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The Roles of Investment Bankers and Actuaries in Mutual Company Restructuring

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Moderator: HARRIS N. BAK

Panelists: PETER C. ENNS
ROBERT M. SMITHEN

Recorder: HARRIS N. BAK

Summary: This session focuses on the roles actuaries and investment bankers play in mutual company restructuring (demutualizations or conversion to mutual holding company) in the following areas:

- *Valuation*
- *Allocation considerations*
- *Policyholder protection issues*

The panelists look at prior restructurings and discuss the nature of the market, regulations, and other conditions that may have influenced the structures of the conversions.

Mr. Harris N. Bak: Restructuring is just another way of saying demutualizations, mutual holding companies downstream, holding systems, etc. We're not going to give a detailed description of how actuaries do calculations for the actuarial contribution of a closed block. We're going to talk about what actuaries and investment bankers do, how they work together, and how their work differs. In addition, many of us haven't had much exposure to Canada. The people on this panel have spent about half of their time working in the U.S. and half in Canada. We'll talk about how the Canadian system is similar and how it's different.

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†Mr. Enns, not a member of the sponsoring organizations, is a Vice President of the Investment Banking Division at Goldman Sachs & Co., in New York, NY.

Note: The charts referred to in the text can be found at the end of the transcript.

Peter Enns is a vice president with Goldman Sachs. Peter has quite a bit of experience in mutual company restructuring. He has worked on Mutual of Canada and All America, and he formerly worked with Merrill Lynch and the Toronto Dominion Bank. Robert Smithen is an FSA and the chief financial officer (CFO) of Canada Life. He is heading demutualization work for Canada Life, and formerly spent over 20 years at Manulife.

This topic is a little dry, so I thought we'd make it a triple X session. We are going to talk about three stages, each represented by the letter X. The first stage is exploration: Why companies should restructure, What type of restructuring they should do if they want to. The second X is execution: How to do it. And the third X is ex-post-facto: How to set up the company to function well after a demutualization.

I'm going to focus on execution, or how you go about doing a restructuring. I'm going to talk about the roles of outside advisors, how the professionals work together or don't, and the differences between U.S. and Canada.

The financial consultants deal with advising the board of directors, eligibility (which means who gets to share in the pie), distribution of value, and form of distribution. Later, I'll talk about policyholder protection, fairness opinions, and valuation. And, finally, I'll discuss appraising the value of the company, a very controversial topic.

Financial advisers work with the board on the financial options and capital needs. This has to do with how they distribute value to policyholders, and not add or subtract capital. The demutualization could be part of a sale or a sponsored demutualization. Frequently there's an initial public offering (IPO), and you bring in additional capital to help the company do acquisitions or other things. One of the big concerns is management. Some of the negatives of demutualizing are fears about being taken over and maximizing shareholder value.

The actuaries advise the board of directors on how to make the plan fair for policyholders, and that has a lot of implications. The legal counsel usually advise the board on their responsibilities as board members. Are they required, for example, to consider alternative plans? If management goes to the board and says, "We have a plan to make it a mutual holding company," is it the board's responsibility to accept that or to also consider alternatives such as full demutualization or a merger?

In many respects the difference in what actuaries and investment bankers do has to do with the difference between an outside perspective and an inside perspective. By that I mean that investment bankers work to make the entity as valuable as

possible and shareholders, collectively, as rich as possible. The actuaries are more concerned that the value is distributed among policyholders in a fair way.

Eligibility issues usually don't involve bankers as much as actuaries and lawyers. Some of the issues that come up are whether to give any shares or the same amount of shares to non-participating policies, whether to give shares to policyholders of subsidiaries of the mutual company, and look-back provisions. In the case of UNUM, for example, I believe they gave shares to people who were in force that had lapsed up to three years before the demutualization. We also consider reinstatement. Suppose you lapse the policy and weren't in force. Then you subsequently reinstated. Is it as if you always were in force? Are you entitled to shares?

In terms of distribution of value, actuaries have been the lead consultants. In 1987, the Garber committee, the Task Force on Mutual Company Conversions; of the SOA put out a paper about the appropriate principles to follow. The principle that's recommended is based on contributions to surplus, and this paper has become the "Bible" in the U.S. One way or another, we say each policyholder should get a share related to how much his or her policy contributes to profit. So, if you had a policy that was older and in force longer, you should get more than someone who had a policy that was priced more thinly.

In other countries, other methods may be used. In Canada, in particular, the plan is to do a simpler form of distribution, where people get so much per policyholder, so much per premium, or so much per cash value. It does not involve a full actuarial calculation. There are a number of reasons for this, and I'll go into them later.

We describe the Canadian approach by saying that people get value in relation to their stakeholdings. For example, if you have a bigger cash value, you have a bigger stake because you're taking a bigger credit risk on the insurance company. If you have a big face amount, you're taking a bigger risk that the company will be around to pay your family when you die, so you have a bigger stake in the company. If you've had a policy for 30 years, you've had a long relationship and deserve a bigger stake than someone who bought a policy a year ago.

Although the bankers don't get involved in the fairness of the distribution, they are very interested in the shape of the distribution. If you graph all the shares by who gets what cumulatively, they're very interested in those results. If it turns out that you had 10 million policyholders and each one got one share, that would be very bad because it's relatively expensive to have a large number of shareholders.

For example, I think the most widely held stock in the country is AT&T with about 3 million shareholders. If Prudential were to demutualize and give everyone a share, it could have over 10 million shareholders, so that could be a concern. Another concern in the same range is what I call the overhang, in which no one wants to sell a new stock and do an IPO. The company has a number of shareholders who are not the kind of people who want to own stock. They are very conservative people who are not comfortable with non-fixed income investments. If millions of people get these small shares and don't want to hold them, they'll be selling into the market and thereby dragging down the potential for the stock to rise. That leads to stage three—seeing that, after the demutualization, the stock goes up. They don't want to do anything before the demutualization, which is going to rain on the party.

By “form of distribution” I mean what the people get. Most people get shares of stock in the holding company of the former mutual life insurance company. Alternatives are to give people cash or policy benefits, such as an increase in the cash value or a bigger face amount. These are dictated by legal, tax, and practical issues. For example, if you have a pension plan with no trustees, you won't give them stock because there is no one to give it to. The employer can't receive money from the employees' pension plan. If you have an IRA plan, you can't give stock to the people who have the IRA or it might disqualify the plan.

What people generally do in those situations is give people benefits, which typically means increasing their cash value. Every company has missing policyholders. They could be old policies, paid-up policies, industrial policies, policyholders who can't be found, or policyholders who are just not answering their mail. Nevertheless, the policy is still in force so you can give them policy benefits. If you want to give them cash, who would you give it to? Do you put it aside somewhere? And what do you do about foreign residents? If you want to give Canadian policyholders stock, you have to register the stock in Canada, and there are expenses involved with that. Obviously, if you give them cash or an increase in benefits with no consideration, that reduces your statutory surplus. Giving stock doesn't affect your capital. So you have to give people what's most appropriate for your capital needs.

While protection is also primarily an actuarial interest, the bankers are involved in this too. Protection means keeping the deal. In other words, if somebody buys a policy from a stock company, he or she knows what the deal is, the price, and what to expect in return. If somebody buys a participating policy from a stock company (which is rare), the company can declare dividends and raise or reduce them, but many states have limitations on how much of the profits the company can make.

A mutual company can declare any dividends it wants. It can cut dividends in half if it wants to because there are no legal restrictions. The board has to declare

dividends, and some states like New York limit accumulated surplus to 10%. So, how does someone know that a mutual company will not just cut dividends after making the sale? The reason is that the board has no purpose other than protecting the policyholders and giving them the best possible deal while keeping enough capital to be solvent. Once it converts to a stock company the deal changes, and board members have conflicting loyalties. They want the cost of insurance to be reasonable, but they also have a responsibility to shareholders to maximize price, which means maximizing earnings and minimizing dividends.

Because of these conflicting loyalties, companies set up a mechanism to protect the policyholders. Typically, it's a closed block in which some assets are put behind a "fire wall." We can't guarantee dividends because future experience could change, but the closed-block assets are set up in such a way that if the experience stays the same, the dividends will stay the same; if the experience changes, the dividends will change accordingly. That is the mechanism usually used for things like participating life insurance.

However, there are some alternatives. Minnesota Mutual set up a dividend assurance program, for example. Rather than segregate assets, they wrote a long paper describing exactly what their dividend philosophy is, how they do mortality studies, all the factors they use to determine the dividends each year, and how they change from year to year. The company essentially guaranteed that, in the future, it will use the same methods and formulas in determining future dividends for these policies. Acacia Mutual did something very similar, but it linked the dividends to an external index.

What are some banking issues in protections? In any protection method, essentially, you can make a cap on company earnings. If a company has guarantees that dividends will not drop below some benchmark, it limits earnings. It does not put a floor on the earnings, so anyone can run a business into the ground, and many of us have succeeded from time to time. However, if you have a business that's volatile and decide to cap earnings, that's not a very attractive business to shareholders. Shareholders buy risky investments because they want to have an upside. A large closed block tends to have a negative effect on the value of the company. If you overprotect people, you're helping them as consumers, but hurting them as shareholders because the same people who have the policies are going to be your shareholder base.

Another issue is that, for GAAP financials, closed-block earnings are segregated. Therefore, if you look at the Equitable GAAP statements, for example, it shows contributions from the closed block on a separate line from other sources of earnings. Some analysts view the closed block as a discontinued operation. If a

company has a price/earnings (P/E) ratio of 10, 15, or 8, it's considered a continuing operation. Discontinued operations receive a lower multiple. So a large closed block or lots of earnings in a closed block would imply a lower valuation, and that's something the investment bankers have to deal with.

In terms of fairness opinions, if investment bankers say the deal is fair from a financial point of view, they're talking about fairness to the corporation in terms of the price of the IPO or price paid by the sponsors. Again the actuaries look at this more by class, and whether it is fairly distributed. Reading the Equitable policyholder information material is very interesting. J.P. Morgan opined that the consideration paid by AXA for those shares, that is, the private transaction, was fair. Goldman Sachs opined that the total amount given to all the policyholders collectively in consideration for surrendering their membership rights was fair. And Dan McCarthy of Milliman & Robertson gave an opinion that the allocation was fair.

The last topic, valuation, is when somebody puts a value on the company. Typically, in the case of mergers and acquisitions, the actuaries will do a projection of discounted cash flows and come up with an actuarial embedded value. Frequently, investment bankers will look at that along with market multiples and GAAP earnings comparables and provide an estimate of what the company is worth to management. Some state regulators have asked for valuations so they will know that the company's IPO price is reasonable and not just an attempt to dump the stock in the market at a low price and deprive policyholders of value. There's been a lot of opposition to valuations for the following reason. We can do our actuarial work as best we can, and the investment bankers can do all the work in the world, but no one knows when the stock market is going up or down. Therefore, if you put a valuation out there and the IPO comes out at a different price, that could create a problem.

Mr. Peter C. Enns: Demutualization is a significant and rapidly growing trend in the life industry. It is a huge part of our business at Goldman Sachs. I'll talk about the rationale for demutualization from two perspectives, as bankers in the investment community and as clients on the insurance side. Then I'm going to talk about executing a demutualization and go over public company considerations, specifically market requirements for a mutual that is about to become a public company in valuation.

Why demutualize? The reasons are fairly straightforward. It's structural, and the structure of a mutual has certain constraints. First, access to capital markets is very limited. In addition, a holding company structure lacks some benefits, including what we call unattractive treatment for goodwill and the inability to place noninsurance subsidiaries under a non-regulated entity. Finally, capital

management and flexibility. Mutual companies are at a competitive disadvantage in making acquisitions, and that's a twofold constraint: (1) the lack of stock issue in a transaction to finance it, and (2) the inability to do "pooling accounting," which eliminates goodwill from a transaction. In high-premium transactions, the latter is a pretty significant disadvantage for mutual insurance companies.

The effect of the more limiting structure in mutual insurance companies has been a significant loss in market share. In comparing asset growth in mutuals and stock companies from 1993 to 1997, we find that the mutual industry assets have grown more slowly at 7.2% than the industry as a whole and significantly slower than stock companies which grow at 10.5%. If you look at net income, the illustration is more dramatic and pronounced, with stock companies growing about 12.6% and mutuals only growing 1.4%. Even those numbers understate what's going on because they are statutory accounting numbers that measure the net income of the regulated insurance entities. Many stock insurance companies have holding companies and other lines of business that don't flow through the regulated entity. Asset managers and other similar types of businesses have been growing even more quickly. As a whole, the stock companies, on an income basis, have a 77% market share of the industry. If you think of yourself as a financial services company rather than a pure insurance company, that market share number would be significantly larger.

Since 1990, mutuals have raised about \$10 billion in capital externally, and stock companies have raised about \$100 billion in capital. That's a huge difference, and it doesn't count stock issued in merger transactions.

Why is it important on the acquisition side? Since 1992, acquisitions in the life U.S. insurance industry have grown significantly and exponentially. Mutuals have played a relatively minor role in this whole consolidation phase. Their asset share is 35–40%, but they are definitely not 35–40% of the buy side on these transactions. The percentage is significantly smaller. So the situation becomes exaggerated over a longer period of time. The result has been a significant increase in global restructuring activity. This is not just a U.S. phenomenon. Each year, we've seen an increased level of announced demutualizations. There have been eight restructurings announced globally this year to date. Most of them have been focused on the larger players in each market, but over time, it's gone down market. Of the top 25 or so U.S. mutuals, the vast majority have done some form of major restructuring already or recently announced plans to restructure.

Let me try to compare, disregarding the status quo, the three main structural alternatives. The first is a company having the ability to do a downstream holding company where as a mutual they take one of their subsidiaries public. The second

is a mutual holding company, with the mutual at the very top and all the other businesses downstream, that is going public. The last is a demutualization. I've laid out some key factors—capital raising, strategic flexibility and execution flexibility—with which to compare these different alternatives as they relate to policyholders. Companies have to view these alternatives from the perspective of their own strategies, current market position, competitive position, and financial strength. It's very important that companies look at things from their own strategic standpoint. Strategy should be driving structure, not the reverse. However, in general, when you go through all of these alternatives, over the long run, demutualization seems to have more favorable attributes.

Demutualization is the only structure that provides for policyholder distribution. In this age of consumer advocacy, policyholders want to get money and, as each one of these demutualizations occurs, more people become aware of them. In other jurisdictions, like England, there's a high expectation of distribution to consumers and a lot of pressure on companies to pay this money out.

Policyholders are protected through a very formal mechanism in all three of the structures with regard to the policy they bought and the deal they think they have.

Finally, potential conflicts of interest between policyholders and shareholders can occur in each one of these three situations, assuming that they are all public companies. Some mutual holding companies have gone public and some haven't. But with the downstream holding company and mutual holding company, there's a much higher degree of conflict of interest between policyholders and shareholders because the ongoing business between the two entities is open and contracts are negotiated back and forth. In a demutualization, the old business or prior account gets closed off, so the degree of policyholder conflict is much less, at least in the U.S.

The ability to raise capital is another factor companies should consider when looking at their alternatives. All three of these structures provide the ability to raise equity and debt capital. The difference is that, under a downstream holding company structure, you're limited in how much equity you can raise based on how much ownership you're willing to give up in the subsidiary. Companies that have real jewels in subsidiaries, be they asset management or whatever, think, "Here's a highly valued subsidiary I can take public and get benefits from." The reality is you can only sell off as much as you're willing to sell off because, at some point, you won't end up controlling it any more, and management is not very comfortable with that. In a mutual holding company, there's a certain trigger point. If you go below that point from an ownership percentage, you have to demutualize because you can't sustain the structure any more. With a demutualization, however, your ability

to raise capital is only constrained by your ability to convince the markets that there's a good use for that capital.

With respect to strategic flexibility, holding company advantages include financial flexibility, the ability to raise stock and cash in place of stock, and goodwill. The downstream holding company and mutual holding company have some of the benefits, but only the demutualization has all of the benefits, including the ability to pool and favorable goodwill treatment.

Finally, stock-based incentive compensation for companies that are pursuing a downstream holding company has some limitations. To a certain degree, even for the mutual holding companies, you create a split between who's working for which entity and who gets the stock options. Some people can be motivated that way but not everybody, which is somewhat problematic from a corporate standpoint. In demutualizations, companies are able to use stock and options to give incentive to the entire organization.

With respect to execution flexibility, existing legislation is the key constraint. For the downstream holding company and the demutualization, there is no problem, but the mutual holding company is state or jurisdiction dependent. When you net all of it out, companies might say that time is important to them. In a downstream holding company, you can take a company public in the life insurance industry from a subsidiary standpoint as quickly as you can take any company public and from start to finish. It would take about four to six months. A mutual holding company can take 12–18 months versus about 18–24 months for a demutualization, depending on how you're structuring it.

In executing a demutualization, the overall process has about five stages. It's a very complex process that absorbs huge amounts of company and outside advisor resources. You can compress the time line somewhat, depending on dialogue with the regulator in your jurisdiction and the specific structural alternative you choose. Even within demutualization for a mutual holding company, some nuances can buy you some time.

Companies often set up teams within their companies to focus on each of the main issues. There's a team that deals strictly with corporate reporting readiness, another that deals strictly with the strategic plan, etc., but all of these things are major issues that need to be dealt with in doing a demutualization. Some are related more to what we do as bankers, as opposed to the actuarial side. There is discussion of the funding of the closed block and actuarial equity-share calculation. That is where more of the actuarial time is spent, and it's the bulk of the work. The areas we get involved in include former distribution, which relates to the IPO side. Other areas

we focus on are drafting policyholder information materials, the IPO mechanics, and overall communication plan. We're very involved in the latter because, once you announce that you are going to pursue a demutualization, we, as bankers, immediately start getting calls from money managers who want to meet with management. Your public introduction doesn't happen at the IPO; it happens when you announce you're planning to demutualize.

Harris described most of what we do as banking advisors. Once companies make their decision to think about showing it to the board, the bankers are brought in. It's usually not from day 1, but very early in the process, because the decision has so much impact on the market from a communications and a valuation standpoint. It affects your net income and how you're going to be viewed relative to your competitors and other investment opportunities out there. So we will be very involved in providing analytical support advising on the financial aspects of the reorganization, and creating all of the documentation.

One of the things companies are most concerned about when demutualizing is how long it will take to adjust to being a public company. They say, "I don't want to be a sitting duck and have somebody take me over." We spend a lot of time helping people understand structural defenses and other things they can do to protect themselves against a hostile offer. And we spend a lot of time near the end working through all the mechanics of the IPO.

Next we spend a lot of time on capitalization decisions and capital structure. Capitalization decisions are driven by your ratings. Rating agencies look at several items in assessing an acceptable rating: industry risks, expected performance, and specific company risks. Company-specific risks aside, the agencies have a ballpark range of leverage that life insurers ought to be thinking about. Companies need to maximize return on equity, and they have to use leverage in their capital structures to get there. They need enough leverage to avoid a ratings downgrade that will make them unable to execute the strategy. But if you look at it from a AA to a triple B world, which is the range where most insurance companies on the life side sit, you'll need about 15–30% leverage in the capital structure, which is a meaningful amount. When you do the math and figure out the ROE impact, you find some companies increase their ROE by 20–25% just by deploying proper leverage into their capital structure.

We spend a lot of time working with companies developing (1) the right capital structure and (2) credibility and dialogue with the rating agencies. All of this is based on a snapshot of an industry player, without looking at the company's specific risks. Part of the rating is derived from the relationship a company has with the rating agencies. The reality is that the rating agencies will make decisions based, in

part, on their confidence that your management team will do what you say it will do. You'll see companies that have very different leverage rates have the same ratings or companies that have the same leverage ratings have completely different ratings. Sometimes they're even in similar product or geographic markets. As a mutual coming out of the box, if you haven't used leverage before in your capital structure, aside from surpluses, in the U.S., often companies have to take time to get up to these leverage rates because the agencies don't know them that well, and don't want them starting on day 1 with a fully leveraged balance sheet. Rob will talk about the Canadian situation. Canadian companies have a history of issuing leverage and, therefore, have had an ongoing dialogue with the rating agencies.

We think distribution issues are incredibly important, and it's an area that causes some tension with people who view themselves as policyholder advocates. In our view, the way to maximize price and the value of the company is to make sure that you have an adequately liquid stock to handle the overhang of policyholders. When companies demutualize, they distribute stock to policyholders, and institutional owners are the vast majority of shareholders in a typical company. In the case of a demutualization, by definition, it's the reverse. Certain people choose to sell in the IPO, but others typically hold on for a little while and sell some months out. If you look at how stocks have traded for companies that have demutualized, usually what happens is isolated company-specific announcements. The stock will be very choppy for about a six- to nine-month period before it resumes a "normal" trading pattern. It will go up with a broad market move up or down, and with a move down, company announcements may happen. Therefore, we definitely counsel our clients to try to maximize the IPO size to create a large institutional flow, because the institutions will drive pricing and liquidity. And they'll be the ones who buy as policyholders are selling. It's not typical or even plausible to expect the average mom-and-pop retail investor to buy in a lot of insurance stocks. Institutional money managers generally own these stocks, so you need a large institutional shareholder base to create good value.

If a company doesn't need a lot of new capital, then what does it do? If it issues new capital and doesn't need it, the company is driving down its ROE, which reduces the value of the company. The other way to handle it is to cash out existing policyholders. This is where the tension comes in. If you cash out existing policyholders, the regulators and some consumer advocates will say that's disadvantageous to policyholders. There is a trade-off, though. If you don't have a large enough offering for the actual IPO price that you will be cashing out, some policyholders that will be suppressed in the trading in the first six to nine months will definitely be worse off than if you had a larger offering with a solid float. Those are the months when most of your policyholders are going to be selling, so they're very much disadvantaged by that. It's a bit of a catch-22 but we think best for the

policyholders and the company to execute an IPO that establishes the company's name in the marketplace and creates a good buying demand for the stock going forward.

A typical IPO of a noninsurance company is 15–20% of the total market cap. So 15–20% of the stock gets sold to institutional or new investors, and the balance is held by the existing investors. In this context, the existing investors would be the policyholders. U.S. demutualization IPOs have averaged more like 39%, a significantly higher amount than a typical IPO. In publicly traded life insurers, institutional investors hold 63% on average, and retail holds 37%. For companies at the point of demutualization, on average, retail has been 65% or 64% of the ownership. After a period of time, the demutualized companies have almost the exact same ratio as large and mid cap life insurance. Over time, there's a natural transition.

Once you have demutualized, what does it matter from a market standpoint how the company is valued? In today's market, it almost doesn't matter what kind of company issues you're facing. The market factors drive it, and factors such as industry conditions and comparable company valuations get put aside. The broader economic and stock market conditions drive where companies are trading right now. Over time, the broader market becomes a bit less important to comparable company valuation, and companies are valued against each other. The universe that invests in insurance companies only has so much money and is going to pick and choose. And, that overall pool of investors goes up and down, depending on people's view of the prospects in the industry and interest rate cycles.

In a stable market, company-specific factors are the most important thing. The issues that the investors focus on most relate to return on equity and earnings outlook. People could interpret measures like historical profitability to mean future profitability, but it's really more than that. People are focused much more on the going forward years than on the past five, except to the degree that they're exactly related. The key measures that the market uses to value companies are price to earnings (P/E) and price to book. P/E ratio is a mathematical calculation: What are the projected earnings of the company in a given year? You apply a P/E ratio of 7, 15, 23, or whatever it is and that gives you a stock price. A company's P/E ratios vary by (1) what the broad market conditions are, (2) what the industry conditions are and how the industry is viewed, and (3) the company specific issues. Investors will look at relative prospects between the insurers, apply a multiple to that, and get a stock price.

Most people are focused less on growth prospects because that's a P/E phenomena. They're focused on ROE, which is the key driver for price to book. Goldman Sachs is in equity insurance and will spend a lot of time doing a global study. It created a

regression model and a report on it that was out last year showing that price to book was, by far, the leading driver of overall valuation, and much less so than P/E. The company's return on equity versus its price to book has the highest correlation against other measures in general.

When we go through cycles, sometimes that changes. If you are in a huge bull market in certain sectors, even within the insurance industry, you will be driven more by P/E. Annuity companies, for example, are growth companies. But when you enter into a more difficult market like we're in now, companies on the investment side focus more on typical price to book and ROE measures for life companies. Historically, life companies have not been viewed as growth vehicles but as value investments.

Looking at the history of demutualizations, those companies that have demutualized in the U.S. have created a significant amount of wealth for shareholders and policyholders. The average price to book of the companies that have already gone public was 0.76 times book. Currently, those same companies are trading at about 1.42 times book. The multiples have expanded for two reasons. One, the stock market has changed and, two, the ROE of most of the companies has increased. For those that have increased, the price of books has expanded significantly. So the key to creating value and wealth for the policyholder and the shareholder has been expanding ROE.

Now that you're public, what are your obligations? What do you need to do with the public markets to make sure that your value is maximized? The first thing companies need to do is set financial objectives and, most important, communicate those objectives to the investment community. Mutual companies historically haven't had to do that. The dialogue with the outside world has been fairly closed as it relates to financial goals and profitability. But this is a different world, and companies have to open up to the investment community and convey their financial targets and how they plan to get there.

Companies sometimes ask us, "Do you need to have a minimum ROE or be at minimum levels in order to even go public? Is there a point at which, from an ROE or an earnings standpoint, we can't go public?" The answer is no, absolute levels at the time you go public are not critical. What's critical is showing a positive trend from that point forward, moving toward your stated targets, and being credible to the market. Companies can go, and have gone public at very low ROEs. The key though is that they have been able to convey that they're going to get to a much higher number in a reasonable period of time. What are more reasonable numbers? Public insurance companies typically target ROEs in the mid teens, and earnings growth of double digits, about 12%.

I want to make a couple other points about being a public company. Investors look forward. They only look backward to agree that they've accurately interpreted what's going to happen in the future. The key is consistency. Companies talk to the investment community, which guides them toward certain numbers based on what it thinks the company is going to do. If you are inconsistent in your results and miss your targets, the market, especially a market like this, will be extremely punishing. So consistency of growth and profitability is critical.

Companies also focus on operating earnings. They'll disregard one-time items, which is how a closed block is perceived. Again, investors focus on double-digit ROEs. There's a split view on market focus. If you look at the insurance world, there are very large, successful companies that just do one thing or control a niche. They've been very successful and they're heavily marketed. Then there are other companies that operate more like a financial services marketplace, and there's no one right answer for success. If you're not a pure player, investors will look at the different units within your company and value each of them. The key is to deliver the performance, not necessarily the structure of your company, in getting there.

You need to have a constant communication with investors. In fact, there's a new group that could start it up within mutual insurers and the demutualized. I guess you could call it the Investor Communications Group. The ongoing dialogue is critical. It almost starts from the point that you announce you're considering a demutualization.

Another hot topic is management compensation programs. These are much loved by the consumer advocates and regulators, and we spend a fair bit of time thinking about the right things to do. Investors want to see managers compensated with a significant stock component. They like that and regulators are starting to understand that now.

Mr. Robert M. Smith: This is a quadruple X-rated exercise because, if you work on the demutualization long enough, the fourth X comes in: Exhaustion. I can promise you that this is a tiring, time-consuming exercise, especially if you are doing this on top of your normal job, which most of us do.

I'm going to talk about the Canadian environment and my own company in going through these three stages of demutualization. The real difference between the role of the actuary and the role of the investment banker in demutualization is simple: The actuaries are the ones who do all the work, and the investment bankers are the ones who make all the money.

In Canada, there are five major insurance companies, four of which are mutuals. Purely by happenstance, the four mutuals decided to demutualize all at once. Of course, we never considered what the other one was doing. There were no regulations in which to demutualize in Canada, so the four companies got together and formed a working group. In trying to help develop a regulatory regime, we've worked very closely together and with the Department of Finance in Canada, which is ultimately responsible for the regulations. The regulators took some of our advice and ignored some, as is their prerogative, but the industry group we formed, which met every two weeks for a half a day since June of 1997, did a great job in leading us to where we are today. Draft regulations were released a couple of months ago, and they look fairly good, although we still have some issues. Comments were received by October 14, 1998, and we hope the final regulations will get promulgated before the end of 1998. Until then, nobody can demutualize in Canada.

I think it is important to understand how different we are from American mutuals. At least three of the four Canadian companies were stock companies, historically, and mutualized at the end of the 1950s or early 1960s to avoid takeovers from big American companies. We became mutual companies, but were really mutuals in stock clothing. The end result was the mutual companies in Canada have a lot of non-participating policyholders. At Canada Life, about 80% of our liabilities are non-participating, and that's true of Sun Life and Manulife as well. So who are we going to distribute to? Canadian regulations say you must distribute to your voting policyholders, which in the three companies I've just mentioned, are virtually all participating policyholders. So 20% or so of the policyholders are going to get 100% of the value. That's very different from the U.S. situation.

We're talking about allocating a windfall fairly. When I went to actuarial school, they didn't tell us how to do this. There are all sorts of different opinions in the Canadian regulations. The company actuary and an independent actuary have to opine on the allocation of value being fair and equitable, and on the establishment of this participating fund, which is slightly different from the U.S. closed fund. I'll talk about that in a minute.

The investment bankers have to give a range of values in our demutualization, something that is causing them great chagrin, and they also likely have to opine on the equivalence of cash. If they're making a cash offer, they have to disclose how they arrived at the amount and determined it was a fair price. In Canada, the regulations provide considerable room for policyholder input, and consumerism is becoming more prevalent up north.

The Canada Life situation isn't too relevant for this audience except for a couple of things. One, we're about halfway through our demutualization, and, two, we operate in four jurisdictions: Canada, the U.S., the U.K., and Ireland. Peter's time frame of 18–24 months is fine if you're operating in one jurisdiction. If you're operating in more than one, it increases the complexity exponentially; the U.K. environment is particularly complicated. And doing a securities issue in the United States can be very complicated for a Canadian company because you get into all sorts of different accounting rules, which I'll talk about very briefly in a minute.

The Irish were very clever. At the end of 1997, Mutual Life of Canada was the first Canadian company to announce its intention to demutualize. The Irish papers picked it up and in the next six weeks, we sold 25,000 participating policies in Ireland, which is more than our in force. It took us six weeks to shut off the flow. We kept raising our minimum levels and still couldn't shut it off. Now we're faced with the very real problem of deciding what to give these people. They're eligible, but we have to be sure they don't unduly dilute everybody else. That's the kind of problem you can face in this new global environment.

In terms of what actuaries do in a demutualization, it depends on the company. At a minimum, the actuary splits the spoils out. In our companies, they'll work out the mechanics of the participating fund, but they can have a much broader role in all of the areas Peter was talking about. What are actuaries if not financial advisors? Good actuaries will be much more involved than just in the purely technical involvement.

What actuaries are involved? The chief actuary and his or her department, plus the actuaries in our business units are all very heavily involved in the demutualization. We also have a consulting actuary from one of the major consulting companies to help us with our international demutualization. In Canada, we also have an "independent actuary," which is just another firm of consulting actuaries. In the U.K., there's a similar concept, but that wasn't enough for the Canadian regulators. They're so burdened with all the companies demutualizing, they've hired consulting actuaries to help them do their evaluation. And there are three sets of those that we have to deal with, one for Canada, one for the U.S. and one for the U.K. So we have our own actuaries and six sets of consulting actuaries for our demutualization. All have their own approaches, which are not necessarily consistent.

On top of that, we have four sets of investment bankers, two we hired and two the regulators have hired (and we pay for). The Canadian regulators have hired one and the U.S. regulators have hired one. The U.K. regulators haven't yet, but they probably will too. And we have four sets of lawyers, one for each of our jurisdictions. So that's fourteen sets of external consultants. You know what they

cost, not to mention trying to manage so many external groups. We also have communication experts and accounting advisors, so the management of this process is no small task.

The key stages of demutualization are examining the options, implementing the plan, and structuring the company as a public company. Peter covered these quite well so I will just say that, in Canada, every one of the companies has opted for a full demutualization rather than taking the interim step of becoming a mutual holding company. Canada Life looked closely at this option and saw advantages, but I didn't think we could get past the consumer problems that have happened in the U.S. and are crossing the border. Jason Atkins is multinational now, so we didn't figure it was worth the problems. In addition, the Canadian regulations wouldn't make it easy, or perhaps even allow it at all.

The role of the actuary in the initial strategic options process is a very important one. I know we're guilty of not spending enough time on this process. Demutualizing is not the only alternative and, if you do a proper analysis, you may come to a very different conclusion than we did. It's trendy these days for everybody to buy everybody else, and we all want "an acquisition currency," but these currencies work two ways. If you have an acquisition currency that's valuable (i.e., your stock trades for a higher multiple than those you're trying to purchase), that's great, but half of the companies are on the other end and will become acquisition targets. We shouldn't forget that.

We all know why you would want to demutualize, but why not is probably worth spending a second on. The financial advisors and bankers will advise you to do it, usually for good reasons. I don't want to be too cynical, but there are many reasons not to do it. First, you become a takeover candidate as soon as you go public. Although it is technically possible to take over a mutual company, it hasn't been done as far as I'm aware. It is certainly much more likely to happen if you become a stock company.

Second, the short-term market pressures are no small issue. Halfway into demutualization, I can tell you I'm feeling those pressures already. We're trying to structure the company and make it look like a good entity for shareholders. However, are we making the right decisions for the long-term interest of the policyholders? We hope we are, but it's easy to succumb to short-term decision making, which is definitely in the long-term disinterest of your shareholders and policyholders.

Third, the cost and the time are real issues. We're spending about 30 months and most of our key people are working on this. That means they're not working on

something that adds value to the company. We hope demutualization ultimately will put us in a position to become a better company but, in the meantime, it doesn't do one thing for the company's bottom line, except worsen it.

Finally, as a public company, we have to deal with all the security regulations. In Canada, we are now what's called a "reporting issuer," which means that we have to announce anything we do publicly. The good old days of not reporting earnings until our annual meeting are long over. We issue quarterly press releases and deal with public markets and the press, and that's not a lot of fun. You have to set up an Investor Relations Department because communicating with the investment community is a full-time job.

Stage 2 is the implementation. The actuary has a key role in the eligibility, allocation of value, determination of the participating fund (which is the Canadian concept of a closed fund), and the actuarial appraisal (should there be one), and even in the distribution methodology (shares, cash, or benefits).

Who is going to be eligible for distribution amounts is important. Canadian rules clearly state who's eligible, so we have no decisions to make. The voting policyholders get the benefits as of a certain cut-off date that has already been pre-selected by each of the Canadian companies.

There is an issue of reinstatements and an interesting issue of acquired or sold blocks. In Canada Life's case, I'll use two real-life examples. We've made a number of acquisitions in the last few years, two of which had significant amounts of participating business. We bought New York Life's Canadian business in 1993, which had both participating and non-participating, but added a lot of participating policyholders. And we bought Manulife's U.K. business in 1995, which also had many participating policyholders. The New York Life purchase made a significant contribution to the surplus of Canada Life because these policies have generated good earnings. In the Manulife case, the participating business was already a closed fund. Manulife had walled it off, so there was no surplus actually transferred. We bought it for nothing, essentially, and the surplus went to Manulife. However, the business now belongs to Canada Life.

In deciding how to treat both blocks, we had four options:

- Exclude them completely, which, in fact, isn't an option because legally we had to include them
- Include them and give them a nominal fixed amount

- Include them and assume they were issued from the date of the acquisition. In other words, all the Manulife policies came to Canada Life in 1995, so their issue date was 1995
- Include them and assume they've always been a policyholder of Canada Life, which means they get their full allocation

The last option is what the policyholder assumes and wants, but is it fair to the other policyholders of Canada Life, particularly in the case of the Manulife block? It could be quite dilutive to our in-force block to treat these policies as if they have always been part of Canada Life. We're still grappling with this one and if anybody has a solution, I'll be happy to take their advice. These six sets of consulting actuaries do not agree on this issue.

In terms of the allocation of value, there's a fixed component and a variable component. The fixed component is included by tradition more than anything else. Every demutualization has had a fixed component, and it typically is anywhere from 10–25% of the amount of the total allocation. So everybody, regardless of policy size, age, etc., gets a certain fixed amount. It can be a minimum number of shares or whatever you choose. Interestingly, the U.K. building societies were all mutual and most of them have demutualized. A number of them gave 100% of the value based on the fixed component, but that's not true of the life insurance demutualizations. There are no actuarial principles governing the fixed component; it's just paying the policyholders for giving up their vote. In Canada, they only give up part of the vote, so we're grappling with what percentage that should be.

The variable component presents the difficult actuarial challenge and Harris talked about the U.S. methodology, which is a contribution to surplus methodology. That probably makes sense if your company's liabilities are participating and the policyholders getting the benefit are the ones who have actually contributed to the surplus. That's not the case in Canada. At least, it hasn't been as much the case in the U.K. and Australia. The U.S. model, where asset shares are used to calculate the contribution to surplus, is not the model the rest of the world is using. Other countries work out some kind of simple formula, and that's what the Canadian companies are going to do.

The formula can be a function of premiums, cash values, reserves, face amount, or some amalgamation of those items. The Canadian companies will be taking this formulaic approach and running asset shares to make sure that the contribution to surplus does not deviate significantly from it. We're trying to ensure that every policyholder gets more than his or her actual contribution so everyone will win. They may not be proportional winners, but everyone wins. This process of setting up asset shares and trying to work out what people have actually contributed to the

surplus of the company is difficult. You have to get the data right, which is very difficult, and get your assumptions right, which is equally difficult, but we do the best we can.

Large policies are a particular problem. A number of companies will have corporate-owned life insurance (COLI) business with huge policies and large distributions. If you take Canada Life's book value only, and we hope we'll trade at higher than book, the average policyholder is going to get about \$7,000. People who own COLI business will get huge multiples of that. It's fair and equitable but will create a perception of unfairness. It's an interesting issue and I don't know what we're going to do yet, but I expect to follow the formula.

If you operate in different territories as we do, you have to try to fit one formula into a variety of different jurisdictions. We have tax regimes, securities regimes and regulatory regimes in four territories. That's twelve sets of rules we're trying to fit our demutualization into and they're not all consistent. It would be nice if they were, but they aren't.

In terms of participating funds, suffice to say that there are real pushes and pulls between putting a lot of money into a participating fund. In the long-term, it ensures that the participating policyholders get their benefits as expected. However, in the short term, it gives less value to the shareholders who have been the participating policyholders from day 1. I think all the Canadian companies are trying hard to ensure that the policy benefits are secure for the participating policyholders, but there's not a large amount of excess funds in the participating account.

There are also pushes and pulls with the regulators in Canada and perhaps with the consumer advocates. But our goal has been to get the maximum value out there because you're liquefying an interest to your participating policyholder, who we think wants cash-in-hand rather than security for future benefits.

Do you need an actuarial appraisal? When we sat down with our consulting actuaries six months ago the first thing they said was, "Let's start working on the appraisal because it's going to take a lot of time and effort." We questioned this and decided that we're not doing an actuarial appraisal. There are good reasons to do one, the best being that your investment banker wants it. If the bankers say they need an appraisal to help them form an opinion about the range of values, which is required in Canada, or to set the IPO price, then you have to do it. It also helps the actuary attest to the fairness of the transaction. The board of the company decides whether to demutualize or not, based partly on getting fair value for the stock. The investment banker says Canada Life is worth \$100, but how do we know that's a

good value? One way is to see if the \$100 is greater or less than the actuarial appraisal.

Despite that, we've decided not to do one or at least not in any kind of detail. It's hugely expensive, very time consuming, and we're not sure it's very meaningful. It would help the board, in one sense, but it would be confusing in another sense because the only value that really matters is the value that the market's going to pay for your stock. Anything else is just a theoretical value. Also, if you do get the appraisal, you may have to disclose it. What would that do to your stock price?

Even at this stage in the demutualization, the actuary has a major role in talking to the investment bankers. He or she has a role in determining whether we distribute cash or shares. Whether you need capital or not, you have to liquefy some of these shares into cash to get the money into the hands of the institutional investors. There are ways to do that and, if you're operating in a number of jurisdictions, those ways aren't easy.

The actuaries have a very important role in figuring out how to structure the company to go forward. You want to make sure as early as possible that your company won't come out with a 5% ROE and that it has a meaningful possibility of generating good earnings. The Canadian mutual is a little more fortunate than its U.S. counterpart in that regard. We've been operating more like stock companies and most of us have low double-digit ROEs. However, it is still not the kind of multiple we need to be able to utilize our stock as an acquisition currency.

Ms. Robin B. Leckie: I'm retired and a policyholder. The suspicion is that companies are demutualizing to enrich management. Maybe they're entitled to be enriched, but my understanding is that, in Canada, they cannot enrich management people more than the interest they may have in their policies at the time of the demutualization, and cannot issue stock options for one year. First, is there any similar limitation in the United States? Second, what happens to the Confederation Life participating policyholders? I don't know who took over that block of business, but do they go back to the original day or is that company going to get stuck? And, finally, I think most of the companies have had difficulty with vanishing premiums, and they're paying out a major award to vanishing premiums. Is that award deducted from their other interests in the demutualization? I want to be sure that my interest is protected.

Mr. Bak: I'll take your questions out of order. As far as companies that had to pay money through policy remediation, for whatever reason, it applies to almost every mutual company in the U.S. and probably Canada too, at least with respect to U.S. business. Whether theoretically pure or not, the general approach is not to deduct

those from what people otherwise get. In other words, if a company made lots of money on a class of policies because of some sales practice and has subsequently given those profits back and we compute the contributions to surplus, we ignore the value of the remediation. That's just pragmatic. If they were to be deducted from the proceeds of a distribution, it will be viewed by the public that we gave them a settlement and then took it away. That's not practical, and I don't think anyone's taken a different approach.

Mr. Smithen: If 100% of the value is going to the participating policyholders, the value is reduced collectively. Obviously, there's a hit but you're right, it's more across the board.

Mr. Bak: As far as the question about stock options, in the U.S., it varies from state to state. In New York, it's a two-year wait. It's different in every state but I think, generally, the state laws do prohibit so-called "getting rich."

Mr. Enns: Most demutualizations, even in New York, always end up being a company-specific negotiation as it relates to many items, including management compensation and stock options.

Mr. Smithen: I can't speak about Confed, Robin, because it's one block we didn't buy. I don't know if other Canadians know what's happening with the Confed block. Dave, do you know?

From the Floor: Yes. Maritime Life bought that block. It's a stock company wholly owned by John Hancock.

Mr. Smithen: That's right. I will say, Robin, that I think the stock option issue is the reddest of red herrings. In fact, the market wants management to get stock options to enhance the value of the shares. If that happens, it's good for the policyholders. Management is going to get paid a fair wage in this day and age—perhaps unfair in your view—whether there are stock options or not.

From the Floor: It is curious to note that the Canadian regulation has nothing in it about closed blocks. I think that's purposeful. Is your company anticipating doing what is materially going to be a closed block? And do you anticipate any problems from Michigan or any state in that regard?

Mr. Smithen: Even for shareholder companies, Canada operates a participating and a non-participating fund. A mutual company has both, so we have to do is reconstruct our existing participating fund. We have a one-time opportunity to get it into the form that makes sense, assuming the regulator agrees with us, and we are in

those discussions now. We have made no decision at Canada Life about whether to go all the way to a closed fund, although it's likely. In Canada, most of the companies will continue to write participating business. If we close off the fund and continue to write that business, real problems can arise in today's environment with low interest rates being able to pay reasonable dividends. There are ways around that, such as a so-called "synthetic" participating fund, which we are looking at quite seriously. We will probably have a closed fund and synthetic participating funds, but we do want to get the value that's trapped today in the participating fund into the hands of the participating policyholders to liquefy their interest immediately and increase the market cap of the company.

Mr. Bak: The participating fund typically has assets that cover the liabilities plus some required capital. A closed block typically is like a gross premium valuation, with assets less than the statutory reserves, and they serve two different purposes. If you took a closed block, put in the participating fund type of funding, and did not take some money out, essentially you're depriving all the shareholders of some of their rightful value. Therefore, I think overfunding by using the full participating fund as a closed block would probably be unfair to some policyholders.

Mr. Smithen: In our case, that overfunding is about \$700 million, so it's a big issue.

From the Floor: My second question is somewhat hypothetical. You indicated that most of these Canadian mutuals were stocks at one point, became mutuals, and now they're going to go back to stocks. You said it was an 80:20 relationship., From a legal perspective, a fairness perspective, or whatever, the natural conclusion might be that many of the non-participating policyholders may have contributed to the surplus of the company, particularly pension contract holders or universal life. Do you anticipate any problems either north or south of the border relative to having to distribute monies to anybody but the voting class of participating policyholders?

Mr. Smithen: At Canada Life, we don't feel strongly about this issue. It is a regulatory issue, and the Canadian regulations are 100% clear: It goes to voting members, which, in our case, are participating policyholders. We're just going to follow the law, so we shouldn't have trouble. There may be an issue in the U.S. because Michigan is starting to make noises in that regard. Do you want to say anything about that, Harris?

Mr. Bak: No, but we have to understand there's no clear analogy in the U.S. Even if a company had a small number of policies that were technically not-par, even

non-participating policies generally have voting rights. There is no large block of policyholders in U.S. mutuals who are non-voting.

Mr. Gary Corbett: Rob, I understand the reasons why the Canadian companies do not want to get into contribution-to-surplus calculations because of the factors you brought up. But it did concern me when the Canadian regulators decided that the actuary would have to determine that the distribution was fair and equitable. What sort of standards do you have? I know you can use premium or cash values, but who's to say that either one of those is fair and equitable?

Mr. Smithen: We are, in fact, doing a contribution-to-surplus, and I believe the other Canadian companies are doing that too. We have a model office for each territory, so it is taking a lot of time, but we are trying to roughly fit a formula.

From the Floor: Are you adopting any contribution as some sort of a standard?

Mr. Smithen: Yes, we are.

From the Floor: We're working for the State of Michigan and helping EquiPartners in its independent actuary role as well. One of our most gut-wrenching decisions is how to define fairness and equity. Some of the considerations are rough equity based on contributions to surplus or that people with larger stakes get more.

Mr. Enns: One thing that could have been brought up as we discuss these multinationals is that, although you can have different policyholder protections in different countries (Canada Life could set up a closed block for its U.S. policyholders and do something else in the U.K.), it's impossible to have a different allocation of value methodology.

Mr. Bak: In three of the four plans I've seen, two policyholders from two different countries with the same premiums would get the same allocation if they had been around from the beginning.

From the Floor: Peter, with all of the companies looking to restructure, how much additional stock can the market absorb in the insurance industry? And what implications does it have for current valuations as well as the long-term industry outlook?

Mr. Enns: Demutualizations historically have done well. You take companies that have, from a public market financial target concept, underperformed, restructure them, and management responds. The companies perform very well as stocks, so investors feel good about that.