TFA 42 (1990-1991) 277-290

A Meeting was held in the Physicians Hall on Monday 19 April 1990 to discuss the subject of Demutualisation. Four main speakers introduced the topic from various points of view. These were:

1. Marshall H. Field, C.B.E, F.I.A.

   Mr Field is a consultant partner in Bacon & Woodrow and a Past President of the Institute of Actuaries.

2. Peter D. Needleman, M.A., F.I.A.

   Mr Needleman is a partner in Tillinghast/Towers Perrin.

3. W. W. Campbell Smith, M.A., L.L.B.

   Mr Smith is a partner in Biggart, Baillie & Gifford in Glasgow.

4. Alexander D. Shedden, B.Sc., F.S.A., F.F.A.

   Mr Shedden is a Past President of the Faculty of Actuaries.

After these presentations the discussion was formally opened by C. Stewart S. Lyon, M.A., F.I.A. who is a Past President of the Institute of Actuaries.

These five contributions are printed in full followed by a summary of the main points raised by the other contributors to the discussion.

Mr M. M. Field, F.I.A.:—My contribution concerns the commercial aspects. If you are contemplating demutualisation you must keep two specific questions well in mind. What is it that is being bought and what is the right price to be paid? As commented at a recent conference concerning building societies, demutualisation is not a strategy, but it might be a means of implementing a strategy.

The mutual life offices have operated very successfully and through extreme changes in external financial conditions over a very long period of time. Lack of access to new capital has not been a problem. Moreover, the proprietary companies transacting with-profits business have also been able to operate with similar success and without recourse to additional capital, unlike their general business comrades. Perhaps the future holds a financial scenario which would strain the solvency of a with-profits office and perhaps offices are now content to operate on a lower level of surplus in excess of their commitments and policyholder expectations.

However, the use of terminal bonus to ease new business strain is comparatively recent and provides an important additional resource, so what causes there to be any doubts as to the continuing viability of any of the mutuals (notwithstanding the views recently expressed by the Scottish Economic Council)? I believe that the cause is to be found in one or both of two other 'isations'—polarisation and unitisation. Polarisation has dramatically reduced the number of firms giving independent advice on life assurance, and coupled with the requirement of best advice, as perceived, it has changed the course of new business flows towards particular companies, especially as regards with-profits business.

Some companies are receiving a larger proportion of the smaller volume of business, while others—those which have a harder task in overcoming the best advice hurdle—face the prospect of a smaller proportion of the smaller volume and that carries well known financial consequences.

The protest continues, and SIB's recent document of forward look envisages a still smaller number of much larger firms of intermediary as, they say, only large firms will be able to provide the range of services required by the regulator. Sir Gordon Borries' recent report on commission disclosure adds further fuel to that fire.

The problem is seen as one of distribution and some are talking of a change from a supplier led industry to one where the distributor dominates. Sir Nicholas Goodison, speaking recently to the Institute of Bankers about financial services across Europe, referred to a change from a system where the supplier was 'God' to one where the customer is 'King'. Perhaps the Financial Services Act has only been the vehicle for a change that was coming to us anyway.

The other 'isation'—unitisation—initially expanded the industry and it significantly enlarges the number of people who look to life assurance as a solution to their financial problems. Latterly, however, it has come to be regarded as a defensive measure and a particularly useful measure as it eliminates, or largely eliminates, the best advice problem.

A with-profits company hitherto operating in the IFA market, as most mutuals have, which has poor prospects for future new business flow, has two sets of strategic options. One would be to find new products attractive to the IFAs, the other would be to find an alternative customer base. I dismiss as an option merely closing to new business and running the fund down. The former would seem to cause the company to rely more heavily on unitised profits and could require the injection of capital to finance the new business strain. In this connection modern product design can do much but product disclosure is a new constraint. The latter option leaves the product range untouched except for some fine tuning to suit the new customers, and that route gives four approaches to my mind.

1. To set up a sales force to sell direct to the public—using tied agents is really a special case of this but needs separate consideration.
2. To sell directly to the public via press advertising and by mailshots.
3. To acquire access to a customer base that already exists.
4. To seek a different market place, perhaps Europe.

Creating a direct-selling sales force carries high risks; the recruitment, retention and productive capacity of the salesmen and their managers are all areas of known difficulty. It is likely to be beyond the resources that could equitably be found from existing policyholders—new capital would be needed.

The tied agent option depends on success in signing them up in the first place and then of retaining them. It is less demanding of capital but it still carries quite a high risk. I venture to suggest it is probably best regarded as an exercise in buying time.

Using direct selling techniques is feasible but carries very high risks if adopted as the sole means of obtaining new business for an operation of any size.

Acquiring the readymade customer base, however, has encouraging models and others are now embarking on it. The possibilities range from a business partnership with no change in financial control, to a joint venture company and on to the control of one party passing to the other. The crucial difference between them is that of ownership. With ownership comes a deep and more lasting commitment. Without it, there is a much greater risk of the arrangement being terminated by one party or the other.

Business partnership implies a management commitment on both sides but no great injection of capital is needed. A joint venture company will need some capital, but the new business strains can be met by the insurance partner via reassurance. The acquisition of one party by the other has formidable capital considerations but they are of a totally different nature from that of raising new capital and are to do with obtaining a fair price for what is being given up. Looking to Europe has attraction but is very daunting in terms of the resources, manpower and finance that would be required—capital certainly would be involved here.

Some of these strategies require capital and so may involve a demutualisation, but perhaps the most attractive depends on a change of ownership and therefore implies demutualisation. The essential point is that the selection of the strategy comes first. Whether and how demutualisation is involved in a consequential matter.

Another advantage claimed for demutualisation, and this was mentioned also at the Building Societies Conference, is that it permits modern systems of motivation of senior staff to be introduced, that is management participation in profits via share ownership or otherwise. However I would not rate that as a major factor.

If the selected strategy needs capital, the demutualisation should be so directed. The commodity being sold is a share in profits and the capital comes from the price paid by the new owners for that share. The new owners could be, or could include, the existing policyholders, thus possibly easing the path of demutualisation; or they could be another party, possibly one bringing other attributes of value to the reformed company. The problems of equity are formidable, particularly as between the new subscribers and the policyholder shareholders who might be offered preferential terms as regards price, or by means of a special bonus declaration as an inducement of the deal, and the third party with the problems of equity are of course the new policyholders. The essential point is that the policyholders are selling some rights (although they might be able to buy some of them back) to another party, possibly an unconnected party. It is a situation that has precedents in North America and elsewhere, and I expect Mr Needleman will talk more on this area.

Where capital is not an important consideration the range of solutions is very wide. I will talk in terms of another institution such as the building society acquiring the life office but the reverse is thought to be possible. In such a case ownership is certainly being ceded but there are many ways of arranging the financial outcome to the various parties with widely differing financial and policyholder expectation consequences. The important difference between them and the previous scenario is that the new owner is probably a single entity and moreover one that is bringing value to the reformed business. The new owner will surely wish to share significantly in the profits of the business brought from its own customer base. As it would be convenient to treat all new business on identical terms as regards bonuses a constraint is introduced.

The treatment of existing business, however, could follow different lines. At one extreme, existing business could be ring fenced in a segregated fund, thus in essence remaining mutual. As little is being sold to the new owners, the price would be quite small. It would reflect the loss of ownership but not of access to profits. The benefit to be gained by achieving a sound and profitable future for the company would be an offset to that price. Between this and the other extreme, of the new owners acquiring the same share of profits from existing business as that for future business (where the price of course would include the value of those profits and could well be substantial), there is a range of solutions capable of meeting the particular needs and resources of the two parties. The effect on the price of adjusting the share of profits from existing business would be dramatic, whereas in terms of commitment to the ongoing operation it would be quite small.

Another degree of freedom is provided by the possibility of a special bonus declaration as the bait of demutualisation, or the establishment of an enhanced bonus rate for existing policies. In effect, part of the value of the rights being sold in that circumstance is being retained by the previous owners and so the price would be less. Further, if there are other classes of business, for example unit-linked or even a unit trust management company, these might be dealt with differently, ownership perhaps passing wholly to the new owners, perhaps not. Group pension business is another class that might be treated specially.

Finally, a word about a hybrid situation where the new owners acquire a majority but not total control.

In one precedent in South Africa, the shares not owned by the incoming party are held in a policyholder trust and that trust has broad representation. In a very recently announced case in Australia, there are to be two classes of member—shareholder members and policyholder members, each with votes. There are a wide range of solutions, but in all cases policyholders, existing and new, do not pay for their rights and yet they share in policyholder profits. These create intriguing situations and no doubt further problems of equity arise.

In any situation there are necessary constraints and I have noted three.

First, it is probable that the new owners will be concerned mainly with the mass market of individual policies and it would be as well to ensure that all such business is held with the one administrative unit, with little or no difference as to the directions of profit flows.

Second, the arrangements should be logical and simple. It might be necessary to amend them at some later date.

Third, at all times, but particularly at such a time, the alternative of closing the fund for new business and running it off should be considered. Whatever proposal is put to the policyholders it would be necessary to demonstrate that it is preferable to closing down.

Much will depend on there being good prospects for profitable new business flows and the solution of selling the offices' existing products to a different but existing customer base has attraction. However, I believe it necessary to recognise the importance of management culture in setting up arrangements of this kind. The two formally separate operations will need to work closely together and differences of culture could cause severe and lasting damage. Where ownership changes, the differences will disappear in time, but in the case of a joint venture company they could cause stress in the establishment of the business strategy and lead to the early reorganisation of the arrangement. The consequences of this on the life office would depend on the provisions made for such an eventuality and on how business taken by the subsidiary is handled, that is, + whether it is reassured into the life office owner or whether it is financed and retained within the subsidiary. The even less formal arrangement of a business partnership is more prone to damage from such causes. In a partnership, total identity of purpose and style are vital to success, particularly to lasting success.

Many partnerships have been launched in the insurance sector over the years, but how many have survived more than twenty years. This almost leads me to the view that where the objective is the acquisition of a new customer base, full demutualisation in favour of a suitable new owner is the option most likely to be successful in the long term, and it is in the long term that we as actuaries are most concerned.

Mr P. D. Needleman, F.I.A.:—I am going to be talking on the U.S. aspects of demutualisation and I would like to focus on three specific aspects which I believe are highly relevant to the U.K.

The first is the legal framework in the U.S. The second is the large amount of actuarial research and discussion that is taking place in the U.S. and in particular of course the work done by the Task Force on mutual company conversion—the Task Force report back in 1987. Thirdly I am going to give a few specific examples of demutualisations that have taken place.

Let me start with a very brief overview of the U.S. market and the changing position of mutuals in that market. We look at the market share over the last 20 years, at least to the end of 1987. It can be seen that the market share of mutuals has dropped significantly, whether measured in terms of assets or surplus. In terms of premiums, the mutuals have clawed back on premium income since 1981, primarily by the introduction of new products such as Universal Life, but they seem to have eaten into their surplus in doing this. Some reduction in the surplus, particularly since 1986, has probably taken place because of new tax laws that were then introduced. These have encouraged mutuals to try to hide away some of their surplus, but generally, U.S. mutuals have operated on a much lower surplus ratio than in the U.K. and also on a much lower ratio than proprietary companies. The need for capital has been the primary but not the only driving force for demutualisation in the U.S. If we look at the changes that have taken place in the last ten years, there has been a significant amount of rationalisation—there have been eleven mergers with other mutuals and ten demutualisations, most of the demutualisations have taken some form of acquisition or inter-group reconstruction, and just one of those—Union Mutual—has involved a public offering of shares.

Let me now talk briefly about the legal requirement in the U.S. About thirty six States allow for demutualisation and twelve are completely silent. A few States actually ban it altogether. The enabling legislation is generally permissive rather than restrictive in that in most cases it merely requires approval from the insurance regulators—it is no more specific than that. The legislation in the State of Maine applied in the Union Mutual case, to which I shall refer, has the following requirements:

The plan has to be approved by the Superintendent of Insurance and also by two thirds of the voting members. It must be fair and equitable, whatever that means. The equity of each member must be determined by formula based on statutory surplus and, interestingly, the eligible members include not only the current policyholders but also policyholders whose policies have terminated in the last three years. In addition all the eligible members have pre-empted subscription rights, i.e. the right to acquire their proportionate part of the shares of the insurer. In effect, members receive a minimum of the statutory surplus and they have the right to purchase all of the shares.

The New York legislation which was enacted in 1988 allows three specific methods, together with any other method which is seen to be fair and equitable. The different methods recognise the differing capital needs and circumstances of the company. They all provide for a closed branch covering the existing participating policyholders. The first method, commonly referred to as the Stock Distribution Method, is appropriate when no additional capital is required. In effect all of the shares, and thus the full value of the mutual, pass to the policyholders. The second method, commonly referred to as the Continuing Entity Method, provides for a public offering of shares for the full market value, The objective is to retain the existing surplus in the company and to raise more capital. The policyholders receive their asset shares and also 10% of the proceeds of the sale as an inducement but they must take up their pre-emptive subscription rights if they are to retain their full equity in the company. The last method, called a Consideration Payout, is intended for small industrial companies where the surplus is less than $50 million, and it effectively provides for a payout of the statutory surplus.

Let me now move on to the second point to which I wish to refer, which is the Task Force on demutualisation. Their brief was to examine the actuarial issues involved in converting a mutual life company to a stock company, and their recommendations concentrated on three specific aspects.

Firstly, how best to maintain the reasonable expectations of policyholders; secondly, how to allocate compensation between the different policyholders, and thirdly, what the total amount of compensation for policyholders should be.

The Task Force recommended that policyholders reasonable expectations were best protected by establishing a closed branch, and the assets that were to be allocated to the closed branch should be sufficient to maintain current bonuses if current experience was to continue. This was effectively their definition of reasonable expectation. I think the concept is equally applicable in the U.K. although my feeling is that something similar involving asset shares would be more appropriate. The Task Force recommended that the compensation to policyholders be allocated in proportion to their relative contribution to surplus. Surplus was defined as the excess of asset shares over the amount allocated to the closed branch on behalf of the policyholders, and is therefore consistent with their definition of what should be included in the closed branch. I think the basic flaw here, and I think the problem in the U.K. situation, is that contribution would often be negative for many recent with-profit policyholders. In practice, most of the demutualisations in the U.S. involve some minimum level of compensation to all policyholders. The last point, which is the total amount of compensation to be provided, is probably the most difficult and contentious facing any company considering demutualisation.

There are a wide range of views as to the nature of policyholders' equitable interest in a mutual and, in the time available, I do not intend to start addressing all those arguments now. The prevailing view in the U.S. is that policyholders own or have rights to the full fair market of the company. This view has been reflected in the three major demutualisations which have taken place and, in effect, the New York legislation also reflects this view.

The Task Force identified the need to achieve a balance between the various parties. If we look at the parties involved, there is first of all the company and they will only undertake the conversion if it can achieve the organisational objectives, for example, raising capital or, more likely, the merging with another organisation. Secondly, there are the policyholders, they need to be satisfied about their contractual obligations and their benefit expectations and also that they receive fair value for their membership rights. Lastly, of course, the investors or the shareholders must be satisfied that they will get a fair return on their investment.

The Task Force had some interesting conclusions on the subject of how much compensation was appropriate. Firstly, they concluded that there was no accepted or scientific basis to determine the right level of compensation—this is quite an interesting conclusion. They felt that the values will necessarily emerge as part of the conversion process and will be influenced by the company's particular circumstances and the state of the market. They also felt it was inappropriate to specify fixed or formula bases for a legal minimum although they did suggest that in a public offering of shares there might be a 'safe harbour' amount, so that provided the payout was in excess of that then the regulator should be satisfied that that was sufficient. The problem of how much is actually enough is one that really exists because, prior to demutualisation, the mutual had no market value and the value subsequently will depend on the structure that is adopted. If there is a public offering, then one solution is to give policyholders pre-emptive subscription rights. In that case the price is then merely a function of the additional capital that has to be raised. If no new capital is needed, then the policyholders will receive all of the shares free. If some shares are to be sold then inevitably the policyholder can only receive a proportion of the shares free and then they must subscribe for the balance if they so choose.

In a sponsored demutualisation, or an acquisition, there is a similar question in that there is no market value available before the mutual has been demutualised. In this case obviously again a balance has to be achieved. The experience in the U.S. shows that the regulators have favoured the policyholders quite clearly although it is my belief that in the case of a financially distressed mutual, then more emphasis is likely to be given to the future shareholders' position as they may need some incentive to take on the obligations of such a company.

Let us now look at the three specific examples on which I would like to focus. These are all fairly major life company conversions. The first was Newnam (?), or formerly Union Mutual, the second was Northwest National and the third was the Maccabees.

There are a number of similarities among these companies. Firstly, they were all well managed, diverse and financially healthy companies. They are located in jurisdictions that had no statutory prescriptions for any payout or were at least fairly unrestricted. Each of the demutualisations was arranged in a manner where market forces chose the ultimate price. They have a number of differences and I would like to focus on two, that is, timing and form. In the Newnam case the form was an initial public offering with capital raised from policyholders and also from employees and other new shareholders. That was accomplished in September 1986. Northwest National was a kind of hybrid structure with existing policyholders and shareholders, and the demutualisation was effectively a clean-up of that, where the shareholders bought out the ownership rights of the existing policyholders. That was completed in 1988. In the case of the Maccabees, this was a sponsored demutualisation where the company was acquired at the same time as it converted to a proprietary company, and it also involved a capital infusion from the new buyer. That was the most recent in January 1989. I believe the last case is likely to be the most common form that will take place in the U.K.

It is interesting to compare the payouts under the three cases. Unfortunately, in the U.S., a lot of things are measured in terms of gap book values but that is their equivalent of the sort of realistic basis of surplus. In the Newnam case the policyholders received $652 million. That was equal to the gap book value at the end of 1985 and it is interesting that it is nearly twice the statutory book value. The payout that was originally proposed for that demutualisation was the statutory surplus at the end of 1984, and that was only $267 million. Although the main statute refers to the distribution being based on statutory surplus, the insurance regulators did not think that was enough and they insisted that it was at least equal to the gap surplus, and that was in fact what was done in the end.

In the Northwest National case the stock was already publicly traded and the shareholders paid the historic average of the stock price to the gap book value, which in fact was only a factor of 0.9.

In the Maccabee's case an actuarial appraisal value was carried out and also the directors received a fairness opinion from an investment bank. The price achieved, which was obviously a negotiated figure, was 1.5 times gap book value.

The various other features of the transactions which I have summarised are, firstly, there was a minimum allocation in all cases and this ranged from $612 per policy in the Newnam case to $135 in the Maccabee's case. That was respectively 15% and 25% of the total payout. In the Newnam case the average payout per policyholder was $4,000—quite a large sum. The balance of the payout in both those cases was allocated in proportion to the contribution to surplus and, interestingly, that was defined as statutory surplus rather than gap surplus. In the Maccabee's case, all the current policyholders were deemed to be eligible. In the Northwest National it was all the participating policyholders. Only in the Newnam case was there this 'look back' period of three years, and that was a requirement of the legislation—a somewhat arbitrary period. As I mentioned, in all three cases, there was a closed branch established.

I would like to leave you with one or two questions which have been actively debated in the U.S. about the responsibilities of the directors.

The first question is, is it the responsibility of the directors to seek deals which maximise the payouts to the current policyholders? Do the policyholders have the right to demand that, and if so, in what circumstances? As a minimum, should the directors consider the possibility of demutualisation as an option and to be able to demonstrate they have done so? How should a mutual react to an unsolicited offer, for example, to be acquired? These are all quite difficult questions. I am sure many of you have given much thought to these and I would be very interested in hearing your answers to those questions in the discussion.

Mr W. W. C. Smith, M.A., L.L.B.:—Within the time allocated to me this evening, I intend to speak briefly on the legal objectives of demutualisation, the mechanics by which it is achieved, summarising the steps involved in the court process and to comment on the role of the court and some of the practical aspects drawing, as you might expect, on the limited precedent available and on the direct practical experience which I, and some at the top table, acquired last year in the context of the FS and Britannia Life transaction. Naturally, all that I have to say is limited to the U.K. position. We have heard from Peter Needleman about the U.S. situation.

I do not propose to go into the commercial terms of any demutualisation scheme—the seeds I think have been sown for a good discussion on that, and I propose to leave that to others much more qualified than me. With the customary desire therefore of the lawyer to define one's terms, let me start by saying there is no such term as demutualisation. You will not find the word in any dictionary, nor will you find any definition of it in any statute. For the purposes of this talk, by demutualisation I mean the process of transforming the ownership of an insurance company from mutual status belonging to its policyholders to a proprietary status belonging to its shareholders who may but need not necessarily be different from its policyholders. In the process, in the majority of cases, the policyholders will have given up their rights of voting and thus control of the mutual company, and the reasons for bringing about the transformation will have been identified in the commercial context that Marshall Field spoke of earlier. The objective of the process of demutualisation, seeing that as the means towards the end rather than the end in itself, is to bring about this transformation with the minimum of disruption to the day-to-day conduct of the business, effecting it in a way which is binding on all concerned, whether they be members, policyholders, creditors, debtors or employees.

Those of you familiar with the Companies Act will realise that a private company can become a public company; a public company can become a private company; a limited company can become an unlimited company and vice versa. Procedures are laid down in the Act for all of these processes, and in every case while there may be a change of name from limited to plc, or vice versa, or by the disappearance of limited from the name, the legal personality of the company has remained as it was, the company in question continues. The leopard has changed its spots but it still remains a leopard. When we come to demutualisation, however, there is no procedure for a mutual company to become a proprietary company, or vice versa. Short of promoting a Private Act of Parliament for the purpose, which would be a possibility, there is simply no procedure for the change of status with the underlying business continuing in the same legal entity. The result is that any scheme of demutualisation must, of necessity, involve the transfer of the underlying business of the mutual company to another form of business enterprise, usually another company. The disposal of all the assets and the liabilities in this way, including the transfer of the rights of the policyholders under their policies from the mutual company to a new vehicle, would require the consent of each and every policyholder and creditor but for the provisions of Section 49 of the Insurance Companies Act of 1982. That section provides for the carrying out of a scheme for the transfer of the whole or part of the long-term business carried on in the United Kingdom by an insurance company to another body, whether that other body is incorporated or not, by means of a court order sanctioning the scheme. Where the court order is made, the property of the transferring insurance company is, by virtue of the order, transferred to the transferee company. The liabilities of the transferor are likewise transferred to and become the liabilities of the transferee company without further ado. The court order once made is then binding on all the parties.

The explanatory notes to Section 49, written at the time it was introduced, suggest that the overall policy of the Act is to avoid the liquidation of the business of a life insurance company wherever possible, and the section was designed to facilitate the transfer of the business of a company that had got into difficulties. I hasten to assure you all that FS Assurance's recent use of the section was not because they were in difficulties but as a result of the very thorough consideration of the very commercial aspects about which Mr Field spoke earlier. What does Section 49 require?:—

1. there must be a scheme for the transfer of the long-term business;
2. the petition must be presented to the court by either the transferor or the transferee for sanction of

the scheme;
3. a report on the terms of the scheme by an independent actuary;
4. advertisement of the fact that the petition has been presented;
5. copies of documents must be available for inspection at various addresses;
6. except where the court has otherwise directed, a statement has to be sent to policyholders and members of each of the companies involved setting out the terms of the scheme and containing a summary of the independent actuary's report—not a full report but a summary described as sufficient to indicate his opinion on the likely effects of the scheme on the long-term policyholders of the companies concerned;
7. the petition and the scheme must be served on the Secretary of State for Trade and Industry;
8. there has to be public display of copies of the petition and the report;
9. at least 21 days need to go by from the first advertisement before the court can hear the petition.

Provision is made for the Secretary of State and any person who alleges that he would be adversely affected by the carrying out of the scheme, including specifically employees of either company, to be heard on the petition. No provision is made for any meeting of the policyholders, of which more later, but the petition must be deposited with the Secretary of State within 10 days. The scheme then takes effect in accordance with its terms of the petition and the terms of any provisions of the court order which may be made to ensure that the scheme is fully and effectively carried out. Wide powers are given to the court in Section 50 to make such provisions, either at the time of the order or subsequently.

A word on what is meant by the court. If both companies involved are Scottish, it is the Court of Session. If both companies are English it is a High Court in England. If both companies are from Northern Ireland, it is the High Court in Northern Ireland, and where there is a mixture the court of either jurisdiction may be used. Within the Court of Session here in Scotland there is no clear guidance as to whether the petition is an Inner House or an Outer House matter. In fact the courts have not yet made rules for the conduct of such petition. However, I am glad to say the Inner House were happy to deal with the FS and Britannia Life scheme.

So much for what the section says. What happens in practice? You will note that I mentioned the section was "silent" on meetings of the members or the policyholders. This is in marked contrast, for example, to the Scheme of Arrangement provisions under the Companies Act where the court directs meetings of members and/or creditors to consider and to approve the scheme. In practical terms, however, it is necessary to hold a meeting of the policyholders. I understand that the DTI, in its regulatory role, is very much of the mind that the policyholders' views should be ascertained. Putting it another way, if the Secretary of State, as is his right, were to come before the court on any hearing of a petition for sanction of a scheme, I believe he would advise the court that any transfer in the context of a proposal to demutualise should involve the policyholders voting on the proposal and the proposal achieving a clear mandate of at least 75% of the votes cast. To enable that vote to be an informed vote, the policyholders should be given sufficient information to make an informed decision. As you can see, this goes considerably further than the rather mechanical provisions of Section 49, which I recited. They simply require the policyholders to be given a statement of the terms of the scheme as well as a summary of the independent actuary's report. Here one comes to a significant divergence between the Company Law and statutory aspects of the proposal and the DTI practice, and I do not for a moment seek to criticise the DTI's practice, which is to encourage policyholder participation and recognise the legitimate interests of the policyholders to be consulted on matters which may vitally affect their interests. In Company Law terms it will be a matter of construction of the Memorandum and Articles of Association of the relevant company whether or not the directors have the power to dispose of the business without the sanction of the members in general meeting. The statutory framework, as I said, makes no mention of policyholders meeting and any form of sanction for the transfer other than the court, but it gives every policyholder the right to be heard on the petition if he can allege that he is adversely affected by the scheme, and if he cannot so allege, why should he be interested in objecting? There is perhaps something of an inconsistency in seeking to obtain the 75% mandate to go forward while at the same time leaving the right of objection with every individual policyholder, and perhaps through time one might see the legislation evolve so as to provide for a statutory requirement of a meeting and a statutory requirement of 75% approval, and for that approval then to be binding on all the policyholders.

I do not propose to say much about the independent actuary's role as this will be covered later by Mr Shedden; suffice it to say that the only guidance in the Act is that there must be a report and that the policyholders require to be sent the summary which I mentioned. The view of the DTI is that the independent actuary's report should not simply be a blessing of the scheme—which I think was the former practice—but should rather set out the pros and cons of the scheme, quantifying these so far as practicable so that the recipients can make up their own mind.

To give some idea of the practical reality then, the transfer scheme for FS Assurance's business to be transferred to Britannia Life was stated on 10 pages of typescript. The policyholders were given a 63 page printed document to allow them to assess whether or not they wished to endorse the demutualisation route.

What of the role of the court and the position of the objector? Fortunately, or otherwise, we had no objectors in the context of the FS/Britannia Life court procedure. Objections were threatened but in the last analysis, none materialised, and it remains to be seen just how the court would handle these in Scotland. I remind you that the objector, or rather the person seeking to be heard, (there is no mention of the word 'objector' in the section) must allege that he would be adversely affected by the carrying out of the scheme. It is probable that a Scotish Court would wish any such person to lodge Written Answers and the matter would proceed by way of Adjustment of the Written Pleadings to focus the issues before any hearing of the petition took place, thereby, I suspect, adding significantly to the length of the procedure.

Although not a demutualisation, it is perhaps instructive to study the London Life case. As all of you probably know, that involved the transfer of the long-term business of London Life, a mutual company, to Australian Mutual Provident, another mutual, and was effective pursuant to Section 49. There was a fairly articulate and vociferous objectors group, who in the first instance were able successfully to challenge the validity of the actions of the chairman of the policyholders meeting called to approve the scheme, when they adjourned the meeting from the morning to the afternoon to enable larger premises to be used. That is not the aspect I wish to consider, however. Rather let us look at the hearing of the petition to approve the scheme. It is instructive to study the comments of the judge when granting approval of the scheme. Essentially the court's task was to approve or otherwise the scheme put before it, not to cast around to see whether or not there couldn't be a better scheme. It was the concern of the court to be satisfied that, taken as a whole, the scheme which was before the court was not unfair to any person or class of persons affected. This was regarded as largely an actuarial matter and hence the Act consigned an important role to the actuary. Additionally, the Secretary of State's opinion, because of the information he possesses in his regulatory role, is an important consideration. The court also paid attention to the size of the mandate from the policyholders' meeting.

Finally, a comment as regards the timescale. It might be helpful for you to know that the entire process from presentation of the petition to the issuing of the order sanctioning the scheme in the FS/Britannia Life case took just under three months. During that period the appropriate advertisements were made in the Press and in the Gazettes. The petition was referred by the court to a reporter, who is an experienced independent lawyer, whose job it is to advise the court whether or not all the detailed procedure of formalities that I mentioned have been properly complied with. His report was lodged in the court and the court heard the petition and granted the order sanctioning the scheme.

The longer process, in fact, was the process of compiling the circular to the policyholders and working up the necessary actuarial reports in relation to the proposal. This is not in any way a criticism of the actuaries involved in what was an extremely complex and novel process, but it is reassuring, to me at least, that it is not just the law's delays that can cause complex transactions to take longer to implement than the parties had at first hoped or assumed.

Mr A. D. Shedden:—I do not have time to deal with all the possible actuarial aspects even if I were qualified to do so but I wish to say a few words about the expectations of policyholders and the rights of members.

The expectations of policyholders are only now being seriously considered by the United Kingdom Actuarial Profession and I understand that a report on this topic may be available soon. However, in North America it has long been accepted by actuaries that with-profits policyholders should receive insurance at cost after providing a contribution to surplus funds. This implies that the returns to policyholders should fairly reflect the investment, mortality and expense experience of the various classes of policyholders concerned.

As we have heard, the Society of Actuaries' Task Force on demutualisation was able to define the expectations of policyholders as requiring the existing scale of dividends to be maintained, if current investment conditions continued to prevail. This definition arises within the context of the continuing entity theory of surplus, under which the thesis is that policyholders' contributions to surplus are not normally returnable. Surplus does not belong to the policyholders but is a corporate resource to be used for financing new business and underwriting investment and other risks. The position in the United Kingdom is essentially similar, but here much greater emphasis on equity investment and a much greater importance of without profits business and other sorties of miscellaneous profits complicates the picture. Policyholders it seems, even as members of a mutual company, have no control over the accumulation of excessive surplus, or its misappropriation for ventures of doubtful value in terms of policyholders' expectations. Nevertheless, the ultimate right to the surplus is clear. On a winding-up or in closing to new business the policyholders get all the surplus sooner or later. This right to surplus is potential only and arises in circumstances where the expectations of policyholders, in the very widest sense of the word, will not be realised. However, in the case of a demutualisation in this country, members have no corresponding right to surplus, although in practice their policy expectations may be protected.

In a sense there is a conflict of interest between the expectations of policyholders and the rights of members.

Consider an Abbey National type of demutualisation where the shares in the new public company are allocated entirely amongst the existing members, with or without pre-emptive purchase of some of the shares. In the case of Abbey National, the company was able to pay the cost of the quotation and service the dividend requirement on its shares without appreciably affecting the nature of competitiveness of its business. The immediate effect, in fact, was an increase in surplus followed by a diminution in the rate at which surplus was accumulating. It is difficult to envisage a mutual life company being able so to demutualise without having to finance part of its dividend out of increased surplus contributions from policyholders. Since the demutualisation would not be allowed to affect existing policyholders adversely, the increase profit requirement would fall entirely on the new business. In such circumstances there could well be a conflict of interest between shareholders and existing policyholders in the amount and use of retained surplus—the shareholders looking for profitable investment in new business, which may well be of a different nature from the existing business, and the existing policyholders relying on existing surplus margins to permit the level of equity investment underpinning their bonus expectations. Incidentally, the shareholders in these circumstances are most likely to be the older policyholders, that is, those whose policies are longest in force, whereas the policyholders with the greater future expectation could be said to be the younger policyholders, that is, those whose policies have the longest terms to run.

The importance of protecting existing surplus following demutualisation is recognised in the New York law, as we have heard. Under the permitted continuing entity method, the so-called 'orphan' surplus—that is, the surplus that has accrued from past generations of policyholders—must be preserved intact, even though interest on that surplus may be paid to the shareholders.

A similar feature was present in a recent South African demutualisation, that of Southern Life, described by Franklin and Lee in the Journal of the Staple Inn Society, Volume 3, and by J. A. A. Guy in a paper to the Actuarial Society of South Africa in August 1988. The scheme involved the merger of Southern Life—a mutual company having a substantial estate—with a proprietary company, Anglo-American Life, to form a new company, Southern Life Association Limited. Further capital was injected, partly by Barclays National Bank Limited and partly through public subscription, with the intention that only 40% of the new company would be owned by the shareholders of the former Anglo-American Life, while 30% would be owned by Barclays and 30% by the general public. Policyholders of both companies were given preferential rights to buy the new shares, but were not given preferential terms. The existing with-profits business of Southern Life was transferred to a notional, segregated tontine fund, the initial amount of which was determined on the basis of a bonus reserve valuation which allowed for full maintenance of current bonus rates, including terminal and claims bonuses.

There were various guarantees supporting the future rates of bonus in this fund and, in addition, the fund was to receive a pro-rata distribution of investment earnings on the scheme estate, that is, the estate of Southern Life at the merger date. The capital of this estate was frozen and may not be distributed to shareholders. The shareholders are entitled to a tenth of the surplus distributed in the new with-profits business fund, which is also segregated, and to all the surplus from the remaining business. Shareholders are not entitled to share in surplus distributed to the existing Southern Life with-profits business, but as this business runs down, an increasing proportion of the interest on the scheme estate will be allocated to the remaining business fund.

In analysing this scheme, Franklin and Lee concluded that the existing with-profits policyholders of Southern Life received nothing in respect of the capital of the estate, the value of future surplus on the in force business or the goodwill value of the marketing organisation. On the other hand, the future bonus prospects of existing policyholders would seem to have been improved. The independent actuary reporting on the scheme felt it sufficient to have regard only to this feature and appears to have ignored the question of members' rights.

While Franklin and Lee felt that too much of the windfall profit had gone to new shareholders who were not former members of the mutual, Guy obviously felt that the scheme preserved the concept of corporate entity under which a company needs working capital to survive, whether its mutual or proprietary, and giving too much of this away could weaken the company. However, Guy's arguments do not necessarily apply where the existing policyholders are allotted some or all of the share capital of the demutualised company.

Turning now to the position in the United Kingdom, although it has been suggested—not by the previous speaker necessarily—that it might be possible for demutualisation to be pursued here via the Companies Act, or by Private Act of Parliament in the case of companies so constituted. The only certain method is, as we have heard, by means of a Section 49 transfer. This requires a report to be made by an independent actuary. As Mr Smith has said, no guidance is given regarding the content of such a report, except that the Act requires the summary of the report to be distributed to policyholders, sufficient to indicate the opinion of the independent actuary on the likely effect of the scheme on the policyholders. In non-demutualisation transfers most independent actuaries appear to interpret this as requiring them to comment on the bonus expectations of with-profits policyholders and on the security of without-profits policyholders. The wording of the Act would seem to be wide enough in the case of a demutualisation to allow comment on membership rights of policyholders. Unfortunately, perhaps, it is not clear what the independent actuary can say about these rights, other than describe what happens to them under the scheme and quantify the compensation, if any, that will be paid for them. The rights had no actuarially assessable value prior to demutualisation and only the market place can put a value on them at the time of demutualisation. However, although the independent actuary may therefore feel constrained in commenting on the aggregate value put on members' rights, he may nevertheless feel able to comment on the fairness of any method of allocation of value amongst members.

There is another possible constraint on the independent actuary in reporting under a Section 49 transfer. He is required to report only on the scheme before the court and can say nothing about possible alternative schemes that might have been considered but have not been presented. Thus, he may be inhibited from raising the possibility of closing the fund to new business, which is of course one way of ensuring that the policyholders of the mutual receive their membership interest in its surplus, albeit at the cost of disruption of policy expectation. Normally, closing the fund to new business does not form part of the expectations of policyholders, or indeed of management. The company would no more want this alternative to be considered when presenting a scheme of transfer than when presenting the Annual Report and Accounts.

As it happened, the possibility of closing a fund to new business was considered in the case of the FS demutualisation but there, the company raised the matter itself in the context of the possible future of the company should the scheme not go through.

It is not my intention to discuss the FS demutualisation in any detail. However, I think it is fair to say that the principle adopted was that of the continuing entity, as in the South African case I have just described, but carried one step further in that the existing with-profits business was not segregated from the new business but in fact remained within the same bonus series as far as reversionary bonuses were concerned. The new company into which FS was transferred and which became a wholly-owned subsidiary of Britannia Building Society, had only one long-term business fund which consisted, initially, of the entire long-term business and surplus of FS Assurance. This fund was supplemented by an injection of capital from the shareholders, determined largely on the basis of a calculation of the embedded value of the stream of future profits likely to emerge from the existing business and from the surplus. The amount of embedded value allowed for the fact that the shareholders would be entitled to up to 10% of all surplus distributed in the fund, including surplus arising from earnings on the capital injection. Although not specifically allocated, the payment was to recompense the existing policyholders for giving up their right to receive all of surplus distributions. Ultimately, this recompense will be received through a system of terminal bonuses. In addition a bonus was paid to existing policyholders in respect of the goodwill on the organisation but no shares, or value for shares, was allotted to policyholders.

In a sense the scheme involved the continuation and enlargement of FS Assurance under another name and it was intended that the experience of the existing FS policyholders would remain that of an ongoing fund open to new business. Within the context of substantial equity investment, this point can be of crucial significance, far more so in the United Kingdom than apparently is thought to be the case in North America.

A closed fund, subject to the experience of an identified set of assets assigned to that fund, would be unlikely to be able to maintain as high a level of equity investment as a fund open to new business. Even with surplus funds this could be so. There are of course other problems associated with closed fund operations.

In essence, the FS policyholders had to judge whether the advantage of realising their potential right to undistributed surplus by virtue of closing the fund to new business was outweighed by the advantage in terms of policyholder expectations of remaining within a viable, continuing organisation. While such a choice is not normally made available to members of a mutual life company, one would expect its potential existence to influence the operations of such companies. At one extreme, the existence of a large, continuing entity surplus or estate might in theory tempt policyholders to close the fund, and might indeed tempt would-be demutualisation predators. It is my understanding that much of the U.S. legislation years ago was prompted by this fear. On the other hand, where there is a small estate—as might be the case if a revolving fund surplus distribution system is in operation—policyholders are likely to be disadvantaged were the fund to be closed to new business and can have little expectation of windfall profits on demutualisation.

C. S. S. Lyon, F.I.A.:—Thank you President for inviting me to start the discussion on this increasingly topical subject. My contribution, though a personal one, is strongly influenced by the chairmanship of the Joint Working Party on the role of the independent actuary in a transfer of long-term business from one company to another, which of course is the way that demutualisation takes effect as we have been told.

The independent actuary is given a crucial though ill-defined role via Section 49 of the Insurance Companies Act. A transfer of long-term business in the U.K., as we have been told, is subject to the approval of the court; the petition to the court must be accompanied by "a report on the terms of the scheme by an independent actuary" and the court will not normally determine the application unless all the affected policyholders have been sent a summary of the actuary's report "sufficient to indicate the opinion of the actuary on the likely effect of the scheme on the long-term policyholders of the companies concerned". That is all the law says about the independent actuary. Questions come quickly to mind. Who is he? Who appoints him? Who briefs him? To whom is he reporting? With which policyholders is he concerned and in what context? Where should he look for information? What is his relationship with a statutory authority and with appointed actuaries? How much work does he himself have to do? How extensive should his report be? Who is responsible for the summary of it that goes to the policyholders? These matters are the stuff of professional guidance but with an important caveat—specific judgements of the court have to be taken into account if they bear on the independent actuary's role; in consequence I think professional guidance will have to be advisory rather than mandatory.

Let us look briefly at the questions I have posed.

First: Who is the independent actuary? I think the answer to this is that he should not have a pecuniary or familial interest in any of the parties to the scheme, an interest, that is, which could lead to a serious challenge to his impartiality by oppenents of the scheme. He should not be a long-term policyholder or a shareholder of any of the parties, nor should he have acted for them in another professional capacity.

Second: Who appoints him? This would normally be the party petitioning the court but it could be one of the other parties.

Third: Who briefs him? This must depend on the circumstances but he must have access to all the parties as he thinks fit if he is to fulfil his role. He should not allow himself to be constrained unreasonably by any of the parties.

Fourth: To whom is he reporting? His job is to assist the court to assess the effect of the scheme on the policyholders concerned. Although remunerated by one of the parties, he is therefore reporting to the court, but the policyholders must also be given the gist of his opinion. Clearly this is to enable them to decide whether to support or oppose the scheme. In the case of a demutualisation those policyholders, who are also members of the company, will want to know the independent actuary's opinion before they vote the necessary constitutional changes. There is a sense therefore in which the actuary is also reporting to policyholders and he needs to bear that in mind in framing his report.

Fifth: With which policyholders is he concerned and in what context? Obviously he is concerned with all those whose policies will be transferred, whether with-profit, non-profit, unit-linked, in force or paid up; also, perhaps less obviously, the present policyholders of any existing long-term fund into which the transfers will be made. The context is an assessment of the consequences for those policyholders of the implementation of the proposed scheme as against its non-implementation. It is clear from the London Life judgement (as has already been said) that the court is not concerned with possible alternative schemes involving other parties, unless it can be shown that the transferring company's directors have been actuated by some improper motive in rejecting them.

Sixth: Where should he look for information? The independent actuary would normally need to look at recent Reports and Accounts and DTI Returns. He also needs to consider reports by appointed actuaries to their directors on such matters as bonus philosophy and prospects. Reports by consulting actuaries and correspondence with statutory authorities may also be relevant. Operational plans of the acquiring company—though they may not be written in tablets of stone—may alert him to potential problems that need to be covered by safeguards built in to the scheme.

Seventh: What is his relationship with the statutory authorities and with the appointed actuaries of the companies concerned? Clearly he should keep in touch with these. The statutory authorities may be able to give him additional background information about the companies involved in the scheme. The appointed actuary or actuaries may be able to provide, in correspondence or discussion, a valuable perspective. In addition, it has become usual for a petition to include appointed actuaries' reports on the scheme and the independent actuary may wish to influence the coverage of such report. He may also want an appointed actuary to carry out investigations on his behalf in the interests of speed and economy.

Eighth: How much work does he need to do himself? This must depend on the circumstances. The independent actuary needs to take an overview of the scheme and in so doing he will form a view on the reliability of the information supplied to him. He may need to sit in on a lot of meetings to do with the drafting of the scheme documents because the parties need to know at an early stage whether there are provisions, or the lack of them, that could make it difficult for him to give a favourable report.

Ninth: How extensive should his report be? Again this will depend on the circumstances. In the case of a demutualisation, the report is likely to be wide-ranging. It must obviously discuss the security of contractual obligation under existing policies. It must discuss whether there will be a dilution of policyholders' rights to share in profits and whether the compensation that will be paid by a proprietor for a share in those rights is appropriate in the circumstances and is to be fairly distributed. Will the acquiring company's development plans pose a threat to transferring policyholders' reasonable expectations? If there are unit-linked policyholders, are there safeguards against the unreasonable use of discretionary powers to increase charges in the future?

Of particular importance in a demutualisation is the loss of members' voting rights. This may be their last opportunity to have a say in the destiny of their company. If so, what are they losing and how are they being compensated? No other scheme is before the court and the independent actuary is not expected to compare the present scheme with hypothetical alternatives involving other parties, but with their existing powers the members could, without the intervention of a third party, close the fund to new business and some members may think that they would benefit by so doing. Under a demutualisation they would lose that power. Although opinions differ on this point, I find it hard to see how the independent actuary could pass, without comment, a scheme which was manifestly less attractive to the members than closing the fund. To do so would be to undervalue the loss of their voting rights. At the end of the day the independent actuary must form a view on whether the scheme being put before the court is advantageous or disadvantageous to the different groups and cohorts of policyholders concerned, and whether it treats those groups and cohorts equitably one with another. He needs to say whether the scheme contains sufficient safeguards for the reasonable expectations of those policyholders. Finally, it is his responsibility to make sure that the summary of his report that goes to policyholders adequately covers the ground in the context of the document in which it appears.

Mr President, the role of the independent actuary in a demutualisation is not one for the fainthearted!

Abstract of the Discussion:—A wide ranging discussion took place with members and guests contributing. This abstract mentions matters concerning policy initially and more technical matters later.

Mutual status was referred to by several speakers concerned that they saw strengths which were being ignored, the lack of conflicts of interests between shareholders, policyholders, the evidence of fear of takeover, and the power of the mutual culture, the proven success of many mutuals over the years both as far as results and growth. On the other hand certain speakers felt that mutuals and traditional with-profits business were indivisible, with-profits business was becoming less profitable and harder to sell, polarisation had merely pointed this up. In addition perhaps traditional with-profits business is an expensive source of capital as it is very unlikely that a new mutual could be launched to do with-profits business now—perhaps this indicates their time is past.

Another main concern of many speakers was the problems of equity. The main problem there is the method of spotting any surplus between current and future policyholders and of course between policyholders and shareholders in the new demutualised enterprise. Whatever happened it was essential to protect the viability of the new enterprise. These two matters can be linked as it is almost certain that shareholders will share in the profits for future policyholders but less likely that they will share where existing policyholders are concerned. Several references were made to recent examples of restructuring both in the U.K. and abroad, highlighting very different approaches. Another issue expressed was that modern contracts often gave few guarantees. In such cases a policyholder had to place considerable trust in the management of an office. Incoming shareholders might act in a less concerned way than the existing management.

In this country all the actual cases so far has used Section 49 of the Insurance Companies Act 1982. This does not require that policyholders have meetings or consent. It was generally agreed that, despite this, it was essential to have meetings and get a 75% vote for the proposals from the policyholders as the Department of Trade would possibly advise the Secretary of State to use his right to be heard in court on any occasion where these steps had not been taken.

The role of the independent actuary was covered in depth. Specific points made included the fact that he had to protect both the policyholder in the demutualising company and those in any company with which it was merging. There was concern that the profession should formulate some guidance on the practices to be used lest the differences which might otherwise arise might bring scorn on the profession. However, the point was also made that the different parties concerned would properly view the one contract from differing financial respects leading to legitimate differences in parameters like the rate of discount. Some of the tasks the appointed actuary is asked to do are not, strictly speaking, purely actuarial. Other informed people can have legitimate views on matters and these should be listened to. However, the actuary has to be more than a super calculating machine processing the views of others and the courts will expect him to use his judgement.

Those with experience of actual cases emphasised that the court is really only interested in the scheme that is before it and will avoid getting drawn into other possible schemes. However, it is likely that any independent actuary reporting on any arrangement would seek to satisfy himself that the scheme is better for the existing policyholder than closing the fund and running it down. Opinions vary on the practicability of such an option, however, and some would see serious practical difficulties in actually doing this; in all probability the residual policyholders would need to be the subject of a smaller transfer in a few years.

Some possible concepts of policy values on surplus were outlined but it is felt that each case has to be treated on its merits. However, possibly some of the more theoretical concepts are not justifiable given the uncertainties inherent in the approximations given. There is also the practical point that policyholders will be asked to vote for the arrangement and some form of inducement may be necessary, even non profit policyholders may have a vote which has a value of some sort.

There was a feeling that recently demutualisation had become an end in itself whereas it has to be seen as a tactic serving a greater strategy. The strategy should indicate whether demutualisation of any kind was necessary and also clearly specify the type of arrangement sought. However, where the strategy was sound, demutualisation could well be of benefit to all, even the existing policyholders; for example, the investment freedom given by the increased capital base would generate more profits than the shareholders took.

The question which was raised as to whether after a Section 49 transfer did the mutual remain in existence as a "shell" was answered in the affirmative. Concern was expressed that Section 49 was not intended to be used in the way proposed and would the courts not essentially object. This did not seem likely. It was also asked if the use of the Companies Act would be at all possible. The answer seems to be that the practical problems are such that it is unlikely that anyone would want to use the Companies Act in the situations being discussed. Companies were exhorted to keep their Articles of Association up to date as otherwise practical difficulties could arise.