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RAISING CAPITAL FOR MUTUAL COMPANIES

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- Access to capital markets
- Use of surplus debentures
- Demutualization
- Securitization
- Sale/leaseback of home office
- Sales of blocks of business
- Rating agency perspectives

MR. ARTHUR G. TYPERMASS: Raising capital for mutual companies—what's it all about? I suspect that this is a fairly new topic for this meeting, or it's one that probably some time ago was really not on the meeting agenda. For the longest time, the mutuals were not focused on raising capital. In fact, I think there was a point at which mutuals might have even been capital averse. There were many complex tax factors and one school of thought said that increasing capital really was not necessarily in the best interest of the corporation or the policyholders.

We have some new factors. We have a new friend, risk-based capital (RBC), and I think it remains to be seen how good a friend RBC is going to turn out to be in the long run. I suspect we're going to change a lot or our friend RBC will change. I don't think the last chapter, by any means, has been written. I also believe that RBC is probably going to have more to say with regard to the risk profile of an insurer's portfolio than it will in terms of capital adequacy or capital development.

Return on equity (ROE) is a concept that is not regarded as being very old by mutual companies. It's something that mutual companies are starting to look at and formulate to a greater degree. I think we're going to hear quite a bit about it. Already I'm hearing intimations such as, now that you have all that capital, how are you going to earn on it? Are you overcapitalized? This comes from other industries that we've observed during the years. Capital was in short supply, capital was raised, and once the capital was in, the real challenge was in terms of how to earn on that. So ROE and return on investment (ROI) are concepts that we'll hear quite a bit about from the mutuals in the coming years.

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I think capital development was influenced by problem cases. I look back about three years ago to 1991 as being in some sense a water-shed period for many insurers. There were some notable failures. I certainly don't have to remind you about those. We've all been through those, observed some of those, and when you look back, the amount of capital in aggregate terms in some cases was simply not enough. The ratios might have been fine. Things that brought on the trouble were probably not really focused on or even analyzed until fairly late in the game. One of the things that sort of struck me, looking back on some of these situations, is that the raw amount of capital just didn't seem to be enough. You didn't have enough money in your pocket to walk around and do your daily work as it were. So I think there is a concept, even beyond the ratios, of just having enough to run your business to feel comfortable.

Then I think, too, we're taking a leaf from experience in other industries. As the banking industry went through a lot of its difficulties, the focus came in terms of capital adequacy and capital development. As we observed things going on in the banking industry, it seemed to me that it was going to inevitably occur in the insurance industry. I think that's had a very heavy influence on increasing the focus on capital by mutual companies.

There are several alternatives for raising capital that come to mind. Perhaps you can think of more, and we can emerge from this meeting with some further ideas. Portfolio transactions can be done. There's demutualization, reinsurance, and Mel will say more about that and the role it might play in capital development. And then there is a fairly new instrument in capital development, surplus notes. I will spend the bulk of my time discussing surplus notes or at least what our experience has been in terms of issuing those in the marketplace.

As to portfolio transactions, some of the things that we can think of are as follows. I think you can certainly divest of nonstrategic businesses. As many insurers diversified away from insurance in the 1980s, they're finding that not all of that experience has been particularly good. You may find in your own companies that some businesses would be better off being disposed of, thus redeploying your capital in some core business where you can do better. I would certainly suggest that you go through the analysis to see whether that's feasible for your own capital development.

In a very good market, you can put together an initial public offering to sell off a minority interest or a substantial minority interest of a business and create a market to realize additional value. This should enable you to obtain some capital for redeployment if that's what's wanted.

Regarding monetizing undervalued assets, you may look throughout your portfolio and find that the carrying values of some assets really don't reflect the true value. I hesitate to use the word *real estate*, but it could be even something such as real estate, where under current conditions can be monetized and effectively deployed as capital. So looking at the portfolio, seeing what's there and what can be done, certainly is an alternative for mutual companies.

As you know, there have been some prominent cases of demutualization, obviously Equitable being the largest that I'm aware of, and somewhat before that in the

mid-1980s Union Mutual into Union Corporation, and some others along the lines. There were some smaller ones, and some are probably even being contemplated. What happened in the late 1980s and early 1990s was really almost a second wave of focus on demutualization. Before that, in the 1980s, there was a lot of interest in it. That interest was tax driven. It had more to do with tax issues as they existed between the stock companies and the mutual companies. The wave that finally hit was really capital driven. So it is an issue that has been looked at as far back as even ten years ago. It sort of stopped and started; not much happened, the tax issue seemed to be resolved in other ways. When significant demutualizations finally occurred, they were more capital driven than tax driven.

Clearly demutualization does provide access to the capital markets, and certainly that's the objective. As we found out, you can have good capital markets and you can have weak capital markets. A stock company will have access there whenever those markets turn out to be receptive. It is a long and costly process. I recall going to a meeting a few years ago when one of these demutualizations was underway. I heard the chief executive officer of that company describe, in a very articulate way, what it was doing. I thought it was a fascinating talk. He threw out an estimate for how long and how much it would be. I'm sure when the final accounting was done that his estimate was probably far below on both counts. For those companies that are looking at demutualizations as an objective, you should be prepared to expend a great deal of time and money going through the process, not the least of which is occupying the full attention of senior management during that period.

Here are some of the advantages that we've seen in surplus notes. I also should say at the outset that surplus notes, where they do exist in various regulatory areas, were designed more for rehabilitation than for capital development. The whole turn in the application of surplus notes as an instrument has taken place in the last year or year-and-a-half. The highly rated companies have access to capital markets through these instruments. I use that term *highly* advisably, because in some of the activity that has taken place, companies well down the investment-grade chain have made use of this instrument. I find that to be a rather interesting development.

The 144A, what I call a semiprivate placement market, has been the market for the surplus notes. Really it's an exemption from SEC registration. So if you're willing to be an SEC registrant, and most mutuals are not, other parts of the capital markets are accessible for surplus notes. The 144A market, up until 1993, was largely untested in terms of its receptivity and its depth for being able to absorb surplus-note issuance. It's proved to be a good one on both fronts. The concern about having to go through the SEC and deal with statutory accounting, and GAAP, and who knows what else, was not a factor. As you'll see, the work that led up to this was much like what you'd have to do to do a regular public issue as an SEC registrant. I don't think much was left out. Again, certainly last year and in the early part of this year, the 144A market has been extremely receptive to these offerings on the part of the insurance industry.

Surplus notes have proven to do double duty. Clearly the investors regard them as a dead instrument. They fully expect to receive their interest and principal, and they

will. But the notes really count for capital, and they show up in the various blanks and annual reports. It is proven again to be a very versatile instrument up until now.

There are some challenges. I don't want to use the word *disadvantage*. Surplus-note issuance requires insurance department approval. The states are all different and, of course, the insurance industry is state regulated. We made a decision at Met Life early on, when we were going to do this, that we would work very closely with the regulators and work with them early on. The experience that we went through proved this to be a very wise decision. Extensive disclosure is required, which goes back to my earlier comment. I think we did all of the work that you would need to do if you were a public company selling a dead issue. The offering circular is lengthy. There was much more disclosure than I think we have ever had at my company, and we really weren't starting from ground zero. By working with Mark at Standard and Poors and some of his counterparts at the other rating agencies, we've really been in that business for about ten years. Every year we go through a very formal review, and we prepare a comprehensive briefing book that supports that review. I thought that putting together that book would be all we'd need to do to issue the surplus notes. Well it certainly was an excellent grounding point and an excellent basis for what we did. But the offering circular has its own particular format that we needed to adhere to, and there was quite a bit of effort expended in putting that together. So again, if you're thinking about a surplus note, understand there's going to be quite a bit of disclosure required in that circular. The offering process really is quite labor intensive, and there are rooms full of attorneys, investment bankers, and the like. That can go on for quite a while.

Now to the issuance process; many of these things had to be done almost simultaneously. Selecting investment bankers, particularly if you're hitting the 144A market, must be done early on. For those of you who take the time to go through the offering circular of the issues that have been done, you will see that a fairly small group of investment bankers have been involved up to now. I'd say there are two criteria. The first is to make sure they understand the industry and company. Many of the leading investment bankers have units that focus exclusively on the insurance industry. The other and equally important criterion is to make sure that they have the power to market the bonds. In the last analysis, this again becomes very important. They have to be able to sell the securities. That's what all of the lead time and all of the work comes down to.

Selection of legal counsel is a fairly early task in the process.

The drafting of the offering circular took most of the time. We started on this process just about a year ago in late April or early May. We spent a great deal of the summer reviewing the various facets of that circular, sending proofs back and forth. There were a lot of late meetings in which everybody put their opinion on the line. In terms of wordsmithing and draftsmanship, you need a lot of patience for it. I think there's a good by-product to that instantly. You'll emerge with a document about your company, the likes of which you probably haven't put together before. Just in terms of an information piece, you probably can find lots of uses for it around the company.

Finally, due diligence goes on during the offering circular drafting. The investment bankers are conducting their own form of due diligence. It's almost a simultaneous process. They are seeking information about the company. They need to find comfort in the areas that might concern them. It might be anything from the condition of the investment portfolio to diversification of product lines, conservatism in reserves, etc. So again, be prepared. They're going to ask many questions that you'll probably take a little offense to, but they're doing it because their counsel is telling them they need to find a certain amount of comfort to sell the bonds.

Have the notes rated. This is very critical. We wanted to keep the rating organizations aware of what we were doing early on. This takes a little judgment also, because you don't want to make a call everyday with every little thing that goes on with the circular or the timetable. So use some judgment, and do not inundate the rating organizations with every draft. Make sure you stay in close contact and provide those drafts of the circular that are quite meaningful, so that they are in a position to conduct their rating review on the issue. Ratings are very important, and we spend a lot of time with the rating organizations, not only discussing the company, but also such things as the position that the surplus notes would occupy under the interpretation of, in Met's case, New York state insurance law. The rating organizations are going to be very interested in how to evaluate that. After all, their job is to advise investors, their customer base. Investors are calling rating organizations for their opinion of the quality of the issue. So understand where it is coming from when that goes on.

In our case, getting the approval of the insurance department was not rapid; it was new. We were the second issuer of the instrument in 1993, but we were the first issuer under what I call New York style. Our decision, along with the insurance department was that we were going to utilize what was in the particular section of the New York law. Whatever we did was going to comply with that law as it was on the books on the day interpreted. With that ground rule we were able to go forward with the regulators and again keep them aware of the various steps along the way.

Finally, the pricing and the sale of notes take place when everything is there. When people are happy with the status of the circular and when the regulators and ratings organizations have signed off on the structure of the deal and the condition of the circular, then you're ready to price and market, which usually goes rapidly.

There has been a lot of activity in this arena: since 1993, nearly $3.5 billion and 12 issuers. Table 1 shows the 1993 activity. These are in chronological order. The chart shows issuer, the various ratings (Moodys, Standard and Poors), the dates of the issues, the size and the structure and then the coupon rates that the issues had. We did a ten, noncall for life and then a 30 noncall for ten. The 30 noncall for ten would allow us, as the issuer, an opportunity to call the issue out at the end of the tenth year. There's a price attached to that feature. Some of the other 30-year issuers did them for noncall for the full period. If you want to do a noncall for ten, on a 30, or some variation of that, there's going to be a price in the marketplace for that feature.

TABLE 1
SURPLUS NOTES
1993 ACTIVITY

Issuer	Ratings	Issue Date	Size/Structure	Coupon
Prudential	A1/AA-	4/22/93	300/10 NC	6.875
MetLife	Aa3/AA	10/28/93	400/10 NC	6.300
MetLife	Aa3/AA	10/28/93	300/30 NC10	7.450
Mass Mutual	Aa3/AA-	11/12/93	250/30 NC	7.625
NY Life	Aa2/AA	12/8/93	100/10 NC	6.400
NY Life	Aa2/AA	12/8/93	250/30 NC10	7.500
Pacific Mutual	A3/AA-	12/21/93	150/30 NC	7.900

Note: NC is a noncall for life.

Continuing into 1994, you can see that other insurers have also come to the market. Again, I think the range of ratings (Table 2) tells me that we're lower down on the investment-grade spectrum, which is something that maybe early on I would not have thought. We thought that this was going to be limited to the biggest and the highest rated company. As you can see, some of those that weren't as large and as highly rated were also able to issue into this market. This proved that the market was quite receptive. I think timing was a factor. Most of the companies that issued in 1993 should be very happy with the execution that they obtained in the markets, because we all know what's happened to interest rates since then.

TABLE 2
SURPLUS NOTES
1994 ACTIVITY

Issuer	Ratings	Issue Date	Size/Stucture	Coupon
General American	A3/A	1/14/94	107/30 NC	7.625
New England	Baa3/A	2/3/94	150/30 NC	7.875
Nationwide	Aa3/AA-	2/9/94	200/10 NC	6.500
Nationwide	Aa3/AA-	2/9/94	300/30 NC10	7.500
John Hancock	A1/AA	2/17/94	450/30 NC	7.375
Principal	Aa3/AA-	3/3/94	200/30 NC10	7.875
Principal	Aa3/AA-	3/3/94	100/50 NC20	8.000

Note: NC is a noncall for life.

Table 3 shows the current situation with some of the issues that are outstanding. On the ten-year issues, these are some of the spreads to treasuries, where these were priced and where they are. Clearly you can see what happened there. It's very interesting, with Prudential being the first and Met following up. As the market became familiar with these issues, the initial offering spreads tightened. This was extremely favorable for the issuer. As of today they have, of course, tightened in to the point where at least among this group, there's a fairly narrow band. Some differences are according to credit rating, but they've really tightened, so those who came later gained a little benefit on the backs of those who blazed the trail, as it were.

TABLE 3
NEW ISSUE SPREADS
RECENT PRICING—10-YEAR ISSUES

Issuer	Date	New Issue Spread	Recent Bid/Offer
Prudential	4/93	112	82/76
MetLife	10/93	95	74/68
New York Life	12/93	73	66/61
Nationwide	2/94	68	73/66

The initial spreads had many components. They had a component in terms of just what a subordinated dead issue would be. They had a component in terms of, if you had, as I mentioned earlier, a noncall feature, you had to pay something for that. Then they had a component in terms of the 144A market versus the public market. Again, for those companies willing and able to be SEC registrants, there is no question that there still remains the basic bond market, the public market. It's a wider market than 144A. So if you're able to do that, which none of these issuers were (they're all in the 144A part of it), it would have been a tighter spread than what you see there on the offer.

Table 4 shows where the 30-year issues came. Again, for my liking, those spreads were fairly wide. The 30-year issues have exhibited the same pattern that the ten-year deals have. In other words, the ones that came later did better. The existing spreads have tightened in.

TABLE 4
NEW ISSUE SPREADS
RECENT PRICING—30-YEAR ISSUES

Issuer	Date	New Issue Spread	Recent Bid/Offer
MetLife	10/93	130	108/103
New York LIfe	12/93	120	102/97
John Hancock	2/94	84	99/93
Principal	3/94	100	115/110

If Wall Street doesn't get you one way, it gets you another way, and when you get to the 30-year issue, it does this. Off the treasuries, on the run, off the run, I never know the difference. But one of them is a fairly new 30-year treasury, the long bond. The other is a more seasoned issue. One yields more than the other, so the new issue is always priced off the one that yields more than the other. That's just the way it's done, so that accounts for what happens on the 30-year part of this. I thought the spreads were a little wide for 30-year money, but I also believe that the spreads are not going to matter in the end. In the end, what's going to matter is your timing on the coupon. Unless you get a call feature and call it out, it's going to be a coupon you're going to live with for a long time. That's what people will look back on. They'll forget the spread, but they'll remember the absolute cost of the funds.

MR. MELVILLE J. YOUNG: I don't think too much of a buyer-beware type of statement needs to be said in advance. Most of you know that I have somewhat of a slant toward reinsurance, and the basis of my talk is going to be our effort of comparison, comparing the features of surplus notes with reinsurance.

It's been an evolutionary process, this process that we've seen recently leading to a new awareness of the need for capital enhancement. We've had a tightening market, leading to aggressive pricing, leading to aggressive investments, leading to a few blowups, leading to increased scrutiny by regulators and downgradings by rating agencies, which has been a major boom for consultants. That's led to further pressure on sales, and that's led to some questionable sales practices, which we've all paid for. It has led to renewed oversight by regulators and pressures for change from Congress. And fortunately, this is finally leading to a cleaning up of our act, maybe for some additional added pressure for capital enhancement.

And the latter has, as Art said, significantly brought about, or at least helped nudge, the RBC. RBC has brought a brand new level of awareness of the importance in the cost of capital. One of the results of that was a very significant increase in the use of surplus notes. A few other things have happened as well. There's been an overdue trend toward strengthened product profitability awareness. There's been an increased investment conservatism. People are cleaning out their balance sheets. There's been a rationalization of businesses; that was going on before, but it seems to be picking up steam. Sales or partial sales of subsidiaries has happened. We've had companies emphasizing certain prime cores of business, focusing on those cores, getting out of other things, and forming some joint ventures. There has been a movement toward merges, associations, and joint ventures, which have been brought about by the focus on expense reduction and the realization that there's a need for increased units under administration.

It seems that virtually every company in the country is interested in buying something. We receive calls daily from companies saying that, if we hear of XYZ, they are interested in buying it. There's a movement toward, and I think this is a little different slant, focused markets. People are realizing that not only did they want to be, say, in an ordinary life line, but they're looking to market that line to certain people. There's been a realization of a need for flexible definition of acceptable sources of distribution. Perhaps we've been tied to our career distribution, or whatever; the distribution is too long. People are becoming aware of the cost of that distribution and that you can't have a meaningful expense reduction without a meaningful reduction in production costs.

The industry seems to be emphasizing two areas in this evolutionary process. One of them is capital enhancement. And as Art said, in the recent past, that has meant a lot for large companies. That's the distinguishing feature. They may have varying levels of ratings, but most of the companies that have sought the surplus-note answer and a movement toward merges, acquisitions, and joint ventures are fairly substantial in size.

We're going to talk a little bit about surplus notes and reinsurance. When we get into that, one wonders where to begin. We have, for several years at least, been trying to

talk to our clients, both reinsurer and ceding companies, about being aware of the cost of capital. We've talked about target surplus using all kinds of similar terminology. But as I said, it wasn't until RBC came about that people finally started focusing on it. Because there was a formula that everyone was using, we could factor in the cost of capital. We were talking to folks for a long time who were looking at debt as being a reasonable way to, through holding companies, do acquisitions and whatever. If they factored in the cost of capital, reinsurance could be a good alternative. We now find, as I'll show later, that we can put more definite numbers to some of this and make the argument a little bit more compelling.

Common wisdom tells us that the interest rate environment through 1993 and early 1994 has been particularly attractive for raising capital through long-term-debt financing. Companies that had the surplus notes were definitely winners. Life insurers that have used surplus notes raised several billions of dollars of capital. It's hard to argue with the timing or the logic, but one commonly held view is that, aside from being a time-consuming and costly demutualization process, surplus notes were virtually the only place that mutual companies had to turn to raise capital. A reinsurance alternative has been viewed, at best, as being a tainted and expensive alternative.

I'd like to take a look at some various aspects of the two vehicles for raising capital, compare them, show the flexibility of the two instruments, and let you decide.

FLEXIBILITY

Surplus notes typically have a fixed repayment schedule, and reinsurance does not have a fixed maturity date. The parties of the reinsurance agreement may reasonably predict the particular repayment pattern, but the provided surplus will actually be recovered only to the extent that there are statutory profits on the business reinsured. Surplus notes of a particular issue are generally widely held, and reinsurance is often conducted between one or two reinsurers and the ceding company. This makes it easier and probably less expensive for the ceding company to renegotiate the terms of a reinsurance agreement, as compared with surplus notes. The covenant of the surplus note will generally limit the issuer's ability to prepay, and the reinsurance treaty generally has a flexible recapture provision. Many reinsurers are even flexible beyond that recapture provision, allowing their clients even more latitude.

CAPACITY

Obviously, a vast market appears to exist for surplus notes, as it encompasses most institutional investors, and the market for surplus provided for reinsurance generally is limited to a handful of reinsurers that specialize in that market. However, due to origination and legal fees, there's a practical, minimum size for a surplus note. None of the notes Art described were below $100 million. This is not true for reinsurance. Market acceptance of surplus notes from companies other than those in the top tier is untested. Reinsurance is available for companies of varying sizes and varying conditions. There may be circumstances in which the amount of capital sought is larger than might be commonly available for the reinsurance market, and that could be a reason why reinsurance might be only a partial solution to additional capital needed by a company. But again, there are small companies in which surplus notes are just not a practical solution, and reinsurance might be the only answer.

INTELLIGENT ASSISTANCE

Well, there's some prejudice. I'm presuming that the reinsurer will provide intelligent assistance. Before a surplus note is issued, investment bankers and institutional investors typically review the issuer's overall financial stability as part of the due-diligence process. The reinsurer will typically not only look at that, but provide added value by looking at the actual product and the marketing and provide some under-writing oversight. Basically it provides a second pair of eyes. The reinsurer looks at the program, and because it is participating in every aspect of it, it wants to make sure that program is viable and sound. I think that's a valuable service, and probably a service that too few companies take advantage of. Regulators should be very happy about this part of the reinsurance process. Sometimes the reinsurer will provide insight into problems before a company gets to the regulatory level.

REGULATORY ENVIRONMENT

Surplus notes have been approved for use for most states in either statute, regulation, or administrative procedure. The commissioner or superintendent of the domiciliary state will normally be required to set the procedure for interest and principal, which often relies on the company meeting certain minimum capital levels after the pay-ments. Surplus notes are accepted as capital for RBC computations and are generally accepted by rating agencies, although longer issues may be viewed more favorably than the shorter ones. There have been no instances of default on the more recent type of surplus notes issued by well-capitalized companies, but one might expect that if a regulatory official were to deny permission for a payment, that could have serious consequences for the company involved, and it might unsettle the market for surplus notes in general.

Reinsurance, after experiencing somewhat of a bumpy road, has entered into a period of relatively rigorous regulation. Prior to 1985, there was virtually no regulation providing how reinsurance was transacted. Our first reinsurance regulation of any significance came about in 1985: New York 102. This was followed by a model regulation for reinsurance, which was followed by passage of that model by most of the states. Recently there has been a change in that model, which has added even additional risk passage through to the reinsurer. Roughly 75% of the states have passed one or the other reinsurance models. This provides for a very significant level of risk. In some cases, the reinsurer might think that 100% or a very significant portion of the risk is being passed through to the ceding company.

The NAIC RBC regulation provides virtually full credit for any capital derived from a reinsurance agreement. But, due to some past history, some people may still feel uncomfortable about the capital raised through reinsurance. This was brought home very clearly to me recently. Despite the participation of several regulators in the process of developing these model regulations, the NAIC's own procedure manual leans on the reinsurance knowledge of the FASB by seeking the guidance of *FAS 113* for determining risk passage. Well, a quick read of *FAS 113* is all that I think is needed to create serious doubt in one's mind as to the level of reinsurance expertise that the FASB possesses. These are the folks, after all, who would like to have us believe that there is no risk in disability-income-claim reserves or that the reinsurer, deciding to be generous and share some of its profits with a ceding company, while assuming all of the risk, in some way reduces the risk of the reinsurance agreement. It's my position that a reinsurance agreement conforming to the standards of the

NAIC, and entered into with the financially secure reinsurer, should be viewed positively by the regulatory and rating agencies.

COST

As I mentioned, we have for some time been looking at the cost of reinsurance and debt and have tried to convince some clients that they need to look at the cost of capital when they're going through that computation. We can show that the net cost of reinsurance compares very favorably with the cost of surplus notes or debt. To compare the relative costs, we've done some modeling, and we tried to factor in the impact of taxes and RBC.

It's good to keep in mind that the interest paid on surplus notes is presently deductible in computing the issuer's federal income tax. In addition, surplus notes are treated as equity for statutory purposes, but for equity tax purposes there is no current tax on the surplus rates or surplus notes. Reinsurance may generate taxable income to the ceding company, but we believe, given some thought and preplanning, that needn't be the case. In general, if the capital raised from reinsurance is treated as fully taxable income, then, from a tax perspective, reinsurance isn't a great vehicle from a cost point of view. However, most or all of the capital often raised through reinsurance can be structured so that it is realized tax free. As a result, the cost of reinsurance compares very favorably with the cost of surplus notes.

Using surplus notes to finance the writing of new business leaves all of the insurance investment risk on the books of the direct writer. Therefore, the insurer must maintain adequate RBC on its books. The establishment of RBC has a cost that can be measured in terms of a reduction in the internal rate of return (IRR) on the block. The reinsurer, on the other hand, accepts all the risk inherent in the block reinsured and will have to pay its share of the losses if the business loses money. The reinsurer must hold its share of the RBC on the block reinsured, and it bears the cost of maintaining it.

We have estimated the cost of reinsurance for a typical block of ordinary life insurance business and compared this with the cost of a hypothetical surplus note. The assumptions are shown in Table 5. (RBC requirements are expressed in terms of premiums and reserves only.)

The results show that, under this set of assumptions, a surplus note would have a net after-tax cost over a ten-year period of 60 basis points per year, taking into account both the interest paid on the surplus note and the interest earned on the investment of the funds received, both discounted to the beginning of the year to be consistent with reinsurance. Reinsurance structured to allow the surplus to move on a tax-neutral basis between the reinsurer and the ceding company would cost an average of 81 basis points over the ten-year period, at which time the ceding company could recapture the reinsurance or maintain it in place. Furthermore, if the business reinsured was unprofitable, then the reinsurer would absorb its share of the losses, and there may actually be no cost or even a gain from the reinsurance. Conversely, the issuer would have to repay the surplus note as long as there was sufficient surplus in the company, the appropriate tests were met, and financial ratios were maintained, regardless of the experience of any single block.

TABLE 5
MODEL ASSUMPTIONS

Statutory life reserves	$50 million
Tax reserves	$45 million
Initial ceding allowance	$ 5 million
Annual premiums	$15 million
Treasury bond rate	7.00% and 9.00%
Spread over treasuries	
Surplus notes	1.70%
Invested assets	0.65% and 1.70%
Hurdle rate	13.00%
Reinsurance risk free	1.25%
Federal income tax rate	35.00%
C-1 risk factor	0.65% of life reserves, 0.50% of reinsurance ceded premiums
C-2 risk factor	1.00% of life reserves
C-3 risk factor	0.75% of life reserves
C-4 risk factor	2.00% of life premiums

The cost comparison is shown in Table 6.

TABLE 6
SURPLUS NOTE VERSUS REINSURANCE COST COMPARISON*

Treasury Rate	Surplus Note Spread	Invested Asset Spread	Surplus Note Cost	Reinsurance Cost	RBC Cost	Total Reinsurance and RBC
7.00%	1.70%	0.65%	0.604%	0.813%	–1.051%	–0.238%
7.00%	1.70%	1.70%	0%	0.813%	–0.962%	–0.149%
9.00%	1.70%	0.65%	0.604%	0.813%	–0.881%	–0.068%
9.00%	1.70%	1.70%	0%	0.813%	–0.792%	0.021%

*Cost is defined as percentage of surplus provided

Also, our assumption of a 170-basis-point spread on the surplus note was obviously too high. Even if that spread was significantly lower, the best we think companies can expect is that the surplus notes will have a zero cost. We assumed that the reinsurer was charging 125 basis points on the capital raised through reinsurance. Obviously, that factor can change as well. The results also show that when you reflect that number after tax, assuming that the surplus comes to you tax free, and then factor in the cost of capital, we actually, in most of our models with those assumptions, come out with the reinsurance having a negative cost.

We've assumed in our work that a typical life insurance company would seek to maintain an RBC ratio of 200%. If the business is reinsured, the reinsurer establishes its share of the capital. We assume that the reinsurance treaty was constructed by using a combination of a coinsurance and modified coinsurance mix, and that only the non-tax-deductible reserves were established by the reinsurer and that an equivalent ceding allowance was paid. In this case, under present RBC regulation, if you believe that reinsurance now has all of the risk passed to the reinsurer on modified

coinsurance the assets stay with the original ceding company and the RBC requirement doesn't flow with the risk. That's a problem that needs to be addressed, and I'm told it is being addressed or at least is being discussed.

Until that happens, all that we've factored in is that the C-2 risk has passed to the reinsurer. The last column in Table 6 attempts to factor in all of the RBC flowing to the reinsurer. Our main mission here is to get you focusing on the cost of capital and factoring the RBC components into your analysis when you analyze reinsurance and other sources of capital-like surplus notes. If you're thinking about doing a surplus note, you might not want to change that. Certainly the timing was great a year or six months ago, and maybe it's still a good time to do it. But you might want to at least think about mixing a component of reinsurance into your capital-raising plans.

MR. MARK PUCCIA: I'd like to start off by providing a picture for you. It's the middle of April, you're Mr. Weave, and you're president of a mutual insurance company by the name of Bob & Weave Life. You're about to live through your worst nightmare. You sit down to breakfast, open the morning paper, and you're confronted with disaster. Your company is on the top of the list in *USA Today* as being one of the ten least capitalized companies as measured by RBC.

You're number one on the list, and you're sharing the headline with some bad company. You know that Ready for Rehab Life has been talking to the regulators already, and Bogus Mutual will be taken over any day. You've got to get off this list. Policyholders are calling, agents are calling to see if they can get advances on their commissions, and you're in a state of panic.

So you call your chief financial officer, Mr. Quick Fix, and tell him to figure out a way to get the company off of this list. Quick Fix thinks a little bit and says he has an idea. "Let's sell surplus notes. Investors are snapping them up. The Met sold them, Prudential sold them, and Mass Mutual sold them. We can, too, and we can raise our RBC. I'll give Art Typermass a call over at Met, and maybe he can tell me how to do it for our company. If Met can sell them, so can we. We're in the same ball game." A few days later, Quick Fix calls back and says there is a bit of a problem. Unfortunately these things must be paid back, investors are looking for a good return, and the regulators aren't happy about that.

But he has another idea. He talked to some of his friends in Bermuda. In fact, he talked to Mel Young over at Tillinghast and he is more than willing to help out by setting up some reinsurance transactions. They are better than surplus notes. They are cheaper. "Now maybe it's going to cost us a little bit in the future years, but this is a crisis and we must do something. The only problem is, the regulators keep tightening up these regulations every year. It gets a little bit tougher, but this is an immediate situation. Let's do it now." You say to do it, to do those reinsurance transactions. But you need some other ideas.

He says, "Let's sell commercial mortgages and buy mortgage-backed securities, some of those collateralized mortgage obligations (CMOs). Of course, we can only sell the good mortgages, the ones that are currently paying. We're going to have to keep all those that are causing us some trouble. We can buy mortgage-backed, and the yield on interest-only (IO) bonds right now is great. We can buy a few IOs and

principal-only (POs) bonds. They're AAA rated, with very little RBC. There's a little bit of volatility with these things, if interest rates move. But we're in a crisis, right? They get such a high yield, and you must feed the policyholder crediting rates. Remember that we had to go and offer those 10% yields in the 8% environment a few years ago with the guaranteed interest contracts (GICs) and the annuities. So these IOs and POs will take care of that."

Quick Fix says, "By the way, speaking of real estate, I have another idea. Let's call the accountants and reconsider writing down that real estate. I know most of our properties are only half occupied, and they're in some bad markets, but I think we can persuade the accountants that these properties are not permanently impaired. We can save ourselves $100 million in write-downs. It will surely improve our RBC, and we're in a crisis. So lets do it." You tell Quick Fix it's a great idea.

"In fact," Quick Fix says, "I've even got another idea. Lets go and securitize the mortgage portfolio. We're going to have keep all the first losses. I know that's where the risk is. We'll have to sell the investment grade paper to the investors. But it's a crisis, it will improve our RBC ratio, and it will help us get off the list." You tell Quick Fix it's a great idea.

Quick Fix says he has another idea. "A couple of Dutch companies have always wanted to buy the home-service business. Yes, I know that it's the crown jewel and the only part of the business that we're making money on right now. But listen, we can get a good capital gain right up front. It improves our RBC ratio, and in fact, we don't need any of the capital to support that business anymore when we go and sell it. We're not going to have the income in the future, but this is a disaster. It's a crisis. We must do it." You tell him it's a great idea.

You then ask, "Quick Fix, what can we do to get the agents to help us out?" Quick Fix replies, "We're going to tell them not to sell life insurance. Look at all the RBC components you've got to put in for that. You have the net amount of risk, and you must have that C-3 component in there as well. Single-premium deferred annuities (SPDAs) have a much lower cost of capital associated with them. And look at the strain you're going to take in with all that new life business. Now I know that SPDAs, especially the way we price them, aren't going to make us a heck of a lot of money, but you must keep the field force happy, right? Let's give them something to sell. We won't make any money on it. That's true. But the fact is, we're going to eliminate that surplus strain." You tell Quick Fix it's a great idea.

Well needless to say, a year or two later, Bob & Weave Life was in the regulators' hands. In fact, there were three or four different policyholder and agent law suits that had to be sorted out to get rid of this problem. But all is not bad. Mr. Quick Fix, who was no longer employed by the company, was the target of many of these suits and was also the proud author of the best-selling book, *The Rise and Fall of Bob & Weave Life*. He was making plenty of money.

Why do I bring this story up? About a month ago, it wasn't *USA Today* but it was *The Wall Street Journal* that did this article, and the authors were nice. They did the 20 largest companies that really didn't have too much of a problem. But *USA Today* is going to do this. Honestly, it is going to happen. The fact that the regulators think

that RBC is not going to get publicized is a farce. It's going to happen. It is an important measure. I want to emphasize that I think it's one part the regulators do half right. It is not a credit rating, but to some extent, it's going to be perceived as a credit rating. It's just one component of the analysis, and you can do many things, such as what Mr. Quick Fix suggested, that can subvert the RBC process. We're sort of on to this kind of stuff. So if you do decide to do these kinds of things, you might want to talk us in advance about it. Naturally, we do think there are some positive benefits to both surplus notes and reinsurance, if done properly. But there are ways not to do them, and they can bring a lot of problems to your company, which will cause its rating to suffer.

RBC is not a broad based measure of credit analysis. There are many things that RBC does not cover. Here are just a few.

WRITING UNPROFITABLE BUSINESS

Indeed, you can have a wonderful RBC measure and be fat, dumb and happy in writing business that's going to lose money. RBC is a static measure. It doesn't look prospectively. Write enough unprofitable business and, believe me, the RBC eventually will catch up to that. But it's not going to be something that will be picked up.

ILLIQUIDITY

Nowhere in RBC is there anything that talks about liquidity. A few companies have been put out of business because they didn't have enough liquid assets to meet what happened to be very liquid liabilities. One thing that the insurance industry has finally started to pick up on is that its liabilities are liquid, and if there aren't enough liquid assets to cover them, you can have some big problems. Cash flow doesn't work real well when things start getting out of hand. It's nice to have assets that can actually be converted to cash.

INAPPROPRIATELY VALUING ASSETS

One of our favorite regulators in California did an interesting thing. A year ago, RBC had been flushed out, and the regulators were saying that RBC is the way to go. Well, there's a company in Kentucky called Kentucky Central. The regulator said, "It has mortgages that are overvalued by $60 million. Basically, they're overvalued by about $100 million, but the company put up a $40 million reserve. There is a $60 million deficit here. We're going to write it off." By doing that, the regulator said, "I am going to ignore these assets, which an RBC formula had a calculation for, and just simply write them down. The company only has $67 million of capital in the first place. Now it's minus that $60 million because I went and knocked these asset values down by $60 million. It has $7 million net in capital. I'll use the RBC ratio and say that the company is inappropriately capitalized and issue a cease and desist order. It can't write business in California. Read between the lines; it is out of business." What happened was that RBC would have simply said they're nonperforming mortgages and here's the charge. The regulator said he was going to revalue them and then apply RBC. Commercial mortgages, equity real estate, and a few other asset classes that don't have a publicly traded value (BA assets) are strong targets for that. That's not picked up by RBC. It does have a meaningful impact in terms of what regulators can and will do.

REINSURANCE AND UNDERRESERVING

Certainly there are transactions that can include reinsurance, although they are becoming less frequent, or transactions where there is underreserving in a company. And again, RBC is not going to pick that up. Mel mentioned disability reserves. Well, for whatever reason, Provident Life and Accident realized a few years ago that its disability reserves were maybe a bit short and had to pump them up by many millions of dollars. RBC goes sort of inverse. The more reserves you have, the more the charge is. So what happened was, it had an inadequate amount of reserves, the RBC charge was too low, and the rest was capital. So now what happens? Well, it turns out that the reserves were too low, so it had to bump them up. That nails capital because the reserves are higher and so is the RBC component. These are interesting things.

PROBLEMS AT A PARENT, SUBSIDIARY OR AFFILIATE

Just look at Monarch Life. It couldn't do voluntary receivership. Monarch Life was doing quite fine. Unfortunately, its parent, Monarch Capital Corporation, had some huge real estate problems. RBC never picked that up. Monarch Capital went into bankruptcy, and the whole situation pulled the subsidiary in. Also, way down the line was a company called Springfield Life that was doing perfectly fine as well. It also got pulled in.

ASSET/LIABILITY MISMATCHES

C-3 risk does not exist in the RBC model. In no way, shape, or form does the RBC model seek to capture interest rate risk. It does not. So there's a lot of potential there for getting around some RBC measures.

Now I'd like to discuss some of the things that we're doing at S&P. I'm not going to bore you with the model that we have. But if you're interested, we do have our own RBC model. We've been doing RBC analysis with insurance companies for several years. We have recently revised our model and recognized a lot of the benefits that the NAIC model has in it. We think it is one element of good measure of financial strength; one of among seven or eight different categories that we have looked at. We looked at profitability and management capabilities. Good management will always make a company better, and bad management can take the strongest one down.

We've looked at profitability, asset quality, asset valuation, and things like that. Even our model is not a panacea for a full-blown credit analysis. We're working on improving our views of interest rate risk and some of the new derivatives that either exist explicitly or implicitly with some of the asset-backed securities that companies have bought.

We've done some statistical work. The NAIC has one charge (10%) for real estate (an asset that's an equity asset by the way) and it has two risks to it. One is that there is an ability for the value of that asset to fluctuate. And two is that there really isn't any market valuation for it. The NAIC gives that a 10% charge, and common stock, which we can obtain the value for by looking in *The New York Times* or *The Wall Street Journal*, has a 30% charge. It is missing the point there. In any case, our model treats that differently. But nonetheless, there's just one charge that fits all. You can look at an empty building in a poor neighborhood and a good building in an

excellent neighborhood and know that they have different values. You shouldn't have just one charge that fits all. Our charge is 18% for equity real estate. We have found through some analysis, that that varies by company, all the way down to about 3%.

I promised to talk a little about how we view some of the surplus enhancement transactions that mutuals and others do. I have four things on my list: surplus notes, asset sales, reinsurance, and securitization. I don't have demutualization, because nobody is using it at this point. It's one of those things that I'd be more than willing to talk to you about in the question-and-answer session.

Our approach is an economic approach. As a rating agency we have a luxury. We don't have to live with regulators, laws, and statutes. We live with economic interpretations versus accounting impact. We don't ignore accounting because, at extremes, it is clearly something we have to deal with. First and foremost, we're trying to look at the economic impact of a transaction. Is it positive or negative for a company? That draws a lot of our thinking, and there's a lot of qualitative and quantitative aspects to it.

Surplus notes, by the way, are a good example of the approach that we take. Many of them have called it debt; even Art has called it debt. I think he's taking an accountant mentality to that. We don't view surplus notes economically as being debt. If you look at them hard enough, they look more like preferred stock. Take a look at a preferred-stock instrument. It is counted as equity. It is really an equity instrument. In fact, surplus notes are even better from an equity perspective, because the regulators, in their most urgent time of need, say there will be no more payments on this thing. It is also a particularly valuable tool in terms of policyholder support.

There really aren't events of default. Because the regulator says if you can't pay you can't pay, there is no event of default. I guess an event of default is if you decide to not pay, and the regulator is saying you can pay. Tell me how many times that's going to happen.

We think that the accounting impact is probably not as important as the economic impact. The economic impact is that a surplus note really is there to provide policyholder support. As a result, we think it's a positive rating factor for the claims-payment-ability rating that applies to policyholder obligations. That being said, there are two caveats. First, surplus notes need to be deeply subordinated, which they all are. Second, they have to have a significant maturity so that they are out there for a while to be a policyholder support.

How do we rate surplus notes relative to other ratings? First and foremost, we think surplus notes are deeply subordinated to policyholder obligations, so we rate them two to three notches below the claims-paying-ability rating of the insurer. They do have, for the most part, a positive impact. We include them in our calculation of RBC, as do the regulators. However, there is a quality-of-capital issue to it, and that quality-of-capital issue is dictated by how much of a capital structure it represents. To the extent that you have up to 15% of the capital structure in surplus notes, we tend to say that's a prudent amount, and that it's a positive. Above and beyond that amount, we think there may be an overreliance on surplus notes. In this case we will

tend to rate the surplus notes lower. We think it has a deleterious effect on the company's claims-paying-ability rating. There's too much of a good thing.

I have some real specifics about surplus notes and when we view them as capital. They do need to be deeply subordinated to policyholder interest and debtholder interest. The preapproval of the payment has a positive and a negative to it. To the extent that there is preapproval of interest payments, that's a positive to the rating of the surplus note. So the Prudential model, as Art has mentioned, is one that we would tend to view positively in terms of rating the note but somewhat negatively in terms of its support for policyholder obligations. We have, in the final analysis, accepted Prudential's surplus notes as a capital support to the policyholders, because the preapproval is based on meeting an RBC guideline. If it got down to that level it would have some severe problems in the first place. So we say that's fine.

We can be different than state regulators. We do talk to state regulators to determine whether, outside of the preapproval model, they have a positive or negative view about what a surplus note is. Sometimes we'll rate the note two or three notches below the claims-paying-ability rating. The New York regulators tend to be more stringent, and they may decide to not let payments occur on a surplus note. We may be more oriented toward three notches, for instance, in New York state.

We do not differentiate the ratings by maturity of the surplus note, but we do differentiate the support that they will provide to policyholders by maturity; i.e., a 30-year note is far better support than a ten-year note.

Here are other things that mutuals can do to raise capital that we can give you some views on. Asset sales are very popular. Asset sales can come in two ways: sales of invested assets with an underlying capital gain and selling lines of business. What do we think about that? Well, was the business core or noncore? If it's a noncore business, and sometimes some of them are volatile, and if you can get a capital gain on that, that's great. You can get capital immediately from that, plus you get capital relief by not being in that line of business. That does tend to help ratings to some extent. If you're talking about a core business, however, and you're selling that, we're going to ask where you are going to get your earnings from in the future; i.e., now you're reinvesting these proceeds into businesses that may not be performing as well. That's more of a mixed bag. You might not improve your rating in that respect. So if it's a noncore business, and you're not really committed to getting your earnings in the future, and you divest and take those earnings and invest them more in your core business, which can earn more money. That can be a positive.

An example, not exactly as good as I'd like, would be Transamerica Corporation. It said it didn't really want to be in the property/casualty business. It took that business, spun it off through an IPO, and made a lot of capital gains on that. Two things happened. It didn't need the capital support of that business and it threw some of those funds down the life company, which does help the life company's rating.

Other examples would be Travelers selling its broker/dealer business, Prudential selling its Macy's holdings, and Mutual of New York selling a big chunk of its business to Aegon. It was a business it really couldn't make any money on prospectively and Aegon could get a lot more value out of it. Selling it helped Mutual of New York.

Reinsurance
If there really is transfer of risk to a quality provider, one that we rate, there is value to reinsurance. We love pure coinsurance. We think that used properly, coinsurance is a wonderful way of providing capital relief, again, to a company that is highly rated. To the extent that you start using modified coinsurance kinds of transactions, we must really understand what you have. I'll leave it at that.

Securitization
Typically, securitization is not as positive a transaction, to the extent that often companies are retaining the junior piece and all the risk is in its asset classes. Retaining the risk may improve your RBC, but economically you're really not better off. We don't like recourse transactions. We like nonrecourse. If you sold the asset, and it's gone, and there is no recourse, that's good, that's positive. But often these things have recourse, or you're retaining the junior piece which means you're really retaining all the risk. Lets be grown-ups about this. There's not risk transfer there.

We think demutualization can be a positive thing. You're not hearing much about it. No examples really come to mind, although something is going on with Confederation Life up in Canada. Indeed, to the extent that it can provide capital to the company, demutualization is a great positive. One problem with demutualization is that a lot of chiefs out there don't want to be Indians. It's an ego issue and that's a real problem. To the extent that we think demutalization can happen, yes we think it's valuable. I must be honest with you; when we come back home from meetings with a number of mutuals, we question why they are mutuals. They really shouldn't be.

I can give you a quick story of one company in which the CEO was nearing retirement. We would meet with him and he would actively talk about the fact that the company ought to merge. In his case, it was merge or consider demutualization. Merger is one of the other aspects that companies can use to seek capital. Well, what happened? We came back to visit him, the day before he retired as a matter of fact, and he had handed the reins over to a much younger man. We asked him the same questions we were asking the previous year. The guy said, "Merger? What? I've got way too many things on my mind to deal with. We might acquire somebody. But merger?" So you're not seeing a lot of that out there. Let me close by saying RBC is only one measurement among many that you need to use in evaluating a company.

MR. FRANK J. BUCK: We're seeing a lot of activity in the marketplace. There are new rules on GAAP for mutuals, and mutuals that are SEC registrants will have to go through and convert over to GAAP. But others are converting to GAAP as well, mainly because they're sharing an interest in getting involved in capital markets down the road. Maybe they are considering demutualization or something else.

MR. DAVID E. NEVE: Just a comment and then a question. Art mentioned his company was the first to really issue surplus notes; I guess our company was the last, just last month. I think we did benefit from the companies that preceded us. We had a very successful offering. It took about five or six weeks, from the time we decided to do it until we got it successfully completed. I would also like to add to the list of criteria that Art mentioned. In selecting an underwriter, pick an underwriter that you think your people can work with. I think if that's in place it will go smoothly.

Obviously the bond market is volatile right now and a many companies have issued surplus notes. Art, do you think this will be a permanent, ongoing source of capital over the next decade? There are obviously 15% limits and those kinds of things. But do you see this as being something that will be used quite often in the future by mutual companies?

MR. TYPERMASS: For the longest time I didn't see any sensible reason why mutual companies wouldn't have some access to the external capital market. In that context I would hope it would be there as a vehicle. There will probably be some further evolutions, if you will, other kinds of securities. I don't think the last chapter has been written by any stretch of the imagination. A lot will have to do with how we all really approach our various regulators, in terms of whether additional instruments can be derived, and that may indeed do better for us. I think we certainly expect to continue to work at that.

MR. YOUNG: Part of the answer, regardless of the means of raising capital, is what folks do with the money. If levels of prudence are beyond what we have had as an industry, about how we're using capital, then many capital markets are going to be available to us.

FROM THE FLOOR: I don't know that much about surplus notes but I've learned something here in the presentation. I have heard, though, that there are rumblings among the state regulators on whether these things really are surplus. And I was just wondering if anyone on the panel has heard that.

MR. PUCCIA: We talk to the regulators each time companies issue notes. Some states are more negatively inclined to them, but having just talked to regulators this week, as a matter of fact in a Midwestern state, they view these as being quite positive. Most states are still viewing surplus notes as a benefit to policyholders and as a benefit to the insurance company.

The one thing you might have heard about was that there are essentially two models for surplus notes: There are those with a preapproval clause, which basically says that if the insurer meets certain conditions, usually tied to RBC, then the regulator will have preapproved interest and principle payments. That model is really out of favor right now and so there is a lot of negativism relative to that. The New York model, as Art mentioned, says that the regulator has to approve all payments of interest and principle and these models are preferred.

FROM THE FLOOR: I'm not that up to date on all of this, but my sense was that some of this was publicity from people who might be categorized as being industry GAAP flies, saying, here you are with an industry in trouble, why are you approving these things? Perhaps bad publicity politically is causing them to back off.

MR. PUCCIA: A certain professor in Indiana might be somewhat negatively viewing these. I have read some articles from Indiana that have implied those kinds of things. The articles have not been favorably disposed to allowing companies in their domicile to issue surplus notes.