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DEMUTUALIZATION--UPDATE AND PERSPECTIVE

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- o Case history of Inter-State Assurance Company
- o Case history of Unionmutual Life
- o Society of Actuaries Task Force on Mutual Life Insurance Company Conversion
- o Demutualization Legislation Proposed in New York

MR. WAID J. DAVIDSON, JR.: In 1984, Inter-State Assurance Company of Des Moines, Iowa proposed to demutualize. This company began as an accident and health writer, expanding to traditional types of participating life insurance products in 1960. In 1980, it became the second company in the U.S. to offer universal life. At that time it also offered increasing premium whole life. Inter-State was extremely successful with these new products. Sales far outstripped the company's original business. Technically, universal life and increasing premium whole life are participating policies, but neither provide dividends as such, so the tremendous surge in production was actually for nonpar type contracts. By 1983 Inter-State had almost $34 million in premium and about $5.5 million in surplus, which of course had not kept pace. The company had structured its marketing very carefully to avoid surplus strain, but being a mutual company, it had no way to raise capital. It could retain earnings or get some relief from reinsurance treaties, but these actions would still leave it starved for capital.

The Iowa Insurance Department was well aware of Inter-State's low surplus. At this time, 1984, Iowa had no specific demutualization law. Subsequently, a preliminary version of the New York law was passed. Inter-State's ultimate demutualization plan would probably not qualify under the new law, but could be approved under the commissioner's discretionary powers. Before this law was enacted, the procedure followed was that the Insurance Commissioner of Iowa was required to approve a corporate reorganization unless he found it to be unfair to someone. There were precedents for demutualization in Iowa in the casualty field. In Inter-State's case, the commissioner was informed early about the negotiations. Form A was filed with all of the details of the plan, a hearing was set and was adjourned only one time for thirty

days. The commissioner issued an order on the demutualization on the 8th of November, 1984. Before I tell you what he said, I will explain the plan.

Inter-State would become a stock life insurance company. Then the Equitable of Iowa Companies, or one of its subsidiaries, would buy all of the stock for $10 million. The Equitable of Iowa Companies is the parent of Equitable Life Insurance Company of Iowa, two smaller life companies, a casualty company, and a retail operation of some Midwest department stores. Equitable Life Insurance of Iowa has $1.3 billion in assets. About two-thirds of its business is on a participating basis. The significance of this is that it had operated a par branch.

A members branch containing everything in the company as of the demutualization date (including the surplus, mandatory security valuation reserve (MSVR) and so on) would be established. It would be walled-off. All future earnings from existing policyholders would remain in this members branch. Investment income would be allocated to it using the investment year method on liabilities and surplus. Expenses would be allocated based on the facilities used. No management fee or profit would be pulled out of the members branch. That is, there would be no fifty cents per thousand or 10 percent of gain from operations before dividends. No new business would be written in the members branch.

The stock branch to be established would finance all new business. It could, if it so desired, write participating policies in the future, but those would not become part of the walled-off members branch. Proceeds from The Equitable's purchase of stock would go into the stock branch and there would be a cross guarantee of benefits. That is, all assets and liabilities of the two branches of the company would back each other. If The Equitable were to sell Inter-State, the members branch would be moved into The Equitable of Iowa to be operated as a walled-off branch under the same terms of its establishment. The expenses of the demutualization would be paid by The Equitable, not by the members branch.

All future profits from the members branch would be distributed to the policyholders. The only thing that would happen would be the allocation of investment income and expenses. The surplus, MSVR, non-admitted assets and similar items in the members branch would be distributed to the policyholders as released. It would be the responsibility of the company actuary to distribute all of these items in an equitable manner. Outside consulting actuaries were to be retained periodically, I think every three years, to prepare a report on adherence to the plan. A copy of this report would be sent to the Iowa Insurance Commissioner.

To distribute the surplus flow-black of the MSVR and the non-admitted assets, the business in Inter-State was divided into five blocks. The first block was the original business of the company, accident and health insurance. Most of this was guaranteed renewable business and was generally in a positive surplus position. The intention was to distribute the future profits and surplus by foregoing rate increases or

increasing benefits, and if necessary, actually reducing premium rates. Dividends would not be used, since none had ever been paid or illustrated for this block.

The second block was the traditional ordinary business consisting of participating whole life, limited payment, life endowment, and term--basically small policies. This block was also in a profit position, but here policyholders would receive a significant, immediate dividend increase and future profit distributions would be in the form of increased dividends.

The third block was the universal life business, which was generally in a deficit position because it was so new. The deficit would be recovered by continuing to retain some margins in the credited items. However, there would be an immediate increase in the interest credited; that is, the spread would be reduced and the future distribution would be in the form of excess interest and reduction in term costs. It was not intended that dividends be paid on this block either, since none had been paid or illustrated in the past.

The fourth block, consisted primarily of large increasing premium whole life contracts and was in a deficit position. Future profits were to be distributed by an increase in death benefits, which would be reinsured. That is, an amount to be distributed would be declared, reinsurance would be purchased with that money and then distributed in the form of additional benefits. Development of additional profits on this block of policies was questionable. Again, it was not contemplated that dividends would be used because none had ever been paid and none was ever illustrated.

The fifth block would be interest-bearing funds. Here the interest margin would simply be reduced.

The surplus, MSVR, and non-admitted assets, as they flowed out, would be included in the distribution. Sufficient surplus would be retained to support the liabilities, but none was to remain when the last policy terminated. In other words, the surplus funds were to be distributed over the life of the policies. The stock branch, effectively, was guaranteeing the contractual benefits which eliminated a lot of the need for large amounts of surplus in the members branch.

The plan of demutualization, as it was written up, was deliberately general. It gave wide latitude to the company actuary in determining how these funds should be distributed. This was to allow him to adjust to changing times over an extended distribution period. A previous plan in Indiana had been drafted too tightly, necessitating legal action to change it. Also, the company actuary's actions were subject to independent actuarial review and a report to the commissioner.

What considerations were to be received by the policyholders of Inter-State?

- Relief of the necessity of financing new business, which had been a significant cost.

- Distribution of future profits.

- Over time, the distribution of the surplus, MSVR, non-admitted assets and other such items.

- Contractural benefit guarantee by the stock branch and by additional capital funds contributed by The Equitable.

- Nonincreasing unit expense levels because the stock branch planned to add new business (unit expenses have a tendency to get out of hand on the runout).

The estimate of the additional distribution, over what would be received without demutualization, came to $115 million over the life of these policies. This had a present value of about $43 million.

In the demutualization process, Inter-State was represented by a law firm and an investment banker. The banker, who also happened to be an actuary, rendered a fairness opinion on behalf of the policyholders. Proxies were sent to the policyholders and Inter-State received almost unanimous approval. The only opposition at the hearing came from an attorney representing some former employees.

The commissioner ruled that the plan was in the interest of the policyholders, approving it subject to five changes:

1. The policyholders were to be made a party to the demutualization plan, possibly so they could sue to enforce it.

2. Terminal dividends were to be paid on policies in a positive surplus position. This was intended to be in the plan, but had not been specifically included in the write-up.

3. The commissioner would be able to require an independent actuarial review on an annual basis.

4. The commissioner would have veto power over the selection of the actuarial firm.

5. Of The Equitable's contribution, $5 million would be transferred to the members branch in payment for existing structure.

The Equitable did not agree to the $5 million transfer and, as was its right under the original contract, withdrew.

Subsequently, Inter-State became a stock subsidiary of Central Life of Iowa, another mutual company. The advantages of this plan, in addition to those previously mentioned, are:

- A continuing connection with a mutual organization for existing policyholders.

- No profit from the existing policyholders accrued to the stock branch.

- The walling-off process protected the existing policyholders from the new stockholders.

- No value needed to be placed on the company, avoiding inherent controversy over what that value ought to be.

- The administrative nightmare of distributing a few shares of stock to some 75,000 policyholders was avoided.

- A monitoring process was set in place through the use of outside independent consulting actuaries. Policyholders had protection in case the company was sold.

- The distribution to the policyholders was treated as dividends for tax purposes. There was a tax opinion to that effect since the distribution was made in the normal way policyholder dividends are distributed. Future payments to the policyholders will be a tax deduction to the insurance company as dividends to policyholders.

- Inter-State's tax loss carry forwards were preserved since, for tax purposes, the form of the company had not changed. This was potentially fairly large.

- The policyholders did not sell their future rights to receive benefits at cost.

From an actuarial appraisal point of view, the potential benefits to the new stockholder can be divided into three categories. First is the present value of future profits on existing business. Due to the walling-off, the appraised value of this is zero. The second category is adjusted book value. This again is zero because all of the adjusted surplus is to be returned to existing policyholders, with interest. The third category is existing structure, usually valued by one or two methods: a rule of thumb which places a value on state licenses and charters; or the present value of future new business. Some value would be produced by the first method. However, the company was writing very competitive contemporary products, so by using the second method the present value, at 15 percent, of these products was probably near zero since they were priced to yield about 15 percent. Remember that the policyholders could expect to receive some $43 million in additional benefits they would not have enjoyed if the demutualization did not occur.

The Central Life arrangement involved moving the Inter-State policyholders, by assumption reinsurance, into Central. There they took on the same rights as Central policyholders: the right of ownership in Central and the right to receive dividends on the same basis as Central policyholders. Inter-State was then converted to a stock company with no business, and became a wholly-owned subsidiary of Central. Capital was contributed. Presumably, Inter-State is continuing to operate as a stock subsidiary of Central with its current management and some of the previous management of Inter-State, one Inter-State manager on the board of Central and vice versa. It appears that the Inter-State policyholders became minority owners of the stock of Inter-State

through their ownership in Central Life. Therefore, they traded their ownership rights in Inter-State for ownership rights in Central. Central, incidentally, was a much larger company having over $100 million in surplus.

MR. DANIEL J. MCCARTHY: Unionmutual Life, as was widely reported during 1984, has made a corporate commitment to investigate and move forward with a plan to demutualize. At a National Association of Insurance Commissioners meeting, the company held an informal meeting with representatives of every state in order to give them a briefing and encourage their questions about the plan. Shortly thereafter December 31, 1984, Unionmutual filed a plan with the Maine Superintendent of Insurance. Maine, unlike Iowa, has a demutualization law. It is a version of the so-called Williams Act which is the demutualization law of some thirteen or fourteen states. Unionmutual's intent was to file a plan that would be consistent with the provisions of this law, without needing to go to the legislature to obtain alterations.

As the law requires, the plan provided a distribution to existing eligible policyholders of an amount equal to the entire surplus of the company. Unionmutual interpreted the law to mean that this amount would be equivalent to their statutory surplus, which was about $265 million as of December 31, 1984. The law provides that the distribution will be in stock; however, the plan may provide that anybody may elect to take cash instead, but cannot get more than 50 percent of the market value of the stock. The law also defines eligible policyholders to be those either in place, or having been in place during a period of at least three years prior to the effective date of the plan. That meant that the plan had to cover people who were policyholders as of any date between January 1, 1982 and December 31, 1984. It should be noted that the company would not have been precluded from having a plan that would go back further.

Although the law in Maine does not provide for a walling-off arrangement, Unionmutual's plan does. (This arrangement has come to be called a participation fund.) The plan provides that for the individual life and annuity participating policyholders a separate fund would be established that would be sufficient to provide for continuation of the company's current dividend scale and the operations thereafter if current experience were to continue. Since the one thing anyone can be sure of is that current experience won't continue unchanged, there was a structure of the type Mr. Davidson described; that is, the company's actuary would make periodic determinations of the dividend adjustments needed in order to keep everything in balance. These adjustments would be reviewed periodically by an outside party.

Early in 1985 the Maine Superintendent of Insurance set about retaining consultants who would be able to advise him on the appropriateness of the plan. He conducted a selection process to obtain an actuarial firm, a law firm and an accounting firm. In the meantime, based on advice from its counsel, Unionmutual determined that there were potential technical problems in the voting rules of the plan, because the voting rules under Unionmutual's charter were slightly different from those described in the Maine demutualization law. There was some concern

that the company might reach the point where it wouldn't know if it had a valid vote or not, assuming it got to the point of being able to take a vote. In addition, the Superintendent began to voice concern about the rule on cash-outs, particularly in the case of somebody who had had a relatively small distribution of the company surplus and would have to take either a few shares (leading to market problems) or cash of only 50 percent of the amount of the stock. The Superintendent just didn't care for that.

Late this spring a change was made in the Maine law to deal with the voting rights issue and the 50 percent cash-out for small holders. The company, in the meantime, submitted a revised plan dealing with each of these aspects and several other minor items it discovered along the way. The revised plan was completed at about the end of June this year. In addition, notice was given to all policyholders and other interested parties.

A structure is being set up under which hearings can be held. The Superintendent's office identified persons who would be interested parties at those hearings. Under the Maine law, those individuals are referred to as "interveners." Three parties were ultimately granted intervener status. Two are former employees of the company. The third is an entity called the "concerned policyholders committee," whose original backers consisted of, among others, some current and former general agents of the company who have retained counsel and have done a fair amount of work. The hearing, when it is held, will be a multiparty affair. A preliminary hearing was held where a number of people appeared including representatives of the New York Insurance Department--Unionmutual is licensed in all states so New York, as well as other states, has a considerable interest in this. In this connection I want to discuss how the draft New York law applies to foreign companies.

For a New York domestic company, the law sets out several methods for demutualization. (When I say "the law" I mean the draft, which has been submitted but not yet enacted.) For a foreign company, that is, a nondomestic company licensed to do business in New York, the law provides that it must file a copy of its plan of reorganization with the Superintendent at least ninety days prior to the date on which the domestic superintendent plans to hold a hearing. The purpose of the lead time is to allow the New York Superintendent time to file with the domestic state's superintendent any objections that New York has, and which would need to be remedied in order for the converted company to continue to do business in New York. Unionmutual has submitted copies of its plan, and has held meetings with the New York Insurance Department to answer questions about it.

The Maine Superintendent's consultants are at work reviewing the plan. It's an interesting situation: there is a lump sum of money and a variety of different classes of policyholders in different lines of business. How does that money get carved up? The law says the distribution needs to be fair and reasonable. That is not a unique test. There is a lot of discussion as to exactly what falls within the range of

fair and reasonable, and the plan is, as it should be, being scrutinized in considerable detail.

At the moment there is no fixed schedule. I think it's fair to say for everybody involved in the process (the company, the superintendent, all consultants) that it is moving far more slowly than anyone had imagined. But the process is going forward. Presumably, hearings will be held and ultimately there will be some action: an approval, an approval with conditions, or any of several other things. Exactly what the next twists and turns are and what the results will be are not clear at this point.

MR. CURTIS E. HUNTINGTON: The Society of Actuaries (SOA) Yearbook describes the purposes of the Task Force on Mutual Life Insurance Company Conversion as follows: "to examine the actuarial issues involved in converting a mutual life insurance company to the stock form of ownership and to produce a record of its examination."

All members of the task force are members of the SOA. Each of them works for a mutual company or an investment banking firm, but does not formally represent his or her employer on the task force. One of the charges of the task force is to keep the participation open to as many people as are interested. Toward this end, the group has added new members periodically and has established a number of committees involving SOA members who are not officially on the task force. Also, numerous interested actuaries have been invited to discuss the issues and present various aspects of the subject to those of us on the task force.

The task force began its work on March 23, 1984, with an initial objective to develop an actuarial mode for the valuation of mutual life insurance companies that could be used to:

1. Quantify the current "fair value" of the entire company.

2. Develop the rationale and quantification of an "entity" value reflecting that part of the fair value not precisely identified with blocks of current policyowners.

3. Articulate a methodology to determine how much of the fair value --possibly including some part of the entity value--belongs to the current policyowners.

4. Articulate a methodology for communicating with policyholders regarding the results of (3).

This is a wide ranging statement of purpose, but it does give an indication of some of the issues that might be raised in its discharge. The task force, in its interim report, reformulated this initial statement to identify three working goals. These are more general than the initial objective.

1. To acquire knowledge on the subject of mutual company conversion--I think everyone who has attended the task force sessions

would agree that that goal has been very well achieved. A significant amount of knowledge on the subject has been gained by all, and although we may not know what the answers are, we are certainly getting a lot of questions and amassing background.

2. To communicate this knowledge to SOA members--In fulfillment of this goal, task force members have held panel discussions at the SOA spring meetings, and have made available the interim report titled "A First Report of the Task Force on Mutual Life Insurance Company Conversions," which has been made available, and there will be an open committee meeting tomorrow. The attempt is clearly to not keep it as a closed group but to have as large a range of participation as possible.

3. To explore the actuarial processes in a mutual life insurance company conversion, and to propose initial principles and standards of the guidance of actuaries responsible for these tasks--In the pursuit of this goal, the task force members are seeking feedback from other actuaries through open dialogue in panel discussions such as this one.

To accomplish the goals we have organized ourselves into four subcommittees:

1. Subcommittee on individual life and annuity products--This subcommittee is charged with working on a model similar to that described in the initial statement of purpose. It is being developed with the assistance of Milliman & Robertson, Inc. in New York. The subcommittee is under the guidance of Mr. Walter Shur.

2. Subcommittee on other product lines--This subcommittee considers everything except individual life and annuity products.

3. Subcommittee on incidental issues--This subcommittee looks at the marketplace, examining questions such as: "What would happen if my company were to demutualize?", and "How would it raise capital?", and "What's going on in the capital market?"

4. Subcommittee on accounting issues for mutuals--This is the most recently organized subcommittee. It is looking at GAAP (or some other form of adjusted earnings) for mutuals. This subcommittee has been organized into three subgroups:

    a. Subgroup on GAAP issues relating to mutual conversions (Barry L. Blazer--Coopers & Lybrand)--This subgroup is examining issues in the category of accounting for the conversion process.

    b. Subgroup on traditional individual participating products (Edward H. Colton--Peat Marwick Mitchell & Company)--This subgroup deals with accounting issues related to products and to the adjusted earnings, or adjusted statements, that are currently maintained.

c. Subgroup on political issues and accounting issues for products other than individual participating) (Robert W. Stein--Ernst & Whinney)--This subgroup is considering how to interrelate with the accounting profession and the various publics actuaries will have to deal with on these issues as well as the miscellaneous accounting issues that might be raised regarding products other than individual participating.

I have indicated the subgroup chairmen along with the names of their firms to emphasize the presence of the big-eight accounting firms. However, note that we are dealing with actuarial representatives aspects of those firms.

To illustrate some of these issues, I will give you some background about the pending New York demutualization bill. The Life Insurance Companies of New York (LICONY) have committees of their own. They have both legal and actuarial issues groups and have been working with the New York Superintendent to come up with a demutualized bill. The committee members met frequently with the regulators. A number of different drafts were prepared and discussed extensively by LICONY. Members of the SOA task force also participated in those discussions providing our perspectives on both the regulations and the broad issues. A bill is now filed with the legislature in New York. It has not been acted on, and it appears likely to not be voted on until next year (during the next legislative session). The bill was submitted by the Governor, thus having the weight of that office behind it. The insurance industry has accepted, in general, the broad principles proposed in the bill. It provides four methods for demutualizing:

1. A nonpublic offering method--This is an internal stock offering to the current policyowners.

2. A public offering method--This involves going into the capital markets to raise additional funds.

3. A white-knight method--This brings the classic defenses of white knight into the process.

4. An "everything else" method--This basically allows the policyholders' membership interests to be converted or exchanged, with consideration determined and allocated to them in a manner deemed by the superintendent to be fair and equitable. If fair and equitable standards can be satisfied, then any method that is acceptable to the superintendent is also acceptable under the bill.

The public offering method produces some interesting stimulation to the development of actuarial principles. It sets up a number of unique accounting devices. One such device is called the "policyowners' preference account," which is defined in the bill to be equal to the excess of a mutual insurer's total admitted assets over the sum of the total assets allocated to the closed block, the policyholders' equity and the statutory reserves and other liabilities attributed to policies not included in the closed block. The bill further adds that the policyholders' preference account shall be so designated and shown as a

footnote to surplus in all the insurer's published and filed statements. In the event of complete liquidation of the insurer, this account would be allocated to policyholders in a manner found fair and equitable by the superintendent. The function of this account is to establish priorities upon liquidation. However, the reorganized insurer would not be able to declare, pay a cash dividend on, or repurchase any of its shares if the amount of the insurer's net preference assets is less than the amount of the policyholders' preference account. This is a broad accounting device that would have some unique impacts on mutual companies which decide to demutualize.

Under all the methods in the proposed New York law, the closed block of business is designated to be operated for policyholder dividend purposes for the exclusive benefit of the policies and contracts that are walled off. Assets are to be allocated to the closed block in an amount which, with the anticipated revenue therefrom, will be sufficient to support this business and to provide for the continuation of current payable dividend scales, if experience continues.

Think of some of the issues that that last sentence raises. It refers to the current payable dividend scale, which means that the experience has to continue. How do you measure and reflect experience changes that might occur? How do you allocate assets when assets go behind the wall? Which assets are going to match the experience that might be coming from that closed block? Is that experience going to be the same as it was when that block was in the parent company? How do you determine that, and how do you blend those together? The real clincher is that none of the assets, nor the revenue therefrom, allocated to the closed block can revert to the benefit of the stockholders of the reorganized insurer. Once you put money on the other side of the wall, it stays there. You need to put enough in to make sure dividends can be maintained, but you can't get the money back if the experience is better than anticipated. I think we all can appreciate some of the problems this bill poses to the industry, and to companies planning to demutualize.

MR. MCCARTHY: Virtually everything said so far in this discussion deals with the United States. The two case histories we heard about are U.S. case histories, and much of the work of the SOA task force, although actuarially not limited to only the U.S., takes place within a U.S. framework. I would urge those of you who are interested in the Canadian situation to read page 15 of the task force's report. It identifies both the accounting and legal structures as fundamentally different between the U.S. and Canada. The report also describes the implications of these differences.

Currently, a lot of law is being written and a lot of actuarial research is going on. One might well ask: "To what end?" We've identified one company that attempted a demutualization, then merged into another mutual company. We also talked about a company currently in the process of demutualizing, and it would seem reasonable to wonder if there are going to be zero, five, ten or twenty companies attempting this in the next ten years or so. I invite Mr. Huntington and Mr. Davidson to comment on what will happen over the next ten years.

MR. HUNTINGTON: I think that a rash of demutualizations occurring in the next ten years is highly unlikely. The problems Mr. Davidson described, and the frustration occurring in the Maine environment, may act as deterrents to companies considering this process. At the same time, if the Unionmutual reorganization is successful, and occurs with limited blood-letting on all sides, then a few more companies might be willing to try it.

MR. DAVIDSON: I suspect that we will be discussing it for the next ten years. A small mutual company, like a small stock company, does have a significant problem in today's environment. The small mutuals are going to have to seek some solution to their capital problems. I'm not sure what that will turn out to be: combining with other mutuals, stocking, or whatever. We don't always like to talk about it, but one of the main impediments to taking action in a mutual company is management. When you try to put two mutuals together, you immediately run into management problems. But, I'm not sure how this will affect the process of demutualization.

MR. MCCARTHY: I'm often struck, when I see the lists of the hundred largest mutuals in Bests' Reports or The National Underwriter, that the hundredth largest mutual is a company with $20 or $25 million in assets. In other words, there are only one hundred mutuals to speak of. The primary causes for demutualization are a desire for growth and the need for capital in order to grow. Another one alluded to by Mr. Davidson, is desperation in one form or another. I would not be surprised to see, over the next decade, many companies in the lower half of the one hundred list seek, by one means or another, to solve problems of limited access to capital by engaging more and more in the pressure-product revolution. All that is not without its costs. I think we'll see a lot of companies seeking some kind of relief, and the efforts of states to pass demutualization legislation will be very helpful. I think Mr. Davidson said that it might have gone differently in Iowa had there been some demutualization legislation there. As for the larger companies, my feeling is about the same as Mr. Huntington's, but that's our speculation.

MR. FREDERICK S. TOWNSEND, JR.: I'd like to ask Mr. Davidson a question. I was surprised at the announcement that Equitable of Iowa was walking away from the Inter-State deal. I thought $5 million was a very small price to pay to acquire a distribution force that was producing over $2 billion face amount a year in cash value insurance. Do you have any further information on why Equitable of Iowa walked away, or felt that $5 million was too high a price to pay?

MR. DAVIDSON: I wouldn't care to comment on all of Equitable's reasoning. When it originally structured the arrangement, the company told the commissioner that it would proceed on the basis of the proposed plan, and not on any other basis. That was made quite clear in the testimony given by the company in support of the plan.

MR. LEWIS P. ROTH: As a member of the SOA task force and the LICONY Committee, I should be able to answer those questions. However, one concern I have is about what is on the other side of the

coin. More and more publicity will be given to demutualization, as laws are passed allowing companies to demutualize. Then, if that action is the desire of management, a lot will be written and discussed about how demutualization is going to benefit the policyholders. If it's that great a deal for policyholders, how do we remain a mutual, if that's what we'd like to do?

MR. HUNTINGTON: That is a real problem. Inordinate pressures may develop, particularly in states where there is only one large mutual company and where a demutualization bill might be passed. The current policyowners would have a potentially large distribution, and the company might find itself in a very difficult position if not demutualizing. Therefore it's incumbent upon companies in those states to make sure that any demutualization legislation provides opportunities that they could be comfortable with, should demutualization ever become their only viable alternative from a public relations point of view.

MR. MCCARTHY: Requirements will be different in some of the laws being passed now. For example, the New York law as proposed, and the Iowa law, which was modeled on an earlier New York proposal, do not require immediate cash distribution, or even stock distribution, as part of the demutualization. Therefore the timing of the distribution can affect the value of what is put behind the wall. However, demutualization statutes based on the Williams Act provide that a company must make a distribution based on the entire surplus of the company. If the surplus of the company is large, the policyholders might conclude that they would prefer to take their money now rather than deal with the dividend process in the future. This is a real issue.

MR. PETER S. KREUTER: Under the plan of demutualization where the walled-off assets could not be returned to the stock company, it seems to me that if the experience is close to what would be expected, the last few remaining policyholders would wind up with a tontine. Was that considered to be a problem by the SOA task force, and is there a proposal to deal with it?

MR. HUNTINGTON: It is an issue that needs to be resolved. It depends on what a company will do in terms of future money put behind the wall, and how that's going to be perceived by the stockholders of the demutualized company. One option is to put away the minimum that is acceptable to the regulatory authorities to maintain the current scale under some set of expected circumstances, with the company's commitment that if the experience becomes adverse, additional funds will be contributed by the parent. That might be preferred over having too much money behind the wall.

The alternative is to establish a dividend scale to be maintained in the future, then conduct frequent reviews of the dividend formulas to make sure adequate amounts are paid to those within the closed block so that, in fact, there is not a tontine at the end. This alternative probably requires a much more detailed analysis than dividend formulas are currently subjected to in the mutual industry. Also, the regulators will probably want to have outside actuarial consultants reviewing the dividend formulas to make sure the appropriate changes are made, so

that a tontine is not developing. Dividends might be larger if the experience is very favorable, but that would be reflected early on in the process of providing those dividends to the policyholders; additionally the tontine effect would be fairly minimal.

MR. MCCARTHY: There is an interesting problem with that. Nobody likes dividend cuts, and as a result, one works very hard not to have them. The actuary is trained to keep little margins here and there to avoid a cutback if things turn just a little bit worse. In this situation, I won't say you have to abandon that mentality, but you can't give it too much weight or Mr. Kreuter's concern could well happen. You have to be pretty close to the mark all the way along the line, even though that may mean a dividend cutback at some point.

MR. DALE S. HAGSTROM: Mr. Davidson, you mentioned that in the original proposal between Equitable of Iowa and Inter-State, all of the assets of the company, including non-admitted, would go behind this wall to be paid as benefits as they convert back to cash. I take it then that the home office building, assuming it was owned by the company, was also put behind that wall?

MR. DAVIDSON: That is correct.

MR. HAGSTROM: Was there a plan, at some point, to sell it for cash or had the company thought that far down the road?

MR. DAVIDSON: No, because it is an expense that will ultimately be absorbed by the operations of the company. It was decided, rather than to debate the appraised value of the building, to carry it on a statutory basis, letting it expense out over time because leasing the space was to continue. The company occupied it entirely. I think it was involved in an urban renewal project. It was a relatively complicated matter.

MR. HAGSTROM: Then the residual value would have to be dealt with at some point down the road.

MR. ROBERT J. CALLAHAN: The question I'm about to ask is based on a telephone call I received, but I don't know whether the company was domestic or foreign. What happens to the surplus of a mutual company that has a stock subsidiary, when management decides to wind down the mutual company by putting all the new business in the stock subsidiary?

MR. MCCARTHY: If it does go to the extreme described, that kind of situation is one where demutualization is an ethical way to proceed before reaching that point. If a company planned, over the long run, on doing all of its business through a stock subsidiary, that company has just made itself a candidate for a conversion to some other form where there are some severe equity problems down the line. But I don't know if that's the only solution to that issue. It certainly makes it more complicated. I know Mr. Smith of Unionmutual Life would agree that the business Unionmutual already has in some of its stock subsidiaries, some of which was, in effect, transferred from the mutual

company to the stock company (in particular, group business that was rewritten in the stock companies) made the conversion plan a good deal more complicated than would have been the case otherwise. Increasingly, as companies write business in stock subsidiaries, they are going to have to deal with it. I think this is the tip of an iceberg of a real problem, and would like to solicit comments about it.

MR. HARRY D. GARBER: This question of mutual companies wanting to maintain themselves as mutuals is a down-the-road vital question, to the extent that mutuals are defined by their participating business and the only true policyowners are the participating policyholders in the parent company. This is especially significant because the industry is now moving away from traditional participating policies, particularly on the individual side. Clearly there is a problem down the road where a demutualization statute is on the books. There will be lawyers who will find opportunities to generate policyholder suits demanding demutualization of companies that will not make sense, overall, for either the policyholders or the company, because of the diminishing nature of the participating business.

The first thing to act on is to get the demutualization statutes on the books, so those are available. Following close behind is a need to think about the nature of the mutual company and to recognize the distinction that exists today between the policyholder who has a participating policy in the parent company and the universal life or variable life policyholder who has a policy in a subsidiary company. There is a legal distinction, but that probably needs to be a distinction without a difference for those who maintain that a mutual company policyholder is a policyholder regardless of where his or her policy is placed. Whether it's a traditional participating policy or universal life form shouldn't make any difference as to how that policyholder is treated. I'm speaking very broadly and lawyers would probably have a good deal of difficulty with what I'm saying. We need to first look at the laws of the various states and then probably change the way mutual companies view their policyholders. There probably has to be an all-embracing view recognizing policyholders in subsidiary companies as having similar rights to policyholders of traditional participating business. That's an issue that has to be thought through and developed. If mutual companies want to maintain themselves as mutuals in an environment where demutualization statutes are on the books and class action suits are the order of the day, a view of this sort must be developed and brought into the states' laws.

MR. RODNEY R. ROHDA: As I have read various items on demutualization, I've wondered if we don't have a little bit of the "grass is always greener" mentality going on. There are mutual companies scrambling to become publicly-owned stock companies in some situations, and there are publicly-owned stock companies scrambling to go private or are involved in leveraged buyouts. In your own deliberations, are there any discussions about what happens if a mutual finally succeeds in becoming a stock company? Is it assumed that most mutuals plan to become publicly-owned stock companies, and have in fact structured various approaches that will guarantee their independence?

MR. MCCARTHY: One piece of the answer I think, Mr. Rohda, is embodied in something Mr. Huntington mentioned about the New York law. There is an anticipation that some companies, particularly smaller ones with limited possibilities and limited capital, will want to demutualize and be acquired as part of that process.

MR. ROHDA: I think that that is a separate issue, and it was Inter-State's mechanism to merge.

MR. MCCARTHY: That's correct. That mechanism is, in effect, being provided in New York for companies in a similar situation. We doubt larger companies would want to be in a position to maintain their independence. Clearly, once you're publicly owned the whole issue of whether or not you maintain your independence is very different from what it is for a mutual company. That is a risk I've heard about from people associated with different companies looking at this issue. It is certainly a risk for which there are some classic antitakeover defenses, and perhaps as well there is some help from regulatory requirements on demutualization. In other words, a company which demutualizes may not immediately be the most attractive candidate for a takeover or a leveraged buyout, because of all the money behind the wall. Nonetheless, if you become a public company, you play by the rules of public companies.

MR. GARBER: The New York law has a give-year stand-still in it, so that if you took the New York approach, you've got five years of freedom.

MR. DAVIDSON: In the process of deciding what action to take, the Inter-State Board investigated all these possibilities. What finally resulted was a plan designed to prevent the possibility of an unfriendly takeover. That was one reason the board members selected what they thought was a very desirable group to work with, and it happened to be Equitable of Iowa. They even put a provision in the plan that if Equitable subsequently sold the company, then the policyholders would be moved into Equitable and would still be protected. They were very concerned about somebody buying the company and trying to strip out the money. But no matter how you structure a plan, if there are people who really want to defeat it, they probably can do so.

MR. HUNTINGTON: Mr. Rohda, I think you may have a wrong impression. I don't want you to think that there are lots of companies who want to demutualize tomorrow, waiting only for legislation to pass to immediately file reorganization plans. I think the vast majority of the members of the SOA task force, if not all of them, are involved from an intellectual and conceptualization viewpoint to provide information about this opportunity to their own management. Some might consider it as an option for the future. If so they need to have an understanding of the consequences of demutualization. I do not expect to see a large number of companies, for example New York domiciled companies, demutualizing the day the legislation is passed. At this point, the purpose of the discussions is more to understand than to develop demutualization plans.

MR. CALLAHAN: As a depositor in a national savings bank in Albany, I recently received literature that it intends to demutualize. Reasons for converting from mutual to stock were noted. It was also noted that the institution did not currently pay any dividends to depositors. However, it offered its depositors the first opportunity to buy stock in the new organization (of a limited amount), while stating that it did not expect to pay stock dividends in the immediate future. Have the panelists looked at the demutualization of other financial institutions?

MR. MCCARTHY: Some of us have looked at the demutualization of savings and loans, many of which were desperation moves as opposed to opportunity moves. Particularly for the larger mutual life companies, there seem to be limited if any parallels from the savings and loan experiences.

MR. GARBER: The savings and loan demutualizations are very different, as Mr. McCarthy points out. Most of those institutions had no surplus left, as a practical matter. They were raising capital--they didn't have any to start with. A model has been developed, essentially approved by the federal authorities, in which a liquidation account must be set up to be equal to the amount in the depositors' accounts. This liquidation account washes out as account holders remove their money from the savings and loan. In effect, the account holders receive no value from the conversion. They get a right to buy stock, but not at a discount from the rate shareholders would buy at. No other direct benefits accrue to them. The only value they receive is that if the company were subsequently to liquidate, then they would have a preference on receiving the value on liquidation. This was considered as a model for mutual life companies, but clearly there is tangible value to distribute. If the insurance industry tried to use this model, there would be outcries from the legislators, the consumers, and the regulators. There was never any hope of putting this kind of legislation on the books, nor would it be right to. It is just the wrong answer for us, because there are real values to which our policyholders should have access. The present laws and legislation proposed in New York all recognize this. So the thrift industry doesn't provide any models for us.

MR. MCCARTHY: Mr. Callahan, I assume the stock offer you received did not include a preferential basis for buying.

MR. CALLAHAN: It gave me the opportunity to buy stock before the general public, but it did not mention any preferential price.

MR. MCCARTHY: That ingredient is present in the Unionmutual plan, and in fact if every policyholder exercised his pre-emptive rights in the Unionmutual plan, there would be no public offering. The sum total of the stock which is theirs through the conversion, plus that which they can buy pre-emptively, will equal the entire amount of the offering. It's not anticipated that that's going to happen but, in theory, if every policyholder elected that option there would be no further offering.