the industry.

In retrospect, it's kind of interesting to look back to the early 1980s and ask why these people did this. Why do they put all this pension money on? If you look at the period 1980-85, a period of very high interest rates beginning to taper by the end, you begin to find the answer. In that period of time, the companies that I'm talking about here had life insurance reserves that grew at only 3% annually. If you net policy loans and all those kinds of things, investable money on the life insurance side moved very little during that period.

At that point, those companies had capital. It was growing at some rate. Their life insurance business measured by reserves were not growing. Most of you will remember that those were the highest lapse rates that the industry has had in recent memory. As a result, to keep the asset side of the house busy and to keep mortgage-generating and bond-generating capabilities together, those companies expanded asset-producing businesses. Times are different, needs are different and, as a result, the actions of the companies are different.

Back to the mid-size companies and back to where we started on expenses. These companies clearly need, in my judgment, growth in their core business. In one sense, they can afford it less than ever. Ratings tell you that. Surplus ratios tell you that. Asset composition tells you that. Fortunately, most of them, including the ones that need it most, have something they can do in the short run. They have blocks of pension business that are not linked, by and large, to their agency forces, which will run off on their own during a fairly short period of time, and which can be allowed to run off so, in effect, capital can be redeployed to a different line of business. The numbers in 1992 for the mid-size companies make that very clear.

Bear in mind that we are speaking generally, because this group of companies includes a few that are extraordinarily well capitalized, a few that are weakly capitalized, and many in the middle. But let's settle for the averages for the moment. What are the choices for a company of that sort? Well, I suppose we could say fundamentally there are three, and the first of them has two subparts to it.

The first choice clearly is to continue as is and that can mean continue and prosper, or it can mean continue and hang on by your fingernails. In fact, I imagine some companies in that category (average capitalization), will do one and some will do the other. One of the things, as we've already said that they clearly can do in the short run (and the short run can take you quite far if half your assets are in pensions), is they can redeploy. Of course, these companies that have not had, in some cases, significant growth on the life insurance side of their business haven't, for the most part, foregone that growth intentionally because of capital shortage.

They have foregone that growth because the agency-generated life insurance sales in the United States, and I'm told in Canada, have leveled off by any reasonable measure. We've got a mature industry. We've got a declining sales force in terms of numbers, at least a declining, traditional sales force, and companies have simply not been able to find the investments in distribution capacity that will enable them to increase their life insurance sales volume. In fact, I said before that the stocks have grown in that area faster than the mutuals.

Now, stocks have access to capital that mutuals don't, but I don't believe that's the end of the story. Sure, the stocks have access to capital that enables them to grow, but that in itself doesn't generate distribution capacity and doesn't sell policies and doesn't put new business on the books and keep it there. In fact, in one way or another, they have found markets, in some cases nontraditional markets, that have enabled them to do that and, as we saw at the very outset of this talk, thereby were able to keep their expense rates flat, a luxury that the mutuals haven't been able to enjoy.

The first choice is to continue. Continue and prosper or continue and hang on. I want to come back to that choice soon, because I think there's an implication in it for the industry. The second choice refers to what Sid was talking about. You can merge. Sid said something very important that I would remind you all to think about if, in any capacity at all, you become involved in a merger discussion. To a considerable extent, one of the reasons that more mergers don't happen is that the company that is the less dominant partner in the merger, the company that either isn't going to be there anymore, or is going to lose more jobs, or is going to lose a home-office identity, or whatever, is reluctant to do that, and that's very true.

But, I will tell you why some of those mergers don't happen. The company that is going to be the dominant one is going to be the survivor, is going to be the one that will still have most of the jobs, but very simply, it gets piggish. It takes two parties, each recognizing reality, to achieve a merger. That is as true of the dominant party as it is of the other party. There are some mergers that didn't happen because a company that correctly perceived that it was in a dominant position assumed that it could run roughshod over the other company.

The third choice that a company can follow, if it has a capital problem or wants to expand in a different direction, is to demutualize. Interestingly, in many respects, that is the most difficult and least productive of the solutions. There are some exceptions to that. It can be dictated by necessity, in which case it's the only solution. I say it's the most difficult and least productive for this reason. If two companies merge, and if they're both of some size and scale relative to each other, you will achieve economies once you put them together. It doesn't happen automatically, but a good management can achieve economies. Thereby that entity, when put together, is going to have a better cost structure than either of those companies did beforehand.

Well, with a demutualization, that is, by and large, not true. There is more capital. You have the opportunity to do things that you may not have had before, but you haven't changed your fundamental situation. Demutualization is a fine way of raising capital, if a company is right on the edge and needs that capital to survive. But I don't believe that having that capital turns a fundamental situation around and solves the problem of inadequate growth, or solves the problem of rising expense rates. Of course, we don't have enough examples in the history of demutualizations in the United States to prove that point one way or the other. We have had four of any size. Maccabee's demutualized because it suddenly became a very hot product company, it was growing very, very fast, and it would have grown right out of its surplus. Fundamentally, it had a choice either to cut that growth back dramatically or find more capital to finance it. So growth wasn't its problem at that time. Capital was its problem. I don't believe that situation translates directly into the situations of all of the mid-size companies, as we've described that niche, in North America.

Demutualization will get them the capital, but there's an agenda of other issues there that have to be addressed before demutualization becomes the answer. Hugh is going to talk about some of the legal issues involved in the demutualization and other transactions. I just want to emphasize very strongly that it's so appealing to say you get this capital, but that doesn't deal with the fundamental problems of many of the companies that would otherwise appear to be reasonable candidates for this kind of a transaction. It is important for those companies to think about their alternatives, restructure their businesses so that they have the capital to grow their core business, think about intelligent mergers, and look at other issues before assuming that a solution that raises capital but doesn't necessarily do anything else is their answer.

MR. KEITH GUBBAY: As Dan mentioned, I'm going to be focusing on a smaller group of mutuals, the next tier below the $4-25 billion band that Dan talked about. My presentation will cover a brief, statistical overview of mutual companies, and I'll identify what I see as some of the challenges and issues that they face. I'll then cover some of the restructuring options and how they fit in with the challenges. Let's look at some overall statistics of mutual life companies in the U.S.

At the end of 1991, there were seven very large mutuals and 15 large mutuals. There were about 40 in the $250 million to $4 billion range, which is where I'm going to focus attention, and there were 48 others that were really very small (below $250 million). We often hear that capital is the main problem or one of the critical issues facing mutuals, so let's look at some of the capital ratios (Table 2). Here we've got estimated capital ratios on a statutory basis and on Moody's risk-adjusted capital basis. The Moody's numbers are obviously estimated from public data, so there's some estimation error there, but I think that the picture is fairly clear.

First, we see mutuals with a far lower capital ratio on average than stocks (7.7% versus 10.5%) and 20 points less on Moody's (119% versus 139%). If you split out the mutuals into the large and mega mutuals versus the mid-size mutuals, you see quite a different picture. The medium-sized mutuals are actually very well capitalized, given the size of their business. This would indicate that maybe capital is not such a big problem for these smaller companies.

TABLE 2
Capital Ratios

	Statutory Capital Ratio[1]	Estimated Moody's Risk-Adjusted Capital Ratio[2]
Industry	9.2%	131%
All mutuals	7.7	119
All stocks	10.5	139
Large/mega mutuals	7.5	117
Medium-sized mutuals	13.9	164

[1](Capital and surplus + mandatory securities valuation reserve [MSVR] + 0.5 dividend liability) ÷ general account assets

[2]Estimated from public data

Ratings are clearly another issue. If you look at the A.M. Best ratings for the large and mega group compared to the mid-size group, you see that the weight is very definitely in favor of the large ones (Table 3). Despite the higher capital ratios that the smaller mutuals have, their ratings are not as favorable. This clearly is a problem. I think that the ratings issue, however, is a little bit less sensitive now than it was a year or two ago. Probably of more concern are expenses and, again, I'm just going to reiterate a bit of what Dan said.

TABLE 3
Ratings
A.M. Best Ratings (1991)

	% Total Companies		
Company Size	A+	A	Other
Large/mega mutuals	82%	9%	9%
Medium-sized mutuals	50	40	10

We, too, do a study of exactly the same methodology, and I've split out the expense ratios here (Chart 1). I'm showing the relative expense position of the different groups of mutuals and stocks, and you can see a 20-25-point difference. The stocks are at 93% and all mutuals are at about 108% or 109%, so there's a 15-18-point difference there. When you look at the medium-sized mutuals, you see a far worse position of 117%. This is total expenses including commissions. The expense reduction in noncommission expenses that this represents, the expense differential, is really quite large.

While capital is not necessarily an issue, and ratings may be an issue, expenses are clearly an issue. What are some of the other challenges that this group of companies is facing? We surveyed 20 CEOs of this mutual company group and asked them what they thought the issues were for the industry, as well as for their own companies. The first column in Table 4 identifies the responses to the question of what they think are issues for mutual companies. The second column is what issues will affect the company's strategy in the next five years.

CHART 1
Expenses
Tillinhast Ordinary Life Expense Index

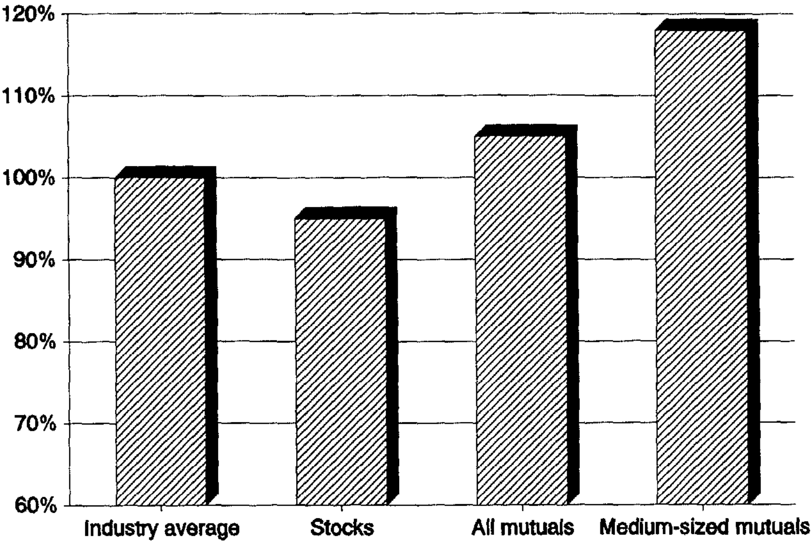

TABLE 4
CEO Survey
Important Issues

Issues	% Responding Positively	
	Issues for Mutuals	Issues Affecting Company Strategy
Capital	88%	21%
Distribution costs	38	14
Profitability	25	7
Critical mass	25	36
Taxation	19	0
Competition	6	25

Apparently, everyone thinks capital is an issue for the industry, but it's not their major problem right now in this group. Clearly some companies have poor asset conditions or may be growing rapidly and need capital, but it's not the main factor. Distribution costs, profitability, critical mass, expenses, and competition are the main issues. To me, these really are all part of the same thing. This, in my mind, is the underlying dilemma for mutuals. How do you compete effectively, given the competitive environment that we face?

If you can solve the problem of competing effectively and capital issue is less of a concern, because a profitable business can raise capital, then I think one of the fundamental problems underlying much of the malaise is that the underlying business is not very profitable or has not been very profitable. So I want to spend a bit of time talking about competition. I'll start with five ways that companies make money in financial services firms.

First is bearing risk, and that's clearly just pooling mortality or other kinds of risks and taking a share or a fee for doing so. Second is managing a spread, and this is the asset-liability function in which the company has assets and liabilities on its balance sheet and manages the difference. Next is processing information, which includes the administrative function as well as processing customer information. Fourth is managing funds, and this differs from managing a spread in the sense that it's the variable component of the business. Fifth is distribution. In a mutual fund business, you're not at risk. You're just managing funds for a fee. In managing a spread, you're clearly at risk as well. Those are the five ways that the financial services companies make money.

Now, a goal of any business is to make money and satisfy a customer need, so let's look at generic customer needs. There are really four that financial services firms seek to fulfill. There may be others, but this is not intended to be a complete analysis. The four basic needs that I see are: (1) reducing uncertainty, and this is the exchange of a known sum at a known time for an unknown sum at an unknown time; (2) providing advice, and usually this is bundled in with the product at the point of sale, but sometimes it's ongoing throughout the life of the product; (3) recordkeeping; and (4) access to money, referring to a number of functions like getting loans from a bank, enhancing cash flow temporarily, or getting a return on an investment. All of those things relate to providing access to money. A bank checking account would be an example of a record-keeping product or satisfying a recordkeeping need.

As I said, you can get more refined, particularly when you break this down into market segments. But if you buy the notion that there are five ways to make money and there are some generic customer needs, what kind of competitive landscape do you get when you put those together? I think it looks like Table 5. There are three important points to make here. First, within a market segment or a customer group, you design products and fit them into this box in such a way that they make money and satisfy a customer need.

Consider a property and casualty product. An example of that would be reducing uncertainty, and perhaps the two ways to make money there are bearing risk and managing a spread. In the case of a checking account, the organization is meeting the needs of the customer by recordkeeping, and it's making money by information processing and managing the spread. I think life insurance companies would typically look at their products and say they would fill this whole box. What does a universal life product do that's sold by a company that has a career agency force? What is that? It's effectively trying to do all of these things at the same time.

TABLE 5
New Patterns Of Competition

Ways to make money	Market/Customer Segment: Reduce Uncertainty	Advice	Record-keeping	Access to Capital
Bear risk Manage spread Process information Manage funds Distribute				

The second point I want to make is that if you buy this picture and you buy that life insurance is really trying to do all of these things, we see that the market, in general, is fragmenting. Each of these little boxes within this big landscape is being picked off by other competitors. The landscape is changing.

The third point I want to make about Table 5 is the impact it has on capital and the need for capital. If you look at the ways to make money, bearing risk is at the top of the list. It's the most capital-intensive of those functions. Managing spread is the second most capital intensive, and processing information is next, and so on. Distribution requires very little capital. What we find in financial services firms in the industry is that new innovations tend to satisfy the same customer need, and doing so uses less capital and transfers more risk away from the company to the customer. Let's look at some examples.

Let's look at junk bonds. Junk bonds replace bank loans. A bank used to make a loan and would try to make money by bearing some risk and by managing a spread. Junk bonds came along and changed the whole economics of that business. Junk bonds make money. They satisfy the same need: access to capital. They make money by distribution and processing information. Someone originates the loan. The investment banker finds a company that needs a loan. The prospectus is put together and is distributed to investors like life companies. The risk is transferred somewhere else. The cost is much lower. The cost of capital is much lower, and we see a more efficient way to meet the same customer need.

An example that's more relevant to life insurance is mutual funds. Mutual funds provide basically the same needs as a segment of the life insurance product, but it does so by using much less capital. It's not a spread product; it's a managed-funds product. It's striking that Fidelity has approximately the same amount of assets as Prudential, I think something on the order of $200 billion. The capital funds of Fidelity are about $500 million, so it is not under pressure to increase that either.

If this is the way that we see competition evolving, if you accept this, then what does it mean for life companies and mutuals in particular? The dilemma is competing effectively. The traditional approach that most life companies use is to try and be all things to all people, to try and fill all the little squares in Table 5, to do all the functions and make money in all the ways. If you buy that, if that is what you're trying to do, then the way to success is to be big, to seek economies of scale, and to be fully integrated to do everything.

The traditional strategies that companies have been pursuing, in my mind, have been replaced by specialization; specialization by market or customer segment, specialization by way of making money. If you accept that that's the way to compete successfully in the future, the basis for success changes. It's not being big in everything and crushing the competition. The basis for success is information advantage and having distinctive competencies in particular functions. If your main way of making money is risk, you need to be good at risk selection. That is the key functional competency. If it's spread, it's asset/liability management, and those are very different skills. There's no reason to expect one company to be able to be excellent at risk selection as well as asset/liability management.

Systems and information processing is clearly related. For managing funds, the mutual fund industry would say the key competency there is really a marketing and packaging skill, as well as some investment ability. The key to success in distribution is clearly having access to customers. Some sort of functional competencies within your organization can drive specialization by way of making money. Similarly, if you're going to specialize by market or customer segment, the key issue there is, can you gain enough information about the market and customer segment? Can you understand needs better than your competitors can and thereby satisfy those needs better?

I see this as the major shift in the way competition is occurring in our industry. Given that, what does this mean for restructuring and the position of mutuals? Well, there are a number of options, as we've talked about. There are a number of options oriented toward raising capital: demutualizations and sponsored demutualizations. We've seen a number of downstream holding companies being floated. New England just recently floated an investment company, as did Equitable. General American floated an HMO and is also trying to float some other operations. It is a good way of raising capital. The mutual holding company approach has been tried in Canada. That, too, is a way of raising capital. But in my mind, it doesn't address any of the underlying issues relating to how to compete.

There are a number of other options. We've talked about mutual company mergers. They clearly have some impact on the way that you can compete, because they address the cost issue and give you some more critical mass. Again, I would question whether a merger of equals and a merger of mutuals that are doing everything together is going to help much. I tend to disagree with Dan when he said that you're probably going to reduce expenses if you merge two mutuals. I think you end up somewhere in the middle, which means that the bigger company or the more efficient company ends up worsening its expense position, but it is larger. There are some questions in my mind about whether mutual mergers are really effective. I think they do have potential.

On the other hand, we've seen many companies exit or acquire lines of business to increase focus in a particular area or to gain some specialization advantages, to redeploy capital, as Dan was talking about. We've seen many joint ventures and strategic alliances. I think these will be increasingly common.

These are ways that companies can choose segments within that matrix. They can choose to compete in particular segments in that matrix and they need to hook up with other people to provide a complete service. It allows them to focus their resources, to gain some specialization advantages and distinctive competencies, as well as to focus their capital and be more effective. I think we'll potentially see some downstream holding-company approaches as a way for mutuals to try and do this together. Two or more mutual companies may go together to try a new venture in a new market, in a new product line with some special focus, and do it jointly.

We asked in that CEO survey which options were most likely to be adopted for the small mutual group, and Table 6 shows the responses. A number of people thought demutualization was a possibility. Sponsored demutualization was more positive, particularly if it was a far and distant owner that only called once a year. Not surprisingly, many would like another mutual to be merged into it, but only a couple in this group decided that they would think about merging into another mutual; and we're not going to say who they were. Of course, most of the CEOs thought joint ventures and strategic alliances would be more common and would help them address the problems of this group.

TABLE 6
CEO Survey
Restructuring Options

Restructuring Options	% Responding Positively
Demutualization	25%
Sponsored demutualization	40
Merge another mutual in	75
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In conclusion, I think the dilemma that these mutuals face really is one of how to compete effectively. It's not one of capital. That's a secondary issue. In my mind, the framework for a solution is focus and specialization supported by joint ventures and alliances. Finally, I think demutualization is only appropriate for a few companies in this group. Some of them do already have a niche and a way to compete and are looking for capital to grow because they have realistic opportunities to grow, or because their asset condition is so weak that they need some immediate help. In general, I don't see demutualization as being a solution for a large number of companies here.

MR. HUGH T. MCCORMICK: I'm going to try to respond from the legal point of view to some of the issues that were raised here by Dan and Keith. I'll approach some of these points from a regulatory and legal point of view, trying to emphasize where there might be interaction between the legal and regulatory community and an actuary.

From a merger point of view, I personally have been involved in some preliminary studies of mutual mergers and with some mergers that in fact did go through. We worked on one in which they got as far as the altar, and then they decided that no one could figure out who was going to run the company afterward. We saw one major mutual merger fall apart because the ages of the two CEOs were too close. From a practical point of view, the management issue really emerges as a huge impediment to a mutual merger. If you can get over the management and human resources issue, and if the merger makes sense from other points of view, you're a long way to getting it accomplished.

From a legal point of view, one of the primary issues that is going to come up is that of domicile. I would guess that most of the mutuals that are going to think about merging are going to be merging across state lines. We looked at one situation up in Connecticut with two Connecticut mutuals. That was lovely because Connecticut had no particular state law. You had to get special legislation to allow a merger of two mutuals in Connecticut, so you had to make up the law as you went along.

In other situations though, there will be merging across state lines, and the regulators of both states are going to have an enormous amount of interest in how the survivor company will be handling the policyholders of the policies that were written when the company was a domestic in their state. Some of the ideas that have been floated around have been, among other things, two closed blocks. Dan probably looked at some of these. I'm under the belief that there have been basically two closed blocks within the survivor company, which we'll talk a little more about later, within the survivor company so that you can preserve the dividend history and expectations of the two different mutuals in the surviving company.

Now, when Phoenix-Home merged, Phoenix was a Connecticut-domiciled company and Home was a New-York-domiciled life company. The New York Insurance Department took a strong interest in the treatment of, in particular, the Home's policyholders and they ended up forcing the reorganized, merged Phoenix Home Life Insurance Company to redomesticate to New York, so the company is now a New York domestic company. Although it's still headquartered, as I understand it, and most of the operations continue to be run out of Hartford, the company is a New York domestic.

The two issues in mergers that have emerged are (1) the human resources issues and (2) the redomestication and the treatment of the continuing dividend expectations of the policyholders of the two different companies. Downstream holding companies have been mentioned. Downstream holding companies as a means of raising capital have had a very mixed record over the years. From a legal and actuarial point of view, I suppose you should be able to look at a downstream holding-company situation and say, "Gee, there's value there. I can liquefy value for the benefit of the parent company. We can continue to write business on a pooling basis, perhaps more."

This is more a property and casualty concept than a life concept, the pooling concept, but it's certainly commonly done in the personal computer world. You can continue to write business through the mutual parent and the downstream holding company. You can still use the system, but you've sold off some of the value in the downstream company to the public and you raise capital that way.

But it has been troublesome from a number of points of view. The loss of control of the subsidiary has been troubling. A couple of years ago, State Mutual, with its relationship with Hanover Insurance, was public news, as there was some maneuvering over ownership of shares and control of the board of directors. That made it into *The Wall Street Journal* as a situation that caused some distress at the company. Also, there have been mixed market reactions to downstream holding companies. The Harleysville Insurance group has had great success with its downstream holding-company situation. Other companies have not done well. The market has not reacted to the stock particularly favorably and so the net result has been that, for all the effort and the trouble, the companies that have done the downstream company systems have not gotten the bang for the buck that they had in mind.

No one has mentioned surplus notes. You still see surplus notes mentioned in articles as recently as the last year or so as a capital-raising alternative. I've never been able to figure out how a surplus note as a capital-raising measure really works, because they're inherently temporary. They are very hard to sell because the repayment of a surplus note is subject to regulatory approvals, typically something very similar to the dividend limitations that apply to stock insurance companies. To pay interest and repay principal on a surplus note, you really are dependent upon the forbearance of the state regulator. I was involved a few years ago on behalf of a commercial bank in New York trying to sell some perpetual surplus notes for mutual companies in the overseas market. It was ultimately a nonstarter, because at the end of the day people would say, "Well, am I guaranteed repayment?" and the answer was, "No, you're not guaranteed repayment."

There have been efforts made during the past couple of years with the New York Insurance Department and with other insurance departments to bring some kind of a regime into place that would allow surplus notes to be at least predictable, except in really troubled circumstances, so that the market might be able to actually sell the surplus-type notes the Euro market. The last thing I've heard about the efforts with the New York Department is that people were interested, they had gotten close to some interesting ideas, and then it kind of slowed down and really has disappeared into demutualization as perhaps being a better way to raise capital, rightly or wrongly. The idea of a truly marketable surplus note is something that we're not going to see anytime in the near future.

There has been mention of exiting or buying lines of business through assumption reinsurance as a way of either freeing up capital or growing assets if you have capital and you want to grow the business for whatever reasons, including reduction of unit costs, if you have excess computer capacity, and whatnot. I'm beginning to see a fair amount of this. We work with some very strong mutual companies that are very actively looking to buy books of business and others that want to free up capital by selling books of business.

Assumption reinsurance, as I'm sure many of you are aware, involves a host of regulatory issues. An NAIC model assumption reinsurance bill is working its way through the NAIC, and the big issue with assumption reinsurance, or the primary problem, has been the concept of novation. How do you handle the policyholders? Do they agree? Can you get the ceding company off the legal risk on the book of business? The only way you traditionally can do it is with a novation. In essence, a novation is when the policyholders sign on the dotted line and say they understand that this book is being sold to Company B and they agree to have Company B be the obligor on the book of business. If you don't get that signature under traditional rules, you do not have a novation, and the ceding company stays liable on the book of business.

The NAIC model would go through this lengthy procedure of notice and noncomplaint and, right now, as it seems to be in draft form, there would be about a three-year term, after sending a couple of notices, of having the opportunity to object to the transfer. There would be a deemed novation of the business which would then, as I say, have the effect of fully transferring all of the risk from the ceding company to the assuming company.

The NAIC model bill sounds kind of cumbersome and difficult to work with. I've been involved in some assumption reinsurance transactions and my sense from a lawyer's point of view is that it would be difficult because of all the mailings that are required. I'm an Equitable policyholder and I never open my mail either.

MR. MCCARTHY: You wrote some of that stuff.

MR. MCCORMICK: Yes, I know I did. I actually did open it. It was really boring. Actually, strictly speaking, I was an Equitable Variable Life Insurance Company policyholder and I got the letter saying that I was not going to share in the consideration and I never opened anything after that.

Just to go back a step here, the one other thing that Keith mentioned that kind of piqued my interest was the joint venture idea. I have gotten some inquiries on different types of joint ventures between life insurance companies and life and health insurance operations.

One of the inquiries that we've gotten recently and we spent a little bit of time looking into is the idea of doing true coinsurance. Interestingly enough, although it uses a very common word, it's not such a common concept. Two companies would write policies and be true coinsurers, unlike the standard coinsurance that you're familiar with, the modco or regular coinsurance. This would be a situation in which the two companies would actually be jointly liable on a book of business.

I guess there are a couple of theories. One would be sharing of cost and sharing of marketing forces and perhaps reducing the cost of putting the business on the books. The real point is from the marketing side. What you're selling to the policyholder is that you're not just buying from XYZ Life Insurance Company. You're buying from ABC and XYZ and you have the combined strength of those two companies behind your policy. It's an intriguing idea. A couple of companies have come to us recently to talk about it. At the same time, I've begun to see some articles in *Best's Review* and other magazines written about this concept. It's something that needs to be thought about.

I don't know if regulatory authorities have actually been asked to review any of these concepts. Frankly, I don't see why a regulator would be terribly concerned. I think this would be a positive development, but one has to be a little bit careful before one tries to guess how regulators are going to react to things that I think are great ideas. They don't always agree.

We're also getting some inquiries on joint ventures in the health area. We're all watching what's going on in Washington, but we don't know what health insurance will look like in six months, or in a year, or a year and a half. But we are talking to some people who are thinking about different kinds of joint-venture operations to preserve a presence in the health market while things change. People are talking to HMOs and not just about setting up their own HMOs, which are enormously expensive propositions. There have been discussions between insurance companies with some health insurance experience and HMOs, thinking how there can be a profitable melding of those two types of business and those two skills and marketing systems and so forth in a way that would be mutually profitable for both sides.

Let me touch on demutualization. Dan McCarthy and I have been involved, in the last couple of years, in two very sizable demutualizations. There are some unannounced demutualizations coming down the road, and I'm not at liberty to mention any names, but some are getting ready to get started. I thought I'd talk about some of the issues that have risen in demutualizations in which the regulators have raised a particular concern about the process and how it is that the actuaries and the lawyers can resolve the issues that the regulators have raised to bring a plan to fruition.

The general requirement of most of the state laws on demutualization is that the plan be fair and equitable. The New York law, which not surprisingly is the most specific of all, basically provides that the reorganization of a mutual life insurance company must be in the best interests of the company and its policyholders, must be fair and equitable to its policyholders, must provide for the enhancement of operations of the demutualized insurer, and must not substantially lessen competition in any line of business.

The actuary and the lawyer together have a very important role in meeting the standard that the plan be fair and equitable. These are three kinds of determinations on which the lawyer and the actuary work together. Who is entitled to receive compensation? What aggregate amount of compensation must be paid out to the policyholders of the reorganizing company? In what form is the compensation to be allocated among the policyholders who are entitled to receive? There are the aggregate policyholders, but then you have to divvy it up and consider the individual policyholders.

As a general matter, and as I'm sure you are well aware, all policyholders of a mutual life insurance company are members of the mutual. As members of the mutual, they have certain rights, which typically are the right to vote and the right to receive distributions of surplus in the fairly unlikely event that the mutual life insurance company liquidates. This consideration that is distributed in a reorganization of a mutual life company basically is issued as compensation for those rights.

In the Equitable and in the UNUM demutualization, the policyholders were given some shares for their voting interests, for their basic interests in the membership, and they were also given variable shares which, in both cases, amounted to some substantial amounts of money distributed to policyholders. The variable piece of the distribution was based on the contribution of different policyholders to the value of the company, to the surplus of the company, or to the distribution value of the company. This is very much an actuary's province to determine the contributions, the past contributions to surplus, the future contributions to surplus. As a matter of fact, this is the point at which the actuary figures it out and then dictates to the lawyer how to write it and we just kind of scribble. We revert to our traditional role as scribbler, because most of the time we don't understand what's being said, but we know it has to be put down in some kind of a legal document.

How much consideration that has to be handed out is an issue that has raised a fair amount of concern in demutualizations over the years. In the UNUM demutualization in 1986, the Maine statute started out by appearing to say that the policyholders were entitled to a distribution of statutory surplus. The Maine superintendent at the time decided that the statutory surplus was only kind of an opening bid, that the law said at least statutory surplus. After a couple of years of fairly detailed and difficult work with the department and with others in the UNUM demutualization, the aggregate amount of value that was handed out to the policyholders was something more in the nature of GAAP surplus, which was roughly double the statutory surplus. Therefore, it was double what the company thought it was going to be handing out in the form of stock. This obviously depleted the value that could be sold into the market in an initial public offering, so it lowered the (expected) amount; although, in retrospect, it doesn't seem to have mattered much, because it raised more money than it ever knew what to do with anyway.

In the Equitable situation, the consideration that was to be handed out was done in the form of shares of stock and then the market value of the shares of stock. This is because of difficulties with a company of that nature. It was just considered to be virtually impossible to fairly appraise the value of the company and to figure out the value of the company to be handed out to policyholders on an appraisal basis. I think it was considered for a period of time and then it was decided that it wasn't feasible.

About eight of the state statutes, incidentally, do provide specifically for appraisals of the company by actuaries, and that's the basis on which a determination of value to be handed out to policyholders is made. For those of you who are in actuarial firms, if demutualization happens, there's a lot of work that will be generated out there in those states doing appraisals.

Actuaries and lawyers spend a lot of time together – and this, again, is when actuaries do the work and then dictate the words to the lawyers -- allocating between the different classes of policyholders, right down to individual policyholders or groups of policyholders. The law requires that the distributions be fair and equitable. Under the New York law, the distributions can be broken down by line of business and can take into account negative and positive contributions to the value of the company. Historically, the negative performance of a book of business can offset positive performance of related books of business, and you end up with net amounts.

It's an incredibly complex process. I watched, with some amazement, as Dan McCarthy and his colleagues went through and did the actuarial contribution memorandum. It was a lengthy and complex document, and I just shook my head periodically as I watched them do it. It came out basically well though, I guess. The plan passed the policyholder vote and was implemented, so it must have been done right.

The most difficult issue that's emerged of late in demutualizations is an issue that was a small issue. As a matter of fact, all of the life demutualizations have had some form of a protection for dividend expectations of participating policyholders. In each one of the prior demutualizations, a closed block kind of concept has been established to provide that the participating dividend-paying whole-life-type policies that were sold on a dividend illustration basis would not deprive the participating policyholders of their dividend expectations. The demutualization of the company results in new management and shareholders and profits to shareholders are needed.

The closed block, which was funded, was created and funded so that there would be assets that would provide for the continuation of the payment of dividends. New York has taken a fairly expansive view of the closed block and has recently, particularly in the Equitable transaction, taken the view that the closed block is really meant to cover not only the traditional, dividend-paying, whole-life participating policies, but rather is meant to cover any kind of participating policy. Under New York law, at least until very recently, any policy sold by a mutual company had to be, by law, participating, even though it was not truly a participating policy. It may have been an excess-interest accumulation policy.

There has been some movement toward the concept that the closed block really represents a continuation of the mutual company inside the stock company for basically the duration of the lives of any of the participating policyholders. It's kind of a troublesome concept. It was brought up in the Equitable transaction. The participating policies, the true par policies, as I call them, the dividend-paying policies, were put in a closed block, and then the par policies that were basically excess-interest-type contracts were put under basically a profit-spread limitation device that was devised by Dan McCarthy. There would always be the expectation on the part of the policyholders that they would share in the profits of the business over time and that the company would only be able to siphon off or use for corporate purposes only some of the profits of the excess-interest-type business.

This, from a lawyer's point of view, strikes me as a fairly expansive reading of the law. We argued strenuously with the Department on some of these issues. I think the concern for a company that's demutualizing in New York is that you just have to be aware that the closed block is going to be a major issue. It's going to be an enormously complex and troublesome issue for a conversion. The other problem, though, which has emerged under New York law is that New York under its statute reserves the right to comment on any demutualization that affects a company doing business or licensed in New York.

If, for example, you're a California mutual and you want to demutualize and you have everything all just nice and fine with the California Insurance Department, the New York Insurance Department can still come in and look at the terms of the plan and determine whether under New York standards it's fair and equitable. Again, this might raise this closed-block issue for a nondomestic company, and the Insurance Department might determine that, by New York standards, the plan isn't fair and equitable. At that point under the law, the New York Department would get in touch with the California Department, enter its comments, and so on and so forth.

The real hammer that it has over the company in my example would be the ability to yank the nondomestic company's license to write business in New York, which is a fairly onerous penalty and probably wouldn't be used readily. But that is ultimately the hammer that the Department has for this extraterritorial review of demutualization.

One other issue that has come up in the demutualization context that's worthy of some note and is of some interest to both lawyers and actuaries is the form of consideration. Typically, stock, cash, or in some cases and under New York law, a form of surplus note can be distributed as a consideration to policyholders. New York law also allows the distribution of policy credits or increased values on contracts or guaranteed dividends. We ran into an issue with the tax-qualified Section 403 (b) contracts and IRA contracts being a significant, although not disproportionately large, part of Equitable's business.

Because of the application of certain technical tax rules prohibiting distributions from tax-sheltered annuities before the attainment of certain events, age 59-and-a-half and other events, and on a parallel line because of certain prohibited transaction rules applicable to individual retirement annuities, the IRS concluded that distribution of stock or cash to owners of either of these types of contracts would risk disqualifying the contract, which is a fairly horrible event. It means all the accumulated value would flow into taxable income, and there might be penalties, and so on and so forth. It's kind of a parade of horribles.

The Equitable requested a ruling from the IRS that would allow the company to distribute stock or cash to these policyholders. The IRS informally said, "Well, we're not going to give you that ruling and, by the way, if you forced us to give you a ruling, we'd probably rule negatively." In other words, it would disqualify the contracts. "We will, however, give you a positive ruling saying that distribution of policy credits is perfectly fine." In other words, it could just add the value of the distribution to that policyholder's tax-sheltered annuity or IRA cash-value accumulation and go off and everyone would be happy. That wasn't a taxable event, it didn't cause disqualification, and everyone was happy.

The fly in the ointment here is that, like distributions of cash in a demutualization, a distribution of a policy credit decapitalizes the company. You've increased your liabilities without increasing your assets, which means you buy the amount of policy credits that you're crediting to these policies. You're out there looking to raise capital, and all of a sudden, here it is. By the process of demutualization, you're depleting your capital. For a company with a significant book of 403(b) or IRA business (a company that I'm now involved with has one-third of its surplus tied up in these kinds of contracts), it's a fairly crippling concept if you're trying to demutualize for the purpose of raising capital.

It's an issue that we're wrestling with right at the present time. It has been my experience that mutual companies write a fair amount of the 403(b) business. I expect there are some fairly large mutual life companies out there for whom this issue would be a significant capital problem. I hope to be able to tell you next year, or Dan can tell you, what the solution is. We think we have some solutions, but at this point they're untried.

MR. MCCARTHY: I was going to comment on Hugh's comment on mergers. There's an issue in common, and yet there's a difference between the policyholder protection issues in mergers and the policyholder protection issues in demutualization. In some mergers you will, in fact, find a closed block kind of structure as you will in a demutualization. In fact, the one Sid's company was involved in was much of that type. In mergers of mutuals, particularly if they both have been operating true par business, there is often a long-term desire to get the two blocks of business ultimately onto one dividend formula. You recognize, however, that at the outset, they come from very different experience, and it's just not feasible to move them together.

In a number of mergers, there have been transition periods, typically five to ten years. The idea is that at the beginning, the structure of the two dividend formulas is retained separately, but over time, you gradually merge them together. For one thing, a new company will have one set of operating expenses. Ultimately, mortality experience may possibly come together over time. You'll ultimately have one investment portfolio, so it's not uncommon to see arrangements in which, after five or ten years, you try to merge the dividends.

Whereas, in a demutualization, the theory is you've now got to worry for the first time about this different owner, this collection of stockholders that was never there before, and it's appropriate to set something up to reassure the policyholders that the presence of that new owner won't cause them to be treated differently. So the arguments, I think, for a closed block are stronger in a demutualization than they are in a merger.