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**TASK FORCE ON MUTUAL LIFE  
INSURANCE COMPANY CONVERSION**

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o A discussion of the committee's final report.

MR. HARRY D. GARBER: I am the Chairman of the Task Force on Mutual Life Insurance Company Conversion. The purpose of this session is to solicit comments on the Task Force report. The panelists will make some brief comments about specific portions of the report in hopes of stimulating discussion.

The first thing I would like to do is list the members of the Task Force who contributed to this effort: Bob Lindsay and Lou Roth of MONY, Dale Gustafson (who retired in the process) and Jim Murphy of the Northwestern Mutual, Bob Lowden of John Hancock, Curtis Huntington of New England, Mike Cowell of State Mutual, Bob Winters, Doug Murch and Ed Price of Prudential, Ed Slaby of Unity Mutual, Jim Tilley of Morgan Stanley, Bob Shapiro who was with Merrill Lynch when he started with us and then started his own firm, Dan McCarthy and Dale Hagstrom of Milliman and Robertson, Hank Ramsey of Penn Mutual, Walt Shur of New York Life, Steve Smith with Union Mutual (now UNUM), Charlie Greeley with Metropolitan, Robin Leckie and Gary Corbett with Manufacturers (although Gary, again, shifted along the way), Jim Wertheimer of Massachusetts Mutual, Mike Berkowitz of Mutual Benefit, and John Elken of Principal Mutual. We had most of the large mutual companies represented.

The Task Force worked hard and effectively and did an outstanding job in dealing with this issue. We are very pleased with the report. The report was

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discussed briefly by the Board of Governors and we were authorized to issue it as an expression of opinion of the Task Force. Also, it will be printed in full in the *Transactions* Vol. 39. It is important that, if there are differences of opinion relating to the conclusions of the Task Force, we use this opportunity to get them into the *Record*.

Let me give some general background. We started by saying that in the conversion process there are usually three interested parties. There is the company itself which is interested in accumulating capital, changing structure, or has some other reasons to convert. The policyholders are interested in preserving their guaranteed benefits, continuing their dividend treatment (whatever that is) and also in receiving fair compensation for the surrender of their membership rights. If the conversion involves raising new capital in the public markets, the new shareholders are the third interested party. Nothing will happen unless all three parties are satisfied that their interests are being met. It is important to remember this when we get to the subject of compensation for policyholders. If the required standard is so high that no shareholder will buy into the company, all that standard does is prevent a conversion.

This analysis permitted us to identify three important issues. First, how can we assure reasonable policyholder dividend expectations? Second, what constitutes the aggregate amount of fair value to distribute to policyholders in a conversion process? And third, how should that fair value be allocated among policyholders? The report addresses each of the issues in appropriate depth. We chose to cover these subjects very broadly rather than get into detailed exploration of the relevant actuarial issues.

Finally, we had some side products from our work. We developed a computer model which the Task Force used in its analyses. We explored, in depth, the issue of management accounting for mutual companies, and there was a report issued by a subgroup of this Task Force and published by the Financial Reporting Section. I commend it to you if you are interested in that subject. Finally, we studied the issue of what the appropriate model is of mutual company financial operations.

Let me start with a few comments on aggregate compensation. Then Dan McCarthy will talk about the closed branch, Walt Shur will discuss the allocation

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of the aggregate amount, and Hank Ramsey will finish with a talk about mutual company capital management practices and related issues.

The question of aggregate compensation to policyholders is one that many people have considered over the years, but not much analytical work has been done. We concluded that there is no recognized basis for determining an amount of distribution, either in the aggregate or policy-by-policy. In fact, there were no guidelines anywhere in practice, in theory, in law, in rights, or in expectations that had any substance other than that someone had used them or thought of them. This doesn't mean that the policyholders should not receive compensation for surrender of membership rights, but as far as we could tell, there was no recognized basis for determining what that amount should be or how it should be allocated. Those of you who followed the travails of the Union Mutual conversion process found out that what was said in law did not turn out to be what was required in fact. Even those people who might rely on the Williams Law for substance would not find much comfort from that proceeding.

So how do we start on this? The report states, "It is clear that, before conversion, a mutual life insurance company has neither an established market value nor an accepted way of defining ownership interests. These values must necessarily emerge as part of the conversion process itself and as the analyses in this section demonstrate clearly, they are affected importantly by the company's circumstances and the general state of the public equity markets."

We started by concentrating on cases involving an initial public offering. We thought that these raised all of the issues and were the most complex to deal with, but we don't mean to imply that this would be the predominant form of conversion. We recognized that this particular area is not primarily an actuarial problem, but as we were the only game in town, we took it on nonetheless because we thought we had some useful things to say.

We started by taking our three interested parties: the company, the policyholders, and the prospective shareholders and working from there. We introduced some formulas, which I would describe as descriptive rather than analytical, and used the results to illustrate certain relationships. The Task Force was struck by the wide range of results that were possible for policyholder compensation, depending particularly on the relationship of the company's book to market value

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as it eventually emerged in a public offering, and on the amount of capital being raised. In some extreme cases involving the raising of large amounts of capital, the company could be accused of acting imprudently relative to its policyholders. It is not unlike situations that arise in public companies where new issues of stock of a very large size could dilute the interests of existing shareholders. The main difference is that in this case we don't start with an initial share value. In fact, we don't start with a value of the company at all, and therefore the question of whether there was a dilution is one that can never be answered conclusively.

Our conclusion in this area was that there was no generally applicable standard. One must recognize in the process that each company's circumstances are different. What an individual policyholder, or policyholders in aggregate, might get in any company conversion is dependent very importantly on that company's situation.

Our suggestion is that the insurance law should contain more than one method of conversion. Second, whatever value the insurance law specifies for policyholder compensation should be regarded not as the appropriate value but as a safe harbor value. So, if the company can provide at least that amount, the insurance department would accept that as reasonable compensation and only inquire into other aspects of the conversion.

MR. DANIEL J. MCCARTHY: The phrase *closed branch* is a kind of shorthand for discussion; a method of dealing with the issue of how to assure that participating policyholders of a company at the time of conversion will continue to have participation after conversion, in roughly the sense that they had it before conversion. How do you assure that dividend expectations (a somewhat loose term) are maintained in some fair fashion? We concluded that in certain cases you don't need to do much of anything. Market forces will take care of it. Imagine, for example, experience rated group insurance or group pension contracts. The tendency was to conclude that market forces would tend to take care of their participation first of all because it is related specifically to the experience of each contract, and second, because the company has almost no discretion in the way it treats those customers. On the other hand, there are policies that have the following kinds of characteristics, of which individual life is the most obvious. First of all, the amount of dividends expected to be paid

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in the future is substantial and will often have been illustrated as part of a sale. The company will have considerable discretion as to the amount and timing of dividends payable. There will tend to be averaging of experience across broad classes of policies. We felt all of those criteria point to the need for some kind of device to assure that participation is managed in the interests of those policyholders over a future period of time. The concept of a "closed branch" is what the Task Force examined in most detail as the device for maintaining such participation.

Conceptually, the closed branch is very simple. It is an accounting device which says "put aside enough assets so that if conditions continue as they are now, that fund together with future premiums and interest, and minus expenses, claims, dividends and so forth, will provide policyholders with the same dividend scale that they have now." The fund will ultimately wind down a good many decades, as the last of those policies ceases to exist, and policyholders will have gotten the dividends they had anticipated getting in the meantime. As for whether a closed branch should be established, the report says it is probably appropriate whenever contracts have the feature of a substantial amount of dividends expected, or have the concept of company discretion, or have the concept of averaging rather than specific experience rating. As a practical matter, you ought to have a group of policies which would be expected to diminish and disappear over time. A set of group insurance policies would not necessarily do this.

Assume for the minute that there is to be a closed branch. What kinds of questions have to be dealt with? You can separate them into two categories. How do you get it started, and how do you keep it going? Start-up questions deal principally with what assets ought to be assigned to the closed branch. How do you select them? How do you determine their amount? Maintenance questions include what kinds of income and expense do you expect will be credited to and charged against the closed branch over time?

It seems fairly obvious that we should assign to the closed branch the premiums, claims, and dividends associated with the policies assigned to the closed branch. It is a little less clear whether the closed branch should be set up in such a way as to charge actual maintenance expenses to it, or whether you would set up a closed branch in which you did not expect to make those charges. There

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are similar arguments to be made for federal income taxes. The report sets forth those considerations in some detail. As you will hear in Walt's comments, it depends to a certain extent on whether there is linkage between the establishment of the closed branch and the determination of the amount of compensation to policyholders. You may well wind up with different answers, depending on whether you have a linked system, which the Task Force is inclined to prefer, or an unlinked system, which was suggested by the statute and actually used in the Union Mutual case conversion.

Regardless of what you do, you can assume that the dividends payable will not be precisely those that would have been payable had the company continued to operate as a mutual, because the financial dynamics of a closed branch over time won't be the same as those of a company which continues to write new business. We suggested in the report that after the early years, during which the closed branch will continue to have positive cash flow, it is probably desirable to opt for stability rather than to expose those policyholders to a kind of disproportionate leveraged risk that would be associated with changing conditions. The report goes into some detail as to the kinds of assets and the kinds of cash flow characteristics that ought to be associated with the management of a closed branch, making it clear that these conditions are particularly important once the branch passes over from positive to negative cash flow. There are some numerical illustrations in the report. For the particular closed branch we illustrate, it takes, depending on how you read it, somewhere between 10 and 20 years to happen. There are some cases in practice (if they were to occur) in which the movement from positive to negative cash flow might happen sooner. The model that is illustrated in the report contemplated the issuing of traditional business in continually increasing amounts right up to the moment of conversion. Not every conversion would fit this mold.

The closed branch viewed as a separate entity would not be statutorily solvent. By and large, the carrying value of its assets would not be as large as its statutory liabilities. Therefore, as you contemplate the need for dividend scale changes over time, in order to be fair to policyholders as experience emerges, you can't use a statutory solvency test by itself. There are really two ideas you do have to work with. One is the concept of aiming at a target which is many years distant at the outset and closer later on, at which time the last dollar of assets will go to pay the last claim when the closed branch ends. We

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also suggest that it will be important to do experience analyses over time, almost in the way you would analyze actual to expected variations in a pension fund, to understand the nature of the changing experience and the need for and the nature of the changing dividend scales that would have to be developed in order to be fair to those customers. On the one hand you don't want the branch to run out of money, although to be sure, the stock company as an entity stands behind it. On the other hand, you don't want it to be a tontine. It will be a tricky exercise in practice to achieve the right balance. The report discusses in some considerable measure some of these issues, focusing particularly on the selection and management of assets. Also, there is some discussion of the kinds of actuarial opinions that will be required at the outset and over time in closed branch management.

MR. WALTER SHUR: During my remarks I am going to refer to Table 1. (Appendix 5 in the report). Once the aggregate amount of compensation is determined by market conditions, by the amount of capital that the company is raising, and perhaps by statute, the question then is how to distribute that amount to the individual policyholders. The only basis I could find in the law anywhere was one in the New York statutes. It says that if a company liquidates, and if after the company is totally unwound there happens to be any money left over, that money is to be given to the policyholders in proportion to the total premiums they have paid to the company since they have been with the company. That did not seem an appropriate basis for demutualization, maybe not even for a liquidation. After a lot of consideration the Task Force felt that a way to allocate the total compensation was primarily in proportion to the surplus contributed to the company by the various classes of policyholders. I use the word *primarily* for a specific reason. In a demutualization the policyholders are giving up some intangible membership rights like the right to vote. One could argue that they should get some compensation for that regardless of whether or not they left any surplus with the company. But overall we felt that an allocation in proportion to surplus contributed was a reasonable basis.

Start with the existing policyholders on the date of demutualization (those who are sharing in the distribution). Calculate the assets that accumulated from those existing policyholders and subtract from that the amount of assets placed in the closed branch on their behalf. The money placed in the closed branch is an amount of assets which, together with future premiums, is going to take care

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TABLE 1

ASSETS ACCUMULATED AT CONVERSION  
IN MODEL COMPANY  
(\$ MILLIONS)

| <u>Approach to Calculating<br/>Assets Accumulated With<br/>Respect to Policies In Force</u>  | <u>For Policies<br/>In Force</u> | <u>Terminated<br/>Policies</u> | <u>All<br/>Policies</u> |
|--|----------------------------------|--------------------------------|-------------------------|
| 1. Mechanical Method   | 2679.0                           | (108.7)                        | 2570.3                  |
| 2. Cost of Insurance (COI) Charge  | (325.6)                          | 325.6                          | 0                       |
| 3. Approach 1: with COI Charge =<br>1 + 2.   | 2353.4                           | 216.9                          | 2570.3                  |
| 4. Unamortized Acquisition<br>Expense (UAE) Charge   | (0.5)                            | 0.5                            | 0                       |
| 5. Approach 2: with COI and UAE<br>Charges = 3 + 4.  | 2352.9                           | 217.4                          | 2570.3                  |
| 6. Approach 3:   |                                  |                                |                         |
| a. Accumulated Charges for<br>the Cost of Capital  | 177.1                            | 286.0                          | 463.1*                  |
| b. Assets Assigned to Policies<br>In Force (other than the<br>assets corresponding to<br>accumulated charges for the<br>cost of capital) | 2107.2                           | 0                              | 2107.2                  |
| c. Total Assets 6a + 6b.   | 2284.3                           | 286.0                          | 2570.3                  |

\* Of this amount, \$16 million is attributable to the payment of lower dividend levels in the early years of the model company's financial operations.

of all the future benefits, the result being that all that money will go back to the policyholders. The assets they have accumulated, less the closed branch amount, represents all the past surplus contributed, plus the present value of any future surplus that they would have left with the company. That seemed like a rational allocation basis and an easy one for demutualizations incorporating a closed branch. We did think about such possibilities as using statutory reserves. We could take the assets accumulated, less statutory reserves, and use that as an allocation basis. That has a couple of problems. First, the statutory reserves are not likely to be equal to the amount which, together with future premiums, would exactly take care of the future benefits. A second practical problem is that most of the current policyholders have contributed negative statutory surplus. It is really not a very useful or practical allocation base.

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We are all familiar with accumulating assets for a block of policies. If you take a block that was issued 30 years ago, we all know how to calculate the assets generated by that block. However, I think most of us are not used to trying to do that calculation for only those policyholders still existing here today. That is a very different question. If you try a cash flow analysis, you will see right away there is a problem. You collect premiums and investment income and charge expenses, but you find you have no death benefits because none of them have died, and you have no surrender benefits because none of them have surrendered, and the result is a very large number. If you took all of the policyholders who have terminated since that original date, and you do this simple cash flow analysis, you get a negative number because all of the death benefits and all of the surrender benefits are included. It became clear that to get the assets on the existing policyholders, there had to be some recognition of some things that have happened with respect to the terminated policyholders.

To explore that question we constructed a model company. The model company started 75 years ago, selling only participating whole life insurance. It had an 8% growth rate each and every year. It earned 8.65% on its nonloaned assets and 7% on its loaned assets. It paid income taxes of 36.8% of its gain. It also had an equity based tax which we set at 3% of surplus. The company ran for 75 years, at which point we presumed demutualization and calculated some pertinent items.

Looking now at Table 1, the company has \$2,570 million of assets. As a first step, what we called the "mechanical method," we took the policies in force today and did a simple cash flow analysis, the result being \$2,679 million. Similarly, for the terminated policies, the result was -\$108.7 million, that being where all the death and surrender benefits were. Obviously, the problem here is the absence of any pooling of mortality charges between existing and terminated policies. We then calculated the cost of insurance for the policies in force over all those past years as \$325.6 million. When we transfer that amount to the terminated side on line 2, we leave \$2,353.4 million as the assets accumulated on the inforce policies, but we now have \$216.9 million as the assets accumulated on the terminated policies. I think that is reasonable and easily understood.

We then looked at the question of surrender benefits. If you have a surrender and there is a loss at the time of surrender, is that something just like a loss

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incurred on death that should be charged against the continuing inforce policy-holders? In the model company there was only a little surplus strain because of first year acquisition expenses. On line 4 we simply amortized the strain over six years and for terminations the unamortized expense was charged to the inforce policies. That made very little difference in this company because of the small strain. It transferred just \$.5 million from the inforce to the terminated block. There are other approaches that could be used here, and other ways to define the gain or loss on surrender.

Approach 3 was the more interesting one. Here we took a different tack. In effect, we said that while they were in force those terminated policies were making use of company surplus. There was an amount of surplus that they were using or renting, if you will, and they ought to be charged for that use. First we defined the amount of surplus "used" by a policy. We took the statutory reserve, plus the dividend liability, plus 5% of the statutory reserves (which was the required surplus for the company), and subtracted the assets that had actually been accumulated by the policies to that time. That is the amount of company surplus they are using and for which they should be charged. We then did a long iterative process for a mature year of issue. We know how much surplus was developed by the time the last policy terminated, so we could solve for the percentage charge you would have to make on the surplus used each year to produce that final total. That turned out to be about 5.7%. For all terminated policies we went back and saw how much surplus they were using in each year, made the charges, and accumulated them. The terminated policies ought to have left that amount of money with the company, which added up to the \$286 million shown on line 6a. Similarly, on the inforce, the accumulated charges were \$177.1 million. The next line is just the balance of the assets, \$2107.2 million. When you get down to the bottom, line 6c, total assets are \$2284.3 million for the inforce policies and \$286 million for the terminated policies. Approach 3 is just a different definition of what the terminated policies should leave with the company. To the extent they produce more or less than that, such differences are either credited to or charged against the inforce policies.

The 5.7% is an interesting number. You can derive it another way. This company is earning about 8.65% on its assets and is paying taxes of 36.8%, so that its after-tax rate of return is roughly 5.3%. Then you have an equity tax

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of 3% which when subtracted from 5.3% leaves 2.3%. This company is earning roughly 2.3% on its surplus. But the company is growing 8% a year. If you are going to maintain the same surplus ratio every year, the required surplus must increase by 8% a year. If it has only been increased 2.3% from the earnings on surplus, then the gains on the business (or those capital charges I talked about) have got to produce the other 5.7%.

Lastly, there are other questions to consider in determining these numbers. What classes should you use? The Task Force felt you should stay with the dividend classes you have used in prior years. It might be reasonable to combine some of these if you feel that the dividends have balanced the classes out, and so, from a surplus point of view, they are not different. For practicality you might combine some. Then there are questions of exactly what charges to make. What do you do with capital gains and losses, guarantee fund assessments, catastrophes, or transfers from one line of business to another line of business to eliminate a deficit? In general, those things ought to be handled, to the extent you can, consistently with dividend practices in those prior years. We don't see conversion as an opportunity to change or undo the dividend practices of past years.

MR. HENRY B. RAMSEY, JR.: I am going to comment on three aspects of the Task Force work. First, I would like to identify what appear to me to be the most important conclusions in the report. Second, I would like to talk a little bit about the increased knowledge of the role of capital which grew out of the Task Force work. Finally, I would like to make a few comments on the process itself.

I would cite five items as the most important conclusions from the Task Force work. Probably the most important clear conclusion reached was that the amount which can be paid to policyholders for membership rights is totally dependent on free market considerations, on the stock price which the marketplace will support at time of conversion. The Task Force recognized that the marketplace assessment of the value of the company will depend upon two things: (1) a valuation of existing business, which involves a valuation at a market earnings rate of the capital cash flows related to that business over the future, and (2) the expectation of the earnings that will be realized on new capital investments by the company. That in turn will be dependent upon the performance record of

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the company with respect to its recent capital investments. This means that legislation must be flexible and not rigid with respect to the magnitude of payment to policyholders for membership rights.

Another critically important conclusion reached is that most mutual companies have significant amounts of entity capital, that is, capital that is not intended to be returned to existing policyholders. This makes it more likely that there will be value available to pay for membership rights.

A third important conclusion is that the establishment of a "closed branch" type accounting technique should create an effective and an adequate vehicle for paying reasonable policyholder dividends to existing policyholders, thus making that a practical operation.

An important conclusion not contained in our primary report, but rather in the report of the Accounting Subcommittee, is that the "Level Return on Equity" accounting method is the most appropriate accounting standard for management reporting in a mutual life insurance company. This is remarkable in several ways. First, mutual companies would endorse a capital-related form of accounting, and second, a group of senior mutual company actuaries could agree on anything. Those of you who have worked with this accounting issue for mutual companies know we have historically had an awful time. We all agreed that GAAP as it was defined originally in the late 1960s and early 1970s didn't work for par business, but we could get no agreement on what should work. Here is a large, diverse group of major mutual life insurance company actuaries who say that this is the best standard for management reporting. That is phenomenal. There are many important considerations dealt with by that committee. If you haven't read that report which was distributed by the Financial Reporting Section, I would urge you to read it.

And finally, while not a conclusion, I think the computer model which M&R developed was tremendously effective in selling the members of the Task Force on what really happens between the blocks of business in a company, its total assets, its capital structure, and how it is affected by changes in dividend scale. The fact that this was a realistic model, which had a very representative dividend scale, and which indeed performed in accordance with a capital theory,

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was very critical in attaining an understanding of how these things hold together.

We obtained much increased knowledge of the role of capital in a life insurance company. The prime theoretical vision of any kind of mutual company is that a group of people get together, pool their resources, share the experience that emerges, and thus obtain the desired service at cost. This model or concept is at the heart of the mutual life insurance company philosophy, but the role of capital in that process has never been clearly understood. Given current practices, it's easy to see that a block of business requires outside capital at the time it starts up. It does not generate enough cash to provide the assets necessary to meet initial expenses, statutory reserve requirements, and provide the statutory surplus that the company needs. Where that capital comes from, and how it should be related to the operation of the blocks of business has not been made very clear in prior analyses. The model work and other exercises engaged in by the Task Force enabled it to understand that there is a direct relationship between the capital needs of individual segments of the business and the capital needs of the company as a whole, and that there is an appropriate means of determining the cost of capital that needs to be charged to policyholders in order to accomplish the company's goals. Since it is absolutely necessary for the company to maintain sufficient capital to continue its business, it becomes obvious that the cost of capital is an element in the cost which mutual policyholders must bear. Through the model and through separate exercises, it has been demonstrated that the cost of capital is directly a function of the required growth rate of the company, less the net investment earnings on the underlying funds related to the capital. An extremely significant relationship was verified through use of the model that a viable block of par business can have greatly varying dividend patterns, but the one single requirement which must be present is that the return on capital invested in the product must be adequate to sustain the growth of the company. So, in the specific model used by the Task Force, which had a fixed rate of growth, and a fixed rate of return, you could demonstrate that blocks of business could sustain the company with differing dividend scales so long as the change in capital needs and the appropriate cost was reflected in the dividend scales.

A disappointment to me in the Task Force report was the failure to emphasize the appropriate cost nature of surplus contributions. It is mentioned, but it

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just doesn't hit hard enough from my viewpoint. In particular, the use of contributions to surplus as the recommended method of allocating the payment to policyholders for membership rights emphasizes this particular cost to the exclusion of all others. The Task Force did sufficient work with respect to what has been described as the "revolving fund method" of operation in a mutual company to demonstrate that a company could theoretically operate with no entity capital. In that case, the overall fund available to pay policyholders when valued at the corporation growth rate would produce no value available for payment to policyholders for membership rights. If the particular definition of a revolving fund described in the Task Force report were in use, each generation would have a calculated zero amount payment to policyholders, since by definition the current value of past and future contributions to surplus is zero for each group. Thus a recommendation of this particular means for allocating payments to policyholders unfortunately implied that this particular method was superior from a conceptual viewpoint. In fact, it is very weak in that respect in that it chooses one particular cost -- the cost of capital -- as being the prime criterion for distributing payments to policyholders. I would much prefer some broader criterion such as total cost, than to emphasize the amount of capital used by contracts as the method for distribution of payments.

Finally I have some comments on the process itself. This was really an exciting thing. It was initiated by people who recognized that the inadequate understanding of the capital structure of mutual life insurance companies was a major stumbling block to understanding and devising appropriate conversion legislation and the carrying out of a successful conversion plan. It was remarkable that there were a large number of senior actuaries from mutual companies who met very regularly and who competed vigorously in an intellectual manner as to the approaches and techniques which might disclose to us the way things really worked in a mutual company. For those who participated, it was an exciting, rewarding experience. I would like to give particular recognition to Harry Garber's contribution. As Chairman, he worked exceedingly hard himself in this project, but he also encouraged the participation of any who were interested, and listened patiently to many points of view with which he disagreed, and in the end had a report which was bought by the whole group. This is an amazing accomplishment. The work of the Task Force had many tenets to it and the subcommittees themselves were exhausting and extensive in the scope of the work undertaken. Harry participated personally in almost all of

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these and gave a balanced leadership which enabled the whole thing to come off. The actuarial profession and the industry are indeed in debt to his leadership. I'd simply like to close with expressing my own personal appreciation for being able to participate in this activity. It was certainly a very rewarding experience for me.

MR. WILLIAM J. TAYLOR: Something which may not come through as clearly as it might is the connection between the amount to be distributed to policyholders and the concept of the market determining the value of that distributed amount. The identification of the problem of the three parties having to be satisfied in order to have a conversion, is a very vital aspect of this approach. It is the thing which makes it work. Having the market value determine the value to be distributed is a key aspect of that concept. In the discussion it was not clear how we got from the assets accumulated by existing policyholders and the amount to be distributed and the market value concept. Can anybody clarify that?

MR. GARBER: We started by trying to connect them very closely. In the first interim report we were using the assets accumulated by policyholders as appropriate compensation. The more we worked, the more we found that the key was, in effect, a market value of those accumulations. Whatever the company has accumulated on an asset basis or on a statutory value basis, has to be converted to market worth in order to make this thing work. What you have accumulated may be worth nothing at all, as some of the thrifts have found out, or may be worth a lot as it was in the Union Mutual case. It all depends on what kind of company you have when you get through with the process, or when you enter into the process. We eventually just cut the tie, realizing that the process of determining what the company needs in the way of capital, and what the market will accept and pay, and what the policyholders get, will reveal the common ground which then can be allocated by actuarial means. In itself, the process of determining the aggregate amount of policyholder compensation is not an actuarial determination. I think we were unsatisfied with that as actuaries, but when you try and use actuarial values given the ebb and flow of markets, you find they are not satisfactory for a public market situation.

MR. TAYLOR: Can I conclude then that you have eliminated entirely any values to be determined in advance of the market's determining of the value or do you still have the mixture?

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MR. GARBER: When you go into a conversion process, you will go in with a set of values you intend to give to policyholders. In so doing you will have worked with your investment banker to determine an aggregate value (and divided up that value) which you believe will permit the company's stock to sell in the market at a particular price. The value is established based on your estimate of the general nature of the effect of the market on the compensation relationships. This will change, of course, as markets change during the process. The whole conversion plan may get thrown out if the market goes way up or down. Your original plan, however, recognizes where your investment banker advisors believe the market would require you to be at that time.

MR. SHUR: It is true that for any particular amount of capital that is raised, and any particular market value of the company, there is an appropriate amount of compensation to give to policyholders. For a different amount of capital raised, there would be a different amount of compensation. There is a range involved. If you try to raise more capital than the top of the range, it just can't be done. If you give compensation in the form of stock to policyholders it is clear that the market value of all the company's stock will be equal to the market value of the stock from the new investors plus the market value of the stock given to policyholders. That is clearly a market value relationship -- not an actuarial relationship.

MR. TAYLOR: That's what I was getting to. Specifically, rather than having compensation to policyholders be defined in dollar amounts in any way, shape, or form, have it be defined in terms of shares. You then have a total number of shares to be distributed to policyholders, along with some method of determining how the shares are to be distributed among the policyholders. When you have the conversion, and the market value is determined by the marketplace, then the policyholders would know what they would be getting in the event that they wanted to cash out rather than take their value all in stock.

MR. GARBER: I think there are two ways you can do that. First, you can issue shares. Second, a company can tell policyholders what their dollar amount is, and what you think the conversion into shares will be, but the actual conversion into shares will depend on the final price. That's the way Union Mutual went. The New York proposed law specifies an actuarial and accounting calculation to determine the aggregate amount, which is the safe harbor amount.

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Using the second approach assures the aggregate compensation to policyholders would equal the desired level; the first approach does not carry that assurance.

MR. MCCARTHY: It is instructive in that regard to take the facts and the numbers of the Union Mutual conversion and apply them to the formulas in the report. You will find they help you get an understanding of what those formulas are saying in terms of the particular dynamics of one conversion.

MR. DALE S. HAGSTROM: I want to emphasize that all of this work was done within the United States legal tradition. There is a very distinct and different tradition for Canada.

I also had two thoughts about the work. The Task Force reasonably concentrated on individual life insurance. However, if a company is demutualized, it will eventually have to deal with the fact that there are things that are allied with individual life insurance, such as individual annuities and perhaps individual health, which might well need to be in the closed branch, but are rather distinct in terms of their risks. If you go to demutualize you will start thinking about the practicalities. Are those in the same closed branch? In setting the closed branch initial assets, if one is a very volatile risk, say an investment risk for individual annuities, and you don't see the same risk exposure in individual life, you must ask how much risk you want to expose the individual life folks to if you fund individual annuity people on the "same basis." You might recognize that the C3 risk and C1 risk are much more important on individual annuities than they are for individual life when you are thinking about what initial closed branch assets you should have.

A second thought I have concerns the equity share, the amount you give upon demutualization. The linked method which the Task Force was inclined to recommend, takes the assets that have accumulated, either past or future, on today's inforce. If you had a defunct line of business with great losses not attributable to today's inforce, it might be reasonable to reduce the amount you give out in light of that historical fact. Obviously, if the market won't buy the stock otherwise, you may be forced to do so.

MR. GARBER: To the extent the losses were charged through the dividend formula to other lines, they would be reflected appropriately. To the extent

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they were not charged to other lines or recognized in the pricing of products in those other lines, then they wouldn't be reflected. We left it at that. Whatever the company had done in the past ought to be carried through.

MR. DONALD D. CODY: I want to express great admiration for this report. I would recommend that as a basic structure for all kinds of other examinations, not only of mutual companies, but also companies that issue nonguaranteed element products. The structure that you set up is good enough and trustworthy enough to serve as a basis for analysis of pricing and internal management financials. This is with respect to your general theory. I want to make a comment about the accounting report, too. I think it is unfortunate if you don't publish that in the *Transactions*, too. The two works ought to be together for the reasons I am giving.

One other comment. How do you expect this report to be used in regulation and laws? Are there actions underway in a variety of states to change the laws so that when they are needed they are available?

MR. GARBER: There is a specific bill in New York which was being written at an early stage of the Task Force work. Some of us participated in its development, although with probably only 20% of the knowledge we had when we finished the report. First, New York has multiple methods, which is one of the things we are recommending. Second, the method that does permit conversion with an immediate public market offering specifies an amount. This amount is bigger than statutory surplus, but less than GAAP book value, and could be characterized as a safe harbor. Safe harbor amounts are largely judgmental.

There is a lot of work going on by an NAIC Committee, which is headed by Terry Lennon of the New York Insurance Department, to draft a model bill which would be modeled on the New York bill. It will be a better, cleaner version, but with the same essential conversion methodologies that are in the proposed bill before the New York legislature.

MR. SHUR: You need at least one way to demutualize without a specific formula. There may be a company that is somewhat troubled and for which it is very important to have a demutualization, and that is the very one that is going to be thwarted by some specific defined amount to be given to policyholders.

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So, in addition to safe harbors, there has to be at least one sort of a free method for which the insurance department can look at the overall situation and still be able to permit the conversion.

MR. GARBER: Built into the New York bill also is what we have characterized as the two-step method, where the first step is just to pass the entire ownership of the company to policyholders by giving them all shares, and then as a second step, at some later time, introduce a public market element. If your market value is very low relative to your book value, that approach would be one which would deliver market value appropriately.

MR. WILLIAM R. BRITTON, JR.: First of all, let me say that I agree with the emphasis in the report on the amount to be distributed to policyholders as being the critical question in conversions and demutualizations. This seems to be the most contentious issue with the regulators, who raise the most questions. I also concur that market values should be the basis that one uses. Where I was disappointed in the report, from a professional standpoint, was in its lack of forceful statement to the effect that we as actuaries have the best ability to give an estimate of a company's market value. This estimate is needed before conversion, if it is to be a Union Mutual situation. Or, there may be situations in which one could have a conversion and simultaneous acquisition where there never is a public market established, at least initially. I think the report is lacking in guidance to actuaries, but more importantly, in not establishing our role. One of the things I found in dealing with conversions, is that all of the other respective professions, investment bankers, lawyers, and accountants, looked to actuaries as having the best knowledge.

MR. MCCARTHY: I don't think the report is in contradiction to what you are saying. The report focuses on market value and, as brought out in the dialogue with Bill Taylor, you have to get some estimates of that ahead of time. Now the report wasn't intended to be a treatise on how to determine a market value. Certainly, actuarial valuation techniques are widely used in establishing ranges of buy/sell prices for companies. I would view that as an issue aside from the focus of the report rather than to say that the report somehow suggested otherwise.

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MR. SHUR: We perhaps gave that impression by bending over backwards so as not to suggest there was some definitive actuarial value that should be given. When it occurred to us that such is not the case at all, we wanted to be sure we made that point very, very clear. You can do all the actuarial work you want in valuing the company, but the current state of the stock market may have more to do with the value of that company than all of that actuarial work, if there's a public market.

MR. GARBER: An additional answer to your question is that the acquisition case was not the one that was on our plate most of the time we were working. By the time it came onto the plate, we were tired and wanted to finish up. So, we plead that we really didn't give much thought to it. We should have, but it came into our view late in the game and without our having the energy to look forcefully at it. I think you are perfectly right. There is a lot of that in here. As we get more and more into individual company situations, trying to look at particular classes of business and so on, it is clear that the report sketched out some general ways of proceeding. There is much work left to be done for actuaries to fine-tune all of these things as they go into actual cases.

MR. TAYLOR: I have one other practical concern, for something that is not going to occur for many years, having to do with the closed branch. Looking out to the future, where that closed branch is tapering off and getting to be much smaller in size, it is obvious that one can do a lot better job dividendwise for that group of policyholders by not running its own portfolio of assets, etc., but rather by having some arrangement with the corporation as a whole for an adequate investment return on its assets. Was there any consideration given to that?

MR. MCCARTHY: We did recognize that there will come a point at which it might be useful, from an investment point of view, for the closed branch to own shares of assets rather than entire distinct assets. It is cleaner at the outset to start with distinct assets if you can, but there might be some situations in which you wouldn't even want to do that. You are talking about questions that are probably 50 or more years out. Perhaps we lack the foresight to see exactly how one of these things will wind down in the end. There are going to have to be some issues raised that are best done in the context of that situation.

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MR. GARBER: We did try to study actual experiences of closed branch runouts, but we weren't able to find a great deal to help us. If we had some experience to rely on, we might have had some more sage comments to include in the report.

MR. TAYLOR: My concern was primarily of trying to assure that we don't get legislation that ties our hands on these matters that are not really going to develop for a number of years.

MR. SHUR: Hopefully, by the time that happens, the closed branch will be such a small part of the company that almost any reasonable approach will be acceptable for the handful of remaining policyholders.

MR. GARBER: You have to remember that you have crossovers anyway. Clearly, to the extent the closed branch was inadequate to pay guaranteed benefits, the company would have to stand behind those. My recollection of the New York bill is that it does not specify the allocation of assets to such a degree that it would be a problem.

MR. SHUR: I don't think it does. It says you need to put in assets that are sufficient to do these things and it doesn't strictly say which assets.

MR. GARBER: Yes, I think taking pieces of assets would be a perfectly satisfactory approach.

MR. CODY: Can you say anything about the possibility of a tontine effect?

MR. GARBER: We said the actuary's task would be to try to make it as little as possible. Obviously, if you decline from 20 policyholders to 1 in one year, there could very well be some tontining.

MR. CODY: You wouldn't want the law to require a tontine, however.

MR. GARBER: Literally, I think that is what it requires.

MR. SHUR: Once the asset goes into the closed branch, it cannot come out and no earnings on it can come out.

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MR. CODY: Do you think the actuary is clever enough to avoid this?

MR. GARBER: No! What we think is that when the branch becomes very small, the actuary will err on the side of overdistributing. It will be an immaterial event for the company to pick up the costs of the last policyholder. As a practical matter, a company would rather do that than leave a million dollars for the last policyholder.

MR. MCCARTHY: There are probably some things you would do, either within the rest of the company or outside, by way of reinsuring as the closed branch gets quite small to establish a clear line to the end.

MR. MICHAEL E. MATEJA: Our company has a small participating department, and the treatment of that department bears directly on the investment question that was just raised. Perhaps 20 years ago there was great concern about the relative treatment of the participating versus the nonparticipating department from a standpoint of investment performance. A very elaborate procedure was developed to assure that the management of the company could never be accused of discriminating unfairly against the participating policyholders. Basically, what it did was go to the cash drawer -- the par cash drawer and the nonpar cash drawer -- each time we were going to buy an asset. If there was 10% of the assets in one drawer and 90% in the other, they shared in that proportion and that process has been followed pretty much inviolately for many, many years. You get the benefit of the diversification. You get some of the good high-yielding deals as well as some lower yielding deals.

MR. SHUR: Is that still an open branch, Mike?

MR. MATEJA: Yes, it is.

MR. MCCARTHY: In managing a closed branch, where your long-term objective is dividend stability, it's not clear that the assets you are acquiring for the corporate entity in total ought logically to be split that way. You might have very different investment objectives for the closed branch than the rest of the company. You need to think about that as you go along. Particularly, I think that's a difference between an open and a closed branch. Your perspective will change in a closed branch.

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MR. SHUR: I would like to suggest that you look at the results of the model separate and apart from demutualization. Here is a normal company that has grown up over 75 years, with many tables describing everything that has happened with that company, including the fact that it has about \$116 million dollars in statutory surplus. The terminated policies have raised something like \$200 million, so a lot more than the statutory surplus has come from terminated policies. A lot of interesting bits of information are in that model.

MR. GARBER: On the particular point about the three different methods of allocating assets between terminated and inforce policies, the Task Force didn't take a position on which was the better method. It seemed they are all approaches that one could use, although we recognized that an insurance department is likely to buy Approach 1 faster than 2 or 3. They have, from our point of view, equal theoretical justification.

MR. RAMSEY: It is all well and good to say you can have a model company in existence that will sustain itself if the company follows the capital charge process that we have described. But how does a mutual company get its initial capital? One of the interesting things we did was to look through our own companies' histories. In the early years, policyholders paid pretty high premiums and companies didn't hold much in the way of reserves nor did they pay much in the way of commissions or administrative expense. If there were a few more deaths in those years, there would be fewer companies today. It appears clear that policyholders paid high premiums and really made "contributions to surplus"; i.e., they left money in the company that wasn't necessary to cover current policyholder costs. Early policyholders really did contribute. Most of the big old companies started in the mid-1800s and had 50 years of experience by the time they got to 1900. In 1900 their size was pretty small in relation to the size of the company today. Almost all have had a 4% to 7% annual rate of growth since 1900; thus if they had enough entity capital in 1900, capital charges to policyholders of the type described would appear to have resulted in quite nominal capital charges over that period for the companies.

