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Closed Blocks and Mutual Company Conversions

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For the last two years, public discussion and debate of conversions of mutual companies to stock companies have been escalating. In 1995, we saw the completion of three life insurance company demutualizations (Midland Mutual Life Insurance Company, State Mutual Life Assurance Company of America and Guarantee Mutual Life Insurance Company).

In 1996, AmerUs formed a mutual holding company structure that involved the conversion of American Mutual Life Insurance Company to a stock company. This was accomplished under a new Iowa statute introduced in 1995. In 1997 General American has also formed a mutual holding company under a Missouri statute similar to that of Iowa, and Acacia Mutual has applied to the District of Columbia Insurance Department to do the same.

A number of other states have recently revised their statutes to allow formation of mutual holding companies, while still others are considering similar changes. Illinois, Michigan, and Pennsylvania have adopted revised demutualization statutes modeled after thrift conversions that provide for members of the demutualizing company to receive nontransferable stock subscription rights rather than outright grants of shares of stock, cash, or more tangible forms of consideration.

Several of these new state laws regarding demutualizations and/or formation of mutual holding companies specifically refer to the formation of a "closed block" for protection of dividend rights for participating policyholders. Until recently, only New York State made specific reference to a closed block in its demutualization statute, although closed blocks have been a feature of almost every life insurance demutualization since Union Mutual's demutualization in 1986.

Given the heightened focus and public debate about demutualization, it would appear to be an auspicious moment to ask some fundamental questions about the closed-block concept:

- What is the purpose of the closed block?
- How does it work?
- What are some of the drawbacks of the closed block?
- How has the concept been implemented?
- Are there preferable alternatives to the closed block?

Purpose of the Closed Block

Participating policyholders of a mutual life insurance company have contractual rights under their policies to receive dividends that represent a share of the surplus earnings of the company. If the mutual company converts to a stock company, either as part of a demutualization or in connection with the formation of a mutual holding company, such policyholders' contractual rights to participate in surplus earnings are not affected. The conversion of the company, however, introduces a competing set of financial interests that do not exist in a mutual company, that is, the interests of stockholders in a return on their capital invested in the company.

While the company is a mutual, policyholders are the only group with a "call" on the earnings of the company. After conversion, any earnings not returned to policyholders as dividends inure to the benefit of the stockholders. Management of the converted company could be influenced to reduce dividends below what they would have been under normal circumstances in order to benefit stockholders. In this situation, boards of directors, management, and regulators involved in mutual company conversions have a duty to ensure that policyholders' dividends are not unfairly reduced to benefit stockholders. This is not to say that dividends will not be reduced after conversion. Dividends should be reduced to the extent that experience factors underlying dividends warrant.

For example, if interest rates decline after conversion, then policyholder dividends should be reduced to reflect such declines. This line of reasoning, we believe, leads to a general principle which could be stated as follows: when experience changes, dividends should be adjusted in the same manner that they would have been adjusted in the absence of a demutualization.

An alternative formulation of this general principle would be that the value of policyholders' permanent contributions to surplus should not be increased after demutualization. The concept of the closed block was developed as a means of assuring that this general principle would be followed by companies undertaking a demutualization.

The "Report of the Task Force on Mutual Life Insurance Company Conversion" (*Transactions of the Society of Actuaries XXXIX*, p. 303) contains the following succinct summary of the rationale behind the closed block:

> " ... the conversion plan should be designed to provide assurance that the policyholders' reasonable dividend expectations (that is, the continuation of the current dividend scale if current experience continues) will be met. If the conversion plan is deficient in this respect, policyholders will be required, in voting on the plan, to weigh the benefit of the compensation offered for the cancellation of their membership rights against the potential of reduced dividends. As a practical matter, therefore, a mechanism that will provide assurance of meeting policyholders' reasonable dividend expectations will probably be a minimum requirement both for regulatory approval of a conversion plan and for obtaining the approval of members."

The Task Force recommended, presumably on the basis of the analysis in the report, that a closed block should be set up for individual policyholders of a mutual life insurance company that converts to a stock company.

The closed block was designed primarily for traditional, fixed-premium, fixed-cash-value policies issued to individuals. Group pension and group life and health policies were excluded, partly because it was thought that policyholders in such cases were generally financially sophisticated and could apply their negotiating leverage to ensure that their interests were protected. Policies that do not pay and are never expected to pay dividends, such as certain types of term insurance policies, are also often excluded. This article is concerned primarily with traditional dividend-paying policies issued to individuals. The subject of what types of policies should be included or excluded from the closed block is beyond the scope of this article.

How the Closed Block Works

The "mechanism" of the closed block as described in the report and as implemented in various U.S. demutualizations works as follows:

- At the point of demutualization, a specific set of invested assets is identified and set aside for the benefit of the affected policies.
- The assets set aside to fund the closed block are determined through trial and error in such a way that the future cash flows from these and future closed-block assets, along with future premiums on closed-block policies are exactly sufficient to pay all future guaranteed benefits, dividends under the current scale, and certain other costs *assuming that experience never changes from the experience underlying the current dividend scale*. The other costs may include policy-related maintenance expenses and commissions, and always include allocable federal income taxes.
- Accounting procedures are set up to track cash flows related to the closed block. By definition, the closed block is a closed system: no cash flows out of or into the closed block are allowed, except cash flows related to closed-block assets (cash investment income, maturities, sales proceeds, prepayments, and so on) or closed-block policies (premiums, dividends, benefit payments and possibly expenses) and allocable taxes. Funds from outside the closed block would be used to support closed block liabilities only in very limited circumstances. These would include: (a) a situation where experience had deteriorated, dividends were set to zero and additional funds were still needed to meet policyholder guarantees, and (b) a situation where management had chosen, for competitive or other reasons, to increase dividends over the long term beyond what they would have been had no demutualization occurred. Both of these possibilities are extremely remote.
- Periodically, statutory based financial statements are prepared that reflect the experience of the closed block, including cash flows and accrual entries such as reserves.
- Dividend scales on closed-block policies are periodically adjusted to reflect actual experience. Care is

maintained in this process to avoid a "tontine" situation. Nevertheless, management retains considerable flexibility in the amount of year-by-year dividend payout.

- Theoretically, the last dollar of closed-block assets is exhausted as the last closed-block policy terminates. This is theoretical because the last closed-block policy will not terminate for 75 years or more from the date the closed block is established. To date, there have been no closed blocks that have terminated.

By setting aside specific assets which are sufficient under the assumption that experience does not change and subsequently tracking all actual cash flows related to the closed block, this mechanism ensures that any deviations of actual experience from the experience assumed in calculating the initial amount of closed-block assets will be exactly offset by an adjustment in dividends for closed-block policies. This is because increasing or decreasing dividends is the only way to "adjust" the amount of assets in the closed block, so that as the last policy terminates, such assets are exhausted.

Given this definition of what the closed block is, it is equally important to recognize what it is not:

- It is not a guarantee that any particular level of dividends will be paid.
- By itself, the closed block does not provide assurance that dividend distribution among policies in the closed block will be equitable, since it operates only at an aggregate level.
- It provides no guideline as to when or by how much dividends should be adjusted, because there is only the indefinite requirement that tontines not be allowed to develop. Substantial variations in the timing of dividend adjustments are possible. Similarly, even in the absence of experience deviations, there is no mechanism to prevent the company from increasing dividends currently only to lower them later.

Practical Application of the Closed Block

There have been eight significant demutualizations of life insurance companies in the U.S. in recent history. Of these, only one, Midland Mutual, has not involved formation of a closed block (Table 1).

Although there is an apparent uniformity in the adoption of a closed block, the actual practical implementation of the closed-block concept has been subject to significant variation, and in many instances, the actual implementation has differed from the "ideal" described in the report.

Expenses

In five of the eight demutualizations involving a closed block, expenses (for example, administrative maintenance expenses and renewal commissions) were not provided for in the initial determination of assets and are not being charged to the ongoing operations of the closed block. (See Table 1 on page 5 for details.) In one case, Guarantee Mutual, expenses were provided for by formula and are being charged against the closed block by the same formula, regardless of actual experience. The effect of either of these approaches is to insulate dividends on closed-block policies from the effect, positive or negative, of actual expenses varying from the expense assumptions underlying the current dividend scale. It effectively makes the closed-block policies nonparticipating with respect to expenses.

The justification generally given for this treatment of expenses is to avoid disagreements over the approach to allocating expenses to the closed block. Of course, expense allocation is part of the normal dividend determination process, which the demutualizing company has followed throughout its previous history as a mutual. The report appears to discourage the practice of not reflecting expenses in the closed block:

> "Of the various alternative treatments of maintenance expenses that might be adopted, the approach most consistent with the model of continued participation for the closed branch would be to make maintenance charges to the closed branch in a manner consistent with past practices and reflecting actual cost levels."

One side effect of not reflecting expenses in the funding of the closed block is that the initial amount of assets required to be set aside is significantly reduced. This may, at least partly, explain why the practice of not reflecting expenses is so widespread. In any event, this widely followed practice significantly changes the degree to which closed-block policies are truly participating after demutualization. Many companies may be expected to implement expense reduction plans post-demutualization. The closed-block mechanism makes it difficult for the policyholders of the former mutual to benefit from these efficiencies, a situation clearly inconsistent with their "legitimate expectations."

TABLE 1

Company	State of Domicile	Date of Demutualization	Closed Block	Maintenance Expenses Provided for
Union Mutual	Maine	1986	Yes	No
Northwestern National	Minnesota	1989	Yes	Yes
Maccabees	Michigan	1989	Yes	Yes
Equitable	New York	1992	Yes	No
Guarantee Mutual	Nebraska	1995	Yes	Yes
Midland Mutual	Ohio	1995	No	N/A
State Mutual	Massachusetts	1995	Yes	No
American Mutual	Iowa	1996	Yes	No

Investment Returns

The determination of the investment income experience to be passed through to participating policyholders through dividends is an area where there is great diversity in practice. *Actuarial Standard of Practice Number 15*, "Dividend Determination and Illustration for Participating Individual Life Insurance Policies and Annuity Contracts," contains the following guidance concerning accepted practice:

> "The use of either the portfolio average approach or the investment generation approach is considered generally accepted practice ... The portfolio average approach for determining investment income, excluding policy loans, for a given block of policies averages the investment income over all groups of policies or over a specific group of policies supported by a portfolio of investments (e.g., a segmentation approach)."

Many mutual companies use the portfolio-average approach to determine investment income for dividend purposes. A key element of this approach is that illustrative dividends on newly issued policies reflect the same level of investment income as the actual dividends payable on in-force policies. Many observers believe this situation provides a healthy discipline on sales illustration practices.

One consequence of the establishment of a closed block is that a company using the portfolio-average approach would not be able to maintain an identity between investment income reflected on dividends on in-force policies and newly issued policies. This is a consequence of setting aside a separate set of invested assets to support policies issued before demutualization. By definition, dividends on closed-block policies will reflect investment income on this set of assets. Policies issued after demutualization would reflect investment income on some other set of assets. Obviously, the level of investment income on the two sets of assets would be identical only by chance.

Formation of a closed block essentially mandates a form of asset segmentation. This fact has an important consequence. Since the company must honor the guarantees in closed-block policies, whether or not the closed-block assets prove sufficient, while better-than-anticipated returns on closed-block assets go entirely to benefit policyholders, there is an incentive for the company to invest closed block assets in relatively safe, but low-yielding investments.

This conflict between the interests of closed-block policyholders and the company would not exist if the closed-block policies shared in the experience of a more broadly defined investment portfolio that included, for example, assets backing newly issued policies, or some or all of the assets backing surplus. Segregating a certain set of assets of which experience is entirely allocated to closed-block policyholders creates a situation in which the investment manager no longer has an incentive to maximize returns within a given investment policy.

In contrast, if the pre-conversion policyholders' dividends are based on the return on a portfolio in which the stockholders have a direct economic interest, then the interests of all the parties are aligned. To compensate for the effects of potential conflicts of interest regarding investment strategy, closed blocks typically have complex, detailed, and often unwieldy investment guidelines.

By forcing the company to set up a separate investment segment for pre-conversion participating policies, the closed block forces companies that have traditionally used the portfolio-average approach or have not segmented assets to change their approach to dividend determination.

Persistency

Although persistency is recognized as a key factor affecting the profitability of life insurance policies, many mutual companies do not have an explicit or, in some cases, an implicit approach to reflecting the impact of changes in persistency experience on dividends. The typical dividend formula used by most mutual companies does not have a specific factor that recognizes the effects of persistency. One of the reasons for this is that the effect of changes in persistency on dividends is not uniform. In other words, better-than-expected persistency can have positive or negative impacts on profitability in different situations. Because of the complexities of reflecting persistency in the dividend-determination process, many companies take the practical approach of not reflecting changes in persistency on dividends.

The formation of a closed block can change this situation dramatically, a fact that was recognized and commented on by the Task Force in its report. In fact, the establishment of a closed block will *require* at least an implicit recognition of persistency differences. The report notes that the model company used to numerically illustrate the concepts embodied in the report, such as the closed block, starts with a "deficit" or "asset shortfall" (excess of liabilities over assets) in the closed block equal to roughly 20% of assets. It goes on to observe:

> "Clearly, in the extreme example of an immediate termination of all policies in the closed branch, there would be an asset shortfall (which would have to be made up from the rest of the assets of the company). A still extreme but more probable example would be additional surrenders in the first year after conversion equal to 10% of the initial in-force business. In this example, this level of excess surrenders would require either an increase of $37 million (from $1,830 million to $1,867 million) in the initial amount of assets included in the closed branch or a reduction of approximately 4% in all dividends payable after the first year of operation of the closed branch."

The "deficit" or "asset shortfall" in the closed block is exacerbated if, as in the case with six of eight of the existing closed blocks, maintenance expenses are not reflected. In such a case, the potential negative impact of poor future persistency on the dividends of closed-block policyholders is magnified. This effect was also recognized and commented on by the Task Force. (See *TSA XXXIX* (1987), p. 378.)

An Alternative Approach

The stated purpose of the closed block in a demutualization is to "provide assurance of meeting policyholders' reasonable dividend expectations." As we have seen, if such dividend expectations are based on a portfolio earnings approach where investment income rates are the same for in-force and new business, then the closed block actually will assure that such expectations are not met. Similarly, when the closed block is set up in such a way that changes in levels of maintenance expenses are not reflected, the benefits of any reductions in expense levels that might be achieved as a result of cost-cutting measures implemented by the company will not be reflected in policyholder dividends. How is this assuring that policyholders' reasonable dividend expectations are being met?

Are there alternative approaches to "provide assurance of meeting policyholders' reasonable dividend expectations?" Since the central issue in maintaining reasonable policyholder dividend expectations is continuity of past practices, a more direct approach would be for the mutual insurer to commit as part of the plan of conversion to continue to determine dividends on pre-conversion policies using the same practices used in the past. The key elements of such practices, which are well-established in the case of most mutual companies, are:

- The way in which policies are assigned to classes for dividend purposes
- The ways by which experience factors are determined
- The frequency of changes in dividend scales
- The level of permanent contributions to surplus.

The specifics of how these elements are determined will vary considerably from company to company. Although complex, the normal dividend determination process usually defines each of these elements with some specificity. The company's continued compliance with its commitment to maintain its dividend practices unchanged can be monitored by comparing actual dividend practices to historical practices as described at the time of conversion. Since continued monitoring of dividend practices is required in the case of the closed block, this would not impose any greater burden on the demutualized company or the regulator than is imposed by the establishment of a closed block. Meanwhile, significant time, effort and expense would be saved on the front end by eliminating the need for costly actuarial and accounting procedures connected with the formation of a closed block.

The procedures for establishing and maintaining a closed block are complex, time-consuming and expensive. The closed-block concept takes a "one-size-fits-all" approach to post-demutualization dividend determination. Moreover, in certain key respects and particularly for certain companies, a closed block may not accomplish the objectives for which it was designed. Other reasonable approaches, which can be demonstrated to be effective and monitorable, should be permitted.