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Demutualization In An International Context

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Summary: The concept of a mutual insurance company is under pressure worldwide. In many countries (the U.S., the U.K., Australia., South Africa, and Canada) mutual companies, many with international operations, are looking to restructure. At the same time, regulators are permitting or encouraging companies to demutualize.

Ms. Sue Ann Collins: I'm the managing principal of Tillinghast-Towers Perrin's life operations here in North America. In line with the description in your program, this session is going to focus on demutualizations and the demutualization process outside the U.S. As most of you know, there are two key actuarial projects in any demutualization; the first one being the protection of policyholders' dividend expectations and the second one being the allocation of the value of the company. For any of you who went to the mutual holding company session (61OF), you'll remember from Paul Ochsner's remarks that in all of the demutualizations in the U.S. so far there has been only one approach to protecting dividends and only one approach to allocating value. In the case of the protection of dividends it's been the use of a closed block, and, as far as the allocation of value, it's been based on the contribution principal in one way or the other. For those of you who may be somewhat familiar with what happens outside the U.S., neither of these approaches has been used internationally to any great degree. Our panelists, Steve Paul Taylor-

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Gooby and Fred Rowley, have firsthand experience in what's happened outside the U.S., and it's my goal that at the end of the session we will learn from both Steve and Fred and maybe even be willing to import some of the ideas that are being used elsewhere in the world.

Steve is a principal in the London office of Tillinghast. He's our worldwide director of practice development. He's been with Tillinghast more than 13 years and specializes in the areas of corporate strategy, demutualization, merger and acquisition (M&A), and corporate restructuring. He is currently involved in several demutualization projects that are taking place outside the U.S. He's a Fellow of the Institute of Actuaries (FIA) and an ASA.

Fred Rowley is the shareholder actuary of AMP, Ltd., which is the demutualized version of AMP, the largest life insurance company in Australia. Many of you may ask what the shareholder actuary does, as I did. It's a newly created position in Australia, and the purpose of the position is to create value for shareholders through actuarial techniques and applications. Fred has worked for three mutuals in his career, two in the U.K. and one in Australia, and all have demutualized in one way or another. His work experience includes many traditional actuarial roles linked by a strong project management component. This was most visibly seen recently when it was Fred's responsibility to see through the actuarial aspects of AMP's demutualization over a two-and-a-half year period. Fred is also an FIA in the U.K. and a Fellow of the Institute of Actuaries in Australia (FIAA).

Steve is going to provide an overview of some of the issues that are leading mutual companies outside the U.S. to look at restructuring options, and he's also going to provide some information on the process and the issues that are faced by companies outside the U.S. Fred is going to present a case study of AMP, and in particular he'll focus on what AMP did to protect policyholders' dividend expectations and how they allocated the value of their company.

Before we get started, I thought it might be useful just to run through the market position that mutuals have in various markets around the world just to set the stage, and I'll start with the U.S. The position of U.S. mutuals has been declining over the last decade. If we just look at new premiums written by mutuals, they were at 35% in 1993, going to 29% at the end of 1996. The assets held by mutuals declined from 41% at the end of 1993 to 38% in 1996. This isn't all that dramatic, but after a slow start, for anyone who reads the financial press, you'll see that there are lots of recent and current restructurings and if I make provisions for the restructurings we can see that the market position of mutuals declines enormously, decreasing to 9% of the new premium written and 14% of the assets held by life companies in the U.S.

If we look at what the position is in Canada, through the end of last year mutual companies had a dominant position in that marketplace, holding more than 50% of the written premium in that market and more than 55% of the assets at the end of 1996, but in the last 8 months we've seen announcements by the 4 largest mutual companies in Canada of their intent to demutualize, and when that happens the amount of premium income written by mutuals declines to 21% and the amount of assets held by mutuals declines to 9%.

Looking briefly at Australia, and Fred will probably fill you in on the details here, ten years ago the mutual companies dominated the Australian life insurance marketplace, and at the end of 1998 there were no mutual companies left in that market. If we look at the U.K., the mutuals have lost market share but not as dramatically. In fact, we think they may even be slowing up to a certain extent. For many of you familiar with the Scottish Amicable transaction in the U.K. in the last couple of years, that board announced its intent to restructure and received several hostile takeover bids. The company was eventually purchased by Prudential U.K., and there is at least a feeling that scenario has weakened the interest on the part of other mutuals to announce their restructuring plans without fully assessing what might happen.

Just briefly on several other markets in the world, there are only two large mutual companies in South Africa, and both of those companies currently are going through demutualizations. Recently, I think the Ministry of Finance in Japan, which also has a large mutual company market, issued a statement encouraging mutual companies there to demutualize by the year 2000.

Mr. Stephen Paul Taylor-Gooby: As Sue indicated, I'm going to talk about some of the factors that are interesting in demutualizations around the world and particularly those that are different from the way that demutualizations are done in the U.S. I'm going to cover a number of different topics. First of all, a little bit of background about the positions of mutual companies in various markets. Second, some of the reasons why demutualization is extremely popular and seems to be an inexorable force moving around the world. Third, some remarks on the actual process by which demutualization takes place. Of course it's different in almost every country, but there are some generic features, particularly the role of the actuary. I will also make some technical remarks on the way member compensation for giving up membership rights has been dealt with in different cases, and some further technical remarks on participating fund reconstructions and some of their attendant considerations—another area that is carried out in a very different way in other parts of the world from how it's done in the U.S. Finally, I will look at some likely future developments.

First of all, the background. As Sue mentioned, in many markets around the world mutual companies have been absolutely dominant in the marketplace. For example, in South Africa more than 50% of the new business premiums were written by mutual companies a few years back. They have the same position in Australia. In Scandinavia pretty much all the life business by law has been written on a mutual basis. And in Japan all the top companies are mutuals and have a very strong position.

The U.K. is similar. I believe up to about 40% of new business premiums were written by mutual companies; not necessarily the top spots that were occupied by stock companies, but really a very strong franchise. These companies have enjoyed somewhat of a pricing advantage over stock companies. The old stories about mutual companies being inefficient and having high expense ratios do not apply, and, in fact, mutuals tend to be among some of the lower cost producers. The lowest cost producer in the U.K. by a long way, the Equitable, is a mutual company.

Here are a number of varying positions on capital, from the very strong to the very weak. Some of the smaller mutuals tend to be short of capital, but, equally, the stronger and larger mutuals, those with good cost ratios and strong, new business growth, tend to have very strong capital positions. Although some of the first demutualizations we saw were clearly companies needing to raise fresh capital in order to stay in business, we're now seeing mutuals that have no need whatsoever to raise capital considering demutualization.

So why are they doing it? Why, when they apparently have a very strong market position, competitive products, and good cost position? Why should a mutual want to consider demutualization? Well, there are a number of reasons, and probably the strongest of all is to be able to take part in the M&A feast that's going on around the world. In a number of markets we're seeing very rapid market consolidation, and that doesn't just affect the smallest companies in the market. Typically, we see the smallest and weakest companies being picked off and finding it very difficult to compete in the market. They're being acquired by larger companies—some as open businesses and some as closed businesses. But it's not just the smaller companies that are getting involved in M&A situations. We've seen a number of very large mergers going on and also some pretty big acquisitions taking place.

An analysis of who are the winners and losers in terms of new business growth or asset growth shows that some of the mutual companies have performed pretty well, but they can only do it through internal growth, and the companies that have really moved up the league tables are those that have been most aggressive at acquiring or merging with other companies. Another feature that we see is that stock prices around the world are extremely high at the moment. If you try to do any sort of analysis of stock prices versus fundamentals in terms of projected profit flows and discounted cash-flow analysis on companies, you have to conclude that stock prices are sky-high. It's very difficult for mutuals to compete in the acquisitions market when they have no stock to offer. There have been a few cases of mutuals making small acquisitions, but they can't really compete in the large acquisition market without stock. One of the primary considerations for demutualization is to issue stock, which can be used as an acquisition currency.

We're also seeing the nature of the financial services market, particularly in Australia and across Europe, changing very rapidly. We no longer tend to think of insurance companies and banks as separate industries but really as a diversified financial services conglomerate, and most of these will want to include both banking products and insurance products in their portfolio. That's probably one of the big differences between what we see internationally and what we see in the U.S. so far, although I understand the position's beginning to change rapidly in the U.S. as well. Bank assurance is seen as the way of the future for at least individual retail insurance. The jury is out. The question is whether these financial services conglomerates can ever compete effectively in the corporate sector, but it's quite clear that these big groups have good cost ratios and can compete very effectively with the old monoline insurance companies.

There's also going to be a radical transformation in the way banking business is done over the next few years, and there are various speculations as to what will happen. Perhaps a lot of insurance business in the future will be sold over the Internet. Thinking from an insurance company point of view, just being one of a thousand financial services providers out there on the Net trying to attract business isn't an attractive proposition unless you have a site that consumers have to visit regularly, and the feeling is that the banks are going to have such sites when people do their personal banking over the Internet. That's going to be the perfect vehicle for selling insurance as well. Whether that scenario will happen or not, it's something that's quite dominant in insurance company thinking.

Consequently, many mutuals are thinking about how they can secure their distribution in future years. Many of these typically distribute through Inter-Financial Associations, which is a particularly insecure form of distribution, and unless they can form some type of merger or join a financial services conglomerate, they feel insecure and very much at risk of changes in the way insurance is sold. That's another reason to demutualize to form business combinations.

A third factor is the decreasing importance of participating business. It has been popular. It has been almost universal in continental Europe. In some countries all insurance business has been participating in the past. That's changing, and, as the number of participating policyholders with membership rights decreases, mutuality becomes less relevant. Another factor that we're beginning to see quite strongly, and this is the one that's affecting those mutuals that really want to stay mutual or at least where the management really wants to stay mutual, is pressure from the members. In a number of building society demutualizations and some insurance company demutualizations, there have been very significant amounts of stock handed out to the members. People are beginning to get turned on to the idea that there are very large amounts of hidden value locked up in mutual companies. Brokers are aware of this. I believe after some of the big Canadian mutuals announced their decision to demutualize, the one that didn't announce that it was considering demutualization managed to sell 30,000 participating policies in a week through one branch in Ireland. I think that was the point when they realized they actually had to start thinking about something like this.

We're seeing not a hostile bid to demutualize a company, but a movement by members to demutualize one of the U.K. building societies right now. That's going to be put to the vote during the next few weeks, and it'll be very interesting to see if that succeeds. There's a big campaign by the management to extol the benefits of mutuality and why the members really should not be interested in their 2,000-pound windfall or whatever it is in order to preserve the benefits of mutuality. It will be interesting to see how that goes. Our feeling is if that goes against the management, there'll be quite a number of other companies that really have to consider demutualization very strongly.

Any talk about reasons for demutualization would not be complete without some of these other reasons, which I'm sure are subsidiary to the former. Mutuals feel quite strongly that they're not competitive in the market for senior management, particularly at the top of the long bull run in the equity markets where other stock companies have very tempting stock option plans that mutuals cannot offer. They cannot compete with cash bonus incentive schemes, with the power and the lure of a stock option plan. Some mutuals are finding it really tough to keep their senior people. Also, some of the smaller, weaker companies will, in fact, need to demutualize to raise capital. There's a final issue of corporate governance. Companies, particularly those with very large amounts of capital, are finding it increasingly difficult to defend the fact that there's no real strong pressure or oversight on the way that those large amounts of members' capital are used.

Having said all of that, that adds up to a pretty compelling case, but there are also some good reasons not to demutualize. I mentioned before the pricing advantage that mutuals enjoy in many markets. We've done a lot of analysis on this and reckoned that it amounts to 15–30 basis points per annum on return on policyholders' assets, which, all other things being equal, is a pretty significant advantage. That will depend on a whole host of things whether expense performance is good or not and it can easily be outweighed not only by poor expense performance, but also the company's capital position. It needs to retain significantly greater-than-average profits to strengthen its capital position. That's probably the most powerful reason to consider staying mutual. We can offer better value to our customers.

There's also the additional financial reporting requirements. I'm not sure that many mutuals realize quite how onerous these can be when they first consider moving from a mutual to a proprietary environment, particularly if companies wish to list on various stock exchanges around the world and suddenly find themselves having to report on, for example, U.S. GAAP, U.K. embedded value methodology, and statutory reports. That can be quite a tough transition to make, and it is expensive. It adds to the overhead. However, I find it an extremely weak argument to stay mutual in order to avoid the financial reporting requirement. It sounds to me a little bit like saying, "It's OK to run a business without knowing how profitable you are and how well you're running it." That leads you straight into the corporate governance argument and many of the old arguments about why mutuals may be more inefficient than stock companies.

Tax positions vary around the world. In the U.K., for example, mutual companies have a tax advantage. There's an argument that they've successfully run within their own revenue for years; that they cannot by definition make profit, so they can't pay any tax on profit. I think the tax authorities are becoming skeptical about this now, but there still is a tax disadvantage to becoming a stock company. A final argument that I hear made frequently is that mutuals do not have to withstand the short-term pressure for performance from analysts and can take a longer term view over investment. It's very debatable whether that argument holds up given that long term's made up of a whole series of short terms, but there may be something in it.

I'm now going to move on to talking a little about the demutualization process. As I said, this is more or less different in every country around the world and even within particular jurisdictions. There are different processes that companies can use in order to make the transition from mutual to stock form. However, there are some common features in all of these, and perhaps the biggest common feature is that most involve the judicial system as the arbiter of whether a proposal is fair to policyholders or not. The final decision is not made by the regulators, although it appears to be that way. It's not made by the policyholders, but by the court.

The typical process that companies go through is circularization to develop all relevant information, including profitability in recent years and pro forma profit statements, as if the company were a stock company. Also it has to fully set out the arguments both for and against demutualization in a particular company's case. A company risks having its proposal to demutualize thrown out of court if it hasn't fairly listed the arguments against the management plan as well as those for the plan. There will typically be a member vote. This will be held at an extraordinary general public meeting, and all members are invited to put in proxy votes. In the life company demutualizations we've had so far, typically they have been overwhelmingly passed, which is no surprise seeing as there's free money on offer in most cases. The votes have been in the order of a 90% acceptance rate.

There will be an independent actuary's report. This is an actuary who is engaged. His or her fees are paid by the company, but his or her client is, in fact, the court, although he or she will work with the regulators to resolve any fears or concerns that the regulators may have about a particular scheme. In the end, his or her report goes into the court, and it's the court that decides whether the scheme is a fair one or not. Once the court has given approval of a scheme, the fact that members have voted in favor of it is one compelling piece of evidence that it should be passed. That court decision is final. The policyholders' contracts with the company are, in fact, changed by that court process, and there can be no comeback against it. That's one of the very nice things about this process—there's no possibility of policyholder lawsuits or class-action lawsuits beyond a certain period after the court decision has been made. The idea is that there has been a proper due process. Any member has the opportunity to put a case against a scheme in court, and they have time to hire their own experts if they can afford to do so. Once that process goes through, there can be no further objection.

Just looking into what the independent actuary's role is there, this is governed typically by professional guidance, which is given to actuaries, and it's pretty similar in a number of the jurisdictions I've talked about. The actuary has to look at a number of different aspects of the proposal. One of the things that the actuary will be looking at is that all groups or members are treated fairly. That's both participating, nonparticipating, individual, corporate, and different classes of policyholder, some of which could benefit more or less at the expense of others. The actuary has to look at whether the policyholders' benefit expectations are preserved by the scheme; whether there's going to be any conflicts of interest postdemutualization that might induce a future company management to reduce, for example, participating policyholder dividends; whether the scheme is sufficiently robust to last for the future; whether perhaps paying dividends in the future will weaken the capital strength of the company compared to staying mutual; and whether security for policyholders is maintained.

One final but important point, in U.K. demutualizations, which I believe does not figure in U.S. demutualizations, the professional guidance requires the independent actuary to consider whether the proposal being put forward is, in fact, the best available proposal. It specifically says that the independent actuary should consider whether policyholders will be better off if the company were closed to new business and the surplus were distributed to those policyholders. Now, in many cases these days that's not the only alternative. A company considering demutualization is effectively putting itself into play and may receive a number of takeover proposals during the demutualization process. The actuary will want to look at all of those and be very clear in his or her judgment at the end of the day that the proposal put forward by the company is, in fact, the best for the members.

In the case of a straight demutualization and float that's pretty easy to do because if companies want to acquire the ex-mutual, then it's pretty easy to say, "Well, if they're that willing to acquire it, then once the market price is established postflotation, they can come and bid and pay an appropriate premium, which the members then will get." If it's a sponsored demutualization, which is leading to acquisition by another company, this may lead the independent actuary to have to consider a number of competing bids and to form a view as to which is the best.

On the subject of member compensation which is talking not only about policyholders' benefits as policyholders but the compensation that members will receive for giving up their membership rights we see a number of different alternatives and ways in which companies compensate members. These vary considerably. In sponsored demutualizations the traditional way has been through additional policyholder dividends. Those have usually generated quite small rewards for policyholders. I think for the first major demutualization in the U.K., Scottish Equitable, policyholders received, I think, 40% of an annual policyholder dividend as an additional dividend, which I think these days would be considered quite a small compensation compared to some of the other demutualization compensation amounts that have been given.

Cash is also used. In the recent Scottish Amicable demutualization, which Sue referred to, the management put forward a proposal that was probably similar to a mutual-holding-company-type proposal. Policyholders would give up membership rights vested in a new holding company with a view to floating that company in three to five years time, which would give the management time to improve the operating performance and, hopefully, increase the value of their shares. Once that proposal became public a number of hostile bids came on the doormat pretty quickly, including one bid from the Prudential of the U.K, which offered a straight cash alternative plus closing of the fund and distribution of all the surplus to the existing members. That was pretty much an unbeatable proposal, and the company eventually had to abandon its own plans and recommend that its members accept the Prudential's offer. Another form of compensation in a sponsored demutualization can be the offer of shares of the acquiring company to policyholders, although there are some questions about the tax status of those and whether they would in all cases be tax-free at the time or whether members might actually have to pay capital gains tax on acquiring those shares.

In the more-popular-these-days demutualizations and flotations different considerations apply. The most common method of compensation is to offer shares in the holding company. These are distributed amongst the members only. There generally is no leakage of shares to outside parties, except that it's becoming common to run an Initial Public Offering (IPO) at the same time as the listing of the shares. There are a number of reasons for this. First, it's an opportunity to raise capital, so why not? It's difficult to go back to the market over the next few years. The second and perhaps more important reason is that the prices of these companies can be extremely volatile immediately after listing. There are a very large number of new shareholders, many of whom have never owned shares before, and it's quite unpredictable how many of them will wish to sell out in the immediate days and weeks after listing. A neat way to handle that is to make an offer to all members prior to the demutualization that they will be guaranteed a certain price if their shares are submitted and resold in an IPO to professional investors. Then there can be a tender beforehand and some sort of indication of what the price is going to be, which may or may not be underwritten.

Quite often shares are issued at a discount in the IPO as to what is the expected price. It may be that employees or possibly members can subscribe for additional shares at a discount. That's always going to be a tricky question for the actuary as to whether this process actually dilutes the value for those members who do not want to participate or do not have the cash to participate.

Moving on, who is eligible for compensation? Again this varies widely. It will typically be defined by the company's constitution, and that can vary. In some countries it's actually prescribed by law. For example, in Canada I believe all participating policyholders are members of the company, and they even continue to have some rights postdemutualization; for example, the election of directors. In other countries this varies. In a lot of the U.K. companies that are demutualized, all policyholders were members, including nonparticipating policyholders. That's also the case in, I think, one of the South African companies that is demutualizing.

There will typically be a cutoff strategy that, once the demutualization plan has been announced, to try to freeze the membership, which should be as closely aligned as possible; those people who are going to receive compensation are the same group of people who actually vote on the demutualization plan. It's also designed to deter carpetbaggers. This is a phrase that has come up in the U.S. There are now carpetbagger Web sites available with the guides to which companies are likely to demutualize that offer the best windfalls and ways by various intermediaries to try to entice people to take out policies or open accounts with those companies. So, policyholders and intermediaries are getting very keen to this possibility of windfalls, and companies can find that their membership gets quite seriously diluted in a short space of time. I think one of the U.K. building societies that talked about demutualization, and whose proposal was voted down, has opened a million new members within a pretty short space of time, and they felt that they had to set up a defense mechanism. After a certain date they required all new members to sign a contract turning over any potential windfall that might happen in the future to charity because they felt they were being taken over very rapidly by people who had no interest in the society and would probably lapse and close their accounts immediately after listing.

The cutoff strategy also is designed to try to remove arbitrage opportunities, particularly with large corporate-owned policies that can move from company to company where you have several demutualizations occurring within a relatively short space of time. A simple cutoff strategy can allow companies to move their large contracts from one company to another, collecting windfalls on the way. Typically, there are two cutoff dates. The only people eligible for the windfall will be those who are members at the date of announcement and also shortly before the date of the vote.

Some considerations. How is the allocation done? This is another area where practice internationally diverges considerably from that in the U.S. The windfall value of the shares that are distributed can be very large compared to the U.S. demutualizations to date. I think the largest we've seen so far is probably one of the U.K. ones where the average amount of shares allocated was close to $10,000, or it reached $10,000 shortly after listing, as the price increased. That's only an average. Some people would receive less and some people considerably more, particularly those with very large policies, possibly companies with corporate-owned life insurance.

In that context how do you allocate shares fairly? The contribution methodology is extremely common, in fact I think universally used to date in the U.S., to analyze what contribution to the company's value or at least the account surplus and future surplus the various groups of policyholders have made. In these analyses where the windfall value is very large, you quickly conclude that simply to allocate shares in proportion to contribution makes no sense. It's quite common for the enterprise value or the estimate of the enterprise value to be around ten times the value of the contribution, even including future contributions from the current members. A lot of the value comes from what we call orphan surplus, which is left behind by past generations of participating policyholders, and increasingly a lot of the surplus will come from nonparticipating policyholders.

Surplus may also come from discontinued businesses that have been sold and have left large chunks of surplus in the company. It also pops out pretty quickly that the contribution from different groups of policyholders is pretty uneven. Some groups can be seen to have contributed negative value. That's increasingly common in these days where mutual companies have large surpluses and have started to distribute some of that surplus through increased policyholder dividends to their current members. If you do a contribution analysis on those policyholder groups, you'll quickly come up with a negative contribution. It seems somewhat unfair that if a company has an aggressive marketing position and has raised its policyholder dividends at a particular time that those policyholders should lose out to the extent of perhaps ten times the additional dividends that they've had and not receive part of the allocation. So, companies have adopted very different ways of allocating shares amongst the members.

Pretty much all of these formerly combined a fixed component and a variable component. It's often said that the fixed allocation is in respect of the vote that's being given up. I think that's probably a misclassification. In fact, all of the allocation in my view is in respect of the vote—both the fixed and the variable amount. The variable component is there to give an appearance of fairness. If you think about what a policyholder thinks of as fair, I think most policyholders will think that if they have a larger policy, they should receive more. If they've had a policy for longer, they should receive more. That has led companies to look pretty much at size and duration measures for allocating shares. We should note that one of the U.K. building societies actually made an allocation that was 100% fixed component—basically total number of shares being issued divided by the number of members. Each member received the same allocation. It was pretty heavily criticized in the press as being a cynical exercise to buy the vote without regard to fairness, but it got the vote and it went through, and it has been completely forgotten. In theoretical terms it's hard to criticize. However, the general perception is that people with bigger policies should get more; that they've somehow done more for the society, irrespective of whether their policies have been profitable for the society or not.

The various size measures that are used could be allocated in terms of face amount, annual premium on regular premium policies, cash value, or asset share, which is a commonly used internal measure, particularly in U.K. companies, to determine dividend policy. Another factor is often duration in force. This is aimed at cutting back the allocations that people get to take out large, single premium policies just before the announcement. The variable component is usually weighted in favor of participating policies. It's been quite common where nonparticipating policyholders are members to give them the fixed amount and not a variable amount. However, even that thinking is beginning to change, and there are some proposals beginning to come forward now that don't discriminate between participating and nonparticipating policyholders. Even nonparticipating policyholders can receive a variable amount. This may sound like contrary thinking to an actuary perhaps, but from the policyholder's view that actually makes quite a lot of sense.

The last technical subject I'm going to talk about is another subject where practice differs quite considerably internationally from that in the U.S., and that's the subject of a participating fund reconstruction. One of the things that the independent actuary opines on during the process is that security and benefit expectations will be maintained, particularly for participating policyholders. Pretty much the only way of doing that is to wall off a separate participating fund with a defined profit restriction. So far, so good. The big difference between what's happened in other parts of the world and the U.S. is that this is not necessarily a closed fund. Companies can and do make a very strong argument that the policyholders will actually be better off if the fund is kept open. The policyholder dividend record can be used to support sales of new business. Without that new business would fall quite sharply. Expense ratios would go up. Now, you can get around that by defining expenses for the closed funds, but it's not great for the company as a whole, and no regulators particularly see their interests served by having a company's new business halved after demutualization.

Typically, what will happen is that a participating fund will be set up and the company has to define an amount of assets to put in that participating fund. It's also clear that the member's interest is best served by allocating the minimum funds possible to that participating fund—essentially funding for expected future benefits and expenses and nothing more. If there's a participating fund existing with substantial amounts of surplus, if that surplus is left in the participating fund and there's a profit restriction and participating business disappears in the future, that surplus is going to be trapped in the fund and cannot contribute to the shareholder value of the company; i.e., it does not contribute to the values that the members receive who are the policyholders at the time of demutualization. So, it would appear to be in everybody's interest to hold that surplus outside the participating fund, but in order to protect the interests of the existing policyholders those assets have to be made available on a contingent basis to the participating policyholders if required.

Thus, demutualizations are now evolving structures where the funding for the restricted participating fund is calculated first of all by making a best estimate of policyholder dividends in the future based on current investment conditions. That's typically done by looking at what has been earned in the past asset share analyses on a policy-by-policy basis, allowing for what we call a glide path, which is that if the company is smoothing benefits from one period of economic conditions to the next, they're allowed to take that into account in setting what they believe are future policyholder dividends. What does that mean? In a typical scenario of falling interest rates companies have not brought their dividend scales down as rapidly as the falling interest rates would indicate but have put in place a policy of bringing dividend scales down over a period of years.

When regulators expect to reduce dividends in the future until they come into line with current interest rates, we call that amount of funding the glide path for bonuses to come down slowly into line. There would also be prefunding of expense and profit transfers. If it's a fund where the shareholders in the future can take out 10% of surpluses distributed, that amount has to be funded for in respect of existing business in setting up the participating fund.

Now, if this fund is going to be open, and the companies have powerful reasons why it should be, they need considerable additional protections for the in-force policyholders. What would these be? Well, the way it's gone so far is, they must have defined future expense charges to the participating funds. Remember, this is an open fund, and that includes acquisition expenses. If an acquisition expense overruns in the future, the shareholder has to bear the difference between what is actually spent on acquiring new business and what is charged to the participating fund a very important protection for those in-force policyholders. There will typically be tax indemnities given, so, again, if there are tax risks, the shareholder takes them. There will be some kind of principles of financial management. This is a document that defines future dividend policy, and this becomes a public document and one of the court-approved documents at the time of demutualization. It typically defines how policyholder dividends will be varied in different future economic scenarios. There may well be definitions of future shareholder dividend policy as well.

There also will have to be earmarked shareholder capital, which is there to fund both statutory valuation strains for new business and transfers made back into the participating fund in terms of certain adverse investment scenarios where guarantees are exposed and losses are made. That's basically the price the company is paying for taking the surplus out of the participating fund it has to be prepared to give some of it back in those adverse investment scenarios.

That's a quick summary of the distinguishing features of international demutualizations. What's going to happen in the future? One thing that's pretty certain is that there are going to be more demutualizations. As Sue said, we're probably going to see a large number in Japan, and we're probably going to see the continent of Europe waking up to the idea, particularly in countries like Germany where there are a lot of mutuals that are now beginning to move away from being 100% participating business and are probably going to need capital in the future. We're also seeing member pressure on the stronger mutuals to release the value that's locked up the mutual and generate a windfall.

We think that mutual holding company conversions are probably unlikely in the international field, and certainly the experience of Scottish Amicable, the one company that tried something close to that, quickly attracted some hostile bids.

And, finally, we think that the actuarial techniques that are being developed in order to protect the participating policyholders in participating fund reconstructions will probably continue to be developed and used much more widely in the future.

Mr. Fred Rowley: The agenda for this talk is to look at AMP's history in the businesses. I have quite a strong project management slant, so I'm looking at the seven vital tasks for demutualization. Within those there are three areas I want to focus on. I've done a lot to particularize this to AMP, and Steve has just done a very good and comprehensive survey of all of the general considerations.

The history of AMP is long. It was founded in 1849 and incorporated by an act of the New South Wales parliament in 1857. The purpose of that incorporation was to allow it to expand internationally into New Zealand and other parts of Australia, followed by expansion into the U.K. in 1908, Hong Kong, and a joint venture in Indonesia much more recently. In between, incidentally, they entered Fiji and Papua New Guinea, but they never got to be big things. AMP carried out the first merger of mutuals I was really seriously aware of with London Life in 1989. That's how I came to join AMP. I was with London Life then. That was carried out in a process very similar to what Steve just described. Later that year—it was a busy year—AMP successfully took over a listed U.K. insurer, a very large brand, against some of the naysayers who were saying that mutuals didn't do that kind of thing.

Going back to the mid-1990s, in Australia and New Zealand AMP can only be described as a very dominant position with 0% and more of the regular premium market share. Unique brand recognition. AMP has as a policy owner one in ten of the whole of the Australian population, and its brand recognition is up there with Coca-Cola and the Simpsons. Everyone has heard of AMP, so in life superannuation AMP is the leading player by a long way. There's a property and casualty subsidiary that is a less significant player but still large and growing in the U.K. I mentioned their major presence in the U.K. Pearl is a top-ten life insurer. It has start-ups in Hong Kong, as I mentioned, Indonesia, and a very successful joint venture in 1995 with Richard Branson's Virgin group in the U.K. doing direct selling of financial products.

Internationally, it has exceptional financial strength, certainly within Australia, and a financial presence that has to be seen to be believed. AMP owns somewhat less than 10% of the Australian equity market, which doesn't make large trades easy. That, in fact, has led AMP to spearhead a large number of sophisticated resource development projects—off-market ventures in other words. I thought of that when Steve mentioned that mutuals can take a long-term view, where you're, say, financing the Sydney harbor tunnel or financing the development of aluminum smelters and so on. It's a unique skill, and we go much further than just the financing.

Demutualization. It's very interesting hearing Steve discuss all the pressures that apply globally. Most of those could be said to apply to AMP. If we'd asked Steve to do that talk two or three years ago, he'd probably have opened by saying a lot of demutualizations result from shortages of capital. That was really the dominant mode back in those days. We felt we were breaking new ground when we had an extremely strong company with a declining participating business, ambitions for global expansion and corresponding economies of scale, and a large and valuable share delivery. I think in those days it wasn't common for shares, as Steve said, to be issued. In January 1996, we set up a task force called Darwin. The idea was to explore what form the organization should take to suit its environment best. That's how the name came about. That year seemed to pass pretty quickly in my memory. Around December 11, we had a press release announcing the intention to propose to the members that we should demutualize. In between December 11, 1996 and September 2, 1997 we actually had an act of parliament passed in New South Wales to enable the demutualization.

It was interesting having to deal with the U.K. because with the U.K. we had a branch rather than a subsidiary, and it was necessary for reasons I'll go into in more detail later to reconstruct that branch. The process we chose was one of those court processes that Steve talked about, but the outcome was made conditional on the ultimate vote. Had the members as a whole not voted for demutualization, the court order would have had no effect. That was an interesting technique and it took some convincing of some parties that that was a good idea. Not long after that court hearing on September 10, 1997 we issued something called an explanatory memorandum, sometimes called an information memorandum, which set out for the members what the arguments were for and against and informed them, in fact, quite fully about the finances in a way that Steve covered earlier. On November 20, 1997 there was a large meeting in Sydney. There were an enormous number of proxies. Approximately 98.5% voted in favor. On January 1, 1998 after a period during which, theoretically, objections could have been made, reconstruction happened and the shares were issued, although at that stage they were not yet tradeable.

On April 22, prospectuses were issued. We issued, I think, five prospectuses or forms, a full briefing for analysts, a shorter briefing for the ordinary ex-policyholder member, New Zealand wraparound, and U.K. wraparound. On June 15, the company did list, and the share price did very well and seems to be holding up. It makes the company worth about $20 billion Australian, which is about $12 billion U.S.

What are the tasks that have to be achieved? First, make the case for change. There are lots of reasons. One of the key ones, of course, is that this crystallizes a large value for the members of the company. The Australian view of that is that directors of a company need to act in the best interest of their members at all times, and if they perceive that this is a possibility which will do well for their members, then it's certainly a valid argument. Of course, it gives access to capital. It gives access to stock for acquisitions, particularly given the strategy. It also gives flexibility. And, of course, there are the arguments about management accountability and incentives. One of the ones that I think is understated is that it sometimes clarifies the relationship between the membership, the policyholders, and the company. When we first announced the proposition we got lots of letters from everybody. We have 2 million policyholders. A lot of them came from policyholders of our subsidiaries who felt they should be members too. That merely illustrates that most of the members actually don't know exactly where they stand. Certainly, they will now as the shareholders or the policyholders or both.

Here are my focus areas: First, preserving the policy benefits in terms of their expectation; second, maintaining the financial adequacy of the company; and third, allocating the shares fairly. Here I should say there's little in the way of professional guidance. There's no statutory guidance, as it were; therefore, it's a problem that each company addresses for itself in the context of its own constitution.

Enhancing the enterprise value. When companies demutualize there are often concessions available. I always think particularly of tax for rollovers and so on, but also opportunities for optimizing capital usage and shifting assets around that may until now give undue concentration risk. I heard it called unstacking the other day. There's an opportunity to achieve this in a demutualization. When delivering it, make sure that what value there is, having been enhanced, is then passed to the members in the best way. This causes us to address topics like dilution, tax effectiveness in the hands of the members, the form of the offering, whether or not there should be an IPO, to what degree, and to what extent. We satisfy the legal requirements. Having said that, of course, demutualization is a joint activity. The lawyers and the actuaries have to meet somewhere. But that's the lawyers. The regulators, of course, are involved, and in our case we had to deal with regulators in at least five jurisdictions that I've named already plus that act of parliament that I almost forgot.

Preservation of policy benefits is one area where the Australian framework is uniquely helpful. The 1995 Life Insurance Act in Australia provided that each company must identify within its statutory funds the attribution of the assets between policyholders. The first thing is to define the policy liabilities, what are set aside for policy liabilities, and how you retain profits in that statutory fund in a mutual. That has to be identified as between the members and the policyholders; that is, even in a mutual between membership interests and policy interests, the processes for defining the policy liabilities for participating business built on asset share calculations. I'm not sure how widely people will be familiar with those things. I guess they're basic to us. This would be an accumulation of premiums less charges with investment return.

On the basis of projections, we've seen that those asset shares will not necessarily support the future dividend pattern that's being built up in history. There's a thing that is known in the glide path item—that is, an extra amount, which is set aside to cope with the excess in the future. Preservation of the continuation of bonuses in certain investment conditions is built into the starting point. We were able, because this was actually done early in 1997 and by that stage the announcement had been made, to reflect in policy liabilities an allowance for the fact that future profit share to the shareholders should be provided for. That didn't preempt the demutualization in the sense that had the demutualization not gone ahead, it would have had very little impact in the mutual context, but it was useful.

Because of that framework it wasn't necessary to have a closed block. The whole process was well-defined. The life act, in addition to requiring those starting balances, required very strict apportionments of expenses and the investment return and controls on apportionment of profit. That, of course, is supervised by the appointed actuary. For the U.K. it was different. There was no such framework, and it was necessary to define a separate process. As I said, we transferred a branch under the court process into a subsidiary, but in order to do this we had to implement binding financial management principles and, in fact, replicate that process of defining starting points, starting maps, and profit shares. That was the key to equity in the later share allocation. Had we left the branch in an uncertain position, it wouldn't have been quite so easy or perhaps possible to be certain about the equity of the share allocation because the value of the surplus might easily have leaked toward the policies in the U.K., and they might have had their shares as well. That scheme, by defining the attribution of all of those assets, regulates the equity between the U.K. and Australia. We were very pleased on September 2, 1997 when the high court sanctioned the transfer.

The second of my focus areas is maintaining the financial adequacy. Again, the life act in Australia is very helpful in this because it defines standards of capital adequacy, and those standards are supplemented by AMP's internal target surplus policy; that is, if we think it would be unwise to skate along just on the very minimum statutory level. Adverse circumstances can easily turn things around, so we set a margin above the legal requirement. The process of financial adequacy, having achieved it, is to demonstrate it, and the demonstration's more important sometimes than the achievement. The achievement we take for granted, but the demonstration and the independent certification, the examination of our policies and our financial position by the insurance commissioner, go to support the demonstration of adequacy. There was also interest from rating agencies. I think they went public in a way that would have helped us, although the insurance commissioner was favorable in his report and, of course, two independent certifications—one by a consulting actuary and the other by the independent financial expert. The reconstruction maintains more than adequate financial strength. The base policy liabilities must be compared against both the solvency requirement in the life insurance act and a capital adequacy requirement. If you take literally the statutory reports, because of asset concentration, the prepicture is actually worse than that. The reconstruction improves matters, but we felt this was the one which exposed us to the most genuine scrutiny.

Adequacy in the U.K. Again, we have a very strong regulatory framework in the U.K. for solvency. We didn't remove capital from the branch. It passed out of the branch and went back in again, into the subsidiary, and for five years it will stay there. The policyholders can be well assured by that. I mentioned the binding nature of the financial management principles. Steve mentioned the independent actuary certifications of the court, which, in fact, said, if I remember the words correctly, that financial security was not compromised by the scheme. There was, of course, regulatory consent that accounts for a lot, and it takes a lot of work in the U.K., but they're very keen on scrutinizing deals like this, and we were very pleased to get that and the favorable report to the court. And, of course, it's done under a court order. So, what the court has ordered AMP cannot choose at some later stage simply to set aside. It's a very binding thing.

On to the third of the focus areas, the allocation of shares, which, of course, must be done fairly and perceived to be done fairly. It's amazing how time flies when things change. We thought that the number would be $10–15 billion to be distributed among 2 million members. This is a background. This is how we approached the problem. We now see, in fact, that it's $20–25 billion, given the market's opinion as of Monday this week. That's the key problem again, just filling in the background of how this situation lies. The members didn't know at that time who was a member and who wasn't, and they didn't know what their rights were as members. Some had been there for 65 years, and some have been there since yesterday. Some have large policies; some small. Many members have many policies. One individual has 400. Many have only one. Some members have aliases either deliberately or accidentally. Our recordkeeping sometimes fluctuates on that. And they hold them in different capacities. This is a very real issue. Sometimes we think it would be fair simply to identify members and give them, say, one entitlement each as a member, but, in fact, people held policies under trust or individuals, and it's not as easy as it looks. For superannuation policies, most of them operate under trusts. We have every type of policy you can think of. We have a large, independent product development section in each of New Zealand, Australia, and the U.K., and, of course, all those London Life products as well, well over 2,000 product tables in 5 different funds and 3 currencies, which is interesting. So, that's our starting position for deciding on share allocation.

What do you do next? Well, philosophically we see the issue of shares as the exchange of members' rights for shareholders' rights. What's the difference? Well, members' rights are actually largely preserved in the shareholders' rights, such as being able to vote and nominate directors. The essential difference for us is, of course, that shareholders acquire property rights as opposed to rights of action. Thus, speaking at meetings is one thing, but being able to sell your shares is another. That's the philosophical basis, but we do take the approach that what is being offered is designed to provide fair value in relation to what is being given up.

While every policy in AMP gives membership rights to someone, some are quantifiable. We had at one time a variable number of votes according to policy size. Steve was saying it's all in relation to votes. Well, that makes votes a very compelling aspect of what we're doing, and it does influence strongly the way the shares are ultimately allocated. Some rights are nonquantifiable. They're the ones like talking at meetings and so on, but they're very real and have a bearing later. Every participating policy gives participation rights, and they generally increase over time. There's no single definition of fair. We sought equitable principles to guide us, and this is where the actuaries and the lawyers met and met and met. There was some discussion. It's interesting that we started off thinking that actuaries and lawyers had the same view of equity, and then we thought they had different views. I think the key difference is that actuaries think that you can calculate something equitably, and, by definition, intrinsically, it will be equitable. The lawyers take the view that they don't know what the hell you're doing with your calculations. They want to be able to look at it afterwards and test it and see that it is equitable. I think that's the nucleus of the different approaches and one of the key factors that calls that into question is the contribution.

Anyway, the board of AMP adopted some equitable principles. One is that there should be a minimum or fixed entitlement provides an economic parcel of shares for people to consider worth holding onto. That's material because if they don't have an economic parcel of shares, then they aren't going to lose all those nonquantifiable rights because they'll sell it in some odd-lots process. It will help them to preserve their membership. There is, of course, the argument that there are large windfall components in what's being distributed here, and all members are members, and there are precedents which very strongly indicate that this is something that the members of mutuals consider as important. I think it's underestimated, but what the members think is important very often reflects what the courts will think is important.

Steve covered this: larger policy, larger entitlement. It's certainly self-evident to anybody who isn't an actuary that should be so, and that includes judges. We think it's natural. In particular it follows the AMP Society's voting characteristics, and, of course, it has a relationship to charges and to the general degree of financial commitment to the company. Participation rights have a separate value. That's clear. Participation rights in AMP actually stem directly from the bylaws that were effectively a part of an act of parliament. The value increases over time. The dividends, often as paid-up additions, you get nearer to maturity are worth more.

The fourth of the major equitable principles we chose is that all members deriving rights from a policy should have equal rights in the shares arising from that policy. Again, we think that's self-evident. You might wonder, why not? The fact was that only the first named member got to vote. It was necessary to think hard about that position, but, in fact, I think that was obviously the right outcome. We found it very hard in policies issued in joint names. We found it hard explaining anything else to all the second named people who were largely female. There are a second set of principles that have more to do with the practical aspects, but basically whatever we devise should be easily explicable, derived in a reasoned manner, technically feasible, and not overexpensive to implement; that is, cost isn't going to drive the issue, but it's always something we have regard to.

Why not past contribution? I guess we've covered that to a large degree. Most of the surplus, the majority, came from policies that are long gone, 10–30 years ago. There might be arguments that all of that should go as surplus to participating policies, but, of course, it's not all distributable, not now and potentially not later, in the sense that new generations of policyholders might come along and dilute that interest. Some of the value comes from future surplus. I hear what's being said about the trend to move from just past contribution to a combination of past and future expected contribution. That's where we had some thoughts since it isn't surplus yet, but, on the other hand, we can't disregard it. Contribution is very irregular. Steve's covered this. We have a significant smoothing of the dividend, and that means that different cohorts or policies are in a very different position, and, indeed, if you price rationally and make rational expense assumptions, contribution should go up with size. That's not always clear. It's a black-box approach. Basically you're asking the members to trust your calculation, and, in particular, your assumptions about, say, what expense levels were 30 years ago split by product, and that's not necessarily rational or justifiable in a court. Also, it's not very much connected with membership rights, which is what we're trying to substitute for. I'm sure there are arguments in favor, but I won't get into those today.

So, what do we end up with? A formula with a fixed component—100 shares per policy, not per member. Every policy can give rise to membership rights. Some of the members holding certain policies would have found it very difficult if we'd given them one allocation as a member. There were people who held many policies as trustees, and what we'd be saying is that the beneficiaries would lose out because of the structure they chose to hold. So, we took it per policy, and while there were disadvantages to both approaches, that seemed to be the fairest. Twenty-three percent of the shares went in that way. Size component. One share for every $10 of premium. That's in-force premium, not cumulative. Basically, that doesn't vary with duration.

It does map pretty well onto the way the voting rights varied in the company. It maps intuitively onto how charges and general contribution would be accumulating and recognizes that, although you could say contribution accumulates over the past life of a policy at the same time as the future contribution that goes in the opposite direction it's subject to a scaling, and those numbers are the break points in the various layers. Up to $40,000 of regular premium, it was 1 share per 10. In the slice up to $1 million it was 0.75. In the slice up to $20 million it was 0.50. And above that was 0.25. If there was actually no premium in force, which happened with a lot of our group policies, then we took $100 of cash value as being equivalent to $10 of premium. That was a participating component. One share per $100 of this measure of participation is the most complex element of the formula. It's the sum of the present value of the sum insured plus five times the present value of the bonus. I guess in the U.S. context you can refer to them as the same. You can regard it as five annual dividends. Forty-five percent of the shares went in that way, and the remaining 32% was the size component.

Just one additional detail. We fixed the exchange rates as of the date of announcement, December 11, 1996. Once we'd gone past that date, it seemed like that was the only one we could use without being said to exercise discretion over it. Regarding share allocation outcome, the participating products got 75% of the shares, corresponding to 57% of the liabilities; 25% went to nonparticipating in relation to 43% in liabilities. That's a rate here of somewhat over 2.0, I suppose, if you're interested in liabilities. It's not a very good measure, but it does give an intuitive feel. U.K. and New Zealand each got around 10%. The U.K., slightly higher; New Zealand slightly lower. That is of interest to British people in New Zealand. I guess the other factor is that it's more likely that people outside of Australia will sell their shares, which will have an impact on marketability.

That covers the three focus areas. One thing that's becoming increasingly apparent as we've gone through all the demutualization listing process is that this is really just the beginning, which is a sobering thought. We need now to execute the corporate strategy that demutualization was designed to facilitate. That will include building the global business through acquisitions, through start-ups where there's a good prospect of a good return in a reasonable time scale, and through increasing effectiveness in the mutuals. If we believe those things about management motivation, then we have to show it by our approach to expenses and to policyholder returns. Of course we're broadening the financial services business from insurance to banking, and perhaps wider. Obviously, we have to cope with reporting in a completely different framework with a reconstructed company. We have disclosure issues, particularly now that we're listed. We have a compliance framework that bites no less, probably a bit harder. And we have that shareholder scrutiny and management motivation. Paul Ochsner said earlier in the week that the cultural change is vital. It is vital, but it's achievable, and we will achieve it through walking the talk and demonstrating that we can do these things and how we will do them in the new framework. Demutualization has opened the door to AMP's future, and it looks like a very interesting future from where I stand.

From the Floor: In terms of giving a fairness opinion, if you're getting away from the contribution principle, at least strictly from the contribution principle, how do you determine if an allocation is fair? Are there any guidelines you can use?

Mr. Taylor-Gooby: I think that's a difficult one to answer. In fact there has not actually been such a fairness opinion in some of the international demutualizations. I believe for Colonial Mutual there was an opinion in the circular that said that the allocation was consistent. It didn't say if it was fair at all. But I think it's a really tough question. What is fair? In whose mind what does fair mean? Is it because there's something written in an SOA task force report or is it in the eyes of the policyholder or the press? Many people will have different views on that.

From the Floor: In Canada, where the guidelines aren't formalized yet, it appears likely they will need fairness opinions both from the appointed actuary and the independent actuary. There you have something where it's more, I think, of an international style of allocation rather than the U.S., but they'll need a U.S. kind of fairness opinion. It's going to be a problem that we all have to face.

Mr. Taylor-Gooby: Yes, I think I'd say I was being a bit glib when I said that there are no fairness opinions. In fact there have been fairness opinions in a number of demutualizations, and the general form that I think those have taken is to give an outline of the philosophies that the company uses and the underlying principles, and then to comment that the allocation appears to be consistent with philosophies and principals.

Mr. Rowley: Yes. Steve's right. There is actually a fairness opinion in the explanatory memorandum for AMP, and it goes just along the lines that Steve just mentioned.

Ms. Collins: Fred, you mentioned in one part of your presentation that there was a defined amount of equity left in the U.K. subsidiary. When the courts or the regulators approved the transaction, did they look at what number of shares was going to be left in the U.K. compared to the equity there or was that not a consideration?

Mr. Rowley: That's interesting. At the time when that transaction went through, the equity wasn't defined. Nevertheless, it was recognized that certain fundamentals would apply. One was that internationally the same basis for share allocation would apply. In fact, as you said, that was one side of it, on the equity side. The other was simply that whatever assets were there before the reconstruction effectively stayed there for a reasonable amount of time.

Ms. Collins: Because that's not an issue for U.S companies, but for some of the Canadian companies I think the jurisdictional issues will be apparent.

Mr. Rowley: I think if I were in a Canadian company, I'd be looking hard to see what happened in the AMP case and in the Colonial Mutual case that went before and in some ways broke ground.

From the Floor: Nick, you said that the vote was in November 1997, yet the listing didn't take place until just recently, June 1998. That seems like a long time. Is there any reason for that?

Mr. Rowley: Yes. First, it's very expensive. Getting into the listing is an expensive activity, and it would have been a preemption of the vote if we had gotten too deeply into the listing activity early on. There was also a lot to manage to be fair. Although it was in November, there was then a 30-day period in which objections might have been lodged that would have challenged the validity of expenditure on this thing. Because of the natural process, the shares were issued at the point of the reconstruction. Remember that the prospectus needed to be issued and, of course, couldn't be issued until the 1997 financials had closed. That work really had to be done in the first and second quarter of this year, and we did it. It was a relatively tight time scale. When we mail policyholders in Australia, there is a cost factor. It costs $2–3 million in postage, and that's before you print anything. It also takes a long time.