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Demutualization: Filling the "GAAP" in Accounting

by Darryl G. Wagner and Patricia E. Matson

The insurance industry has entered a period of consolidation, reorganization, and rethinking of strategic direction. For mutual insurers, this means evaluating options such as demutualization or conversion to a mutual insurance holding company (MIHC). Demutualization is the process by which a mutual insurance company converts to a stock insurance company. Upon demutualization, policyholders exchange their membership rights in the mutual insurance company for some form of compensation. Types of compensation include stock, cash, policy credits, and subscription rights (which give policyholders first rights to purchase stock). An alternative to demutualization is for a mutual insurance company to form an MIHC. In this instance, the mutual insurer is converted to stock form and becomes a stockholder-owned entity that operates as a subsidiary of the newly formed MIHC. Policyholder membership rights are transferred to the MIHC, while contractual rights are maintained in the stock company.

Nearly all states have regulations regarding demutualization, and many also have statutes regulating conversion to an MIHC. Regulations generally specify certain requirements regarding the protection of the rights of mutual company policyholders, such as rights to vote, rights to participate in the divisible surplus of the company through dividends, and rights to company surplus in the event of liquidation.

Many unique accounting issues arise when a mutual insurer demutualizes or converts to an MIHC. The American Institute of Certified Public Accountants (AICPA) has formed a Demutualization Task Force to address several issues regarding GAAP for mutual companies that have converted. The key issues and the preliminary recommendations of the task force are outlined in the sections that follow.

Reporting of GAAP Earnings - the Policyholder Dividend Obligation

In connection with a demutualization or the formation of an MIHC, most state insurance departments have required (and will likely require in the future) that a closed block or alternative mechanism be established to protect the dividend expectations of participating policyholders. Generally, specific assets are allocated to the closed block to meet the future obligations of included policies.

The assets allocated to the closed block are in an amount such that they, together with future revenue from closed block policies, will provide sufficient cash flows for all future policy benefits, certain expenses, and dividends at the current scale. The determination of assets assumes continuation into the future of the current dividend scale and experience underlying the current dividend scale.

Over time, actual closed block experience will differ from that assumed for funding purposes, and therefore, the policies in the closed block will generate excesses or shortfalls in earnings (as compared with initial projections). Since excess earnings typically cannot be taken out of the closed block, they must be returned to policyholders through increased dividends. One approach to recognizing that the required ultimate return of such excess earnings "belongs" to policyholders rather than shareholders is to establish an additional liability for closed block policyholders which is referred to as a "policyholder dividend obligation."

A policyholder dividend obligation (PDO) represents the accumulated earnings of the closed block in excess of the pattern anticipated in the initial funding. Such amounts will result in additional future dividends to closed block policyholders, unless otherwise offset by future negative performance of the closed block.

If a PDO is not created, excess closed block earnings would be recorded as profit from the closed block and would therefore be part of the closed block contribution that benefits shareholders. Shareholder profits would increase at the time of the excess earnings and would be reduced in future years as dividend scales are increased to return the excess earnings to closed block policyholders.

To provide additional perspective regarding the mechanics of the PDO, we developed a simple example of the balance sheet and income statement impact of the closed block, both with and without a PDO, under three interest rate scenarios.

The example shows, for each scenario, five years of policy cash flows, balance sheets, and income statements for a book of business that consists of paid-up participating life insurance contracts. The total starting assets of the company are assumed to be $500,000, and the entire book of business is assumed to be in the closed block. Annual dividends paid to the policyholders equal 50% of the excess interest earned over the 4% guaranteed interest on the policy funds during the year. For simplicity, it was assumed that no lapses or deaths would occur, and lapse and mortality rates were excluded from reserve calculations.

Table I shows amounts assuming that interest rates over the five-year period are equal to those assumed in determining closed block assets and liabilities. On the balance sheet, starting closed block assets are calculated as the present value of future benefit and dividend payments, discounted at the assumed earned rate (7.0%). The starting closed block assets ($427,601) are less than the starting GAAP reserve ($445,182) because the assets are set aside based on the assumed earnings rate while the GAAP reserve is established using the lower contractual rate (4.0%) to discount the future cash flows. For years two through five, closed block assets equal the prior year amount plus interest earned, less benefit payments and dividends.

Table I

Balance Sheet	Beginning of Year					
	1	2	3	4	5	6
Closed Block Assets	$427,601	$350,855	$269,970	$184,706	$94,806	$0
Deferred Acquisition Costs	8,791	6,067	3,769	1,952	674	0
Other Open Block Assets	63,608	68,061	72,825	77,923	83,378	89,214
Closed Block Liabilities						
Benefits	$445,182	$362,990	$277,509	$188,609	$96,154	$0
PDO	0	0	0	0	0	0
Total	$445,182	$362,990	$277,509	$188,609	$96,154	$0
Equity	$54,818	$61,994	$69,056	$75,971	$82,704	$89,214

Income Statement	Year					
	1	2	3	4	5	Total
Interest on Open Block Assets	$4,453	$4,764	$5,098	$5,455	$5,836	$25,606
Contribution from Closed Block						
Interest Earned on Assets	$29,932	$24,560	$18,898	$12,929	$6,636	$92,956
Benefits	100,000	100,000	100,000	100,000	100,000	500,000
Dividends	6,678	5,445	4,163	2,829	1,442	20,557
Amortization of DAC	2,724	2,298	1,817	1,278	674	8,791
Change in Benefit Reserve	(82,193)	(85,480)	(88,900)	(92,456)	(96,154)	(445,182)
Change in PDO	0	0	0	0	0	0
Total Contribution	$2,724	$2,298	$1,817	$1,278	$674	$8,791
Total Profit	$7,176	$7,062	$6,915	$6,733	$6,510	$34,396

Some amounts may not reconcile due to rounding.

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An Actuarial Analysis of FAS 133 (Part 1)
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Implementation

The Statement's breadth and complexity will make the implementation effort daunting. Hedge relationships must now be documented at adoption date and most companies will need system modifications to develop and track the required changes in fair value, hedge effectiveness and related accounting entries. Also, while the Statement specifically excludes certain traditional insurance contracts from its scope, some products that previously were considered as insurance products instead have to be accounted for in whole or in part as derivatives under FAS 133. While the FASB's recent decision to delay the required adoption date effectively to January 1, 2001, provides some desperately needed breathing room for most insurance companies, systems and business process changes may take between 3 and 12 months to effectuate. Many insurers will need to work around events such as Year 2000 black-out periods, the 1999 year-end financial reporting cycle, business acquisitions and other activities.

From a systems perspective, the following checklist identifies minimal functional requirements for a FAS 133 compliant implementation:

- Manage formal hedge documentation at FAS 133 adoption and at hedge inception
- Manage hedge designations
- Measure hedge effectiveness
- Attribute gains and losses to risk factor
- Manage OCI accounting
- Perform mark-to-market of hedges and, where necessary, hedged items

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For simplicity, the initial deferred acquisition costs (DAC) asset was set equal to 50% of the difference between the beginning closed block assets and the beginning closed block liabilities. This also equals the total expected future profits (undiscounted) on the book of business, since the remaining 50% of the excess of closed block liabilities over closed block assets is released from the closed block over time. The expected future profits on the book of business that will be included in the company's net income (after DAC amortization) are shown in the income statement line labeled "total contribution." For years two through five, DAC equals the prior year amount less amortization.

Starting open block assets equal $500,000 (the total starting assets of the company) less closed block assets and DAC. For years two through five, open block assets equal the prior year amount plus interest earned.

GAAP reserves are calculated as the present value of future benefits, discounted at the guaranteed rate of interest (4.0%). Since in this example, experience over the five-year period equals initial estimates, no PDO is created in any year.

On the income statement, interest on open and closed block assets equals the actual earned rate (7.0%) multiplied by the beginning amount of assets. DAC is amortized in proportion to profits (total contribution) on the book of business (and, since the expected gross profit has been divided equally in our example between DAC and the company's profit after amortization of DAC, DAC amortization is exactly equal to total contribution).

The profits emerging on the book of business may be viewed as the gradual release of the "closed block deficit," or the excess of closed block liabilities over closed block assets. The initial closed block deficit is $17,581, which equals the sum of total DAC amortization and total contribution from the closed block over the five-year period.

Tables II and III show amounts under a scenario in which the interest earned in year one is one percentage point greater than assumed (8.0%), on the closed block assets only. Since the excess interest earned in year one can not be "removed" from the closed block, it must be distributed to policyholders through increased dividends. In Table II, no PDO is assumed to be created, while in Table III a PDO is assumed.

In year 1, the Table II dividend is identical to that of Table I since we assume that no additional amount would be distributed until after the results for the year are known. Therefore, dividends in years two through five were increased (by a flat amount each year) such that the closed block asset balance is $0 at the end of year five, and the total contribution from the closed block remains unchanged. The flat addition to the year 2 through 5 dividends ($1,263 per year) was calculated by assuming that the original excess earnings amount would be distributed evenly over the remaining contract term, with each year's remaining balance increasing at 7% interest per year.

Table II

Balance Sheet	Beginning of Year					
	1	2	3	4	5	6
Closed Block Assets	$427,601	$355,131	$273,283	$186,988	$95,985	$0
Deferred Acquisition Costs	8,791	3,929	2,113	811	84	0
Other Open Block Assets	63,608	68,061	72,825	77,923	83,378	89,214
Closed Block Liabilities						
Benefits	$445,182	$362,990	$277,509	$188,609	$96,154	$0
PDO	0	0	0	0	0	0
Total	$445,182	$362,990	$277,509	$188,609	$96,154	$0
Equity	$54,818	$64,132	$70,712	$77,112	$83,293	$89,214

Income Statement	Year					
	1	2	3	4	5	Total
Interest on Open Block Assets	$4,453	$4,764	$5,098	$5,455	$5,836	$25,606
Contribution from Closed Block						
Interest Earned on Assets	$34,208	$24,859	$19,130	$13,089	$6,719	$98,005
Benefits	100,000	100,000	100,000	100,000	100,000	500,000
Dividends	6,678	6,707	5,425	4,092	2,705	25,607
Amortization of DAC	4,862	1,816	1,302	727	84	8,791
Change in Benefit Reserve	(82,193)	(85,480)	(88,900)	(92,456)	(96,154)	(445,182)
Change in PDO	0	0	0	0	0	0
Total Contribution	$4,862	$1,816	$1,302	$727	$84	$8,791
Total Profit	$9,314	$6,580	$6,400	$6,181	$5,920	$34,396

Some amounts may not reconcile due to rounding

In Table II, since excess interest is earned in year one, but is not paid out in dividends until years two through five, the pattern of profits emerging from the closed block changes; more profit is released in year one, and less is released in years two through five. The change in profit pattern results in a proportional change in DAC amortization. The contribution from the closed block does not change in total, but the pattern of the contribution changes.

An analysis of the difference in the first year contribution from the closed block in Table II versus Table I is as follows:

Table I first year contribution $2,724
Excess earnings on closed block assets 4,276
Additional DAC amortization (equals 50% of excess earnings) . . . .(2,138)
Table II first year contribution **$4,862**

In Table III, the PDO at the beginning of year two equals the excess interest earned in year one, which is the amount that will be paid out in extra dividends in years two through five. For years three through five, the PDO equals the prior year PDO plus interest, less the extra dividend payment. Creation of the PDO causes profits to emerge as originally expected, so that both total contribution and the pattern of contribution are the same as shown in Table I. In addition, DAC amortization is the same as shown in Exhibit I.

Table III

Balance Sheet	Beginning of Year					
	1	2	3	4	5	6
Closed Block Assets	$427,601	$355,131	$273,283	$186,988	$95,985	$0
Deferred Acquisition Costs	8,791	6,067	3,769	1,952	674	0
Other Open Block Assets	63,608	68,061	72,825	77,923	83,378	89,214
Closed Block Liabilities						
Benefits	$445,182	$362,990	$277,509	$188,609	$96,154	$0
PDO	0	4,276	3,313	2,282	1,179	0
Total	$445,182	$367,266	$280,822	$190,892	$97,333	$0
Equity	$54,818	$61,994	$69,056	$75,971	$82,704	$89,214
Income Statement	Year					
	1	2	3	4	5	Total
Interest on Open Block Assets	$4,453	$4,764	$5,098	$5,455	$5,836	$25,606
Contribution from Closed Block						
Interest Earned on Assets	$34,208	$24,859	$19,130	$13,089	$6,719	$98,005
Benefits	100,000	100,000	100,000	100,000	100,000	500,000
Dividends	6,678	6,707	5,425	4,092	2,705	25,607
Amortization of DAC	2,724	2,298	1,817	1,278	674	8,791
Change in Benefit Reserve	(82,193)	(85,480)	(88,900)	(92,456)	(96,154)	(445,182)
Change in PDO	4,276	(963)	(1,031)	(1,103)	(1,179)	0
Total Contribution	$2,724	$2,298	$1,817	$1,278	$674	$8,791
Total Profit	$7,176	$7,062	$6,915	$6,733	$6,510	$34,396

Some amounts may not reconcile due to rounding.

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Arguments in favor of creation of a PDO include:

- Consistency with Statement of Financial Accounting Standards No. 60 (FAS 60), *Accounting and Reporting by Insurance Enterprises* and the caveats contained in Statement of Position (SOP) 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*. For example, FAS 60 states "the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders equity by a charge to operations and a credit to a liability…" and SOP 95-1 states "while segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interests may be meaningful in a stock life insurance company, it is not meaningful for a mutual life insurance enterprise, because the objective of such presentation is to identify amounts that are not distributable to stockholders"

- Avoidance of "inappropriate" fluctuations in shareholder earnings.

Arguments against the need for a PDO include:

- The inherent "cap" on shareholder profits (equal to the closed block deficit)

- The impact of DAC amortization, which tends to reduce volatility

- The fact that volatility of results is simply part of the accounting model for this type of business

The tentative conclusion of the task force is that a PDO should be created, since it will prevent premature recognition of shareholder profits on the closed block business, and it reflects the nature of the excess earnings as being distributable to policyholders.

The task force also concluded that in the event that experience is less favorable than originally estimated, no negative PDO, or "Policyholder Dividend Asset" should be created.

> ***"The tentative conclusion of the task force is that a PDO should be created, since it will prevent premature recognition of shareholder profits on the closed block business, and it reflects the nature of the excess earnings as being distributable to policyholders."***

Other items addressed by the task force are:

Applicable financial accounting standards:
According to FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, stock insurance companies writing participating business may account for such business under FAS 60 or SOP 95-1. However, mutual companies must follow the guidance prescribed by SOP 95-1 if participating policies meet certain criteria. The task force tentatively concluded that accounting guidance in SOP 95-1 should continue to be applied by demutualizing insurers after demutualization to all participating contracts that meet the conditions of SOP 95-1. The task force also concluded that the segregation of undistributed accumulated excess earnings on participating contracts is meaningful in a stock life insurance company because the objective of such segregation is to identify amounts not distributable to stockholders. Therefore, the provisions of paragraph 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to such contracts sold before and after the date of conversion.

Closed block treatment on balance sheet and income statement:
For demutualizations that have occurred to date, closed block financial information has been shown as single line items on the balance sheet (one for closed block assets and one for closed block liabilities) and income statement (the contribution from the closed block). An alternative to this presentation is to use a fully consolidated approach. The task force tentatively recommended that a consolidated approach be used for the balance sheet and income statement. The task force also recommended disclosure requirements for the closed block, which include a description of the closed block and selected financial data for the closed block.

Accounting for retained earnings at the date of demutualization:
The task force tentatively concluded that an insurance enterprise converting under a distribution form of demutualization should reclassify all accumulated retained earnings of the demutualized insurance enterprise as of the date of demutualization to capital stock and paid-in capital accounts. The rationale is that this most appropriately reflects the nature of the policyholder distribution, which is a distribution of the then-existing equity to the "owners" of the mutual insurer's equity. The task force also tentatively concluded that no such reclassification was necessary in the event of a subscription rights demutualization or conversion to an MIHC.

Accounting for dividends in an MIHC:
Another issue addressed by the task

force relates to the treatment of dividends paid from a stock insurance subsidiary to an MIHC. Since the MIHC has ownership interests in the converted stock company, it will receive stockholder dividends from the stock company. The task force tentatively concluded that a dividend declared by a stock insurer (and/or its holding company) payable to its shareholder(s) is a common corporate capital transaction. Therefore, a cash dividend to the MIHC should be accounted for no differently than any other dividend to stockholders. Under existing laws or regulations, an MIHC is required to own controlling voting interest in the stock insurance company, and therefore should reflect the stock insurance company or intermediate holding company on a consolidated basis, and the intercompany dividend would therefore be eliminated.

The task force is still in the process of discussing tentative conclusions with AcSEC and FASB. The current expectation is completion of an exposure draft SOP regarding accounting related to mutual company conversions in early 2000. Given the number and size of mutual insurer conversion transactions currently underway, this guidance will have a significant impact and truly fill an important "GAAP" in accounting.

We encourage actuaries to review the draft SOP and provide comments and suggestions. To receive a copy of the draft, please contact the American Academy of Actuaries or visit the AICPA website at aicpa.org.

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New Developments in E & E

by Larry Gorski

By now, most actuaries are well aware of the significant changes in the SOA Education and Examination syllabus that are scheduled to occur during 2000. The new syllabus emphasizes actuarial principles while relegating nation-specific material to examples that illustrate more general actuarial principles or the Professional Development component. For instance, US statutory accounting and the Standard Valuation Law will not be studied in detail by students as they progress through the SOA actuarial examination process. This means that a person becoming an FSA under the new syllabus may not have studied the rules of U.S. statutory accounting or the reserving method defined in the Standard Valuation Law as part of any examination part of the SOA Education and Examination system.

This situation creates a problem for the American Academy of Actuaries in its role of promulgating qualification standards for actuaries. The newly adopted (10/1/98) Qualification Standards for Prescribed Statements of Actuarial Opinion (PSAO) identifies both General Standards, and for some PSAOs, Specific Qualification Standards that must be met before an actuary can sign a PSAO. In general, actuaries signing a PSAO that must be filed with a statutory annual statement that deals with reserves must meet both the General and Specific Qualification Standards. The Specific Qualification Standards are satisfied by successfully completing relevant examinations administered by the American Academy of Actuaries, the Casualty Actuarial Society, or the Society of Actuaries on topics such as policy forms and coverages, dividends and reinsurance, statutory insurance accounting and valuation of liabilities. With the change in the SOA syllabus, new FSAs will not be tested on all of these items.

The American Academy of Actuaries, through its Council on Professionalism, has been working with the leadership of the SOA to develop a seminar and testing program designed so that new FSAs can meet the Specific Qualification Standards associated with life and health annual statement opinions. Current thinking is that the seminar will run for two to three days with a test at the end of the seminar. While not yet finalized, it is expected that the seminar will cover U.S. statutory accounting, the Standard Valuation Law, the Actuarial Opinion and Memorandum Regulation and any relevant Actuarial Standards of Practice. The test is not intended to evaluate memorization skills but problem solving skills, so it may be of the open book variety. Since the amount of material to be covered during the seminar is expected to be significant, participants will probably be expected to review some specific material before the start of the seminar.

The Academy task force responsible for this project will be chaired by Robert B. Likins. Bob chaired the Academy Committee on Qualifications, which was responsible for developing the recently adopted Qualification Standards for Prescribed Statements of Actuarial Opinion.

Because of the need to get the seminar program up and running by the fall of 2000, the Academy is communicating with the leadership of the Society of Actuaries in trying to resolve issues on a timely basis. The Section may be asked to provide input on specific aspects of the seminar and testing program. The SOA Financial Reporting Section will continue to keep its members informed through this newsletter of any new developments.

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