

## ASOP No. 37—June 2000

### Appendix 2

#### Comments on the Second Exposure Draft and Task Force Responses

The second exposure draft of the proposed standard was circulated for review in December 1999, with a comment deadline of May 1, 2000. Eight letters of comment (two from the same person) were received. The Task Force on Allocation of Policyholder Equity carefully reviewed each comment letter. Summarized below are the significant issues or questions contained in the comment letters, printed in roman type. The task force's responses appear in **boldface**.

#### General Comments

One commentator took issue with the statement in appendix 1, which was quoted from the Garber Committee Report, that the determination of the aggregate amount of policyholder consideration is a nonactuarial matter. **The task force notes that the aggregate amount of policyholder consideration in most demutualizations has been set by the marketplace. In any event, the task force believes that the determination of the aggregate value to be distributed to policyholders is beyond the scope of this standard.**

One commentator suggested that the ASB is not qualified to determine whether a method of allocation is "fair and equitable." **The task force believes that actuaries are the appropriate professionals to form and state an opinion as to whether a plan of conversion is appropriate from an actuarial perspective, and the ASB is the proper body to set standards for actuaries performing this role.**

#### Transmittal Memorandum

One commentator questioned the use of the word "reasonable" in the context of "reasonable dividend expectations." **The task force believes that the term "reasonable dividend expectations" is generally well understood as defined in ASOP No. 33.**

#### Section 2. Definitions

Section 2.1, Actuarial Contribution—One commentator questioned whether the phrase "contribution...to the company's surplus" should be clarified to indicate that this is the amount remaining in the current surplus account and is, thus, net of all previous policyholder dividends paid or apportioned. **The task force agrees that this is the proper meaning, but did not believe that further clarification was necessary.**

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### Section 3. Analysis of Issues and Recommended Practices

Section 3.1, Policyholder Eligibility—One commentator noted that the proposed standard did not include any discussion of the fact that some policyholders may purchase a policy from a mutual company that has announced its intention to demutualize solely or primarily to receive consideration. Noting that such activity could have the impact of diluting the value of the consideration paid to other policyholders, this commentator suggested that this would be inequitable and that the proposed standard might be revised to specify that the actuary should consider this in setting the allocation basis. Specifically, the commentator suggested that only policies issued prior to the announcement of the company’s intent to demutualize would be eligible for a fixed component. **The task force recognizes that the question of which policyowners are eligible to receive consideration is frequently addressed in the demutualization statutes of the states. Such statutes often specify particular eligibility dates. If policies are in force on these dates, they are eligible to receive consideration. The task force notes that policyholders receive consideration in exchange for relinquishing their membership rights and that newly issued policies generally have membership rights similar to policies that have been in force for longer periods of time. Moreover, as the commentator acknowledges, it would not be appropriate to attempt to classify policyholders by their intent in purchasing their policies, even if it were feasible. The task force believed that the standard should not be amended to address the situation pointed out by the commentator.**

Section 3.2.3, Basis for Allocating the Variable Component—One commentator recommended that the proposed standard require the actuary to obtain an opinion of counsel as to whether the actuarial contribution method as defined in the proposed standard violates applicable law. In particular, this commentator focused on the fact that the definition of actuarial contribution in the proposed standard includes both a historical and a prospective component. **The task force is aware that there has been controversy over the correct interpretation of certain state statutes with respect to whether or not it is appropriate to take future expected profits into account in the allocation of consideration. In cases where such controversy could potentially arise, the task force expects that the actuary would act with appropriate professional discretion to assure that the methodology used complied with applicable law. A number of state statutes are quite clear about the issue, and there is substantial precedent in certain states sanctioning the methodology set forth in the standard. Therefore, the task force does not believe that a blanket requirement for the actuary to obtain opinion of counsel on this issue is necessary. Furthermore, the task force notes that section 1.2, Scope, provides that “if a conflict exists between this standard and applicable law or regulation, compliance with applicable law or regulation is not considered a deviation from this standard.” Thus, the actuary is not required to apply the methodology in section 3.2.3 when, in the actuary’s professional judgment, this method conflicts with applicable law or regulation.**

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Three commentators offered the opinion that the inclusion of a prospective component in the definition of actuarial contribution *per se* violated the contractual rights of mutual company policyholders. One of the bases cited for this opinion was the belief that mutual insurers operated on a basis in which insurance is provided “at cost” and, therefore, over their entire life, mutual company policies do not make a permanent contribution to surplus. If this was the case, the actuarial contribution, including both prospective and retrospective components, would be zero, and thus there would be no basis for the allocation of variable shares. These commentators point out that if the actuarial contribution were calculated with reference only to the historical component, on the other hand, there would presumably be a non-zero result for the typical company with positive surplus. One of these commentators expressed the opinion that use of both historical and prospective components in the calculation of the actuarial contribution defeats the expectation that the mutual policyholder will obtain insurance at cost.

**The task force believes that the definition of actuarial contribution contained in the standard is appropriate. The standard takes no position on whether the “entity capital” model, where policies make permanent contributions to surplus, or the “revolving fund” model, where all contributions to surplus are returned over a policy’s life, is preferable as a philosophy for setting dividends for a mutual company. The task force does note, however, that different opinions on this issue have been expressed in actuarial literature over the years. (See, for example, “Some Actuarial Considerations for Mutual Companies,” *TSA*, XXXI (1979) by Robin B. Leckie.) The rationale for the definition of actuarial contribution as including both a historical and a prospective component is not based on adherence to one or the other of these theoretical models. It is predicated, rather, on the concept that the allocation of consideration should be based, in part, on the relative economic value of the policy to the company. The task force believes that actuarial contribution, as defined in the standard, represents a fair estimate of this economic value and is preferable to an alternative definition that ignores the value of future expected contributions to surplus. The task force notes that the definition of actuarial contribution in the standard has resulted in positive actuarial contributions over a broad range of policies in the several actual demutualizations where it has been applied. The task force also notes that the adoption of such a definition of actuarial contribution has no impact on a mutual company’s dividend-setting practices or pricing philosophy, either before or after demutualization (and thus does not affect the expectation that the mutual policyholder may obtain insurance at cost).**

Section 3.2.4(g), Reinsurance—One commentator, while agreeing in general with the distinction between risk and surplus relief reinsurance, noted that the complexity of some agreements will require consideration of both their structure and purpose. **The task force agreed, and added a sentence to that effect.**

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### Section 4. Communications and Disclosures

Section 4.1, Reliance on Data Supplied by Others, and section 4.2, Reliance on Asset Cash-Flow Projections Supplied by Others—One commentator opined that the actuary should be required to review data and projections of others, and that the modifying phrase “when practicable” in sections 4.1 and 4.2 was unduly lenient. **The task force notes that practical limitations do exist as to what can be reviewed. Nevertheless, the language in both sections was modified to make it clear that the actuary should perform this review “to the extent” practicable.**

### Prior Commentary and Responses from the First Exposure Draft

One commentator repeated the earlier suggestion that there should be a statement of policy or policies that will guide the demutualization, similar to that required by ASOP No. 1, *The Redetermination (or Determination) of Non-Guaranteed Charges and/or Benefits for Life Insurance and Annuity Contracts*, for redetermination of nonguaranteed elements. **In contrast to determination of nonguaranteed elements, the allocation of policyholder consideration occurs at a point in time and does not involve the ongoing application of consistent policies over a period of time. Observers are thus able to assess the appropriateness of the single result of the allocation process without reference to some additional statement of principles put forth by the converting company. In any case, the standard does not prevent a converting company from putting forth such principles. The task force still does not believe that a requirement for a statement of principles of allocation is necessary.**

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