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Demutualization in Canada

Toward growth and international competitiveness

by Mike Lombardi

The Canadian insurance industry is entering a new century and a new era of stock ownership. It is experiencing a radical transformation as the five largest Canadian mutual insurers complete their conversion to public companies. Over 2.5 million Canadians and 1 million others outside Canada are exchanging their intangible ownership rights for shares, cash, or policy credits, according to the Canadian Life and Health Insurance Association.

Mutual Life (now known as Clarica Life), Manulife, and Canada Life all demutualized in the last half of 1999, and Industrial-Alliance and Sun Life intend to complete demutualization early this year. After these changeovers, only a few small mutual insurers will remain in the Canadian market.

The value of the windfall benefits to be shared by eligible policyholders worldwide may exceed $25 billion Canadian (over $16 billion U.S.), and is believed to be the largest transfer of wealth in Canadian history. Manulife's initial public offering (IPO) of C$2.5 billion broke the previous all-time record held by the Canadian National Railway for its 1995 IPO valued at C$2.3 billion. The impact of Canadian demutualizations will extend to eligible policyholders in the United States, Hong Kong, the Philippines, the United Kingdom, and Ireland.

Some interesting differences exist between the U.S. and Canadian waves of demutualizations. Canadian mutuals tend to be well-capitalized and international in scope, with non-Canadians forming the majority of policyholders in the larger companies. This is true of very few U.S. mutuals, where U.S. policyholders predominate. (One important consequence of the Canadian mutuals' internationalism has been the need to deal with multiple national regulators during the demutualization process.)

The timing of the decision to demutualize has been heavily influenced by the significant changes and opportunities arising in the domestic and global financial services marketplace and the growing popularity of capital markets. The enactment of federal legislation allowing demutualization in March 1999 gave the demutualizing companies the necessary process and regulations to move forward.

Consolidation in the Canadian life insurance industry recently has resulted in a smaller number of larger and stronger companies. The need for both greater access to capital and financial flexibility has been the main motivation behind demutualization in Canada. The desire to better align the financial interests of owners and management, to attract strong management, and to attain greater financial discipline imposed by public scrutiny are also factors encouraging demutualization.

Distribution of value

While the alternatives of both sponsored demutualization and the mutual holding company structure have been used in other demutualizations, the five Canadian companies have taken the approach of "pure," or full, demutualization. Each company's value is distributed among eligible policyholders, and the newly demutualized company, or its upstream holding company, is publicly listed on the stock exchange.

The entire value of a company demutualizing in Canada must be distributed among policyholders who, on the eligibility day, had the right to vote at policyholders' meetings. In most cases, only policyholders of participating policies are entitled to vote. Unlike U.S. demutualizations, a policy is not required to be in force on the actual day of demutualization, which is typically one to two years after the eligibility day.

Management and employees are prohibited from receiving any special compensation as a result of demutualization, other than benefits to which they are entitled as eligible policyholders. Although the demutualizing companies intend to establish incentive compensation stock option plans, they cannot do so until shares have been listed for at least one year.

The formula for the allocation of value in demutualizations consists of two parts, one fixed and the other variable.

The fixed component, a flat number of shares for every eligible policyholder, compensates for their loss of voting control of the company. Typically, the fixed allocation has been between 15% and 25% of the total allocation.

The variable component recognizes the ownership interests other than voting rights. In Canada, as in other non-U.S. demutualizations, the variable allocation does not follow the contribution to surplus method as strictly as is done in the United States. Instead, a more general "fair and equitable" allocation formula is used. Reasons for not using the "contribution-to-surplus" approach include the fact that much of the surplus may have arisen from contributions from previous generations of policyholders, the surplus may have been generated primarily by

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ineligible non-par policies which do not share in demutualization proceeds, or par businesses for some blocks or across entire countries may have generated a cumulative loss (a negative contribution to surplus). The Canadian allocation formulas, while indirectly linked to profitability analysis, tend to be based on factors applied to more easily identifiable proxies or "policy metrics" such as duration, premiums, cash values, or face amounts.

The status of non-par policies is also different. In almost every U.S. state, non-par policyholders vote for directors of mutual companies. Therefore, non-par policyholders have traditionally received the fixed consideration. In Canada, in contrast, non-par policyholders usually do not have the vote. The current governing statute, the Insurance Companies Act, empowers mutual insurance companies to grant voting rights to non-par policyholders, but only one company has done so. So the various Canadian demutualization plans, with the exception of Clarica (and Industrial-Alliance, a provincially registered company not subject to the Insurance Companies Act) do not provide for any demutualization proceeds to non-par policyholders.

Canada's Insurance Companies Act requires mutual companies to maintain participating and non-participating business in separate accounts. At demutualization, a restructuring of accounts takes place. The non-participating account is redesigned as the shareholders' account. The participating accounts are separated into three categories: closed block, ancillary block, and open block.

Policyholders' reasonable expectations of dividends and other non-guaranteed benefits are protected through the requirement to establish a closed block from which transfers to the shareholders account are not allowed. The assets backing the closed-block accounts established for business issued before demutualization may be commingled with the assets supporting new participating business.

The margins for adverse deviations are held in a separate participating account called the ancillary block. Shareholders are entitled to the release of these provisions as determined by the company's Appointed Actuary.

If new participating business is to be issued, sufficient shareholder capital must be placed in the open block to support five years' of new business, capital that may be repaid to shareholders when it is no longer required. Shareholders will also be entitled to a portion of the profits that emerge from the open-block accounts established for new participating business issued after demutualization.

The balance in the participating accounts after providing for the closed, ancillary, and open blocks is transferred to the shareholders' account. As shareholders, existing participating policyholders remain owners of this surplus.

At present, Canadian regulations require that large insurers be widely held upon conversion and for two years thereafter, meaning that no one person may hold more than 10% of any class of shares of the demutualized company or an upstream holding company. The minister of finance has also announced that mergers among or acquisitions of demutualized firms would not be permitted during the two-year transition period. The ownership issue is currently under review for both banks and insurance companies.

More changes ahead

So, what's next? Significant changes and opportunities are arising in the financial services marketplace as competition, consolidation, globalization, and technology continue to transform the environment. Demutualization is not the end of the story, it is merely the beginning.

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Canadian actuaries at a crossroads

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10 years? The pricing and reserving of segregated fund (variable annuity) guarantees need more work before all parties can have the same confidence as with traditional products. Life companies' financial problems in the past decade largely stemmed from asset quality. Actuaries can prevent the next decade's problems from being due to pricing and reserving issues — which, if they occur, will be blamed on our profession for letting them happen.

To end on a positive note: As editor of this issue, I have the role of welcoming new Society President Norm Crowder on behalf of *The Actuary's* editorial board. This issue contains his speech from the recent 50th Anniversary Annual Meeting. We wish him a successful and enjoyable year.

With this issue, The Actuary *welcomes Charles McLeod as a new associate editor. He has served on a number of SOA and Canadian Institute of Actuaries (CIA) committees, and he has been a member of the CIA Council, the Institute's governing body. Until recently, he was chief financial officer of Canada Life's U.K. division. He now runs his own life insurance consulting practice. He can be reached by e-mail at* charlesmcleod@sympatico.ca.