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Session 9IF Foreign Insurer Reorganizations

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Summary: Several U.S. and Canadian insurers have announced their intention to reorganize, within permitted regulations, primarily to access capital and further company growth. This reorganization poses several questions:

- *Are domestic and multinational insurers based in other countries reorganizing?*
- *Will competition result in reorganizations in these countries?*
- *What perspectives do regulators have?*

Panelists discuss the considerations of foreign-based life insurers desiring to reorganize, including regulatory matters.

Mr. Michael E. Gabon: We have two distinguished guests from the U.K. who have worked internationally and will share their experiences and some case studies/examples of foreign reorganizations. We can then talk about how those might differ from reorganizations in the U.S. or Canada.

John Jenkins is a Fellow of the Institute of Actuaries. John works at KPMG in its London office, and he has worked on various projects in the U.K. all the way down to South Africa, where he was involved with the Old Mutual demutualization.

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

Following John will be Andrew Chamberlain. Andrew is the chief actuary at the Government Actuary Department in the U.K. The Government Actuary Department is an outsourcing function of the Financial Services Authority.

Given that we have a small group today, perhaps we can make the session more informal by introducing ourselves.

Mr. Devin L. Reimer: I work for Equitable of Iowa Companies based in Des Moines, Iowa. About one year-and-a-half ago we were acquired by the ING Group, which is a global insurance and banking conglomerate based in the Netherlands.

Mr. Daniel F. Bass: I'm from Pacific Life in Newport Beach, California, and we're currently in a mutual holding company structure.

Mr. Craig A. Meridan: I'm chief actuary for Prudential International in the U.S. Previously, I worked for Tillinghast for 12 years and lived in Europe for four years and Asia for two years. Since joining Prudential I've worked down in South America. So, I've hit all the major areas around the world, and I'm interested in getting an update on what's happening in the U.K.

From the Floor: I'm with Lincoln Re and probably the only nonactuary in the room. I'm here because I just got some news in March that they'd like me to move to Brussels to look at the European situation for our company, and I am going to learn everything I can about international at this meeting.

Mr. James F. Toole: I'm on the International Section Council. I'm with Milliman & Robertson in Denver. My focus is Latin America, but I'm willing to listen to stuff about Europe, too.

Mr. John Jenkins: About 70% of my talk will cover the U.K. and 30% will cover other countries. The U.K. has been very active recently in terms of all sorts of restructuring. Yes, demutualization will be a significant part of it, but the title of the session is actually wider than demutualization, so we're going to look at some other types of restructuring as well.

In the U.K., we have increasing competition, too many companies, and too little business. About five years ago, we had about 200 life companies in the U.K. Now it's down to 30 or so larger ones. There's been a lot of consolidation, and the market will contract further without any doubt. We've had quite a few regulatory changes forcing the pace. In particular, in 1995, a regime was introduced for disclosing the charges on policies. Companies were required to project policies to maturity using the company's own charges so that customers had a way of comparing the charges over the full term of a policy. That's had a

big effect, particularly in the broker market. The government is now going to take that a stage further and introduce what it calls more user-friendly ledger tables to try and make it even more obvious to the public which are the high charging companies and which are the low charging companies.

Mr. Toole: In projecting those charges, is that like an illustration in the U.S.?

Mr. Gabon: The question is, "What are they projecting?" In the U.K., there are certain requirements for projections in sales illustrations, certain guarantee tables versus current, but I don't think the U.K.'s regulations on illustrations are as extensive as they are in the U.S. Nevertheless, it's a way for applicants or brokers to compare one policy with another, often looking at reduction in yield.

Mr. Jenkins: There are various ways of doing it, and I'll refer to some of it in a moment, but before 1995 we had a regime where the whole industry used the same charges. It was designed to be a generic illustration rather than enabling different companies to differentiate between each other. Whether consumers will take any notice of these things remains to be seen, but, nevertheless, the fact that these figures have to be put into the public domain means that companies are forced to do something about it if they come out really bad. They don't like the newspapers printing an article showing their companies at the bottom of the table.

You have some companies with shortages of capital, particularly mutuals. We had a bit of a bonus (or "dividends" in U.S. terms) war in the 1980s. Guaranteed annuities is a current issue that I won't go into too much because we could spend an entire session on that. Many companies have expense overruns. All of those things have eroded capital. There's the ever-increasing trend here toward integrated financial services, banks owning insurance companies, and insurance companies owning banks. I think that's what started off the transition to our new FSA regulator, rather than the separate regulators we've had in the past.

I should say something about with-profits business. I think you call it participating business. We call it "with-profits." It's still a very important thing in the U.K. It provides smoothed rather than unsmoothed investment returns. We call unsmoothed "unit-linked" and smoothed "with-profits." The more modern form of it is called "unitized with profits." Unit-linked products are similar to variable products in U.S. terms. You have a number of units at a unit price to make it fit on the unit-linked systems, but it's still with-profits. And this type of product has, I think, driven some of the structural changes that I'm going to describe in a moment.

Finally, by way of background, the U.K. industry cost base is very high. The average acquisition expense ratio is 80–87%. That's acquisition expenses

divided by new annual premiums plus 10% of single premiums, which is a measure that we use. That's quite high. The range is from 14–200%. So, we have some very competitive companies and some very uncompetitive companies as far as acquisition efficiency is concerned. The nonacquisition ratio average is 8%, and it is not quite so important. That's slightly better, but there's a tremendous range from 1–20%. Mike mentioned the reductions in yield. A typical 10-year product, on average, has a 3.6% per annum reduction in yield, with a range from 1.2–5.3%. It's debatable whether anybody should be taking out the policy at all, particularly when you consider the competition in the traditional life industry in the U.K. On average, it's not particularly efficient. Although it has some efficient and very efficient players in it, the inefficient players have given rise to the restructurings in many cases.

Mr. Gabon: John, what portion of that is commissions?

Mr. Jenkins: Between one-half and two-thirds of that would be commissions in general. It's generally regarded that the acquisition commission is high. That's controllable to some extent, but the noncommission expense includes the back-office costs and the sales and marketing overhead costs, which generally are regarded as being too high. The old adage in the U.K. is that a life insurance salesman sells one policy a week, and that's enough for him to drive his Jaguar around. Only that's changing because there's some pretty stiff competition coming around. The new individual savings account introduced recently by the government has some tax benefits, but the most competitive versions have no initial charges, just over one-half a percent ongoing charge. The reduction in yield in that case is just 0.55%, by definition, as compared with the average of 3.6%. That's a big difference. A lot of companies are pricing these at a loss at the moment, but they expect to make profits, if they actually get the relevant large amounts of funds under management built up.

The product I've just described is not accepted in general. Companies have this product available with a very low charge, 0.55% per annum, and yet are still selling traditional policies with a reduction in yield in excess of 2%. Where that's going to lead them, I don't know. We might have another misselling incident coming along there.

Moving on to demutualizations, Table 1 shows the recent cases.

Demutualizations started in the late 1980s in the U.K. The date on the table is the date of implementation, which is always a year or so after the actual thing was announced. The main flotation (or public stock offering in U.S. terms) we've had was the Norwich Union. Colonial wasn't really a U.K. company, but a branch of an Australian company. We haven't had many flotations yet. Norwich Union was the first.

TABLE 1
U.K. - DEMUTUALIZATIONS - RECENT CASES

Date	Mutual	Acquired by	Nature of Acquirer
1/1/90	FS Assurance	Britannia	Bank
1/1/92	Scottish Mutual	Abbey National	Bank
1/1/94	Scottish Equitable	Aegon	Insurer
1/1/96	Provident Mutual	General Accident	Insurer
1/1/97	Clerical Medical	Halifax	Bank
1/1/97	Colonial	Floated - Australia	-
6/15/97	Norwich Union	Floated - U.K.	-
9/30/97	Scottish Amicable	Prudential	Insurer
1/1/98	London Life	AMP (existing owner)	Insurer
1/1/00 *	NPI	AMP/Pearl	Insurer

* According to plan

- Plus other similar cases
- Plus U.K. branches of overseas parents

Mr. Gabon: That was a demutualization?

Mr. Jenkins: Yes. Norwich Union was previously a mutual, and it went straight from being a mutual to a company floated on the stock exchange. One of the other ones has actually been acquired. For example, Scottish Mutual was acquired lock, stock, and barrel by one particular parent. A watershed was Clerical Medical in that it was the first time a mutual was actually hawked around the market. Scottish Mutual decided to get into bed with Abbey National because it suited them, but this was the first time there was any evidence of the directors of the mutual actually having to take active and semi-public steps to hawk the thing around the market to get the correct price. That's set a trend, and, in fact, for Scottish Amicable, which I'll come to later, the first thing that its directors proposed didn't go through. It was obviously not the best that could be achieved. There was such an outcry publicly in the financial press that it didn't go through. NPI is going through the process at the moment and, if all goes according to plan, it will demutualize on January 1, 2000.

Chart 1 shows the basic structure by which companies have demutualized in the U.K. You start off with a mutual, set up a new life company, and transfer all the existing business across. Section 49 transfer is a legal thing that I'll talk about later. The acquirer has to put a large amount of capital into the new life company, and the new business comes in. The 100/0 means 100% of the profits go to the policyholders and zero to the shareholders, which is obviously the case for a mutual. In the proprietary company, it's 90/10, where 90% goes to policyholders and 10% goes to the shareholders; that's the traditional way in which with-profits business is run in the U.K.

That method is fine, except that, for unit-linked business, you end up giving 90% of the profits on unit-linked business to the with-profits policyholders. Chart 2

shows a modified version of this method being used in practice. Because this is the new company, we have two funds. In addition to the shareholders' fund, you have a fund that is entirely shareholders, and then you have the closed 90/10 with-profits fund. The new business comes in, the with-profits bit is reassured, and the unit-linked business stays there. That means the shareholders can get their hands on 100% of the unit-linked profits. That's a slightly better structure, and several of them have used it.

The capital, which the acquirer has to put in, is used for a number of things. The capital buys the 10% share of future profits that the shareholders now are going to get, but it's actually used to do a few other things. There's normally a special reversionary bonus, which is a bit of a carrot for the policyholders. Higher terminal bonuses get paid out over a period of time, and they're not reserved for in the U.K. at the moment. Having this extra capital there also acts to increase the published free asset ratio of the company. A lot of these mutuals were forced to demutualize because of lack of capital, so having this capital come in, even though it's earmarked for something else over the long term, does improve the free asset ratio in the short term.

That's fine if you want to increase your published free assets, but it's a bit inefficient from the acquirer's point of view. The acquirer has to set up a large chunk of capital to get an income stream of these little 10 percents over a period of time, and like the bank, the capital rate, the hurdle rate, is 13–14%, and that's quite high nowadays. There is another approach, and I'm going to illustrate it with Scottish Amicable. It also gets a bit more complicated.

Prudential ended up winning the bid to buy Scottish Amicable. Prudential set up a new 100/0 fund, a new mutual fund within the main Prudential company, and put the Scottish Amicable business in there, with the business remaining mutual. It's a mutual fund within a proprietary company. They set up a brand new company called the New Scot Am Life, which is a 100% shareholder company. The new business goes in there, and the profits go into this fund because it's difficult to have a with-profits fund in a new company. There's no track record. And obviously, the capital had to go in to capitalize the company. But, because the new owner, Prudential, did not have to buy out this 10% share of future services, as in the previous case, the amount of capital that it had to put into this new company was a lot less. This is actually the more modern way of doing it, and, in fact, NPI is following this method as well. The advantages of this are lower capital.

NPI is going through a variation on this theme. Rather than structuring the business the way Prudential did, Australian Mutual Provident (AMP) is setting up two new companies, one to receive the old business and one to take the new

business. The old company will remain a proprietary company owned by AMP, but it's still a mutual company as far as the policyholders are concerned.

Mr. Gabon: This structure didn't seem to solve the issue of putting additional capital into the mutual company. The 100/0 is put into the new 100/0 fund, but it's still undercapitalized, presumably.

Mr. Jenkins: I don't think capital was necessarily the issue for the Scottish Amicable demutualization. It had more to do with the long-term-future-of-the-organization argument. And although this is a new 100/0 subfund within Prudential, each company only has to produce one free-asset ratio. You actually have the free-asset ratio for the whole of Prudential backing these policyholders.

Mr. Andrew Chamberlain: And there was an additional feature in this scheme, whereby the investment policy was to be determined going forward with regard to part of the fund. There was a piece of capital earmarked within the main Prudential fund as available to support the former Scottish Amicable business in a dire emergency. So it wasn't added to the fund, but it was there to be called on. Most with-profits business in the U.K. is invested largely in equities. There is a considerable risk element, and having recourse to that additional capital means you can write that equity market for longer.

Mr. Jenkins: This business is administered partially in London and partially in Scotland. This business in Scotland is administered by the same people who run this company in Scotland, but it's actually a subfund of Prudential. The bonus rates are determined by the experience of the one part, rather than by the experience of all the parts, subject to the comments which Andrew just made.

Expense deals might shed some light on that question. Quite often with various restructurings, including demutualizations (but not only), we have a closed fund and an open fund. The closed fund often has with-profits business. You have these expense deals set up between the closed fund and the open fund, and the agreement says that the closed fund gets charged x pounds per annum per policy, going up with inflation, plus a certain amount of the funds under management. And that's it, nothing more. The expense risk is taken out of that fund and given to the shareholders. That's happened with the Scottish Amicable deal and others as well.

That gives less uncertainty for the policyholders and scope for the shareholders to make a reasonable profit. The charges would actually be intended to make the shareholder profit of, say, 10–15%. And slightly contentiously, there's scope for some further profits shareholders can actually increase the efficiency of the company. Andrew might say that if great expense savings are achieved, some of

those might have to go back to the policyholders, but it's a means by which a closed fund can be run down fairly successfully without large expense risks.

I've come across this in a number of situations now, including, for example, the Old Mutual deal, which I'll talk about later. The original mutuality concept envisions providing a product "at cost" with no profit margins or, alternatively, having all profits returned to the policyholders. Then there's a rationale for remaining mutual.

Some mutuals have made this transition and have more profit-making classes of business. The unitized with-profits and the unit-linked have the same charging structure. However much profit you make on the unit-linked, you must make on the unitized with-profits, at its simplest level. You actually find mutuals making profits on very large chunks of their business, and going out to do so. It strikes me that the rationale for remaining mutual is then much reduced, and actuarially it's a very short step to demutualize. That certainly was a characteristic of the Old Mutual.

Scottish Widows, Friends Provident, Scottish Life, Scottish Provident, Standard Life, Equitable Life, and National Mutual are the mutuals left in the U.K. Some are more likely to demutualize than others. Friends Provident could go either way. For Scottish Life, I think it's a question of when rather than if. Scottish Provident could go either way. There are strong rumors that Scottish Widows is going to demutualize. Equitable Life is an interesting case. It's the model mutual in the U.K., with extremely low costs. It got itself into a bit of a knot on guaranteed annuities, which it may or may not be able to survive. If it can get through that, the company probably has quite a good future. If it doesn't get through this particular problem, it could be sunk. It's probably the only life office in the U.K. that doesn't have to go out and sell. People knock on its door and say I want to buy a policy from you. Everybody else has to go hunting. And that's why their expense ratios are so low.

We've seen a spate of big mergers: AXA Equity & Law/Sun Life, Commercial Union/General Accident, and Royal Life/Sun Alliance. The latter two companies, which are composites, have general insurance business or property/casualty business in addition to the life. And in the second of these three mergers, the rationale for the merger was very heavily, I think, acquiring the casualty business, and the life business was tacked on. In the first one, it was generally two life companies merging.

The cost drivers are very strong. Although the companies have been merged, the with-profits funds, the main funds of the life businesses, haven't been merged yet in any of these cases. There's a bit of controversy over Royal Life and Sun Alliance, which tried to merge the with-profits funds. And there's a lesson for the

actuarial profession in that a number of actuaries formally said this proposed merger is fine, but the proposed merger didn't seem to pass the smell test. The published financial strength of each company was completely different. Royal Life is quite strong, and it got better recently. Sun Alliance was weaker, and it got worse recently, so they basically had to call the whole thing off. It remains to be seen whether they will try to do it again at some time in the future, but there's a bit of a lesson to be learned here.

IAXA-Sun Life has avoided attempting to merge the funds so far. It has the "old" AXA Equity & Law fund and the "old" Sun Life fund, and set up a brand new company called AXA Sun Life, where all the new business comes into. The new company's managers reassure the new with-profits business, that's all unitized with-profits (UWP), down to the old AXA company and the unit-linked business down to the old Sun Life company. And, to complete the circle, they've even reassured the old unit-linked business from the old AXA to the old Sun Life. They have quite a neat structure, with most of the with-profits business in the old AXA and most of the unit-linked business in the old Sun Life, although it does have a closed with-profits fund. I think they've done that to avoid tackling this rather gigantic task of merging the funds and having to address the orphan asset issues in one company in particular. I'll talk about that later.

Another interesting merger example is a case called Britannia Life, owned by a building society, which is like a savings bank. Managers had this idea to buy up other companies to get their volumes up and their costs down. They did actually complete a legal merger of two companies, Crusader Insurance and Life Association of Scotland, into Britannia Life. They went from three life companies to one life company, and we know quite a lot about this company because it's been an important client for us in the U.K. But the point is, it's very, very hard to achieve the expense savings. You can put the three companies into one legally, and that's what they did. But they basically have a big building with three sets of staff, three sets of computer systems, and three sets of everything else in it. They are now gradually integrating these operations and getting some expense savings. It's very, very hard work indeed. The lesson is that you don't get the expense savings and efficiencies just by shoving these life companies together. You really have to work at it.

We have two vulture funds in the U.K.: Century Life and Windsor Life. Vulture funds are companies that buy up closed blocks of business. I think it might mean something slightly different in the U.S. But these companies have made a business out of buying up closed blocks of with-profits and unit-linked business that nobody wants and running them off. Both of these companies have eaten several unwanted portfolios, on the order of five or six each, I think, and there's no doubt that many more of these portfolios are going to become available as the U.K. industry contracts. They can only eat slowly, though. Having gobbled

something up, they need to spend a year digesting it and integrating it properly, and then they can go on and do the next one. But they do it very well, and Century Life in particular has quite good systems.

Orphan assets are probably quite unique to the U.K. In certain U.K. companies, spare assets have been built up over a long period of time, and there's an issue which has been going around the last two or three years about who owns them. It was actually sparked off when AMP made an acquisition at a bit of a knocked-down price because no value was attributed to orphan assets. What happens is the shareholders seek to identify the orphan assets and get them divided up between the shareholders and the policyholders. A number of cases have actually been done: Britannic, United Friendly, London & Manchester, and Legal & General. One big case, Prudential, is outstanding, which is a bit of a puzzle, because it announced publicly two years ago that it was in discussions with the regulators. So far Prudential hasn't actually announced a solution, whereas all the others, 10 months after they announced that they were in discussion with the regulators, announced the conclusion.

There are also several mutuals with very large amounts of orphan assets, and it remains to be seen what happens with those. We know that there are some people with their eyes on these orphan assets, and the numbers are big. Britannic is a company with total assets of around about \$9 billion–\$10 billion, and the shareholders' orphan assets were identified as \$1 billion.

From the Floor: Can you give us some explanation as to how these assets arise?

Mr. Jenkins: A common thing among all these companies is they've written what we call industrial business, which is door-to-door collecting business. In the case of Britannic, most of these orphan assets came from the industrial business. Basically, over a long period of time, the policyholders weren't paid out the full amount that they were due, which sounds rather sinister, but in practice it's not quite as sinister as it may seem. The methods did not exist to calculate the asset shares in the way that they are now. When companies first started investing in equities, they were extremely cautious about paying out on the back of unrealized capital appreciation because they thought it would disappear again, but you cannot deny that a lot of it came from underpaying on previous maturities over decades. In some cases, it came from profits on nonprofit business which had been accumulated and in other cases from the shareholder putting capital into the fund a long, long time ago, which had accumulated with equity returns and is now quite significant. So I don't think it's quite as sinister as it sounds, although the amounts involved are mouth-watering.

Mr. Chamberlain: I think it's fair to say that it's the pre-computer age that is as much responsible as anything for this. These days, actuaries in the U.K. in these sort of companies will occasionally be looking at stochastic models of future equity returns and risk profiles of various shapes and sizes all very quickly with computers. Go back 15 years, and the actuarial valuation tied up the company's mainframe for hours, and they only got to do it once a year or whatever, so they simply didn't have the understanding of the risks and dynamics of the business that they can obtain today.

Mr. Jenkins: Britannic took its long-term business fund, which was all 90/10 (90% policyholders, 10% shareholders), and did a complete reorganization, and this was the remainder of the 90/10 fund. It put the nonprofit business, the non-participating business, into a 0/100 fund and that's where the shareholders' orphan assets reside. They're not allowed to get their hands on the capital under the Britannic scheme, but they can transfer the smoothed investment return on the orphan assets, 7% per annum, to the shareholders' fund each year. That enables them to add £70 million onto their dividend, which increases the dividend by a very significant amount overnight.

In one of the orphan asset restructurings, the company has actually negotiated to get some of the capital out after five years. Britannic, on the other hand, actually didn't want the capital out. Britannic has a very strong fund, and it was quite happy to maintain the strength of the fund. To have the investment return and keep the dividend up in order to keep predators away is very useful for them.

Third-party administration is a form of restructuring that is now very common in the U.K. New companies, particularly new bank insurance companies, are using third parties for everything. Other life insurers provide the service. In fact, Century Life, one of the vulture funds that I mentioned earlier, provides third-party administration. Also, there are specialist noninsurance companies as well, and you can outsource all sorts of things. I'm sure that sort of thing happens in the U.S. as well. You can actually have a virtual life office.

I thought we'd say something about Section 49 of the Insurance Companies Act. Some people call it Schedule 2(c) because Section 49 just says PC Schedule 2(c). I still use the old term. It's a means by which you can transfer portfolios of insurance business from one company to another. It gets used for demutualization where you form a brand new company with no business in it and transfer across the business in the mutual. But it's broader than demutualization. You draw up a legal scheme. You get a report by an independent actuary because that's what the law says. There are often reports by the two appointed actuaries of the giving and receiving life companies. Although that's not mandatory, it's quite common practice for it to happen now. You send a summary of the whole scheme to policyholders and give them a chance to

object, and they can turn up at the court hearing. You have a court hearing where everybody is allowed to speak. The judge bangs his gavel, and it's implemented.

Mr. Gabon: How long is that process?

Mr. Jenkins: It probably takes six months to a year for a complicated case. Simple cases can get through quicker than that. In fact, somebody once told me that, if you could actually get the legal signature of every single policyholder, you wouldn't need to go through Section 49.

Mr. Chamberlain: Yes, you would.

Mr. Jenkins: You used to be able to avoid it, but now you can't?

Mr. Chamberlain: You do have to go through it, yes.

Mr. Jenkins: But I think there were some transfers of reinsurance business, and if you're a reinsurer, you only have a small number of policyholders. So, it is more feasible to get the signature of every policyholder. But, as Andrew said, you do have to go through Section 49 now anyway, unfortunately.

Mr. Gabon: I think you'll see the procedure is very similar to many of the state requirements in demutualizations or mutual holding company conversions, but what might differ is the detail behind those items. For example, a state may require that, say, two-thirds of policyholders must be in favor. I'm not sure what the specific thresholds are or what needs to be circulated to policyholders. There's the definition of a closed block. I think you touched on that. Certain issues like that are fairly similar, which is interesting.

Mr. Jenkins: Well, so much for the U.K. I'll have a quick canter through some other territories, which is partly a mixture of my own experience and partly some input from my KPMG colleagues around the world. If you ask a difficult question on some of these territories, you might stump me. Australia is relatively similar to the U.K. It has been through a spate of demutualizations. In fact, my colleague over there actually describes it now as being complete, which basically means that all the significant mutuals are gone. There's been rationalization and acquisitions and, interestingly, quite a lot of former U.K. companies deciding to pull out of Australia and sell their business to Colonial and local Australian companies. I think that's partly because of the problems that they face in the U.K. They have their hands full sorting out the U.K. and don't particularly want to run another operation down under. And Australia also has been putting all the regulatory bodies under the same regulator instead of having one for banks and

one for insurance companies and one for whatever else. It's now all under one regulator in Australia which is very similar to the U.K.

There are a few noticeable trends in that market. One is separation of risk and investment, which is happening a little bit in the U.K., but I wouldn't say it's a major feature at the moment. Another is the rationalization of old product types into new ones, which has already happened in the U.K. All new with-profits business becomes unitized with-profits. We have a fairly stable situation there now. There's no new fundamental product development going on. There are a few fancy funds and guaranteed equity products, but fundamentally the other product development has plateaued. And in Australia they focus more on the value of customers and distribution channels, and that applies equally to the U.K.

South Africa is an interesting country, and I did spend quite a lot of time down there last year on the Old Mutual deal. Maybe you'd be interested to know that there is no company called Old Mutual. It's actually called the South African Mutual Life Assurance Society (SAMLAS), and Old Mutual is just a nickname for it. And there is another one called SANLAM. You have all these mnemonics in South Africa, SAM this and SAN that, and nobody can really remember now what they stood for. Both companies floated on the stock markets, demutualized, and gave shares to all the existing policyholders. There was no one big purchaser coming along. The Old Mutual one hasn't happened yet. It floats on the U.K. stock market on July 12, 1999.

The Old Mutual deal is interesting because the top-level holding company is a British company registered in London. The floating on the U.K. stock exchange caused quite a few political problems in South Africa. Some politicians in South Africa didn't want that to happen. And what basically drove it was the need to access capital and the problems surrounding capital import and export within South Africa. But Old Mutual did actually manage to persuade the regulators to let them do that. It's going to be listed on the Johannesburg stock exchange and one or two others as well, but the primary listing is London.

Another interesting feature of this company is that it owns one of the biggest banks in South Africa, which raises some very interesting problems, such as whether this particular insurance company should be owning a bank. The bank (Nedcor) is actually more profitable than the insurance company. I'm not going to go into the details, but that did cause quite a few technical problems.

Old Mutual is one of the companies that sparked off this philosophical point that I made. It was levying participation charges on the policyholders' funds, similar to a fund management charge, of 1% per annum, for three or four years at least. I think the managers borrowed the concept from AMP when it was run as a mutual. But, they were actually running the thing as a proprietary company and

levying charges on the policyholders, and they were going into a shareholders' fund, but there were no dividends being paid because there were no shareholders. Arguably, what they've actually got now is a much more honest structure. They're levying charges on the policyholders, and the policyholders will actually get the dividends. There's also been a number of acquisitions and rationalizations in South Africa just as in any other territory.

Germany is an interesting place. The Germans have a distinction between large and small mutuals. The small ones are very much like clubs and apparently not of much interest to serious financial services players. The larger ones, according to what my colleagues in Germany tell me, don't act like genuine mutuals. They announce explicit profits each year, in the same way as the U.K. building societies did. There are not many left now, but when the building societies were still mutual, they used to announce profits, which always struck me as being rather unusual. The mutual building societies would announce record profits and nobody would stop to think, "Hang on, this is a mutual company." The mutual life offices wouldn't announce any profits because they were mutuals.

The German mutuals seem more like proprietary mutuals. Germany has quite a lot of horizontal affiliations between mutuals, other insurance companies, and banks. They're gentlemen's agreements with nothing particularly written down.

One recent large merger between HUK-Coburg and HDI has created the third largest insurance operation in Germany. Apparently, this had nothing to do with cutting costs. This was a merger to grow and compete with Allianz.

There haven't actually been any demutualizations in Germany yet, and one point which I did manage to establish from our German office is that the "orphan assets" issue has recently been through the German courts as well. The Germans call them "hidden reserves," but from what I can tell, it's very much the same thing. Andrew might be interested to know that the German courts have decided that policyholders have no interest whatsoever in any of the hidden reserves that any of these insurance companies have. This is a completely different view from that of the U.K. regulators/courts.

In France, there's a similar distinction between small and large mutuals. The small ones are like clubs, and not of much interest. Somewhat surprisingly, demutualization is currently regarded as legally impossible. It would be akin to a liquidation, and that causes great problems under French law, as the mutuals are viewed legally as a collection of individuals rather than a corporate body. We have something in the U.K. called friendly societies, mutuals that, until recently, had no legal corporate existence. They were considered a collection of individuals getting together to do things together. The Friendly Societies Act of

1992 allowed them to incorporate and become corporate bodies in their own right.

Belgium is similar to France. It only has one very large mutual. The others are very, very small and groupings of individuals rather than corporate bodies. So, demutualizing them is particularly difficult.

Mr. Chamberlain: I will cover some of the types of reorganization. Bear in mind that I'm from the U.K. and I advise the regulator. I'm going to be talking entirely from a U.K. perspective. I can't give the views of other regulators around the world because I don't know what they are. I can guess a bit, and I'll try and pick a few points out where I can. I'll focus fairly heavily on demutualizations because it's such a topical subject all around the world, but many of the comments apply to other reorganizations as well. I will go through one or two of the experiences from a regulatory perspective and touch on "transfer or transformation," which has an interesting difference in the U.K. Maybe it's a European distinction.

With respect to types of reorganization, demutualization is the obvious one. Mergers create many of the same problems, as do reconstructions, the sort of thing that Britannic went through in reconstructing the funds. In many ways, the issues from a regulatory perspective are very much the same.

Let's look at the issues involved in mergers of insurance funds. When do they take place? Very often they follow the purchase of one company by a different group. That's the most common single instance. They also take place, however, within a well-established group. Maybe for tax reasons or some other reason, they previously operated through more than one insurer and the original reason has gone away. Now they want to bring those insurers together into one corporate entity. And finally, you get some partial transfers, where only part of the business of a company is being moved into another company.

The first issue that the regulator tends to be interested in is whether there is any participating or with-profits business either being transferred, most significantly, or otherwise involved. You start by taking a block of profitable unit-linked business or other non-participating business, which in the U.K. may well form part of the participating fund. If you start moving that to a shareholder-owned company, will profits go with it? Clearly, there could be issues for the policyholders. Are the existing rights of policyholders actually clear?

Here, we have the disadvantage of history. Many of our companies have been going for a long, long time and the rules set out when they were set up are far from clear. As in Germany, there were an awful lot of gentlemen's agreements, or understandings. Nobody ever wrote them down. And modern investors in

proprietary companies tend to be a little less gentlemanly than some of their predecessors were.

If you are merging participating funds, are the participating terms equivalent? Are their rights very different? John mentioned 90/10 funds, but there are participating companies where the shareholders have set up the funds on a fixed-charge basis. If you have the two sorts of business, one where all the profits go to policyholders and one where only 90% does, and you put them together, how do you decide how much attracts a shareholder's share and how much doesn't?

Are the financial strengths of the two funds the same? Clearly, if a policyholder is in a strong fund merged with a weaker fund, you end up with a sort of middle-strength fund. In fact, the Section 49 transfer arrangement was originally introduced into U.K. law in 1870, following a scandal in the 1860s. One particular company had absorbed company after company after company before this process took place. It was a reasonably strong company, but it kept taking on weak companies. By the end, you had one very large weak company, and it went belly up. So, in the 1870s, they still had to deal with that sort of problem.

Most reorganizations are seen in proprietary companies. Mutuals don't tend to reorganize unless they go whole hog and demutualize. Usually they aren't involved with this orphan assets issue. There is a participating fund. Policyholders have rights to profits, but what rights do they have? Does it include a block of assets that's just sitting there and not really doing anything? Some constitutions of companies are fairly clear, and the policyholders do have rights; some are very clear, and policyholders have no rights. But in most funds, it is not clear. Although the policyholders were sold a policy that said they participated in the profits of the company, it was never made clear which profits of the company they participated in and which they did not participate in. And, in practice, they receive bonuses based on various different methods, but never encompassing the whole. Was that because policyholders weren't entitled to certain profits or was it because companies had just decided not to pay out all the profits?

The process of reorganization is done completely by regulator consent. There is no court process. The company decides it wants to change its articles of association, which is one of the legal parts of the structure of any company in the U.K., or otherwise make amendments to the way it runs its insurance funds. All it requires is the consent of the regulator. This is a passive consent, in fact. They don't require a piece of paper from the regulator saying, "You may do this." They require a piece of paper saying, "If you do this, we won't exercise the powers of intervention that we have." It's the same thing.

There have only been a handful of reorganization cases in the U.K., and most of them have been focused on the industrial business—the old door-to-door premium collection—once a substantial part of the insurance business in the U.K. but is now a very minor part and rapidly declining. I think there are only three significant players left in the industrial business market: one mutual, one proprietary (Britannic), and one company that is almost a mutual but actually has some shareholders (they're only allowed to take about £12,000 a year in profits out of the company). The latter is part of the cooperative movement. The insurance companies buy a collection of cooperatives and run it effectively as another cooperative.

Let's go on to demutualizations. There have been various types of demutualizations, various motives, various changes for policyholders, and, indeed, quite a lot of different forms of compensation to the policyholders for agreeing to demutualize.

So what are the main types? Rescue, which is pretty obvious; purchase, when another party acquires the mutual; and flotation. I thought you'd know what flotation clearly meant, but this is another case where we use a word that you don't. Companies have talked regularly about being floated on the stock exchange. It's not a particular insurance term. And this has been a possibility for one and an actuality to another.

What have the motivations for demutualization been? Creating a more appropriate corporate structure is often been quoted as the reason. You can tell me what that means if you like. Access to capital much more frequently is the reason. "More appropriate corporate structure." I'll tell you what that means—management aspirations—and I think I need say no more. Sometimes it has to do with strategic investments that are just simply too large for the mutual organization to hold. For example, a mutual life insurer could have underneath it a large general insurance company. This asset could be enormously valuable, but it's a capital asset, not something you can distribute to policyholders as bonuses or whatever. This causes some difficulties, so isn't really an appropriate structure. Sometimes companies cite regulatory constraints as the reason for seeking a more appropriate corporate structure. I don't know what that means right now. We're a very helpful lot.

Gaining access to capital is necessary to fulfill management aspirations, a strategic financial imperative, or solvency requirements. Sometimes these last two are the same thing. The strategic financial imperative is to stay solvent in a statutory sense, but sometimes the strategic financial imperative is not quite solvency. In this case, companies have particular requirements for operating in different markets, building integrated financial services organizations, or so forth.

And, either they're going to end up with a large, bulky, inappropriate asset or they need more capital.

What changes do the policyholders see? They lose their voting rights. That's the most obvious thing. They can no longer elect the board of directors. However, in the U.K., most of the policyholders who turn up to the annual general meeting are staff people, usually the salespeople. A lot of mutuals are actually run by the salespeople for the salespeople.

Their participation in the fund changes character. They may no longer enjoy benefits or otherwise varying expenses. They may be on fixed expenses. There may be a proprietor's share of all profits, including the investment profits. And I can't emphasize too much how important investment-oriented with-profits business is in the U.K. Most of it these days is what we call pension business, or deferred annuity business, and it's an asset accumulation vehicle. Most of it is lifetime. Investment returns are critical, typically invested in equities. If 10% of your return is going to go to the proprietors, it's quite a different characteristic. New business strain, however, can be removed by one of these processes. You find that that can be quite beneficial to the current policyholders. And there can be other changes as well.

The forms of compensation we see are cash payments or stock. But if cash payments are being made or stock is being issued to policyholders, what are they losing from their policies? Immediate policy enhancements take place for any compensation that goes through in that form and is being recycled into policies. As policyholders, they're probably not losing anything.

Additional money can be put into the participating fund. This is what happens when proprietors are buying a future share. They're buying a future 10% of all profits. So, they put more money in, which eventually will emerge as their 10%, if everything works out according to plan.

Then there are all these external support mechanisms. The Prudential/Scottish Amicable one was a good example. The one that is still developing, NPI, is another example in which support mechanisms will be put in place to add security to the with-profits fund.

In the U.K., we've had several "purchases," at least one "rescue," and one major "flotation." Some of the others might have been rescues, but there's only one that we could categorize as such. The Australian flotations, such as AMP and Colonial, were the ones that had an impact on the U.K. Then we have the Canadian proposals, only two of which now affect the U.K.: Sun Life and Canada Life.

Scottish Equitable was a purchase. I'm just picking a few at random here. This was a purchase by a non-U.K. insurance group, Aegon of the Netherlands, a well-established company. A closed fund was established for the with-profits business, and a rather complex system was set up whereby the nonprofit business was gradually transferred from the with-profit policyholders to the acquirer. There also was a complex voting trust arrangement of some type. I don't quite understand how it worked, but it gave policyholders some control over the company in the transition.

Scottish Mutual is still allowed to call itself Scottish Mutual, although it's no longer mutual. It was simply acquired by a bank, which was quite controversial at the time, but they got away with it. And that was a much more simple, straightforward exercise.

Scottish Amicable's purchase was complicated a lot with arrows going in various directions on John's diagram. Quite different solutions were selected for all of these purchases. The only thing they have in common now is that they're all called "Scottish."

The rescue was a company called Provident Mutual that was probably the first company that actually hawked itself around, but it managed to keep it a secret. It needed rescuing, and General Accident came to the rescue.

One major flotation was Norwich Union. And we have the two Australians flotations. Colonial was the first. This was a very difficult example for the regulator because Colonial got itself into trouble in Australia. The U.K. branch was quite robust, fairly well-off, not particularly large, certainly not a big player in U.K. terms, but a very significant part of Colonial, however. Colonial got in the position where it had to withdraw money from the U.K. branch to support the rest of the world operations. This was despite the fact that, in Australia, the legislation provides for separate statutory funds that are supposed to stand alone, but it appears that they only stand alone when it suits them. When it doesn't suit, there are ways of transferring money between the branches. That was quite a difficult one because we ended up having to deal with a company that was getting a lot weaker.

AMP was a complete contrast. AMP's U.K. branch was very small, apart from the fact that it had acquired a company called London Life. And London Life in the U.K., up until the point it was acquired, was very much like the Equitable Life in the U.K.—a very high-quality client with fairly low acquisition expense because it didn't tend to pay commission. It was a very popular home for the policies of lawyers, actuaries, accountants, and so forth. This made its technical merger with AMP quite a controversial issue because there were an awful lot of people who knew an awful lot about it and knew how to make a lot of complaints. But

AMP was actually adding financial strength to London Life, which somewhat overreached itself during the 1980s. That made the flirtation of AMP quite an interesting issue in the U.K., because only less than 10 years after this controversial merger, they were floating. Actually the London Life policyholders ended up doing extremely well.

Then we come to the Canadian proposals, Canada Life and Sun Life. These are currently approaching their court dates within two weeks of each other. It's quite clear that the U.S. sensitivity for antitrust doesn't quite extend to Canada, where their proposals are remarkably similar. We could think they were following a common script, but they're not quite. We've seen enough differences to know they're not following a common script, but there have been a lot of difficulties because the attitude of the Canadian regulators seems to be much more toward creating a company with high shareholder value, whereas the U.K. regulator has always been more concerned with ensuring that policyholders are looked after. I'll now to talk about the objectives of the U.K. regulator.

First and foremost for any regulator, solvency must be ensured. Second, we have an expression in the U.K. called "policyholders' reasonable expectations," which they're also using in Canada. It's been in the U.K. legislation since 1973, and it was encapsulated in a concept that was originally talked about by actuaries during the previous five or so years. Nobody actually knows precisely what it means, and it's an interesting issue of debate. And third on the regulator's list is value maximization. It is important. We don't want to see the value of the mutual not fully reflected. Policyholders' reasonable expectations is usually the key one, because solvency is a statutory expression. There is no definition in statute. So the regulator has come up with a guideline for demutualizations in particular. We should expect no reduction in policy benefits. Any demutualization benefits that are not in the form of policy benefits must come from the sort of things that wouldn't end up in the policy. Goodwill is a good example. The source of the compensation funds can, therefore, be quite critical.

There's also an expectation in relation to risk and reward. This brings us to the issue of things like fixed expenses. If a company currently has high expenses, the regulator would say you cannot go for fixed expenses because the policyholders would reasonably expect the management to try and bring them down. If they're currently above average, there's a good expectation of achieving that, and, therefore, are the fixed expenses actually a benefit? It's often because there's been some improvement program that hasn't yet delivered, but it can just be that management is not very good. But policyholders' reasonable expectations is the key area that the U.K. regulator ends up debating with all reorganizations.

A small technical issue John mentioned is Section 49 and Schedule 2(c). But there is no procedure within the U.K. by which a mutual can turn itself into a proprietary. There is no legal transformation procedure. And, indeed, we had to tell the Canadians that their method of transformation meant they could not continue to operate as a branch through the transformation. Same with the Australians. It is simply not legal to do so. Therefore, the practice is to transfer the business to another insurer, often a funding vehicle, but not always. Sometimes you can back the mutual into one of its subsidiaries, for example. As I say, this applies even to non-U.K. insurers if they're operating in the U.K.

There won't be many overseas mutuals left by the end of 1999. In fact, I can't think of one. There aren't, in fact, many branches left in the U.K. after the Canadian demutualizations. There's a branch of American Life or whatever it calls itself these days; it keeps changing its name, so I'm always losing track of it. There's a branch of the State Insurance Company of Pakistan. There's a branch of the Life Insurance Corporation of India. There are a few European branches operating, but under European law they're no longer the U.K. regulator's province.

Mr. Gabon: On the vulture companies and your mention of buying blocks of business, do they pay a premium and/or are they interested in distribution as folks in this country are in terms of mortality and expenses activity? Distribution is a big part of the package frequently.

Mr. Chamberlain: The answer is, no, they're not interested in distribution at all, and that's why they tend to be called vulture funds, because they hover around waiting for something to die, and when it's dead, they pick it up. If there's any breath left in it, somebody probably comes along and buys the distribution. That may then leave you with a subject for the vulture funds, and that often happens. You find that a company will sell off its distribution and then allow itself to be acquired by the vulture. Also, the structure of U.K. business is such that virtually any block of business, because of the regulatory capital tied up in it, has a net present value. So they're always paying something. Whether they're paying full value is more debatable because they're in it for a profit.

Mr. Jenkins: We've had a number of experiences at KPMG with these transactions, and they will pay what we call embedded value, present value of future profits, provided that present value is calculated on a sensible basis. And you often find that the vendor produces a document saying, "Here's the embedded value of this. We want a £100 million for this block of business." They will go through it being very critical on the assumptions, and once they've gotten down to what would generally be regarded as sensible assumptions and not overoptimistic assumptions, then they will be willing to pay that price, but they won't overpay.

They're sufficiently experienced, and they know the hassle that they will get into, but there's one area where they are quite clever. Supposing you have an existing owner of an insurance company whose expenses are £30 per annum per policy. During the negotiations, the existing owner and the vulture fund will look at an embedded value, calculating it on £30 per annum per policy. What the vulture fund buyers won't tell you is that when they actually get it integrated into their system and into their operating efforts, they'll get the expenses down to £15 per policy. That's where they pocket their money, by buying it based on one set of expenses. Normally, the companies doing the selling are pretty inefficient, so they may say, "We're getting the embedded value for this based on our expenses. There's no loss on our balance sheet." But when the vulture gets it and integrates it, it'll be on a much lower expense base, and that's how it makes its money.

Mr. Gabon: When these mutual companies are being bended and folded and 49'd into their new corporate structure, how do the policyholders react to this? Are there shock lapses or are they just glad to have a new piece of stock in their pockets?

Mr. Chamberlain: I would say the latter. There's been a spate of demutualizations in the U.K., and the building societies, as we call them, or savings banks in your terminology, have demutualized. The experience seems to be that people just want the cash in their pockets now to buy a holiday. The fact that their mortgage interest rate is going to be 3% higher for the next 25 years doesn't cut any ice. And I think it's probably even worse for the insurance companies because most of the policyholders won't know whether they have a policy with a mutual or a proprietary. They'll know they have a policy with Standard Life, and somebody else has a policy with Prudential. But if you ask them if they're with a mutual company or a proprietary, even among the ones who know the difference between the two, the vast majority wouldn't know whether Scottish Life is a proprietary or a mutual.

Mr. Jenkins: Unless it's called mutual, but not even then. We know one actuary in the U.K. who does work for the selling regulator rather than the solvency regulator, and, quite honestly, the regulators at the time of the Scottish Mutual deal just did not wake up to the fact that a company called Scottish Mutual was demutualizing and still wanting to call itself Scottish Mutual. Had they picked up on that point sooner, they would have prevented that happening.

Mr. Chamberlain: I'm not sure they could have done anything about it anyway.

CHART 1
U.K. DEMUTUALIZATIONS STRUCTURES
METHOD 1a

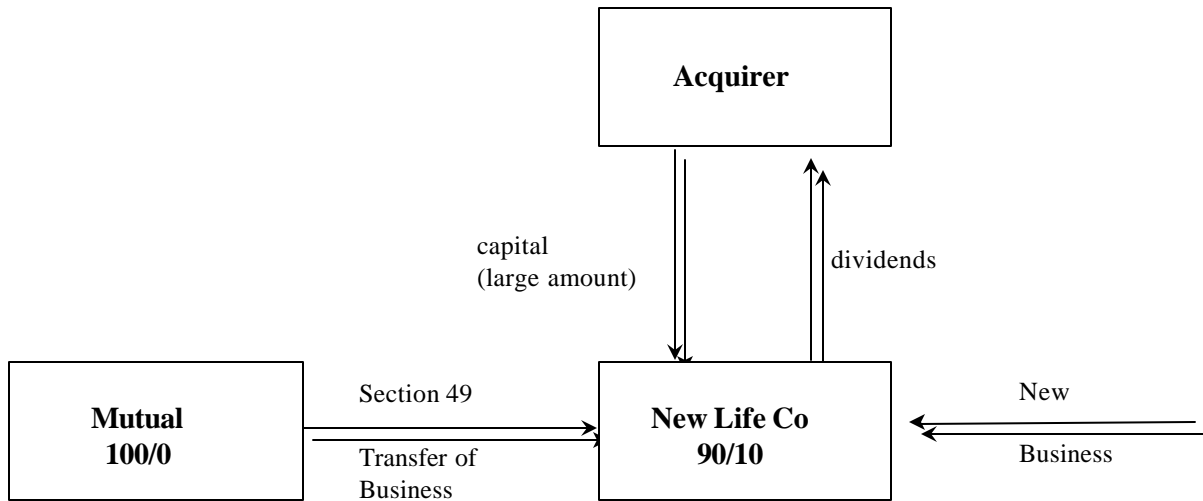
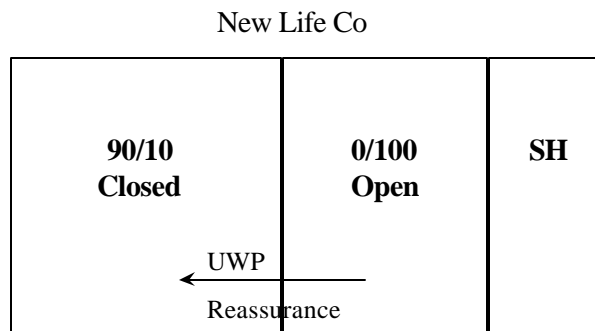


CHART 2
U.K. DEMUTUALIZATIONS STRUCTURES
METHOD 1b

As Method 1a, but . . .



■ more common than 1a



Examples:

- FS Assurance
- Scottish Mutual
- Clerical Medical
- Colonial