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SURVIVAL STRATEGIES FOR MUTUALS

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This forum will address issues facing mutual companies concerning the ability to ensure profitable growth. Various strategies, including surplus notes, demutualization, merger, and sale/acquisition of blocks of business will be discussed.

MR. DALE S. HAGSTROM. I'm a consulting actuary with Milliman & Robertson in New York. I have worked for a mutual company but I've been with Milliman & Robertson for 16 years, more often than not consulting with mutual life insurance companies, both advising mutuals continuing in that status and working with mutuals that demutualize. This is not a session on demutualization, but if you want to ask questions about that, I would be more than happy to talk about that.

Sidney LeBlanc is the senior vice president, financial and pension operations, at Pan-American Life, a mutual company in both the U.S. and in Latin America.

Let me start with just a few comments to encourage discussion. The title of the session includes the concepts of survival and mutuals. The survival issue is an issue for both mutuals and stocks. The strategies issue is obviously one for stocks and mutuals as well. So what's special about mutuals here? There are probably four aspects that are specific to mutuals, and we can talk about many things that would be equally applicable to stocks. First, mutuals have more restricted sources of capital, so we could talk about capital management. Second, management compensation at a mutual is different from that at a stock company. Stock companies can have incentive compensation that's stock based. Mutuals find that harder to do, except in some shadow fashion, perhaps. Third, the agents of a mutual insurance company have more influence than they do at a stock company because there isn't another more powerful source of external control or external second-guessing. Stockholders will come in regularly, if not at least once a quarter, to tell you how you're doing. The next loudest voice you hear from the outside is from the agents, because you don't have that at the mutual. The fourth area in which the survival strategy for mutuals could differ is just the possible decision to demutualize. That's not an issue for stock companies.

Then there's the question of survival. Why have companies failed? If companies are just going along for 100 years and having no problems, then what's the issue on survival? But where companies have failed, we have something to talk about. We can see what happened there and learn from that.

Last, there are different sorts of strategies; strategies of doing your business, strategies of having the organization live, and strategies on how to manage capital. I now ask Sid to present some material he's prepared.

MR. SIDNEY A. LEBLANC: We're in a tough business. The primary markets—life and health insurance and annuities—are characterized by low-return, high-risk, mature markets. There's competition from inside and outside the industry, and that's the good news. As a mutual company, we also are lucky enough to have a fairly inflexible form.

We have limited access to capital and limited ability to return capital. That's important because excess capital is expensive. The mutual company has limited ability to have an upstream holding company. Downstream holding companies are less flexible. It has limited ability to issue debt and to do acquisitions. This inflexibility and some of the options in that regard are a part of what the session is about.

FROM THE FLOOR: What do you mean when you say limited ability to return capital?

MR. LEBLANC: A stock company can buy its own stock or pay dividends, so it winds up with less capital. If a mutual company has extra capital, it can pay dividends to policyowners, but that normally isn't the way to reduce capital. Capital is usually returned by accident in mutual companies.

FROM THE FLOOR: How about acquisitions?

MR. LEBLANC: Acquisitions reduce capital very efficiently.

The four topics mentioned in the program are surplus notes, demutualizations, mergers, and sales/acquisitions of blocks of business. I think an important point on those is that they are valuable to us, but they're not magic. They don't solve your problems if you have problems in terms of growth or expense rates. If you are not doing a good job, indeed, some of these aren't available to you. You can't demutualize if you're doing a terrible job because nobody's going to buy your stock. That same issue would be true, maybe to a lesser extent, on surplus notes or mergers of equals. So the key is to have a strategy to obtain a sustainable, competitive advantage. In short, the first priority is strategy, and the second is structure.

I do want to spend a little time talking about the structure, and I'll start with the topic of mutual mergers. Pan-American did a mutual merger in 1992. Charlotte Liberty Mutual, a small company, merged into Pan-American. It was done on a win-win basis and both companies were satisfied with it. Indeed, this has to be on a win-win basis for such a merger to happen. If the other company's managers don't think it's a good deal for themselves and policyowners, then it won't happen. Our transaction was structured on that basis. That's why we did it, we thought it was a good idea. We looked for companies that we thought were candidates for merger. We selected 15 companies and we contacted them. It turned out we were very good pickers and very poor closers. Of the 15, five have merged already. They were all companies of our size or smaller ($2 billion or less). Of those five, we were very close to being the merger partner of one. All five merged with companies in their own metropolitan areas. The one that we were close to was almost in agreement with somebody else before we were brought in. We took about three weeks and put a proposal on the table, which was more favorable to the management and policyowners than the other proposal was. They almost merged with us, but in the end, they stayed in their backyard. We are having discussions with a sixth company on that list with which we hope to merge this year. If that happens, of these 15, we still think 9 companies are likely merger candidates.

MR. SHELDON WISHNICK: As an acquiring company, what are the specific advantages of choosing a mutual company instead of a stock company as a merger partner?

MR. LEBLANC: Merging with a mutual company is like buying a block of business, but they pay you for it. You've taken its surplus just as you've taken its business.

If you want to merge with a stock company, you would have to demutualize or set up a mutual holding company or some other structure to make that happen. But, if you want to buy a stock company, of course, then you have to pay for the acquisition. There's a limited ability to set up goodwill on our books as a mutual company or to have debt at a holding company. Buying a stock company is problematic, to do it to any extent.

Shortly after our last merger, Bob Shapiro and I wrote an article in the *CLU Journal*. There have been very few mutual mergers of equals. Most have been in an acquisition situation, where there was a surviving company and a company that went out of business. Conceptually, mergers of equals have a great deal of positive impact. You increase size and diversification of business and profits. There should be some synergy. There are economies of scale. You reach critical mass. It should have improved ratings and improved management because there are both companies to pick from. All that should result in improved profits or dividends to the ultimate owners of the company. So many good things happen from mutual mergers of equals. Phoenix Home is probably the prime example of a merger that was more or less of equals.

I think there are two basic questions to ask when merging with equals: who's the boss, and where's the company? Once you decide that, then it's not quite so equal anymore. As they said in *Animal Farm*, all animals are equal, but some animals are more equal than others. One of the companies has the upper hand. Of the mergers that have happened, most have been of a big company and a small company, where there was clearly a surviving company and a company that was, in a sense, acquired.

And that was actually the situation with our Charlotte Liberty Mutual merger. If you look at mergers of unequals, you see some of the same positives that you have with mergers of equals, but the situation's a little different in that it's a great deal for the acquiring company. It's a good deal for the policyowners of both companies. Normally, the company that goes out of existence is having some problems. It may not be insolvent, but it might be having problems in relation to sales or expenses. After the merger, it tends to have an ability to increase dividends down the line by reducing expenses. Actually, we paid out some extra dividends at merger, but I think that's probably the only case in which that's happened.

An important point is that merger only happens if the management of the acquired company is satisfied with the situation. To a large extent, the management of a mutual company owns the company. It can continue doing poorly for a long time. The board obviously has some supervision of that, but the board tends to stay out of the way as long as it is not going insolvent. And if the company has declining sales, it should be throwing off substantial profits from its renewal business, plus interest on surplus going to profits. So a company with declining sales, even with high expense rates, would tend to be showing statutory profits. But at the same time, it is dissipating the value of the company, putting the company in a worse situation. It's important for companies in that posture to arrange their destiny while they're still in a strong position.

When you talk about the viewpoint of the acquired company, merging with a larger company, means loss of jobs, not only the loss of a job for the president, but also jobs for

all your employees, so it's a serious matter. When you start talking about loss of jobs, most people tend to lose their sense of humor. You need to compensate those people for what they're giving up. If they're doing something that is in the best interest of their policyowners, and it's not in their own best interest, they should be compensated beyond a normal severance level. That compensation can be in terms of jobs for the executives, consulting contracts, or payments that should go beyond the level of normal severance in an acquisition. Management shouldn't be treated as if it owns a controlling interest. Managers shouldn't have a windfall and be made rich, but the payments should compensate them for the loss of careers, which can be fairly numerous.

MR. PAUL NITSOU: With regards to mergers of mutuals, are the general funds combined? Also, how are the policyholders of the company being acquired involved in the approval process of all this?

MR. LEBLANC: Well, the surplus of the two companies is combined. Normally, you would keep a separate class for the policyowners of the acquired company and track the dividends separately. With any merger, there must be a policyowner vote, at least of the acquired company, and normally a vote of the policyowners of both companies, in order to approve it.

MR. HAGSTROM: How that works in practice can vary. Sometimes the acquiring company might have an evergreen proxy from its policyowners. For small transactions, they can have a vote at which they use the proxy, but the company doesn't ask them for new, explicit authority.

MR. LEBLANC: I think there have been a couple of mergers of very small mutuals where there haven't been votes on either end. They'd really have to be below the radar screen to do that. It would obviously have to be approved by both states.

Regarding surplus notes, they have had a bad reputation for many years. They were used by companies that were in trouble. They were a big percentage of surplus because the company needed a big increase in surplus. In 1993–94, many large, substantial companies that were not in trouble issued surplus notes. Actually, all the surplus notes that were issued in 1993–94 were to substantial companies. Only one note was issued below $100 million. And I think virtually all of them were for amounts in the neighborhood of a modest 10% of surplus. So the bad reputation that surplus notes had in the past doesn't exist with regard to recent surplus notes.

It does increase statutory surplus. It does not increase GAAP surplus. There's a relatively low cost associated with it. Most of the ones that were issued cost between 70 and 130 basis points over Treasuries. You could turn around and invest for not much less than that, so the net cost was fairly nominal. Since then, the effective costs have probably gone up a little bit, because there's some question about the holding value for life insurance companies, but I don't think the cost has gone up substantially.

It is fairly tax-efficient. The interest on the payments to the surplus noteholders are considered interest on debt, so they're deductible; they're not dividends. The surplus note is generally not considered part of the surplus; the surplus note is not part of the surplus differential earnings amount tax base. Again, you must be careful with the way you write your surplus note contract, but you should be able to achieve both of those results.

Standard & Poor's (S&P) has said that as long as it's a small part of surplus and it's a long duration note (say, for example, a 30-year note is 10% of your surplus), it has a favorable view of it. Joel Salomon said yesterday that Moody's views it as debt. So the different rating agencies have different approaches. Minimum size is an issue because only one note issued was below $100 million, and it was about $70 million for National Life of Vermont. That tends to take it out of the realm of most mid-size or smaller companies. Much of the cost is associated with issuing a public note.

The issue of accounting has come up. After these were issued, the NAIC looked at them and had some discussion about whether an insurance company, as the investor in a surplus note, could hold it at amortized value versus holding it at market value or zero value. The answer is, it depends. It depends on where the other company is regarding its surplus ratios or surplus level in risk-based capital (RBC).

MR. EDWARD J. FREEMAN: Regarding the surplus notes, how do you see *FAS 115* (and the impact that that's going to have on the volatility of the balance sheets) impacting the cost efficiency of this?

MR. LEBLANC: From the point of view of the person investing in it?

MR. FREEMAN: I expect that the interest rates will have to increase on these bonds. Do you still see them as being viable instruments?

MR. LEBLANC: Well, the issue you're addressing is from the point of view of a company investing in surplus notes, rather than a company issuing surplus notes. That investing company would have to follow *FAS 115* in setting the value of its surplus notes. Or is there an issue on the other side?

MR. FREEMAN: No, I'm thinking of it from the point of view of, you wanted to issue the surplus notes, and the cost you must pay for those is the yield that you're going to be charged for those notes. Is that going to be increased significantly because of *FAS 115*?

MR. LEBLANC: I don't know that *FAS 115* would have that much impact on it. If I'm buying surplus notes of some other company, if I have a choice of buying that or buying a (normal) bond, either one is subject to *FAS 115*. So that wouldn't necessarily make me pay less (or more) for the surplus note than the bond.

The regulations that came out about insurance companies holding the surplus notes at amortized value drove up the cost and made them less efficient and less desirable. If you have to borrow at 130 basis points over Treasury, and you're going to invest at 100 basis points, then you have to pay a 30-basis-point spread. But if the bond you bought at 100 basis points is a Bbb bond, that issuer may go broke. Whereas we're viewing ourselves as not going broke. So there is a cost associated with that, and it's really based on the spread.

MR. HAGSTROM: Understand that there was heavy activity then, and then the window closed, in terms of what seemed to be efficient. What got issued got locked in at very specific, fixed, and relatively low rates, and call-protected to the buyer for 20 or 30 years. So the interest rate that the insurer is paying isn't going to go up, even though companies now will seem more volatile in terms of their results. The point that Sid made at the very

start is that you can talk about these as a means to an end in terms of managing surplus. A key to survival strategies is making sure that you take the limited resource of capital (which is a little harder to get for a mutual company, perhaps, than for a stock) and manage your capital. Do you know where your capital is deployed, and are you getting an adequate return on it? Suppose you want to be a mutual company for the next 100 years, and you want to grow at 10% (to keep economies of scale). Your liabilities will grow at 10% and your surplus needs to grow at 10%, too, or you're going to become more highly leveraged. If you don't have enough capital, then your surplus needs to grow even faster than your liabilities grow.

Why do companies fail? What survival issues are there for mutuals or stocks? Do you have any experience or want to point out what you think is the key reason that some of the companies failed in the last five years?

MR. FREEMAN: Regarding the Confederation Life failure in Canada, it had overinvested in mortgages and in bonds that were backed by property, and then all of a sudden it had too much in mortgages that were failing and basically no resource for capital. Even though it had a good earnings stream ahead, it could not get capital to refinance the company. It was very difficult to get capital to keep the company going because surplus notes come at the bottom of the pecking order in a rehabilitation. Confederation's lack of ability to get capital sure hurt in that particular circumstance. It failed and was cut up into little pieces. It was a 100-year-old company in Canada. It's unfortunate.

MR. S. MICHAEL MCLAUGHLIN: Something similar happened with Mutual Benefit Life here; there was a huge amount of investment in real estate. At one time, it looked like that was a foolproof investment, and so there was quite a bit of concentration in real-estate-type investments. At one time that looked wise, and then, quite quickly, there was a turnaround in the real estate market. Again, there was no ability to quickly respond to that. In fact, the company would have liked to dispose of those assets quite quickly, and really did not need capital, or maybe did not need capital in large amounts. It would gradually rebuild capital over time. That just was not possible with real estate investments because of limited liquidity.

In fact, likewise with some other noninsurance companies that had gotten involved in derivatives, there, too, the ability to respond quickly was not there. Companies that used derivatives to enhance yield, and therefore generate their own internal capital or generate wider spreads, attempted to do something that looked like it would work for a while, but then the market changed very quickly. There are some pretty harsh lessons there. The moral of the story is not to concentrate in a particular type of instrument. To survive, try to retain the ability to respond quickly and start out with sufficient capital to be able to suffer some impairment without having to go under the control of the state insurance regulators.

I'm very interested in what mutuals think. To what extent are mutuals able to generate capital internally to meet all the various obligations (paying dividends and paying whatever returns are needed to nonparticipating policyholders) and also diversify or manage their own business so as to generate capital internally, without going to any surplus note or what have you? Has that changed? How can mutuals generate some of their own capital to be sturdier, to deal with impairment of asset values and so on?

MR. HAGSTROM: Your question for the group is, what returns should they get, or how can they achieve those high returns?

MR. MCLAUGHLIN: What's the whole set of various options available to mutuals? It's such a competitive market. Can we pay a lower credited rate on our universal life business, or can we reduce dividends just slightly, enough so that the policyholders are not harmed unduly, but enough so it causes us to retain more capital within the company? Why can't we reduce our dividends just a bit to retain more capital within the organization? And then what are some of those other options? For example, have we seen enough use of downstream holding companies as a way to generate capital in mutuals? It seems like it would be a good approach. It has been done a few times, but it's not a particularly widespread approach. I'd just be curious as to whether there are some unseen difficulties in taking that approach as well.

MR. HAGSTROM: The mutual life insurers aren't necessarily setting the prices in their competitive markets. Also, there has been a little bit of a respite for a few years, but clearly the equity tax, the differential earnings tax, is going to become very large, just because of the way the law works, comparing the wrong years. The IRS doesn't give the mutuals the benefit of the negative when it's wrong in one direction, even through it's going to reverse, sure as two years will pass. That's going to be a very heavy tax in the next year or two.

Are there sustainable, competitive advantages that mutual companies can bring to bear? You can't very easily or effectively patent your products. A mutual insurer has differences from a stock insurer which can be either the strengths or weaknesses. Mutual insurers can operate with longer-term horizons because they don't have stockholders. The good news is you can probably do things more rationally, if you are rational and insightful. On the other hand, if you do things irrationally, then as a mutual company, you may not have a wake-up call for years, in theory.

Take investments, as an example, with their risk-return tradeoffs. When you manage a company, how do you create the corporate culture with adequate fiduciary responsibility? It's easy to go down on the investment side quickly. The problem isn't just inadequate capital, it's illiquidity for which you then need capital to compensate. If you have to sell something quickly, you may have to take a loss, and you need the capital to cover that.

So how do you moderate the extremes suggested by your experts, whether it be the actuaries doing product pricing or investment people making investment decisions? They say what niche is a good bet and then move to concentrate your risks there, and they have great self-confidence and look like geniuses when the bets are turning out well. At what point does someone who's not in that department, who doesn't work for the investment chief, contradict what the chief says to the board? Who says, "I think we're doing too much of this good thing. We have to be less greedy because I'm afraid." How do you reward and keep a whistle-blower who's such a coward? The chief actuary could be the official designated worrier who worries about all the risks and the capital structure. Or the chief financial officer could be in charge of worrying. How do you support, keep, and not have that person lose credibility in the good times, when he or she just seems to be an unnecessary drag on your desire to do great things? That's the hardest issue.

MR. LEBLANC: The first question asked was, can you cut dividends as a way to raise capital? If you cut it on new policies, you hurt your sales. If you cut it on old policies, you have equity issues, and it may well hurt your sales, too. So can you find the sustainable, competitive advantage, a niche market where you can charge more than the other guy and make more money?

As a practical matter, most mutual companies have raised capital internally. They didn't have to go to the capital markets or demutualize or do surplus notes, in part because they haven't grown too fast. If more of them get into acquisitions or into annuities, they're going to have to be more concerned about capital.

The main reason for demutualizing is to get capital. In Equitable's case, it was low on capital, and in UNUM's case, it wanted to grow more. Usually mutual insurance companies haven't been growing fast enough to have the need for more capital.

There have been a few successful examples of downstream holding companies, in particular, selling shares of what they own. General American comes to mind, obviously, in making some nice profits by selling a piece of what it owns.

MR. CHARLES WITTENBERG: We've had the experience of dealing with five companies in the guarantee system that folded. Two had unique problems. One had an outside investor come in and strip the company down to where it went under and had no assets left; there are still court cases involving that one. The other one became involved in the small-group business and wrote more than it could handle. It got into the same problem that a mutual would. It couldn't attract any capital from outside and just convoluted its way downward.

The other three had more interesting problems. One got into straight life insurance and took on too many risks that were not adequately priced. It didn't have a strong capital base. It did try some financing efforts, and of course, eventually the cash-flow earnings from its block of business were not sufficient to service the debt, and the banker came calling. The second tried to spend its way out of it, and the problem was that it tried to save the west side of Chicago with second mortgages, a bad choice of investment. When its banker came calling, he didn't care that it was a stock rather than a mutual company either. And it had done enough surplus relief so that when it came to my former company for surplus relief, our analysis was that it didn't have enough earnings to service even the present surplus relief. They also just spiraled down. The final one had a product problem. It wrote volumes of annuities, but it made an error in judgment, so some of its annuities did not qualify as annuities under the definition of the tax code. It started getting penalties and lawsuits. That dragged its assets down. So we've learned that there are as many different ways as you can imagine, and if you wanted to, you could lump most of them under bad, poor, or inadequate management. Whether it was the actuary, the CFO, or the president—the team let down the rest of the people in the company who depended on them. Most of those things can happen in the mutual structure and the stock structure.

MR. LEBLANC: If you had to point to one reason, particularly for the smaller companies, it was management mistakes. There's also a tendency, when an actuary does dynamic solvency testing, to run a multitude of studies that address asset/liability management when that isn't the problem; the problem is much more basic. I guess if you look at

the larger companies, probably the area of asset problems is the number-one reason why they've gone under.

MR. EDWARD L. ROBBINS: I'd like to go back to this internal generation of capital issue. I'd like to know to what extent companies are measuring their internal rate of return on a basis that they're happy with, variances from the internal rate of return that they're expecting, given the concept that the internal rate of return that a company's generating is basically its limit to the growth of capital.

MR. LEBLANC: Do you have a particular way that you normally do that, Ed?

MR. ROBBINS: Well, let me give an example. Let's say a company has a standard of a 15% after-tax rate of return that it's pricing to. And it does its statutory forecasts that way. In other words, the premium income, the reserve increases, and all these kinds of things on its statutory budgeting or forecast are consistent with the 15% rate of return that it would be generating on its business, if in fact it were pricing that way. You generate your variances from that, as your experience emerges, and you back down from that into the sources of losses, gains, variances, etc., by mortality, etc., from what was forecast to achieve those returns.

MR. LEBLANC: Something like that might make sense. Clearly your growth rate is constrained by your internal rate of return over the long haul in a mutual company, and it would make some sense to look at that. I don't know if many companies are doing that; maybe people in the audience could comment on what they're doing in that regard. When you do an internal rate of return, you normally have to allocate surplus to lines of business, and so you have to have a surplus formula. The NAIC has given us one, and most people want to have a multiple of that. You also could get into questions about who owns which assets, when you allocate the surplus to lines. But I think a reporting system along those lines would make some sense.

MR. ROBBINS: The paper that was written, maybe ten years ago, regarding an ideal financial reporting system for mutuals, dealt with an internal rate-of-return system. I think you might be familiar with that paper.

MR. HAGSTROM: Was it the one by Hank Ramsey?

MR. ROBBINS: Yes, that was the one, Dale. If you use a base such as that, you can get to something rational along those lines rather than depend on an arbitrary formula such as the RBC formula, or Moody's, or something like that. That might be a more effective way to do it.

MR. HAGSTROM: My own thought is that companies also need to do some more analyses that ask whether they are making the right decisions on the margin, not just what the average results are now. One needs a regular exercise to analyze the decisions being made. Perhaps a regular review of the pricing is needed vis-à-vis actual, with some further analyses that say, on the margin, how is that working? Are we making reasonable decisions where we had decisions to make? Even if you have done a good analysis of where capital should be and that sort of thing, in normal financial reporting you're still reporting an average for the year. And then how many of the things that drive profit this year are not particularly changeable this year? Regarding the things we can change today,

are we making those decisions correctly? That tends to be a marginal analysis and a little harder to fit into the framework of a financial reporting system, which inevitably tends to show an average result.

One question Mike McLaughlin asked was, what are the sustainable advantages? Consider niches or special products we can go after that are more profitable. Well, suppose they're more profitable because they're more risky, or someone else hasn't gone after them for some reason. Do I have some particular advantage, such as a strong agency force or just a very large size, or something else that gives me an advantage there, or is it possible just because I'm taking a risk that no one else is willing to take? And as long as things go well, that's great. Then when it goes badly, you get problems.

Let's consider the possible risks that could interfere with survival. You take mortality risks and you worry that when they find the molecular basis for most diseases through genetic research, the legislatures are going to prevent you from having as much information as the insurance applicant. Your new business is going to be much riskier on a mortality basis. You can't study all the things that your customers will very possibly know about themselves. Will it be difficult to create a sustainable advantage in mortality? It is difficult to have a sustainable advantage in the investment area because you want to limit how concentrated you are.

So what is left? The agency force, which involves both the good and the bad for most mutuals, is another competitive advantage or disadvantage, but the mutuals must live with it and work with it. One possible, sustainable advantage would be expense control, not just in the agency, but also in the home office. Disciplined expense control is a sustainable advantage that goes right to the bottom line and can't be easily copied.

We can image other areas that may or may not pay off: asset/liability management, agent-owned reinsurance, and what is in your files (but is not yet electronically captured), which is an immense amount of material on your policyholders that you could organize electronically and feed back to the field as a sales tool to get the efficiency of your sales force up. But expense control strikes me as the one that you can directly deal with and that your competitors probably aren't doing enough with. The variable costs are often under control, but fixed-cost layers need work.

MR. LEBLANC: Regarding competitive advantage, the conventional wisdom is that there's only room for one low-cost provider in any market, and K Mart would be an example of one more than one Wal-Mart. But in insurance there probably is room for considerably more than that, and so that may be a sustainable, competitive advantage or niche.

At Pan-American, we have a niche in Honduras. Most people don't want to be in Honduras; it's a small insurance market, it has many frightening characteristics about it—a number of which, incidentally, apply to Mexico as well, but in Honduras it is a little worse. We've been there for 80 years. That type of continuity might be taken for granted in the U.S., but it certainly isn't in Honduras. So that's a good example of a true niche, where we can charge more. If Prudential went into Honduras, the people there would say "We know Pan-American's good, but who is this Prudential?" That's going a little far afield, but there are opportunities in the U.S. for niches in mortgage insurance or

in credit insurance, or in some market in addition to trying to get your expenses lower than anybody else's.

MR. MCLAUGHLIN: I think Dale made a really good point when talking about expenses, because my own observation is that there is probably room for improvement there in many companies, companies of all types, including stock and mutual insurance companies, but certainly not excluding mutuals. The merger of mutuals quite often leads to a loss of jobs and is just another indication that there are many situations where the same amount of business can be managed by fewer people. So productivity improvements and expense reductions are some of the areas where mutuals might want to focus their attention, just in terms of a survival effort.

I work with a group of mutuals, and we do ask that same question as to whether they measure their own performance internally, using internal rate-of-return methods. Quite a small minority do. Only 10% of the companies that we have looked at and surveyed, in fact, use an internal rate-of-return measure. Those few do a nice job of setting up their whole system, their reserves and deferred-acquisition-cost assets, such that they aim to get a level internal rate of return, and they analyze variance. What's interesting is that even where that is done, some of the targets are perhaps not quite as aggressive as you might think.

We've done other surveys that look at the typical return on equity of stock companies versus mutuals, but in many cases you find that the stock companies do have a higher return on equity. There's enough of a difference that you ask what would be different about stocks and mutuals. In some cases you hear from the mutual companies that perhaps they're aiming at a different target. Should the same target be aimed? In other words, are stocks and mutuals now competing for capital in the same marketplace? Should they be taking the same stern look at expenses and other aspects of internal management that stock companies do? Whereas the discipline of possible acquisition of a stock company is always out there, it's less so for a mutual. Does that mean that there's a difference in view, in outlook, in targets?

MR. LEBLANC: If you made that comment ten years ago, the large mutuals would be indignant and say that they should have a lower rate of return because their purpose is to provide their insurance at net cost, and they're doing that for their policyowners. There's more of a stock company mentality, even in the big mutuals today, and there's more interest in a higher rate of return, although there is still that concept of mutuality. Despite that, I think the mutuals aim at a lower rate of return. I don't think that says they're necessarily less efficient; it says something about their efforts to get a lower cost to their policyowners.

MR. DOUGLAS A. ECKLEY: I have two questions about mutual mergers. It seems there might be room for corruption in mutual mergers if management acts as if it owns the mutual and can write its own golden handshake in the process of merging the company into a larger mutual. Do you have any concerns about that?

Second, when the merged mutual's policyholders get their own class, is there a normal amount of dividend enhancement in terms of a percentage of surplus?

MR. LEBLANC: There's been very little abuse in terms of overpaying management of mutual companies. Again, I start from the viewpoint that they're doing something that is in the best interest of their policyowners. They're giving up their jobs in many cases. So they should be compensated well for that.

The counterexamples are rare. About eight years ago, Rushmore Mutual approached a number of companies about merging and the top management wanted to get compensation that amounted to approximately ten times salary. It approached Pan-American and a number of other companies, but we backed away because of the smell test. Ultimately, the state came in and took them over, fired management, and merged it anyway. We'd come out ahead from a purely financial viewpoint, to pay these people ten times salary and take the company over. This would have been a nice deal for us financially, but it's an inappropriate use of that company's surplus. That was a fairly unusual situation.

With the other mutual mergers, the payments to management have been appropriate. There is, of course, the policyowners' vote on that. Normally, policyowners will vote for what the management recommends. There's a state approval process. In the Covenant-Provident merger, the state actually asked for less payments to management. In that case, there were payments not only to the Covenant management, but also to the Provident management. I'm a little unsure as to why Provident management should get anything in that case, but I thought the idea of cutting back Covenant management's payments was inappropriate. I thought that the payments that were due to the Covenant management were appropriate in the circumstance. So the state insurance department does have a role in the amount of payments, and there has been very little abuse. And again, I start from the viewpoint that there should be a fairly high hurdle as to how much should be paid to management.

In regards to the dividends, I am not aware of any history that would show what classes of dividends got after merger. I think normally there have been increases in dividends to the policyowners of the acquired company. There's more surplus available and there are new expense efficiencies in many cases.

MR. HAGSTROM: A Georgia mutual called State Mutual (not the one in Worcester) has acquired over the past ten years at least six very small mutuals that probably wouldn't be on your radar screen. At least in some of their early ones, they regularly paid about 10% more dividend for the first four years than the policyholders had been getting. But we're talking about very small amounts of money, and it's not clear what the guarantee was after that.

Dividends are a moving target. Portfolio interest rates have been dropping for a decade, and often the company that's being merged out of existence probably has been paying more in dividends than it was earning or more than it could afford to pay. So if policyholders are able to keep even the same dividend that they've been getting, it is a victory. If the company had stayed separate, that dividend would surely have been cut, or they'd lose their insurance benefits and lose their cash value in a bankruptcy. So even maintaining the same dividend scale would be an enhancement, compared with what they should have expected if they had good actuarial insight as to how their company was doing.

As I understand the Home Life and Phoenix merger, the expense savings go to the benefit of both groups. You have different products, and they're going to have different mortality

pools, at least conceptually. They have different assets they're bringing into it, so there are probably different yields for a period of time. The reality is that once they're together, one management will want to run one company and will have an incentive to do well by all of the policyholders, because it's in the company management's interest to get them all to persist. The whole point of the merger was to get economies of scale, so you're not going to go out of your way to try to shortchange one set. At the same time, actuarial parity would suggest, if one company had bad investments or bad mortality, that the dividend scale should reflect that.

MR. LEBLANC: Actually, if we talk about how much is to be paid to management, it's kind of interesting to put yourself in the shoes of a company CEO. You could be a fairly sizable company with $10 billion in assets. You're an individual life company. You're selling large policies in the very competitive personal-producing general agent (PPGA) marketplace. You have fairly high expenses. You haven't grown in several years and your expenses, therefore, are going up. The Prudential comes down the road and says that you should merge with it. "If you merge with us, we can cut your expenses by 50%. We can increase your dividends to your current policyowners. You can use our name." You're not a known name when you go out to sell business. You don't have a niche in any sense; you're just one of the guys out there selling individual life insurance. As part of the Prudential family, you'll be a piece of the rock, you'll be able to sell for less. So there are many compelling reasons to consider it. But if you do it, you have to move, if you even have a job. In the first place, you're not going to be president, you're going to be—well, we'll create a position for you—senior vice president in charge of projects, or something. The people in your home town, where you're an important player, are going to lose their jobs. All of the jobs now are going to Prudential. There's not a lot of motivation to do that.

You're trying to do things to make your company better and you have some things on the drawing board. Some things that you're trying to do will work out. The automatic answer is, "Of course we're not going to merge. We're going to work this out ourselves, and we have plans to do it." If you're honest with yourself, you might say, "Well, many of those plans probably won't work because we've been trying them for years. We're going to try to cut expenses and grow our way out of it." It's tough to be honest and say that it probably is in the best interest of your policyowners to merge.

Somebody who has enough guts to make that call and affect his or her and many other people's careers should be compensated for that loss of career. Again, you're not paying him for the value of the company or a controlling interest, but you're paying him for loss of career, what he gave up in terms of his pension, and the fact that he acted as a broker for the owners and got them increased dividends. If you look at what brokers get paid, and if you pay him a percentage of an additional $*X* million in policyholder dividends a year, you're looking at some large numbers. So, without saying that I want to compensate him for what he lost, but for what he did for the owners, I think I can justify some meaningful payments to management.

MR. HAGSTROM: On that same line, what would you pay if you hired some consultant who specialized in helping you cut down your company expenses 20%? Here is a person

who is taking on the role of being the ax wielder, in effect. That is a tough job. People who do that job—whether they're part of internal management or consultants or whatever—tend to be very well paid because no one else wants their job.

MR. LEBLANC: Yes. It is not pleasant.