JIA 118 (1991) 400-404

RESTRUCTURING MUTUALS—PRINCIPLES AND PRACTICE

By D. R. L. Paul, B.Sc., F.F.A., A. M. Eastwood, M.A., F.F.A., D. J. P. Hare, B.Sc., Ph.D., F.F.A., A. S. Macdonald, B.Sc., F.F.A., J. R. Muirhead, B.Sc., F.F.A., J. F. Mulligan, B.Sc., F.F.A., D. M. Pike, B.Sc., F.F.A. and E. F. Smith, M.A., F.F.A.

[Presented to the Institute of Actuaries, 25 March 1991]

Summary of the Paper written by The Bonus and Valuation Research Group of the Faculty of Actuaries. For the full text of this paper see the *Transactions of the Faculty of Actuaries* **43**, II.

CONTENTS

SECTIONS 4–6: MODELLING

Sections 4–6 explored several of the demutualisation issues using a computer model office whose main features were:

(a) The start of the projection period was taken as 1990, with the office's profile being built up assuming financial conditions, tax regimes and bonus declarations similar to those prevailing from 1949 until 1990.
(b) After 1990, the office moved to a dynamic investment strategy, so that the proportion of the fund invested in gilts reflected the office's strength on the statutory minimum valuation basis (see Section 5.8).
The strategy was to maximise the proportion of the fund invested in equities, subject to the A/L ratio (defined in Section 6.1.1) not falling below a 'danger level' of 1·15. The danger level of 1·15 was chosen as a rule of thumb, on the grounds that the mismatching test used (Section 5.9) only allowed for a 25% fall in equity prices, which is by no means extreme, and that some further mismatching test might have to be satisfied even immediately after a fall in equity prices.
(c) The model office wrote conventional with-profits 25-year endowment assurances on males aged 30 at entry. The model computed the asset shares of individual tranches throughout with terminal bonuses being declared so as to equate final asset shares with the actual payouts.

Three yardsticks of financial performance were chosen as measures to compare different offices, or different scenarios within the same office:

(a) The ratio of assets to liabilities (The A/L Ratio).
(b) The proportion invested in equities.
(c) The relative maturity values payable.

Using these three measures, comparisons were made of:

(a) closure *versus* continuing mutual *versus* demutualising,
(b) the effect of the estate,
(c) the impact of investment shocks, and
(d) the effects of the injection of a purchase price (the model having first been used to explore alternative approaches by which a purchase price might be determined).

Section 7, 'Summary and Conclusion', is reproduced in full below:

7. SUMMARY AND CONCLUSION

7.1 In Section 2, we considered the background which might lead a mutual life office to consider restructuring. We looked back to the roots of mutuals and examined the possible *raison d'être* of a life office. We concluded that the management of a mutual life office should have a clear idea of its current philosophy especially at the time of a restructuring; this should help guide the decision-taking when considering the options available. Reassessment of a mutual life office's philosophy might itself lead management to consider restructuring, even if the office were strong and vital. (Sections 2 and 4.8)

7.2 The reasonable expectations of policyholders must be the overriding guiding factor when considering restructuring. We do not believe that it is clear-cut that meeting the policyholders' reasonable expectations necessarily entails aiming to pay out to them at least as much as they would have received had any additional estate been distributed amongst them. However, it must also be borne in mind that the policyholders may vote for an alternative scheme of restructuring should they perceive it as being more in their interests. (Section 2.11) At various stages in our modelling, in Section 6, different philosophies were adopted, and it was demonstrated that, even if the additional estate (defined in Section 4.4) is not used *directly* to increase the pay-outs to existing policyholders, they might benefit from restructuring.

7.3 We observed at the end of Section 3.5 that fuller disclosure is particularly relevant at the time of restructuring. Giving details of proposed methods and quantifying asset shares at the time of demutualisation, together with the duty of the demutualised office's Appointed Actuary to safeguard policyholders' reasonable expectations (which would become better defined by the disclosure of such information), should ensure that the interests of existing policyholders are well protected.

7.4 In Section 4.5 we described the 'flywheel effect' whereby an office which has expanded rapidly, on returning to a steadier rate of expansion, can be dominated by the premium income from the recently written business for many years. This result is, of course, not restricted to mutuals which restructure, and merely highlights the need for the actuary to project forward the progress of the office and avoid being faced with the impossible task of making a sudden change in direction. In the case of demutualisation, the potential for profits from future business will be important to the purchaser. Clearly the policyholders of a mutual office which has recently succeeded in expanding its new business base can hope to extract a higher price (as a proportion of current assets) in respect of the opportunity to profit from new business. (Section 6.6)

7.5 In Section 6.2 it was demonstrated that an office with an estate deficit (defined in Section 4.6) can reduce the relative size and effect of this deficit if it continues writing new business. Should such an office close, the estate deficit would be uncovered and it would become impossible to pay full asset shares to the existing policyholders. (Section 6.3)

7.6 Given our chosen parameters and dynamic investment strategy, the constraints on investment in a closed mutual were rather less than we had expected. Even when we incorporated quite severe investment shocks (over and above the in-built solvency margin and mismatching tests), it was not evident that a closed fund must constrain its investment strategy on a contingency basis. It could pursue a more ambitious strategy *until* a shock occurred, although subsequent investment freedom might be more limited than in a continuing mutual. (Points (1) and (2) preceding Table 14 in Section 6.4)

7.7 We would expect a closed fund to be particularly sensitive to the profile of the office at the time of closure, so it may be dangerous to generalise our results; indeed we would suggest that the robustness of a closed fund should be extensively modelled whenever the option is considered.

7.8 Except for any 'sweetener', the principal financial advantage for policyholders from demutualisation arises from improved investment freedom (or higher guarantees for the same investment freedom). The actual worth of this greater freedom is clearly dependent on the relative performance of equities and gilts, and in our modelling we have sought to highlight this.

7.9 If the existing policyholders are likely to be affected by restricted investment freedom were no restructuring to take place, they might choose to give up a proportion of their asset shares and/or allow any additional estate to be passed ultimately to shareholders. This would be in exchange for access to shareholder capital and the resultant investment freedom allowing the possibility of larger payouts. (Sections 4.7 and 6.8)

7.10 Apart from the receipt of assets given up by policyholders as described in Section 7.9, the purchaser is unlikely to be attracted to the scheme by gains from the existing business alone. The purchaser is more likely to be aiming to profit from business written in the future. The purchaser's assessment of scope for profits from this latter source will limit the size of the sweetener which the policyholders can obtain. (Section 6.6)

7.11 In the context of a demutualisation, the existing policyholders could expect to benefit in exchange for profits from any new business which would have been written had there been no injection of capital and no change in distribution channels. The benefit may take the form of merely increased investment freedom or security, or of an explicit sweetener. The existing policyholders would find it more difficult to argue that they should benefit from additional new business which can *only* be written if further capital is injected. The same can be said of any new business which can be written through new distribution channels opened by the purchaser. (Section 6.6)

7.12 The value placed on the profits from writing new business following restructuring is highly sensitive to the assumptions made. (Section 6.6) This makes it particularly important for the prospective purchaser also to consider whether or not there will be sufficient working capital to support the new business plans and retain the ability to pursue a competitive investment strategy for with-profits business. (Section 6.7)

7.13 We would not claim that the simulation results in Section 6 are of global application, but they illustrate some of the investigations which can be appropriate. We see a need for extensive modelling when considering restructuring options, taking into account the particular circumstances applicable in any actual case.

ABSTRACT OF THE DISCUSSION ON THE TWO PAPERS

Mr A. S. Macdonald, F.F.A. (introducing the paper 'Restructuring Mutuals—Principles and Practice'): In the paper the Faculty Research Group first set out to explore the background to demutualisation, both by examination of recent case studies, and by considering the reasons which might lead a company to abandon mutual status. This line of thought always led us back to the question of how a mutual might justify its existence, and why it might continue to write new business. The view a mutual takes of its mission in life, what we call the *raison d'être* in the paper, will have an important bearing on the action it takes if and when it is forced to consider a major change, and we have discussed some of the pressures which are currently putting mutuals in just that position. However, the question of restructuring a mutual is a much wider one than some recent case studies would indicate, and that is why we called the paper 'restructuring mutuals' and not simply 'demutualisation'.

When we came to the financial aspects of restructuring, we felt that some conventional wisdoms needed to be tested. The benefits of demutualisation, as opposed to alternative courses of action, depend on the answers to certain key questions which we have set out in Section 4.10. We used the model office to explore these questions in a number of carefully chosen scenarios.

I should like to emphasise here, as we have in the paper, that our results are particular and not general, but they have led to some conclusions set out in Section 7, which we feel are useful in themselves. However, more significantly, they point to the need for extensive modelling to be carried out if restructuring is under consideration. To what extent the bases and assumptions underlying the models, and the range of answers produced by the models, should be disclosed and should bear upon the decisions of the policyholders and the Court, is a question which we have not tried to answer.

Mr T. J. Sheldon (opening the discussion): It is appropriate that these two topics of demutualisation and the management of a with-profits fund be considered together, since a restructuring forces a company to think carefully about its strategy, bonus philosophy and policyholders' reasonable expectations.

Needleman & Westall commence Section 2 by posing the question "what is a mutual life assurance company?" and introduce the concept of orphan surplus necessary for an appreciation of the revolving fund and entity theories of mutuals. The Research Group paper introduces the parallel concept of the additional estate, which is defined as total assets less total asset shares attributable to existing policies. The current position is succinctly summarised in § 2.1.8 of Needleman & Westall's paper, which includes the statement that "the company will decide what to do with the orphan surplus". While reference is made to With-Profits Guides, the question of disclosure to policyholders regarding the management of with-profits business in general, and of the orphan surplus in particular, is not examined in detail.

At the end of Section 3.5, the Research Group comment that "without some evaluation of the accumulated asset shares or of the terminal bonuses prospectively payable to existing shareholders, it is impossible to form a true picture of the overall financial position of the office". I support this view and would welcome fuller disclosure of these matters, not only in the event of a demutualisation or restructuring, but as an ongoing communication exercise to enable the office's policyholders and their advisors to obtain a greater understanding of their benefit expectations.

The principal conclusions of the Policyholders' Reasonable Expectations Working Party are set out in Section 2.8 of the Research Group paper and I agree that point (iii) is contentious. It states that "In the circumstances of a 'major change' in a life office (such as a demutualisation), policyholders may reasonably expect that the proposed new arrangements do not disadvantage them as compared with the option of a closed fund." In debating this point, it is helpful to distinguish between reasonable benefit expectations and membership rights, a distinction also drawn by Needleman & Westall. While it might seem unreasonable that benefit expectations be suddenly changed at the time of a restructuring, in a demutualisation membership rights are lost and members could justifiably seek compensation for that loss. GN15, dealing with Section 49 transfers, requires the independent