



AMERICAN ACADEMY *of* ACTUARIES

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## **Policyholder Protection In Mutual Life Insurance Company Reorganizations**

### **Introduction**

This practice note was prepared by a work group organized by the Committee on Life Insurance Financial Reporting of the American Academy of Actuaries. The work group was charged with developing a description of some of the current practices that could be used by actuaries in the United States.

The practice notes represent a description of practices believed by the work group to be commonly employed by actuaries in the United States in 1998. The purpose of the practice notes is to assist actuaries with the requirement of adequacy testing by supplying examples of some of the common approaches to this work. However, no representation of completeness is made; other approaches may also be in common use. It should be recognized that the information contained in the practice notes provides guidance, but is not a definitive statement as to what constitutes generally accepted practice in this area. This practice note has not been promulgated by the Actuarial Standards Board, nor is it binding on any actuary.

Comments are welcome as to the appropriateness of the practice notes, desirability of annual updating, validity of substantive disagreements, etc. Comments should be sent to (chairperson) at (his or her) Directory address. This practice note covers some possible answers to a number of different questions that were asked by and posed to members of the work group and that have not otherwise been covered in other practice notes.

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**Q. What are we protecting?**

**A.** The rights and expectations of participating policyholders in a mutual life insurance company fall into two categories:

1. Contract rights, such as:
  - a) the right to receive the benefits guaranteed under the policy and
  - b) the expectation of receiving dividends based on emerging experience for the class of policies to which the contract belongs.
2. Membership rights which include the right to vote for the company's board of directors and, by extension, to receive value upon the dissolution or conversion of the company to another form.

This practice note assumes that a mutual company conversion will not adversely affect the ability of a company to meet its contractual guarantees. It does not address issues related to membership rights and distribution of value. It focuses on the question of protecting the "reasonable dividend expectations" of policyholders upon demutualization.

**Q. What methods have been used to protect in-force policyholders in the event of demutualization and other restructurings?**

**A.** The focus in demutualizations has been on protecting the reasonable dividend expectations of participating policies—most specifically, the dividend interests of individual participating life, annuity or health contracts, for which there is an expectation of dividends in the year that the reorganization is effective.

Almost all demutualizations that have occurred as of this writing have included a "closed block" for these types of contracts. The creation of a closed block entails selecting a group of policies and allocating assets to support those policies, such that the cash flows from these assets, together with premiums and other cash flows associated with the designated policies, will be sufficient to pay all future claims and closed block expenses, and to maintain the current dividend scales for the closed block policies, assuming that the experience factors underlying the current dividend scales do not change. Assets committed to the closed block cannot revert to the benefit of shareholders.

Some plans of reorganization have also described some form of protection for individual participating policies for which there is no expectation of dividends being paid in the year that the reorganization is effective. One way of doing that is to define the future statutory gains that are expected for the line of business, based on the same methods and assumptions that were used

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for distribution of value calculations, and to define certain indexes or ratios which will be used to measure deviations from those objectives. For example:

- For life insurance policies with adjustable premiums, the mortality experience which emerges over time can be compared to a mortality index. If (on a cumulative basis) experience is more favorable than the index, then future premiums will be adjusted downward.
- For annuity contracts, the excess (if any) of the cumulative actual investment spread over the cumulative expected investment spread can be measured and used to increase interest rate credits or payments.
- For medical insurance and disability income policies, the short fall (if any) of the actual loss ratio from the expected loss ratio can be measured and used to adjust future premiums or benefits.

The plan of reorganization may provide that the methods and indexes established at the time of reorganization cannot be changed without regulatory approval.

In one mutual holding company conversion, in lieu of a closed block, policyholder dividend protection was provided by describing, in some detail, the current dividend policy of the company and the future methods for adjusting the interest rate and “all other” components of the dividend calculations. An annual certification must be provided to the superintendent of insurance that the stated dividend policy is being followed, and the superintendent must be notified of all dividend scale actions.

Typically, no protection of dividends or non guaranteed elements is provided for group life, health or pension policies. The theory is that these contracts tend to be individually experience rated, and that they are sold in highly competitive markets to sophisticated corporate customers. Therefore, the pressures of the marketplace will assure reasonable treatment.

While most state demutualization laws are silent on the subject of policyholder protection, there are several variations in these statutes. Some say that closed blocks “may” or “shall” be established under certain circumstances. Even in the absence of a legal mandate, regulators may require some form of protection, especially for individual participating contracts.

The reorganization of the Massachusetts Savings Bank Life Insurance (which was technically not a demutualization but extremely similar to one) established a Policyholder’s Protective Committee elected by the policyholders with the right to review the dividend setting methodology.

**Q. What is the general purpose of policyholder protection devices?**

- A.** The conversion of a mutual life insurance company to a stock form should not affect the

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ability of the company to meet the “reasonable dividend expectations” of policyholders. Reasonable dividend expectations are defined as meaning the continuation of the current dividend scales, assuming that the experience factors underlying the scales do not change.

Policyholder protection devices also serve to avoid these conflicts:

- If policyholders are not assured that a reorganization will not affect their dividends (other things being equal), then they would be forced to weigh the trade-off between receiving immediate compensation for the cancellation of their membership rights against the possibility of a reduction in future dividends. In that case, policyholders would not have enough information to make an informed choice.
- Without a dividend protection mechanism, the management of the converted company, and its board of directors, would also be presented with a potential conflict each year between allocating distributable earnings to shareholders vs. policyholders.

**Q. What is the design objective for the closed block?**

**A.** A closed block is generally designed so that the dividends on the policies in the block will change in aggregate only to the extent justified by changes in experience.

**Q. What documents describe the operations of a closed block?**

**A.** The operations of a closed block are often described in several different documents:

- The plan of reorganization of the company will have some reference to the closed block.
- The closed block memorandum (which is an appendix to the plan of reorganization) describes the closed block funding, and (typically) the general principles for allocating taxes and charging expenses (if any are charged) to the closed block.
- The plan of operations is a more detailed document which contains the day-to-day information for the company’s staff to operate the closed block on a day-to-day basis.

**Q. What do these documents include?**

**A.** The plan of reorganization typically describes in general how the closed block will operate. It contains:

- a general statement of the nature and purpose of the closed block
- a description of insurance cash flows that will flow into the closed block (premiums,

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annuity considerations, repayments of policy loans and policy loan interest, etc.)

- a description of insurance cash flows that will flow out of the closed block ( death, surrender, withdrawal, and maturity benefits; new policy loans paid in cash; annuity and other income benefits; dividends paid in cash, etc.)
- a description of which types of taxes will be charged to the closed block
- treatment of commissions and administrative expenses
- a description of investment and investment-related cash flows into and out of the closed block, including treatment of transaction costs, other acquisition expenses, and investment management expenses
- treatment of the AVR and IMR that would be attributable to closed block assets

The plan of reorganization may also contain statements about the dividend policy for closed block business, including a comment about the need to avoid tontine effects and at the same time adhere to the contribution principle.

The plan usually references the need to prepare annual financial statements for the closed block, to perform required regulatory reporting, and to retain an independent actuary to do periodic review and reports on closed block operations. Finally, the plan may provide for terminating the closed block, typically subject to approval by the appropriate insurance regulator.

The closed block memorandum contains additional information about the initial funding of the closed block, as well as other details about its operation. This memorandum typically describes, in some detail, the methods and experience assumptions that were used to model the closed block policies in order to determine the initial amount of assets that should be allocated to the closed block; adjustments for policies which will be added to the closed block after the initial funding date; a description of how expenses and taxes (other than income taxes) will be charged to the closed block in the future; and a detailed description of how federal income taxes will be assessed against the closed block.

The plan of operations contains all of the detail information the company staff needs to operate the closed block. This includes such items as the account codes to which all cash receipts are credited and cash disbursements charged, rules for handling investment income, rules for handling loans between the closed block and the open block (the rest of the company), guidelines as to the amount of cash to be held in cash or short term investments, and the complete details of how taxes are allocated and expenses charged (if any) to the closed block.

**Q. Is there any difference between dividend policy before and after establishment of closed block?**

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**A.** While the purpose of the closed block is to facilitate continuing the company's current dividend scales, assuming that current experience remains the same, there may be some differences in dividend practice due to the following factors:

- The plan of reorganization typically contains wording about the need to avoid a tontine effect in closed block operations. This requires periodically projecting closed block results, to assure that the objective of using up all closed block assets as the business winds down is achieved. These projections may indicate a need for some adjustments to dividends.
- The closed block may not be charged for certain types of investment expenses, administrative expenses, or taxes that would have been reflected in the company's dividend methodology prior to demutualization. In effect, dividends are therefore insulated against the effects of future gains or losses associated with these items.
- Dividends paid on business outside a closed block may increase or decrease to reflect the financial condition of the company. Dividends on policies inside a closed block are insulated against such changes, (although the company could transfer funds to, but not from, the closed block if it wished). Under a normal closed block operation the portfolio rate of the closed block will be different from the portfolio rate of the open block. (The open block here means those policies that would be part of the individual segment if a closed block had not been established, both existing policies not included in the closed block and policies issued after the closed block is closed.) If the new money rate is lower than the portfolio rate at and after the time of the establishment of the closed block then the portfolio rate of the closed block will decline slower than the individual portfolio rate would have without a closed block (i.e. if the company had remained a mutual company), and the open block portfolio rate will be lower than the closed block portfolio rate. If the new money rate is higher than the portfolio rate at and after the time of the establishment of the closed block, the opposite will occur. A structure that has been considered, but not yet used in any closed block, which avoids some of these problems is a "shared portfolio structure" where the closed block has a defined dynamic share of a portfolio that supports the closed block and similar open block policies. Some actuaries believe that such a structure could be established with rules sufficiently tight to pass regulatory muster.
- The closed block plan of operation may also provide for terminating the closed block at some point in the future (usually subject to regulatory approval); for example, when the size of the closed block is so small as to make future results unstable. As a practical matter, no company has faced this situation yet.

**Q. Should the closed block documents include any comments on the dividend policy?**

**A.** The extent to which the plan of reorganization, or the closed block memorandum, has

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commented on dividend policy has varied from transaction to transaction. There is usually at least a general statement about the purpose and intent of the closed block. Some plans have been more explicit about the need to control tontine effects, and adherence to the contribution principle.

**Q. Should the closed block documents include a provision for the termination of the closed block?**

**A.** As noted in Question 7, some plans have included a specific provision relating to terminating the closed block, subject to regulatory approval.

**Q. How are expenses treated?**

**A.** Certain expenses attributable to closed block business commonly are not charged to the closed block. This reduces the need for regulatory oversight of expense allocation practices and also reduces the funding levels. Certain expenses which are not determined on an allocation basis are more commonly charged to the closed block, such as direct real estate expenses, commissions or premium taxes.

Alternatively, a fixed unit expense formula may be used to determine charges to the closed block, irrespective of actual expenses. This avoids the need for allocation of expenses.

**Q. What would be a typical investment policy for a closed block?**

**A.** The investment policy for the closed block would typically reflect the company's areas of investment expertise, its investment policies for open blocks of similar business, the initial asset composition of the closed block and the company's asset-liability management practices. Although the initial closed block assets may be composed primarily of investment grade fixed income investments, new investments are more likely to include some below investment grade assets, mortgages and perhaps even equity type investments. The regulatory review of the initial funding is facilitated by using (as much as possible) assets rated at investment grade, or the top one or two below investment grades. This does not adversely affect future dividend expectations (because higher funding is required). However, investment in only top quality assets will make it less likely that the current dividend scale can be maintained, even if interest rates are level.

**Q. Does the tax allocation methodology of the closed block need to follow the company's practice with respect to Individual Life or other lines of business?**

**A.** No. The primary objective of the tax allocation methodology used for the closed block is that it preclude judgment to the greatest extent possible and that it provide a reasonable allocation of

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taxes under a wide range of future circumstance. Allocation of taxes to the closed block will be controlled by the methodology specified in the closed block documents (usually in the closed block memorandum). It may be quite different from the method used by the company historically to allocate taxes to the business that is placed in the closed block. The closed block funding calculations will reflect the allocation of tax specified in the closed block documents and this allocation will be used for the actual closed block operation. For example, a simple approach to closed block operations (and funding) might be to treat the closed block as a separate company for tax purposes and allocate the amount of tax so calculated regardless of the previous method of tax allocation methodology used by the company.

**Q. Is IRC809 Tax (Equity Tax) normally reflected in closed block calculations?**

**A.** IRC809 Tax has been ignored in all closed block calculations to date. In all cases the tax allocation methodology has specified that IRC809 will not be charged to the closed block. Under a full demutualization it will not be payable by the converted stock company. For a mutual holding company closed block, it is possible that the IRC809 Tax may be assessed to the company for some period after the conversion. Even in this case the Equity Tax has been ignored in the funding of the closed block and not charged to the closed block (although it will have been charged to the company) in the operation of the closed block. Among the reasons are that the actual tax rate has been very erratic, some key questions such as treatment of negative DERs have not yet been resolved, and the closed block (by its nature) has negative surplus.

**Q. How is IRC848 (“Proxy DAC Tax”) treated in closed block calculations?**

**A.** It is important that the closed block memorandum define how prior deferrals under IRC848 are amortized. Does the tax benefit go to the open block or the closed block? Tax payments based on future premiums would typically be charged to the closed block (and funded for) and deferrals based on such payments would lead to amortizations that would be credited to the closed block.

**Q. How is reinsurance treated in the design of a closed block?**

**A.** Reinsurance affects both the policies that are included in the closed block and the financial operations of the closed block.

Indemnity reinsurance (whether ceded or assumed) is ignored for the purpose of determining which policies are included in a closed block. Assumption reinsurance that has been completed is treated as if the policies were originally written by the assuming company. Thus, policies reinsured into the mutual company under an assumption reinsurance agreement are treated as being policies of the mutual company. Policies ceded from the mutual company under an assumption reinsurance agreement are treated as not being policies of the mutual insurance

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company.

Indemnity reinsurance ceded affects the financial operation of the closed block and should be reflected in the funding calculation. The closed block is charged for the reinsurance premiums and receives reinsurance claims, allowances, and refunds. (Indemnity reinsurance assumed normally has no effect on the closed block since policies it covers are not within the closed block.)

**Q. Which policies are included in a closed block?**

**A.** Any direction that applicable statutes might give as to policies that should or should not be included in the closed block should be followed in the design of the closed block. Generally, individual policies with dividend payments based on recent experience are included in the closed block. Interest-sensitive contracts are generally not included. True group policies are not generally included but pseudo-group may be (e.g. policies sold through a Rhode Island Trust).  
*[Include table of recent demutualizations showing what is included in closed block.]*

The following criteria might be used as guidance as to what business should be included:

- a) The class of business currently receives or has expectations of receiving policy dividends where significant discretion exists as to whether the dividends are paid or at what level of payment.
- b) The methodology used to determine the dividends is based on the experience of a class of policyholders rather than that of a single policy.
- c) There should be an expectation that the closed block will decrease in size and over time will cease to exist as the last policy terminates.

These criteria suggest that the closed block should consist of participating individual policies for which there existed an experience based dividend scale. This could include life, health or annuity contracts. The actuary should also consider whether there are group contracts which, for all intent and purposes, have been treated as (and have attributes similar to) individual contracts and, as a result, should be included in the closed block.

The following criteria might be used as guidance that it is inappropriate or unnecessary to include certain types of business in the closed block.

- a) The policyholder has the opportunity and ability to acquire similar coverage from another insurer at a similar cost.
- b) The policy is one that could remain in force indefinitely.

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- c) The policy allows a significant increase in the number of lives covered.
- d) All of the significant elements of cost and/or benefit to the policyholder are guaranteed or are variable but with limited management discretion.

The following types of business normally are excluded from the closed block:

- a) Non-participating policies
- b) Participating policies where experience based dividends have not been, and are not expected to be, paid
- c) Group coverage (Life, Health, Pension)
- d) Any insurance coverage issued by a stock subsidiary
- e) Indemnity reinsurance assumed
- f) New sales after the effective date of the conversion
- g) Variable Life and Annuities

“Excess Interest” contracts (e.g. SPDA, UL) are normally managed similarly in stock and mutual companies. The non guaranteed elements are determined using a prospective, market sensitive, approach as opposed to dividends which are normally set to distribute surplus accumulation on a retrospective basis. Thus, they have so far been excluded from the closed block. The actuary may consider whether some other form of policyholder protection (such as those discussed in Q2) is appropriate.

**Q. How are supplemental benefits, accumulated dividends, paid-up additions, riders, term conversions, reinstatements, and non-forfeitures handled?**

**A.** Supplemental benefits, dividend accumulations, paid-up additions, and riders are generally included if the base policy is included. Similarly, a policy purchased after the closed block effective date as a conversion of a term policy would generally be included if the term policy had been included and if the conversion policy is of the type that would be included in the closed block. Reinstatements of closed block policies would generally be “reinstated” to the closed block, and policies of the type included in the closed block which are in a nonforfeiture status (reduced paid-up, extended term) would also be included. The foregoing general rules may be superseded for administrative reasons, so as to maintain segregation of the accounting items for the closed block.

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**Q. Are supplementary contracts arising from individual policies included in the closed block?**

**A.** Supplementary contracts may either be included or excluded. The decision depends on such items as:

- a) whether they can be identified for accounting purposes separately from the underlying policies and from supplementary contracts from policies of types not included in the closed block.
- b) whether they involve significant company discretion in setting interest crediting rates (or other nonguaranteed elements).
- c) whether the investments backing them are in the same portfolio as the policies in the closed block.

**Q. How is the amount of assets to be included in a closed block determined?**

**A.** A best estimate projection of the liability and policy loan cash flows of all policies included in the closed block is made using assumptions underlying the current dividend scale and assuming no future changes in dividend scale. This projection reflects the expense treatment and tax treatment specified in the closed block documents and includes no investment income. The after-tax cash flows from this projection are discounted at the after-tax reinvestment rate to give an initial estimate of the amount of assets needed to fund the closed block.

A trial portfolio of assets is assembled from the company's existing assets (usually from the individual line), and their future cash flows (both investment income and maturities) are projected with an appropriate allowance for default. If the present value of the asset cash flows equals the present value of the liability and policy loan cash flows, the closed block has been funded correctly. If not, the initial assets are adjusted until it is.

**Q. How are particular assets chosen for closed block?**

**A.** It is generally considered desirable to fund closed blocks with assets that have predictable and nonvolatile investment returns. Thus, where possible bonds and mortgages are selected and equities, Schedule BA Assets, and real estate are excluded. This general principle may need to be modified if there are not sufficient assets in the bond and mortgage categories. Again, it is preferable to limit the assets used to those in NAIC categories 1, 2, and 3 (that is down to and including Moody's BA rating) although, again, the amount of available assets may dictate other approaches. (It is common for the closed block to own part, but not all, of an asset, particularly large mortgages, just as assets may be shared between investment segments.)

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Some demutualizations have deferred full funding of the closed block until cash is available from the IPO. Under these conditions, appropriate adjustments are made for the lost investment income between the period of establishment of the closed block and the final funding, and for any difference in yield that the assets purchased for final funding may have from the reinvestment rate assumed in the funding calculations.

Within these criteria, assets may be selected to achieve particular yield or duration objectives.

**Q. How are policy loans treated in the closed block?**

**A.** Policy loans are projected separately from other assets. The amount of policy loans in force at each year end is projected, usually as a constant percentage of available cash value. This percentage will be different for each segment of the business that has different loan provisions and should be preserved for that segment to be consistent with dividends paid. Investment income on policy loans is projected at the current policy loan rate (net of policy loan expenses if they are charged to the closed block).

**Q. How are AVR and IMR Treated in closed block Funding?**

**A.** The closed block funding calculations reflect cash transactions. AVR and IMR are not cash and so do not affect the closed block funding.

**Q. What assumptions are used to project liabilities?**

**A.** The current dividend scale together with the recent experience underlying the current dividend scale are used to project the liabilities.

**Q. What does “current dividend scale” mean?**

**A.** “Current dividend scale” means the latest scale adopted by the Board when the closed block funding is calculated. Only the dividend scale that has been adopted by the Board should be considered. Scales that are being tested by the company, but have not yet been adopted, should not be used.

**Q. What does “recent experience” mean?**

**A.** “Recent Experience” means the most recent experience available when the current dividend scale most recently could have been changed.

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**Q. What are the particular concerns with respect to the reinvestment rate?**

**A.** The assumption for investment of cash flows produced by the insurance operations and the initial assets will depend on how the company manages its dividend scale.

If the company uses a portfolio rate dividend scale then there should be one reinvestment pool which is assumed to earn the gross investment yield used when setting the dividend scale less an appropriate charge for future defaults. This will normally be different from the interest rate used to compute dividends since it will be the investment rate before any spread for profit or contribution to surplus is deducted.

If the company uses a segmented IYM approach or segmented asset portfolios, cash flows should be projected separately for each IYM block or asset segment. Each projection will incorporate an assumed reinvestment rate equal to the portfolio rate for that block which will normally differ from other blocks.

It should be noted that the reinvestment rate in these two cases will likely be different (and could be significantly different) from the new money rate in effect at the time of conversion since the reinvestment rate is equal to the portfolio rate which is a blended rate of investments made at different points in time.

If the company uses a “bucket” IYM approach where each bucket’s portion of a policy’s asset share (i.e., created in a given year) uses a separate investment rate based on that bucket’s investment results, and if projections of the “current scale” assume that new buckets are invested at the current new money rate, then the closed block projection would use a reinvestment rate equal to the current new money rate before any deductions for risk or profit except the cost of defaults. That is, the reinvestment rate is still consistent with the dividend scale, which reflects the future effect of new money rates under this approach.

Capital gains and losses may have been reflected in investment income, often on a smoothed basis. It is generally appropriate to include those in determining the reinvestment assumption.

**Q. How should changes in investment policy be reflected?**

**A.** It is normally desirable for the investment policy of the closed block to be as similar as possible to the investment policy for the assets supporting closed block policies before the conversion. If the investment policy is different, it is possible that the reinvestment rate should be adjusted to reflect this difference.

There are essentially two schools of thought: If the company changes the investment policy to reduce investment risk, deciding no longer to invest in common stock even though the portfolio prior to conversion had a 10% common stock component with a considerably higher expected yield, then the reinvestment rate as determined above should be reduced by the reduction in the risk adjusted expected yield. Then the closed block policyholder will be able to expect the same

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dividend scale without continuing to take quite the same investment risk. This was the position the Life Operating Committee of the ASB took in drafting the closed block standard of practice which will be exposed shortly.

If the standard of practice demands that the cost of safer investments (reflected in a lower expected yield) does not reduce the dividends to be expected by closed block participants, it is possible that regulators will be motivated to demand an extremely safe investment policy since it has no effect on expected dividends, even though it reduces the value of policyholder equity. Some practitioners argue that the reduction in expected yield should not affect the reinvestment rate, because they dislike this outcome and because of what might have been said in the past to policyholders about the company's investment policy.

**Q. How are profits from subsidiaries treated?**

**A.** Gains from other sources (such as group lines of business deemed to be owned by the individual line) that will be outside the closed block should, in general, not be considered in setting the reinvestment rate since these gains will not inure to the closed block in the future.

**Q. May future changes unrelated to future experience be assumed in the dividend scale?**

**A.** There has not been an example so far where the company has successfully increased its dividend margins. There has been at least one example of where a company's current margin was considered unusually high compared to history and the company reduced it.

**Q. If dividend mortality has been increased in anticipation of future excess claims (such as AIDS), how should this be reflected in the funding assumptions?**

**A.** The mortality assumptions used for funding should reflect the same deterioration. Similar treatment should be accorded other assumptions under similar circumstance.

**Q. What sensitivity testing is normally performed?**

**A.** Scenario Testing such as is used in Cash Flow Testing is not normally used for closed block analysis. If the closed block is designed correctly, when the interest environment changes the dividends will change appropriately to accommodate this. Sensitivity Testing typically revolves around lapse sensitivity and possibly initial asset default rates sensitivity.