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ISSUANCE OF SURPLUS NOTES BY MUTUAL INSURANCE COMPANIES

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ROBERT E. SCHNEIDER
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Recorder: MAHMOUD BARATI

Panelists will discuss recent activity, advantages and disadvantages (from the viewpoint of the issuer, the recipient, and the investor), risks and cost involved, process, implications for investment management, regulatory developments, financial impacts, financial statements, rating agencies, and future trends.

MR. JOSEPH H. TAN: Surplus notes, also known as surplus debentures, contribution certificates, capital notes and other names are subordinated surplus contributions.

Who among us has worked with or worked for an insurance company that either has surplus notes in its surplus account or holds surplus note assets? Since their initial conception, surplus notes have come a long way and have undergone various changes. Some of you may be familiar that with SEC rule 144A as it applies to surplus notes in the capital markets.

You may also notice that starting in 1994 there are some companies in the NAIC annual statement showing the line surplus notes in a surplus account. Such surplus notes should be clearly identified and clearly disclosed in the notes to financial statements.

For those of you who work with companies that hold surplus notes in their asset portfolios, you may know that such surplus notes are allowed as admitted assets only in an amount determined by the securities valuation office of the NAIC. And that investment income on such notes cannot be reported as accrued until payment by the issuer has been approved by the insurer's domiciliary commissioner.

These financial reporting issues and other similar issues relating to surplus notes have been extensively discussed in the last few years by the NAIC. There's an NAIC working group chaired by Dana Rudmose of the Ohio Insurance Department, which undertook extensive discussion in this subject.

Due to wide differences among various state practices, the NAIC working group undertook a survey from the various states. The results of this survey were distributed by the NAIC Accounting Practices and Procedures Task Force (that's the EX4 task force) at the NAIC meeting in New Orleans in December 1994.

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Looking at the results of the survey, one cannot help but notice the wide differences in the practices, statutes and philosophies of the various states that range from Alabama to Wyoming. If anyone is interested in a copy of this survey please contact me.

We're privileged to have three distinguished panelists who will acquaint us with surplus notes. Our panelists are a regulator, an insurance company representative, and a Wall Street firm representative.

Our first speaker is the Honorable Commissioner Robert Wilcox from the state of Utah. Bob is an Associate of the Society of Actuaries, a Member of the American Academy of Actuaries, a Fellow of the Conference of Consulting Actuaries, and an Enrolled Actuary. He is currently serving on the board of the Academy, the Academy Life Practice Council, the Academy Health Practice Council, and the Conference editorial committee. Among his assignments in the NAIC are chair of the EX4 Subcommittee on Financial Reporting, the chair of the Life Disclosure Working Group, the chair of the Health Organization Risk-Based Capital Working Group, and a member of Life A Committee. Bob will discuss the historical and current developments and the financial reporting and regulatory aspects of surplus notes.

Our second speaker is Robert E. Schneider, executive vice president and chief financial officer of The New England. In that capacity Bob is responsible for the supervision of all accounting, actuarial, audit and tax planning functions for the parent company and its three insurance subsidiaries. He is also a member of the company's board of directors. Bob is a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, and a Fellow of the Canadian Institute of Actuaries. Bob will discuss process, cost, and financial impacts relating to surplus notes, primarily from an insurance company perspective.

Our third speaker is John Forrey, who is first vice president of Merrill Lynch. John is responsible for issues relating to foreign banks as well as insurance and real estate companies. John holds a bachelor of arts degree from Lafayette College and an MBA from Fordham University. John will provide us with the capital market perspective on surplus notes.

My name is Joe Tan and I'm with the National Actuarial Network Inc. Our recorder is Mr. Mahmoud Barati from Aurora National Life Assurance Company.

MR. ROBERT E. WILCOX: My experience with surplus notes has been at small mutual companies. I think this gives us an idea of the historical perspective of surplus notes. They have been issued in the past under regulatory requirements and statutory provisions that were intended to allow affiliates and other interested parties to "prop up" a weak mutual or assist in the formation of the mutual.

When assistance was required by a larger mutual, an adequate source of funds was either not available or was available in some other form. Through affiliated investors, although we don't have parents of mutuals in the usual sense, there have often been affiliates that have been in a position to be that common source of funding through surplus notes for a

mutual. But there may be other kinds of affiliates, noninsurance affiliates that may fit that bill as well. A related marketing organization might be a logical source of funding.

There have been occasions where policyholders have stepped forward to provide funding for a mutual insurer. I've seen this occur in the case of a large group policyholder that utilized surplus notes to form a small mutual company that was then qualified with the IRS as a voluntary employees' beneficiary association (VEBA).

Subsequently, after the notes had been repaid for several years, the owners of the policy changed, and then they decided to abandon the VEBA. They again used surplus notes as a means of recovering funds to plow back into employee benefits and avoid the retroactive disqualification of the VEBA. So there have been some rather innovative kinds of things done by policyholders using surplus notes. Of course, in every jurisdiction, all of this has to be done under the tight control of the commissioner in the state of domicile.

You'll have an opportunity to hear a good deal more about surplus notes when we hear from the other two speakers. But we now have surplus notes being used by large mutuals and not only by small mutuals. It's a means of shoring up their surplus or a way to go to the capital when you can't issue stock.

As a result of SEC rule 144A, we now have unrelated investors, investors that are not involved in this transaction because of the close relationship that they have to the mutual company and the need for their own reasons to "prop up" that mutual. And so we now have a completely different environment with, in fact, surplus notes being tradable securities.

I'd like to share with you the way of some statistics that may be of interest to you with regard to the currently outstanding surplus notes. It can also tell where that might take us.

As you can see in Table 1, we have approximately $6.5 billion of surplus notes issued by life companies and $3 billion of surplus notes issued by property and casualty (P&C) companies. The dominant portion of those issued are under section 144A rules coming from the life side.

TABLE 1
SURPLUS NOTES ISSUED (A/S PG.3)
AS OF DECEMBER 31, 1994

	Life	P & C	Total
Under SEC Rule 144A	$3,106,168,644	$ 900,000,000	$4,006,168,644
Private Placed	3,317,775,501	2,095,200,267	5,412,975,768
Total Per Annual Statements	6,423,944,145	2,995,200,267	9,419,144,412
Less Intercompany	(100,000,000)	(400,000,000)	(500,000,000)
Adjusted Total	6,323,944,145	2,595,200,267	8,919,144,412

If we delete from those totals the intercompany surplus notes ($100 million on the life side and $400 million from the P&C side), we end up with $6.3 billion of surplus notes issued

by life and health companies. Some $2.6 billion of surplus notes were issued by P&C companies for a total of just under $9 billion of outstanding surplus notes.

Now we look at the other side of the equation—surplus notes held by insurers—are shown in Table 2. Of the total outstanding surplus notes held, life companies are holding about $550 million. The P&C companies have just over $500 million for a total of about $1 billion in surplus notes held by companies. Again, if we deduct the intercompany, we find that the life companies certainly dominate in holding the surplus note. If we take the total ratio of that, that is, notes owned by insurers to notes issued by insurers, just about 6.25 % of the issued surplus notes are being held by insurers.

TABLE 2
SURPLUS NOTES OWNED (SCH. BA)
AS OF DECEMBER 31, 1994

	Life	P & C	Total
Statement Value	$551,739,419	$506,366,591	$1,058,106,010
Less Intercompany	(100,000,000)	(400,000,000)	(500,000,000)
Adjusted Total	451,739,419	106,366,591	558,106,010
Notes Owned as Percentage of Notes Issued			6.26%

That ratio was just recently developed from the 1994 annual statement. It is leading the committee under Dana Rudmose of Ohio to prepare a recommendation in its report that will come back to EX4 at the upcoming meeting in St. Louis. The recommendation is that we take no definitive action to change the lay of the land with regard to surplus notes being held as investments by insurers at this time. We've considered making some additional changes to the risk-based capital requirements or some other things but I believe the recommendation that they will bring back is that, right now, we will continue to monitor and observe what's going on there. We'll reserve some future time for making any changes in that process.

With regards to the regulatory aspects, approval is required from the commissioner. The approvals that are required are both as to form and substance. And I checked with the regulators in my own department and they could not recall ever having received a surplus note filing that didn't require modification before it could be approved. And I think you'd find that in most states the departments are rather fussy about both form and substance of what's contained in those notes. You'll run into the kinds of problem like differences in the requirements from state to state.

Our particular state precludes the making of public offerings of surplus notes by statute. There's a limitation of the number of holders of surplus notes that can be approved. And the approval of the commissioner is required in advance for those to be sold to other insurers. Each payment, whether principal or interest, requires prior approval of the commissioner before being made.

A note or two on financial reporting. The issuing company reports these numbers below the line. On page three line 24A of the life company blank or line 32 of the P&C blank. And the admitted value that those are held as an investment is in an amount determined by

the securities valuation office of the NAIC. And it has a process that it goes through for determining those values, but let me quote from the accounting practices manual that is to be followed in determining the values of these securities.

> The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments. And adding same to any other equity instruments in the issuer held directly or indirectly by the holder of the instrument. In addition, such instruments shall be considered in the limitations on investments and affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer's domiciliary commissioner.

So the requirements for holding these as investments are rather strict. Table 3 shows the risk-based capital and asset valuation reserve (AVR) requirements of the surplus notes on the statements of the holder of the notes.

TABLE 3
SUMMARY OF INSURER CHARGES
FOR INVESTMENT IN SURPLUS NOTES

	Statement Value	RBC Charge	AVR Charge
Life:			
NRSRO Rated 1	Amortized Cost	0.023	0.03
NRSRO 2-6 or Unrated	Formula	0.03-0.30	0.04-0.22
P&C:			
NRSRO Rated 1	Amortized Cost	0.2	n/a
NRSRO 2-6 or Unrated	Formula	0.2	n/a

This explains why life companies are so much more likely to be holding surplus notes than P&C companies. First, for a life company, the risk-based capital charge for a one-rated security in a life company is 2.3%. The risk-based capital charge for a one-rated security in a P&C company is 20%. I think that number by itself explains why the traded securities, like the 144A securities, are being held by life companies.

The AVR charge adds another 3% for the one-rated security. And, of course, on the P&C side there's not an equivalent to the AVR charge. But you can see the significant difference in the risk-based capital charges between the life companies and the P&C companies. Even though the risk-based capital formulas will continue to be modified over time, that's the way they stand right now, and I don't think that the P&C working group is intending any change in the near future on the risk-based capital charge for these securities.

And I think that explains why Table 2 shows so many more of the securities being held on the part of the life companies.

MR. ROBERT E. SCHNEIDER: As Joe mentioned, I'm the chief financial officer of New England Life. In February 1994, we issued $150 million of surplus notes under Rule 144A. My remarks will be about the process, the costs, and the financial statement implications of those types of surplus notes. And we'll deal only with the publicly traded surplus notes that have been issued since 1993.

I'll just cover very quickly a definition of these notes from the investor's point of view. They are like any other rated debt instrument, except the investor has to understand it notwithstanding the rating they get from a Moody's or S&P. These notes are subordinate to the claims of policyholders and to any senior debt that the company has issued or might ever issue, and, in fact, to any liabilities that are on the balance sheet. Basically they rank just above equity. They are tradable under Rule 144A, although its not a terribly active market.

The notes are treated as equity as Commissioner Wilcox mentioned, for statutory accounting purposes. They are written in the surplus account. Some of you may be familiar with the capital structure either of stock, life insurance companies or of banks. I tend to think of surplus notes as similar to subordinated debt that is sometimes issued by holding companies of stock companies and then put into the operating insurance companies as capital.

Another analogy is tier-two capital for banks. Banks are required to hold a certain amount of capital for regulatory purposes, some of which is called tier one, which is basically the common equity they have. They're also allowed to count subordinated debt as tier-two capital and can count a certain amount of that as capital for regulatory purposes. Surplus notes function much like they do in a mutual insurance company.

The commissioner must approve the payment of principal and interest, which is sort of the final control that allows surplus notes to be treated as capital. The first surplus note issued under Rule 144A was issued by the Prudential in the summer of 1993. It did not require each payment of principal and interest to be approved at the time it was due rather it allowed interest to be paid as long as the company wasn't in receivership. It allowed principal to be paid as long as certain risk-based capital tests were passed.

My understanding was that it was not terribly popular among members of the NAIC. In fact, it has been effectively outlawed since that. No one can get credit as surplus or capital for a note with that structure.

By the way, the reason for that structure, is initially investment banking community. At least one of the more conservative investment banking firms felt that the investment community would not accept an instrument with as much uncertainty as might be inherent in the requirement that every payment receive approval at the time it was due. I guess Metropolitan issued the second surplus note on a 144A later in 1993. The success of that issue demonstrated that there wasn't a show stopper for the buying, institutional buyers. I don't think it has been an issue in any rating or any issue since.

Since these are dead instruments, they do have a stated maturity. The surplus note range has been from 10 to 50 years. There's at least one or two 50-year issues. There's a concentration of 10-year and 30-year maturities. I believe that those are primarily particular maturities driven by the fact that those time horizons are in demand by the institutional investment community. Some of the notes with maturities in excess of ten years are callable, typically at ten years. But many of them are noncallable for reasons I'll get into later.

SURPLUS NOTES BY MUTUAL INSURANCE COMPANIES

What do you have to go through to issue a surplus note if you're a mutual company? The first step is to select an underwriter or investment banker; in fact, select a couple. Also, select a law firm to represent your interests. This is a very important step if you're the issuer. The advisors you choose can often mean the difference between success and failure, unless you have a slam/dunk deal. Very few mutuals do. Investment bankers have been known to decide late in a deal that either something about the company that they discover in due diligence or the condition of the market makes it more difficult to sell than they thought, and so they back out. You want to be very careful to select your underwriters with a great deal of care.

Virtually everyone that we spoke to agreed that it is really important to use two underwriting firms. One of them will be the lead manager. The main reason for this is after the notes are sold, the underwriters are the market makers. The investment community feels much better having two market makers than one.

Second, you get a couple of points of view as you go through the process of developing the note and overcoming whatever issues arise. And you obtain several different views of the proper price when it comes time to sell it. But I think the main issue is to have a couple of people that will maintain the market for the issue after it's issued.

You have to pick an underwriter with a very strong institutional sales force. Mutual companies are not generally household names. And they're not active issuers of debt instruments, so people that are going to buy them won't be terribly familiar with your company. Therefore, you need an institutional sales force that will be able to get to those people.

Most of the time that it takes to issue a surplus note goes into the development of what's called the offering circular. That's really the prospectus, although technically it's not a prospectus because its not a registered deal.

The outside attorneys that you choose will guide you through the process. And this is why its important to choose a lawyer whom you feel comfortable working. You spend a great deal of time with your lawyers and, at times, even though they're your friends in this deal, they won't seem like it as you go through this process.

The major parts of the offering circular are shown below. I think they're fairly self-explanatory except for, perhaps, the one labeled investment considerations. Some people refer to these as risk factors. It's often the only section of the entire circular that a buyer will read. What it is intended to be is disclosure of whatever material issues there are with respect to a company. It tends to come down to being a listing of every bad thing either your lawyers or the lawyers for the underwriters can think of to say about the company:

- description of company and business
- description of notes
- investment considerations
- details of asset portfolio
- details of liabilities

You would know that the offering circular is a very complete document if you've ever seen one that was issued and prepared by the companies that issued them. They reveal a lot about companies. There's much more information in there that is generally made public. If you ever want to know anything about a company that has issued surplus notes, the right place to go is their offering circular.

As Commissioner Wilcox mentioned, the notes do require regulatory review and approval. Now what will happen is that the offering circular is reviewed by the state insurance department, who is responsible. But the offering circular is not approved by the state insurance department. In fact, there's specific language that says it didn't have anything to do with the circular. The lawyers try to relieve it of any responsibly if investors later feel that they didn't like the deal they got into.

The insurance department will give a letter of approval to the company which basically allows it to issue the notes. It states specifically that the proceeds will be accounted for as surplus. Underwriters require that to be done before they'll consider taking anything to market.

Internal staffs are involved from many areas. One of these projects doesn't necessarily utilize many people, but the people who are involved tend to be involved on a very intense basis. Your actuaries will have to supply a lot of data for the preparation of the offering circular, but they tend not to be the drivers of this process. I would say that treasury and legal staffs typically are leaders in the process and responsible for coordination with the underwriters, the regulators, and the rating agencies, they also tend to drive the process of preparing the offering circular.

There are several forms of costs associated with issuing surplus notes. The most notable upfront costs are the ones identified on the screen. The underwriting discount is the fee that your underwriters will charge; since these are debt offerings, it tends to be a pretty standard scale. For example, on a ten-year deal, I think its five-eighths of a point of the face amount. And on a thirty-year deal, it's seven-eighths.

Those tend to be the most reasonable fees that you'll run into in these deals. It's like when you deal with investment bankers. Normally the underwriters will pay their own expenses and the expenses of their council out of that underwriting discount. If you have an unusual situation that requires a great deal of expense and due diligence, you might be asked to pick up those kinds of fees. You'll have to pay your own lawyers and your own accountants. The accountants are involved because they are responsible for the preparation of the financial statements that go into the offering circular and have to give an opinion on those statements. Neither the lawyers nor the accountants will be cheap in this process.

In order to provide the rating, rating agencies charge fees based on the face amount of the offering. Typically you have to have both a Standard and Poor's (S&P) and a Moody's rating because you're a new issuer.

Finally, there are the internal staff costs, as I mentioned, but there tends not to be many people. One thing I didn't mention is how I might treat the printing bill as an internal staff

cost. You have to have a financial printer as you go through the process of preparing the offering circular. You will be amazed how much financial printers cost.

It is important to track your ongoing expenses, and the main one is the rating agency fees. You have to maintain a rating which requires annual review, and therefore, annual fees. The physical agent, which is basically a bank, is responsible for disbursing the interest to the investors. That's a very small cost. Obviously the big cost of all of this is the interest that you have to pay to the investors.

There are income statement and balance sheet impacts of having issued surplus notes. The first, of course, statutory surplus, is increased as Commissioner Wilcox mentioned. It doesn't affect income and is separately identified in the surplus account. There's no change to unassigned surplus.

For GAAP purposes surplus notes will be treated as debt, assuming that all of the mutual companies get to the point of providing GAAP statements. And there's a charge to income for the annual costs of the interest. The net bottom line impact of that, of course, depends on what is done with the proceeds. If they are parked in interest bearing investments, there's offsetting investment income and potentially some negative spread if you sell notes at one price and buy assets at another simultaneously. If you invest the proceeds in your basic business and form a surplus strain or something, then, of course, you should have profits to offset these interest costs, but the timing may be an issue because they won't necessarily flow at the same time as the interest costs.

One main advantage to the issuer of surplus notes is obviously the increase in statutory capital and the intended improvement in all of the ratios that are affected, such as surplused assets or the risk-based capital ratio.

The notes provide access to the capital market, for the first time in any quantity for mutual companies. I think this is a form of access that, as recently as two years ago, simply was unavailable for mutual companies.

Furthermore, there's the long-term nature of the capital. If you issue a 30-year surplus note, management can think of that as permanent capital, and at least current management can think of it as a permanent capital. We're not going to have to pay it back. Some day somebody else is going to be responsible for that.

Naturally wherever there are advantages there are some disadvantages. First is the fixed nature of the interest cost. The disadvantage is not necessarily having an interest cost. After all, you've had the use of the proceeds, but it has a fixed nature. Even though this is a fair trade-off, the fact is that this is permanent capital on which an interest payment comes due every six months and you must meet it.

Second, you can't always count on being able to access the market. There was a great deal of activity from fall 1993 until March 1994. And then there has been very little issued since. I think it's probably a reflection of the general turbulence in the bond markets, rather than anything specific about surplus notes, but basically the window has been closed for a year now.

As Commissioner Wilcox noted, insurance companies are also investors in surplus notes. I didn't mention asset/liability matching. The existence of a fixed-cost liability requires consideration in asset/liability matching. Cash-flow testing would be an obvious place that you'd have to consider it. Second, since you have a very long liability, to the extent you match it with interest bearing assets requires us to consider types of assets that are different from what we normally use.

At New England, we've established a separate segment in our general account. And we've put in much longer assets than we would normally use for any of our product lines. We're looking at 25- and 30-year bonds because that's the length of the surplus note.

What we've done is put the proceeds into highly rated, publicly traded bonds, which gives us the flexibility to react to any changes in the environment. But nevertheless they're longer than our normal investment.

If an insurance company is an investor in surplus notes, there are both advantages and disadvantages. First, there is some additional yield, these instruments tend to have a wider spread to treasuries than a senior corporate debt with the equivalent rating.

Second, you can buy names that you can't otherwise buy. There was a great deal of interest in both the Prudential and Metropolitan offerings when they first came out. And my understanding was one of the main reasons is because those are very well-known, very highly regarded companies, and there was simply no way to invest in them before these issues were available. Given the call protection (the fact that these are noncallable for 30 years), they sometimes form a nice match to very long liabilities that we have in some of our product lines.

The disadvantages are twofold. First, there is relative lack of liquidity. They are tradable but its not an active market, so I think you'd have to qualify them as somewhat illiquid. And second, these instruments don't receive the regulatory treatment as Commissioner Wilcox was outlining of debt with the identical ratings. Normally if you buy a dead instrument, you can slot it into category one through six and know the carrying value and the risk-based capital (RBC) and AVR implications. With surplus notes, there is special treatment based on some tests of unassigned surplus. If the issuer doesn't meet those tests, then the insurance company investor will have to carry them at a discount. This probably makes them somewhat less attractive to insurance companies as investors than to other types of institutions who do not have to follow the same rules.

Finally just a few remarks on rating agency implications. First, as I mentioned, both S&P and Moody's ratings are required, as a practical matter, when issuing notes. That means, you also have to agree to maintain the ratings. That means you have to agree to an ongoing dialogue with the rating agencies, so you don't maintain the option of walking away if you get tired of them.

The rating of the notes depends on several factors. They usually are tied to the claims paying or financial strength rating of the issuers. But they are rated two to three notches lower than financial strength or the claims-paying rating. The higher those ratings, the less spread there will be. For example, a company with a straight AA rating might get a

two-notch difference so it will have an A plus rating on the surplus note. A single-A-rated company will get a three-notch differential.

There are implications for the claims-paying rating itself. Most of the agencies will give credit as capital note proceeds. Moody's is the notable exception. It treats them as debt, and, in fact, it probably gives you a little bit of a negative affect if you have issued it in leverage to the balance sheet. But S&P, Duff & Phelps, and Best's will all give equity treatment. The credit depends on the length (longer is better), which is why there has been a preponderance of the 30-year notes. What's kind of interesting is they won't give credit beyond the call date, which is another reason why so many of the 30 years are noncallable. Apparently they feel that even though the call will occur only if its advantageous to the issuer, there's no chance that it can be put to the issuer. That lack of certainty that the proceeds will be in the capital account for the full term, reduces the credit that they are willing to give for surplus notes.

MR. JOHN FORREY: As Joe mentioned, I'm going to try and focus my comments on the capital market's perspective on surplus notes.

Some of these topics have already been covered so I'll try to briefly cover them. From a historical perspective, surplus notes were typically issued by troubled insurance companies. What changed in 1993? The Prudential became the first healthy insurer to access the capital markets by issuing a surplus note under Rule 144A. Rule 144A states that you don't have to register the securities with the SEC. They can only be purchased by qualified buyers.

One of the key features of Prudential's issue, as mentioned, was that surplus notes are basically subordinated to everything. They are deeply subordinated securities. Also, there was the feature that payments of principal and interest must be approved by the regulators, if the risk-based capital is at or below the company action level. So, I guess, another way of flipping that around is that you don't have to get approval, as long as you have sufficient risk-based capital.

Since this was the first transaction of its type, the Prudential deal had to come at a wider spread than one might think. Again, despite the fact that it was a way to invest in some of the Prudential securities, it was basically priced at about 120 basis points over the ten-year Treasury. Then the spread narrowed over the next several weeks as people became more comfortable with the structure and the whole idea of a surplus note.

Now again, as it was mentioned, other state regulators were uncomfortable with this Prudential structure, specifically the preapproval process. In general, the regulators wanted complete control and the ability to have to approve every payment of interest and principal. So, as a result, a new structure was devised and it has been adapted to the New York style structure. But, in this case, every payment of principal and interest has to be approved by the respective regulator.

To be quite honest, this subjective condition has given investors a bit of concern. I think it was a hurdle that people had to get over. But the market seems to have reached what I think is the correct conclusion, which is that regulators are quite reasonable and that the

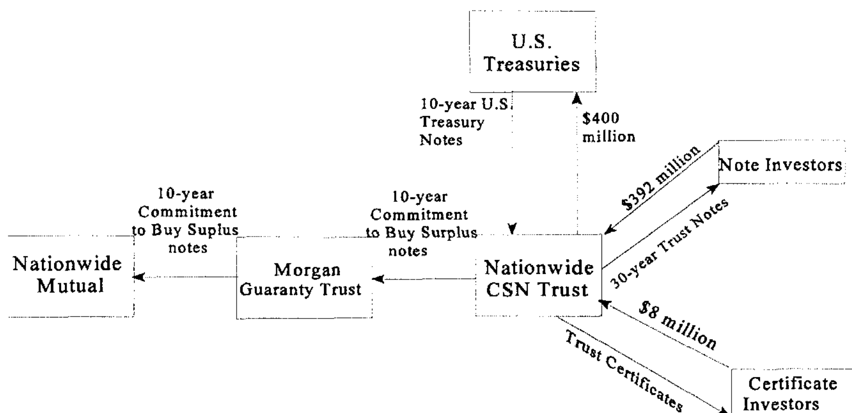
stopping of payment for anything short of a real problem situation would really be a self-defeating proposition.

Where has the market gone? The next issue was made by Metropolitan. You've seen quite a few very large companies access the market. We basically have 15 different issuers. Twelve of them are life companies and three of them are property and casualty companies. You have 23 different surplus notes. And the total market now holds $4.9 billion, which would include some issues that were made in 1995. All of the issues since the Prudential deal are New York style. I think what's interesting is that we see that the market seems to basically be indifferent between the two structures. They've come to the conclusion that even though at face value the Prudential structure would be more appealing, there really seems to be no spread differential.

The maturities have varied from ten years to as long as 50 years in the case of a principal mutual deal. I think it was significant that it tested the market's interest in an investment with such a long term. I think many people felt that a 50-year deal was not something that could be done or successfully placed. The other interesting thing is that the credit market is obviously viewing the different issuers in a fairly wide range, and some of the issuers are trading as tight as 80 basis points over the Treasury. Some of the notes are out as wide as 300 basis points over Treasury. So there is a very diverse market.

Earlier this year, Nationwide Mutual came out with what I thought was very innovative financing. They issued what's called a contingent surplus note. I don't know if any of you are familiar with it so let's go over what they did.

CHART 1
NATIONWIDE CONTINGENT SURPLUS NOTES



Basically, Nationwide was of the opinion that it didn't need capital now, but it wanted access to the market in case it needed capital at some time down the road, perhaps if a catastrophe hit or if it had some other capital needs.

It set up a trust, Nationwide CSN trust. And that entity basically issued some trust notes to investors and some trust certificates, for a total of $400 million. It took the proceeds and invested them in ten-year Treasuries. And then the trust has issued essentially an option through Morgan Guaranty to Nationwide Mutual to draw down surplus notes at any time. And again, at any time during a ten-year period it can basically drawn down and issue surplus notes to the trust that will pass on the Treasuries to Nationwide. If it does not issue the surplus note, basically, the trust will be unwound and the bonds and the certificates will be called. So, the treasuries will mature, and the proceeds will be used to pay off the investors.

Nationwide cited the fact that it viewed this as being inexpensive reinsurance. I think *The New York Times* published a recent article mentioning this as another vehicle for reinsurance.

What's interesting is that these notes were rated the same as Nationwide's traditional surplus notes that were issued in 1994. And effectively, after analyzing the cash flows and the credit risk, it really is very similar to a traditional surplus note; again it's very innovative financing.

The underwriter helps prepare the documentation, which really focuses on an offering memorandum or offering circular. That's very similar to an S1 document. This is an extremely detailed document with a lot of disclosure about the company, and it includes a business review of financials, management discussion analysis, and obviously, a description of the securities.

The next major role of the underwriter is the due diligence. This is very thorough. In fact, it really approaches the level of due diligence given to an equity initial public offering. Most mutual companies have not undergone this type of process or this degree of disclosure for an issuance. It is a major undertaking for a mutual company. Depending on the strength of the insurer, an asset review by the underwriter might also be necessary. This can take several days or even a couple of weeks.

The next step is the marketing of the surplus note. Typically the way it would work for the underwriter is the corporate bond research department, which is the area that I work in, would basically sit down with the sales force at our firm and do a detailed run-through of the company and then really hit on the credit fundamentals. Essentially it's an education of the sales force. At about the same time, the offering memorandum is sent out to investors and some investors have time to do their own credit work.

About a day or two before the expected pricing, the insurance company will have a conference call with investors. They'll talk for 20–30 minutes about the company's business lines, their strategy, and their financial performance. At the end of that, they'll open it up for questions and answers from investors. Its really the highlight of the marketing process; its the company's opportunity to sell their story to the investors, and it gives investors a chance to ask any questions that they might have. The final process for the underwriter is the pricing. An underwriter's syndicate will send out price talk to the market. The price talk level is based on the underwriter's opinion of where the note should be priced. And its usually keyed off where similar credits are trading in the marketplace.

Investors then will give feedback to that price talk and there's a little bit of give and take and a clearing level is reached and the notes are priced.

I'll just briefly discuss the rating agencies. The rating agencies obviously are very important because the ratings influence the price of the surplus notes. Over and above the rating is the language that they might put in the rating announcement. In the other words, is there a stable outlook? Do the ratings look a little bit vulnerable? All of that can have an impact. And then the other thing the rating agencies do is place restrictions on the size of the deals. As Bob mentioned, there are leverage considerations and the rating agencies talk as if they limit the amount of surplus notes you can have in your capital structure.

How are they rated? Again, it is keyed off the claims-paying rating. Typically it's two notches. So if you have a Aa3 and AA minus, you'll have a surplus note rating of A2/A. Again, as was mentioned, as you go down the rating scale, you might have a three-notch spread.

I already mentioned the fact that Moody's and S&P limit surplus notes in the capital structure to about 15–20% of the pro forma surplus base. S&P will typically give 75–100% equity treatment to surplus notes. Again, it focuses on the life of the maturity and things of that nature when determining how much it will give credit for. Moody's, on the other hand, views surplus notes as debt and gives zero treatment or zero equity treatment.

Now how do we value surplus notes, or how does the market seem to view valuing surplus notes? Well effectively surplus notes have a structure that is a hybrid between a debt instrument and a preferred instrument. While they have a final maturity unlike a perpetual preferred, they are obviously deeply subordinated. And the interest payments can be deferred without being in default.

Let's look at a few examples. How do surplus notes look versus other sectors? Bob had already mentioned comparing them to a bank holding company or a bond. I think it is very interesting because, again, you have regulatory risks of getting cash flow up out of the regulated bank entity to the holding company. Double AA surplus notes are trading at the same level as a weak single A or a high triple BBB subordinated bank holding company issue. Met Life is at ~6.30% surplus notes and all three are trading just a couple basis points wider than a First Fidelity subordinated holding company issue.

If you look at it versus an insurance holding company, it's an interesting exercise given that insurance holding companies generally rely on the cash flow coming out of the regulated insurance entity to service the debt. Here you have a situation where Mass Mutual is trading almost 30 basis points behind a Geico with similar ratings.

Obviously, you do have the 144A and there are some adjustments that must be made because there is less liquidity in a surplus note. In general, I think it's a fairly significant spread.

Finally, how does it look versus a perpetual preferred security? In this situation they're trading what I would consider to be only moderately better than a fully taxable, perpetual

preferred. If you look at Hancock's surplus note and compare that to Providian's Perpetual Preferred, you see its a fully taxable non-DRD perpetual preferred. You're really only talking about 50 basis points. So, again, it seems to be a hybrid and the market seems to be viewing it that way.

Who are the investors that we've seen participate in the surplus note market? The largest investor base has been the total return money managers. And they're looking for the incremental spread as well as investment performance from these securities. You also have pension funds, state governments, and bank trust departments participating in the sector.

What I found interesting from Bob Wilcox's discussion was the amount of participation by insurance companies. We had estimated that it was about 10–15% in the general account. I thought it was very interesting to see that it's actually quite a bit less than that. The reasons why insurance companies might be more reluctant to invest in the surplus notes are obvious. First, they typically don't want to give capital to their competitors. Obviously, the regulatory situation has more punitive risk-based capital charges versus bonds. Those are some reasons why we didn't see insurance companies becoming large players in the surplus note market as buyers.

I think another interesting point is that the 144A narrows the potential buyer base for surplus notes. As a 144A security there are many investors that simply can't buy them. There are many investors who, as a policy, do not buy 144A securities.

Typically the illiquidity with the one less liquid market with the 144A securities and the smaller potential buy base can cost an investor or an issuer anywhere between 5 and 15 basis points.

Let me wrap up with some ideas about future developments. One of the most frequent questions I get is, are we going to see some more contingent surplus note issuers? We know that many companies have looked at it. But, to date, Nationwide is the only one that has actually executed one. I think companies are wrestling with the breakeven type analysis. Does it make sense? You save money upfront if you're looking at it as a reinsurance substitute. But when you do a breakeven analysis, it may or may not work for you.

Again, I think we might see some, but at this point, there has only been one issue of that type. Will there be more property and casualty issuers? As I said, 12 of the 15 issuers to date are life companies. I think we will see more P&C issuers. But it seems that the life companies are more concerned about the risk-based capital ratios for competitive purposes. I think, it will still be heavily weighted on the life side.

What about stock companies issuing surplus notes? Stock companies or stock insurance companies have looked at it, but, I think, when all is said and done, it doesn't really make sense. A stock company could issue through the holding company or issue public bonds.

Let's discuss the total potential supply. Investors get concerned. I think they have a feeling that there's this huge industry out there that's ready to unleash a massive supply of surplus notes. The reality is that there's a limited supply when you think about the fact that

to issue a 144A type security effectively, you must have a certain deal size. This is not a private type security. You probably have to have at least $75 million and maybe more than $100 million to get people's attention. Based on that, regulators and the rating agencies put constraints on you to have no more than 15–20% of your surplus base represented by surplus notes. You have to have a certain size company. I'd say, for a smaller, lesser-known company, there better be a pretty strong credit for the markets to accept this type of deeply subordinated security. We don't see a huge potential supply. But there clearly will be some more surplus notes issued in the near future.

FROM THE FLOOR: Can an investor of a surplus note sue to accelerate or recover his interest in the investment?

MR. FORREY: You can sue. You have a right to do that. But no, you cannot accelerate the payment of the security. And that's one of the key issues regarding the structural disincentives for investors.

MR. WILCOX: I would say the language in the offering memorandum makes it pretty clear that you have basically no rights if a regulator takes action. The regulators have been very concerned that the language is very strong about their discretion. So, as John said, you can always sue in this country over anything, but I think the chances of winning aren't very good.

FROM THE FLOOR: What kind of pricing is involved as far as the yield required?

MR. WILCOX: With regard to the affiliated investor, the rate that's stated tends to be a fairly reasonable one, because the parties involved are a parent, a subsidiary, or some interested parties.

MR. TAN: Some surplus notes could demand as high as a 15% required return.

FROM THE FLOOR: Rather than selling a surplus note, can a mutual company accomplish the same thing by putting up a stock subsidiary and selling it?

MR. WILCOX: Nobody will buy it.

MR. SCHNEIDER: Regarding the mutual, the problem is who will buy it?

MR. WILCOX: You would have a stock subsidiary but its not an operating company. At my mutual company, all of our operations, all of our sales, all of our profits are in the mutual parent. If we establish a stock subsidiary and go to the market and say, why don't you buy stock in this neat little vehicle; they're not going to fall for it.

MR. SCHNEIDER: You could go through a complicated process of moving your business into a stock subsidiary and then sell off that stock subsidiary, but that's a complex process and has to be an operating company; it can't be simply a financing vehicle.

MR. WILCOX: I think there's a big difference between what is, in the end, a dead surplus note, and the real equity that you would have if you issued common stock in a subsidiary.

MR. FORREY: Yes, I think it's obvious. There's a maturity on these securities. You know, there's a coupon that you expect to get. It's very different. I mean again, it's a deeply subordinated security. As I said, its a hybrid and has more of the characteristics of a preferred stock. But again, I think, its very different from a common equity interest or a common security.

FROM THE FLOOR: Has there been any move to securitize or to put together a group of surplus notes and sell it off? Derivatives are an example.

MR. FORREY: Well, I think you can customize. No, we haven't seen any move to do that. Again, an issuer could issue a shorter surplus note if that's where the market was. We've seen a tug-of-war where the issuers typically want to go out long, as long as possible. Investors may want to be more comfortable in the ten-year sector. It depends on where rates are and where they see rates going. Eventually, its either something that can be issued or cannot. Second, 144A securities are less liquid than public bonds. There's no question. But there's much more liquidity than people think there is. For example, at Merrill Lynch, we trade surplus notes off our public bond traders; we don't trade it off our private desk. So we try to get more flow, and I think that has been a positive factor.

MR. WILCOX: John isn't there an element of that securitization in the Nationwide arrangement with the trust? Even though it's for a different purpose?

MR. FORREY: Yes, I guess you could look at it that way. You have the same risk as owning a surplus note in my mind. I mean, I think, its an interesting vehicle.

MR. WILCOX: But it goes through a similar process.

MR. FORREY: Right.

MR. WILCOX: With a different purpose in mind.

MR. FORREY: Right.

MR. TAN: John how about making a derivative instrument out of it? The Wall Street firms are well known for slicing pieces of the instrument and selling them to various investors.

MR. FORREY: You know anything is possible. But what I can say is, I think the investor base that has participated in this are your traditional bond buyers. And they're comfortable buying it. So, you know, that's possible but I'm not aware of any. Now they're looking to do a derivative type structure or securitization. What I can tell you is the rating agencies don't give you any capital. S&P will not give you any surplus treatment for the contingent surplus. So you don't get any equity treatment upfront. But they don't penalize you on the leverage basis other than the cost of servicing the debt. You get leverage added to the company and you don't get any equity treatment, but I'd say it's not overly significant one way or the other. For IRS purposes, the surplus is not subject to surplus tax; it's considered dead for tax purposes.

FROM THE FLOOR: The interest?

MR. FORREY: The interest is deductible. The certificates are subordinate to the notes, and the reason that the certificates were issued is twofold. One is for the notes to qualify as debt for tax purposes. And the second one I believe is to have the notes qualify for ERISA purposes as well. It was structured that way.

FROM THE FLOOR: That is the highest rate.

MR. FORREY: Yes. I think it was 12.2% for the certificates. And the coupon on the notes was 9⅞. It won't change. Obviously there's the statutory and regulatory accounting. I think people now view it as again being a quasi debt instrument. So, you know, I'd be surprised if that would change things from an investor's standpoint, I've seen GAAP statements that would be viewed positively from the insurance issuers.

MR. SCHNEIDER: This is opinion but, I don't think you'll have a terribly large impact if you look at stock companies. They tend to want to get some debt into their capital structure. In other words, if your regulatory capital is all pure equity capital, you have a very expensive capital base. The situation that mutuals find themselves in is capital has to be equity capital. It's pretty hard to calculate or be sure you can calculate the cost of capital from a mutual company cost equity capital. You have to feel that the cost of debt is lower than the cost of capital. So, if you can get a 20% lower cost of capital into your capital structure, you're better off, so I don't think GAAP statements will make them less attractive to mutuals.

MR. TAN: A question for Commissioner Wilcox. As regulators, what do you consider in deciding on the approval process of the transactions and also the payment of principal and interest? Perhaps you could relate it to the companies in your state where one company is an issuer and the other company is a holder of the surplus note.

MR. WILCOX: First, let me say, we have no 144A transactions in Utah. These are all coming from the larger companies in New York, Illinois, and Ohio. I guess there's a limited amount in California and Massachusetts, but there are none in Utah.

I think the concerns that we have are on the surplus notes that we've approved in Utah; we're generally looking at private placement notes. And we wanted to make sure that there is as much understanding on the part of the investor as there is on the part of the issuer. Then there are no surprises down the road when we deny payment or deny approval for payment of the payments that are due. And then we track, very carefully, in each instance. It requires a separate application each time payments are to be made and we review the policyholders security that will exist before and after the payment of the surplus note to make sure that the policyholders are adequately protected in the process.

In any jurisdiction, whether its Utah or Massachusetts, the repayment of surplus notes is a consideration. I think we're all concerned about making sure that there is a reasonably even flow of funds that are involved in these. One of the concerns occurs when you have a company that is getting closer to the time when the surplus note is to be repaid and is still depending on that surplus to remain viable in the marketplace.

There has been some discussion and consideration of increasing the risk-based capital charge during the last few years before the maturity of the surplus note. Then, the money, in essence, is set aside in anticipation of the repayment of the surplus note. And I know that Best does something like that in its rating process during the last few years of a surplus note. We may find some movement within regulators to do that through the risk-based capital vehicle.