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LIFE COMPANY SOLVENCY -- HAS THE INDUSTRY STABILIZED?

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Recorder: EDWARD P. MOHORIC

- Recent insolvencies -- are there similar situations waiting to be discovered?
- How meaningful are current financial statements?
- What do rating agencies say? And how much confidence is there in their ratings?
- The role of cash-flow testing, AVR/IMR, and risk-based capital formulas

MR. EDWARD P. MOHORIC: Over the last two years, as the industry has focused on Executive Life, there followed a succession of additional failures that I'm sure nobody anticipated: First Capital, Fidelity Bankers, Monarch, Kentucky Central, Guaranty Security, New Jersey Life, and others. The mutuals were not immune either; Mutual Benefit, of course, Fidelity Mutual later, and even the Blue Crosses -- with the failure of the West Virginia plan and speculations on other plans -- have not been immune to the solvency issue. Has the industry stabilized now? Well, Kentucky Central and Coastal States have been taken over just this year, and one company, American Integrity, was taken over just last week. If I tried to stereotype why we've had the rash of insolvencies in the last two years, I don't think I could stereotype them into one or two simple reasons. Was it junk bonds? Was it real estate? Was it aggressive reserving practice? That was definitely a contributor. Heavy surplus relief use? Aggressive pricing of products? Was it the press and the subsequent run on the banks? In some cases, that had a contributing impact.

The last two years have seen the emergence of two new forces in the life insurance industry. One is the importance of the rating agencies. They've become, in many people's minds, the real regulators of the industry. As a rating improves or declines, it can quickly turn sales on and off. The second event has been the oncoming impact of risk-based capital (RBC). It's not a perfect measure to be sure, but it has been a benchmark for regulators, and it's one that is sending the industry scurrying in search of capital.

We're privileged to have two distinguished speakers who are going to give us their views on solvency from the rating bureau perspective and from the capital-raising perspective. They'll tell us whether they believe the industry's stabilized and will give us their perceptions on what the future holds and, most importantly, what companies can do to remain solvent. Larry Brossman is chief operating officer of the insurance

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rating section of Duff & Phelps. He has 30 years of experience in the insurance industry, and he will discuss Duff & Phelps' rating practices, risk-based capital, and other items from the rating bureau's perspective.

David DeNunzio is managing director for insurance at CS First Boston. He will give us the investment banker's view of capital, capital raising, and where he sees the industry going.

MR. LARRY A. BROSSMAN: I'm going to cover six things: (1) I'm going to just basically do kind of a quick solvency review. Ed talked about some of them; essentially what happened, how we got here. (2) I'm going to briefly summarize the Duff & Phelps rating process. I believe most of you are familiar with the kind of process that Duff & Phelps and Standard & Poor's (S&P) and Moody's use. (3) I want to talk about the key issue facing the life insurance industry today, and that's real estate. (4) I want to spend a few minutes telling you how a rating agency views and uses RBC. (5) I want to tell you how to use ratings or basically what ratings are and what they aren't. (6) Finally, I want to conclude with some comments on the future of the life, health, and annuity industry, particularly with some comments regarding solvency.

Between 1983 and 1989, Baldwin-United, Mission, American Mutual, and Integrated Resources all became insolvent. They are not small companies. All except American Mutual were billion-dollar or multibillion-dollar failures. This demonstrated clearly that major insolvencies could occur in the life insurance industry today, and they created the impetus for a new rating system for insurance companies, a better predictive tool, if you please, because not a single one of them was predicted by the rating organizations or systems in place at that time. Baldwin United, a life and annuity company, failed in 1983 and took four years to work out. Mission, a billion-dollar property and casualty company, failed in 1987, and it's still being sorted out on the reinsurance side. American Mutual, a \$500 million property and casualty company, failed in 1989. And then Integrated Resources was taken over in 1989.

Certainly, one of the most troublesome years in the history of the life insurance industry was 1991. Executive Life of California, Executive Life of New Jersey, First Capital, Fidelity Bankers, Mutual Benefit, and Monarch – every single one of these large, multibillion-dollar corporations failed. The first four failed because of junk bonds. I'll have some comment on that later. The last two, Mutual Benefit and Monarch, were essentially real-estate-related-type failures. And if major insolvencies of this type had continued at that rate, I have little doubt in my own mind that we would have had some form of federal intervention. Obviously, this situation is different now. I will finish with some comments on how I view the future strength of the industry, but just so people don't get too idle, Fidelity Mutual was a billion-dollar mutual company that failed late in 1992, and again, as Ed said, we had another billion-dollar state takeover with Kentucky Central early in 1993.

Some people think that the issue for insurance companies with junk bonds and real estate is over; now that insurance companies have shifted away from these investments, everything's going to be fine. The junk bond investments and real estate were really ways of trying to solve the financial pressures that were facing the life insurance industry. Many of you are involved in pricing. You understand exactly what I'm saying. There are several trends that are influencing virtually everything

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that's going on in the life insurance industry today. I'm not going to comment on these trends in detail, but briefly they are:

1. The move away from traditional products,
2. more competition from other financial institutions,
3. lower profit margins (leading to surplus explosion),
4. new forms of structure and ownership,
5. new ways of raising capital (demutualization, leveraged buyout (LBO) transaction, securitization of assets),
6. the internationalization of the insurance business,
7. the move to insurance products with little or no risk and few guarantees (insurance companies essentially getting out of the insurance business),
8. excess capacity, and
9. rating agencies and their evaluation of insurance companies.

The point I want to make is that momentous changes are occurring in the life insurance industry today, and we need to look at the industry with a new mindset. It is not the same business that it was.

Now I have a brief comment to make on the Duff & Phelps rating process. Because of the concerns brought about by those failures we talked about, buyers of insurance, distributors of insurance and insurance companies encouraged Duff & Phelps and other SEC-approved national statistical rating organizations in the late 1980s to start or to develop a better predictive tool for the rating of insurance companies. Claims-paying-ability ratings was the result of that. This was not a new methodology, something that we created for insurance companies. Essentially we brought across the same methodology that Duff & Phelps has used for some 60 years in the rating of bonds and preferred stock. We use the term *financial strength rating* interchangeably with that of *claims-paying ability*. Claims-paying ability is an independent evaluation of an insurance company's ability to meet its future obligations under the contracts and products it sells. It is based on two kinds of future obligations: obligations under contracts already sold and obligations under contracts that may be sold. It is not a prediction that this is a good place to invest money or that the company itself will make money. It goes to the risk profile of the company's product. We have a 17-point rating scale. The first ten grades are what we call investment grade. This is the same type of scale we use to rate bonds and preferred stock. One of the reasons this kind of scale is helpful, and you can see some of the other organizations responding, is to get more differentiation in the rating scale. Our scale is exactly the same as S&P's. We intend our ratings to compare with S&P's. We do not norm our ratings to A.M. Best. We do not consider the methodology comparable or the rating scale comparable. We do norm to Moody's, which uses essentially the same scale except that Moody's uses 1s, 2s and 3s, instead of pluses and minuses, and uses little as within a delineation. The three scales are intended to compare and, frankly, that's one of the strengths that these scales bring to the process.

I'm not going to go over our rating procedure in detail, except to say that it is a combination quantitative-qualitative process. We have a list of things we ask for – some 12-15 items. On the property and casualty side, we send a team. We use insurance-experienced people in the process. We meet with them, if necessary, have

conference calls, or bring some of their people in to visit us. There is an appeal process, and ratings that become final are then published in the media. Once ratings are published, they are reviewed whenever a significant event occurs, but at least quarterly, and a full-scale review is conducted on an annual basis. We know that our process is working if, whenever a major development happens regarding an insurance company, we do not read about it first in *The Wall Street Journal* or *The New York Times*. If that happened, we would know the process is not working. The important point here is that our process is ongoing and continuous. In my opinion, you cannot evaluate or put a financial rating or predictive rating on an insurance company and rely on statutory data that you receive once a year. We have seen companies that have completely changed themselves or reconstituted themselves within a year. It is absolutely essential to use the combined process to have ratings that have predictive value.

Now I'd like to spend a minute or two talking to you about the most fundamental issue, the most troublesome issue from a rating agency standpoint in evaluating insurance companies today: real estate. The two things that gave the insurance industry trouble were junk bonds and real estate. And although the fall in the value of junk bonds did cause the failure of Executive Life, First Capital, and Fidelity Bankers, junk bonds are yesterday's issue. The rise in the market value of junk bonds allowed most insurance companies to liquidate their junk bonds at a gain, or at least only a small loss, and junk-bond holdings of most insurance companies today are now within reasonable limits. Had the less-than-investment-grade market not risen, we might very well have seen some other large insurance company failures and, again, significant pressure for federal intervention.

Real estate, however, is another matter. We have great concerns about a number of companies and how they're managing through the real estate situation. And when we say real estate for insurance companies, we're not talking about that little slice of 2.7% (see Chart 1), which is real estate either for investment purposes, or taken in lieu of foreclosure, or as a result of foreclosure. We're really talking about mortgage loans, and we're not talking about securitized government loans, or Ginnie Maes, or Fannie Maes, or collateralized mortgage obligation (CMOs), which are up in the government bond slice. We're talking about mortgages in that 22.9% slice that's there.

Now, how does Duff & Phelps evaluate real estate when we go in and visit a company? We try to judge four things.

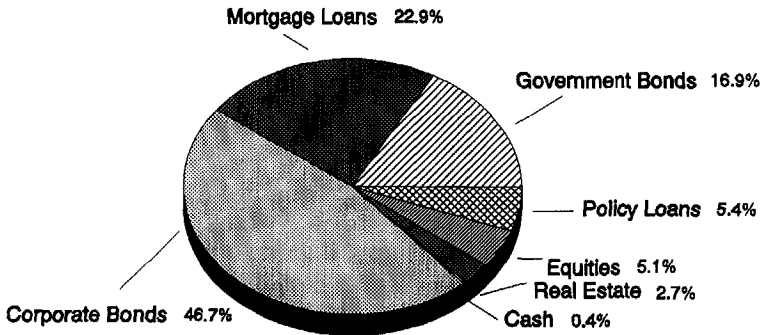
1. First, we're trying to judge the absolute size of the portfolio. If your company is somewhere in that 20-25% range, which puts you in an industry norm, then you will have a reasonable holding in the mortgage area. Many of the companies that are troubled in the mortgage area have portfolios that are reasonably healthy, but have numbers that are 40-45%, not 22-25%. So, first, we have to see what the absolute size of your problem is.
2. Then we look at the type and quality of your portfolio.
3. Then we look at the ability to manage a portfolio. There is no substitute in evaluation of management for sitting across the table and eyeballing people. I'm sure many of you agree with that. We try to judge two things: their ability to manage a healthy portfolio and their ability to manage a sick portfolio.

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And, frankly, we like companies where that's split. Sometimes the people who are in love with the security when they bought it tend to stay with it possibly longer than they should have.

4. We want to know what your future position is regarding mortgage and real estate investments.

CHART 1
Distribution of Life Company
Investments for the General Account



Source: American Council of Life Insurance Fact Book, 1991

When we try to evaluate the type and quality of your portfolio, we look at four things.

1. How is it put together? In the old days, when you put together a real estate portfolio, you never loaned more than 75% of the value. Some companies are taking that number even lower now.
2. Level of construction loans. When you made a loan, did something exist?
3. If you did many commercial loans (it could be office buildings or it could be shopping centers), did you have a series of leases in place?
4. Did you have diversification of fundamental principle, not only of investments, but also in the business that you write?

If a company has a normal sized portfolio and follows these rules, we will see a healthy insurance company portfolio. There might be some problem, some geographic things, but if all of these are observed, we should see a portfolio that the company can manage through. What we find now when we go in and look at insurance companies is that all of these rules have, in various degrees, been broken. At one time, you couldn't get into Houston unless you loaned 100% or 90% of market value because the inflation rate was so high. Construction loans were just started as a concept, and people who were trying to get a bigger piece of the action because of competitive pressures bought raw land, holes in the ground, erector sets, and see-through office buildings. In the old days, it was Sears on one end,

Bloomington's on the other, and now it's essentially Wal-Mart and forget everything else. We have seen people build office buildings with no expected commitment. Everyone knew there were certain sections of the country where real estate only went up, and that was in Texas, Phoenix, and Southern California. Of course, we know now, in the real estate market, those are all currently troubled areas.

So, to the extent that a company follows these rules, we should see a reasonably healthy company. The rating process is not a science. I wish it were. A lot of judgment is involved. But one of the most important things is to get good data. Fortunately, in real estate, we have one of the best sources of good data, and that is the ACLI. Table 1 shows commercial real estate numbers, which is really where the issue is. As many of you know, restructures were not always in there, because then you could dump them into restructures and get them out of the gross. The ACLI now has restructures in there and loans foreclosed during the year. This gives you a health picture on what's happening. We norm to this data. And if you look at 1988, 1989, and 1990, you see that it ranged from 6.89% to just under 7.96%. There is nothing to get alarmed about, but it almost doubled in 1991. And 1992 was a very critical year, with an increase of some 400 basis points. So, we have size of portfolio, quality, and then industry norms, and that's how we attempt to judge a real estate portfolio.

TABLE 1
Life Insurance Industry
Mortgage Loan Delinquencies & Foreclosures

As of	60-Day Delinquencies	Restructured Loans	Loan Foreclosed During Year	Total
12/31/92	6.62%	7.44%	3.22%	17.28%
12/31/91	5.93	5.09	2.16	13.18
12/31/90	3.62	2.92	1.42	7.96
12/31/89	2.47	2.73	1.15	6.35
12/31/88	2.74	2.62	1.53	6.89

Source: ACLI Reports

Now, let me comment on RBC. How is it viewed by Duff & Phelps as a rating agency? We're all looking for the single number or the single answer. It is my opinion that there is no single answer. And although there is a rule for RBC, I would like to make a few comments to you about this. It's just a tool from our standpoint. Other information is needed. More important to me are two things: Are you meeting your pricing assumptions in the product you're putting out? If you're not, tell me why not. The best single standard to use today as to whether that company will survive, not have bad publicity, or be subject to runs, is the company's ability to put profitable product out with reasonable retention. That's a better measure, and no one single number is going to tell you that. You do need to do the qualitative aspects of the business, but on the marketing side, you try to make a judgment. Do you care for me? Do you know what you're talking about and can I trust you? If you can prove those things, you can sell a person anything. We use the concepts in rating. And when we look at management, it's an important kind of thing. We believe that qualitative analysis and how they manage is important to the process.

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Appropriate use of RBC has always been a question. I have in front of me a letter dated July 31, 1992 signed by Bill McCartney, the NAIC President, and Terry Lennon of the New York Insurance Department. The letter says, "The formula, as previously stated, was not developed to be used for rating or by rating companies, and we hope it will not be used in that capacity either now or in the future."

In the case of Duff & Phelps, we go in and ask a company, "What is your RBC?" Some actuaries who still have religion about that before the 1993 returns are out will say, "I can't tell you, but it's within 220 and 235." I should tell you how we handle that. We have honored this request. If you look at the Duff & Phelps report, you will never see RBC published as a number, but we do ask for it, and I'll comment on other things that we ask for as well. So, we're interested in RBC.

Virtually all companies are over 100%. It went through true junior college grading, so now even the failing people are over 100%. In the case of Duff & Phelps, we have always been interested in how much capital you have and how you manage capital. What happens with RBC? The companies hide behind it now. They say RBC, we say, well, how do you manage capital? We're much more interested in how much capital you believe is adequate and whether all your capital is allocated. We go into companies where everybody's making money except they have half the capital. It's stuck up at the corporate level. Do you push it all down? And what after-tax return do you manage to? And what level of RBC and/or capital are you going to manage to in the future? That's what we always asked for, and that's what we're still asking for.

I'll make a few comments on RBC and how we see it developing in the future. We share in its inappropriate use as a rating standard. From our standpoint, RBC works only on the downside. If you're going to use 70% of RBC or some adjusted number as a warning benchmark, that will only give the department a chance to go in and pronounce somebody ill who's already dead. On the high side, it simply does not work, and that's where the danger is going to come in. These numbers will find their way into the *National Underwriter*. That's a fact. It's going to be out there. For anybody who thought you could have this and it would not get published, that was foolish from day one. It will be published, but it does not work on the high side. As a matter of fact, when RBC gets too high, it's counterproductive, from our standpoint, and will drop a rating. We're in the process of publishing a reduced rating on a company with 1,000% of RBC. Excess RBC carries another message and it's negative. So, there's a range. And obviously some of those things will be developing.

We have other concerns. Companies are going to be tempted to invest in more exotic securities and to take a C-3 or duration risk, and that's where the games will be played. Triple-A investments like CMOs and other things that have cost companies millions will become more common, because essentially they are hidden from RBC. I'm not sure you can ever come up with a single base number on asset/liability matching, and so we've been concerned about that. Also, we see companies making investment decisions. For instance, if they have large holdings in very successful investments, they're selling off essentially good investments just because they're afraid to hold them anymore. So, it's producing some negative actions in the marketplace, and that's important. Also, it may tend to encourage companies to use

less conservative reserving standards. Some people are changing their reserves because they need it in capital, because they believe RBC is going to become a marching order. And what's really concerning us is, what level of RBC are companies going to manage to? Because, as you know, from the pricing side, if you're carrying more capital than you need from a risk profile, it is going to impact the ability to get returns. Essentially, get a portfolio rate, and it will impact how you price your products, particularly if you got hurdle rates of 12% or 15% after-tax returns, which are what many of the good companies that we deal with require.

I want to tell you what our ratings are and what they are not, with some comments about both appropriate use and inappropriate use. The methodology that I've summarized for you, is, in my opinion, a good methodology. In my opinion, it's the only methodology, the combination of qualitative and quantitative. You cannot rely merely on quantitative data in the current environment. We have only two ratings published where we do not have a full contractual relationship with a client, and both those are in the process of current review. We hope not to have any, although we are committed to have coverage on all of the top 50 life, health, and annuity companies. We are currently missing only a handful. We'll do the 25 intercompany pools, and then we're going to do the international side. We'll do those on publicly available information if we have to, but we don't want to. We have never had a client take a rating from us and then cancel subsequently. We renew year by year on the contracts, and the contract provides that we must be told of any significant event, or the company is in violation of the contract. And that is the kind of relationship that produces effective ratings, in my opinion. It's a basis for cross-rating agency comparison. If you want to keep the federal government out of the insurance business, the two things that are the most important to see that does not happen are:

1. Improve the quality of state regulation. Have more and more insurance departments of the quality of New York and staff of the quality of Terry Lennon's.
2. Have in place a number of professional independent rating services that are capable of intensive evaluation of the financial strength of insurance companies and that publish ratings that have predictive value. No company rated A or better by Duff & Phelps has ever failed.

We're the only major rating agency that had a full-process rating on Executive Life and never had it out of the Triple B category. But we do consider Moody's and S&P's peers. I believe that your competition is not only insurance companies, but also banks and fidelity investments and investment bankers on Wall Street who are synthesizing almost every product you have. Those products also need to be rated. And we can rate those products by using the same methodology on the same rating scale. In the future, having a rating scale that works for cross-industry comparison is going to become very critical.

Our claims-paying ratings are frequently misunderstood. We have a service line. Anyone in the United States can call our service line, give us a company name, and we will give them what the rating is, and we will tell them what it means on our rating scale. If they want to buy a separate report, we sell them for \$25, although we prefer not to do it. We prefer they get them from the company, but we do it as a public accommodation and we get some very sad calls. People say, "I bought this

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long-term care product. Is this a good product to buy?" Our ratings do not tell you which company has the best product rate or feature. Nor do they tell you which company has the best client service or support. That's the role for the broker, the agent, the consultant, or the advisor. Some companies that have high claims-paying ability sell products that you wouldn't buy, sell, or recommend. They sell products with no guarantees, a low-risk profile in an unsophisticated market. That's not what we're rating. And that's frequently confused in the marketplace.

I want to conclude by giving you four predictions or comments as to the future of the life, health, and annuity business.

1. First, the life insurance industry is very strong as contrasted to other industries with which it competes. We see basically the life insurance industry as a double-A-type business. Next to the U.S. government, the life insurance industry is one of the safest places for people and companies to put their funds today. What do I mean by that? We estimate that some 85-90% of the cash flow coming into the life insurance industry today is coming into companies rated in the double-A range or higher. And by that, we mean double A minus or higher. If you look at the top 50 life, health, and annuity companies in the United States, 45 of them have a rating in the double-A category, be it double A minus or higher, from one of the SEC nationally approved statistical rating organizations. One has no ratings. The other four have at least an A plus rating. That is a picture of a very strong and a very healthy industry. We have never tried to sell ratings on the basis of scaring people about the business and the industry. We want to be a constructive force in the business and not a destructive one.
2. There are real differences among insurance companies and their financial strength and, in many cases, those differences are widening. This is the ability to make money in the business. Many of the companies that we've seen throughout this whole period have continued to make 12%, 15%, 18%, and 20% after tax through returns on fully allocated capital. Yet, if you look at the lowest quadrant of companies in this business, particularly mutual companies, you'll see that their returns are some 5% or less.
3. There will be an increasing need for better tools to evaluate the financial strength of insurance companies. And ratings are basically here to stay as more investments and tax-oriented insurance products are sold and competition intensifies.
4. There's going to be increasing need and demand for financial strength and insurance company ratings, and not one, but several ratings, for balance and perspective, and our ratings are one of those tools.

MR. DAVID A. DENUNZIO: I thought I would talk a little bit about the capital markets generally and their view of the life sector specifically. So, by definition then, we'll be focusing on the stock companies, but I think most of my comments will be applicable to the mutual sector as well.

You just heard Larry talk a little bit about the rating agency perspective on solvency. I think the equity capital markets are increasingly sophisticated in developing a point of view on this subject. From their perspective, in very simple terms, solvency is the ability to have enough assets to meet liabilities today and in the future. It's related to

the timetable to work out asset values. And traditionally the industry has focused on policyholder views (they're regulated that way), and the policyholder attributes to the solvency question in the sense of creating a run on the bank. But I'd submit to you that, indeed, short-term-oriented shareholders, and increasingly creditors as well, nonpolicyholder creditors, sometimes have been putting pressure on financial institutions, and we've seen it in the banks and we're now seeing it in the insurance sector, to recognize asset values at inappropriate times and, therefore, contribute to or exacerbate the problem. If you think about how you can improve solvency, obviously raising additional capital is one route, but the rate at which investors are going to capitalize earning streams is going to determine the marginal cost of that capital and, indeed, the availability of that. And one of the things that's gone on in this sort of SEC environment in which we find ourselves is that the sort of increasing income statement and balance sheet disclosure obligations that the people now have essentially put managements in a glass house. Analysts' opinions, and these are coming from analysts of two years ago, really couldn't tell you what percentage mortgage loans constituted.

To go back to Larry's pie chart of a company's portfolio (Chart 1), they can tell you what percentage in California of commercial mortgage loans are nonperforming and past sixty days due and so forth. But those opinions can now swing policyholder confidence in a very real way and result in increased or accelerated redemption of products. I think going forward, the capital markets are going to increase their degree of influence over future insolvencies.

The other thing I'd ask you to keep in mind as we talk about the capital markets is the connection with insurance stocks and interest rates. Insurance stocks are, and have been for a long time, considered interest-rate sensitive. Low interest rates are thought to serve to limit industry competition somewhat, as well as to contribute to increased book value through rising portfolio values. And, in contrast, higher interest rates are thought to lead to increased competitive pressures, as people believe the need to compete more on rate. So, let's go back in time and look at the markets during the last several years, as some of the more notable seizures have taken place. Chart 2 shows the 5-year and the 30-year treasury rate since the beginning of 1991, together with the timing of some of the more prominent seizures that Larry had talked about. (I would like to apologize now to those of you who are Canadians, because all my data is U.S. data.) You can see that the pace of the problem slowed down in 1992 as interest rates continued to move down. I'd be hesitant to draw a causal relationship here, but I think lower interest rates and some of the rising, high-yield values that Larry talked about bought the industry some time.

If you look now at the same data plotted against stock market performance in Chart 3, you can see, beginning in 1992, that the life companies began to significantly outperform the market. Most people don't realize that. Again, I don't think there's a cause-and-effect relationship here by any means, but I do believe that this improvement in valuations has given companies enormous breathing room and created a more favorable environment for them to raise capital. They may not have liked their prices either before or now, feeling that the stocks are undervalued, but nonetheless, they are coming to the market in very significant measure.

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CHART 2
Interest Rates and Life Seizures

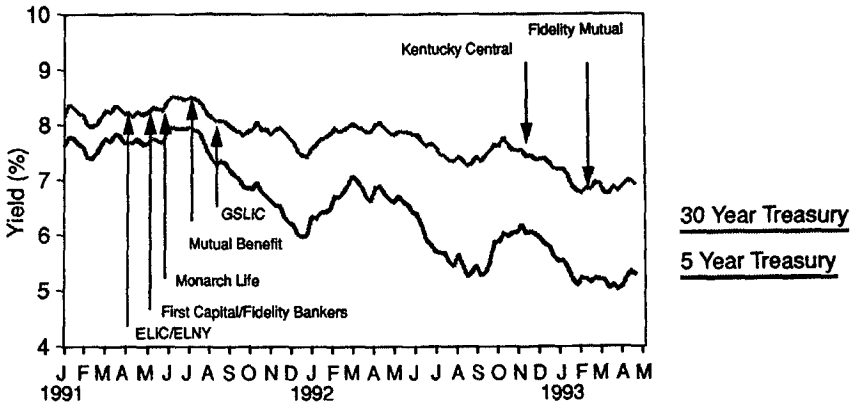
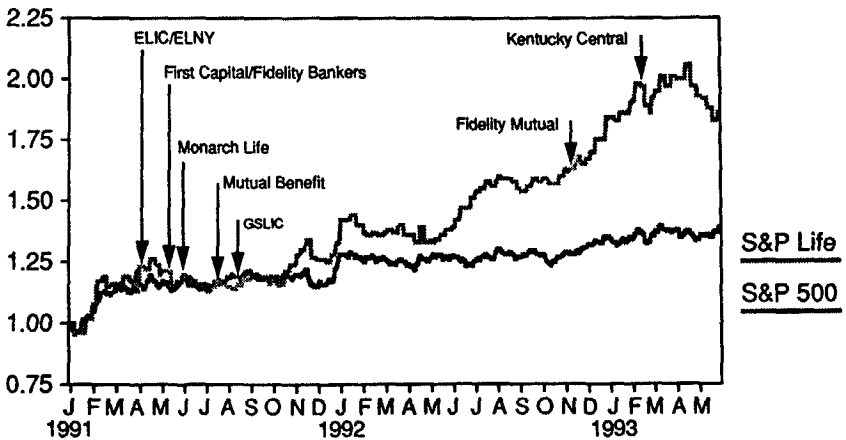


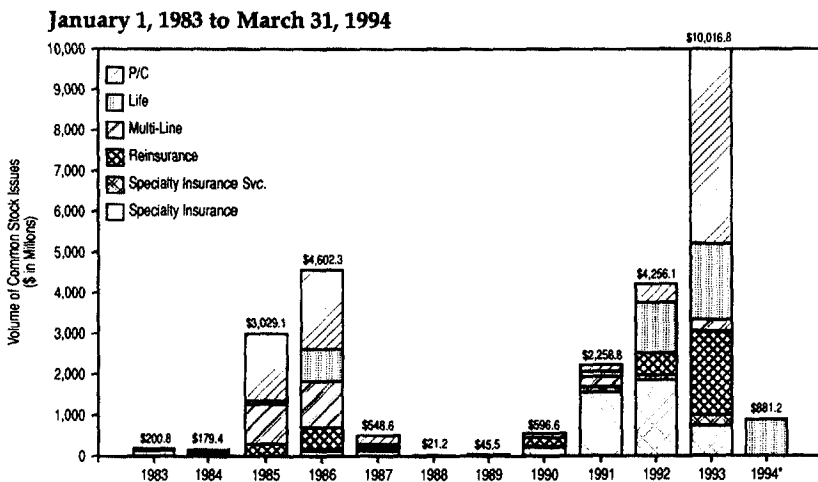
CHART 3
Stock Performance and Life Seizures



I would like to talk now about the industry's ability to raise capital from the new-issue market. Obviously, there are many ways to raise new capital at an operating-company level. In fact, to digress for a minute, a major problem in several of these failures was the fact that parent companies relied too heavily on debt financing to fund required capital downstream. There are a number of what I would call "social policy" questions here. Just as the SEC has started to regulate holding companies in the securities industry in the wake of Drexel's failure (because they couldn't roll over their commercial paper), it would not surprise me if there was increasing support for regulators to have much more control over insurance holding companies. And if you think about it, we regulate public utility holding companies. We regulate bank holding companies. We regulate security broker-dealer holding companies, but we don't regulate insurance holding companies. If I were in an industry like yours, that's something I would think about.

Back to capital though. Let's focus on new stock issuance. Chart 4 is a bar graph of new issuance activity in the insurance sector from 1980 to 1993. We're only measuring \$15 million or more, and this is just common stock (secluded convertible securities, surplus notes, things of that nature). One of the things you can see here is that we're at record levels, again, in the 1992-93 period. Allstate's recent \$2 billion transaction in 1993 is not on there. So, in 1993, we're already up over \$4 billion, and I think we're clearly going to set an industry record here in the next few weeks.

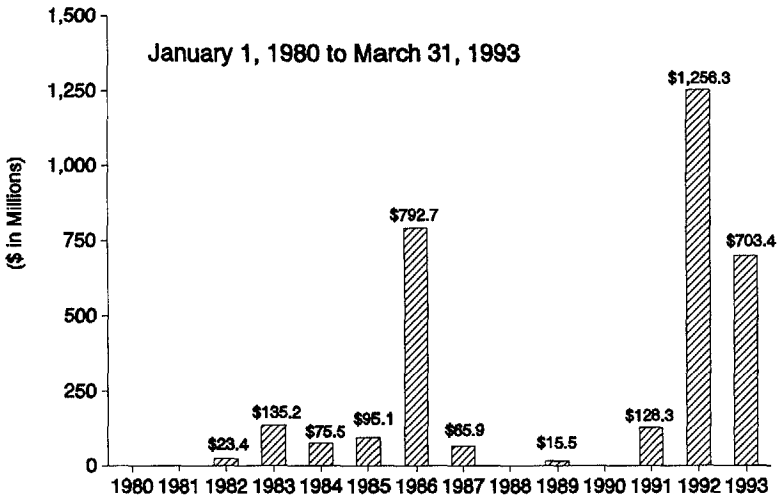
CHART 4
Volume of Insurance Common Stock Issues
(over \$15mm)



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If you just look at the life sector (Chart 5), you'll see that there are some years where there's no new issuance activity at all, and yet we are going to be at records levels in 1993. Why is that? What's driving that?

CHART 5
Volume of Life Insurance Common Stock Issues
(over \$15mm)



Well, obviously, people are taking advantage of those rising stock prices to reequitize their balance sheets. They all have a number of common characteristics that I think are very relevant for this audience. So, let's just spend a minute going through these.

1. First, most of them tend to be specialty companies in some way, shape, or form. Now, specialty can mean a number of things; either a focused product offering or a focused customer base as held through financial institutions, but as a general matter, these companies tend not to be all things to all people. They tend to focus on a specific niche and do that very well.
2. Control over distribution, perhaps not as much control as the capital markets might like to see, but whether it's a direct marketing organization, a captive sales force, or agent-owned reinsurance companies, there's a story to be told to the public in almost every case about that.
3. In addition, most can make a case on their cost structure, because the equity market, in particular, recognizes the importance of being a low-cost producer in the financial services sector as a whole, not just the insurance market, because the products tend to be somewhat commoditywide. That's one of the reasons that this sector sells at a discount.
4. They can all show reasonable growth prospects. The sector is clearly viewed as being mature. But, within it, there are companies and areas that are viewed as having a fair degree of innovation, that are able to take market share, particularly if you're a low-cost provider and you can control your

distribution and, therefore, can demonstrate reasonable, if not significant, growth opportunities. The sector does trade at a discount to the market. The degree of the discount, for those of you who don't follow it, would probably shock you. On the basis of 1994 earnings, the market's selling at about 17.5 times. The life insurance sector generally is about 11 times. So, you don't need to show wonderful growth. You just need to show reasonable growth.

5. Last, many of these companies are deleveraging, and they're seeking to reequitize their balance sheets, or they're solving asset-quality problems, whether it's junk bonds, or real estate, or what have you. And the market perceives the offering to provide a permanent fix.

There are some other things that I didn't include in this list, but I probably should have. The most important is what I call accounting clarity. Many insurance company managements, in our experience anyway, think statutory numbers first and GAAP second, if at all. The equity market, on the other hand, thinks GAAP, but does think about statutory. Top managements, particularly at the CEO level, who are facile at going back and forth between statutory numbers and GAAP numbers in their discussions with investors, are actually quite rare. One of the things that's happened in the last couple of years with this spurt of issuance activity is that investors are getting much smarter at insurance accounting, and that's made it necessary for the company managements to bring their own level up a little bit. If any of you have taken a look at the statistical supplements that a number of the stock companies publish now, some of them are getting to be very thick. All of these equity analysts are working with public information. It's a little bit different from the information Larry is dealing with.

I'm going to talk about demutualization, because I know it's a topic that many of you have thought about and probably continue to think about. The first question that we think about in terms of the capital market's aspects of demutualization is whether you should demutualize in the context of an initial public offering (IPO). Obviously, there's no generic answer to that. Demutualizations have been done without IPOs. They've certainly been done in the context of merger and acquisition transactions as well.

But let's assume that one of the reasons you are thinking about demutualization is that you want to go public and have direct access to the equity capital markets. You then need to think about the so-called strategic investor. Obviously, one of the notable things about the Equitable transaction was the presence of Axa. The capital markets took great comfort from its presence. It validated, to some extent, the company's strategy and gave investors comfort that there was access to additional funding away from it, away from the public markets if the company required it, not so much in a contractual or a legal sense, but from the standpoint of people assuming that the parent would want to protect its investment.

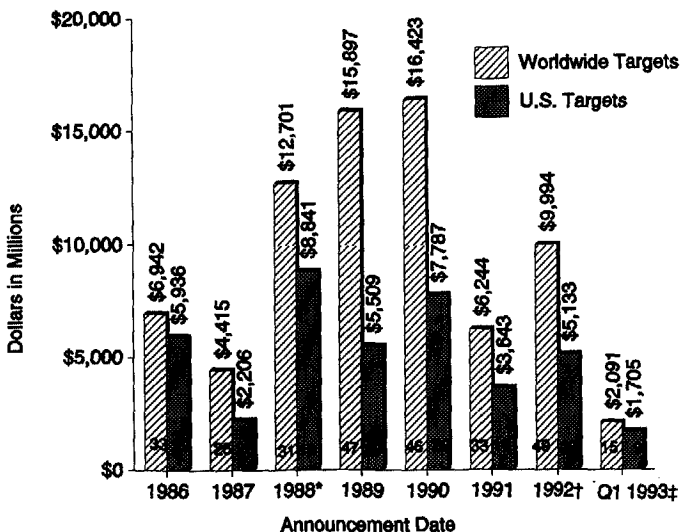
So, the first question you have to ask yourself is: is the Equitable model the right model for me in terms of finding a strategic investor? We believe it's going to be rather difficult for most companies to duplicate that success, largely because there aren't too many more Axas out there, and for some reasons we'll soon get to. Second, the ability to tell a story to the markets is absolutely critical. People who have an unfocused strategy are going to find themselves coming up very short on this one. You have to keep asking yourself the same question that the equity

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investor will ask him/herself and that is: what's distinctive? Every CEO has a tendency to view his or her company with a tremendous amount of pride. They all think they're generally doing a good job, and many of them are surprised when we tell them that the capital markets are not going to be as receptive to their company and their offering as they think it will be. And lastly, remember that in this game, you're always competing for the investor's marginal dollar. There's always a competing investment alternative out there for people. If you can't demonstrate a sustainable and relatively high ROE, the interest level on the part of investors and, therefore, the resultant valuation, is likely to be low.

Let's turn now to the mergers and acquisitions market and look at sort of similar volume data, as we did to the new issuance business over the last several years. Chart 6 shows the dollar volume, and you can see that we're down significantly from the peak years of the late 1980s, and also that the U.S. constitutes roughly half the market on a worldwide basis. I'm measuring just equity in these transactions. These are not assets. If I did this on an asset basis, it would be significantly higher. We're also not picking up block transactions. These are going-concern transactions.

CHART 6
Completed Insurance Mergers and Acquisitions Transactions
(over \$25MM)



* Includes the \$5,200MM Acquisition of Farmers Group by BAT Industries plc.

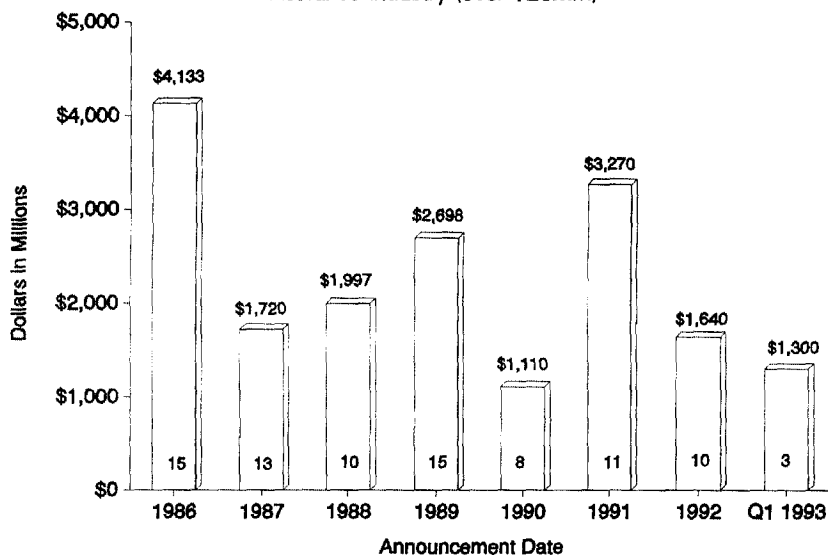
† 1992 includes \$304.6MM representing two worldwide transactions pending as of 5/20/93. Number of deals includes six transactions with nondisclosed values.

‡ Includes \$1,703.1MM representing seven worldwide transactions pending as of 5/20/93. Number of deals includes five transactions with nondisclosed values.

If we, again, segment that data to just look at the life business (Chart 7), you'll see we're reasonably stable in the 1980s and then fall off the cliff in 1990 with some of the problems in the industry. It rebounded a little bit in 1991, although a billion dollars of that \$3.3 billion is Equitable money coming in. It fell off again in 1992, but

we're rebounding here in the first quarter of 1993, and I think 1993 is actually going to turn out to be quite a good year in this market. The numbers at the bottom of each box are the numbers of transactions each year, which have remained relatively stable.

CHART 7
Acquisition Activity in the U.S. Life
Insurance Industry (over \$25MM)



Note: Numbers in bar indicate number of transactions

What's behind some of that falloff? Quite frankly, in the 1992 period, the strength of the equity market that we've talked about diverted a number of companies, particularly the higher-quality ones, out of the mergers and acquisitions market and into the public equity market. Private-market values were not as high as public-market values. We ourselves, last year, had three, what we thought were mergers and acquisitions assignments that turned into initial public offerings because we could get much better values for the client. But I think, probably more importantly, the problem here has been that most potential acquires have been focused on their own problems and issues and are not pursuing the sorts of merger and acquisition opportunities that are out there and available. Consequently, the number of potential acquires is relatively limited. Balance sheets, particularly for the larger companies, have really not been in very good shape. For those that are financially strong and could be acquires, they tend to have very narrow acquisition criteria, and they're generally reluctant to take on situations that require significant operational or structural change.

As I said before, one of the reasons there aren't too many more Axas out there is because of this balance sheet issue and the fact that with a few isolated exceptions, there aren't that many companies with a lot of spare change in their pockets looking

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for those kinds of investments. Also, there's the control issue. We could argue a lot about whether Axa has control of Equitable or not, but people do want control as a general matter if they are going to come into a situation with a tremendous amount of fresh capital. So, that's the demand side of the equation.

On the supply side of the equation, obviously one of the things that's going on in this environment is that the supply is very large. A number of companies want to divest parts of their operation that are underperforming in an effort to boost their own stock price.

So, what does all this mean going forward? First of all, in our view, demand is going to continue to lag supply. Supply is going to remain high as the multilines slim down to their core businesses and the industrial companies monetize their insurance operations and retreat from some of the investments that were made in the 1980s. That's actually been a little bit of a double whammy for this market. Not only are those new entrants of the 1980s not soaking up any demand here, not creating any demand really for properties, they are, in fact, net sellers. If you want to acquire most of those operations, even those that aren't formally for sale like Xerox, obviously you can acquire those.

Europeans, who have been significant buyers, particularly in the property and casualty sector, but to a lesser extent in the life sector as well, are clearly focused on other parts of the world. The ones who want to be here, like the Dutch, are here. And the people who are not here are not here by design. They generally don't have a strategy or an intention to get themselves here. The Japanese, who a lot of pundits predicted would come to the U.S. in a much larger way, still, in our judgment, are several years away from that. In fact, we actually have gone backward with the Japanese. A couple of years ago, most of them were here in reasonable ways doing studies, looking at the market. Now, many of these people have been recalled, and they do not even have studies going on. And the few that have tentatively stepped in here have done it on a start-up basis. They've not chosen, with one or two big exceptions, to do it by acquisition. But therein lies the opportunity for people.

We do think that activity levels will improve. First, in the leveraged sector, one of the things I point out to you is that virtually all of the leveraged deals of the 1980s in the life business have "worked." And they've yielded appropriate debt pay-downs and, in most cases, very significant equity returns to their shareholders, the equity sponsors. Consequently, many equity sponsors are now anxious to do insurance deals. I probably have two or three meetings a week with people who, as a general matter, don't know anything about the life business, but control enormous pools of equity, who say, "bring me a transaction." So, there is going to be some capital that's now outside the industry that will flow into the sector during those sorts of deals. They're going to have to get past Larry, but properly structured, those transactions can and will be done.

Second are what I call here strategic combinations, which allow crossselling of products for strengthened distributions, e.g., UNUM and Colonial Companies will continue to be done. Those transactions make an awful lot of sense. The mutual sector clearly will consolidate. We've now done two large mergers of mutuals: The Phoenix Home transaction, which in many respects, I think, was sort of a trail blazing

deal, and we're now in the midst of doing another one in the health field for two of the Blue Cross/Blue Shield plans. There are a number of obstacles to those transactions, however. Interestingly enough, the obstacles don't tend to be legal or financial. As a general matter, they tend to be social. Generally, CEOs don't like to give up their post, and it either takes someone who's close to retirement, and is likely to step down in any event, or someone who truly is visionary and who can realize the strategic benefits of a combination and can sacrifice his or her own ego for the good of the company. Those individuals are actually quite rare. We probably had close to a dozen of these proceed down the path in some way, shape, or form with discussions, and actually very few of them really end up going anywhere. But I think that's something that over time we will clearly see more of.

Next, I will discuss rescue capital. Rescue capital is defined to be a new investment in a troubled situation; perhaps one that's even in rehabilitation, where somebody can take control in exchange for an investment that solves a particular problem. One of the things I point out to you is that these types of investments have generally paid off very nicely for the acquirer. And, in fact, one of the things we've seen in these recent life seizures is that the regulators are disposing of these companies in a more traditional merger and acquisition context. Our firm was fortunate enough to advise regulators in four of those transactions, and in several instances, we were able to generate what clearly was multiple bidding interest in those properties. Obviously, when you're looking at something in rehabilitation or something that's not in rehabilitation, but clearly troubled, there's some differences in how you approach it from a traditional mergers and acquisitions situation. The criteria by which you evaluate bids and by which you evaluate your own investment are somewhat different, but the process is the same. And I think some of the better managed companies are realizing that this can be a very attractive way to grow your business, and the regulators are realizing it's a very attractive way for them to fulfill their fiduciary obligations to policyholders.

Finally, we think that increased capital needs are going to lead to more joint-venture activity, particularly as you think about the factory side of the business and the tremendous amount of back-office processing capacity in the industry, which, as the cost per unit of technology continues to go down, means that not everybody should do their own processing. Just as the banking system and the securities industry have come together and formed commonly owned clearing systems, I think it's quite possible that you're going to see the insurance industry get together on some basis and pool many of the common functions from the factory side. It would make sense for many companies.

Now, let me talk a little bit about what might happen to life solvency during the next several years, particularly if the yield curve changes dramatically or we have a period of sustained rising interest rates. We at this session are supposed to make some predictions about that. It's always very risky to do that, but I will tell you that there are two schools of thought on the street with respect to interest rates. One says that interest rates are at record lows, that they're not likely to last, and that an increase in inflation is just around the corner and the rates should generally be moving up. Therefore, if you're interested in financing, finance now while the window is open. Others say that we're entering a whole new trading level here, where double-digit rates on the long bond will be something to tell your grandchildren about and, indeed,

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we'll see rates trade in a fairly narrow band, potentially even continuing to move down. Undoubtedly, having said there are two general views, this audience probably has a third, but I think most people can be characterized as in one of those two camps.

I assume that all of you are trying to manage your companies without taking enormous interest rate risks or at least by knowing what risks you are taking. And I think in contrast to the late-1990-to-early-1991 period, we're seeing a tremendous focus on liquidity. The restructuring of people's portfolios has been taking place. There has been the realization of capital gains and so forth, which many observers believe has been driven by RBC. In fact, we would argue it has been driven much more by a desire for increased liquidity even if some yield were sacrificed. Indeed, I think this activity would be going on even if RBC weren't around. So, by and large, to the extent that restructuring is taking place, I think people are far better positioned for any disintermediation that may occur, should we see rates rise. There is also better access to the capital markets. And consequently, I don't think you're going to see the levels of failures and seizures that you saw during the 1991 period.

So, let me try to summarize here quickly and leave you with the following thoughts. Number one, the capital markets and particularly the equity capital markets are going to play a much more important role in assessing solvency. The rating agencies are obviously already making a dramatic impact, and I would submit to you that equity analysts and stock prices are going to begin to assume much more of a similar oracle status. Those companies that don't have a salable story for the equity markets will find their stock trading at a discount to their peer group, and access to those markets will be severely curtailed, which in turn is likely to affect policyholder confidence.

Number two, in trying to predict the number and magnitude of future insolvencies, you tell me what interest rates and the equity market will do over the next several years, and then we can make some judgment about that question. I believe that while the companies have been given some breathing room here and generally are in better shape, clearly we're not totally out of the woods yet. Any sort of sharp sustained spike in interest rates, or maybe more importantly a drop in the equity market, is going to create some more problems.

Three, there are a number of common attributes of companies that are accessing the market share, and it would behoove managements to orient themselves in such a manner if indeed having access to the capital markets is important to them.

Finally, the rehabilitation activity and some of the other things I talked about in the mergers and acquisitions sector will create merger and acquisition opportunities for smart acquires. Clearly, regulators, both before the fact and after the fact, are going to continue to look for those sorts of solutions.

MR. MOHORIC: Dave, what with the advent of RBC, it strikes me that it's changing the way insurance companies are investing. Has the impact of penalizing companies for investing in high-yield bonds or in real estate affected the marketplace for these investments? Given that the insurance companies, both in the U.S. and Canada, are a major investment force, if insurance companies start to shy away from mortgage

loans because of the RBC, it strikes me from a macro view that this could really have an impact on the mortgage market. Also, for companies that would be classified as high yield, it would impact their own ability to raise capital. This could shrink the market and have an overall impact on lending markets. Do you see this happening?

MR. DENUNZIO: Yes. Absolutely. In fact, I think you're seeing it already. Those of you on the investment side know this. The nature of the private placement market has changed rather dramatically, particularly for the lower-quality credits that the people aren't interested in holding anymore because companies get penalized for it. Those securities are not going through the traditional private placement channel to the life sector. They're going to other places and, frankly, that has made it more difficult for many of those companies to get that kind of financing. There is the same thing in the mortgage sector. It has, in effect, created an opportunity for us to create new mortgage-type securities that we can sell in other ways to the life insurance companies or to sell to other kinds of investors. You are seeing investment flows change there and, I think, from a macro economic perspective, that's not necessarily a good thing for the U.S. economy.

MR. JOE E. DAVIS: Larry, when I was in grade school and I brought an A home, my parents were quite happy. If I brought an A plus home, they were elated; maybe shocked. If I'm looking up a company and I find three or four A pluses, I still don't know what I have. I've got to get someone to interpret it for me. Is there any hope that the rating agencies will get together and come up with a common scale?

MR. BROSSMAN: Your question is a good one. I testified in New York when S&P had come up with its barbecue ratings. I guess it was trying to get the other agents to say that was confusing; I didn't figure it was my place to say that, and I didn't at the hearing. But I think the different scales are very confusing. For the rating agencies, if your ratings don't trade, you're not in business. The thing that's probably most important is to have a number of agencies using a corresponding scale like you have with S&P and Moody's and Duff & Phelps. The rating system is presently very confusing, but there's a historic background, and I don't think it's going to change. It's just like the term *claims-paying-ability* ratings. When we started out, we thought claims-paying ability was a hospital administration kind of thing; how quickly you got your claims paid. But that was a historic term, and then Moody's started calling it financial-strength ratings. So, we used them interchangeably. The confusion is unfortunate. We do compare our ratings on an ongoing basis, we make them available, and we do compare our ratings to S&P and Moody's. We do not norm to A.M. Best. We do not consider it a comparable system.

Is the system confusing? Yes. Do you think it would be better if we had something else? I agree with you. I think what we have to do is educate. When I talk to some producer groups, I tell them where I think the trading lines are. I think A plus and higher ratings are very strong ratings.

FROM THE FLOOR: We obviously don't know where interest rates are going to go, but insurance companies develop strategies based on management's expectations about where those interest rates are going to go. When you talk to companies to rate them, what's the general feeling? Do insurance companies expect rates to increase, decrease, stay the same? And, in your opinion, are they right?

MR. BROSSMAN: I don't know. I think rates are going to go up, because you can't get much lower.