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# Session 77PD
# Mutual Companies—Extinct in Canada?

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*Summary: A tidal wave of demutualization has hit Canada. Canada's largest mutuals are all converting to stock companies. The demutualization process in Canada includes many similarities and some important differences with that used in other jurisdictions, in particular Australia, the U.K., and the U.S. Even within Canada, the different circumstances and objectives of each company have led to important variations in how demutualization is being implemented.*

*Topics covered include:*
- *The Canadian demutualization process and some interesting differences between companies and across borders.*
- *How is eligibility determined?*
- *What process is being used to determine allocation of shareholder value?*
- *What mechanisms are in place to protect policyholders' reasonable expectations?*
- *What internal and financial structural changes are driven by demutualization?*
- *How financial markets assess stock value for companies operating internationally.*

**Mr. Mike Lombardi:** I'll be the introductory speaker, and I'll set the scene. I'll talk about trends in major markets worldwide. I'll talk a little bit about why companies demutualize and common issues across all demutualizing companies.

I'm not sure if we have some non-life actuaries in the audience, but I thought I'd ask, What is demutualization? It's the conversion of a mutual company to a stock company. In particular, in Canada, there are five companies demutualizing: Mutual Life, Sun Life, Manulife, Canada Life, and Industrial-Alliance. Why is it happening now? For one reason, it couldn't have happened without enabling legislation, and this came up very recently. It has been argued in the past that if

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these demutualization statutes had been in place, perhaps a company like Confederation Life might have survived by demutualizing.

The nature of the business is changing. Par business is less and less relevant in the financial services world. There's competition from other financial institutions. Corporate governance is an issue. Policyholders don't feel or act like owners or investors. In a changing landscape where banks, mutual funds, insurance companies, and so on compete for each other's business, there's a blurring of distinctions between the traditional silos or pillars.

Let's turn to the rest of the world and see what's happening in other countries. I'd like to discuss trends in major markets. Let's start with the U.K. In the U.K., there has been a rash of restructuring activity. The primary form of demutualization there is sponsored demutualization, rather than the company going public or going through a mutual holding company. Some demutualizations, such as Norwich Union, did go through their demutualization through a public offering. Because of weak takeover protection, there's a possibility of hostile demutualization. Some of you close to the scene might remember the Scottish Amicable story where the management thought they were going to demutualize one way and then another company came along and said, "No, we've got a better offer for the policyholders." Lo and behold, that offer was in effect, and I'm not sure if management got its desires or kept its employment. In any case, that's possible there.

In Australia the three major mutual companies have demutualized. We have National Mutual, Colonial Mutual, and AMP. AMP went through a public offering route, whereas National was a sponsored demutualization. The sponsor was AXA, a French company.

South Africa just came on the scene within the last year or so. Its two largest major mutuals have demutualized: SANLAM and Old Mutual.

Japanese companies are beginning to demutualize. This has been encouraged by the government and the Ministry of Finance, partly because of the financial difficulties of life companies and banks. It has been charitably said that if they were on a proper accounting basis, many of these insurance companies and banks might, by our standards, be bankrupt, so they're interested in any and all forms of financial assistance and the ability to raise external money. Finally, the use of outside partners as sponsors is highly encouraged, and a number of companies have been talking to some of these Japanese mutual companies to form strategic alliances or to help them in their demutualization process.

In the U.S. there has been a steady and accelerating trend. Until recently, mutual holding companies had been the preferred route for demutualization. That has been changing as a result of some consumer and regulatory pressures. In fact, a lot of the more recent announcements have described themselves as a full demutualization where the policyholders will actually get shares that can be traded. We now have Prudential, Met Life, Mutual of Omaha, John Hancock, Mutual of New York, and MONY Life all demutualizing.

A similar tidal wave is in progress in Canada. Clarica, formerly Mutual Life, has now become a public company. For obvious reasons, it didn't wish to retain its name.

The policyholder vote took place in June, and they were listed in July, solely in Canada for now. With Manulife, the policyholder vote took place in July, and they were listed in September in five stock exchanges: Toronto, New York, Hong Kong, Montreal, and the Philippines. Canada Life just had its recent vote last month in September, so they're on their roadshow. Industrial-Alliance is a provincially registered company. As some of you know, companies can register either federally or provincially, so Industrial-Alliance is subject to provincial regulations and, in fact, there weren't any, so a special statute was created for the demutualization of Industrial-Alliance. In many ways, it follows the federal form and regulations. Finally, Sun Life has announced that it will have its policyholder vote in December, and it's expected to list its shares on the U.K., U.S., Canadian, and a few other exchanges.

To set the stage, I'll talk about some of the generic reasons why companies demutualize. The first reason is corporate governance. It has been said that the way mutual companies are run and governed is a bit of an anachronism, and they really should be run as public companies subject to all the disciplines and approaches taken there.

Another reason is access to capital. A mutual company is limited to the capital it can raise. There are only two real sources of capital, and both of them are limited. One is writing profitable business, and the other is subordinated debt or the equivalent. There's a limit as to how much of those you can raise, and there are regulatory limitations on that.

Acquisition currency is a third reason. If you are actually a stock company, you don't necessarily have to pay cash for any acquisition. You can trade your stock as a form of exchange, and if your stock is trading at one-and-one-half or two times its book value, you can actually do quite a deal through a stock exchange or an exchange of shares. Unfortunately, if you're a mutual company, you can't do this, so all you can do, if you want to grow and if the consolidation is taking place, is pay cash and deplete your risk-based capital or minimum continuing capital and surplus requirement, but that doesn't help things too much. It's plain that that puts mutuals at a competitive disadvantage.

Mutuality is no longer relevant. In the old days, mutual companies were set up as a means of a group of individuals to get insurance at the lowest cost. These days insurance companies compete internationally. They're sophisticated investors. Some of them have derivatives, banks, and so on. It's pretty hard to argue that this is still true to the reason for the concept of insurance and shooting for the lowest cost. In fact, a lot of these policyholders wouldn't have a clue as to what their company is investing in and what the risks are that are being taken in their name and on their behalf.

Another reason why companies demutualize: ownership of surplus is clarified. The perpetual question of "Who owns surplus?" can be argued ad infinitum, but once you demutualize, it's very clear who owns the surplus and who owns the shares.

In a full demutualization, it actually crystallizes the value in the hands of policyholders. You actually get a tradable security. If you don't like what the company is investing in, you can invest somewhere else, and if you want to retain your insurance policy, you can do that. You can actually separate the two concepts, whereas in a mutual company you're either completely in or you're completely out.

The one reason that management likes to talk about is how demutualization introduces the discipline of listed companies. These will no longer be run like old clubs where profit or bottom line doesn't matter. Once you demutualize, you'll enter the brave world of stock markets and analysts and global financial services; therefore, you'll be more disciplined as a management and as a company.

Stock options are one reason that is not talked about too much. The diplomatic way of saying this is that demutualization allows stock companies to attract top quality management and compete for the best management around. You've read about the less charitable comments in the press, and I will not make any unprofessional comments.

Now I'll address concerns. Not all companies feel that demutualization is in their best interest, so what are some of the concerns? There could be a loss of legal or tax advantage depending on the jurisdiction, the country, the state, or whatever.

Another concern is takeover risk. Management likes to be self-perpetuating. However, in the U.S. and in some other countries, there is no takeover protection, so once you demutualize, you are a target virtually from day one. In other countries, such as Australia and Canada, there is some limited takeover protection. In Canada, the company to initially demutualize has to be widely held for the first two years, and no one investor can hold more than 10% of the shares. After the two-year period, when in theory the company has found its feet and its place in the marketplace, there is less protection available, except for the very largest companies.

The next reason is cost. If it costs $50–100 million to pay all the lawyers and consultant firms to demutualize, and your surplus is $1 million or less, this is not an option open to you. Cost is a big factor in demutualization.

Loss of business focus. It can take up to two or three years to demutualize, and it really absorbs a lot of the attention of management and staff. The question that is being asked by your policyholders while you're going through the process of determining whether they are individual or group is Who's minding the store during all this time and who's taking care of business? There's a risk that your business will go away or that customer service may decline compared to its former excellent levels.

Conflict between policyholders and shareholders will be new. If you're a mutual company, it's "one for all and all for one"; everybody shares in the spoils. Whereas once you're a listed company, actions that may be in the policyholders' best interest may not be in the shareholders' best interest and vice versa, so there's a bit of ongoing tension going on there after a company demutualizes, and some people feel that that's not worth it.

Is there a loss of competitive pricing advantage? The question mark is there because it has been said that mutuals write their business expecting a lower target ROI or ROE. Mutuals, of course, deny this. They say that we are as competitive and as bottom-line focused as everybody else, but the question mark is still there because it has been said that is the situation. Once you demutualize and have to price your products with the proper ROI, you may find that you're uncompetitive, so what are you doing after demutualization?

I'll talk about some common issues that my panelists will speak about.

- Legal process. Exactly what do you have to do to demutualize?
- Eligibility. Who gets shares? How many?
- Allocation as far as value. Am I getting cash, shares, extra dividends, and benefits?
- Taxation of proceeds. This can get quite tricky. How do you tax proceeds, especially if you're a multinational and you have individual or corporate policyholders all over the world? That needs to be resolved.
- Voting rights. Voting rights disappear; however, in Canada, it's a bit of an anomaly, where policyholders continue to have the right to vote for up to one-third of the Board of Directors.
- Protection of policyholders' reasonable expectations. Our panelists will speak about closed blocks and par funds in a little bit more detail, but that is a common issue.
- Executive compensation. How much is allowed? Is it allowed? What are the limitations? That's another concern.
- Takeover limitations, which I alluded to before, are another common issue.

Let me introduce the speakers. Steve Friedman is a senior partner with Debevoise & Plimpton and has a distinguished background. Prior to rejoining Debevoise & Plimpton in September 1993, Mr. Friedman was executive vice president and general counsel of the Equitable Companies, Inc. Mr. Friedman has also served as a commissioner of the Securities and Exchange Commission, deputy assistant secretary of the treasury for Capital Markets Policy, special assistant to the U.S. Maritime Administrator, and law clerk to Justice William J. Brennan, Jr., of the U.S. Supreme Court. Mr. Friedman first joined Debevoise & Plimpton in 1965 and became a partner in 1971. He received his A.B. magna cum laude from the Woodrow Wilson School of Public and International Affairs at Princeton University and his L.L.B. magna cum laude from Harvard Law School, where he was editor of the *Harvard Law Review* and a recipient of the Sears Prize.

Following Steve, we'll have Nick Bauer, who is with Eckler Partners. He worked 26 years in a medium-sized life company, the last seven of those as a CEO. Since

1986, he has been a consultant to financial institutions and most recently with two Canadian mutuals, acting as their independent actuary.

**Mr. Stephen J. Friedman:** What I'd like to do is highlight some of the differences between the U.S. and Canadian demutualizations, and I'd like to do that using Equitable and Manulife as counterpoints. Those are the two demutualizations I know best. I was involved deeply in both of them. It's fascinating because the process looks the same. In fact, there were significant differences at almost every major step on almost every major issue.

The first two differences were factual. One had to do with the size of the companies, and the second had to do with the decidedly international character of the Canadian companies as opposed to the U.S. companies. It is also partially because of the differences in the legal systems, and from those two factual differences flowed an enormous number of structural differences. The resolution of issues in a different way had a profound effect on eligibility, on the allocation formula, the cash-out mechanism, the initial public offering (IPO), the relationship between the IPO and the demutualization, and a variety of other things.

Let's start by looking at the size differences. By size, I really mean value of the company. Equitable is a particularly dramatic example, and you see it very strongly. As I'm sure you all know, the typical demutualization allocates what the policyholders get between fixed consideration, which is essentially compensation for the vote, and so-called variable consideration, which is compensation for their share in the equity. The fixed consideration in the Equitable case was three shares. At the Equitable IPO price that was $27. The fixed consideration in the Manulife demutualization was US $1,600, an enormous difference in value.

If you look at the post-IPO values of the company, the total value of Equitable was about $1.4 billion and of Manulife about $6.1 billion—there were differences in size. Equitable raised $1 billion first from a private placement from AXA and another $300 million in the IPO. Manulife used none of its IPO of $1.6 billion for new capital. The company, if anything, overcapitalized in order to fund expenses and principally cash-outs.

There were reasons for that. Equitable's demutualization, which was the first really large one that came after UNUM, came after the period of enormous growth in the 1980s that consumed capital. Equitable had a very serious GIC problem that consumed another $1.5 billion of capital. This all took place in the early 1990s, during the throes of the real estate recession in the U.S. and Canada. Equitable had $17 billion in real estate investments. This was a very high quality, very bad asset class during that period. There was a desperate need of capital. After this billion-dollar investment, Equitable in fact doubled within a year, so it was a very good investment for AXA.

Let's discuss the new U.S. demutualizations. Unfortunately, I just put down the number of shareholders because the companies have not announced values and, unlike the situation in Canada, there's no valuation of the company that goes out to policyholders, but the sizes of these companies are really stupendous. Met, for

example, has probably 12-million-plus eligible policyholders. Three million of those hold industrial life policies with face value of less than $100. No one has paid any premiums on those policies for years.

The magnitude of this is really stupendous. If you treated each of those as a separate shareholder, the cost of maintaining that shareholder base would be about $50 million a year, mailing them annual reports, proxy statements, and maintaining the accounts. Met is doing what no other U.S. company is doing: it's going to demutualize into a trust, and all of the policyholders will have interest in the trust, and different legal and disclosure requirements flow from those. Certainly Met and Hancock (Hancock is the smallest of the three and larger than Equitable) are all quite healthy companies, and the values are going to be quite substantial.

The second major difference is the international character, and you see this very decidedly with Manulife. These percentages represent the allocation of the variable consideration. I've used that as a proxy. About 40% of the company was in Canada, about 40% was in the U.S., and 20% was in Asia, principally Hong Kong and the Philippines. In that sense, Manulife is closer to some of the Australian demutualizations than the U.S. companies. If you look at Equitable, State Mutual, and Mony as examples, there are very few policyholders outside of the U.S. There is no real business outside of the U.S. They tend to be migrants, and no shares were issued to anyone outside the U.S.

What's the effect of all this? Let's start with the international side. The international character of these demutualizations just had a really profound effect. It had a very significant effect on regulatory attitudes, and I'm going to come back to this and give you a few examples, but let me just pose the question broadly. If a regulator in more than one country has jurisdiction over a demutualization (Michigan in Manulife's case; the Philippines and Hong Kong decided not to assert any jurisdiction), what is that regulator supposed to do? There's only one plan of demutualization. It's approved by the Office of the Superintendent of Financial Institutions (OSFI) in Canada, which is Manulife's primary regulator. When OSFI approves the plan, what is there for Michigan to do? It has jurisdiction, it has a statute, and it has an obligation to approve it as fair and equitable. How does it exercise that jurisdiction? It's a very difficult question.

Nick is going to talk about the allocation formula, and you'll see the significant effect that the international character of Manulife's business had on the allocation formula, which is dramatically different from the formula used in any of the U.S. demutualizations. It had a tremendous effect on cash-outs. The U.S. demutualizations, in order to avoid complying with the securities laws of other countries, basically cashed out everybody outside the U.S. The Canadian companies really can't do that.

What's the function of the IPO? Part of the function is to raise capital. Its most significant function is to create a broad and deep liquid market for this mass of shares that are being put into little envelopes and, in effect, mailed out to policyholders. It is also supposed to create a mechanism for the transfer of those shares from people who don't think of themselves as investors. Many who don't

even have brokerage accounts think of their relationship with the company as a policyholder relationship.

Another function is to create a mechanism for the orderly transfer of those shares from their hands to the shares of institutional investors because life insurance stocks tend to be institutional stocks. If you issue shares all over the world, then you must create a broad and deep liquid market all over the world. I'll come back to the structure of cash-outs, which was really quite fascinating.

Let me spend a minute on the regulatory attitudes. Manulife's basic principle in designing this plan (which was true of every aspect of the plan, even actuarial and nonactuarial) was that a policyholder holding a policy with a given set of attributes ought to be treated the same no matter where in the world he or she was a resident, because we believe very strongly that a regulator in a non-Canadian jurisdiction would have a difficult time approving a plan, or even just standing by and watching it go forward, if a policyholder, subject to that regulator's jurisdiction, was being treated worse off than someone holding the same policy in another country. This seems obvious, right?

What we encountered here was at least one regulator who, in effect, said to us, "Wait a minute, I really have a different idea about the way this money ought to be distributed. What I would like you to do is tell me how much money you've allocated to my jurisdiction, and I'll tell you how I think you ought to distribute it." We said to somebody, "We really can't be in a position of having different plans," besides the fact that this is illegal in Canada, which is the jurisdiction of law that governs this demutualization. We really can't be in a position of having regulators in different countries in effect approving different plans. You can imagine the sort of race to the bottom as the regulator in each jurisdiction tries to devise a set of principles that will make him or her look politically better to his or her policyholders. The regulator in another country says, "That's a good idea, I think I'll change." We managed to convince this regulator that the principle of uniformity was the right one, but it was really the first time this issue had ever been confronted. As you'll see, it came up in spades in a very dramatic way when we got to the issue of eligibility.

Why did we concede that any regulator other than OSFI had any jurisdiction? First of all, I think deep down, we really didn't think we had a lot of choice. Manulife was in something of a different position from the other companies because it had converted most of its business from a branch to a subsidiary in the U.S., but Sun Life and Canada Life had branches. Manulife still had its branch. It just wasn't primary business.

Second, there was a securities law consideration, which was quite important. The demutualization itself, that is, the issuance of shares in exchange for ownership rights in the company, is a sale of securities for securities law purposes and would be subject to the registration, that is, the prospectus requirements of the U.S. securities laws, but there's an exemption. I'm not talking about the IPO. I'm talking about the early stage. If it's subject to the securities laws, then the mailing of the policyholder information statement, the proxy statement, would have had to

have been processed through the Security and Exchange Commission (SEC) first, which would have been much more time consuming and difficult.

All of the U.S. demutualizations have been exempt from registration under a provision of the Securities Act called Section 3(a)(10), which basically says that the registration rules don't apply to securities issued in a transaction approved by an administrative agency or a court as fair and equitable. When the New York Insurance Department approved the Equitable Manulife demutualization as fair and equitable, that qualified the Equitable demutualization for this exemption. The problem is the statute was drafted with U.S. companies in mind, and if you read the definition of administrative agencies, it doesn't include non-U.S. administrative agencies, so OSFI's approval of the plan wasn't good enough to get us 3(a)(10) exemption.

We had a choice. We could have used a Canadian court; there was actually a mechanism in Canada for getting the court to approve the plan as fair and equitable. I think all of us who thought about it were horrified at the possibility of a judge with absolutely no insurance background trying to resolve disputes about the fairness of the actuarial allocation mechanisms. It was really a frightening thought, so we decided to, in effect, agree with Michigan and encourage the state to hold a demutualization proceeding, which would result in a decision by a U.S. administrative agency that the transaction was fair and equitable, and in which U.S. policies were being issued shares.

Manulife operates in every state in the U.S. We thought that it would be more likely that the other U.S. Commissioners would stand by and not be active if they were confident that there was one U.S. regulator that was taking an active role in supervising this. That's what gave rise to this.

I mentioned eligibility as an example. There were two significant differences. The question here is which policyholders are eligible to vote and to get money, because there were significant amounts of money here. There were two significant differences between the Canadian and the U.S. models. The first is a cutoff date and the second is the status of nonparticipating policyholders. In every U.S. demutualization, the cutoff date was the date the plan was adopted by the board of directors.

There's usually a public announcement. The company puts out an announcement that says the board has authorized the management to develop a plan with the so-called announcement date. Three or four months later, the plan has been negotiated with the insurance department, which has given it an informal approval. Then the board adopts the plan and that's the adoption date, and usually the policyholders that hold policies on that date are the eligible policyholders. All the Canadian companies used the announcement date, that is, long before the plan was developed.

Why was that? That really flowed from concern about the effect of the amount of money involved in these policies, a minimum of US $1,600. Just to give you a sense of this, there were lots of ordinary people who were getting $20,000–60,000

and more, and there were large corporate-owned life insurance (COLI) holders in the U.S. that were getting tens of millions of dollars.

There's a wonderful story about a Manulife officer who called up a COLI holder who had a lot of money, to see whether he was going to keep his shares or sell them, because the officer was trying to figure out how to make the offering process orderly. Because this is an insurance policy, it was in the human resources department, so he got this fellow in human resources who obviously hadn't read it. It's a big thick stack of paper, and the Manulife fellow said, "You've got this policyholder information statement?" "Yes, ah-ha." "And your company is going to get a fair amount of money?" "Ah-ha, yes." "I want to talk to you about what you're going to do." "Ah-ha, yes." "You know, it's about $60 million." And there was this dead silence on the other side of the phone, and he could hear this fellow rustling around in the wastepaper basket trying to dig out this hunk of paper he has thrown away unread!

The concern was that if the eligibility date were the adoption date, the possibility of participating in the demutualization would become an uncontrollable element in the sales process and the sales force would use it as a way of selling new policies: "We're going to demutualize. There's a lot of money in this for you. Buy our policy." We were concerned about the possibility of a secondary market developing between the announcement date and the adoption date. Because the amounts were very large, and because of the way the allocation formula was configured, there was concern about what you do with somebody who decides to let his policy lapse or surrender his policy. The company is really not in a position to tell them anything because the plan hasn't even been adopted and they would lose their eligibility and there were significant amounts of money lost. All the Canadian companies and, in fact, the Canadian regulations adopted the announcement date as the eligibility date.

The second major difference was the role of nonpar policyholders. In almost every state of the U.S., nonpar policyholders of mutuals have a vote and the fixed consideration, this $1,600, is viewed as compensation for the surrender of corporate governance rights. In every U.S. demutualization, nonpar policyholders have gotten the fixed consideration. In Canada, the current statute, the Insurance Companies Act, authorizes nonpar policyholders to be given the vote, but none of, I believe, Manulife, Sun Life, or Canada Life (I think the Mutual was different) granted any voting rights to nonpar policyholders, so nonpar policyholders got nothing in this demutualization. Indeed, they didn't fall within the definition under the Canadian regulations of eligible policyholders, so it was illegal to give it to them.

Michigan was very concerned about this. It was really a political concern because these things have become a political football. As Mike said, we've seen it in the mutual holding company transactions, and there are very active consumer groups that scrutinize these plans. There was a lot of concern in Michigan about the political reaction to nonpar policyholders not receiving anything, and, in fact, the Manulife demutualization spanned the tenure of three commissioners. They were short tenures.

The second one actually wrote a public letter to OSFI on the proposed regulation saying, "I think it's fundamentally unfair to exclude nonpar policyholders." The Commissioner actually toyed with the idea of saying, "Tell me how much money you're going to put in the U.S. and maybe we should allocate some of that to nonparticipating policyholders in the U.S." Fortunately, it was illegal under the Canadian regulations, but it's another example of the international character, the difference in legal systems, and the difference in culture affecting these things. Let me spend a minute on cash-outs. In U.S. demutualizations, everyone outside the U.S. is cashed out; otherwise you have to comply with their securities laws. That wasn't possible in Canada because 60% of the shares were going outside of Canada. The company could not do an IPO large enough to cash out all those people or 60% of the value of the company. That meant there would have been no market on the New York Stock Exchange. It really wasn't feasible, so the effect of that was that we had to have securities law compliance in the U.S., the Philippines, and Hong Kong.

There's also a question about whether it would have been fair to cash out everybody other than Canadians. It would have appeared to be a kind of jingoistic freeze-out. There is also a special tax problem, and it's one of these technical issues that has a significant ripple effect.

In the U.S., cash-outs take place when the policyholder elects the cash-out, the company increases the size of its IPO sufficiently to fund all those cash-outs, and it gives the cash to the collecting policyholders. In the U.S., it is taxed as a capital gain, it's a surrender of a property interest, and there is ownership interest in the company in exchange for a cash payment. In Canada, the payment is viewed as a dividend and there's withholding. The problem is that under the Canadian-U.S. Tax Treaty, it's not at all clear that you can use the withholding for ordinary income in Canada against your tax liability for capital gains tax in the U.S. That means there would have been a double tax on U.S. policyholders who elected cash.

In order to avoid that, we constructed this mechanism so that every policyholder outside Canada who checks the cash election authorizes the shares to which that policyholder is entitled to be issued to a custodian and authorizes the company to sell those shares on the policyholders' behalf in the public offering. In fact, I've forgotten the percentage, but of this $1.6 billion, a very high percentage was a secondary offering. In terms of numbers of sellers, it is the largest secondary offering in world history. There were tens of thousands of sellers, and we did that in order to make sure that all those people got capital gains treatment on the cash and the company subsidized the underwriter's commission on that sale.

Again, all sorts of ripple effects flowed from that. One of them was that we discovered the policyholders in Asia had a very high preference for cash. The cash-out elections in demutualizations range from 18% to 22%. Manulife was running in that range, except in Asia it was 50%. That was partly because of concern about the liquidity of their markets, but really it's a cultural preference for cash. At the same time, during this period (this was when the IPO was being priced), there was a significant deterioration in equity value for life insurance stock. Lincoln National lost 10% of its value in one day. The market was deteriorating significantly for life

insurance stocks. They had these huge cash-outs. It also created a special tax problem. The company decided they couldn't really do an IPO large enough to cash everybody out.

Every plan, including Manulife's, provides for this contingency. It basically says that if the company decides it's not in the best interest of everybody to do an IPO that size, it will cut everybody back. In the U.S. demutualizations, the cutback is applied first to the larger holders, and the small holders tend not to be cut back. Manulife decided, for whatever reason, to do it pro rata. Manulife had no odd lot holders, which are a nightmare to have. All the U.S. companies had all these little teeny shareholders with 27 shares and so forth. Manulife had none of that. No one was allocated fewer than 100 shares. The effect of this proration meant that every policyholder that elected cash ended up with a little tag end of a few shares, which created concern about a market overhang and concern about cash maintenance.

Let me spend just a minute on a couple of IPO issues because they're interesting. Again, you can see what structural differences flowed. In the U.S. demutualizations, the demutualization is effective on the closing date of the IPO. When you do an IPO, on day one, the offering commences, the closing is usually three or five days later, and the underwriters have an out, so that if you have a market crash, like the one in 1987, in theory, the underwriters don't have to close. In fact, in 1987 there were underwriters that didn't close, as the market collapsed on that Monday.

Actually, when the underwriters offer the shares, the company is not yet demutualized. The shares don't exist even though they start trading the next day. The company demutualizes immediately, in effect, prior to the closing of the IPO, and then the company has the shares to give to the underwriters to make delivery.

There is a special provision in the U.S. and Canadian securities markets called the multijurisdictional disclosure system (MJDS). Basically, this is a great thing for Canadian companies because it says that the SEC will accept Canadian filings and, more importantly, won't review Canadian registration statements that have been approved by the Canadian securities regulators. It has a huge effect on timing and on the ease of doing a global offering.

In order to qualify for MJDS, you have to have a float of 75 million shares outstanding. We convinced the SEC that we satisfied that float because the demutualization was effective before the IPO, but the SEC insisted that there be a few days' spread between the effective date of the demutualization and the closing of the IPO. They wanted the demutualization effective before the offering began, which is on day one. That meant, in theory, that if the underwriters exercised their market out, some terrible thing would have happened. We'd be in a position where we were demutualized, but we didn't have an IPO. Everyone at the beginning was terrified of this. I think Manulife became satisfied, and I think the others were satisfied as well that this really is not a real problem. The likelihood of something occurring during that five-day period that would be of significant concern on day one is on the order of 0.5%. Second, since the IPO funds the cash-outs,

how do you do the cash-outs? There were just a host of issues that flowed from the fact that the demutualization was effective and the rest of it wasn't.

We had to list in all these markets in order to create the kind of deep markets we were talking about. In the Philippines, there's a special tax rule that gives a low tax to transactions on the exchange and gives Philippine policyholders the benefit of that. We had to make the first secondary sale by all these thousands of people to the underwriters be actually a call on the stock exchange. All these things just came out of the woodwork. There were currency issues.

The last difference is that the New York law is terribly strict on management purchases of shares. It basically says that management can't have options for a year after demutualization, and it can't even go out in the market and purchase shares. Investors hate that and the analysts hate that. They want management to have an economic interest in the company. OSFI was wise enough to recognize that. No options can be granted to management for a year in Canada as in the States, but they are free to buy shares in the market and indeed the CEO of Manulife bought $5 million worth of shares on the first day.

**Mr. Nicholas Bauer:** "Demutualizations: The Canadian Experience" should have a subtitle, "An Actuarial Perspective." What I'll try to do is give you a flavor of the actuarial issues in Canada. I will try to do a little comparison with the U.S., but I claim no expertise, no personal experience of the kind that Steve has had in the U.S., so please accept that caveat.

Four large federally licensed mutuals demutualized. All announced their plans to demutualize in the first half of 1998, which was interesting because, at the time, there was no legislation and really no regulation in place permitting demutualization and governing how it would work. There was one single general provision in the Insurance Companies Act that said companies can demutualize, but without appropriate supporting regulation and so on, it really became legally impossible to do so. There was considerable pressure for the government to bring in appropriate legislation, and there were intense negotiations going on all through 1998 between industry, the Canadian regulatory agency (the Office of the Superintendent of Financial Institutions—OSFI), and the Department of Finance, which represents the executive branch. It's part of the government. As for what rules ought to govern the demutualization, finance, if you like, brings the political perspective as much as anything else.

The regulatory regime was finally set in the spring of 1999. To be more precise, the final rules became known and were accepted by parliamentary committees late in 1998, but by the time they got around to fully adopting it in parliament and proclaiming royal assent, it was spring of 1999. A couple of weeks before then Mutual Life, now Clarica, actually went with its IPO.

As Mike mentioned, there was one provincial company where there was no existing regulatory regime at all, so there had to be a private member's bill shaped for that one particular demutualization. The regulatory regime that was finally adopted prescribes the process of how companies must go about demutualization. It

consists of a set of regulations supporting the law. The law has relatively few provisions in it, but the regulations are quite detailed. In addition, OSFI published a set of internal guidelines, colloquially referred to as the OSFI rules, which govern and with which demutualization has to comply. Those regulations and guidelines govern documentation, what must be sent to policyholders, how the whole thing must be prepared, time frames, regulatory approvals, and so on.

The key signposts are review and approval by OSFI. That has to be happening before the second major key point, which is the special general meeting (SGM) of policyholders, which then approves the process. There is no open regulatory hearing as there is in the U.S. The key meeting, as I said, is the SGM, but the material has to be reviewed and approved in advance. Once the policyholders vote and approve—which tends to be a foregone conclusion because who can resist a large windfall; then the plan is sent to the Minister for final approval.

The key documentation that has to accompany the demutualization process that is submitted to OSFI includes the conversion plan or demutualization plan. This is the legal document adopted by the board of the demutualizing company, which describes and sets legal context for the process. The policyholders' circular goes only to voting policyholders and informs them of the process, especially how it is governed. It includes the conversion plan. It explains in laymen's terms how the allocation of shares was decided, how policyholders' reasonable expectations are protected, and so on, and it must be accompanied by an opinion of the Appointed Actuary (AA) of the company and of the Independent Actuary (IA). We'll discuss the role of the IA a little more later. Finally, the investment bankers' opinion of the value of the company is needed, which really is an opinion on the range of value that they expect the shares to fall into.

The actuarial opinions have to come from the AA and from the IA. Both have to opine that the allocation is fair and equitable to the participating policyholders and the voting policyholders. The plan includes appropriate measures for protection of the participating policyholders and reasonable expectations for dividends and for nonguaranteed benefits and their contractual obligations.

Now, a word here about the roles of the two actuaries. The AA in Canada is a statutory responsibility. The AA is sort of a guardian of financial health in the sense that he opines on the actuarial liabilities and also issues an opinion on the financial condition of the company by the preparation of the dynamic capital adequacy test. There is great reliance on the work of the AA since his work is governed only by professional standards, and there are virtually no regulatory prescriptions as to how you calculate policy liabilities.

Let's turn to the role of the IA. The Canadian tradition is to rely on regulatory supervision combined with an IA's opinion for material transactions that affect the policyholder such as mergers, amalgamations, assumption reinsurance, trading of blocks of business, and the like. It was natural, therefore, to follow the same process on demutualization. The actuarial opinion must opine on the sufficiency of funding of the par accounts to support new business (more about par accounts later), and it must opine that the security and vitality of the company is not

adversely affected by the demutualization. Finally, a small additional task for the IA only is to opine on the policy credits: instead of shares or cash, policyholders get policy credit enhancement of policy values or a reduction of premiums or the like, which are an appropriate substitute for shares. That really was a trivial exercise because virtually all companies distributed either shares or cash to virtually everybody with one minor exception in the U.S.—the law essentially forbade the distribution of either.

There are two kinds of external actuarial roles in Canadian demutualizations. The first is to advise and support the internal and complementing internal resources of the company and advise the actuarial area of the company. That role is similar to the situation in the U.S., but no opinion is necessarily issued by the advising actuary, unless the company asks for it.

The second one is the IA's opinion, which follows the Canadian tradition, as I said, of requiring Independent Actuarial opinions on major transactions. The IA is engaged by the company, initially approached by the company, but has to be approved by OSFI and reports to OSFI, the policyholders, and the board. His opinion can be made available to other regulators. As Steve said, where it's multijurisdictional, opinions can go to the Michigan regulator, foreign regulator, and so on.

Finally, OSFI engaged its own actuarial support, whose role is twofold. One is to assist OSFI in drafting its guidelines, and the other is to just peer over the IA's shoulder to make sure that he did his job with appropriate due diligence and thoroughness.

Steve already talked about how eligibility is mandated by regulation, contrary to the U.S. and contrary to other jurisdictions. It is mainly mandated through the voting policyholders on the selected eligibility date, but that still left a whole host of issues that the company had to wrestle with. Even a task as simple as identifying precisely who the voting policyholders and participating policyholders are was not a simple exercise. You'd be surprised by how vaguely policy contracts can be written. The IA role in this was only an indirect one, which called for a review of whether the company had applied due skill and care to the identification of the eligible policyholders. This is needed so that when it comes to allocation, one can be assured that the allocation goes to all the right people. Incidentally, on the subtopic of voting policyholders, there is an exception to the point that Steve made. In Quebec only, which is where the fifth company, Industrial-Alliance, is licensed, all members of a mutual are voting, and all members, whether participating or nonparticipating policyholders, will in fact get a share.

Let's turn to the allocation. The regulations require that the allocation be of the company's entire value; it must be fair and equitable, but what is fair and equitable is not defined; therefore, it was desirable for the IA to develop internal criteria in advance, rather than run after the fact. That's what we did. My firm was involved in three of the four demutualizations as IAs, so it was particularly important for us to ensure that our standards were consistent across all three companies that we were opining on.

The allocation of the entire value usually is fairly straightforward, because none of the companies had any additional interest in the company. There were no par shares, or anything of the kind that had a claim, but it does raise the possibility of dilution if the company includes, as part of the IPO, a particularly sizable block of new Treasury shares. We developed the criterion that as long as the additional Treasury shares included, in addition to those shares that are allocated to policyholders, not more than 10% of those allocated to the policyholders, we would assume that there is no material dilution of policyholder value.

The allocation formula: As Steve said, there were fundamental differences. In the Canadian environment, all five companies followed or are following what colloquially became known as the policy metrics method. The method has been followed in all non-U.S. precedents, whereas the U.S. has followed the contribution method. The formula drivers for the policy metrics method are simple accessible metrics, cash value, premium, some insured duration, and things that the policyholder can readily identify directly from the policy or from information routinely received from the company which is therefore verifiable. The formula, should, however, be designed to meet the company's principles of allocation.

There is a comparison between the policy metrics method and the U.S. method. Why are the two different and how did they come to be? In the U.S., the contribution method of surplus distribution is deeply ingrained in mutual companies, and it therefore was a natural to evolve as the basis on which the shares should be allocated. Are most people familiar with the contribution method? Basically, the issue is that it is historical or retrospective.

The contribution method of surplus distribution is largely followed in Canada, though with less intense rigor than in the U.S., but it is less or not followed elsewhere. Most U.S. companies are single territory, as Steve described, so there is no great issue in multiterritory jurisdictions, whereas three of the four Canadian companies are multijurisdictional. The U.S. mutuals issue mostly or entirely par business, at least through the parent company itself, whereas in the other ones and in Canadians, in particular, nonpar is an important and an increasing component. In some of the mutuals, it is a dominant component of the total business of the company.

Finally, in the case of the U.S., if you compare the likely value that the market will put on the aggregate shares of the company and the aggregate contributions, they tend to be roughly in the same ballpark—far from identical, but roughly on the same order of magnitude. In Canada, the allocable value can be much greater. So much of the value gradually falls out of the nonparticipating business or out of policies that are no longer in force.

How do you arrive at those policy metrics? Each company's policy metrics formula must follow that company's principles of allocation and will depend on the company's history, its management of its business, its surplus, its lines of business, and its dividend distribution philosophy.

One major issue in Canada is that the contribution method, even where they were wanting to adopt it, tends to lead to results that would be unacceptable to non-North American foreign regulators. Outside North America, data might be unavailable or dubious, simply because the contribution method just wasn't followed there. The right kind of data to build contributions can be simply unavailable. Nonetheless, the Canadian companies did their best to calculate the contributions by territory and by line of business for two purposes. One is to compare and develop a policy metrics formula that is related to the contribution to surplus by territory and by major line. Another is to check that the allocation is not less than the contribution for material blocks of business, whenever the allocation was substantially in excess of total contribution.

The second major role of both the AA and IA is to opine on policyholders' reasonable expectations (PRE). Notice that, contrary to the U.S. and most other jurisdictions (this is kind of unique to Canada), there is separation of accounts: there is the par account and a nonpar and shareholders' account. They have to be maintained separately by both mutuals and stock companies.

The par accounts on demutualization were then subdivided into the par account for the existing business, which contained two components: the closed block, similar to U.S. closed blocks, and an ancillary block. The ancillary block contained everything that was liability in the previous par account, and that was not needed to put in the closed block. The excess of whatever is in the par account, which is not needed to cover either the closed or ancillary block, could be transferred to the shareholders' accounts. All the par surplus flows over on demutualization into the shareholders' account. However, there is a flow back. One of the requirements of the regulation is that the converted company have a new open block for new par business, and it must be capitalized sufficiently so that it would support that new business and not have a capital deficiency for at least five years or longer.

Once the accounts are set up, there can be transfers between the accounts after demutualization. There is no transfer out of the closed block. The closed block is closed, but from the ancillary account, anything that is not required to support benefits to policyholders or expenses in the ancillary account, once it's released, can be flowed over to the shareholders' account. All of the surplus out of the ancillary account will flow over to the shareholders' account, but the shareholders' account undertakes an obligation to support either the ancillary or the closed fund if either of them is found deficient. That is, their assets are not quite enough to cover their liabilities. Closed is closed, in the sense that nothing can flow over to the shareholders' account, but there can be sharing of experience between the closed block and other parts of the company. I'll cover that in a moment.

What is included in the closed block are policies needing PRE protection. Dividends are normally determined annually by the board, and subject to all the good and sound rules that you're aware of. However, the closed block usually excludes those policies that either are par in name only and have fixed dividends or no dividends, and group business, where dividends tend to be determined by contractual formula rather than by board action, and any nonpar riders, the profits from which are not

used to support the dividend scales. All of that is quite similar to the construction of the closed blocks in the U.S.

However, the ancillary fund is quite different from how it's done in the U.S. It contains the provision for adverse deviation of the closed-block policies. What's in the closed blocks is only the amount needed on a best-estimate basis to satisfy PRE of the participating policyholders. If there is any excess of that, the provision for adverse deviation goes to the ancillary block and will end up in the shareholders' accounts, if not needed to cover benefits. The ancillary block also contains other par policies not needing protection and any amounts on deposit, the profits from which are not used to support dividends.

The open block has, as I said, only the seed capital for the new business, and it has to be enough to make sure that there is no capital deficiency regarding the open block for at least five years.

The Canadian definition of PRE is to use best-estimate assumptions, plus a margin for adverse deviation. This is the normal policy liability. It's called the policy premium method, and it's, essentially, a gross premium valuation.

The policyholders' reasonable expectation that must be covered with the margin by that liability is defined by communication, oral or written, with policyholders, agents, and the past dividend declaration practice of the company.

In the valuation, future dividend scales are assumed to follow normal management practice given best-estimate assumptions. That is contrary to U.S. practices. If you expect portfolio interest rates to drift down, then it is normal to assume a reducing scale of future dividend declarations, with the reduction being in line with past company policy, including taking into account any lags in following experience that the company might normally run.

The current scale and experience, which is the normal U.S. method for funding of closed blocks and for what PRE means, might be a satisfactory approximation in Canada, but it needs to be supported. It's not necessarily a satisfactory approximation.

In setting up the closed blocks, the OSFI rules that I described before govern the guidelines that define the future operation of the closed block. How are expenses and taxes to be charged to the closed block? How is investment income to be allocated to it, and when must the closed block be topped up from the outside? That's the no tontine rule and no deficiency rule. If you run a closed block and, for example, you start declaring dividends because the market is demanding larger dividends than what the closed block can afford, then the shareholder must top up the closed block to the point where the balance is reestablished. Similarly, if under a current dividend declaration, the closed-block asset balance becomes materially larger than the value of the actuarially calculated value of policyholders' reasonable expectations, then the company is obligated to increase the dividends to again bring the two in balance and not build up too much of a surplus in the closed block.

As I said, the purpose of the operating rules is similar to the operating rules in the U.S., and they generally work quite similarly. The expenses may be allocated. Canadian rules allow the expenses to be allocated by the same kind of practice as the company followed in the past. In fact, all of the demutualizing companies chose to fix the expenses to be charged to the closed block, which is similar to what is happening in the U.S. The fixed expenses can include inflation, and the expense formula will include obviously any commissions chargeable to closed-block policies, and the closed block will be funded accordingly.

It may share experience with the open block, either interest or mortality, where you put the two together, run a portfolio interest fund for the closed block and the open block together, and then allocate the interest pro rata in proportion to book liabilities. As long as there are safeguards around that, the allocation of interest to the existing block is fair and permitted, which is similar for mortality.

The closed-block funding follows best-estimate assumptions. The IA will do an evaluation by comparing to the best-estimate assumptions that have to be disclosed in the last valuation and by asking for justification for any departure from whatever the best-estimate assumptions underlying the last valuation of liabilities prior to demutualization contained. That is the case if there are glide paths in the dividend scale. When there are glide paths, there is a difference between the current dividend assumptions and the current actual experience. Because of lags in recognizing experience, which can be in either direction, then it is appropriate to assume a glide path through which the dividend scale is dropped gradually in harmony with the PRE experience. To the extent that such glide paths are used, the closed block must be funded for them.

Inflation funding: If inflation of expenses in the past has resulted in a corresponding reduction in dividend expense factors, then it is appropriate to fund the closed block for current expenses without considering inflation. If, however, that is not the case, then it is appropriate to fund the current closed block with expenses with the anticipated rate of inflation.

Finally, if, for any reason, the closed block becomes insufficient, there has to be a commitment of a top-up from the shareholder, either from the ancillary fund or, if funds are insufficient, then it must come from the shareholders' fund to fully protect PRE.

To make sure that the initially set regime is assiduously followed, the AA of the company is required to report periodically, at least annually, whether the company is complying with the operating growth and rules of its demutualization. In particular, there must be compliance with regard to the closed block, experience on gain and loss experience in the closed block, on the dividend recommendation, and its conformity with the operating rules. On the ancillary block, the report has to cover the current provision for adverse deviation and explain any change in assumptions and margins compared to the initial ones and generally the par account experience. I'm not sure why that latter is relevant because the ancillary block ultimately ends up with the shareholder, but the regulations require it.

One last point, mutual holding companies: Those are simply not permitted for federal companies. Past Quebec demutualizations used the mutual holding companies system, but the full demutualization model is being followed for the one current Canadian demutualization.

I will leave you with one parting comment for anybody who is contemplating the system. I was asked by a retired senior officer, What was the biggest surprise that I encountered in demutualization work? After reflecting, I answered, literally the sheer volume and magnitude of work that's associated with the process. It's just unbelievable. Everybody thinks they understand, when they go into the process, and as you go through the process, it just gets worse and worse and worse.