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Treatment of Closed Blocks in Demutualizations

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Summary: Standard demutualizations and holding company formation often create a “closed block” of participating policies. This session covers some of the issues underlying closed blocks as well as the Actuarial Standard of Practice Exposure Draft and the American Academy of Actuaries Practice Note, which were recently developed to provide guidance to actuaries developing closed blocks.

Mr. J. Peter Duran: I’m a partner with Ernst and Young in New York. Godfrey Perrott, a principal with Milliman & Robertson in Boston, has been heavily involved in demutualizations and chairs the Actuarial Standards Board (ASB) Task Force that is currently drafting an Actuarial Standard of Practice (ASOP) on closed blocks. Our second speaker will be Mike Slipowitz, vice president with Mutual of New York. He is responsible for financial reporting and forecasting for GAAP, statutory valuation, and cash-flow testing. He’s been heavily involved with the development of Mutual of New York’s closed block for its demutualization. Our final speaker is Barry Shemin, senior vice president and corporate actuary with John Hancock. Barry has been heavily involved with the actuarial aspects of Hancock’s demutualization, both the allocation of consideration to policyholders and the closed block. He chairs the ACLI’s Actuarial Committee. Godfrey is going to speak about the ASOP that’s being drafted, and then Mike and Barry are going to address the specific issues that they have faced at their companies in developing a closed block.

Mr. Godfrey Perrott: I’m going to give you a brief status of the closed block ASOP, talk about what a closed block is and some key concepts, discuss what guidance is

available from the draft ASOP, and talk about the status of the Academy practice notes.

The closed block ASOP has been exposed. The exposure period is over. We received 18 comment letters. The only significant issue the comment letters raised was the question of the reinvestment rate and, in particular, how that interacts with any change in investment policy before and after the closed block is formed. Some of the comment letters clearly indicate some misconceptions about what a closed block is or, maybe more important, what it is not. The task force is currently digesting the letters, revising the ASOP, and preparing a document that talks about the comments we got and what we did with them. Our objective is to present a revised standard of practice (SOP) with the appropriate cover documents to the ASB in December. We hope it will approve it after the usual editing. This assumes that the Life Committee of the ASB also approves it, but I anticipate that this will happen before December. Assuming that happens, the final SOP should be issued at the end of 1998 or in very early 1999.

What does a closed block do? It controls the overall dividends paid over time, does constrained management in aggregate over time, provides that all of the regulatory discussion can occur at one time instead of over the next 50–100 years, and accounts for the cash transaction of the closed block.

What does a closed block not do? It doesn't affect any benefits of the closed-block policy other than dividends. They're still policies of the insurance company, and all of the insurance company assets still stand behind the contractual benefits in those policies. It does not meet its own surplus; the policies are protected by the surplus of the company. It doesn't control the allocation of dividends by class. The dividend actuary still has to perform the allocation, and it's still controlled by *ASOP No. 15*. It doesn't control the exact timing of dividends. The theory that has evolved around closed blocks is that they provide what has been called a "glide path" for the statutory surplus to reach zero. The dividend actuary and management of the company are trying to manage the dividends to keep close to that glide path, but it is not something that has to be followed mindlessly, particularly when that would disrupt the business.

The key concept of the closed block is that, if the experience underlying the current dividend scale continues without change, then the company will be able to pay the current dividend scale without change. If the experience is more favorable, more dividends can and will be paid. If it's less favorable, fewer dividends will be paid. As part of this mechanism, the initial assets of the closed block are less than the initial liabilities. The difference between them, ignoring for a minute treatment of expenses, is the present value of expected profit. Furthermore, most closed blocks

have been funded without expenses because one of the purposes is to have all of the regulatory discussions at one time. If a company continues to allocate expenses to the closed block, there is always the potential for discussion of its allocation methods, which are never precise. And there will always be a difference of opinion, so the typical structure has been to keep the expenses outside the closed block, make them an obligation of the rest of the company, and not fund for them within the closed block.

What does a company do to set up a closed block? First and most important, it defines the operating rules and then calculates the funding to determine what assets are needed. The operating rules, very simply, say what is charged to the closed block, what is credited to the closed block, and what assets it will receive initially. Benefits, investment income, and premium, are credited or charged to the closed block. Typically, expenses are not charged to the closed block, but taxes are.

Once you have a set of operating rules, in order to calculate the funding, the actuary starts off with a projection of liability cash flows, which typically includes, even though they're not a liability, a projection of policy loan activity, what the utilization will be, and what investment income will be received on them. In this projection, you assume that the current dividend scale continues without change. There are only two intellectually consistent ways to fund a closed block. One is to continue the current dividend scale without change, which as a corollary means that you need to project using the assumptions underlying the dividend scale, rather than current assumptions. That's particularly true with respect to the reinvestment rate. The alternative is to project using realistic assumptions and model the change in the dividends that would result from those assumptions. The 1987 report of the SOA task force recommends strongly using the former approach. I believe it's because trying to convince or reach closure with regulators and their advisors that you have projected the true way dividends would change with changing experience would be almost impossible. It's an easier task to identify what assumptions underlie the current dividend scale, and project forward using those assumptions.

Having projected the cash flows, you discount them at the after-tax equivalent of the reinvestment rate to determine the initial funding. You then select a trial set of assets that approximately match this initial funding, and project the closed block starting with the trial assets, with their own investment cash flows and repayments, and investing all available cash at the reinvestment rate. You'll probably find that at the end of the closed block projection the surplus isn't zero. You use that to adjust the initial assets, and reiterate until you have the correct funding.

The last thing you need to do as part of the funding, which can be complicated, is determine how the funding will be adjusted for interim issues. Typically, a closed

block is established before a company demutualizes or converts to a mutual holding company, but the policies that are issued between the establishment date of the closed block and the conversion date are included in the closed block. Some method to adjust the assets appropriately has to be determined.

What are the key points of guidance in the draft ASOP? Most important is that the funding calculations should be based on the plan of operations. The sequence has to be: (1) design the closed block and (2) determine what funding is needed to operate it. The second key point is that the actuary must understand any changes planned in the investment policy from the time period before the closed block until after the closed block. The third key point is that the assumptions underlying the dividend scale should be current, even if the dividend scale has persisted for some time. Our conclusion was that, in effect, a company keeps readopting its dividend scale even if it hasn't changed it for several years, so the most recent period is appropriate. And finally, the ASOP includes some guidance on what type of business should or should not be included in the closed block.

Simultaneous with the drafting of the ASOP, an Academy committee chaired by Henry Siegel drafted two practice notes: "Policyholder Protection" and "Accounting for the Closed Block." The practice notes will be released shortly after the ASOP is adopted. Each practice note consists of a set of questions and answers. The practice notes are statements of what people do, but are not intended to be guidelines.

Mr. Michael Slipowitz: Mutual of New York is undergoing the process of demutualization under Section 7312 of the New York insurance law, the statute governing demutualizations. We announced our intention to demutualize in September 1997 and our board of directors approved the plan of reorganization in August 1998. Our policyholder vote is scheduled to be completed in early November, and our goal is to have the plan's effective date set prior to the end of 1998.

In setting up the closed block, the eligible policies for us were individual participating policies that had a dividend scale payable in 1998, and they needed to be in force on or shortly after the plan's effective date. The 1998 issues will be included in the closed block. In addition, nonforfeiture, extended term, and reduced paid-up options, will be included in the closed block.

Legally, the extended term option for our company is a nonparticipating contract, but because it's so closely allied to the original participating policy, we reached agreement with New York to include those policies in the closed block. Most of our term insurance contracts were excluded. Even though they're participating for

the most part, there was no expectation of paying a dividend and no dividend was being paid. We also excluded some participating policies, such as individual medical care and disability income, because of the very limited amount of dividends being paid. We have some protection of the dividend scale in the sense that we will be required to monitor the assumptions underlying the calculation of actuarial equity shares and, in addition, follow rules such as Regulation 62 in providing certain guarantees about the dividend scale, depending on what occurs. But we will not include them in the actual closed block. When we looked at the reserves in the closed block, essentially 99% are for life insurance and less than 1% are for participating annuities.

In setting up the funding, we needed to determine the amount of assets that, together with future premium flows and investment income, are reasonably expected to support benefit payments, policy loans, certain expenses, federal taxes, and, if the experience underlying the current dividend scale continues, the dividend scale as well.

We had the funding established effective January 1, 1998; however, we are including the 1998 issues, and we will be making a deduction against the closed block funding in terms of a present value factor per thousand of face amount of insurance. It's a deduction against the closed block funding because you are at the very beginning of the policy, have most of your acquisition costs behind you, and essentially need negative amounts of assets at an initial starting point. We'll be making those deductions as soon as possible after the plan effective date.

We will be doing another deduction 60 days thereafter. If a policy application is received prior to the plan effective date and goes through underwriting in a timely fashion, then it will also be included in the closed block. Other aspects of the closed block funding we had to look at were deferred and uncollected premiums, policy loans and related accrued interest, and in-process death claims.

When we selected the assets, we excluded equities such as real estate or common stock. About 85% of the assets were bonds, the vast majority of which were investment-grade bonds, and a limited amount of NAIC-3 bonds. We also had some commercial and farm mortgage loans in the closed block. When we defined the investment strategy in calculating the closed-block funding we didn't have any equities assumed to be purchased. Again, primarily we'll be investing in investment-grade bonds, NAIC-3s, and mortgage lending, as long as certain minimum debt-to-coverage ratios are maintained on the properties underlying the mortgage.

One of the key assumptions, as Godfrey mentioned, is the reinvestment rate underlying the closed block funding. You will need to determine whether there's any impact from switching the characteristics of the assets prior to the demutualization and establishment of the closed block, where you had an equity component in your dividend scale compared with the reinvestment rate you might have with your fixed-income-only portfolio. We don't expect to have any borrowing, but if any does occur, that would be made at the reinvestment rate. We also had to cover assumptions, maturities of assets, prepayment assumptions, and default. For some of the mortgages, we had to expect some refinancing. You need to consider sales assumptions, although we didn't expect that for our portfolio.

To avoid the subjective allocation of expenses, we will not charge any expenses to the closed block. The only exception would be if we do end up foreclosing on a mortgage. Until we dispose of the loan, we would reflect any direct property expenses, such as real estate taxes or property maintenance costs.

On the product liability side, we built assumptions in for mortality, persistency (where we looked at differences between base policies), additions, and nonforfeiture options. We reflected policy loan utilization rates, which reflected differences between fixed-loan-rate policy activity versus variable-loan-rate activity. We also had assumptions for the use of dividends that varied by different policy classes—for example, buying paid-up additions or leaving money on deposit, using it to reduce premium or taking it in cash. The only expenses that we will be charging in the closed block are premium taxes and unrecoverable guarantee fund assessments. We will not charge the renewal commissions nor any litigation expenses to the closed block.

You end up with a closed block deficit because of the exclusion of most expenses and the conservative statutory reserves. Consequently, the amount of assets were significantly less than the statutory liabilities.

Another thing we had to consider was reinsurance. Many of the closed-block policies had participated in our facultative reinsurance program and automatic reinsurance program. We looked at the treaties we had in place and our historical experience and did reflect that cost in the closed block funding. In contrast, we did not reflect financial reinsurance in the closed block at all. We also had to consider waiver of premium on disability and modal adjustments on premiums.

Federal taxes are charged to the closed block as if it's a separate but affiliated life insurance company. Cash will be withdrawn from the closed block throughout the year. Then, at the end of each year, to reflect the proper share and to the extent there's any IRS adjustment on audit for prior year returns, we would go back and

reflect that in the closed block as well. We have to follow established procedures for line of business allocation. In this case, the closed block is looked at as a line of business, so we must comply with Regulation 33 to determine the share of federal taxes for the closed block.

We also had to take into account the existing deferred acquisition cost (DAC) tax balance and how that was scheduled to be amortized, and reflect the DAC tax on future premium flows. Although we don't expect this to happen, if the closed block ever shows a loss or deduction and the corporation as a whole can use that deduction, then the closed block would get credit for the loss.

The accounting for the closed block is fairly extensive, and we set up a separate general ledger for it. It will have its own cash book, and we'll be monitoring cash flows in and out of the closed block throughout the year. Numerous areas of our company, and I'm sure any company that goes through this, will have to be involved in this process. We have significant involvement in our information technology area, policyholder service area, accounting, actuarial, legal, and investment departments. They'll need to be clear on the investment strategy and the cash flows of the closed block. We had extensive involvement from our outside auditors, PriceWaterhouseCoopers, which has done a fine job advising us on the actuarial side. The auditors looked very carefully at the procedures that we've established to ensure that we're following everything we will need to follow to make sure the closed block is accurate. We'll be filing an annual statement, we hope, every July 1, based on the preceding year, that will cover typical blue book pages, assets, liabilities, deficits, cashflow, and various schedules.

How do you manage dividends under the closed block? Well, we haven't done it yet, so I'll tell you what I think we're going to do. If the experience is better than what's underlying our current scale, in the long run, we will increase our dividend. If experience is worse, we'll decrease it. At management's discretion, the dividend can be supported by assets outside the closed block. So, for competitive reasons, if that is the way to go, then we would consider doing that. Mechanically, the way we are anticipating doing it is that we have the in-force business mapped to modeled cells. Each of those cells has an expected ratio of assets to liabilities all the way out through time, consistent with that initial point in time closed block funding ratio. At each point in time, when we want to look at how we're doing relative to the initial glide path, we will apply those factors, look at what the expected or required assets are, and compare those to the actual assets in the closed block. At that point, we'll have to determine whether it's (1) a significant enough difference that a dividend scale change is appropriate or (2) just a temporary fluctuation.

We also have to be able to identify the appropriate component of the dividend scale that's underlying any difference between actual and expected assets, whether it's the interest component, mortality expense, or whatever. The goal is to avoid a tontine at the very end.

When you demutualize, typically, you're looking to raise capital, go into the initial public offering (IPO) marketplace, and become a publicly traded company. In doing that, your GAAP financial statements are going to be quite important. We had to look very carefully at the impact on our GAAP balance sheet and income statement of unamortized DACs. You have a series of expected gross margins or profits projected out prior to demutualization. A key component of that is what your assets are earning relative to your current and future dividend scale is currently and might be in the future. We had to look at that carefully to see whether the impact of the selection of assets for the closed block changed that whole calculation. You want to look at it from a balance sheet perspective as well as an ongoing income statement perspective.

When you report the results in your GAAP financial statements, your experience is basically collapsed into a single line item referred to as "the contribution from the closed block." Unless there's a disaster or an exception, that number should be positive cumulatively through time, because it just represents the fact that your initial GAAP liabilities are bigger than your initial GAAP assets. Through time, to the end of 90 years or whatever, the contribution from closed block will reflect that initial difference. It's somewhat different from a statutory concept because, on the GAAP basis, under Financial Accounting Standard (FAS) No. 120, you're going to have the reserves on a net-level premium basis. And you're going to have a dividend liability that is only the earned portion of the liability. On the asset side, you're going to have the DAC balance. You might have some small differences in your carrying values of assets as GAAP versus statutory, but you'll still end up with a GAAP deficit, and that contribution from closed block on a GAAP basis will reflect the initial accounting difference.

When we prepared to enter the public marketplace, we had to put together form S-1 for an IPO. Within that document, you need to have pro forma financial statements that show the closed block contribution as being established January 1, 1997, in our case. That was a difficult exercise, because we had to back out our 1997 and 1998 issues from all our accounting data, which was a chore in itself. We had to show this for a full year through June 1998. When you set up the closed block and you're reporting on an ongoing basis, you'll bring back in those 1997 and 1998 issues. But it's an interesting challenge to discuss that with the Wall Street analysts, trying to get them to understand your financials, the earnings power of the company, and what the closed block numbers mean.

The contribution from closed block, then, will exclude any investment income on the closed block deficit, as well as any potential imputed capital you might have allocated to it. The investment analysts will look at the closed block as a minority interest in the company. Coming from a mutual company environment, the one thing they need to understand is that the target returns after dividends may not be at the level they would expect from a typical stock company.

You will have to communicate the advantages to shareholders. With rare exception, because of the way the funding of a closed block works and the dividend mechanism, the main leverage point shareholders have in terms of enhancing profitability on these policies is expense management. If you can manage the expenses effectively, those amounts are not going to offset your dividend scale, and the shareholders will benefit from that. The contribution from the closed block will add to the GAAP net worth of the entity in the public marketplace, which initially is primarily your policyholders.

Mr. Barry L. Shemin: We're not nearly as far along in the process as Mutual of New York, so we don't have many answers. We don't have a plan that's been approved by the board, the regulators, or the policyholders, so we don't know how our closed block is going to end up being structured. I would like to focus on the issues that a typical or not-so-typical company and its typical or not-so-typical actuary might have to confront as it tries to put a closed block together. In the process, I'm going to try to highlight some of the alternatives that might be available and some of the pros and cons that might go along with them. I'm going to start with the operation of the closed block. It drives the amount of funding in some important respects as well as some of the other elements of the closed block design. Then I'm going to cover some issues related to the scope of the business that's in the closed block. I'll talk about the investment portfolios that a company needs to set up and a couple of issues related to GAAP accounting.

With respect to the operation of the closed block, the first issue is what items are going to be charged. I'll start with expenses and commissions, because they're the big ones. As both Godfrey and Mike mentioned, most companies have not charged expenses or commissions to the closed block. If you do, it will increase the funding that's required, and it also passes on to policyholders the future changes in expense levels. Due to the nature of the operation of the closed block, this then would have to be reflected in dividend changes down the road, much as would have been the case had the company remained a mutual. Not charging expenses reduces the funding and puts the shareholders at risk for future expense changes, which could be good or bad. But, perhaps more important, we hope it avoids ongoing involvement by the regulators with the expense allocation methods that the company is going to use in the future. With one exception, the more recent

demutualizations have not charged these items to the closed block, so I guess those latter arguments can be fairly persuasive.

If expenses are not going to be charged to the closed block, a related question of interest, to actuaries at least, is what to do about reinsurance expense allowances. As a general matter, the ins and outs under reinsurance agreements covering the closed block business would be charged to the closed block. An argument can be made that, if the expenses of the closed block business are not going to be charged to the closed block, then the expense allowances under the reinsurance agreements covering closed block business should not be credited there either. But if you credit them outside the closed block, you have to set up additional administrative procedures because you'll need to separate the various reinsurance items in the accounting for the closed block, rather than have them all go there. Also, crediting reinsurance expense allowances outside the closed block would result in an increase in the funding.

Finally, how should financial reinsurance on the closed block business be treated? In most cases, financial reinsurance is intended to fulfill corporate capital needs. The selection of which business to do the financial reinsurance on doesn't usually have much to do with specific needs of the business, so there are some strong arguments for having the cost of financial reinsurance charged outside the closed block.

Another operational issue is what to do about class action settlements. Almost every company has been the beneficiary, if that's the right word, of one of these settlements, and they usually provide enhancements to the kinds of policies that are going to be in the closed block. These enhancements can include such things as premium refunds, the makeup of vanishing premiums, enhancements to dividend credits, or issuing new policies of the type that go into the closed block, but with more favorable terms. The question here is how to reflect these various forms of relief in the operation of the closed block. The objective is not to charge them to the closed block, but rather to insulate the closed block from any of the costs of these settlements.

For administrative reasons, it may be very difficult to segregate all of the items completely and, in fact, one may actually have to pay or credit some of these costs from within the closed block. For example, you don't want to be cutting two dividend checks. In that case, the company would need to develop operational mechanisms to reimburse the closed block for any costs it might have incurred in paying some enhanced benefits that result from class action relief. Alternatively, some of the forms of relief might be paid from outside the closed block. An example might be a refund of premium on rescission. In a case like that, some

transfers of, say, the cash value on such a policy, might need to be made from the closed block so that the closed block doesn't get a windfall.

One of the fundamental requirements of closed-block operations is a very strong segregation of cash to allow for audit and limit the degree of discretion that the company might have going forward. This is likely to raise some systems and administration issues related to both the insurance and investment cash flows. It may be necessary to develop some special procedures so that the premiums, claims, and all the other cash items can be separated between the closed block portion and the rest on a very timely basis. Companies may now be doing monthly allocations of some of these items, but that probably is not going to be good enough to obtain the kind of segregation needed for the closed block.

On the investment side, the segregation issues may be harder to deal with. Many companies maintain a single bank account and a single short-term investment pool for the investment flows, such as interest and principal payments. These flows may then be allocated among the different general account investment portfolios some time later, with an approximate true-up of the short-term interest earnings in the interim. The closed block, by contrast, will probably have to have its own bank account, and the investment flows will need to make their way into this bank account on a very timely basis. That will probably require some additional systems or procedures to identify and to allocate the investment cash flow between the closed block and the other portfolios.

What kind of business is included in the scope of the closed block? The bulk of the business consists of traditional participating dividend-paying life insurance, but other kinds of business are around the edges and debatable. Specifically, what about small blocks of business other than life insurance that pay dividends? You might have some old retirement annuities or perhaps some individual or health insurance that pays dividends. In theory, these businesses need the protection of the closed block, but administratively, it could be very difficult or expensive to include them, particularly if they are funded from different investment portfolios, or if the administrative systems used also cover business outside the closed block. It might just not be worth making all the adjustments needed to include this type of business. One could make the argument that for small blocks of this type, a company is unlikely to take actions that would adversely affect these policyholders, so they might not need the protection at all. But if this argument should prove to be unconvincing to regulators and the company still wants to keep the business outside the closed block, it might need to set up some other kind of protective device to limit the company's discretion for this business in the future.

Another question is what to do with indeterminate premium term business. Term policies and riders often have identical provisions, and term riders on closed block policies would typically be included in the closed block. In addition, the systems for administering term policies may be heavily integrated with whole life policies and/or with term riders, thereby making it very difficult to exclude term policies from the closed block while maintaining the required cash segregation. However, indeterminate premium term policies are not dividend-paying, so including them in the closed block could expose the remainder of the block to some mortality fluctuations. Of course, in many cases, term business is heavily reinsured, and the existence of reinsurance should be a strong argument for allowing these policies to be included in the closed block.

Next I'd like to talk about the structure of a company's investment portfolios and how it is likely to be affected by the establishment of the closed block. Before the closed block is established, a typical company would probably have one or more investment portfolios to support its various products. Every company is different, but it is typical, particularly among larger companies, to have some level of segmentation of investment portfolios. That segmentation will have to change.

When the closed block is established, a company will probably need at least three different kinds of portfolios. First, it will need the closed-block portfolio. Second, it will need open-block portfolios to support the in-force business outside the closed block, plus any new business written after the company converts. And finally, it will need a residual portfolio for the assets that don't belong in either the closed-block or open-block portfolios. Each of these portfolios will raise some issues, and even the ones outside the closed block need to be addressed while the closed block is being designed.

The purpose of the closed-block portfolio is to fund the closed-block benefits, dividends, and any other items, like expenses, if they are going to be charged to the closed block. Part of the regulators' review of the closed-block funding calculations will generally be a negotiation about the default assumptions for different classes of investments. In prior conversions, companies have generally come to the conclusion that the default assumptions on lower-quality or equity-type investments make it more favorable to keep those investments out of the closed block. As a result, the investments in the closed block have generally been of somewhat higher quality than those in the prior portfolio backing up the closed block business. The supply of those higher-quality investments might not be large enough to fund the closed block at the required level. If this turns out to be the case, the company might decide to include some lower-quality assets in the closed block or provide additional cash funding from the IPO.

The open-block portfolios support policies not included in the closed block and any participating new business that the company might write after it converts to stock form. There may be more than one of these portfolios, and each one needs to meet the company's normal portfolio management standards, including asset quality, diversification, and asset/liability management. In addition, each of these open-block portfolios must support the current level of nonguaranteed elements for its products because it wouldn't make sense for, say, the interest credits on universal life to have to change as a result of establishing the closed block. You want to keep them the same as they would have been had the closed block not been established.

Life products in the open-block portfolios must comply with the life insurance illustration regulation. To accomplish all of that, open-block portfolios need to be created with assets whose earnings rates are consistent with current policy credits, comply with the life insurance illustration regulation, and meet company investment portfolio requirements. Achieving all of these objectives at once not only requires a lot of attention to detail, but also raises some questions about the supply of assets, particularly if most of the higher-quality assets have to be used in the closed block.

The residual portfolio has several purposes. On a cash basis, it's the place where the items that are not being charged to the closed block need to be funded. If expenses and commissions are not being charged to the closed block, substantial cash will need to be available out of the residual portfolio to pay for these items. Looking at it from the balance sheet perspective, the residual portfolio is backing up the portion of the reserves on the closed-block business that's not being backed up by the closed-block asset portfolio. As Godfrey and Mike mentioned, closed-block reserves typically exceed closed-block assets. Finally, from an earnings perspective, the residual portfolio will generate earnings that will not affect future policyholder dividends, so they will accrue to the shareholders of the company.

The actual content of the residual portfolio may vary dramatically from one company to another because it consists of what's left over after designing the closed-block and open-block portfolios. It will probably be heavily weighted with lower-quality assets and, consequently, its performance may be more volatile than that of the other portfolios. In addition, cash flow may become an issue, because some of the equity investments that did not end up in the closed block also might not have much cash flow, and a lot of cash flow is needed to pay for expenses and commissions on the closed-block business.

I'd like to conclude by talking about a couple of issues related to GAAP accounting for the closed block under *FAS No. 120*. The first issue is how one determines the interest assumption used to get gross margins for amortizing the DACs. Because the

closed block is likely to have higher quality assets, its portfolio rate may be lower than the portfolio rate that was previously funding the closed-block business. If this new lower portfolio rate is used to determine the gross margins, then future margins will be lower than had previously been expected. As a result, there will be a significant amortization of DAC at the time the closed block is established.

Intuitively, this does not seem like the right thing to happen, because the company still has all the same assets and liabilities, which leads to the question of whether there are ways to avoid a write-down of this type. The answer, if there is one, may lie in the choice of assets to impute in determining the interest assumption. Because the closed-block assets will not completely cover the GAAP benefit reserves, an assumption has to be made about the earnings on the remaining assets. It would seem that, by including the earnings on all or part of the residual portfolio, one could justify an interest assumption close to the prior one. To avoid manipulation of this assumption going forward, it probably will be necessary to document a specific group of assets that would be used for this purpose.

Another issue is whether to have a GAAP glide path for the closed block. The GAAP glide path is a mechanism required for closed blocks under *FAS No. 60*, which are all but extinct. It's a form of restricted profits accounting. If the GAAP earnings of the closed block are higher than those projected at the time the closed block is established, the difference goes into a reserve. If GAAP earnings are below the glide path, everything flows through directly to current earnings, but the shortfall could be made up by higher GAAP earnings in later periods. There is a diversity of practice among the companies that have set up closed blocks under *FAS No. 120*. Most are using a glide path, but at least one is not. In its favor, a glide path does have the effect of stabilizing GAAP earnings, at least if the excess earnings come before the shortfalls. But it reduces management's ability to influence the timing of earnings through short-term actions in closed-block dividend scales.

Finally, I want to touch on some issues related to the nature of unlocking under *FAS No. 120* for a closed block. One of these is whether the unlocking should be done in such a way that the lifetime margins are always preserved at the level originally projected for the closed block on the grounds that the mechanics of the closed block operation will, in the long term, deliver these margins. If this approach is used, it would replace the revised best-estimate assumption approach used in the normal *FAS No. 120* unlocking.

Another issue relates to the fact that the *FAS No. 120* gross margins will emerge partially from the experience of the closed block, such as mortality and some of the investment experience, and partially from experience outside the closed block, such as some of the remaining investment experience and expenses. The question is,

when some of these experience factors change, should the effect of the unlocking to reflect these changes all show up in that one liner, "closed block contributions to GAAP earnings," or should some of it be presented outside of the closed block?

I don't have answers to these questions, but I do think they are worth considering when establishing the closed block, as the entity converts to a public corporation that's going to be reporting GAAP earnings. I want to apologize for giving you more questions than answers, but it's only a half-hearted apology. I think companies are different enough that it's probably more important for you to know the questions you should be asking for your companies or your clients than to know the answers for mine.

From the Floor: I was wondering if you could help me out on the treatment of ongoing administrative expenses. In the U.S. environment, it seems that there's a preference to remove the funding requirement for those expenses from the closed block. In the past, I presume the dividend scales of the prior policyholders would have incorporated a component in the dividends for emerging expense experience. In removing the ongoing expenses from the funding requirement for the closed block, does that change the expectations of the prior policyholders with respect to dividends?

Mr. Perrott: I don't think it changes the expectations of prior policyholders. However, as a practical matter, at least in the recent past, companies have focused, appropriately, far more closely on the interest component of the dividend scale than on the expense component. In all but one case of the U.S. demutualizations or establishment of closed blocks, expenses have not been funded. In that exception, they were funded on a formula basis, not on an allocated basis, which, in effect, has the same walling-off of experience. Dividend actuaries who are managing closed blocks are still thinking about expenses in third priority. They spend 97% of their time thinking about interest, 2.9% of their time thinking about mortality, and then they get to expenses.

Mr. Duran: It clearly does remove the participating nature of the dividends with respect to expenses.

Mr. Shemin: The theory is that the expenses implicitly embedded in your dividend formulas over the long term are essentially those that are now going to be implicitly charged to policyholders. The only thing changing is that there won't be any variation from that implicit level going forward.

Mr. Richard F. Lambert: I'd like to ask Godfrey to comment on the assumptions underlying the dividend scale. I thought I heard you say that if you set the scale a

couple of years ago and held it, then you should be funding the closed block based on the assumptions underlying the scale when it was set. Later, you said that the committee decided that you must reset the assumptions each year.

Mr. Perrott: The task force did spend a lot of time discussing this, in many different ways. The conclusion we came to, which is in the exposure draft and which has not been contravened by any of the comments we've received, was that, whether a company actually voted to continue a dividend scale, or simply continued it without a board vote, the only reasonable approach is to say that it is continuing it deliberately. So the experience that is consistent with the most recent implicit or explicit adoption of the dividend scale is the experience that should be used for the closed-block funding.

Mr. Kurt K. Von Schilling: I would like to follow up on the expense component discussion. As part of the overall demutualization process, my understanding is that there's an actuarial opinion stated, which goes to the policyholders, reporting the impact of demutualization on the future dividend expectations. Hence, if you are closing off the potential to gain from future expense savings, is that indicated in the opinion?

Mr. Slipowitz: I did not sign the opinion so, unfortunately, I don't remember precisely, but in the policyholder mailings there's an extensive dialogue about how the closed block operates, and it states very clearly that the expenses are not part of the closed-block funding.

Mr. Von Schilling: The expenses are not part of the closed-block funding, but are you also indicating that there will be no potential future gain from that source, nor any loss, because expenses will fluctuate above or below expectations?

Mr. Slipowitz: Yes. I don't recall the exact wording, but it is discussed.

Mr. Von Schilling: I have another question along the same lines. I have the impression that after demutualization and the establishment of the closed fund, you're restructuring the assets to be of a higher quality than before. Hence, that will impact the rates of returns achieved. Is that taken into consideration when establishing the initial funding, and is there a charge to surplus to establish the extra funds needed to make up the differential?

Mr. Perrott: I think it's important to differentiate the initial assets used to fund the closed block and the investment policy that the closed block follows after establishment. To my knowledge, in all of the closed blocks that have been funded, the actual expected runoff of the initial assets, net an assumed default charge, is

used in the funding. So the funding is automatically adjusted for the return on the initial assets, net of the default charge. In dealing with the assets that are purchased after the closed block is established, this is an evolving area that has not been addressed completely in the past. If you look at some demutualizations, however, you will find that the plan sets a quality cap instead of a quality floor, or in addition to a quality floor, on the new investments. It does not automatically require higher-grade investments.

Mr. Shemin: I just wanted to re-emphasize that the comments about higher quality all of us have made refer to only the initial assets. The reason for this is that the regulators are afraid you'll dump the current garbage that you have into the closed block. With respect to future investments, there's more of an even trade-off. In most cases, regulators have understood that, if you make the reinvestment policy too conservative, in the long run, that will hurt the closed-block policyholders. It makes more sense for the company to invest in a range of securities, much as it would have done for the business outside the closed block. It doesn't follow, at least in the practices that have occurred so far, that there is an expectation of higher investment quality on reinvested assets to the extent that it would cause the future expectations to change.

Mr. Slipowitz: One of the conditions or agreements that we set out was that we would require New York State approval to change our future investment strategy. So it's possible that the investment approach we initially established would not be logical at some point in the future, but we must get permission from the state to change the strategy.

Mr. Armand M. de Palo: I have a concern on the closed block. You get assurances from a closed block, but I truly believe that the ultimate down-the-path effect of a closed block is underperformance of the dividend scale. When you don't have a closed block, you have all the assets and all the earnings power of the company backing the dividend scale, and you can invest in a wider range of assets. Your assets and surplus can be invested in equities or the company can invest in new lines of business that generate additional earnings. Once you go with a closed block, they may lock in the scale at that point in time and have some experience gains, but you get a less aggressive handling of the closed block funds. I describe that as death by bleeding slowly. You're not going to be cheated and you're not going to have any great risks. In fact, you're probably going to see your policies better protected, but underperforming. The end result of a closed block, as it goes through time, is that it will underperform a well-managed mutual company that has all the assets backing all of its participating business.

If you go through a demutualization, this does not bother me, because the equity value of the company is distributed to par policyholders. In fact, they're going through a change in classification, from being par policyholders with an equity interest in the overall company to par policyholders who have limited rights in a nonpar company. In a mutual holding company situation, the surplus of the company, at least on the part that's not funded by outside investors, still has some earnings potential to enhance the dividends of that block of business. By going through a closed block on a mutual holding company structure, it is very likely that you're going to end up either with that company not writing new par business or with future new par business that is not written in that closed block having a more aggressive investment strategy, once again, to the detriment of the closed block. There may not be a better solution, though, because the regulators are concerned about raping the closed block. I agree that closed blocks stop that from occurring, but the long-term underperformance may be worth a lot more than any small amount of money that a policyholder gets through a demutualization. I'd like comments on this from anyone on the panel.

Mr. Perrott: Guardian is an example of a company that's been very successful investing its par policyholder's funds in other lines of business. Other mutual companies have been noticeably unsuccessful doing that, and the dividends, as a result, have been reduced rather than increased. So I would agree with you that it removes the opportunity, but I would disagree that it's one-sided. I think it removes an opportunity for gain, and it removes an opportunity for loss. The quality over the long term of the investment management of the company, and the operational management (because you're really investing in operations), determines what will happen.

Mr. Duran: Does the SOP address the issue Armand raised? Does it permit actuaries to do the funding calculation, taking into account profits from other lines of business if they've done so in the past, if that's been the company's practice?

Mr. Perrott: That is required if it has been the company's past practice. The gains that would have come in from other lines become embedded in the funding.

Mr. Duran: Would that include surplus as well?

Mr. Perrott: It would include whatever supports the dividend scale.

Mr. Duran: Does that allay your concern at all, Armand?

Mr. de Palo: It may allay my concern in words, but not in practice. Let's leave other lines out because most companies don't directly allocate the earnings of other

lines to a particular product; they use the growth and surplus to fund the growth of the company. Instead let's take an example where you have a block of business that has no other lines of business, but has a large amount of surplus. You invest your surplus in more aggressive assets, such as equities, and your core assets in more conservative assets. When you close the block down, you can no longer take the earnings of more conservative assets and all the potential excess earnings on surplus, which would have been shared. The ability of different lines of business to offset cash flow for C-1 and C-2 risks, are now eliminated from this block as well. Therefore, the company cannot invest this block as aggressively as it can a wider, more diverse portfolio that allows risk from one line of business to be offset by the risks of others, thereby lowering the overall risk of the company. I'm not disagreeing that, in exchange for that, they get a safer scale, be it lower, on an expected basis.

Mr. Perrott: Armand, you're wrong.

Mr. de Palo: I could be, but time will tell.

Mr. Perrott: You're wrong under the following scenario, which I think is the one you're postulating. In the past, the company has supported the dividend scale from earnings on surplus. In the future, the company is going to invest the closed-block assets in more conservative investments. If that closed block is funded correctly, the actuary will use a reinvestment rate, which reflects the conservative nature of the assets. That will increase the funding and support dividends at the current level, which includes the investment on surplus, not on the level that would simply be supported by the high-grade investments being made within the closed block.

Mr. de Palo: I know that's what it says. But let's take an extreme situation where you've been very successful in equities. It is very possible, following through on your scenario, that the starting assets are actually greater than the liabilities of the policy, because as you move into lower yielding, safer assets, those assets may not be able to support the dividend scale that in the past has benefited from the equity position of the company. As time goes on, we'll see if the written word matches the actual practice.

Mr. Paul G. Schott: I have a question concerning eventual extinction of the closed block. Once a closed block is created, does it continue to exist right to the very last policy—100 years or longer? Or, after so many decades, can it be folded into the open block? How might regulators answer this question?

Mr. Slipowitz: My understanding is that it goes to the very bitter end. I don't plan to be around at that point, but I think the goal is to manage it to avoid a tontine.

Mr. Perrott: I don't believe any closed block will go to the bitter end, because it becomes inherently unstable, particularly when it gets down to a few hundred policies. There is significant disagreement among regulators about what should happen. But I believe that, at some point, companies operating a closed block will approach their regulator and make some offer—for example, to guarantee the current dividend scale and simply treat it as a liability—to eliminate the closed block before it becomes volatile. The oldest closed block in modern demutualizations is UNUM's. It's 15 years old and has about 70 or 80 years to run, so it will be a while before we find out what happens.

Mr. Jeffrey Robinson: What has it been like to deal with the regulators? Mike, you've had to deal with the New York Insurance Department. It's difficult to deal with them on any issue, and they have a lot of responsibility for this one in particular. Where do other states come in on the issue? If you get approval from your state of domicile, does everybody else go along with it?

Mr. Slipowitz: It's certainly an exhaustive process to go through all the nitty-gritty detail with the regulators. This is a fairly complicated process that probably deserves extensive review, so from that perspective, I think some of the review is appropriate. It's obvious that the legal part of the insurance department is extensively involved in this. There's the actuarial component, but there also seems to be a tremendous amount of involvement from the legal side, on both the company and the regulatory side. It's an exhaustive process. They have their own advisors who are looking at everything you've done and asking questions. And you have to be responsive.

Mr. Robinson: Even the New York Insurance Department doesn't seem to have the staff size or experience to deal with something like that. Have they slowed you down because they didn't have the internal resources?

Mr. Perrott: The point that Mike just made, that the regulators have hired advisors, is a critical point, because no regulatory staff has the horsepower to do the job. The advisors that the regulators have hired have, in general, been very helpful to the process, because part of their assignment is to educate the regulators. With respect to the second part of your question, the only nondomicile regulator that has gotten involved is New York. There is a specific requirement in the New York law for them to determine that a foreign insurer who's licensed in New York is not harmful to the New York policyholders.

Mr. Slipowitz: I would like to share one story about the process of getting advisors. There was a period of time for us that was quite frustrating, because every time we

thought we had an advisor who had no conflict of interest, one of the Big Seven, Big Six, Big Five, or whatever it's going to end up being, was in the process of merging. And, just when we thought we were ready to move this along a little faster, something came up that gave us some problems.

Mr. Robinson: Who are these advisors? Are they consultants or accountants? What type of firms do they come from?

Mr. Perrott: Most of the work advising either companies or regulators has been done by Milliman & Robertson, Tillinghast, Ernst, Coopers, and Price.

Mr. Duran: I have a question for Mike and Barry. When you establish a closed block, you isolate the assets on the in-force business. If then you're going to be selling new participating business, there's a different pool of assets that backs the new business. Therefore, if you used to be a portfolio rate company, you can't be anymore. Has that caused any consternation at either of your companies, and how do you plan to deal with that?

Mr. Slipowitz: We've filed to have a participating whole life policy as a stock company, and we plan to follow all the rules that require segregation of assets and underlying experience. One outstanding question is how much of this we are going to sell. There are some people in our field force who still want to sell whole life, but we're going to have to see just how big a portion of our sales this product represents.

Mr. Shemin: I agree with Mike that it's hard to find a demutualized company that's currently selling a lot of whole life insurance. We still sell some, and we're planning to make the products available, it probably will be through our non New York stock subsidiary, John Hancock Variable Life, so that the business we issue in most states will not be subject to the New York profit limitations on par business, which are extraterritorial. We would expect to sell par business in New York and two other states out of the former mutual. Peter is correct in the sense that one would have to look at the dividend-crediting methodology to see whether it needs to be changed. For example, it's virtually impossible to maintain any kind of money focus inside the closed block if one had it outside the closed block, because all of the assets are getting scrambled.