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SURPLUS MANAGEMENT STRATEGIES

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Recorder: DONALD F. BEHAN

After the panel is interviewed, the audience will have an opportunity to ask questions on the topics discussed, including risk-based capital (RBC), reinsurance, growth and profitability, cost of capital, and required surplus.

MR. DONALD F. BEHAN: I'm pleased that we have two excellent panelists with us. Donald D. Solow is vice president of Life Reinsurance Corporation of America, and he has spent most of his career as an actuary focusing on reinsurance. But he also has had many other types of experience as an actuary, ranging from being involved with credit insurance and annuities to being involved in the investment function and being involved in the tax function for a while.

Hank Lauricella—Francis E. Lauricella, Jr.—is a vice president with J. P. Morgan & Company. He is not a member of the Society and I appreciate his willingness to come to New Orleans. Hank actually hails from New Orleans but is based in San Francisco. Hank has been with J. P. Morgan for ten years and has spent his most recent time there focusing on the insurance industry, primarily on the life insurance industry. He has a bachelor's degree from Harvard and a master's degree in business from Yale Business School. He has been involved in a number of transactions with life insurers involving the issues that we are going to talk about.

The subject of surplus management strategies is obviously an important one if you look around at some of the problem situations that have happened in recent years. It is clear that it is good to have an idea of how you are going to be able to maintain your surplus going out into the future.

But I think there are many other situations, other than the obvious ones that you have seen, where companies have become aware of surplus problems emerging in the near future, and they have done things that they really did not want to do. They did things that would not have been part of their long-term strategy because they found themselves getting into a difficult situation in relation to surplus. Many companies, not only the obvious ones, would have benefitted from a better strategy for surplus management. I hope that today we will be able to get into some of the issues that you are interested in and talk about some of the surplus management alternatives.

Hank, when we talk about a surplus management strategy, what are we really talking about? What do we need to have in mind as we come up with a strategy for managing surplus?

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MR. FRANCIS E. LAURICELLA, JR.: I think what it primarily entails is an explicit allocation of capital to particular lines of business, combined with performance measurements—return on surplus by line of business, for example. This might sound rather simplistic, but in a variety of projects that we have worked on, we have found that this type of surplus management is a fairly recent development, particularly among mutuals. It is a management technique probably followed with less rigor by life insurance companies, especially mutuals, than by industrial companies.

Having said that, I think the advent of RBC has really forced life insurers, both stock and mutual, to focus on this concept, and the industry has come a long way very rapidly into understanding just how precious surplus is and how to manage it.

MR. BEHAN: Do you see RBC driving this issue? In other words, if we're talking about surplus management, what is it we really should be looking at? Is it statutory, GAAP, RBC, or ratings?

MR. LAURICELLA: I think life insurers have different constituencies that they have to please. I would like to say that companies should be mainly concerned with economic return and franchise value, that they should be more focused on GAAP numbers than not, but state regulators, who serve a critical function, have an essentially different way of looking at things and must be pleased as well. So life insurers must do a juggling act that industrial companies certainly don't have to do.

MR. BEHAN: Don, when you are dealing with reinsurance and dealing with surplus management issues through that vehicle, do you look at the statutory or the GAAP effect? What do you really focus on? What are companies really interested in doing as you talk to them?

MR. DONALD D. SOLOW: Often the key question is, what is your real constraint? In some instances you are constrained by RBC. You may be constrained by rating agencies. Or you may be constrained by your own feelings of how much capital you should have to run your business. And I would argue that the most onerous constraint may be the one that you have to manage to. So that is where reinsurance often comes into play. Look at which of these constraints is giving you the most problem and then look for a solution to that.

MR. BEHAN: Can it be any of those constraints, or do you usually see one in particular?

MR. SOLOW: Well, usually it would be statutory surplus. A company may be just growing too fast and outgrowing its statutory surplus. But many times it is the rating agencies also. The rating agencies have, arguably, gotten a little bit tougher lately, and companies are looking now to keep their rating where they think it should be in order to reach their target sales volumes. But I think RBC, in some instances, was not really an issue. Companies found themselves much higher than they thought they would come out on that scale, and they are not so concerned about it. So it is surplus for growth, we are seeing problems there, and rating agency capital requirements.

MR. LAURICELLA: Could I just mention one other thing? From a stock company's point of view, there is an interesting trade-off between the returns on capital required by investors and the kinds of surplus levels that might be required to placate the rating agencies. For example, I also was very surprised at the RBC levels when they were published. Many companies were in excess of 200% of what they really needed, and some were much higher than that. That suggested to me that some of these companies were not necessarily earning the kinds of returns that stock investors would demand. I think many companies are recognizing this and are considering ways to reduce RBC, say down to 175%. In one recent acquisition, the acquirer plans to finance the trans action partly by taking redundant capital out of the target, which has been operated in excess of 400%. It's hard to please shareholders at those RBC levels. A mutual company does not have to satisfy their constituency (the shareholders) who might not necessarily view that as redundant.

MR. BEHAN: And when we talk about surplus management strategies, it doesn't necessarily mean that we are trying to figure out how to get more surplus into the business.

MR. LAURICELLA: No, it is how to use what you have very effectively and very efficiently. I think that is the key.

MR. BEHAN: By a show of hands let me just figure out who is in the audience. For example, how many of you are associated with mutual life insurance companies? How many are associated with stock life insurance companies? Are there regulators? Who are consultants? There are a few more stock people than mutual, but we do have a good number of mutual people. We do not have regulators in the group. There are a fair number of consultants. It's interesting. I am a little surprised, frankly, that there is a good mix of mutual and stock. I would think that because the stock companies have more opportunities to have different vehicles for raising surplus that they would have a higher level of interest, but it appears that everybody is concerned about the issue.

Hank, could we talk a little bit about some of the things that you can do to manage surplus? What techniques would you actually use?

MR. LAURICELLA: In the summer of 1991, when Mutual Benefit ran into its problems and the rating agencies began downgrading large numbers of companies, there was renewed interest in demutualization, and in the case of many companies, particularly mutuals, an effort to scale back top-line growth. Many companies simply decided to grow more slowly and to let the statutory profits emerge on their in-force business, increasing their capital and surplus in a way that the rating agencies will find satisfactory. Later the demand for variable products increased sharply. That allowed companies to renew growth, but with less capital-intensive products.

MR. BEHAN: Do you see some changes, Don, in terms of how reinsurance is being used, in terms of the transfer of risk issue, and that sort of thing?

MR. SOLOW: Yes, the old style "surplus relief" has really gone by the wayside. In some cases the regulators deemed it inappropriate to improve your balance sheet without moving risk to the reinsurer. So the fee-based, 2%-of-surplus treaty is harder to do. It probably can still be done, but much of the risk needs to be transferred. So we see companies now that are thinking more strategically. If they want to reinsure blocks of business, they are recognizing that they are going to give up the profits on that business. All the risks are going to be transferred, and I would say that all the profits are going to be transferred. So this means that it is not so much a temporary borrowing, if you will, of surplus, but rather a long-range plan to get some surplus from a reinsurer. I think some of the reinsurers are probably richer in surplus than they would like to be, and they have some money to invest.

So the key is obviously the degree of risk transfer, and it must satisfy the new regulations and the spirit of those regulations. Otherwise, I think the regulators will come back and say, "This is exactly what we have been trying to avoid."

MR. BEHAN: I think it sounds kind of harsh to say all the profits are going to be transferred. What do companies do if they think that they have a problem to deal with now, but they don't want to give up all those future profits?

MR. SOLOW: Giving up the future profits is probably not as bad as it sounds. If you price your product for a specific return, and the reinsurer is also happy with that return, then you should get a ceding allowance on the order of the present value of those profits, and you would be getting a fair exchange. Rather than having something come to you in the future, you can get it now. There may be instances where the reinsurer's profit goal is different. In that case, possibly, you get more than you would normally expect. Possibly you would get less. But if the reinsurer's profit goals are similar, then it is just an exchange of the future profits for something now. And sometimes the now is more important, if you are growing more rapidly than you had planned to. You may need some surplus now.

MR. LAURICELLA: Another form of surplus management that companies pursued was to restructure their investment portfolios to reduce exposure to risky assets that have very high capital requirements, such as high-yield bonds and mortgages and real estate.

It is interesting that RBC for mortgage-backed securities, which have an interest rate risk associated with them, are lower than they are for mortgages. I think this prompted the industry to focus much more on acquiring these sorts of assets, and the result is that many companies altered their investment risk profile, increasing interest rate risk and reducing credit risk. This has been a very major trend over the last few years.

MR. BEHAN: Let's talk a little bit about going outside the company, actually raising capital in some way. Let's talk about some of the tools. Is it just a matter of surplus notes or selling stock? What are some of the other tools that are being used or could be used by companies, and how are those tools changing?

MR. LAURICELLA: As I said earlier, there was renewed interest in demutualization in the 1990s. The success of the Equitable demutualization encouraged, I think, a lot of mutuals to reinvestigate the merits of becoming a stock company. Quite a few companies considered that, but in the end, they did not demutualize. I think they did not because the cost proved to be very high. Moreover, the management time required was very extensive. In one instance, in which the company did not really need the capital, the regulators questioned the entire process and discouraged the company from demutualizing.

Having said that, there was still a lot of pressure on many mutuals to improve their capital position to please, not so much the regulators, I think, as the rating agencies. Fortunately, public capital market conditions evolved, allowing mutuals to issue surplus notes to public market investors beginning in 1993. There had never been a public market for surplus notes before; in the past they had been issued primarily for strategic or emergency reasons to a closely related party of the issuer. In 1993, however, a public market for surplus notes developed quite quickly, as highly rated mutuals offered investors attractive yields at a time of low interest rates. So this market developed successfully, allowing possibly some life insurance companies that might otherwise have seriously considered demutualization to get the capital that they thought they needed without spending all the time and the pain of going through demutualization.

Another significant capital-raising trend has been the divestiture of downstream subsidiary stock companies. There was a wave of this during the 1992–93 period, when multiples in the public market for life insurance stocks were at extremely high levels, and many companies, including mutuals and the Blues, took advantage of high valuations by partially selling off subsidiaries.

MR. BEHAN: I guess you've seen some of that in the health maintenance organization (HMO) area also. I believe multiples are very high there.

MR. LAURICELLA: Right. There they actually continue to be high. I was thinking of cases such as General America, which sold its HMO—that was actually in 1991, I believe. It was partially sold to the public. And Blue Cross of California sold Wellpoint. So, yes, there have been quite a few transactions in the managed-care sector.

MR. BEHAN: Don, you go around to many companies and talk with people about specific issues related to a particular reinsurance deal. As you do that, do you have a sense that there is an overall strategy that people are working within, and you are going in and doing a step within an overall strategy? Or are these all just one off, where a person sees a need to get some surplus and goes out and does a deal for that particular need and then goes on to something else?

MR. SOLOW: I think the only theme that I see consistently is that some of the methods that Hank has talked about are really for how you are going to position your total capital base long term, whether you are going to go to the equity markets, the debt markets, and so on. But as a reinsurer, we see companies when their need for surplus is a little bit smaller. Maybe a company only needs $10 million. Certainly a mutual company is not going to demutualize to raise $10 million of surplus. There probably is not much of a market for surplus notes to raise only $10 million of surplus. So we are finding that companies have smaller needs and want to customize how they acquire that surplus. The reinsurance market, I think, is going to companies that say, "We have these smaller needs short term" and then the reinsurers can structure something that works for those needs. There is not much of a consistent pattern, other than that these are usually companies that are going through a period where they are just growing faster than their capital base can support, and they see a need for surplus, maybe only over the next two, three, four, or five years, and after that their projections show that they are OK. So they are not likely to take radical steps to raise that kind of money but would prefer some customized reinsurance arrangement instead.

MR. BEHAN: At this point we have been through a brief outline of what some of the subjects are here that you might be interested in. Now I would like to make this more of a participatory session and get the audience involved. I hope that some of you have questions for the panelists or comments about your own observations on this subject.

MR. DONALD A. SKOKAN: I have a question about how one would go about determining the cost of capital for a mutual insurance company.

MR. LAURICELLA: Well, I guess I'll try to take a stab at that. I suppose one proxy might be the cost of equity derived from the capital asset pricing model. First, you would identify a group of stock companies in similar lines of business and with a similar level of profitability. A mutual would need some type of GAAP reporting system in place to measure GAAP profitability in order to select peers. Then, for these peer companies, you would estimate the average beta, which is the sensitivity of these stocks to movements in the market as a whole. This average beta would serve as a proxy for the mutual's theoretical beta. Next, you would multiply this estimated beta by the market risk premium and finally add the product of that calculation to the risk-free rate by using the 30-year government bond yield. That process might give you a very rough estimate of the company's cost of capital.

MR. DALE S. HAGSTROM: I do not want to dare disagree with Hank, because he's an expert on capital markets and I'm not. But the question of cost of capital for a mutual company, obviously, is not real straightforward, and therefore I have about four theories, all of which are probably different. But let me throw them out just for your thinking, because maybe one is relevant to you.

First, as a target, you must determine a kind of minimum cost of capital that you ought to charge yourself in terms of pricing. Recognize what your long-term growth rate in that mutual company is. Assume, for the moment, you can't get capital anyplace else. If, over the next hundred years, you are going to grow at a 10% rate, your capital had better be growing at 10%. So, after tax, after equity tax, and every other thing, you had better be earning at least 10% if that's your growth rate long term. Maybe that's not your cost of capital, but in some sense you had better be aware of it.

The thing that Hank was getting at it in effect says that part of your capital or maybe all your capital in mutual companies, comes from policyholders who don't realize they are making an equity investment when they buy their life insurance. In some sense there may be almost a mixture there of debt and equity, and Hank was getting at some mixture there. I can't for the life of me figure that out, so maybe what Hank said makes sense.

MR. LAURICELLA: I see your point. I was making a simple assumption that it was all equity.

FROM THE FLOOR: You can get people to give you money, capital, in a par product at less than a classic 15% return; then maybe your cost of capital is a little lower than the equity sort of thing.

Another notion I have, maybe not true, is that you would say to yourself, "What's my cost of capital? What might I have to carve back on?" I think Hank mentioned as a quick fix that some companies had slowed down their growth. Fine. That means they gave up an opportunity to use some capital. That was a cost of getting that capital more visibly on the books. Ask yourself, what is your return on that equity you could have invested in new business and not on average, but on the margin? I mean, you didn't get rid of your overhead when you slowed down your new growth. That's a sign of a slowly dying company, if you don't do anything else, if you don't find a way to cut expenses, whatever. So that return on equity, on the margin not charging fixed overhead is what you gave up, and that is the cost of capital that you, as a quick fix, tried to get on your books by slowing down that growth. So that is a rather high cost of capital, I suspect. I mean, if that is your alternative, when the time comes that is going to be your cost of capital, and maybe you should start recognizing it today.

MR. BEHAN: Don, you mentioned earlier that if a company's profit target for return on equity is different from the reinsurer's, then there could be some differences in the price or in the transfer that is made. Maybe all the profits get transferred and maybe not. But do you get into explicitly looking at some of these cost-of-capital issues in pricing, and do you deal with that with your customers?

MR. SOLOW: As a publicly traded company, we need to be concerned with cost of capital. I would take the approach that if people have already indicated an interest in reinsurance as a solution, they have looked at alternate sources of capital and the costs of those sources of capital and have come to the conclusion that either reinsurance is a cheaper cost of capital or just more convenient or more customizable. So I would just say that at the point they have come to us, they have probably made that decision.

MR. RICHARD CHARLES MURPHY: Regarding the property and casualty (P&C) companies, we are beginning to see a lot of offshore reinsurers set up in Bermuda and various other places. We are also beginning to see some books of business in the casualty insurers split between good books and bad books, and the bad books walk off with a little surplus, and the good books hope to make a lot of money. There don't seem to be the same kind of creative changes going on in the life insurance industry as yet, but I'm wondering whether that is simply going to be coming. Are there ways, for instance, to attract outside investors other than through a reinsurance mechanism, which is not looked on very well by many of the rating agencies, where you could, in fact, put some of the liabilities for an existing company off-balance sheet, or you could perhaps put some of its growth to another company that might be owned in an equity basis?

MR. SOLOW: Yes, we have been seeing some activity in reinsurers setting up offshore companies. I don't know if the regulators would like the words "off-balance sheet" too much, because I think they have some fear that some reserves go into the ocean and don't appear on the other side.

MR. LAURICELLA: I guess I'm not so sure the good bank/bad bank model is going to work for the life insurance industry, because the nature of the problems that the P&C companies face is potentially more problematic and long-term than that faced by the life insurance industry. With P&C insurers, the problem involves long-term reserve adequacy, and with the life insurance companies, the problems are typically asset related. I think that the life insurance industry has been able to really go a long way already to solve a lot of its problems by reconfiguring its investment portfolios. As a result, the financial strength of the life insurance industry is greater today than it was several years ago. But I'm not sure you can say that about the P&C industry, where environmental exposures have caused so much concern among investors and some companies are being forced to think of very creative ways to deal with the problem. So I just think the problems are essentially different, and I don't really expect to see them resort to the good bank/bad bank structure. Also, I suppose that if this structure made sense for life insurers, we would already have seen more of it, when the industry's asset-related problems were more acute than they are today.

MR. OWEN A. REED: One problem that has intrigued me the last few years is that of subsidiary company investments. Ten or 15 years ago, most big companies started diversifying into subsidiaries, and the outcome seems to be that companies are being hit with a double whammy. For the investments that proved to be poor, the surplus just went off the books. Those investments have never given a decent rate of return. For those investments that have proved to be good, color the odds one of five, you can't mark them up to market at all. So in another sense your surplus is also being depleted, even if you have made a good bet. It seems to me that there has to be some regulatory way out of this problem somewhere down the line—that you can have a periodic enhancement of the value of the subsidiaries through an appraisal process or something.

Another comment I'd like to make is that I think you need to compare life insurance companies primarily with other financial institutions such as banks. It seems to me, in Canada anyway, nearly all the banks are big, and 40% of their capital is in subordinated debt and 60% is in equity. The way they manage their business units is that the servicing of the subordinated debt is a charge against income, and then they calculate a target return on the shareholders' equity. So it drives up the yield on the shareholders' equity that they're after. They are at 17.5% after tax. Whichever way you slice the tomato, the lesson that the banks seem to be teaching the life industry is that the name of the game is you need a mixture of subordinated debt and something else. And if you're a mutual company, the something else is your own already existing surplus. As you've been saying, you need to get a decent return on it.

MR. LAURICELLA: That is a fairly complicated comment to respond to. As for subsidiary investments, I'm not sure what the NAIC is thinking about to change the valuation process, but I do know that the capital allocation currently required is extremely high, possibly unreasonably high in many cases, given the nature of some of the businesses the subsidiaries are involved in. I expect increasingly to see mutual life insurance companies try to sell off part of their investment in subsidiaries to put a clear market value on those investments. There are examples of that already. Some companies have had difficulty convincing the rating agencies that their surplus should be enhanced to reflect the market value of the subsidiary. I think the rating agencies look through the accounting and try to reflect this, but there is often some skepticism about the values of these properties. So to actually put the matter to rest, one company sold off part of the subsidiary, establishing values that the rating agencies couldn't argue with.

MR. BEHAN: Hank, isn't that a very expensive way of proving a point?

MR. LAURICELLA: Well, going beyond that, because capital is very scarce, there might be a good reason to let some of these subsidiaries start financing themselves, if there is actually a receptive capital market. In the case of managed-care companies, there certainly has been. That may be the case with investment management subsidiaries as well. So I think it goes beyond that.

Now I have more difficulty with the second question about the banks, partly because my understanding is that there are more restrictions on a U.S. life insurer's ability to raise debt than there may be on a Canadian life insurer's. So even if it does make sense for mutuals to try to leverage themselves a bit financially, I'm not sure it is always feasible. But I think in the long run the regulators are going to have to think long and hard about this, because it does appear that the banks increasingly will become competitors. If the banks have some sort of cost advantage due to their financing structure, then it is really not fair for the life insurance industry. I think we are probably apt to see a lot of regulatory changes as the banks increase their presence in the market.

MR. BEHAN: I'd like to raise a question for the panel or the audience. I would like to ask you about the perception of the strength of a company, as we look at surplus or capital, and use that as an indication of how strong a company is. It seems strange, with all the effort that has gone into the RBC model and into coming up with the values, that the real focus is on the ratings and on how the rating agencies see the company. The rating agencies don't seem to, necessarily, place a great deal of weight on the RBC. They seem to have other ways of looking at companies that, perhaps, attach different weights or use a different approach. Is there any comment or agreement or disagreement with that observation?

MR. SKOKAN: We have just done some analysis of the formulas that are in use by several of the rating agencies in relation to RBC, and there are some significant differences about how they deal with some components of what goes into a capital adequacy formula. Subsidiaries is one that sticks out in my mind as something where there is a vast difference between these various formulas that are in use. So you do get different results, depending on which formula and who is doing the analysis. We also looked at some of the ratings that had been given by Moody's and Standard & Poor's to various companies, and what the range of RBC ratio is for all of the AA companies in any size of sample that you want. Our observation was that during the last two or three years, there is a fairly wide range of RBC ratios to get a given rating from, say, Moody's or Standard & Poor's, but that ratio has been increasing each year, and the range has been narrowing as time has gone on. So I guess that I would say that, first, the rating agencies are tightening up a little bit and, second, there is some convergence as to how they are viewing companies. But, again, back to my first comment, there are some significant differences in how the agencies look at various components in your asset base, things such as investments in subsidiaries.

MR. MURPHY: I would agree that the rating agencies seem to be driving the actions of our company in looking at its surplus to a much greater degree than RBC. In fact, when the rating agencies look at a multiline company, they really don't care too much about the RBC of the life insurance company as much as they might care about the P&C environmental exposure. So this really causes some actions within the company that cause you to step back and look at the standard ways of, for instance, adjusting your investment portfolio to adjust for mortgages or high yield, and to say that while that might improve the RBC, there is not a lot of point in improving it from 431% to 470%. What really is, perhaps, more appropriate is to recognize that the rating agency is going to have a market standard for the surplus, and that market standard might be 6%, 6.5%, or 7%. It is that ratio that is going to have to be maintained in order to maintain your rating, and it is totally independent of the RBC. For that reason you're going to be looking at nonstandard solutions to this problem of the liabilities and the surplus, which will involve, I think, potentially looking at subsidiaries, or offshore, or off-balance-sheet financing of businesses. You just can't maintain the ratings and stay in the business doing the traditional mechanisms when you are not going to be judged by the traditional mechanisms.

MR. BEHAN: There is obviously a lot of interest in this subject. Just looking around at the number of people in this session, by being here you've said that you think that this is an important subject, and it seems to me one of the important issues is, how does this get wrapped into your management process? How does this become part of the management decision process, so that five years down the road you don't find yourself at a place that you didn't know you were going to, and you don't make decisions now that you're going to look back at and say, "Why didn't we realize what the surplus implications of that decision would be?" I'd like to get some comments on how some people in the audience have done that. Have you actually got this baked into your management process at this point? Are you using these techniques to review decisions?

MR. LAURICELLA: Ten years ago, life insurance companies had much greater flexibility than they do now to pursue whatever strategy they thought made a lot of sense. I think the change is largely because of rating agency scrutiny and RBC. I don't think companies are taking the kinds of risks with mortgages and concentrations of a particular asset class in a particular region—office buildings in the Southwest or warehouses in the Midwest or whatever—that companies pursued in the past with good and bad outcomes. It's just not possible anymore to make the investment bets, and maybe even the product line bets, that companies were willing to make in the past, which is probably good for policyholders in terms of the security of their principal. But I think reducing the flexibility of insurance companies to manage their investments may put the industry at a disadvantage as it competes for funds, for the savings dollar, with other competitors who are less restricted.

MR. BEHAN: So, essentially, whether management is doing it or not, external forces are pushing in a direction.

MR. LAURICELLA: That's my perception.

MR. BEHAN: It is a direction of conservatism rather than what the best results necessarily are.

MR. LAURICELLA: It depends. I'm not sure that the investment portfolios of life insurance companies in the long run are going to be able to meet policyholder demands. The competitiveness of a cash-value life insurance policy versus another investment alternative in the end comes down partly to its relative return. If the life insurance policy is backed by assets that can only be invested in extremely conservative instruments, then the return on the policy over the long haul may not be as robust as it was in the past. Whether that's good or bad, I don't know. There may not be the same degree of insolvencies or rehabilitations that occurred in the recent past, but the industry may be less competitive as a result.

MR. SOLOW: I would just add that the industry has been traditionally a good source of funding for private placement securities and commercial mortgages and other similarly enhanced-return assets. That place in the economy may be somewhat in jeopardy, if the rating agencies are looking to force companies into a more conservative mold. I think it is important, to the extent that the rating agencies can be educated on how all these different types of assets will fit into your own company's broad picture. I think we know that over the long run an investment with a higher return is going to build surplus much quicker than an investment with a lower return. To steer away from those may not always be the most prudent thing to do for the long run.

MR. BEHAN: Are there other areas or other issues that we should be talking about? I told our two panelists that I was trying to figure out a question that I could get them into a fight over, but it doesn't seem that there are too many controversial issues. I suppose we should have somebody from one of the rating agencies here to beat up a little bit.

MR. JOEL STEVEN SALOMON: I guess not too many people were at the last session, How Does Your Insurance Company Rate?, because many of your views are somewhat contradictory to what I said there. Just a few comments. Generally, at Moody's, as opposed to some other rating agencies, we don't set any benchmarks. There has been some talk about RBC, and we have our own internal risk-adjusted capital ratio, but I can tell you, right off the bat, that at least one company is Aaa rated and has a very low Moody's risk-adjusted capital ratio. There are reverse instances as well, companies that have a very high ratio that might be lowly rated. So there is not one or even many ratios that we look at that can be thrown into a black box that spews out a rating. I went into a lot of qualitative issues in my presentation that we look at to determine the rating: a company's market position, the products that the company sells, its interest rate risk, capital adequacy, and so on. So we tend to emphasize the qualitative issues much more than some of the other rating agencies, and it is very hard to get that across, but I think it's important. There is not one specific ratio or group of ratios that we look at. There might appear to be some tightening, or it might appear that you need a certain RBC ratio, or Moody's risk-adjusted capital ratio to have a certain rating, but I have to stress that that is not the case. There are external forces coming into play. We see a lot of secular changes in the industry, such as banks and other financial institutions competing more aggressively with the industry on fixed annuities, variable annuities, and other products. I think that's much more important than looking at an RBC ratio and saying it's 250% and that the company is a certain rating.

Another key point is that we see ourselves as independent observers of a company. It is, I guess, disheartening to think that companies think that the rating agencies are driving the companies' goals and management and how they run their business. We think that companies should determine how they run their business without having the rating agency play a part at all. I have heard some people say, "This is the ratio we need to hit to get this rating." That is a cause of concern at Moody's. I just think it is important to state that we don't think it is appropriate to manage a company. We are just independent observers.

MR. BEHAN: Can you explain or are you surprised by the perception that the ratings are getting tougher, that ratings are tending to go down? How would you respond to that?

MR. SALOMON: As I mentioned, there are secular changes going on in the industry. There is increased competition from outside and within the industry. We see excess capacity. There are almost 2,000 life insurance companies. That number needs to come down. We have seen some of that in the last year. American General has taken over Franklin and made a large investment in Western National. There have been other failed takeovers on the stock life insurance side. We see that as being likely to accelerate. So there is excess capacity and other financial institutions coming in to increase competition. I think that is one important issue. I think increased regulation is another important issue. There has been RBC and companies have had to deal with that. There has been the proposed model investment law, which could reduce the company's flexibility on the asset allocation side. So there are changes going on that may be somewhat outside insurance companies' control. There has been some tax regulation over the years that the companies can't control. On the mutual side there is the equity tax. I believe this year it is going to be significantly higher. That is something that is a pure cash outlay that the company can't control. That is likely to be at least part of the reason why there is some pressure on ratings. I don't think there is significant downward pressure. As I said in my presentation, we think, in general, the average rating right now for Moody's companies is Aa3. Long term we see pressure, but short term we expect results to be stable.