JSS 31 (1988) 89-125

DEMUTUALIZATION

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(A paper presented in its original form to the Society on 14 April 1987)

1. INTRODUCTION

As far as we are aware there have been no life insurance demutualizations in the U.K. in recent times, that is conversions from mutual to proprietary form. There has been movement in the other direction: in the 1960's a number of U.K. proprietary companies converted to mutual form to escape the unwelcome attentions of the corporate raiders of the time.

In the U.S. and South Africa however, the two countries which give us the demutualization examples in this paper, there have been in recent years a number of significant demutualizations. In the next chapter we give a sketch of the background to demutualization in these countries.

In Section 3 we explore why a mutual might wish to undergo such a lengthy, costly and probably painful process. The motivation will vary from country to country, depending on the particular economic and institutional background. We have tried to be as general as possible.

Section 4 is entitled 'Actuarial Considerations'. The discussion in this chapter deliberately avoids the question of the policyholders' 'legal rights' on demutualization. We believe that actuarial opinion will play a vital part in any plan of demutualization of a mutual life insurer.

Sections 5 and 6 consider the question of 'legal rights' in the U.K. from the point of view of the mutual's constitution and, in Section 6, from the point of view of applicable U.K. legislation. We are indebted to Alan Barker of Linklaters & Paines for commenting on this part of the paper. Any opinions expressed remain, of course, the authors' own.

Finally, we present our conclusions in Section 7. Appendices A and B describe, respectively, the Union Mutual and Southern Life demutualizations.

At this stage we put forward what we believe to be a fundamental principle in any demutualization, namely that policyholders should have their 'reasonable expectations' fulfilled. An uncontentious example is that non-profit policyholders should not see the security of their policies diminished. This paper will concentrate on the reasonable expectations of the mutual's members. A narrow, and in our opinion generally unacceptable, use of the term limits it to reasonable *benefit* expectations as holders of an insurance contract; a more generous use considers the compensation for cancellation of their rights as members, in the legal sense, of the mutual. It is in this latter use of the term that the U.S. and South African experience is significantly different.

2. OVERSEAS EXPERIENCE

2.1 *United States*

According to one source there have been approximately "one hundred demutualizations of life companies in the United States and about the same number of casualty company demutualizations" (1). It appears that some of the early demutualizations were carried out for the benefit of the management and other insiders rather than the policyholders. A case often cited in the U.S. literature on this subject is that of Madison Mutual, a Wisconsin mutual fire insurance company. In about 1880 Madison Mutual reinsured its business with a proprietary company and was dissolved. "The surplus amassed by Madison Mutual was, unfortunately, lost sight of in the reinsurance transaction"! (2) The Wisconsin legislature (in the U.S. insurance companies are regulated essentially by individual State rather than Federal law) attempted to improve its control of such actions but in the end abandoned the attempt and prohibited demutualization entirely. New York State, where some of the biggest U.S. mutuals are located, banned demutualization of its life insurance companies in 1922. At the same time the NCIC ('National Convention of Insurance Commissioners', now the NAIC or 'National Association of Insurance Commissioners') recommended that demutualization be banned in all States and that this be enshrined in State legislation. This was not in fact carried out and demutualization continued to occur, in several cases leading to insiders in the mutual receiving a windfall profit.

The current situation is confused: 35 states have legislation permitting demutualization in one form or another of which 17 have based their legislation on the so-called 'Williams' Model'. New York permits only the demutualization of non-life insurers while three states ban demutualization outright. The 12 remaining states and the District of Columbia are silent on the subject.

The Union Mutual, located in the State of Maine, was floated at the end of 1986 as a proprietary company on the New York Stock Exchange. This is by far the largest U.S. life insurance demutualization that has occurred (assets in excess of \$5bn) and the process is likely to have considerable influence over future demutualizations. Maine is one of the 17 states mentioned above that has legislation based on the Williams' Model and as a result it is worth examining the Maine Statute in some detail. The major provisions of the Maine Statute are as follows:

— The Superintendent of Insurance must approve the plan of demutualization.
— Approval must also be given by at least two thirds of the members entitled to vote and voting at a meeting called for the purpose.
— Each member is deemed to have an 'equitable interest' in the mutual's statutory surplus.
— The eligible members, who for this purpose include policyholders who have terminated their contracts within the prior three years, have

pre-emptive rights to all the stock in the demutualized insurer. Their equitable interest may be applied to reduce the cost of the shares.

The Union Mutual case is described and commented on in Appendix A. At this stage the important point to note is that under the Maine Statute the members, who happen, as is generally the case in the U.S., to be the with-profits policyholders, are entitled in theory to all the stock and therefore to all the windfall profit that inevitably arises on demutualization. (For a discussion of the nature of the windfall, see 4.4.2.) Secondly, an individual member's entitlement must be fair and reasonable: what this means is not, however, spelled out.

The big New York mutuals, the Metropolitan, the Equitable and New York Life, controlling some $150 billion in assets, have no doubt observed the Union Mutual process with more than a passing interest. The Society of Actuaries set up a Task Force on Mutual Life Insurance Company Conversion (the 'Task Force') in July 1984 "to examine the actuarial issues involved in converting a mutual life insurance company to a stock form of ownership and to produce a record of its examination" (3). Its latest draft has been heavily drawn upon in this paper. Although the Task Force is concerned with actuarial rather than legal issues its report will undoubtedly influence proposed demutualization legislation in New York State (where for life insurance companies, as mentioned above, demutualization is currently banned).

2.2 *South Africa*

The South African experience is of interest not only because it provides recent examples of demutualization (the most important of which, the Southern Life Anglo-American merger, is explained and commented on in Appendix B) but also because South African insurance legislation is derived from that of the U.K., so that the procedures followed are highly relevant to the U.K.

There are some common features in the examples of demutualization that we are aware of. In each case demutualization was accomplished through a portfolio transfer which, in South Africa as in the U.K., requires the sanction of the Court and an independent actuary's report commenting on the transfer from the point of view of its effects on the policyholders. In practice the actuary's report in South Africa is expected to state that the security and reasonable expectations of policyholders will not be diminished as a result of the transfer.

Reasonable expectations in South Africa seem to have been interpreted as, at a minimum, the maintenance of current rates of bonus, as long as current conditions continue, for the existing with-profits policyholders. A similar principle has applied in the recent U.S. examples in so far as policy benefits are concerned. The big difference is that in the U.S. it is considered, and as we have seen this is partly a question of State law, that members of a mutual should be additionally compensated for loss of their membership rights as well as receiving policy benefits, including policy dividends, which are at least as good as would have been ultimately received without demutualization.

In South Africa the issue of compensation for cancellation of membership rights has not been specifically addressed although in practice in some cases future benefit expectations of with-profits policyholders have been significantly enhanced in the demutualization process. This no doubt reflects the lack of specific demutualization legislation. Companies have had to make the best use of what is available—hence the transfer of portfolio route which is seen to protect the interests of policyholders through the report of the independent actuary. The sanction of the Court is then binding on the policyholders. The defect of this route is that it was never designed to cope with demutualization.

Two of the cases, in 1972 and 1974, involved the takeover of the South African operations of Canadian mutuals, Manufacturers' Life and Sun Life, by Liberty Life of Africa. Liberty Life undertook to distribute 90% of the surplus arising from the with-profits business of these operations by way of bonus. There was also a guarantee of the bonus rates as at the date of takeover for a limited time as long as experience did not change too adversely, in which case the 'guaranteed' bonus rates would be adjusted downwards ('adverse experience' was defined in the Scheme of transfer of long term business presented to the Court).

The important point to note here is that there was no question of the policyholders receiving value for the cancellation of membership rights, since that part of the existing estate transferred under the Scheme and any future profits from non-profits business were for the benefit of Liberty Life. Further it could be argued that their reasonable expectations as holders of insurance contracts were impaired since the with-profits policyholders now received only 90% of future surplus on their own business. The Canadian mutuals justified this on the grounds that their South African operations were uneconomic, requiring a substantial subsidy from Canadian with-profit policyholders. To the extent that this was a rescue operation it seems not unreasonable that any potential windfall gain should accrue to the acquiring company. After all, the acquiring company can realize the gain only by operating the business more efficiently.

The most recent case, in 1984, was the merger of a mutual, Southern Life, with a proprietary company, Anglo-American Life. This is described in Appendix B. As in the earlier cases the assets and liabilities of Southern Life were transferred to Anglo-American Life with the sanction of the Court. The main features were as follows:

— Assets were hypothecated to existing with-profits policyholders of the Southern Life of an amount equal to a gross premium reserve on realistic future assumptions with full allowance for the maintenance of current reversionary and terminal bonuses.
— Future experience, other than investment experience, for this class of business was to be segregated from other classes in the merged company. All surplus on the segregated with-profits business was to be available for that class alone.
— The capital amount of the estate, that is the excess of the total assets of

Southern Life over the initial assets hypothecated to the Southern Life with-profits business and the reserve required for the non-profit business, was set aside for the benefit of the existing with-profits business. A proportion of the investment earnings on the estate is apportioned to the existing with-profits business. (This proportion will diminish in time as new business is written.) The balance of the investment income is distributable to shareholders.

It can be seen that a substantial part of the estate is for the ultimate benefit of the new shareholders. The existing with-profits policyholders certainly received a windfall increase in their bonus expectation but the new shareholders received not only a significant part of the estate but also the future profits from Southern Life's non-profit business and the goodwill in the marketing organization. It must be stressed that there was no question of a rescue here. Southern Life was financially very sound.

How can this, in equity, be justified? In this connexion the report of the independent actuary is worth considering. The fundamental premise of the report is contained in Section 6.2:

'In order to determine whether the Scheme would or could prejudice the holders of Southern Life Association with profit policies, it is, to my mind, necessary, and also sufficient, to compare the circumstances determining their reasonable benefit expectations before the scheme becomes effective, i.e. in the past, with those that will determine their expectations after the scheme is implemented, i.e. in future'. (4)

This is the normal approach taken in South Africa by the independent actuary reporting on a Scheme of transfer of long term business. In this case the independent actuary had no difficulty in showing that the reasonable benefit expectations of the with-profits policyholders would be improved.

In our view, however, reasonable expectations in a demutualization should go beyond the policy benefits themselves and take into account membership rights. Unless the mutual is being rescued it seems unreasonable that a substantial part of the windfall should be realized by new shareholders who are not the mutual's members.

3. WHY DEMUTUALIZE?

3.1 *Surplus Constraints*

The major difference between a proprietary life insurance company and a mutual is that while the proprietary company can raise additional capital from its shareholders to finance development, the mutual is entirely dependent on internally generated funds derived from charges levied on the insurance products it sells. These charges are limited, however, by a mutual's very nature: its objective, following from its natural advantage, is to provide better value products to consumers because there are no shareholders demanding their share of surplus. Thus a mutual, no matter how efficient in its operations, may be constrained in its development plans, for example to develop a new product line or diversify into non-insurance financial services, by lack of surplus. In this situation management has the choice of cutting back on development plans which may be necessary to the mutual's long term viability, or of taking risks to improve the surplus ratio, for example by mismatching. The failure of United Kingdom Provident Institution is a classic example of the risks inherent in the latter strategy.

One way of raising permanent capital, without demutualization, is to form a 'downstream' holding company to hold as subsidiaries the various ventures which require additional capital. This capital can be raised by floating off up to 49% of the holding company shares, the parent mutual retaining control. This does not however solve the problem of a relatively weak surplus position in the parent mutual itself (see Section 3.2 below) nor does it achieve the advantages of an 'upstream' holding company as outlined in Section 3.3.

There is another choice—merger with a financially stronger mutual. This is tantamount to giving up its independence. There would probably be a fundamental reorganization involving loss of administrative staff and senior management. The loss of senior management is unlikely to be from the financially stronger partner and will not, therefore, be attractive to the junior partner.

3.2 *Insurance Regulation*

There are several ways in which insurance regulation can constrain a mutual's operations, the most obvious way being through minimum actuarial reserve and surplus requirements. As regulators better understand how companies operate they may impose higher reserve and surplus requirements in particular areas.

A pertinent example of this in the U.K. is the Department of Trade and Industry's desire for life insurance companies to hold significant mismatch reserves in respect of their traditional with-profits business, reflecting the high equity content of the assets backing the liabilities of this class. This directly reduces surplus ratios. A proprietary company can restore the surplus ratio by raising further equity capital—a mutual cannot.

Another way is to restrict a mutual's ability to diversify into other businesses. This is explained in Section 3.3 below:

3.3. *Group Structure and Diversification*

There has been a significant trend in recent years for proprietary insurance groups to form 'upstream' holding companies. Mutuals cannot, in their very nature, do this.

Other businesses, for example a fund management subsidiary or overseas insurance subsidiaries, may be held directly by the holding company rather than through the life insurance company. This places them beyond the reach of potentially restrictive domestic insurance regulation, which has several advantages. For example:

- A life insurer may not be permitted to engage in particular activities, even if held through a subsidiary, unless these are closely related to its basic insurance business. There is some concern in the U.K. that Section 16 of the Insurance Companies Act 1982, which derives from E.E.C. legislation, could be applied in this way more restrictively in the future than it is now.
- Subsidiaries are not then subject to stringent asset valuation and admissability rules. If the mutual owns the subsidiary then a write down of the subsidiary's asset value directly reduces the parent mutual's surplus.
- A holding company structure generally provides more flexibility in the presentation of operating results, in tax strategy and in methods of financing the operation.

3.4 *Management Incentives*

Incentive based compensation is becoming increasingly popular in many countries. A mutual is at a disadvantage compared with a proprietary company in that it cannot offer share based incentive plans. There is of course nothing to stop a mutual from introducing a bonus plan for its senior executives though to do this would require a well-defined set of performance goals in the absence of a 'bottom line'. A bonus plan is also much less tax effective. It is not clear, however, that bonus plans for the most senior management are appropriate in mutuals where the members exercise so little real control, although it could be said that this is not very different from the situation in a proprietary company with widely held shares. A mutual contemplating such a plan could well attract unfavourable comment from the outside.

3.5 *'Culture' Problems*

However 'commercially minded' a mutual may be, in the sense that it competes aggressively for new business with proprietary companies, the process of demutualization is likely to involve a culture shock. This is true even for a successful, financially strong mutual with ambitious management, particularly if the aim of the mutual is to be a quoted independent proprietary life company rather than to be acquired by another company. Management, now acting on behalf of shareholders as well as policyholders, must pay attention to the bottom line; it will need to react more quickly to short term fluctuations in the company's operating environment to prevent a fall in its share price and will probably need more sophisticated management information systems as a result; it will have to learn to communicate with shareholders and the financial community; finally it may have to cope with unwelcome takeover bids. Nonetheless the management of some mutuals would probably welcome the challenge of operating in the new, less protected, environment.

Probably the most difficult cultural change is to persuade the field force and brokers that there will be positive benefits to them. After all if a mutual has stressed the benefits of mutuality—insurance at 'cost'—in its competition with proprietary insurance companies it will have some explaining to do! It will be necessary to communicate the importance of the greater security and/or ability to grow, that additional capital will bring, and the greater efficiency which shareholder scrutiny may bring.

4. ACTUARIAL CONSIDERATIONS

4.1 *Introduction*

To recapitulate, the crucial issues to be addressed in any plan of demutualization are firstly the fulfillment of contractual promises to policyholders by ensuring that their reasonable benefit expectations are met in some well-defined way and secondly the compensation, if any, to members of the mutual for the cancellation of their membership rights.

The first issue has been resolved in the U.S. and South African cases presented in the Appendices by setting aside for the benefit of the in-force with-profits policyholders assets that at the date of demutualization are sufficient to fulfill their reasonable benefit expectations and by segregating the future experience of these policies so ensuring that the surplus generated by them in the future may be returned to them. This has been called the 'walling-off' principle.

The second issue is much more contentious as can be seen from the discussion to Leckie's excellent paper to the U.S. Society of Actuaries. Here the U.S. and South African experience is very different with the South African Court taking a more limited view of policyholders' rights. The U.S. view, and this partly follows from State legislation, is that it is more reasonable, on grounds of equity, to distribute a windfall to the policyholders than to the new shareholders (unless the new shareholders and the policyholders are one and the same). There is a third possibility—that the windfall belongs to the State! A variant of this viewpoint is put forward by Leckie in his paper. He concludes that on the wind-up of a mutual surplus assets "can either be transferred to the insolvency fund of the state or province or be apportioned among the jurisdictions on some equitable basis". It is not as wild an idea as it seems—the House of Lords recently came to a similar conclusion in the case of the Trustee Savings Bank ('TSB') demutualization.

In this chapter we explore further this difficult issue whilst restricting our approach to *actuarial* considerations. Questions of ownership in the legal sense are left to the following two chapters.

There is we think general agreement that payments in cancellation of membership rights cannot be scientifically assessed. The fundamental problem, recognized by the Task Force, is that the windfall value built up in a mutual has been contributed not only by the current generation of with-profits policyholders but also by policies which have terminated. In coming to this conclusion, with which we agree, the Task Force has developed two theories of mutual operation which are not only of interest in themselves but also shed light on the sense in which current policyholders 'own' the mutual. These two theories have been named by the Task Force the Entity and Revolving Fund Theories (The Revolving Fund Theory may be regarded as a special case of the Entity Theory). These are described in Section 4.2 below.

Notwithstanding this fundamental problem, 'as a practical matter and as a matter of perceived equity, the Task Force believes that most companies will choose to determine the membership values allocated to individual members in a manner that reflects the relative contributions of the members to accumulated capital; in addition, these values might reflect some compensation for the cancellation of the less tangible attributes of membership, the right to vote for directors, etc'. We discuss in Section 4.3 the Task Force's definition of the member's contribution and its applicability to the U.K. Finally in Section 4.4 we consider the possible structure of a demutualized life insurance company.

4.2 *Theories of Mutual Company Operation*

4.2.1 *Entity Theory*

According to this theory a mutual is run as a continuing entity, hence the name. It is run for the benefit of future as well as existing with-profits policyholders, who for the moment we will assume are identified with the mutual membership. If the mutual is to grow by writing new business it must raise the capital to do so from its members: this is a mutual's fundamental operating constraint. It must, therefore, levy a surplus charge on its with-profits business.

The capital base of such a mutual would be made up as follows:

(1) Statutory surplus less internal liabilities not reflected in statutory reserves (for example reserves for terminal bonus).
(2) The present value of surplus charges needed to recover new business strain. This represents a temporary surplus charge on an individual with-profits policy.
(3) The present value of permanent surplus charges on the in-force with-profits business.

Components (2) and (3) might be termed the invisible surplus.

To clarify this structure we consider a simple but hopefully realistic example. Let us assume the following arbitrary but not unreasonable numbers:

Total assets (valued at market)	100
Statutory reserves plus internal liabilities ('internal reserves')	80
Retrospective asset share	70
Gross premium reserve	60

The internal reserves of 80 exceed the published net premium reserves because there will be included for example a reserve for terminal bonus expected to be paid plus a reserve for deferred tax on unrealized gains. (These internal liabilities are held in the U.K. within the investment reserve.)

The retrospective asset share for the in-force with-profits business is less than the internal reserves because of the conservatism built into the statutory reserves.

The gross premium reserve makes allowance on current realistic assumptions for the maintenance of current bonus rates. The reserve is less than the retrospective asset share because this mutual is organized according to the entity theory—with-profits policyholders are expected to make a permanent contribution to surplus.

Visible surplus

This is the difference between total assets and the internal reserves, in our example 20.

Recovery of new business strain

This is the difference between the internal reserves and the retrospective asset share. It represents a temporary loan from the mutual to the with-profits policyholders. In our example this is 10.

Contribution to surplus

This is the difference between retrospective asset share and the gross premium reserve defining reasonable expectations. In our example this is 10.

Estate

The excess of total assets over the retrospective asset share, representing assets which cannot be directly attributed to the in-force with-profits business. This is 30 in our example.

Invisible surplus

This represents the present value of future surplus charges generated by the in-force with-profits business. This is 20 in our example.

The total of visible and invisible surplus is therefore 40.

Under this theory the part of surplus contributed by past generations, which we have termed the estate, is not allocated to any particular existing product line. It is general surplus to be exercised for the long term benefit of policyholders, current and future. This seems to be in accord with how most mutuals are actually operated. If management felt that the interests of existing with-profits policyholders were paramount, consistent with the theory that the existing with-profits policyholders own the surplus, then a logical consequence would be to liquidate the mutual. We are not aware of any such action in practice!

Under this operational theory the estate of the office belongs to no one. Is this consistent with any legal requirements? The only guidance here comes from the mutual's constitution: the U.K. Insurance Companies Act is silent on demutualization. We have examined the constitutions that legally define the operations of U.K. mutuals. The main right of members, in a mutual considered as a going concern, is to vote for Directors: the allocation of surplus and its distribution amongst the various classes of with-profits business are at the sole discretion of the Directors, sometimes with the advice of the Appointed Actuary. (In the situation where the mutual is being wound up, the rules of some mutuals remove the responsibility for allocating surplus from the Directors to the Actuary or the Court.) In theory some class of members could elect Directors that would influence the allocation of surplus but this seems very unlikely given the difficulties of organizing support among a large body of policyholders with no economic relationship other than their being policyholders of the same company. We understand that the position in the U.S. is very similar.

4.2.2 *Revolving Fund Theory*

According to this theory of mutual operation insurance is provided to with-profits policyholders at cost, in the sense that no permanent surplus charges are levied on members' policies. There needs to be a temporary charge for financing new business strain. The reasonable benefits expectation in such an operation would be the return of with-profits policyholders' premiums less expenses and cost of insurance, accumulated at the net rate of return achieved on assets, that is the retrospective asset share. At any time the visible surplus would be nil. Any invisible surplus would merely represent the recovery of new business strain.

Under the revolving fund theory all the surplus, invisible and visible, is held on behalf of the existing with-profits policyholders: there is no unallocated estate.

As an example we could have the following situation:

Total assets (valued at market)	100
Internal reserves	100
Retrospective asset share	90
Gross premium reserve	90

The excess assets of 10 required to finance new business strain could have been obtained from surplus reinsurance or, in some countries, through the issuing of surplus notes.

The theory is attractive because it helps to resolve the ownership issue but unfortunately for the theory most mutuals do not appear to operate in this way. New business growth in such a mutual would have to be constrained in the long term to be below the after-tax yield available on assets. (See, for example, the formulae derived by T. S. Bunch in his paper also published in this volume (5).) In practice mutuals are quite as aggressive in the pursuit of new business as their proprietary counterparts.

Another attractive part of the revolving fund theory is that insurance is received at cost, which is supposed to be a fundamental tenet of mutual insurance. It does not, however, follow that better value for money will always be obtained in such a mutual rather than in a mutual which seeks to grow and needs to charge accordingly. A significant estate allows a riskier but also potentially a more rewarding investment policy for the ultimate benefit of with-profits policyholders: this includes the writing of non-profit business. A larger, growing organization should also be able to achieve economies of scale in the administration of business which will benefit existing as well as future with-profits policyholders.

4.3 *Members' Contributions*

Under the entity theory the total surplus of the mutual, both visible and invisible, consists of surplus contributed by the current generation of with-profits policyholders plus an estate effectively contributed by past generations. The Task Force recommends that the members' contribution be defined as the excess of the retrospective asset share over the assets required to fulfil reasonable benefit expectations and that any windfall be distributed to members in proportion to their contribution. This has at least the merit that if the estate and any goodwill in the marketing organization were zero the total amount allocated to each member would be simply the retrospective asset share. In practice, unfortunately, the estate plus goodwill, at least in the U.K., will represent a major part of the windfall.

There are other significant problems with the Task Force approach. In the first place the method depends crucially in its application on the definition of the assets required to fulfil reasonable benefit expectations. This has generally, both in the U.S. and South Africa, been taken to be a gross premium reserve, on realistic assumptions, with allowance for the maintenance of the current levels of bonus (South Africa) or policy dividend (U.S.).

This has almost become a definition of reasonable expectations but it is based on the dubious assertion that the Actuary has always declared the appropriate bonus rate in the past in accordance with an equitable structure of surplus charges. In practice bonus levels are determined on more pragmatic grounds and there may well be considerable inequities between classes and between generations. This will considerably distort the contribution to surplus by class and hence the windfall profit allocated by class. A possible solution would be to investigate retrospectively bonus earning power by class and to impose an equitable charging structure through a system of special bonuses on demutualization.

Another problem arises with the Task Force approach, in its application to the U.K., because of the existence of non-profit business, including unit-linked business, within the mutual. This is commented on in Subsection 4.3.1.

4.3.1 *Non-profit business*

In the U.S. mutuals generally do not write non-profit business except in wholly owned subsidiaries. The non-profit policyholders are not members of the parent mutual and hence have no voting rights. In the U.K. however in the majority of mutuals non-profit policyholders rank pari-passu with with-profits policyholders as far as voting rights are concerned. It seems to us that in such a mutual non-profit policyholders could expect to have a share in the demutualization windfall.

As far as traditional non-profit business is concerned we do not believe that there is any *actuarial* justification for this to receive a share of the windfall. Consider a mutual that issued a significant volume of non-profit endowment business (top-up mortgage business perhaps) in the days before double digit interest rates. This business will have proved to have been highly profitable to the mutual. Applying the Task Force theory would give this class a significant share of the windfall. The flaw in the contribution to surplus approach is that it does not recognize the difference in risk to the mutual of writing with-profits business on the one hand and non-profit business on the other. If interest rates had fallen since the issue of our block of non-profit endowments the mutual would have made a significant loss. With with-profits business the mutual could still have levied its target surplus charge through an adjustment to the bonus rate declared.

Different considerations might apply to unit-linked business which is today much more significant than traditional non-profit business. Traditional non-profit contracts contain significant guarantees. The conventional theory is that this is good business for mutuals to write as long as the risks, chiefly investment and expense risks, are reflected in the pricing and the mutual is sufficiently strong financially to bear these risks. Ultimately this business should be a more rewarding investment of the estate than investment in securities. Unit-linked business does not fit this theory very well: investment risks and profits are passed to the policyholder and some modern contracts pass on the mortality, disability and even expense risks as well. The charges which the insurer may levy are open ended so that, in adverse conditions, the charges may be raised without limit. The adverse conditions are not always confined to those arising from the writing of this type or class of business, so that the policies can be made to participate in any general losses of the insurer. This is identical to the position of a traditional with-profits policy with regard to general losses. The with-profits policy differs in that it may share in theory in the general profits of the insurer.

How real is the difference? Mutuals have in recent years entered the unit-linked market in a serious way, either for the first time or through the relaunching of their operation with a modern product range. Their new unit-linked contracts are competing directly with their traditional with-profits contracts, for example in the mortgage endowment market and in individual pensions. It is hard to see how a mutual could suggest that its with-profits bonuses would benefit from surplus generated by unit-linked business as the logical implication is that the with-profits contract would be better value. This would not seem to be the appropriate message to the brokers in the context of 'best advice'! The proliferation of unitized with-profits contracts simply reinforces the point. Should unit-linked and with-profits business within a mutual be equivalently priced, in the sense that the present value of surplus charges per unit of sale should be the same?

Operationally then there is an increasingly close resemblance between with-profits and unit-linked business.

In the mutuals where unit-linked policyholders are members (this goes without saying for holders of unitized with-profits contracts) and where the product design passes on to those policyholders the same risks shared by the with-profits policyholders there is a reasonable actuarial argument for considering them to have membership rights to surplus equivalent to those of the with-profits policyholders.

If unit-linked policies are included, the application of the Task Force theory could give some unexpected results. For example, there is general agreement amongst U.K. actuaries that bonus levels on with-profits business are too high, at least for the younger generations of policyholders. As a result the contribution to surplus, in the Task Force sense, made by with-profits business, and hence their share of the windfall, would be depressed relative to the contribution made by unit-linked business. The unit-linked policyholders could end up controlling the demutualized company!

4.4 *Structure of the Demutualized Insurer*

In the introduction to this chapter we put forward the two fundamental principles that seem to be at the heart of demutualization, namely:

(1) fulfilling contractual promises by ensuring that reasonable benefit expectations do not suffer as a result of demutualization.
(2) compensating members for the cancellation of their membership rights.

We have discussed above how some insight is gained into these principles through consideration of the entity theory of mutual operation. How should the demutualized operation be structured in accordance with these principles? We consider this in relation to each of our principles below.

4.4.1 *Reasonable benefit expectations*

The assets needed at the time of demutualization to fulfil reasonable benefit expectations have been discussed in Section 4.3 above. How should these assets be applied in the future? The method adopted in the Union Mutual and Southern Life cases was to set up a segregated with-profits subfund initially equal to the required assets. In the future all surplus generated by the subfund will be for the exclusive benefit of the existing with-profits business, in the sense that services provided to the policies in the subfund are charged at cost without any loading for surplus or shareholders' profit. There are many actuarial considerations to be taken into account in the operation of such a subfund.

(1) Should the subfund be open or closed to new business? In the Union

Mutual and Southern Life cases the subfunds were closed to new business. The problem with the subfund being open is that the assets specifically allocated to the with-profits business at the date of demutualization could be used to support new business on other than commercial terms, thus depressing bonus expectations. Further the new shareholders will probably want to have a direct interest, say 10%, in the surplus generated by new with-profits business. New with-profits business would then need to be written in another subfund with clearly defined shareholder participation rights.

(2) The nature of the assets backing the subfund should reflect the nature of the liabilities. Ideally the asset mix should not be affected by demutualization otherwise reasonable expectations may be impaired. However with a closed fund the equity content of the assets should probably decline over time to allow better matching as the guaranteed level of benefit increases.

(3) Should there be a minimum bonus guarantee for the in-force business as at the date of demutualization? The Southern Life case (See Appendix B) included this but the minimum bonus scale may be reduced to reflect adverse experience: it is not guaranteed. It seems to us quite reasonable that the bonuses payable should reflect the actual experience of the subfund; the concern would be that bonus within the subfund is likely to be more volatile than if the with-profits business were part, for purposes of bonus, of the general long-term fund. (It would of course be part of the long term fund as far as the fulfilment of contractual guarantees was concerned.) A low guaranteed bonus scale may well be appropriate.

(4) Should all with-profits business be allocated to a subfund and should different classes of with-profits business require separate subfunds? The issue is the degree of protection needed to ensure that policyholders do receive their reasonable benefit expectations in the new environment. For individual business, for which bonuses depend on the pooling of investment, mortality and expense risks, a method is needed that segregates experience. For group with-profits business where experience is already isolated to some extent because the contract involves less risk sharing, the maintenance of existing bonus practices may be sufficient. It may be necessary to publicize the internal workings of the contracts.

Within individual business there is probably no need to create subfunds for different classes. It should be sufficient to rely on the Appointed Actuary's investigations. This is, after all, no different from the normal situation in a mutual.

4.4.2 *Member's compensation*

How is the amount of the windfall to be determined? An analysis of the sources of the windfall can be made using the well-established appraisal value technique for valuing proprietary life insurance companies. According to this, the economic or appraisal value of a life insurance company may be analysed into three components:

(1) The shareholders' interest in disclosed capital and surplus, with surplus adjusted to reflect market values for assets.
(2) The present value of the shareholders' interest in future surplus generated by the in-force business.
(3) Goodwill or the value to shareholders of business yet to be written.

Consider the following structure for the demutualized insurer:

— The with-profits business as at the date of demutualization is written within a mutual subfund of the long term fund. All future surplus generated within this subfund will be ultimately distributed to these with-profits policyholders. In terms of our example in 4.2.1 the initial assets of this subfund amount to 60.
— Other assets and liabilities form a new non-profit fund within the long term fund. The total of visible and invisible surplus attributed to this non-profit fund is 40.
— New with-profits business is written in a separate subfund with defined shareholder participation rights. Financing may be obtained from the non-profit fund.

This particular structure maximizes the windfall value because the total surplus is allocated to the new shareholders. An obvious alternative structure is to allocate the windfall surplus to the new business with-profits fund. If shareholder participation in new with-profits business was 10%, say, then the windfall as far as the new shareholders are concerned would be reduced to 10% of 40, or just 4. The balance of the windfall surplus is in effect distributed to future with-profits policyholders. This may seem attractive because it reduces the current windfall but the new structure may not be stable once we extend our example to include, realistically, non-profit business. It is by no means clear whether the current split of unit-linked and with-profits business in the U.K. will remain stable. If unit-linked business was eventually to dominate, as in Ireland for example, the with-profits business written since demutualization would in theory be entitled to potentially enormous bonuses, bonuses which were quite unreasonable. A further reconstruction would then be required.

In terms of our appraisal value components the sum of (a) and (b) is 40. There may also be capital subscribed by the new shareholders, which will boost (a).

In a typical quoted with-profits life insurance company the in-force with-profits business will generate a steady stream of dividends to shareholders through the mechanism of transfers to profit and loss account calculated as the shareholders' share of the cost of bonus. There is no equivalent to this in the demutualized insurer as far as the existing business at the date of demutualization is concerned. If we extend our model to include non-profit business then there will be the equivalent of (b) for this class. Mutuals, however, have seriously entered the unit-linked market only relatively recently so the value contributed to (b) is unlikely to be very significant. The resulting insurer would have the peculiar financial characteristics of a newly formed company with a mature distribution system. Earnings will be much more volatile than for a typical quoted with-profits office. This will make the fixing of a demutualization price more difficult—there will be nothing on the market with which it can be compared.

The value to be placed on (c) is in any event difficult to determine; it will be particularly difficult in a demutualization. The mutual may have laid considerable stress in its marketing image on mutuality. As a result, sales of with-profits business may fall sharply after the demutualization process is complete.

The windfall value will in practice be determined not by actuarial appraisal values but by the price put on the shares by the market. Nevertheless because the demutualized insurer will have unusual characteristics an actuarial appraisal value if likely to be a very important input to the price determination.

4.4.3 *Distribution of the windfall*

The windfall may be distributed in three ways:

(1) As enhanced ultimate policy benefits, for example through additional assets allocated to the closed with-profits fund.
(2) As cash.
(3) As shares in the new company.

These different ways will no doubt have differing tax implications for individual policyholders. The consideration of these is beyond the scope of this paper. We wish to concentrate on the actuarial issues.

Where the mutual is looking to be acquired, that is in the view of its management it is no longer viable as an independent organization, then methods 1 or 2 may well be appropriate. However, where the mutual is financially strong and wishes to retain its independence as far as possible post demutualization, and this will be the situation for big mutuals contemplating this action, then methods 1 and 2 have very serious flaws. In the first place the windfall value, including goodwill, could well exceed the surplus, depending on the post demutualization structure. This would be the situation in our example. Thus a very substantial amount of capital would need to be raised on the flotation of the company, which would make the whole process much more difficult, if not impossible. Secondly, the distribution to policyholders prior to flotation would involve a valuation of the windfall that would inevitably be different from the value placed on the company by the market. If the value distributed to policyholders exceeds the value placed on the company by the market, the flotation cannot take place. Alternatively the new shareholders receive an unearned windfall.

The resolution of this conundrum is to give the policyholders a pre-emptive right to the shares, as in the Union Mutual case. The value of the windfall is then determined by the market and the existing surplus structure remains intact, minimizing the need for new capital. As in the case of the pricing of the TSB issue the pricing of the shares is arbitrary: the price is simply a function of the additional capital required. For example if no further capital is required the shares would be issued at a price of zero. The windfall would be realized in the aftermarket.

A mutual that demutualizes in this way will emerge with a very large number of shareholders relative to the size of the company. No doubt a significant number of policyholders will dispose of their windfall profit in the after market, especially those who have only a few shares, but even so a relatively large number will remain. The cost of providing regular shareholders' information will be correspondingly large. This is the price of people's capitalism!

5. CONSTITUTIONS OF U.K. MUTUAL LIFE COMPANIES

In this section we look at the rules contained in the constitutions of U.K. mutual life companies. Often the rules will be embodied in a Memorandum and Articles of Association but in many cases the constitution will be called by a different name. Our comments are directed towards their possible influence on a plan of demutualization. It should, however, be remembered that the rules, in the main, are designed to apply to the affairs of the mutual as a going concern in its mutual form so that they are ill adapted to dealing with demutualization. Also, the rules can usually be changed; in most cases by a vote of the members.

5.1 *Form of Incorporation*

By private Act of Parliament	13	mutuals
Under the Companies Act	13	"
Under the Industrial and Provident Societies Act	1	"
	27	

The form of incorporation affects the methods which are available to the mutual in order to effect a change in its rules, other than by a simple vote of the members. For example a mutual incorporated by private Act of Parliament might require a new private Act; a mutual incorporated under the Companies Act might need to seek the sanction of the Court for the proposed change under Section 425 of the Companies Act. Legal advice would be necessary in any particular situation.

5.2 *Membership Definition*

All policyholders	18	mutuals
All with-profits policyholders	8	,,
Only Ordinary Branch policyholders	1	,,
	27	

Two mutuals require the size of a policy to be above certain minimum levels before a vote is given. The majority of mutuals grant voting rights to all policyholders, irrespective of their rights to share in the profits of the mutual. In a demutualization this voting power in theory confers an interest in any windfall value to be distributed.

5.3 *Number of Votes*

One per member or per policy	19	mutuals
Depends on policy size	8	,,
	27	

Within the second group, the following formulae exist:

One vote per £1 of regular annual premium (1)
One vote per £1,000 basic sum assured (1)
One vote per £25 basic sum assured (but only 1 if an annuity) (1)
One vote plus one per £500 basic sum assured with a maximum of 25 votes (1)
Dependent on basic sum assured, with a maximum of 5 votes (3)
Dependent on basic sum assured, with a maximum of 15 votes (1)

If voting power is relevant to the interests of members in a demutualization, then the weight of voting power is relevant. Most mutuals give one vote to each policyholder, irrespective of policy size, and the remainder weight by policy size but using formulae that seem anomalous in today's conditions. For example, the holder of a with-profits single premium policy would have no votes in some mutuals and in others high sum assured policies are given disproportionate weight. In one mutual, which is about to call a meeting of the members to change the rules, it is doubtful whether unit-linked policyholders have a vote because this requires the policy to have a sum assured.

5.4 *Requirement for a change in the rules*

Mutuals constituted by a private Act of Parliament generally require at least a 75% vote in favour of the change at a meeting of members. Two of these require two separate votes to be taken. Mutuals constituted under the Companies Act require a 75% vote in favour as provided for by Section 9 of the Companies Act.

5.5 *Provisions for Surplus Distribution in the Normal Course of Events*

Who decides on the allocation?

The Directors	20	mutuals
The Directors and the Actuary	4	,,
Silent	3	,,
	27	

In six of the cases where the Directors decide, they must have regard to the advice of the Actuary.

Who may receive the surplus?

Any policyholder	6	mutuals
Only holders of with-profits policies	18	,,
Silent	3	,,
	27	

In four of the 18 cases where only with-profits policyholders may receive surplus, there is the further restriction that surplus arising in any fund may only be distributed to policyholders of that fund.

In nearly all mutuals the allocation of surplus decision is given to the Directors, in a minority of cases with the advice of the Actuary. The power of members to influence surplus distribution is then confined broadly to the power to elect Directors who may better represent their interests. In the normal course of events this is unlikely to occur but the situation is likely to be different in a demutualization with a substantial windfall to be distributed.

5.6 *Provisions for Surplus Distribution on Winding up*

Many of the constitutions are silent on this point.

Who decides on the allocation?

The Directors	5	mutuals
The Directors and the Actuary	1	,,
The Directors and the members	1	,,
The Court	2	,,
The Actuary using policy values as weights	2	,,
The President of the Faculty	2	,,
Silent	14	,,
	27	

Who may receive the surplus?

Any policyholder	4	mutuals
Only holders of with-profits policies	6	,,
Any policyholder or the with-profits policyholders	2	,,
Silent	15	,,
	27	

Demutualization is similar to winding up the mutual, in that the mutual entity ceases to exist and there is a windfall surplus distribution (in a demutualization, however, the windfall is greater than on wind-up because goodwill is preserved). These provisions are very relevant to the allocation of any windfall on demutualization.

Surplus allocation in the normal course of events is usually a decision for the Directors but on winding up we see that in several cases the decision rests with third parties such as the Court and the Actuary. For two mutuals, not only the third party but also the method of allocation is laid down: the Actuary using policy values as weights.

5.7 *Demutualization Provisions*

One mutual's Memorandum forbids conversion into or amalgamation with a proprietary company.

6. U.K. LEGISLATION

How might demutualization be achieved in the U.K.? It must be stressed that there are no precedents in recent times as far as we are aware so that the various routes suggested are untried and therefore speculative. Further the procedure in any particular case will depend on the mutual's particular form of incorporation and the rules constraining its operation. For example 13 U.K. mutuals (see Section 5) are incorporated under private Acts of Parliament. Demutualization might require specific legislation for such a mutual, which could involve protracted scrutiny by Parliament. In the aftermath of the TSB affair Parliament may now be more alive to the question of ownership rights in a mutual.

The problem is that there is no U.K. insurance legislation dealing directly with demutualization. It is instructive to look at the situation for companies in general.

6.1 *Company Reconstructions*

Arrangements and Reconstructions are dealt with under Sections 425 to 430 of the Companies Act 1985. The main provisions are as follows:

— The company or any of its members may apply to the Court to consider the reconstruction.
— If a majority in number representing 'three quarters in value' of the members who vote do so in favour of the reconstruction and the Court also sanctions it, then the reconstruction is *binding* on all the members.

It may be that this is a feasible route for the demutualization of a life insurance company.

It is highly desirable that the Court should be involved, firstly to give the various classes of members the opportunity to consider the reconstruction but also to provide a decision which, if favourable, is binding. The demutualized insurer can then be acquired or floated on the stock exchange in the secure knowledge that its intentions will not be thwarted by disaffected members (shades of the TSB!) bringing a Court action against the company.

There is a problem however. As we have seen in Section 4, actuarial calculations are necessary to ensure that the reasonable expectations of policyholders are fulfilled. There is no provision for actuarial advice under these Sections of the Companies Act. It is quite likely that more than one consulting actuary would be brought in to represent the interests of different classes of members (for example the scheme of reconstruction might provide for the windfall to be distributed entirely to the with-profits policyholders, ignoring the claims of unit-linked policyholders who also happened to be members of the mutual) and as this is an untried procedure it is not clear to what extent the Court would require or disregard such actuarial advice. The Secretary of State of the Department of Trade and Industry might well intervene if he feels that an insurance company may be unable to fulfil the reasonable expectations of policyholders.

6.2 *Insurance Company Legislation*

The analogues to Sections 425 to 430 of the Companies Act 1985 in life insurance company legislation are Sections 49 and 50 of the Insurance Companies Act 1982. These Sections regulate the transfer of long term business from one life insurance company ('the transferor company') to another ('the transferee company'). Either the transferor or transferee company may apply to the Court for an order sanctioning the Scheme of transfer. Without such sanction no transfer can take place. There are various requirements that need to be met before the Court will consider the Scheme.

— There must be a report on the terms of the Scheme by an independent actuary.

— Notice of the transfer must be published in various journals and newspapers.
— "Except where the Court has otherwise directed" a statement setting out the terms of the Scheme and containing a summary of the independent actuary's report must be sent to every policyholder. This requirement is generally waived but in a demutualization such a waiver seems doubtful.
— Notice must be given to the Secretary of State.
— In practice, provided the proposals seem satisfactory to the Department of Trade and Industry, the Secretary of State will not be represented at the hearing. Section 49 states that the Secretary of State and indeed any person "who alleges that he would be adversely affected by the carrying out of the Scheme, shall be entitled to be heard" by the Court.

Demutualization could be obtained using this route either through merger with an existing proprietary company, as in the Southern Life case, or through transferring the long term business into a newly authorized life insurance company created for this purpose.

There are nonetheless also problems with this route. In the first place it would be much simpler if there was legislation under the Insurance Companies Act, as there is under the Companies Act, to permit direct reconstruction without having to proceed via an artifical transfer of engagements to a new life insurance company set up purely for the purpose of receiving the business. The process of transfer introduces, for example, tax problems which a direct reconstruction would avoid. More importantly however the role of the independent actuary in the matter of portfolio transfers has been limited in the U.K. to considering the reasonable expectations of long term policyholders as policyholders, not as in a demutualization, as members of the mutual. We have noted the same problem in South Africa where the transfer of portfolio route has featured in all recent examples.

For the independent actuary to consider membership rights would be to extend his customary role. This is equally true of the Secretary of State. In these circumstances it might well be up to the Court to champion the rights of members as owners as distinct from policyholders.

In a 1973 case (6) the Court had to consider a scheme of reconstruction under the U.K. Companies Act of the NFU ('National Farmers' Union') Development Trust Limited, a company limited by guarantee without a share capital, its objects being generally to assist the farming community. The NFU Development Company Limited was a member in addition to some 94,000 other members, all farmers. It was proposed under the scheme that to reduce expenses of administration the membership be reduced to 7, one of the 7 being the NFU Development Company Limited. No compensation was offered to the other members for loss of their membership rights.

The Court refused to give its sanction to the Scheme on the grounds that no compensation was provided for cancellation of membership rights. This case therefore represents an important precedent for a life insurance company demutualization but does not shed light on what constitutes adequate compensation.

7. CONCLUSIONS

7.1 *Introduction*

It is not the purpose of this paper to convince U.K. mutuals that they should immediately rush out and demutualize. We do believe, however, that any mutual making long term plans should be aware of the demutualization option. We hope that this paper will make a contribution to their understanding of a complex subject.

7.2 *Overseas Experience*

We have had to look overseas, to the U.S. and South Africa, for examples of demutualization in recent times. We have noted that a very different view has in practice been taken as to the rights of the mutual's members on demutualization. In South Africa the emphasis has been on the fulfilment of the members' reasonable benefit expectations as holders of insurance contracts; in the U.S. their rights as members, which are cancelled on demutualization, have been explicitly taken into account. We believe that reasonable expectations should encompass both aspects.

7.3 *Why Demutualize?*

Although mutuals have a 'natural advantage' in competing against proprietary insurance companies, because mutuals have no shareholders, they do face operational disadvantages which are inherent in the mutual form.

The most important disadvantage is that a mutual is entirely dependent on internally generated funds for future development. This may restrict the mutual's ability to carry out such development, which may threaten its long term viability. In this situation the alternatives to demutualization are not attractive—taking financial risks to improve the surplus ratio as United Kingdom Provident Institution did or merging with a larger mutual. Other operational disadvantages include restrictions imposed by insurance regulation, particularly possible restrictions on diversification into other financial services.

Demutualization is not merely a complex technical process. It involves fundamental changes in the mutual's culture which need to be understood and addressed by the mutual's management well in advance of the technical process itself. Apart from the need of management to concern itself with the bottom line perhaps the most difficult challenge will be to convince the sales organization that the change is beneficial.

7.4 *Actuarial Considerations*

We have examined the Actuarial considerations involved in fulfilling reasonable expectations on demutualization. In order to do this we reviewed two theories of mutual life insurance company operation put forward by the Society of Actuaries' Task Force; the Entity and Revolving Fund Theories. We agree with the Task Force that the Entity Theory better represents a mutual's operations in practice. The implication for demutualization is that only a part of the demutualization windfall has been contributed by the current members of the mutual. The balance, and probably the major part, has been contributed by prior generations of members and other policyholders. Thus the windfall on demutualization is truly a windfall and there can be no scientific way of distributing it. Nevertheless an attempt must be made: we have considered the Task Force's approach and have commented on some of the problems inherent in the method and, in particular, in its application to the U.K. where, unlike for the most part in the U.S., mutuals write both traditional non-profit and unit-linked business.

On actuarial grounds we conclude that traditional non-profit business should have *no* share in the demutualization windfall but that for unit-linked policies the situation is much less clear cut, particularly for the more recent product designs.

We have also considered how the structure of the demutualized insurer is affected by the requirement to fulfil reasonable expectations. The reasonable benefit expectations of members, that is as holders of insurance contracts, may be fulfilled by segregating their future experience from the rest of the company in a closed subfund. This subfund will operate like a mutual within the long term fund.

The windfall value arising on demutualization may be assessed using standard techniques developed for valuing proprietary life insurance companies. The demutualized insurer will have an unusual structure compared to quoted life insurance companies because it will lack the stream of future shareholder profits generated by in-force with-profits business. This will make its earnings more volatile and its market value more difficult to assess.

7.5 *U.K. Legislation*

The majority of U.K. mutuals surveyed (18 out of 27) give voting rights to all policyholders not just to with-profits policyholders. In such mutuals the traditional non-profit policyholders, despite our conclusion above made from an actuarial point of view, will expect a share in the demutualization windfall through the exercise of their voting rights. Thus the actual share out of the windfall will reflect both actuarial and legal considerations.

The essential legal problem is that in the U.K. neither the mutual's constitution nor U.K. legislation deal directly with demutualization. We have considered three possible demutualization routes:

(1) By private Act of Parliament (available only to mutuals constituted in this way).
(2) By reconstruction under the Companies Act.
(3) By a transfer of long term business under the Insurance Companies Act.

Routes 2 and 3 require the sanction of the Court, which is desirable because its sanction is binding on the policyholders.

Only the third route specifically requires actuarial advice, in the form of a report by an independent actuary who represents the policyholders. Such advice is, we believe, essential to any equitable plan of demutualization. Even this route is not without problems, however. In the first place there may be tax problems. Secondly, independent actuaries in the U.K. have reported on transfers of long term business from the point of view of the security and reasonable expectations of policyholders, not from the point of view of their rights as members.

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APPENDIX A

THE UNION MUTUAL CASE

The Company Involved

Union Mutual	A mutual life insurance company chartered under Maine law in 1848. The company provides a broad line of disability, health and life insurance products, as well as group pension products. Consolidated assets at 31 December 1985 were U.S.$5·5 billion.

Outline of the Transaction

Union Mutual converted from mutual to proprietary status. The converted company's shares were held by UNUM Corporation, a holding company created specifically for this purpose. All existing policies of insurance with the mutual continued unaffected by the conversion. Eligible policyholders of the mutual had their membership rights in the mutual cancelled and received either cash or shares in UNUM in return. A public offering of shares in UNUM followed the conversion and the shares in UNUM are now listed on the New York Stock Exchange.

Reasons for the Transaction

The board resolution of Union Mutual which adopted the plan of conversion gave the following reasons for doing so:

(i) To provide policyholders with an opportunity to convert their illiquid membership interest in the company into marketable securities or cash.

(ii) A capital stock and holding company form was considered the one allowing the company to compete most effectively and respond best to the challenges of an increasingly competitive environment. This is in the long term best interests of the company's policyholders.

(iii) The proposed stock form of organization would allow access to capital markets broader than those readily available to a mutual insurance company.

(iv) The proposed corporate structure will provide flexibility, greater than that possible for a mutual life insurance company, to meet new competitive challenges. [The corporate structure involved the insurance company being a subsidiary of a holding company. The holding company's other activities and investments would then not be hindered by insurance company regulations, as might be the case if the mutual acted or invested in the same way.]

The offer document for UNUM added the following:

(v) To enhance opportunities for acquisitions, including the ability to use paper rather than cash.
(vi) To make stock or stock rights available as incentives for its current and future employees.

Legislative Background

A plan of conversion was adopted which set out the steps to be followed. The plan was first submitted to the Superintendent of Insurance for the State of Maine for his approval. The Statutes of the State of Maine set out several requirements of any such plan which must be met before the Superintendent can approve it. They include:

(i) It must be fair and equitable.
(ii) It must be approved by not less than 2/3 of the insurer's members voting at a meeting called for this purpose.
(iii) The equity of each member in the insurer must be determined by a fair and reasonable formula which is based on the insurer's statutory surplus.
(iv) The plan must give to each member a pre-emptive right to acquire his proportionate part of all the proposed capital stock of the insurer (and to apply upon the purchase thereof the amount of his equity in the insurer).
(v) The members entitled to participate in the purchase of stock or distribution of assets shall include not less than all current policyholders of the insurer and each existing person who had been a policyholder of the insurer within the prior three years.
(vi) The price paid by members for shares must not exceed the price paid by others.

The Statute makes specific allowance for employees of the insurer to participate in application for stock at the same price as the members, if the members do not take up all of their pre-emptive rights.

It will be clear from the summary of the plan given below that the Statutes determined most of its provisions. The Statutes require that the members have the option of owning the whole of the newly created stock company. In effect, the Statutes ensure that the members can receive the whole of the statutory surplus of the insurer by applying their equity share to purchase stock and then selling this stock in the market.

The Statutes require that all policyholders of the insurer are entitled to participate in stock purchase or asset distribution, irrespective of their membership or profit participation rights in the insurer. In Union Mutual's case, all policies are with-profits; but some have no expectation of future dividends (bonuses).

Procedure Adopted

The mutual was reconstructed as a stock company with the shares owned by a holding company created for this purpose.

The equity share of each eligible policyholder in the statutory surplus of the mutual at 31 December 1984 was calculated. The equity shares of eligible policyholders were then adjusted so that the total equity shares equalled the GAAP surplus of the mutual at 31 December 1985. This confusing situation arose because of the requirement in the Maine Statute that the equity share calculation be based on statutory surplus. The total minimum distribution to policyholders was based on GAAP surplus recognizing, presumably, that the higher GAAP figure more closely represented the windfall value of the mutual. An eligible policyholder was defined as any person or body who owned a policy which was in force at any time during the three years ending on 31 December 1984.

Each policyholder was offered a pre-emptive right to purchase a proportion of the total share capital of UNUM Corporation. The proportion was equal to the proportion of the total statutory surplus that the policyholder's equity share represents. The dollar value of the policyholder's equity share could be applied to purchase the shares offered but was not sufficient to buy all of them. The total of equity shares would have been sufficient to purchase about one half of the shares offered.

Policyholders with small equity shares (less than $2,500) and holders of certain group annuity contracts had the option of cash, equal to their equity share, in place of shares. All other policyholder's equity shares were applied automatically to the purchase of shares on their behalf.

In practice very few policyholders purchased more shares than those arising from their equity share. The remaining shares were offered to the general public at a price of $25·50. This was lower than the $28·00 price used for the policyholder offering and so extra shares were allocated to the policyholders to reduce the effective price paid to $25·50 per share.

All policies of insurance of the mutual are left unaffected by the conversion except that the membership interest that policyholders had in Union Mutual is cancelled.

Provisions for the Safeguarding of Policyholder's Interests

With-profit policies of the mutual will remain participating as long as they remain in force. When the conversion became effective, the mutual established the Participation Fund Account ('PFA') for the sole benefit of all its individual participating life and annuity policies and contracts.

The amount of the PFA at outset was equal to the present value of future benefits and bonuses plus certain expenses less the value of future premiums. The assumptions used in this calculation were to be consistent with their current experience, and the bonuses allowed for to be at 1986 levels. Specific assets, amounting in value to about $300m, were identified as making up the PFA at outset.

No assets, investment earnings or gains from operations of the PFA will be available to Union Mutual or the parent company during the operation of the PFA or upon its termination. In the unlikely event of the assets of the PFA being inadequate to provide for the guaranteed benefits (i.e. before further bonus additions) then Union Mutual would be required to provide for the shortfall.

The bonuses declared on policies in the PFA are to be modified in the light of future experience so as to be equitable and so that the whole of the PFA will be paid out over time to the policies included.

Calculation of Each Policy's Equity Share

The division of the company's surplus among eligible policyholders was based on each policy's accumulated contribution to this surplus.

Each policy was assigned to a class within each of the major lines of business written by the mutual. Each such class contained essentially homogeneous policies with respect to experience and risk characteristics. For each class, annual contributions to surplus were determined using the actual experience of the class. These annual contributions were accumulated using the actual annual investment returns achieved to 31 December 1984. By combining the annual contributions by class with the individual characteristics of a policy, the policy's share in the total contribution to statutory surplus as at 31 December 1984 was calculated.

The equity share was then derived from this contribution using the following formula and after ratioing so as to give the GAAP surplus at 31 December 1985 in total.

$$ES=[S-(EP\times \$612{\cdot}25)]\times\frac{C}{TC}+\$612{\cdot}25$$

where ES = equity share
S = surplus
EP = the number of eligible policyholders
C = the contribution (but not less than zero) of the particular eligible policyholder to surplus
TC = the aggregate amount of C for all eligible policyholders

S exceeds TC because part of statutory surplus has been contributed by policies which terminated more than three years prior to 31 December 1984.

The formula can be seen to provide for a minimum equity share of $612·25. This is designed to recognize that the policyholder is relinquishing intangible membership interests in the mutual for which some allowance should be made which is independent of the contribution to statutory surplus.

Summary

The Union Mutual case is an example of the application of State law based on the Williams' Model demutualization statute. Two important aspects of this case are:

(i) That the reasonable benefit expectations of with-profits policyholders were safeguarded by establishing a separate fund within the demutualized company. This fund is to be used solely for the benefit of the policyholders included and will be paid out in full to them. This feature is not part of the Williams' Model but is likely to be a feature of revised demutualization legislation.

(ii) The policyholders of the mutual had a pre-emptive right to their share in the stock of the demutualized company. This ensured that it was possible for the windfall profit on demutualization to all go to the policyholders who were giving up their membership rights.

The calculation of the equity share was constrained by the Maine Statute with its emphasis on *statutory* surplus. The Task Force believes that the members' contribution to surplus should be consistent with the methodology used for defining the initial assets allocated to the PFA and has therefore rejected the contribution to statutory surplus as an appropriate measure.

In order to exercise their pre-emptive right to all the shares in UNUM Corporation, the eligible policyholders were required to contribute cash in addition to the value of their equity share in the surplus. In practice, this will inevitably restrict the ability or will of some policyholders to take up their full rights and so benefit from all of their share in the windfall. We consider this aspect of the plan of conversion to be an unnecessary obstacle in general to the apparent aim of allowing the policyholders to receive all of the windfall benefit.

Very few policyholders applied cash, other than their equity share, to the purchase of shares in the Corporation and many of those given the cash option took it up. After being offered and sold at $25·50, the shares proceeded to trade in the $28–$32 range. The premium achieved in the after market was thus relatively modest so that in practice the policyholders did receive the bulk of the windfall value achieved. As in the case of TSB, the subscription monies remained within the company that was being sold.

APPENDIX B

THE SOUTHERN LIFE CASE

Parties Involved

The parties to this transaction were:

The Southern Life Association ('SLA')	A South African mutual life insurance company. Funds at 31 March 1984 were R1·7 billion.
Anglo American Corporation of South Africa Limited ('Anglo')	South Africa's leading mining finance and industrial group.
Anglo American Life Assurance Company Limited ('AAL')	A South African proprietary life insurance company which is a subsidiary of Anglo. Funds at 31 March 1984 were R1·76 billion.
Barclays National Bank Limited ('Barclays')	South Africa's largest bank.

Outline of the transaction

The transaction involved the amalgamation of the businesses of SLA and AAL so as to create an enlarged life company to be known as The Southern Life Association Limited ('The Southern'). Barclays and the general public purchased shares in The Southern so as to leave Anglo and Barclays with significant equity interests.

The transaction was effective from 1 April 1984.

Reasons for the Transaction

The board of SLA perceived a trend, both in South Africa and abroad, towards finding methods of combining the expertise, networks and resources of life insurance companies, banks and other financial institutions. The financial strength, influence and facilities provided by each, it was argued, can be so organized as to complement those of the others. Life insurers who remain isolated were thought to be liable to lose market share, to face escalating unit costs and to find themselves restricted in the range of products and services which they can effectively supply.

SLA wished to participate in these trends in the financial services market and had been exploring ways of acquiring other life insurers and also of developing relationships with complementary financial houses. SLA felt inhibited in these efforts by its inability, as a mutual life insurer, either to purchase other companies, other than outright for cash, or to offer its own equity capital to any prospective partner in a new venture. Furthermore, it was felt that the security of the interests of SLA's existing policyholders would require safeguarding before any change in SLA's status could be contemplated.

The amalgamation with AAL combined with the involvement of Barclays was seen as a relationship which would enable The Southern to compete more effectively with the other major life insurers to the benefit of its policyholders.

We must assume that, for their part, Anglo and Barclays viewed the transaction as an attractive investment.

Procedure Adopted

The business of SLA was transferred to AAL which was renamed The Southern. The share capital of The Southern was enlarged and Barclays paid R135 million to acquire some of the new shares. The general public were invited to subscribe for further new shares. The monies received from these share sales remained in The Southern.

The shareholdings in The Southern after the transactions were:

	%
Anglo	
ordinary shares	37·5
convertible preference shares	2·5
Barclays	
ordinary shares	30·0
The general public	
ordinary shares	30·0
	100·0

One special share was also issued, and this is referred to in the next section.

Preference was given in the public offering to applications from policyholders of SLA and AAL, members of staff, pension funds, members of the insurance broking fraternity and other business associates.

Provisions for the Safeguarding of Policyholders' Interests

Within the Scheme setting out the procedure to be adopted, there were provisions specifically intended to safeguard policyholders' interests. The provisions provided for both representation for policyholders on the board of The Southern and financial provisions to protect and enhance the 'reasonable benefit expectations' of policyholders.

The method previously used by SLA to elect its Directors is to be used by the 'old segregated policyholders' of The Southern to appoint trustees. These trustees then elect four directors to the board of The Southern. The special share ensures the right of these Directors to participate in Board discussions. As a group, they have one vote on Board resolutions.

The financial provisions affected each policy differently depending on which of the following categories it fell into:

'Old segregated policy'—a with-profits policy of SLA, other than one stated to participate in profits arising from specified sources, in respect of a proposal received prior to Court confirmation of the Scheme.

'New segregated policy'—a similarly participating policy of The Southern in respect of a proposal received after Court confirmation of the Scheme.

'Non-segregated business'—all business of The Southern other than old segregated business and new segregated business. This business thus comprises:

(i) non-profits policies written by SLA,
(ii) all policies written by AAL prior to confirmation of the Scheme, and
(iii) non-profits policies written by The Southern after confirmation of the Scheme, including unit-linked and deposit administration business.

The Scheme requires the Appointed Actuary of The Southern to divide the company's surplus each year into six parts, attributable to:

— The disclosed shareholders' funds and the general estate. (Policyholders have no rights of participation in the general estate.)
— The Scheme Estate (see below).
— The Guarantee Reserve Fund (see below).
— Old segregated business.
— New segregated business.
— Non-segregated business.

Financial Provisions Relating to Old Segregated Business

Two funds were established within The Southern as part of the financial provisions of the Scheme.

The Scheme Estate

The initial amount of this fund was the amount by which the Appointed Actuary to The Southern determined that the net asset value of SLA exceeded the value of SLA's actuarial liabilities at 31 March 1984. The valuation of the liabilities was on a realistic gross premium reserve basis and allowed for maintenance of reversionary and terminal bonuses at their current levels.

The Scheme Estate is maintained as a notionally separate fund within The Southern. The investment earnings arising from the investment of the Scheme Estate are allocated between old segregated business and non-segregated business in proportion to the actuarial liabilities of The Southern in respect of each such class of business.

The formula for the allocation of these investment earnings allocates to the old segregated business a proportion which:

(i) would start at a level close to the proportion of SLA's liabilities at 1 April 1984 which related to with-profits policies, and
(ii) would reduce to zero as the old segregated business ran off and the total liabilities of The Southern, other than in respect of new segregated business, increased.

Should it become necessary, the capital of the Scheme Estate may be used to support the cost of bonuses on old segregated business. The Southern has the option to return any capital used in this way by transfer from subsequent net surpluses in respect of old segregated business. The capital of the Scheme Estate may not at any time be distributed to shareholders as dividends. The Scheme Estate is thus held in perpetuity with a reducing proportion of its investment income forming part of the annual surplus of old segregated business. The rest of the investment income on the Scheme Estate forms part of the annual surplus of The Southern's non-segregated business and is thus for the ultimate benefit of the shareholders.

The Guarantee Reserve Fund

This Fund was established from a proportion of the investment earnings on the new share capital raised from Barclays and the general public. The proportion was 80% in the first year of operation of The Southern reducing to zero after 20 years. Investment earnings of the Guarantee Reserve Fund are allocated to this fund.

The Guarantee Reserve Fund will be debited by transfer to the old segregated reserve fund should this latter fund be in deficit. The old segregated reserve fund is the fund in which surplus earned but not distributed in respect of old segregated business is held.

From time to time the Appointed Actuary of The Southern is to investigate the adequacy of the Guarantee Reserve Fund. He or she may recommend a reduction in the fund if it is considered to be excessive in relation to the likely maximum cost of supplementing future bonuses on old segregated business. The utilization of any such reduction in this fund is at the discretion of The Southern.

Minimum levels for future bonus rates on old segregated policies were specified in the Scheme. The rates are to be not less than the greater of

— the bonus rates applicable to new segregated policies with reasonably equivalent premium rates and bonus structures, and
— the minimum bonus scale.

The minimum bonus scale is the bonus level declared on old segregated policies and current at the date of Court confirmation of the Scheme except in circumstances where the experience of The Southern with regard to investment earnings, mortality and expenses, taken as a whole, has deteriorated beyond certain levels. These levels were designed to be pitched so that experience would have to deteriorate further than would be necessary to cause a reduction in bonus rates in the absence of the Scheme before the minimum bonus scale could be reduced.

The Scheme provided that the surplus arising in respect of old segregated business, including the old segregated reserve fund, can be applied only for the benefit of old segregated policyholders.

Financial Provisions Relating to Non-Segregated Business

The scheme provided for the Appointed Actuary of The Southern to certify, for any policy with benefits dependent on some degree of discretion by The Southern, that such discretion has been exercised equitably, with proper regard to reasonable benefit expectations, with proper allowance for rights to share in surplus, and that the same approach has been adopted as used before the scheme took effect.

Financial Provisions Relating to New Segregated Business

Policyholders are to receive not less than 90% of the distributed surplus of new segregated business.

Summary

The Southern Life case is an example of the application of what has come to be termed the 'reasonable benefit expectations' or RBE approach to demutualization. The crucial difference between this approach and the approach taken in the Union Mutual case is in the terms that are deemed sufficient to make the transaction fair to the members of the mutual. The RBE approach as seen here rests on the transaction being fair if the RBE of the members of the mutual are not reduced by the transaction. For this purpose the RBE taken into consideration are those pertaining prior to the transaction. That is, RBE with the mutual insurer continuing as a going concern. Thus excluded from these reasonable benefit expectations of the members are:

(i) the estate of the mutual which would, in the normal course of events, be passed on for the security of the next generation of mutual policyholders, and
(ii) the present value of future surplus on the in-force business, including non-profit business, and
(iii) the goodwill value of the marketing organization of the mutual insurer.

In fact, in the Southern Life case, the with profit policyholders of SLA could expect to receive more than their RBE as defined above after demutualization. This is because of the provisions in the transaction for:

(i) segregation of this business, so that it ceases to be affected by new business written on other than commercial terms,

(ii) the entitlement to a share of the investment earnings of the Scheme Estate, and

(iii) the minimum bonus level safeguards that would be effective in deteriorating circumstances.

Despite these improvements in RBE, the transaction involved part of the investment income on the estate of SLA and the whole of the commercial value of the marketing organization of SLA becoming part of the proprietary company, The Southern. Only a part of this windfall was available to members of SLA since their share in the Southern was limited to 30%.

Through the public offering of shares, The Southern was successfully floated on the Johannesburg Stock Exchange. The shares gave a premium of 30% to the purchase price in the after market.