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The demutualization of The Equitable

by Gary Corbett

The conversion of The Equitable Life Assurance Society (ELAS) from a mutual life insurance company to a stockholder-owned holding company, The Equitable Companies Incorporated, was completed on July 22, 1992. EquitCos (EQ) became a 100% owner of ELAS, which continues to hold interests in many other stock financial service companies, including Equitable Variable Life Insurance Company (EVLICO), the same as before conversion.

This conversion, although not the first, was the largest and most complex. It was the first to take place under a modern demutualization statute — Section 7312 of the New York Insurance Law, enacted in 1988.

The New York statute reflects many of the concepts contained in the July 1987 "Report of the Society's Task Force on Mutual Life Insurance Company Conversion." I served on this task force chaired by Harry Garber of The Equitable. The influence of the task force report is not surprising, given the significance of actuarial elements in any demutualization.

This article explains the process, with a brief description of the actuarial areas of interest.

Feasibility study

In July 1990, The Equitable's board of directors approved an investigation into the feasibility of demutualization, with the understanding we would proceed to demutualize if practical. We already had decided that demutualization would be a two-step process:

- Obtaining an initial pre-demutualization investment or commitment

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Message to the members

Ask an actuary

by Walter S. Rugland
1992-93 President
Address at SOA Annual Meeting
October 27, 1992

I want you to know I take great pride in being an actuary. It is an honorable and respected profession. Let me tell you why I think so.

First of all, we have the public trust and stand accountable for the quality of our work. And, we are a profession because of the way we apply our research in practice, because we practice in a way that the people who use our work can rely on our results, because we attest that we are qualified to do the work we do, and because we are able to discipline ourselves.

I am proud to have grown up the son of an actuary. I know I share this with only a few of you. It is a privilege, and to this, I attribute my sense

Walter S. Rugland

of heritage and tradition. Anticipating this day made my Dad very proud.

So, I am proud of our profession's unique history, recorded so well in Jack Moorhead's book, *Our Yesterdays*, and in our shelves of literature. I stand in awe visiting the home of the

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In this issue:

Canadian Constitution put to the electorate in October was a compromise to meet the needs of many of the competing interests of Canadians. It had the support of the three major federal parties, the support of all 10 provinces, of labor and business, and of aborigines. Yet, in this case, the Canadian electorate believed there was too much compromise and voted it down.

I believe actuaries are considered among the most principled of all professionals. Our integrity and adherence to the principles of our profession make us stand out and raise us to high esteem in the view of those we serve. This is what enables us to be proud and happy to be members of the profession. We should never compromise those principles. At times, however, is compromise necessary and desirable? Consider these three instances:

- Without compromising our principles in any way, can we find ways to broaden our input into the businesses in which we work? Although we have so much to offer, too often our contribution fails to be passed on in language that can be understood, too often the implications of alternatives are glossed over, and too often we don't understand other interests necessary to an optimum result.
- One of the characteristics of the current political scene is the influence of special interests at the expense of the common good. Let us in our professional endeavors be cognizant of broad principles before we stress a special interest, or worse, a personal interest.
- An important principle of the Society is the integrity and standards of the FSA. Does it then follow that universities cannot play a more significant part in our basic education? I think not. Were we right in turning down an expanded role for long-term Associates? I think not. In my opinion, in neither case would we have been compromising basic principles.

Never in my career have I ever doubted the wisdom of becoming an actuary. To be a member of this profession is to be a winner.

The Equitable cont'd

- Actual demutualization and Initial Public Offering (IPO)

The project would take two years, culminating with the IPO and formal demutualization on July 22, 1992.

Determining a method

One of our first tasks was to determine the method we would use to demutualize. The New York statute permits four methods:

1) Distribute stock to policyholders but raise no outside capital
2) Distribute stock equal to policyholder equity (a calculated amount described later) and sell enough stock to the public so the total market value of the company is equal to policyholder equity plus the amount contributed by new shareholders
3) Distribute statutory surplus to policy owners (permitted only for small companies)
4) Any other method approved by the superintendent

Method 2 was designed by the Society's task force for companies that wanted to raise capital as part of the demutualization process. Unfortunately, in practice, it has two flaws:

- The difficulty of determining how much stock to issue to ensure that the new shareholders' market value would approximate the amount they have paid for the stock
- The assumption that the market value of the company, before introducing outside capital, is at least equal to policyholders' equity

In early 1991 we determined that our policyholder equity exceeded, by a fair margin, the company's probable market value. Therefore, the only option available to the company was Method 4, because capital could not be raised under the terms of Method 1.

Our estimate of market value was based on an early 1991 actuarial appraisal (basically, adjusted net worth plus present value of future profits), plus ongoing discussions with prospective investors and their bankers.

Obtaining an investor

Negotiations with potential investors took up most of the first six months of 1991. These negotiations were very complex, because investors needed to understand all the implications on future earnings of such structures as the "closed block," described later in this article. Every week we understood a little more about the implications of the closed block, first on statutory surplus and profit and later on GAAP book value and earnings.

A third party to these negotiations was the New York Insurance Department (NYID), including their investment and actuarial advisors.

Finally, on July 18, 1991, we struck a deal with the French insurance company, Axa, with which the NYID concurred. Axa put $1 billion into The Equitable, $250 million represented by a surplus note and $750 million represented by a secured note, both of which would convert to capital upon demutualization.

Now, all we had to do was demutualize and float an IPO. The IPO was required not only to raise additional capital, but also to meet a condition in the Axa investment agreement. In the agreement, the conversion of the Axa investment to capital was dependent on an IPO that produced at least $300 million of net proceeds.

Developing the plan

Following the Axa investment, we all turned our attention to developing the demutualization plan. Twenty task forces were formed to deal with different aspects of the project. More than 100 Equitable employees devoted much of their time to the effort. Our staff was supported by outside actuarial, legal, and investment firms, as well as by advisors retained by Axa. We have identified about $150 million in total costs, not counting compensation and related expenses for our own employees. By any measure, it was a huge effort.

We met weekly, or even more often, with the NYID and their actuarial, investment, and legal advisors. The actuaries were most involved with three areas:

- Policyholder equity
- The closed block
- Special provisions for par policies not in the closed block

Policyholder equity

Although Method 4 does not mention how shares should be allocated to policyholders in exchange for their membership rights in the mutual company, we calculated policyholder equity as described in Method 2. Because our market value would not support the entire policyholder equity, policyholders would receive less than 100% of their calculated equity. This percentage depended on the market

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value of the shares issued to policyholders.

Although we paid cash or policy credits in lieu of shares to some policyholders, all calculations assumed everyone received shares. We simply converted the value of shares to cash or policy credits as a last step for the affected policyholders.

The number of shares allocated to all eligible policyholders was about 30 million. All eligible policyholders (nonpar as well as par) received a fixed component of 3 shares. This fixed component totaled about 6.5 million shares. Subtracting 6.5 from 30 million leaves 23.5 million shares. The remaining shares, called the "variable amount," were then allocated to par policyholders in the proportion of their policies' past and expected future contributions, called the "actuarial contribution," to The Equitable's surplus.

The calculation of actuarial contribution for each in-force policy was a huge job. We collected historical data back to 1910. We built models to capture the most significant profit-generating features of each type of policy. Obviously, we had to make many approximations, especially for the distant past.

For each of 10 major product lines, we calculated the line's actuarial contribution as the sum of the actuarial contributions for the policies in-force in that line. For those lines with a negative actuarial contribution in total, such as GICs and individual medical, we set the actuarial contribution for that line and for all policies in the line to zero.

For those lines with positive actuarial contributions in total, we first spread any negatives proportionately over policies with positive actuarial contributions. As a result, the sum of the individual policy actuarial contributions for the line became equal to the actuarial contribution for the line in total. For example, if the sum of positives was $1 billion and the total for the line was $900 million, then the adjusted actuarial contribution for each positive policy was 90% of its calculated actuarial contribution and zero for negative actuarial contributions. (We could not actually charge negative actuarial contributions to policyholders.)

We then added up the adjusted positive actuarial contributions for the entire company and calculated each policy's share as a percentage of the total company adjusted actuarial contribution. Each policy then received this percentage of the total variable amount of shares distributed to policyholders.

The result was to pay approximately 46% of the variable amount to individual life policyholders and lesser percentages to other product lines.

The closed block

Issues relating to the closed block consumed most of my time in the last half of 1991. Almost every aspect had to be negotiated with the NYID, which played both advocate and judge roles, limiting our negotiating powers.

As with policyholder equity, Method 4 does not require setting up a closed block, required under methods 1 and 2. However, there was never any question that we would set up a closed block to protect par policyholders. Our use of Method 4 permitted us to exclude non-dividend paying par policies from the closed block, which we could not have done under Method 2.

The closed block is composed of all The Equitable's dividend-paying individual policies. It is labeled "closed," because no new policies will be added to the block after the effective date. Thus, over time, the number of policies in the closed block will decrease, and the closed block itself will disappear when the last closed block policyholder dies or surrenders his or her policy.

The purpose of the closed block is to assure policyholders' reasonable dividend expectations when the former mutual becomes a stock company and is operated primarily for the benefit of its shareholders, rather than its policyholders. The closed block operates to assure closed block policyholders that dividends post-demutualization will be determined on a basis consistent with the way they were determined before demutualization.

All premiums paid by closed block policyholders are credited to the closed block, and all benefits (death or termination) and policyholder dividends are paid out of the closed block. Premium and income taxes also are paid out of the closed block. However, normal expenses and commissions are not charged to the closed block and are not funded for in the closed block.

Certain assets, primarily bonds and mortgages, in the investment

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E & E CORNER

The proposal to merge two Associateship examinations, Course 160 (Survival Models, a required course) and Course 162 (Construction of Tables, an elective) into a single required course was approved and will be effective with the November 1993 examination session. The rationale for the merger is that the existing courses overlap and can be combined with no real loss of coverage.

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The new Health Policy elective (G-527, Health Policy) is very popular with candidates, and 492 registered for the exam in November.

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Case studies were introduced on exams I445, Individual Health Insurance and G-522, Continuing Care Retirement Communities and Long-Term Care Insurance for the November 1992 session.

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Grades for the November 1992 exam session were expected to be mailed on December 23 for Exams 100 and 110, January 8 for the remaining Associateship exams, and January 15 for the Fellowship exams. Candidates may call the interactive voice response (IVR) system after these dates for their pass/fail results. The IVR number is 708-706-3579.

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The Society of Actuaries will have a Finance Track operational beginning with the fall 1993 session. The Finance Track offers broad training in financial reporting, valuation, finance, and solvency management.

The track will consist of existing and newly developed courses. Existing courses that will be required in the Finance Track are I-442C, Advanced Topics in Valuation and Financial Reporting-Canada, or I-443U, Advanced Topics in Valuation and Financial Reporting-U.S. and V-580, Corporate Finance. The new courses under development will cover Financial Management, Advanced Financial Management and Taxation (Canada or U.S.), and Corporate Strategy and Solvency Management. Full descriptions will appear in the 1993 Fall Fellowship Catalog.

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well regarded in educational circles in his country. He wrote a textbook, *The Application of Group Theory in Physics*, that was translated into six languages and is still used at many universities.

Starting a new life

The couple now has refugee status, but they hope to receive their green cards this year. They say everyone they've met here has been very helpful, and they look forward to finding jobs and possibly settling in Chicago. "We have made many friends here," Anna says.

The Equitable cont'd

segment backing the policies going into the closed block were selected for the closed block. The amount of closed block assets was determined as the amount, together with anticipated earnings from these assets and revenue from closed block policies, that was reasonably expected to be sufficient to pay guaranteed benefits and taxes and to maintain the 1991 dividend scales if the experience (of 1990) underlying such scales continues. The closed block assets will decrease to zero when the last policy leaves the closed block. Under no circumstances can the assets allocated to the closed block nor the revenue from them revert to the benefit of stockholders.

Individual policies not in the closed block

For the non-dividend paying individual par policies excluded from the closed block, the NYID required that we protect these policies similar to the closed block policies. We designed a process to prevent the stock company from making more profit from these policies than had been assumed in the calculation of their actuarial contributions.

Distributing actual excess profits would have presented many of the closed block problems again, such as allocation of expenses and valuing of asset cash flows. Therefore, we concentrated on the most significant component of profits for a product (for example, interest spread for annuities and claims ratio for health insurance). We then established a process where experience in these components that proved better than we had assumed in allocating policyholder consideration would be distributed over time to policyholders in each class.

The actuarial negotiations with the NYID were largely completed in time to finalize the plan adopted by our board in November 1991. Work related to the non-dividend paying policies not in the closed block continued into early 1992.

Regulatory obstacles

Many other regulatory hurdles had to be jumped, most at the federal level. We had to negotiate with the Department of Labor for ERISA rulings and with the IRS for corporate and personal tax rulings. The biggest obstacle was the Securities and Exchange Commission (SEC) in the preparation of our prospectus or S-1. Space does not permit even a list of all the issues with which we had to deal. To give you some idea of the complexity, at one of the many drafting meetings with attorneys representing us, Axa, and the underwriters, one of our people asked the underwriter's attorney (who spends 100% of his time on S-1s and related issues), "On a scale of one to ten, compared to other issues you've worked on, how complicated is this one?" The answer was, "Thirteen."

Two issues we faced warrant mentioning. The first was related to whether we could continue to GAAP-account for our traditional life insurance business as we had in the past. Although we were a mutual company, we had been producing statements basically in accord with stock GAAP, attested to by our auditors. For traditional life insurance, we had not been using FAS 60, but a modification of FAS 97 called "Source of Earnings." Everyone, including the major accounting firms and the FASB staff, agreed that FAS 60 gross premiums are not a good representation of revenue for the par business of a mutual company. However, we were still required to follow the dictates of FAS 97, which prescribes FAS 60 as the accounting model for traditional life products, including participating. Therefore, as part of the conversion, we had to revise all our GAAP factors for the affected business.

The second issue was how the results of the closed block should be presented in our GAAP financial statements. We believed the most meaningful presentation would be to show the line-by-line closed block results in a separate column and then consolidate them with the open block. The SEC insisted on a one-line entry on the profit and loss statement, reflecting the net earnings of the closed block. This results in our P&L not being comparable to other companies, because closed block premiums are excluded from revenue, but the expense related to closed block policies (which are not charged to the closed block) are in the open block. Therefore, we'll have a meaningless high ratio of expenses to revenue.

Meeting the deadline

I never believed we could complete everything on schedule — an acceptable plan for adoption by the board on November 27, 1991, and the IPO by mid-July 1992. That we met those ambitious deadlines is a credit to many people, both within the company and outside it. In particular, the regulators (the NYID and the SEC) spent countless hours on this project. We didn't always agree with them, but we could not fault their effort and cooperation.

No more complex transaction in the insurance industry exists than converting a mutual insurance company. Even with all the complexities, many companies are exploring demutualization to gain access to outside capital and to enhance the flexibility of the company to react to changes in the financial services marketplace.

Gary Corbett is an independent consultant and the former senior vice president and chief actuary of The Equitable insurance companies. He is a past President of the Society of Actuaries.

New Zealand cont'd

insights as I discussed these issues with my New Zealand colleagues.

Many SOA members travel abroad, on business and for pleasure. The newsletter of the new International Section will try to list upcoming foreign meetings. If SOA members can tailor their travel plans to include attendance at some of these meetings, they will find it, as I have, to be a rewarding opportunity.

Curtis Huntington, Chairperson of the Committee on International Relations and a Council member of the International Section, is corporate actuary at The New England Mutual Life Insurance Company.