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DEMUTUALIZATION

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Panelists:	JOHN H. FLITTIE
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- o Demutualization process overview
- o Considerations (pros and cons)
- o Current developments--Society of Actuaries committee; New York legislation
- o Accounting for the demutualized company?
- o How will investment analysts view the demutualized company?

MR. JAY M. JAFFE: Our four speakers will give you a wide perspective on the subject of demutualization. Mr. Vogel will speak today as a consultant, and as someone who has been involved in strategic planning at a large mutual company. Mr. Flittie, being associated with an accounting firm as a consultant, will present a view of what Certified Public Accounting (CPA) firms see as the problems with, and opportunities for, demutualization. Mr. Garber has been studying the theoretical and practical aspects of the topic, and will give us an update on what is currently happening. Finally, Mr. Townsend, who approaches this from the point of view of the stock market, will give us the bottom line on what it all really means.

MR. JULIUS VOGEL: It is generally acknowledged that, while a life insurance company may have a number of important business objectives it seeks to accomplish by demutualizing, one of the paramount goals is that it be carried out in a way that is fair and equitable to the company's policyholders. However, there is a wide range of opinion about what arrangements are required for the plan to be fair and equitable. In this connection, it is reasonable to consider the policyholder both as a customer and as an owner of the company.

As a customer, the policyholder has entered into a contract with the company that obliges the company to insure him at a price that is adjusted through dividends to reflect, in a reasonably accurate way,

what it costs the company to provide the coverage. This price frequently provides for some permanent contribution to the surplus of the company. The equitable treatment of the policyholder as a customer would seem to require that the terms of the contract continue to be carried out by the company after the demutualization. Also, the price paid by the policyholder for his coverage, after dividends, should continue to reflect the emerging experience of the company as analyzed to identify reasonable classes. In general, the benefits provided by the insurance, and the price of the insurance to the customer, should not be adversely affected by the demutualization. I have not read or heard anything on the subject that disagrees with this description of equitable treatment of the policyholder in his role as customer, and I do not think there is much of an issue here.

Issues arise when we turn to consider the policyholder as an owner of the company. The first is whether the policyholder is in fact an owner. There is a point of view that he is not. According to this point of view, the policyholder came to the company as a customer, not as an investor. The policyholder's ownership rights are essentially limited to voting for the directors. Furthermore, the ownership rights cannot be sold or passed on in an estate. In short this point of view holds that, in the event of demutualization, the policyholder's contractual rights as a customer should continue to be respected, but the policyholder is entitled to nothing further.

By a similar argument, the policyholder is regarded as a customer except in the event of liquidation of the company, in which case he would be entitled to share in the proceeds. However, it is argued that a company being liquidated would in all likelihood have no value to pass on to policyholders, after the legitimate demands of creditors (including the policyholders regarded as customers) have been satisfied. Once again, the conclusion is that policyholders have no meaningful ownership interest that should be recognized in a demutualization.

It has also been argued that the very fact mutual companies continue to sell new business, and try to grow in size, indicates that policyholders are not owners. The idea behind this assertion is that if the policyholders were really the owners, it would be to their advantage for the company to stop investing its surplus in new business and pay it out immediately in the form of increased dividends. Thus, the argument is that a mutual company is a going concern, with a life of its own and with a right to accumulate and retain the surplus it needs to survive and grow. Furthermore, this argument asserts that this has been, and continues to be, recognized as an appropriate state of affairs since that is how the mutual industry has always operated and continues to operate. Therefore, changing the form of the company from mutual to stock should not justify any disbursement of company assets beyond what is required to satisfy the ongoing contractual rights of the policyholders regarded only as customers.

There is, of course, an opposing point of view that holds that equitable treatment of policyholders requires more than that their rights as customers be recognized and protected. The idea that a mutual company is owned by its policyholders is one of long standing and one that

has hardly ever been challenged over the years. This is a traditional argument in favor of recognizing policyholder ownership rights. Also, it is held that the policyholders who contributed the money that built the company have more right to benefit from a demutualization than do the as yet nonexistent stockholders. Questions are raised about what will happen when the market recognizes the value of the company, and about who will benefit from that recognition at the expense of whom.

As to the inability of mutual company policyholders to dispose of their ownership rights by sale or by will, the argument is made that the same restrictions apply in other ownership situations, typically in the case of shares of stock in a professional corporation. These can be held only by employees of the corporation and must be sold back to the corporation upon the withdrawal or death of the shareholder.

Let us assume, for the sake of argument, that the policyholders are entitled to some distribution upon conversion of a mutual life company to a stock company. What should the aggregate distribution be? The possible points of view include the following:

- The total surplus contributed by the current policyholders.
- The total aggregate statutory surplus of the company.
- The total aggregate statutory surplus of the company, subject to some adjustments that will probably increase the amount to be distributed so as to reflect what might be called the "true" or "realistic" or "going concern" or "market" value of the company.

The arguments in favor of each of these claims are obvious. The argument for restricting the distribution to the total surplus contributed by the current policyholders is that there is no reason for current policyholders to share in surplus contributed by generations of policyholders who are no longer around. The argument for distributing the statutory surplus is that it is the legally recognized surplus of the company. Furthermore, some demutualization laws specify the statutory surplus as the amount to be distributed. Finally, the argument for distributing more than the statutory surplus is that the company is worth more than that amount, and the additional value belongs to the policyholders.

Turning more specifically to the first suggestion, that the aggregate distribution to the policyholders should be the total surplus contributed by the current policyholders, an obvious issue is how that amount should be calculated. One way to do this might be to compare the current statutory surplus of the company with the amount held, say forty or fifty years ago (when essentially no current policyholders were yet in force), but with this 1935 or 1945 surplus amount accumulated at some appropriate after-tax interest rate. The conclusion from such a calculation might be that the current policyholders have actually made a negative or only a small positive contribution to the current surplus, and therefore are entitled to little or no distribution upon demutualization. A counterargument to this line of reasoning might be that the policyholders in force in 1935 and 1945 took their surplus with them as they left the company, so that the amounts now held as surplus were

contributed by the current policyholders. Another argument might be that any surplus left behind by the departing policyholders was immediately distributed as annual dividends to the remaining policyholders and is no longer in the company. Once again the conclusion is that all the current surplus was contributed by the current policyholders.

Another issue arises if the company's dividend philosophy has always been to accumulate a permanent contribution to surplus from each policy each year, either to finance future growth or to build up a fund against extreme catastrophies. The issue is whether it is appropriate to distribute any or all of such permanent contributions upon demutualization.

As mentioned before, the arguments for the idea that the statutory surplus is the amount that should be distributed to the policyholders in the event of a demutualization rest on the official recognition given by regulators to the statutory surplus, and on the requirement in several state demutualization statutes that the distribution be based on the statutory surplus.

The arguments against fixing upon statutory surplus as the amount to be distributed ultimately rest on the idea that statutory surplus may not be an adequate measure of the worth of the company. For example, statutory surplus depends on the reserve bases chosen by the company. It also depends on the relative volume of newly issued versus old business, and on the amount held as mandatory securities valuation reserve (MSVR), etc. It does not reflect any differences between market value and annual statement value of company assets, nor does it reflect such going concern values as the company's reputation or marketing and administrative organizations.

Such considerations lead to the argument that the proper amount to be distributed to the policyholders is some adjusted surplus figure which reflects what the company is really worth. The argument against this approach is that it would lead to undeserved and unfair windfalls to policyholders at the possible expense of the continued viability of the company. There is another argument that such going concern values as the company's marketing and administrative organizations are perhaps as likely to be negative as positive.

The next category of issues I shall review deals with which policyholders are entitled to take part in the distribution. Should all current policyholders share in it? What about new policyholders who have not yet made a positive contribution to surplus? What about long-term policyholders who ceased to be in force shortly before the effective date of the demutualization? What about short-term policyholders who left shortly before the demutualization? What about policyholders who terminated a long time ago, but left some surplus with the company as they died or withdrew? What about former policyholders who have died since leaving the company? Should their estates be opened for purposes of receiving the distribution? It will be obvious that arguments of fairness and equity, and of practicality as well, can be made with respect to all of the possible recipients.

Once we have decided how much, if anything, is to be distributed to the policyholders as owners, and which policyholders are to share in the distribution, the next question is how the shares of each eligible policyholder are to be determined. One statute seems to require that the distribution be in proportion to premiums paid over a specified period of years. That may be appropriate for a property/liability company demutualization, but it is less obviously appropriate for a life insurance company. It would seem that the professional guidelines on dividend philosophy might be extended to cover this situation. That is, some form of the contribution principle should apply. However, even here issues arise. For example, is it more appropriate to allocate accumulated gains from surrender to the specific plan/age/duration cells giving rise to the gains, or should the gains somehow be spread over the in-force policies in a more general way? Another question is whether a policyholder's ownership rights have some minimum worth so that even policies that are in the red from a retrospective asset share point of view are entitled to a minimum distribution.

The final issues I will mention have to do with the form of distribution of policyholders' ownership interests. The distribution can take the form of cash, common stock, an increase in policy benefits or possibly a decrease in premium rates. If all, or a substantial part, of the surplus of the company is distributed in cash, the company will have to immediately find investors to buy shares of stock and replenish the surplus. On the other hand, is it fair to deny the policyholders the right to receive their distribution in cash? Some statutes give the policyholder the right to receive cash instead of stock, but the choice of cash reduces the amount distributed to the policyholder by a specified percentage. The issue then becomes whether the extent of the reduction is an appropriate balance between equity to the policyholder and the need of the company to survive.

There is, moreover, a practical problem associated with a distribution made in the form of stock without a cash-out option. The result of such a distribution is that the company will have to deal with a very large number of small stockholders, a number that is probably far in excess of what might be expected in a publicly owned company of the same size.

If the decision is to make the distribution in the form of increased benefits or reduced future premiums, there is a question of whether it is fair to, in effect, defer payment of the distribution until the benefits become payable or the premiums fall due, rather than designing a more immediate distribution. Also, questions arise as to how the increased benefits or reduced premiums should be recognized on the company's balance sheet, and the impact that such recognition will have on the company's surplus position.

To sum up this presentation, I have tried to suggest that there are substantial issues of fairness and equity involved in deciding:

- whether policyholders are entitled to any distribution as owners of a demutualizing life company.

- o what aggregate amount should be distributed to policyholders in their capacity as owners, if such entitlement exists.
- o which policyholders are eligible to share in any such distribution.
- o how the shares of the eligible policyholders should be determined.
- o what form any such distribution should take.

No doubt, a more finely grained dissection of the demutualization process would bring further questions of fairness and equity to light. It seems to me that these issues and their resolution are of substantial professional and practical interest.

MR. JOHN H. FLITTIE: Keeping in mind Mr. Vogel's definitive presentation, I would like for you to imagine yourself as President of Sunset Mutual Life Insurance Company, one of the top forty mutual life insurance companies in the country engaged in all lines of business. Six months ago, you went to a meeting of company executives. At this meeting demutualization was discussed in some detail. You came back to the office, called your management group together and asked for a study on the implications for Sunset. Today, you had an all-day meeting with your managers to discuss their findings.

First, the Vice President and Actuary gave a thoughtful, well-reasoned presentation of the issues involved in the process of demutualization. He concluded that, while there is no cookbook yet, equity and fairness must be foremost. The Chief Financial Officer gave his report which said that there is something out there called Generally Accepted Accounting Principles (GAAP). He was not sure what the numbers would be on that basis, but suspected you would not like them. Also, he had been called on by three investment banking firms wanting to take the company public. One of these firms felt the management group could get rich through founder's stock prior to the public offering. The tax savings that might be achieved by not being a mutual company would probably be at least offset by the necessity of paying a dividend to shareholders. The General Counsel gave a lengthy report on state regulatory problems. However, even if there is a statute in Sunset's home state, it is not really known what the attitudes of the regulators are going to be. His presentation covered state and federal securities laws. He also handed you a bunch of press clippings from the _Wall Street Journal_ about a company in Maine.

The Vice President of Individual Agencies was not sure whether the field force could really handle representing a stock company, because they had always sold on the basis of "Grab a Piece of the Sunset." However, he personally favored demutualization because he had always wanted to be in the full financial planning business. Now they could do that, and it was likely that tax shelters would be much easier to sell than endowments. Also, he mentioned that many of the top agents had been muttering about wanting to have some equity in the business that they were producing. He thought this might be a good way. The Group Vice President reported that his representatives and customers are not concerned whether or not Sunset is a mutual company. They

are just looking for performance. But he was looking forward to having more capital available to support additional guaranteed investment contract (GIC) business. He was particularly interested in acquiring a property/casualty company so that he could offer group auto and group homeowner's insurance to his customers. The Controller reported in and said he did not really know what this process would cost, but that someone had said it would cost $1 million just to prepare and mail the proxies to the 175,000 policyholders. The Data Processing Vice-President mentioned that he could not possibly provide the GAAP reserves and accounting information for at least two years. Even then, he would need the new "Star Wars" computer system that he had been wanting you to approve in any event.

When you got back to your office, you received some phone calls. First of all, the chairman of the agents' advisory group called and said: "You're thinking of doing what?" Second, two calls came from your outside directors who said they were concerned about possible class action law suits by policyholders and agents. Then, your golfing buddy, the President of Wildlife, a local stock company, called. You know he has had his eye on your surplus for quite a while as a way to support his annuity business. He called to say that Sunset really ought to be talking about merging, and, of course if it did, there would be big stock options available for the President.

At this point, what do you do as President of Sunset Life? Probably the first thing you do, and we have seen quite a bit of this in the paper in the last few months, is issue a statement saying that, after consideration, Sunset has decided not to demutualize. Then you sit back and ask yourself, "Why was I thinking about this in the first place? What are the advantages?"

Those can probably be boiled down into three categories, and we will start with the easy ones. First, there may be a short-term federal income tax advantage, but it is probably not a compelling reason to demutualize. Second, you may desire to offer equity-based compensation plans to your executives and field force. This is probably not a reason to demutualize either, because much the same result can be achieved with instruments like phantom stock, performance shares and agent-owned life insurance companies you would manage for them. Also, it would appear that Treasury II has created a great new incentive compensation device called "Cash Anyway." Third is the advantage that you sit back and think about. It is the ability of Sunset to finance growth; the ability to have the financial wherewithal to play in the league you might want to play in.

Demutualization does offer the ability to raise capital from outside your policyholder group--either debit or equity capital. Demutualization offers the opportunity to increase your underwriting capability, to make acquisitions or to enter new businesses. It involves the ability to form upstream holding companies which, in the same way, increase your flexibility in making acquisitions and in entering new businesses. In the past twenty years, there have been a number of demutualizations, more of which have been property/casualty than life. The majority of them have been driven, it would appear, by the desire to increase

capital because of a weak balance sheet. However, as President of Sunset, you are thinking about this opportunistically--having the ability to increase your capital base and understanding how this can help you to survive and prosper into the 1990s.

What is wrong with our scenario of what has happened at Sunset? First of all, it has treated demutualization as an event, perhaps as the destination of your corporate journey rather than simply one of many possible transactions on the journey to where your company wants to go. What is missing is how demutualization, or perhaps remaining as a mutual company, fits into the strategic plan of Sunset Mutual--if there is a strategic plan. As a first step, Sunset needs to define what it wants to be as a company and when it wants to get there. It needs a realistic, and perhaps agonizing, appraisal of the company's strengths and weaknesses, its ability to achieve its goals. These might include: strengths in marketing; positioning in the industry; financial ability; and, perhaps, the item that is overlooked so often in considering demutualization and expansion, the company human resources capabilities. Is the internal management up to taking on these new responsibilities, these new businesses, this expansion, this growth? Is your field force or distribution system an asset or a liability?

As a second step, Sunset needs to establish a realistic implementation plan to achieve its goals. As President, you must decide whether demutualization will help you do so or whether it will be a relatively expensive and time-consuming roadblock along the way. If, you are going to seriously consider demutualizing, you must simultaneously consider your viability as a stock company and as a profit making entity. This is all about the trip to the marketplace, either in a public offering or in the public trading of your stock or in merger negotiations. It is a trip that is new to most mutual companies. You must consider what your capital structure would look like as a stock company --both the amount and the debt/equity mix. You must consider how the capital will be employed. It is nice to go out and raise $50 million in a stock offering, but you must know how you are going to employ that capital to get a reasonable return on shareholder equity. This capital might be employed either in an extension of your present business or perhaps by investing in OPB (Other People's Businesses). Historically, insurers have not done as well in OPB as they have in their own business. When assessing how an offering will be received by the marketplace, there needs to be a realistic expectation that the capital will be well employed. At the same time, can you reasonably attract good people? Are you willing to pay them in these new ventures? They may look different and do different things than the people employed in your present business.

The next question is: What return on shareholder equity can you really achieve on a GAAP basis? You need to so some fairly realistic short- and long-term financial projections on a GAAP basis using realistic assumptions about what you can expect to sell. It should be based on the GAAP profits that can be developed from products you are likely to be selling as a stock company. This is because the profits from this future business may be the only profits that you will be

living with, as you may have to completely give up any profits on the existing block of business.

Given this financial scenario as a stock company, can you attract that required amount of capital at a reasonable cost? This is particularly important if a significant portion of your present surplus will be refunded to the policyholders, either in cash or in the form of increased policy benefits. It is quite important to get an opinion of the marketplace relatively early on from the investment bankers who might underwrite such an offering. It is like manufacturing dog food. The acid test is: Will the dogs eat it? Here you are considering taking something new to the marketplace, and you need to get the opinion of people who would be charged with making that security offering.

It is important to recognize, when talking to investment bankers, that your state regulatory authorities might force a valuation of the company that is higher than the market is willing to pay. It is also conceivable that your security might not be very attractive in the marketplace. For example, consider a very extreme scenario where all of, or perhaps more than, the present statutory surplus is refunded in cash or benefits to present policyholders. Also consider that all profits on old business would be pledged to existing policyholders under this scenario. Consider that only a portion of your home office overhead could be allocated to the participating branch. Consider your distribution system. Is it an asset or a liability? Consider that you are in a highly competitive environment. Even if you design a new product, someone else is going to be on the street with it in ninety days. Consider that your stock branch is a new entity with no immediate source of profits. Consider that the capital brought in from investors will be exposed to risks on existing business. How would the marketplace view this initial public offering? I am looking forward to hearing about that from Mr. Townsend. Just as important, is management willing to be measured on the basis of the results of this type of entity? Managers will now have to be much more short-term oriented and be driven by profits more than they have been in a mutual company. It has been said that mutual companies have enjoyed the nearest thing to Japanese management, they could successfully take the long view and did not have to worry about quarterly fluctuations. This is going to go by the boards as a stock company.

All of these financial items are interrelated with the ABCs of the demutualization process which Mr. Vogel has spoken about. The ABCs are really Valuation, Allocation and Distribution. If your distribution is going to be in stock, you may be able to convince the regulators that you do not have to recognize future values of the company because future values will come through the stock's performance. If, on the other hand, the distribution is to be in cash, the regulators might argue that some going concern values should be included because, as an owner of the company, the policyholder is severing his relationship and should get a fair market value. If you are successful in walling off surplus (which may be the best solution if you are able to), the amount of capital to be raised in the open market is reduced. Hence, the company could be more leveraged and, in theory, a higher rate of return on equity should result. However, the biggest issue is what

will happen to future profits on existing business. Can some of these profits be captured by shareholders, perhaps in the form of a management fee or a risk charge?

Perhaps in thinking about the demutualization process, it is instructive to look at the thrift institutions, the savings and loans and the mutual savings banks. A large number of them have demutualized in the last five years. In fact, there was a rush to the door of demutualization at the time when disintermediation was most serious. Most of them, however, were able to set up a liquidating account for their surplus. This was pledged for the protection of customers should the savings and loans liquidate, but entailed no immediate distribution to them, and perhaps even no future distribution. Instead, in most cases, they were given subscription rights, warrants or opportunity to purchase stock at a lower price. Although only 1 to 2 percent of them bought stock, those who did bought a large amount and, in many cases, nearly subscribed the offerings. Incidentally, it is also interesting to look a year to two later at these demutualized thrift institutions. Quite a few of them have merged. Many of them have been targets for either friendly or unfriendly takeovers.

In conclusion, regardless of your strategic plan (which you really need to have to justify demutualization), the state regulators are, by law, charged with the protection and the fair treatment of policyholders. That will be their sole concern--not your plan for joining the financial services community. I believe that any plan that is designed to enhance the operation of the company must also enhance the rights of the existing policyholders. Otherwise it will not fly.

MR. HARRY D. GARBER: I have had the opportunity to serve as the chairman of the Society's committee on demutualization. Today, I will cover what that committee is doing and also the current developments in the New York law. This will add a dimension beyond with Mr. Vogel and Mr. Flittie have given you.

Let me make a couple of preliminary points. The first is that we have been going through a tremendous learning period. When the committee first assembled, people sat around and debated who owned a mutual company and things of that nature. We then began to work on the process of demutualization; determining what actuarial questions are involved and what we need to do to help other actuaries carry out their functions in a demutualization. The committee is studying a number of areas in detail and the in the process there has been a tremendous burst of learning, understanding and increased knowledge. I would characterize our position a year ago as knowing 5 percent of what there is to know about this subject. At this point, we may know 50 percent. Both of those may be overstated, but the point is that there has been a tremendous increase in knowledge. It has come both from the work of the committee and from some of the events outside the committee meetings.

For example, there is the Union Mutual conversion process under way in Maine. Also, there have been attempted conversions by companies in states where the insurance department could set the "market" value.

Our conclusion is that whenever politics becomes involved in establishing a company's value, there will almost never be a conversion effected. The insurance commissioner cannot undervalue a company; he always has to overvalue it. If the market will not pay that price, then the conversion will fail. In developing the structure of the proposed New York law, we were able to persuade the regulators to rely on real market values, or on an actuarial estimate of value, and should not try to set it themselves.

The New York process has been very interesting, especially in the expansion of knowledge on both sides. It has been a true negotiation. We now have an agreed-upon bill which the governor has sent to the legislature. I am not sure that the bill will be passed this year, although I think it will be passed before the end of 1986. For the first time, we have tried to design a law for a large complex mutual life company and not a casualty company. Most of the present laws are based on casualty company circumstances.

In the process of negotiation with New York officials, we discussed some of the questions that Mr. Flittie and Mr. Vogel were talking about, but with some interesting differences. We found out, for example, that the New York Insurance Department has always believed mutual companies operated on the revolving surplus approach. That is, capital is accumulated from policies, and as the policyholders leave, it is all paid back to them. In this model no surplus belongs to old policyholders whose policies are no longer in force. Most mutuals have not operated on that basis for a good number of years (if they ever did), but that is how the regulators believed they operated. We are still dealing with them on this issue.

Second, we learned that it was tremendously important to New York State that New York companies leave money in the state. That is, they did not want capital pulled out of a company that was being demutualized. As a result, we have had to go to some lengths to ensure that capital will be retained by a company after a demutualization. That was one of their prime objectives which we were not aware of initially.

I think that this learning is not limited strictly to demutualization. In the process of trying to learn about mutual company conversions, we have learned a great deal about what it is to be a mutual company and how mutuals operate. The committee is formed from a group of senior actuaries, but we are all learning more about how a mutual company should be operated. It has been a very interesting process, and this learning experience is one that will continue, although I think that the pace will slow down somewhat.

The goals of the Society committee members are essentially to acquire knowledge about the subject and communicate it to the Society's members. We will be sending our first report out in a couple of months. Second, we have assisted in the preparation of legislation. We are not, as a committee, taking any positions on the subject, but individual members will be able to use their newly acquired knowledge in their negotiations with the various states on legislative matters.

Third, to the extent that there are actuarial processes involved, we want to examine the principles which apply, determine what standards should exist and, in general, be of assistance to actuaries who get involved in the details of demutualizations.

For a demutualization to be successful, it must be recognized that there are three interested parties, and that the demutualization itself must satisfy all of them. These parties are the company (including its management), the policyholders and the shareholders of the demutualized company. Any new law should be designed to permit their several interests to be satisfied. The law has to be designed in a way which will permit the company to achieve a presence in the equity markets, and which will permit it some flexibility in its corporate structure.

The whole question of the interest of officers and directors is a very important one in this context. The history of demutualizations is replete with officers and directors making off with the policyholders' money. It is this history that has caused an absolute prohibition in some states on demutualizations. This is an issue that must be dealt with very carefully. In the proposed New York legislation, for example, we have bent over backwards by preventing officers and directors from buying any stock in the company for two years following the demutualization. We believe this period is too long, but there must be some mechanism to ensure that officers and directors do not take advantage of the situation.

The shareholders' interests are important, but the position we have taken within the Society committee (and the position taken in the New York legislation) is that shareholders can take care of themselves. As long as they have sufficient information and other investment opportunities they will invest in the stock of a converted company only if they believe it is a good investment. There is nothing we particularly have to be concerned about on their behalf. However, if the market is going to be relied upon to establish values, then it has to be a market with some breadth and depth; it cannot be a market where all of the shares are sold to one buyer.

As far as policyholders are concerned, there is a very practical consideration. Any demutualization plan will require a favorable vote from policyholders, probably a two-thirds majority. Whatever is being offered to them not only has to be a good deal, but it has to appear to be a good deal. Appearances may be as important as the actual amounts. Their interests are essentially the three Mr. Vogel has mentioned: the protection of policy guarantees; the maintenance of dividend expectations (the ability to continue the dividend scale if current experience continues); fair compensation for surrender of membership rights.

Four areas have been worked on both in New York and by the committee. I am going to spend a lot of time on only two of them. One is the question of dividend expectations and their protection. Mr. Vogel stated the theory that has been assumed in the proposed New York law. The conclusion the Society committee has come to, and which has been incorporated into the legislation, is that the company needs to set up a

closed branch for its existing par business at the time of a demutualization. No new issues would be added to this closed branch. No money could be withdrawn from the closed branch on behalf of the company. Certain expense charges could be made, but these would be described in the material sent to policyholders before the conversion vote. It would be necessary to put into the closed branch enough assets to ensure that the guarantees would be met and that the current scale of dividends could be paid if current experience continues. Obviously, if the investment earnings of the closed branch increase, there will be more money available and dividends could be improved. If interest rates go down, there would eventually be smaller earnings in the closed branch and less ability to pay dividends. The point is that a block of assets is being chosen and forever devoted to the policyholders. This is an essential piece of the proposed New York law.

The Society committee is investigating several elements of this concept. One is how to establish a closed branch and how to operate it because it will not be sufficient to merely continue the dividend scales in effect. Every year or two, emerging experience must be examined and dividends adjusted so that as the block expires, the last policyholder does not receive $1 trillion.

If a closed branch is established which meets these criteria, and even has some conservatism, it will be found that the amount of assets required is less than the statutory liabilities, and, possibly, by a considerable margin. This is because the present value of all future contributions to surplus which would have emerged on that business has been extracted up front by this process. In addition, the process recaptures all of the charges in the dividend formula for the amortization of new business costs--if no new business costs are charged to the fund. Hence, fewer assets are required than statutory liabilities. The difference could be fairly large. The Society committee has developed a model to study this aspect, and has determined that the ratio of required assets to statutory liabilities in the closed block could be as low as 80 to 90 percent. You can see that this difference could be larger than the statutory surplus itself.

One of the key questions which has yet to be answered is: What charges are to be made against the fund? These would have to be defined in any material that was sent to policyholders. Obviously, certain expense charges, perhaps including taxes, would be made. Again, a balance must be established between the expected costs which should be recovered versus what charges will appear to be reasonable to policyholders. Union Mutual, which has also set up this kind of arrangement, proposes to make only maintenance expense charges. As I understand it, there will not be a charge for sales costs. Other questions are: Which assets do you put in the closed branch? What choices do you have?

Another question is: Which of your lines of business should be included? The proposed New York law does not require all of your par business to go into the closed branch. It would permit a company to keep some or all of its group business out. The theory is that if a closed branch is being established, it should only include business

which must terminate eventually. Theoretically, group contracts could continue forever. Hence, there is the ability to keep group business out, but each company will have to make its own choices based on its particular situation.

The first essential element is, therefore, a closed branch. Having set up a closed branch with assets less than statutory liabilities, there is a new dimension with respect to the determination of the policyholders' equity. Statutory surplus no longer has a unique position in measuring policyholder values. The committee is exploring a new approach to the determination of these values. Under this approach the assets of the company would be divided into three pots. The first pot would contain the assets which have been accumulated by terminated policyholders or by nonpar business. The second pot would contain the assets which have been accumulated with respect to participating business that is not in the closed branch. The third pot would contain the assets accumulated with respect to business in the closed branch. The assets in the first pot would not be taken into account in the measurement of the aggregate policyholders' equity. With respect to the second pot, the amount of statutory surplus accumulated for contracts not in the closed branch would be included in the measurement of the policyholders' equity.

With respect to the business in the closed branch, the amount of the policyholders' equity would be the excess of the assets which have been accumulated under their contracts over the assets in the closed branch. A simple definition of this amount is that it represents all the past earnings from these policyholders plus the present value of all future earnings. This is a tidy statement and says that these policyholders will receive value for every contribution that they had made or would make to the company. Although this is an aggregate measure in the proposed New York law, it can be subdivided to become a policy by policy measure as well. An interesting characteristic of this measure is that it is almost always positive. The use of this measure also facilitates the establishment and operation of the closed branch. If the assumptions underlying the closed branch are a little conservative, the total body of policyholders will still receive the same amount of money; they will just get it in a different form. Instead of stock, they will receive it as dividends or vice versa. However, these decisions will affect who receives the funds and in what form.

The Society committee is trying to deal with a host of theoretical and practical problems. One is the degree of accuracy which might be desirable in accumulating assets for all of the policies that are in force. That is, in itself, a challenging process in terms of information requirements. There are other questions concerning the treatment of unprofitable lines of business, capital gains and losses, etc. We have established a tentative principle that a company should not undo past dividend decisions in a conversion process. This is a principle which we are in the midst of testing. For example, accidental death and disability earnings may have been averaged over all policies. When accumulating the assets for the policies in force, the same ought to be done. Similarly, if there was an unprofitable line of business that is long gone and, back in 1950, the company charged some of the costs of

that line to its existing participating business, it should not now decide to omit that charge in accumulating assets. This tentative principle to not redo the past must still be tested further. If it is sustained, however, it is a method which begins to resolve some of the issues that have been raised by Mr. Vogel and Mr. Flittie.

There are a couple of other small points I would like to mention. A company contemplating demutualization will have to prepare GAAP accounting statements. The original GAAP deliberations did not satisfactorily resolve the definition of GAAP for the participating business of mutual companies, nor obviously, the question of GAAP for a closed branch of a converted mutual company. A subgroup of the committee is beginning to look at GAAP. Its task is to develop ideas which can be discussed with the accounting profession. Over the years, the application of GAAP to mutuals has been stymied because few mutuals were interested. I think there is considerable interest in this subject now, and it is one which extends beyond demutualization. Therefore, that has become an active project of the committee.

There are a number of questions relating to statutory accounting for a converted company. For example, when a closed branch has been set up as the result of a conversion process, it is a very interesting problem to try to determine what the statutory balance sheet should look like. We have had some discussions with New York, but that is one issue where a lot of work remains to be done.

Finally, I have a heading called market considerations. Many actuaries, particularly mutual company actuaries, have been able to live without understanding a great deal about how the equity markets function and how the way in which a company does business affects its market value. I think that everywhere we turn on this subject, we come to the question of how conversion decisions affect the company's appearance in the market. We must become educated. The committee is not trying to do new things, but rather is considering the effects of various circumstances on the ability of the company to go to market. This is an area being looked at as a constraint, not as an area for new discoveries.

MR. FREDERICK S. TOWNSEND, JR.: For those of you who are not familiar with our organization, Conning & Company is a member firm of the New York Stock Exchange. Although we are involved in a variety of business activities, our primary source of revenue is providing a research advisory service on insurance stocks for institutional investors. This is the point of view from which I will address the subject today.

In assessing how an investment analyst might view the process, it is important to identify the basic characteristics of what is being demutualized. Obviously, the first fact is that you are looking at mutual companies. Second,the largest of these companies probably operate on a branch office or career agency system. Third, most of these companies are primarily writers of ordinary life insurance and are generally not dominated by specialty lines of business. Within the ordinary life line, the business is virtually 100 percent participating. In addition, one is looking at a low ratio of surplus liabilities relative to

those found in stock companies. However, there is, in the case of the largest mutuals, a very large aggregate dollar amount of surplus relative to stock companies.

A stockbroker might be likened to a life insurance agent. A life insurance agent likes having products. He wants all the current interest-sensitive products, cheap annual renewable term, annuities, etc. My product line has been disappearing since the 1970s due to mergers and acquisitions. Some insurance companies have gone private--for example, Reliance and CNA. Other life companies have been acquired by noninsurance companies. There are companies like American Brands, Ashland Oil, Xerox and ITT getting into the insurance business. I will have to give up following these stocks, and recommending them to my clients, unless I want to follow the tobacco industry or the business equipment industry or the oil industry. So my product line has been diminishing.

The number of major publicly held companies in the large market has been drastically reduced. Most institutional investors want a minimum of $200 million or $300 million of value before they will consider investing in a stock because of their inability to create sufficient investment position otherwise. The supply of pure life companies, which are not members of multiline groups having exposure to the property/casualty industry, has been diminishing. There are very few pure life insurance companies with $200 to $300 million of market value which the institutional investor can buy. There is an investor audience that likes life insurance stocks, so, if more product can be created, to some extent there is a market.

A positive aspect of demutualization is the potential conversion of a large field force to the writing of nonparticipating insurance without building a field force from ground zero. A new stock company starts with no field force, but a demutualized company may have the benefit of having a captive or career agency force. However, branch office distribution systems are viewed by some investors as being costly and inefficient. In recent years, some branch office companies have eliminated marginal agents, consolidated offices, purchased alternative distribution systems or converted from fixed-cost to variable-cost distribution systems. Furthermore, growth in large branch office companies has generally been below the industry average in recent years. This reflects industry conditions, including disintermediation and an active replacement market, but also the handicap of aggregate size and the inability to expand a large captive sales force.

Branch office companies are at a competitive disadvantage because of their relatively high distribution costs and overhead expenses, and relatively slow growth. Investors may prefer companies with specialized marketing niches, or with above-average growth potential in sales and in-force business. They may avoid investing in demutualized companies dependent upon a branch office distribution system. On the other hand, a demutualized company, if it can convert a significant proportion of its production to a nonparticipating basis, can create a substantial sales level and rapid growth from a zero base. The growth rate in

nonparticipating business can be very high in the early years following demutualization.

During the 1970s, the life insurance industry experienced a 7 percent annual growth in ordinary life premium income and a 15 percent annual growth in ordinary life statutory earnings. Thus, during the 1970s, investment in the ordinary life line of business was attractive.

During the 1980s, increased cash surrenders and replacement activity have slowed asset growth. Lower prices on new products have slowed premium growth, and interest-sensitive products have sharply reduced prospective profit margins. Favorable tax deductions have been eliminated by changes in the Internal Revenue Code.

In the unfavorable operating environment of the 1980s, those stock life companies which have experienced rapid growth in ordinary life sales and earnings per share operate in special market niches, and/or with variable cost or specialized distribution systems. To the extent that companies with low-cost distribution systems and cost effective products have grown rapidly by replacing high-cost products in mature companies with old blocks of business in force, the growth of companies' old blocks of business has been below-average during the 1980s as a result of increased lapse and surrender activity.

Thus, during the 1980s, investors have favored those companies with low-cost distribution systems and cost-effective products which recorded substantial sales growth in the ordinary life (or specialty) lines of business. Investors discounted the price-earnings multiples and price to book value ratios which they were willing to pay for investment in traditional branch office or career agency companies.

The major prospective candidates for demutualization are generally licensed in New York State, and/or other states which place a limitation on the amount of participating department profits which inure to the benefit of stockholders. On a statutory basis, generally only 10 percent of the participating department profits insure to the benefit of stockholders. Thus, from a stockholder perspective, in a company which writes both participating and nonparticipating ordinary life insurance, stockholders would prefer to direct the sales effort towards profitable nonparticipating business on which 100 percent of the statutory profits insure to their benefit.

On a GAAP reporting basis, the effects of demutualization are unclear with respect to participating business. By this statement, I mean that different stock companies report stockholder earnings on different bases. Most companies allocate 90 percent of the earnings on participating insurance to the policyholders and hold such amount as a policyholder liability. Some companies credit stockholders with 10 percent of the participating department earnings, plus all the undistributed portion of the 90 percent share of the participating department earnings. Thus, depending upon the accounting treatment selected by a demutualized company, the level of earnings could double, triple, or quadruple.

In my opinion, it is improper to represent all of the undistributed earnings of the participating department as inuring to the benefit of stockholders, particularly for any company operating in New York State. However, if a demutualized company were to adopt this accounting treatment, it could immediately convert the undistributed earnings of the participating department to shareholder earnings on a GAAP reporting basis. When such earnings per share are multiplied by an industry-average price-earnings multiple, an artificially high value results. It is artificial because 90 percent of the participating department earnings cannot be paid out as shareholder dividends. Therefore, such funds should not be represented as shareholder earnings.

Some state statutes restrict mutual company surplus accumulation to 10 percent of policy liabilities, while some stock companies have accumulated surplus exceeding 20 percent of policy liabilities. Thus, the ratio of assets to surplus is much higher for many mutual companies than for the typical stock company.

The asset leverage in mutual companies produces a conflict. It provides a reason to demutualize because of the inability of mutual companies to raise capital. It also provides a reason not to demutualize because takeover specialists, who like to acquire companies with high asset leverage ratios, would welcome the demutualization of the large, asset-rich mutual companies. Thus, demutualized companies could be high-priority acquisition targets for those groups of investors who are well known for their use of corporate assets in one acquisition to finance subsequent acquisitions.

In my opinion, there will be very few demutualizations in the life insurance industry, unless such demutualizations are structured to retain voting control with current management. My opinion stems from the belief that mutual company officers and directors will recognize the takeover threat and will not risk having their companies acquired by asset-hungry takeover specialists.

The largest mutual companies have surplus amounts which are multiples of their respective stock company counterparts. This has several ramifications. First, assuming that existing surplus at the time of demutualization is allocated or distributed to policyholders, an equal or larger amount of stockholder surplus must be raised in a public offering.

Second, because new business might be shifted to a nonparticipating basis, which may be considered riskier than participating business from a solvency point of view, a higher ratio of surplus to liabilities might be prudent for the recently demutualized company.

Third, the popularity of interest-sensitive and low-priced nonparticipating products has placed tremendous surplus strains on stock life companies with quickly growing sales. Several such companies have come to the public and private markets to raise additional capital to finance new business.

Fourth, the marketplace acceptance of interest-sensitive products has created asset growth which exceeds surplus growth, even for companies generating statutory earnings. This has caused some stock companies to raise additional capital to maintain a favorable Best's rating.

Thus, a demutualizing company may consider it prudent to raise more money in the public market than the amount of surplus it held as a mutual company. Such public offerings could be in the hundreds of millions of dollars.

Can the stock market absorb one, two, three or more public stock offerings, each of which is several hundred million dollars? Probably not. Several major insurance companies have raised additional capital in 1985, including CIGNA ($250 million), Aetna ($242 million), Travelers ($200 million), Torchmark ($150 million) and Kemper ($135 million).

If there is limited capital in the public market to finance demutualizations, then several conclusions may be drawn:

- First come, first served. Go to the well before it runs dry.
- Only smaller and medium-sized mutual companies may be able to sell stock at a fair and reasonable price.
- Large mutual companies must adopt innovative structures for demutualization which convert policyholder surplus to shareholder surplus.

How do I, as an investment analyst, view demutualization?

- Just as a life insurance salesman wants a broad product portfolio, a stockbroker specializing in insurance stocks welcomes new public companies with very large aggregate market values and prospective high levels of trading activity. This generates increased commission revenues for stockbrokers.
- The largest mutual companies, licensed in New York State and operating on branch office systems, with large surplus amounts, may be most difficult to bring to market at a fair price.
- The threat of hostile takeovers by asset predators will convince many large mutual companies to adopt protective measures or to forego demutualization.
- Smaller to medium-sized mutual companies which have significantly increased sales with new interest-sensitive products may find it not only necessary to demutualize to continue their sales momentum, but may also find the stock market willing to pay a generous price for rapid growth in a small company.

MR. JAFFE: These have certainly been four of the best presentations I have heard in a long time. I know the amount of effort that went into your presentations is reflected in the quality of your comments today.

After a few comments of my own, I will open the discussion. To keep this in perspective, at least in the United States,let us remember that there are only about 130 mutual life insurance companies. Probably a third of those are so small that the subject of demutualization really does not apply to them. A third are in the medium-size category which Mr. Townsend has spoken about, and a third are fairly large.

There is some defacto demutualization occurring which was not mentioned. Downstream stock companies and other ventures have been appearing in the marketplace for some time. Today many of the mutual companies are hard to distinguish from the stock companies. They come very close to issuing the same products. A friend of mine, who is an executive with a mutual company, threw out a taunting question: Who is going to be the last true mutual policyholder of some of the companies which are issuing products that cannot be distinguished between par and nonpar? The surplus distribution problem may resolve itself if there are no par policyholders left. I think a good long-term investment might be a true participating policy in each of the major mutual companies.

The problem is that we have been looking at things on one hand, and then on the other hand. There always seems to be more than one answer to any question that is raised. It reminds me of an old story about Harry Truman. His economists would come to him and they would say, "On the one hand this, and on the other hand that." Truman's reply was: "Oh, for a one-armed economist." We need that, in a sense, although we are still at the wrestling stage with these problems, and I think that will continue for some time.

MR. CLAUDE Y. PACQUIN: My remarks should in no way be attributed to my employer. On the panel we have four distinguished gentlemen. However, none of them is a representative of government or of the public interest, and I thought I would appoint myself Devil's Advocate. I hate to equate the Devil with the public interest, but I will attempt to serve as an advocate for the public view to perhaps give us a more balanced presentation. I have not prepared my remarks ahead of time and they are largely a reaction to the comments I have heard today.

I think one of the first assumptions I detect in the panelists' remarks is that only individual life policyholders may be considered as owners of mutual insurance companies. There is a presumption or assumption with which I am not prepared to agree readily. I suspect that those people who bought health insurance policies in mutual companies are as much owners as those who bought life policies. I think that group policyholders could be considered owners as much as individual policyholders.

MR. GARBER: I do not think there would be any disagreement with Mr. Pacquin on that issue. If we left that impression, it was inadvertent. Any policy which says participating on its face would be considered to be participating for this purpose.

MR. PACQUIN: I would extend that to annuity holders as well. Another thought I had was with respect to borrowers. I have been a borrower in a savings and loan association which converted to a mutual

savings bank, and then demutualized. All I had with them was a mortgage. Lo and behold, I was entitled to receive some of their stock. I cannot understand why mortgagors in mutual insurance companies are not considered to be somewhat like credit union members. Both the borrowers and the savers may be considered owners, and I think some recognition might be given to those people who have contributed to the company, other than by being policyholders or purchasers of insurance against risk.

The third point I would like to make concerns the age of the mutual insurance companies, the amount of surplus that has been accumulated, and the virtual impossibility of ascribing that surplus to living or identifiable policyholders. If I were to look at this from the point of view of the state, I might consider an application of the escheat laws. Escheat laws apply to regular estates where a person dies without any identifiable heirs. Sometimes there is a law which is known as a "laughing heirs law." Laughing heirs are people who never knew that they had some great-uncle who died in Colorado owning a gold mine, and naturally, they laugh a lot when they receive their windfall. I think that there is an analogy here with respect to demutualization and that there are some people who stand ready and eager to accept the windfall, but who do not really deserve it. A state might then consider applying its escheat laws and receiving a share of stock to be issued by a mutual company. For instance, the federal government has bailed out Chrysler Corporation and has received some stock options in the process. Now, I agree that here the state has not really done anything compared to what was done for Chrysler Corporation, but, nevertheless, the state may be interested in receiving a share of a potential windfall through demutualization. If we were talking about Europe instead of the United States, mutual insurance companies would probably be nationalized and then denationalized in about ten years through a public offering. That might resolve the problem quite nicely.

Finally, I considered the role of the Society of Actuaries. It seems to me that the Society's role, as a body of professionals, should be limited to studying all of the aspects of demutualization without taking too much of a business bias. Perhaps the Society should appoint committee members who, using the wealth of knowledge that we have as professionals, would look at the issues from the points of view of both the regulator and the public interest.

I thought that the presentation was very good, and I expressed earlier. However, I felt it was from a point of view which needed to be counterbalanced by another point of view, which I hope I have introduced elegantly and clearly enough.

MR. GARBER: As far as the Society's committee is concerned, I think Mr. Pacquin's points are well taken and we intend to run it as he has suggested. We have open meetings, although we do not send out invitations. Anyone may come to our meetings which are ordinarily held in my office on the last Friday of each month. We try to expose matters for discussion and bring in different points of view. Admittedly, it is a group which tends to be drawn from mutual company

actuaries, mainly because those are the actuaries most interested in this subject. But we do try to be fairly broad.

I have just one comment on the escheat concept. Some of us were worried that state officials would raise that concept in negotiations. They did not, but that does not mean that some state will not raise it in the future.

MR. JIM PILGRIM: How does one determine how many votes each policyholder will receive?

MR. GARBER: That is decided by contract or by law, and it is usually one vote per policyholder, not per policy. One of the problems which arises in determining the distribution of values to policyholders (how many policyholder/shareholders will have $10 of value and how many will have $1,000 and so forth) is the difficulty of aggregating the policies of a policyholder.

MR. ROBERT C. DOWSETT: I read somewhere that there have been about 100 demutualizations in the last twenty years. Do any of the panel members have any statistics about completed demutualizations?

MR. JAFFE: There have been twenty-six completed since 1968. I was involved in one of these, and I must tell you that, not only was it a great deal of fun, but it was a very interesting process. Four of these were life companies; twenty-two were property/casualty. There are a couple of life and one property/casualty cases still pending. I think the Union Mutual case will set the tone for future demutualizations. However, that is not being resolved as fast as I thought it would be. Does anyone have any idea how long it is going to take for that to be completed or at least decided?

MR. GARBER: I believe that they were aiming to complete it this year. They have a problem now that, in the state of Maine the insurance commissioner cannot contract for outside resources. Even though they have selected some outside consultants and lawyers, there is a contracting arm somewhere in the state government which is holding things up. They had hoped to have a hearing in June. That schedule now seems to be set back. One of the interesting things about a conversion is that, for a large company, the process has to run on a calendar year basis. Because the determination of policyholder values is based on year-end values, the company has to start the conversion process at the beginning of a calendar year and hope that it can be completed before the end of the calendar year. That becomes a practical constraint on these activities.

MR. JAFFE: We are probably looking, at the earliest, at the end of 1986.

MR. A. HENRY KUNKEMUELLER: We have heard some interesting discussions about the valuing of liabilities and of the resulting surplus. I would like to ask the panelists how they have considered valuing the assets and what the implications of using the market value of the assets would be?

MR. GARBER: Essentially, the method by which assets are valued is irrelevant in the closed branch because what you are really doing is equating present values of cash flows from the assets with those expected from the liabilities. If you are calculating the present value at the dividend interest rate, all you need do is make sure that the cash flows from the assets, plus the premiums, will match the payouts. Hence, it is not important to put a value on those assets because you can proceed using statutory values for this purpose. It is perfectly satisfactory.

MR. JAFFE: We have come to the end of today's session. One other topic that certainly could have come up was President Reagan's new tax plan. If he had decided, instead of coming up with a new tax plan, to demutualize the United States government, then, instead of sitting here worrying about how much we would get as policyholders, we would be worrying about the bill we would be scheduled to receive to fund the national debt. That would be the ultimate demutualization.