RECORD OF SOCIETY OF ACTUARIES
1994 VOL. 20 NO. 2

HOW CAN MUTUALS GET INTO THE CAPITAL-RAISING BUSINESS?

Moderator: DONALD F. BEHAN
Panelists: MATTHEW R. BEIZER*
NORRIS W. CLARK†
FRANCIS de REGNAUCOURT
Recorder: DONALD F. BEHAN

The acquisition of adequate capital continues to be a problem for most mutuals, and the problem will likely intensify in the future. This session will discuss the various ways a mutual company might attempt to access the capital markets and the various procedures and instruments that might be employed to acquired capital.

MR. DONALD F. BEHAN: Francis de Regnaucourt is a senior analyst with Moody's Investors Service. Francis is a Fellow of the Society of Actuaries, and is actually the only Society member on the panel. Francis has had a career in the insurance industry and in consulting in several countries. He is presently with Moody's and is involved in the evaluation of credit ratings for insurance companies and for the financial instruments that are being issued by insurance companies.

Matt Beizer is a vice president with Merrill Lynch in the Investment Banking Group. He specializes in services to insurance companies, and that involves both mergers and acquisitions for insurance companies and capital raising. He has been involved for a number of years with insurance company issues, including some of the major surplus-note issues that have taken place. He is very knowledgeable about this area. Before he joined Merrill Lynch, for a number of years, he was with the law firm of Simpson, Thatcher & Bartlett.

Norris Clark, the Deputy Commissioner of Insurance for the State of California, is also the chief of financial surveillance for the State of California Insurance Department. He has been with the insurance department for many years. He is active with the NAIC and is chairman of the Accounting Practices and Procedures Task Force for the NAIC. He is on the emerging issues working group, I believe it's called. He also was involved in writing the regulations governing surplus notes. So all three of the panelists are very knowledgeable about this subject.

There are a number of things that we can talk about. What do we mean by capital raising? Why do companies need to raise capital? What are the ways that it can be done? Some of the issues related to surplus notes have become quite popular during the last year or so. During that time, companies have raised approximately $4 billion worth of capital through the issuance of surplus notes.

---

*Mr. Beizer, not a member of the sponsoring organizations, is Vice President of Merrill Lynch in New York, NY.

†Mr. Clark, not a member of the sponsoring organizations, is Deputy Commissioner of the State of California Department of Insurance in Los Angeles, CA.

MR. MATTHEW R. BEIZER: There are a number of different elements of capital and capital raising, and I think we have to differentiate between them. Some of the questions are, is capital needed, where's the capital needed, and in what form? Is it equity capital? Is it debt capital? Is it capital at the mutual company? Is it capital at a downstream holding company, either debt or equity capital to be injected into a stock company? Or is it capital at a finance subsidiary? So I think that we need to differentiate that way. I think we also need to differentiate between whether we're talking about a capital number or a surplus number, surplus plus asset valuation reserve (AVR), or whether we're talking about risk-based capital (RBC), or whether we're talking about a company's long-term capital needs relative to its profitability and growth. The issues sometimes become a little bit fuzzy, in terms of precisely what we are addressing. It's helpful to distinguish between all of those, as we think about the issue. Some folks talk about things being short-term capital raising, and that is, in effect, a reallocation of earnings or profits going forward. They really don't add at all to a company's profitability stream.

MR. FRANCIS de REGNAUCOURT: Just from what Matt said in this short speech, I think you heard 12 definitions of capital. And all are perfectly valid ones. So in the overall spectrum of things, you can go from short-term bank lending that gets you over the year end, when you don't want to have a negative cash balance, all the way to pure policyowners' surplus, where it's money that you've made over the years. And along this stream is short-term and medium-term debt, ten-year debt, 30-year debt, and maybe preferred stock for those of you who can issue stock. Surplus notes fit somewhere in between. At Moody's, we know that the regulators will give them the treatment of equity capital. We know they're deeply subordinated. They come behind every other obligation of the organization, certainly behind all indebtedness, and behind all policyholder claims. The payments, both interest and principal, are subject to regulatory approval. So all that has the effect of moving them down the scale toward equity. But we do rate them, by and large, as debt, because they have debt-like characteristics. They are a fixed obligation; whether it's ten years, 30 years, or even, in some cases, 50 years. So viewed that way, it's partway down the spectrum, not quite to the level of equity, but about as close to equity as anything gets that has coupon payments and principal payments.

MR. BEHAN: So Francis, when you're saying you rate them as debt, when you look at the instruments, that are being traded, you look at them as debt. What about when you rate a company that has issued one of these things?

MR. de REGNAUCOURT: When you look at a company that has, in effect, issued debt, you start to look at leverage. Because when you issue debt, you've taken on leverage. And that's one of the things we look at in companies that have issued debt. Certainly we give them debt ratings. We look at coverage ratios. For the large majority of large mutual insurance companies, coverage ratios are so high, it becomes almost immaterial. But, debt is, for the most part, what we treat it as. And, as Don says, turning the mirror around, if you now look at the financial strength of an insurance company that has issued surplus notes, when you evaluate that company you look at what is, in effect, a fixed-debt burden. You overlay that on all the other considerations that go into a financial-strength rating.

MR. BEHAN: Norris, how do you feel about the need for companies to raise capital? Are there any characteristics among the mutuals that you might look at that would indicate whether they need to get into capital raising?

MR. NORRIS W. CLARK: I guess I would look at what's happened during the last year. As an example, the mutuals that have been involved in the capital raising, are probably those that had the least need to raise it. In preparation for this session, I just happened to go through the list of life companies licensed in California. Seven of the ten largest, by any measure, are mutuals. And about half of those went to the capital markets during the last year to sell their surplus notes. A summary of the reasons has been listed and was given in a presentation that was made to the emerging issues group in December 1993 by Alan Routhenstein of Merrill Lynch. It's kind of an interesting summary of why they believe they needed capital.

It said, "For most of the past three decades, mutual life insurance companies have been net generators of capital. In the past few years, management of a number of those mutuals have focused on capital adequacy for a number of reasons, including the following." And this would be his list of why companies think they need capital. First is "the effects of asset problems, particularly related to real estate assets." So he believed that companies are looking to correct some structural asset problems, which have cropped up into the economy during the last couple of years. Second is "a regulatory focus on capital adequacy through the RBC model acts and regulations." And third is "growth in insurance products, other than traditional whole life, that have lower profit margins or that generate a high level of initial surplus strain."

The third one, particularly, is interesting in my mind. It would seem that when you're going to the markets, telling them that you need capital because you're writing less profitable products than you have traditionally, it's sort of the antithesis of the reasons you would be able to generate capital. You hear many reasons for why you need capital. Those are three that are listed. The companies that have raised them probably could not identify the clear need or reason that they went to the capital markets, other than there was a window of opportunity. The interest rate environment was right. And they could do it. And their competitors were doing it.

MR. BEHAN: People here are with companies that presumably are still interested in the subject of raising capital. In the spirit of the experimental nature of this session, I guess I'd like to get some people to comment on why you are here. What do you see as a motivation to raise capital? Is it just because it's cheap? If that is the case, then I guess we would have had a different reaction three months ago than perhaps we would have right now. The surplus notes generally tend to be quite long—out to 50 years in some cases. If it was cheap last year, it's probably not nearly as cheap right now. The spreads went down for a while and are starting to go back up again. So are there reasons other than because it's cheap? I'd like to hear from some people from companies that either haven't done it yet or are thinking of doing it again.

FROM THE FLOOR: I have more of a question on the salability of the surplus notes, on how you're finding the investors to invest in them. Because of all the restrictions on them, it doesn't seem like a very good investment. The returns have been great on the life companies' side, at least. They've become a very inexpensive finance mechanism. But I'm amazed at the amount that's been sold, based on the restrictions. The other thing I'd like to ask is, what is the appetite in the P&C industry? For mutuals in that environment, obviously, the results are a lot more volatile than in the life industry. What does the market look like there?

MR. BEIZER: I guess that's probably a question for me. I would say that to characterize the market, about 80% of the surplus notes to date have been purchased by funds, by money managers, etc. About 20% have been purchased by insurance companies, either for the general account or, more typically, I think, for the separate accounts. Having said that, I think that one of the ways that you can tell market receptivity to the product has been how spreads have reacted during the course of approximately the year since this product was first issued. The Prudential is the first company that issued a surplus-note product. Now, as many of you know, and I'm not sure how familiar you all are with how these are structured, there is sort of the Prudential structure, and then there's every other surplus note offering. The Prudential structure effectively was a preapproval mechanism. Unless the company was really in extremis, there was no reason that the company couldn't continue paying interest payments without any approval mechanism in effect by the state regulator.

In any event, the Prudential spread was 112 basis points over the treasuries at that point. That was a ten-year instrument. Very quickly and very dramatically, after that, the spreads narrowed to, at its most narrow, approximately 73 or so basis points on the bid side, and that's typical. And for the Met Life transaction, which was the second of these, you saw a narrowing of spreads also. And in effect, what happened was, as the market for these broadened and as investors got more used to the product and were comfortable with the payment restrictions, the spreads tended to narrow significantly. Now with interest rates ticking up dramatically, and not only in terms of the rise in the rates, but also volatility, or at least perceived volatility of the rates, those spreads have widened again, typically by on the order of 20-30 basis points over the course of time. But overall we found that there is a market for surplus notes, and that there are investors who are prepared to buy them, because of or despite what can be perceived as relatively narrow spreads. I think some of that was perception that the initial offerings were at wider spreads than they should be, so there was some arbitrage there.

Let me answer the second question with respect to the property/casualty companies. Of the 13 surplus-note offerings that have been brought to date, 11 of them have been on the life side. Two of them, Nationwide and Farmers Group, have been on the property/casualty side. Part of this was timing, and I think part of it is that issues relating to the P&C companies are different from the life companies in terms of exposure to catastrophes and a whole host of issues that apply to the property and casualty (P&C) companies. Also there is a sense among investors, I think, that these companies, from a credit perspective, may be a bit harder to understand and are somewhat more volatile. These transactions were priced at a higher spread to treasuries than I think a comparably rated life company would have been, in part because of the perceived risks associated with that type of company.

FROM THE FLOOR: Wasn't the Farmers Group issue also reduced a little bit, from $400 to $300 million?

MR. BEIZER: To $300 million, yes.

FROM THE FLOOR: Was that because of demand? Or because of the spread?

MR. BEIZER: We weren't involved in that transaction so it's hard for me to really comment.

FROM THE FLOOR: I will make a couple of comments on this, first, as to, in our case, why we did it. It was not primarily because it was cheap. It turned out to be much cheaper when we actually did it than we thought it would be when we decided to do it. It was a combination of things, partially driven by RBC ratios, where it appears to, at least fairly clearly, count. But it was not so clear what the impact of RBC ratios in the public mind was going to be. And we frankly wanted ours to be higher than it was before we did the transaction. That was one piece, as well as just general concern that as a mutual you have limited opportunities for access. There was definitely some chance that our growth would require capital going forward, even though it might not have right at this instant. Just in terms of who's buying, I think, the most common characteristics of the buyers, at least in our case, was that they had a total-return perspective. Our issue was 30 years, noncallable, and there just is not that much out there that's noncallable for 30 years, outside treasuries. So it's hard for a bond mutual fund, for example, that is doing some planning in terms of interest rate forecasting to buy something that'll appreciate when interest rates go down as much as an issue like ours would. And a number of the others were also noncallable for substantial periods of time.

MR. BEHAN: We were looking at some of the RBC ratios for some of the companies that did this. I don't remember any specific numbers, but, for a company that took its RBC ratio from, let's say, 380% to 410%, does that really make a difference?

FROM THE FLOOR: It's hard for me to relate to that.

FROM THE FLOOR: Ours went from about 160% to 185%. We thought that move was beneficial.

MR. BEHAN: That's before doubling?

FROM THE FLOOR: Right.

MR. DANIEL J. KUNESH: Let me preface my question for Norris with the statement that I'm in favor of surplus notes and anything that allows the industry to leverage itself positively from outside capital, particularly the mutuals. But representing the regulatory community, how can regulators justify surplus notes, given that Moody's considers it as debt. The IRS considers it debt. Accountants consider it debt under generally accepted accounting principles, and, in effect, it's nothing more than leveraging, creating capital out of future, leveraged profits.

MR. CLARK: Well there was certainly a lot of debate on what it was from the statutory perspective. And surplus notes have been around in some form or another for as long as I've been in insurance regulation, which is too long. But a real focus came when the feds started looking at the same issues you've just addressed. If everybody else calls it debt, how it can be surplus or capital for an insurance company?

Strong arguments were made by the industry and by regulators as to why it was a suitable mechanism to be considered surplus. There were constraints that could be placed on it to make it almost, as some regulators would say, better than common stock. The accounting rules were drafted with that in mind, basically tying this up totally so that it was at the discretion of the insurance regulator whether you could make any payments on it. That's what the accounting rules now require. There are no sets of conditions that are prescribed beforehand to meet the payment. At the time the company is going to make a payment, it's analyzed and the company decides whether it can repay, just as it would if it were going to pay a dividend on common stock. Therein, I guess, lies the justification. There's a feeling that because it's totally subject to regulatory control, it's as good as common stock.

MR. MELVILLE J. YOUNG: I'll ask sort of a mirror question of Francis. If we had two different companies that we were looking at, and one of them had a block of business that had a fairly solid future earnings stream, and another one didn't, and the one that had the fairly solid future earnings stream was able to capitalize some of that, be it reinsurance or surplus notes, it would seem to me that it would be fair to let the company that's got the future earning stream recognize that in some way. And either reinsurance or surplus notes seem to accomplish that. Why doesn't Moody's recognize that?

MR. de REGNAUCOURT: I'd argue with you, Mel, that we do. We recognize it and give it weight. You might not like the direction of the weight. There's capital and I stick my arms out to show you there's a great big spectrum of it. And we do look at quality of capital. We talked about surplus notes earlier, and we mentioned some of its equitylike characteristics and some of its debtlike characteristics. We came down on the side of giving it debt coverage and giving it debt ratings. We've also in the past talked a lot about reinsurance, specifically financial reinsurance. Let's get away from just the operating reinsurance for people who go over their retention limits. We have, in the past, mentioned in companies ratings, as we looked at their capital, that part of the capital was based on financial reinsurance. And we published that in our statistics. If you look at the overall quality of capital, it is of a lesser quality than entirely unallocated surplus. We're not required to put a rating specifically on a reinsurance transaction, so we don't have to isolate it the way we have to isolate the effect of a surplus note, when we rate it specifically. As you know, a rating decision is the weighing of many things. New money coming in the door from the outside is a stone on the positive side. Taking on debt and fixed commitments in the future is a stone on the negative side. When you do a reinsurance transaction, you have a good block of business, if somebody is willing to reinsure. That's a stone on the positive side. But when you hypothecate many of those profits in the future, that's a stone on the negative side. The fact that you were able to make that line in your NAIC blank that says surplus look higher with that financial reinsurance is a mild positive. But it's mainly a cosmetic one.

As I think everyone knows, you can make life insurance company financial statements say just about anything. And that's why there's a whole business out there in going beyond those books and trying to put an opinion about the financial strength of that company in one little combination of letters and numbers, going through all that. Our job, we believe, is just to go through all that. If it's reinsurance, what does it achieve that's good? Was the company really financially better off than before? If risk was truly transferred, it probably was. If there was absolutely no risk transfer, I must tell you something. That company looks the same to me before as after the transaction. This is all a long-winded way to say that reinsurance gets looked at in the quality of capital just like surplus notes get looked at in the quality of capital. And we try to fit it in the spectrum. Two different companies will get a very different fit, based on all the other things that they do or don't do.

MR. YOUNG: I just would urge you, Francis, to take a look at some of the fine work that Norris and some of the other regulators have done to make sure that some of the reinsurance transactions that you're calling financial don't happen.

MR. de REGNAUCOURT: That's a fair statement.

MR. BEHAN: Norris, do you want to comment on the reinsurance transactions that aren't happening anymore?

MR. CLARK: Well, what's been alluded to is that the quality of surplus-relief reinsurance has, to those companies that follow the rules, been upgraded substantially during the last ten years. There was a great deal of emphasis placed, particularly in the late 1980s, on developing rules whereby there had to be clear evidence of risk transfer for surplus relief to be reflected on the balance sheet. In conjunction with that, there were also requirements for accounting that changed the way in which reinsurance could generate actual earnings to insurance companies. Therefore, we attempt to catch those companies that aren't following the rules. We look at reinsurance extensively in all of the analysis we do of companies. If it ends up being reflected and has been reviewed, we believe that it has created some permanent benefits to the insurance company.

MR. BEHAN: Would anybody want to comment on whether this is the first step of a number of steps that you might be taking to raise capital in the marketplace? What would draw you to this session if you've already raised a significant amount of money from the sale of surplus notes? Does anybody want to comment on that?

For those of you who have already sold surplus notes, are you still looking for creative ideas for generating capital? Maybe some of you can raise your hands if you are still looking for ways to increase capital through transactions of some kind?

MR. MATTHEW J. SHERWOOD: My question is not directed to the exact issue you were mentioning, but it's related: was 1993 the banner year? Or if it's going to happen from here on in, perhaps the surplus notes might have a variable interest rate. That was my major issue. Might there be a variable interest rate surplus note?

MR. BEIZER: Not surprisingly, those of us in the investment banking community have been thinking up new and exciting ideas for surplus notes. For example, one of the thoughts that we had was the idea of doing a zero-coupon surplus note, interestingly enough. It might be of more comfort and less concern for both the regulators and rating agencies. Now, sure, we've talked about variable-rate surplus notes with the rise in interest rates and the uncertainty relating to where the debt markets are right now. There's something of a hiatus in the surplus-note world right now. But we are talking to some folks and thinking about some other wrinkles on surplus notes.

One idea that we think may have some merit, and that we've been kicking around, is the idea of a surplus note with characteristics of a perpetual stock. It's perpetual, first of all. The payments on a semiannual basis or what have you would be approved both by the board and by the regulator. If there's a failure to pay those, there would be no default, but the investors would have the opportunity to place folks on the board. Interestingly enough, our thought from Merrill Lynch's perspective, is that perhaps there would be a retail interest in that. We do a large amount of perpetual preferred stock that we place on a retail basis, and that would bring a tremendous marketing force to bear. Now there are obviously a number of issues that we're thinking about and dealing with internally, but the thought there would be to take a perpetual preferred instrument and fit it within the rubric of the surplus notes.

So there are a number of things that we're talking about, but frankly, the Met Life type of transaction has been the way that all companies have gone. The issues have been, is it 10 years? Is it 30 years? Is it 30 years noncall ten? Can we do 50 years? One company did do a tranche that was a 50-year noncall 20. But typically companies have used the sort of plain vanilla duplicate of the Met Life offering circular.

MR. BEHAN: How many of you are familiar with Section 144A securities? Maybe it'll be worthwhile, when you're talking about retail, if you could just say a little bit more about the fact that these aren't retail.

MR. BEIZER: No, these are not retail. They're sold institutionally to, as I said, money managers, funds, etc. There are effectively, if you think about it, a number of ways that securities can be sold. They can be sold publicly, that is, registered with the SEC. They can be sold on a purely private basis, meaning that there is no after-market trading, in which the securities are sold to a typically very small group of investors. Or they can be sold via Section 144A. Section 144A is sort of a hybrid rule. It's a private-placement rule, but effectively, the way that it works is that it creates an aftermarket, and there are a number of very significant advantages to that. The securities are sold to qualified institutional buyers, that is, institutions that own or manage more than $100 million of assets. There's a simplified documentation procedure, whereby the disclosure approximates SEC-type disclosure, but you file on a statutory basis. You don't have the whole SEC process of filing the documents, receiving comments, and fighting with the SEC for some period of time. You don't have ongoing, quarterly disclosure obligations or 8K-type obligations. Also, I should add, one advantage to the 144A marketplace is that for a debt instrument, you don't have the same type of coverages that you would in a purely privately placed debt security.

There is also a broader investor base than a pure private-placement security, because there is an aftermarket of trading among the qualified institutional buyers for these securities. And as a result, the spreads tend to more closely be akin to publicly traded securities, rather than privately placed securities. And frankly, that's one of the reasons that the spreads here tend to be somewhat narrower than you might think. But all of the surplus note offerings to date have been 144A offerings. None have been publicly done. We've talked to one or two smaller mutuals about the idea of doing a purely privately placed surplus note. The problem there is that the costs are much more substantial, both in terms of the underwriting spread and the gross spread over treasuries. And you may have to deal there with covenants that would be problematic for the regulator and for the rating agency. So none of those have happened yet.

MR. BEHAN: Francis, in looking at these instruments, the surplus notes, and trying to attach a rating to those, would you deal with the fact that it's a 144A, in a different way from the way you would deal with one that was actually a retail type of deal?

MR. de REGNAUCOURT: On the face of it, no we would not deal with it differently. You really look at the nature of the debt. I cannot think of a circumstance in which we would rate something differently because of it. We specifically look at the covenants. What's really special in a surplus note is the fact that regulatory approval is required for each payment, and we spend time agonizing over that and asking ourselves what it means. I, in my rather short experience, can't think of where we would have rated that differently, based on how it was sold and to whom.

MR. BEHAN: I'd like to come back to the fact that some of these instruments might look a little different, depending on who is holding a particular instrument; in other words, somehow compounding of insurance risk or something along these lines. Would you want to comment on whether all the insurance companies should be going out and investing in surplus notes of other companies? Or how do you feel about that?

MR. CLARK: I don't think so. But there are provisions that are being developed for, as it turns out, the instruments that have been issued over the last year. Specific valuation standards have been developed and, I believe, will be brought up for adoption next month by the NAIC. Insurance companies that hold these issues, depending upon asset-to-surplus ratios and size, can essentially carry the surplus notes as debt instruments, subject to the RBC and AVR factors for those. If those standards are not met, they end up being carried as a category-six bond, which is akin to common stock with similar factors.

I guess there's some question as to the mirroring of the accounting treatment, if we're looking at the issuer as creating capital or equity with these things, which is akin to stock, as I said earlier. Does it make sense to have somebody who is holding them account for them as if they were being held in a debt instrument? And that's something that needs to be, I think, looked into a little further.

MR. BEIZER: If I can just clarify, I'm not sure that everyone is aware of this, but the surplus notes working group has proposed a rule that effectively says if a surplus note is issued by a company with a surplus-to-assets ratio in excess of 5%, that's treated as an NAIC-2. And if it's less than 5%, in terms of surplus to assets, it is treated as an NAIC-6. So that, I think, is a draconian measure. On one hand is the issue of, is it debt or is it equity? And obviously, the NAIC-6 treats it more like an equitylike instrument. On the other hand, it does seem, at least to us at Merrill, to be a Draconian treatment. First, looking at a surplus-to-assets test is, in a way, an antiquated test because it really isn't tied to RBC in any way. Second, it seems to be an arbitrary measure that, if you're at 5.001 it's treated as a two, and if you're at 4.999 it's treated as a six. And theoretically, that could change from quarter to quarter, depending on whether a company is close or whether it is right above the margin or right below the margin, I guess.

MR. BEHAN: So what if that starts pushing some insurance companies out of the market for buying these? How would you feel about that?

MR. CLARK: Well, I'm not sure how many of them are in the market right now. Matt might be a little more qualified to comment on that. But I suspect that there are not many, and they're waiting for the clarification of how they will be able to value these things.

MR. BEHAN: Well, I guess Matt is telling us that there is $600 or $700 million worth of these things that are owned by insurance companies.

MR. BEIZER: But I think much of that, though, is actually in separate accounts and is not in general accounts. There are also, as I understand it, at least some states whose regulators will not allow insurance companies to own them in the general account.

MR. BEHAN: I just checked some notes that I have on a 1967 tax case, *Union Mutual* vs. *the Commissioner*. That related to the ability, which was upheld in that case, of companies to take a deduction for the interest that they pay on the surplus notes. My point is that this goes back at least 30 years, recognizing that case probably didn't come up for some time after the notes were issued. So if we look at surplus notes, I don't know if this is something that was already brought up by somebody, is this a 1993 phenomenon? And given that there seems to be a lot of interest on the part of companies in raising capital, do we need to start looking for a different vehicle?

Maybe I could address one specific thing. If we started going to a public type of security, it sounds like a expensive process compared with the 144A process. We recognize that these companies are not currently reporting to the SEC, in some cases, at least. So they're going to have to go through that whole process. What kind of costs will there be?

MR. BEIZER: Presumably, another form of a security, be it a perpetual preferred security, what have you, could still be issued and sold under 144A. But the costs, in fact, are greater. There is an exemption in terms of allowing a mutual company to file under statutory statements, I think, for the first four or more months of the year. But be that as it may, there are ongoing quarterly requirements, 8K-type requirements, etc. So if a company files publicly, it does become subject to all of the reporting requirements of the SEC. And that's the reason that most companies have opted not to do that.

If it's a more retail-like security, though, intended for the retail mom-and-pop investor, then it would require public issuance and registration.

MR. JAMES F. REISKYTL: I want to go back to an earlier question. You said that most of the surplus notes, arguably, were for companies that didn't need the surplus, but they were cheap. If that, in fact, were the motivating factor, you'd think they would be doing a lot more of them. Obviously the market has shifted, but when the market is back in that range, presumably they would act again. But is there a limit on how many of these can be done by a company from your perspective? And what about small or medium-sized companies? Would the spreads be quite a bit different for them, because they are small or medium-sized? I'd like general comment on that. How do you look at this? Suppose it wasn't $300 or $400 million, but it was $1 or $2 billion. Would that make a difference?

MR. BEIZER: It's an interesting question, as to how large a surplus-note offering could actually be. I think the largest that's been done to date has really been the Metropolitan's. The Metropolitan did two tranches which, together, were $700 million. At that point, we thought that it could do a billion dollars. In today's market, that would be obviously much more difficult, given what's going on. To some extent, what you've seen in the surplus-note market has been that the companies that offered surplus notes initially were really high quality in terms of their ratings: Met Life, Mass Mutual, and New York Life, etc. What has started to happen, and what you'll see happening now, is that a number of the medium-sized mutuals are taking hard looks at doing the same thing, but offering sizes that are smaller, in the $50, $60, $70 million range. To answer another one of your questions, I discussed the maximum amount in terms of the market amount. But in terms of the total amount that a company can issue, it is really a function as much of how the regulators and Moody's and S&P view the company as it is of what we could sell. I think at this point, though, it would be unlikely for us to be able to do a billion-dollar offering based on today's market conditions.

MR. BEHAN: Francis, would a company have any benchmark to think about in terms of how much of this would be to its benefit? And beyond what point does it start raising questions of its own?

MR. de REGNAUCOURT: Well, we certainly don't operate on benchmarks. What happens when a company issues more debt compared with its equity is that it's leveraged. And leverage means that there is a multiplier effect on negative events; losses from real estate or losses from expenses or bad operations. There's a spectrum, and a company can issue as much or as little of this as it chooses, we hope for the right economic reasons, and we will usually give them an indication, when they come to us with a level, of whether it will affect the rating. There's no doubt that increased leverage increases downward pressure on a rating.

Now, for example, in every case that I can think of, no company has had its financial-strength rating lowered because it issued surplus notes. There was a little downward pressure because of the increased leverage, but not enough to make a notch difference. There's almost no doubt that if a company went from zero debt to equity to 1:1 debt to equity, there would be some severe downward pressure on that company's rating. If, however, when you throw in all the other stones that go into the balance, that company had such predictable and such stable earnings that leverage was deemed not to be a major problem, it could stay at the same rating level it was at before. If it's like most companies where it's not always that stable and predictable, when leverage does get high enough—and high enough is a case-by-case kind of a thing—it brings the rating down. But there are no benchmarks or rules. Companies must do what's right for them.

MR. BEHAN: So there's no benchmark, but it's somewhere between 0 and 50%, I guess?

MR. de REGNAUCOURT: Well 50 is extreme; that would have an effect on somebody's rating. And there's still a possibility that some companies and some businesses could take on a lot of leverage without a negative rating action.

MR. BEIZER: You may want to correct me if I'm mistaken, but I think Moody's and Standard & Poor's (S&P) take a slightly different approach toward surplus notes and the maximum amount of surplus notes that would be permissible for a company to issue. I'm going to fuzz up the numbers here, just to protect the innocent, but we were involved in a situation (I'm using fictitious numbers) in which S&P would have been prepared, for example, to allow a company to issue $300 million of surplus notes, and Moody's came in at effectively two-thirds of that. So I think that there is a slightly different approach between Moody's and S&P, in terms of how equitylike they view this instrument. We've heard from S&P that a typical benchmark is something like 15% of total adjusted capital, as a rule of thumb, plus or minus, as a maximum. And most of the surplus-note offerings to date have actually been below that.

MR. BEHAN: Actually, I think that same benchmark was mentioned at the Orlando meeting by an individual from S&P. So that's safe.

MR. de REGNAUCOURT: What Matt said is true. Different rating agencies look at things in different ways. It's not like it's all one block and they're all the same. What I wish to correct is the words *permissible* or *allowed*. The role of a rating agency is not to be a regulator or to tell companies what they can and can't do. The rating agencies do not work for the insurers, they work for the investors. They are, in effect, the press. They express an opinion as to the financial strength of the company. If the company finds it in its best interest to issue surplus notes to the tune of 50%, that may just be one of the wisest things it ever did. On the other hand, Moody's, which expresses an opinion on credit, must say what it thinks about the credit of that company, with the leverage that's put in. And it will do so whether or not the company likes it.

But *allowing* or *permitting* are not really part of our role. We just express an opinion on creditworthiness.

MR. MARVIN D. FINEMAN: This session purportedly will cover many ways for mutuals to raise capital, and we've had heavy emphasis on surplus notes. Mel did mention reinsurance and another topic that I'll just throw out that hasn't been covered—demutualizing. It has been covered in great depth in some other sessions. One advantage that the surplus notes obviously have is that the control of the company remains with the current management, which might not happen in the event of a demutualization. Does anybody else have comments on other comparisons between demutualizing which creates equity that cannot be deemed anything other than equity and the issuing surplus notes?

MR. BEIZER: I think, obviously, that issuing surplus notes and demutualizing are about as different as night and day. The companies that could avail themselves of issuing surplus notes did so because it's vastly easier, simpler, less cumbersome, and less expensive than going through the demutualization process.

Having said that, and thinking about demutualizations, there are many reasons why many mutuals are, frankly, very hesitant to start on that course. It's not only the fact that it's expensive and time-consuming, but not all mutual companies are really ready to be public. There are issues, such as GAAP financials, that companies need to face. Also, a demutualization transaction in the absence of another type of offering, be it a common-stock offering or in Northwestern National's example it was a debt offering initially, is really surplus dissipating. We don't think of it that way, but it is, because in all of the experiences of public demutualizations, to date in the U.S. there has been a cash-out option. And there are enormous regulatory hurdles. To some extent, there's a question as to whether healthy mutual companies can demutualize in all states in the U.S.; not only because of what the statutes say, but also because of a sense of how the regulators approach the demutualization process, which can vary, as you know, from state to state.

Having said that, a number of companies are looking at demutualization. State Mutual is pursuing it. It has been announced publicly in an aggressive manner. Our sense is that of the companies that are looking at demutualization right now, many of them are not the big companies, but many of them tend to be the smaller or more medium-sized companies that really couldn't take advantage of the surplus notes phenomenon. They really think they need capital, both from a ratings perspective and to be able to compete effectively with companies that have much more available access to the equity markets, because they're stock companies and they want to be able to compete with the larger mutuals.

MR. de REGNAUCOURT: You have brought up a very good point, which I guess I haven't thought of much before. In most of my comments so far, I pointed to the direction that extra debt probably makes downward pressure on your rating. If, on the other hand, you increase equity through basically selling to new owners and getting some outside money, it brings about another whole issue, which is a ratings issue, and that is parentage. If you were to sell 100% of yourself to a very stable, old-line European life insurance company, with the stated strategy of having one-third of the operations in the U.S., that is one parentage concern. If you're publicly held, that's quite another parentage concern. And if you belong to Consolidated Consolidations Inc., which has a history of buying at least two companies a year, chewing them up, and spitting them out at a profit twice a year, that's another whole parentage concern, when your long-term financial strength is concerned. And the issue of control is something that must be taken into consideration. So other ways of raising capital may avoid some of the problems with debt and bring on other problems of their own.

MR. ANTHONY T. SPANO: Norris, last fall the NAIC adopted a valuation procedure for the surplus notes, in which, if the company has a ratio of surplus to assets of at least 5%, the note is valued at face value. If the company is below that, you go down gradually, until you reach a certain point where it's valued at zero. Now, with that as background, I was wondering what the rationale was for this latest proposal that you referred to, where you suddenly jumped from NAIC-2 to NAIC-6, depending upon whether you are over or below the 5% benchmark. Offhand, it would seem logical that you would go down gradually, that if the company is above 5%, you would classify it as two. Then if it's just a shade below five, you would go down to three, and then four, and then five, and so forth.

MR. CLARK: Well, not having participated in that group, I'm not sure I understand the rationale. Again, we talked about this a little earlier. There are some good arguments that could be made that you always treat a surplus note as an equity and mark to market. That would seem to balance the liability-surplus side, where we're counting it as equity. If we're counting an instrument as an equity, then how can we have somebody who holds it call it debt? Those thresholds that you've outlined and that were discussed earlier—this bright line, right here is a two, and right here is a six and is treated as an equity, and then maybe next year it's a two again—do not seem to make sense. And I think there's going to be some discussion of that in June 1994. That last change has not been adopted yet, and I think a number of issues have to be examined.

MR. BEHAN: We've talked about surplus notes, and we just briefly mentioned demutualization and reinsurance. What about monetization of various assets? Is that something that people in the audience are interested in? Would you like to hear about what has been done or could be done in terms of monetization? Is that really raising capital? Do you think that selling off various assets qualifies as raising capital?

MR. de REGNAUCOURT: If you actually take an asset and truly sell it, then chances are you've reduced your risk, especially if you're getting cash for it, leaving aside the profitability aspects of that. By reducing risk and adding to the cash, you've probably helped the company a bit. Here are some of the kinds of transactions we see, and this was real popular in the early 1980s. Companies would take equity real estate, such as their own home office buildings, which were held at very low values in their books, sell them to a subsidiary company, and turn right around and lease them back to themselves. Now they had subsidiaries that were worth the market value of the asset. I can tell you that we consider it our job to undo that transaction for the purpose of looking at the company's economic worth. The company is worth the same before the transaction as it is after the transaction. So the more artificial a transaction is, which just brings up that number of surplus on the NAIC blank, the less good it does to a company's ratings. But collateralizing troubled real estate can be a positive deal. You may or may not do well economically, based on the price you get. But if you look at the risk side of the balance that I was talking about, the goods and the bads, you can truly get some of the risky things out of the way and reduce your risk profile.

MR. CLARK: There have been a number of efforts during the last ten years to do exactly that: to monetize assets or to discount to present value a future earnings stream and sell it, bring it into earnings, and then pay it back over a payback period. We looked at sale of future revenues about three years ago, and after delving into the realities of those transactions, decided that they were not sales, but loans. Commission levelization, through a roundabout way, tried to create a deferred-acquisition cost asset. The types of reinsurance that we talked about earlier were essentially trying to do that in each of those instances and has not been allowed as surplus. We've looked through the transactions and the substance of the transactions and decided that they were simply loans or ways to circumvent the accounting practices. You basically have to determine if the earning process is complete. Are there any continuing requirements that an insurer is going to have to make to actually realize those gains? Or, after the payback period is over with, is the company going to be in a better financial condition than it would have been if it didn't do anything? And in almost all the instances that we were looking at, the decision was made at the end of the payback period that the company was in no better, and in perhaps worse, financial condition than it would have been if it hadn't entered into the transaction.

MR. BEHAN: What about selling stock in a subsidiary and sharing ownership of the subsidiary? There are, I guess, an infinite variety of transactions. And to some extent, we tend to focus on the negative ones, because they're the ones that you end up spending a lot of time looking at and trying to figure out what the substance is. But have you seen transactions that are a little more clear-cut, a company basically having created value somewhere, and getting part of its value out in the form of cash? Is that going on?

MR. BEIZER: Well sure, and certainly the last few years, in particular, has seen a wave of initial public offerings. I think in 1992-93, about $10 billion of capital was raised, just in initial public offerings, both for life insurance companies and for P&C companies. In terms of looking at the public offering market, the market tends to be either boom or bust for insurance companies. For example, in 1989 it was impossible to take any kind of an insurance company public. The markets have gotten, here in 1994, much choppier recently, with interest rates moving as they have, and with many funds holding more insurance paper now than they did a few years ago. And having said that, values have tended, both for P&C and for life insurance stocks, to have come down during the last four or five months. So it's our hope that you'll see a renewed effort to see offerings.

But in fact, many mutual companies need capital that own insurance subsidiaries and that own noninsurance subsidiaries. And one way for a company to avail itself of that capital is the public offering route. Frankly, not that many mutual companies have taken advantage of that opportunity recently. However, there are a number of ways to think about this and transactions to do. One particular advantage for a mutual company to make a subsidiary public is the opportunity to effectively mark the equity of that company up from the basis on which it's being held by the mutual to a market-value rate, less a discount that's typically negotiated with the standard valuation office (SVO). A number of companies have done this. State Mutual is an example; New England is another. And in fact, one interesting transaction for companies that we've thought of and talked to some folks about, is the idea that the company owning a subsidiary sell that for stock to a publicly traded company, and thereby be a majority or significant minority owner in a publicly traded entity. There are real advantages to that in terms of the value that capital can be carried at.

In fact, you can't just view these as negative transactions. There are good, solid, business reasons. They may make sense, particularly where there's a subsidiary that needs capital and needs to grow.

MR. BEHAN: Matt, you just mentioned a number of $10 billion. Is that in the insurance industry?

MR. BEIZER: Yes.

MR. BEHAN: So this isn't just mutual companies?

MR. BEIZER: This is not just mutuals.

MR. BEHAN: In other words, the $3 or $4 billion of surplus notes can't be compared with the $10 billion of initial public offering.

MR. BEIZER: No. The $4 billion was the amount of capital that was specifically raised by mutual insurance companies through surplus notes. The $10 billion is from the entire insurance industry raising capital through the form of initial public offerings during the last two years.

MR. de REGNAUCOURT: I won't say it's common, but it has happened for foreign companies. I can think of a specific example of a Canadian mutual company. It wanted to expand in the U.S., but it did not want to draw down its capital in its own domestic market. It wanted to keep a high capitalization. This particular company formed a U.S. subsidiary that then went and raised debt in this case, not equity, from which it intended to do some acquisitions. This was done through 1994 as the base of its U.S. expansion. And certainly, a number of Europeans, and most notably the Dutch, tend to have big U.S. holding companies which provide debt-raising capacities. They may, one day, issue equity to finance their U.S. expansion. So even mutuals, foreign mutuals mind you, will use capital raising as a way to finance expansion. I haven't seen much on the domestic side.

MS. DIANE WALLACE: I'm struck by all of the talented people here who either attempt to create innovative transactions or poke holes in such transactions that are essentially designed to recognize on the balance sheet the present value of future expected profits. And I wonder if that might more efficiently be accomplished by changing our accounting system to begin with. Or is that a dangerous statement, because so many people here, including myself, might be out of work? Certainly the accounting system could be changed to either have more realistic reserve valuation or deferred acquisition cost assets, as we do in GAAP, to accomplish the same end.

MR. CLARK: Well, as you well know, that has been discussed at length. The basic issue always comes up in looking at transactions. Are you doing something that is trying to circumvent an existing accounting or valuation practice? And if, in fact, there's true value associated with that transaction, then why are we requiring this subterfuge to be created to get around some practice? So that brings us to, should we look at the practice? Is the practice wrong? In almost every instance that I've talked about today, that's exactly the process that we followed, with the conclusion almost always being there's a needed conservatism in statutory accounting that does not allow the majority of regulators who are making the policy change their minds about the accounting practice. Again, the clear example is, why don't we recognize deferred acquisition costs as an asset? That takes care of many transactions and puts you out of business. That may be one reason to do it. But a consensus has not been reached that the accounting system is basically incorrect with respect to the statutory needs for conservatism.

MR. FINEMAN: I'd just like to add that you could probably simplify everyone's life if you adopted an accounting system that more nearly matched what is used by the business world and then concentrated on the amount of capital that you demand a company have to support that system. Put your conservatism into the determination of viable surplus, rather than into a line determination of the conservatism for every item in the statement. That's where you're generating a lot of wasted time on your part, having to vet all of these transactions.

MR. CLARK: I don't disagree with that personally, as much as some people might think. There's been a strong push, particularly by the industry and the accounting industry, to change the accounting system; by going to GAAP and looking at the things you're talking about. Make the adjustments in the totality. Don't get bogged down in focusing on every single asset and liability line. Last year there was a strong push to have a hearing to do exactly that, to get comment on changing the entire accounting system. Surprisingly, the technical people wanted to go ahead and have a full airing of the issues. Certain insurance commissioners didn't want to. Now we've come around full circle again, and I'm not sure what the results are going to be, but we are going to do that exact thing next month. We're going to have a hearing on whether we should look substantially to GAAP practices as a basis for the accounting system and make exceptions, as opposed to having our own stand-alone, wholly-developed statutory accounting principles system.

MR. DANIEL J. KUNETZ: I wanted to go back to a demutualization question or comment. I actually have two questions. One is for Francis. In the last 20 years, it's my understanding that the S&L industry has had approximately 1,000 demutualizations and raised capital of probably $16 or $17 billion. The state of Illinois is about to pass a law, I understand, that is structured around the federal law that permits demutualization of S&Ls of the thrift industry. This is very similar in the sense that it does not follow the philosophy that the policyholders are not only owners of their policies, but they own the company, lock, stock, and barrel in terms of capital and surplus and value in the company. The philosophy is that they have a right to nontransferable stock-redemption certificates or subscriptions, and they have a right to buy stock in the company. They have first right, but at the same time, management has the right to buy up to about 35%, and employees get up to 10%, or something like that. Francis, what has happened? What has your experience been? Have the ratings of such S&Ls gone up? Has it been a positive thing? Second, would people think differently if all the state laws were similar?

MR. de REGNAUCOURT: Dan, you've got me a little bit outside of my area of expertise. Moody's does rate S&Ls, but I'm not in that group. They've tended to not be rated real high, and the insurance companies, in particular, get rated much higher as I think correctly reflects their financial strengths. All I can say is, I've been personally involved in one as a subscriber, and I thought, boy, it's a good deal! If I were rating one of these, the part you said about management being able to buy that much would raise some alarm in my mind.

Put yourselves in a hypothetical situation, in which a medium-sized mutual were to be demutualized. You have a financial-strength rating, which is an opinion to the policyholders or to the contractholders of that company as to their chances of being paid in the future. You'd want to look very carefully at what protections are being built into what is usually called the closed book, for people who have contracts with that company now. Issues include things such as ownership in the future, which we touched on just a little while ago, particularly by management. But the single most important structural thing I'd want to look at is what will the rights of policyholders be under the new structure of the corporation? Dollars to doughnuts, we'll be faced with that at some point in the future.

MR. REISKYTL: As long as we're into guaranty funds, I am not interested in reducing the accounting standards for the industry, because I'm not very interested in bailing out everyone else. I suspect that could go for many other people here. I don't think the accounting system, frankly, has anything to do with this issue of capital. People could differ. That's really my second point. I don't care if it's GAAP; why do you need capital? And you've referred to that earlier. If it is because you have a basic problem with the business you're writing, your management, your investments, whatever it may be, that is one thing. Or do you have a temporary need because you want to expand into another country or expand your agency system? You would get totally different answers.

If it's the former, heaven help us if we weaken the accounting system. That will only exacerbate the problems. If it's the latter, there are temporary means of achieving these ends, and the advent of the surplus note surely creates a new opportunity to do this. So I think it has been said here many times, but to me the accounting system is not the boogeyman in this issue. The real issue is how well you are running your business. If you are running it well, presumably you have all the capital you need, unless you run into unusual temporary needs, and you have to decide how to meet them, either through reinsurance or these other mechanisms. I think, so often, in the issues that have been raised, companies are not in the best position, they're not strong enough, they don't have the fundamentals, and hence they have a problem.

I come back to Norris and say that I'm not here, as anyone might guess, to decide the issues of surplus notes. We're probably one of the few who are not sure they're cheap. And maybe we just have a strange sense of how we measure things, because many others think they are. But I wonder, along that line, have you given some thought to the fact that you're going to have to make annual decisions whether to approve the payment of interest, or will the NAIC, or someone? Do you wish to comment on how you will make that decision?

MR. CLARK: Well, I know the issue has come up recently; people were brainstorming as to the willingness of regulators to actually say no to an interest payment, if, in fact, they think the repercussions are a run on the bank. Initially, I thought that was an excellent point. Does that throw another factor into decision making that we hadn't considered? In reality, as much as some people don't think so, regulators are fairly rational people. And there's no thought that a commissioner was going to say, just for the heck of it, "I'm not letting them pay interest this month, just because I don't feel like it." So basically, in approving these, we've looked at them in very much the way that the people who are selling them and the investors who are buying them are looking at them. What is the probability that this company is going to be able to continually make its interest payments and ultimately pay its principal? Is it going to be able to have some nominal spread, so that it continues to grow its surplus over and above the interest payments and the cost associated with issuing them?

We're only going to stop interest payments if, in fact, there's a serious financial problem. And we're going to do that whether it's a surplus-note interest payment, a dividend, or any other sort of distribution to those other than the policyholders. So I don't really think, in the end, that's going to be a problem. You are going to stop payments when there is a problem, and you're going to have to deal with all of the ramifications of those financial problems in addition to the simple stopping of a payment.