ACTUARIAL STANDARDS BOARD

Actuarial Standard
of Practice
No. 37

Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations

Developed by the
Task Force on Allocation of Policyholder Equity of the
Life Committee of the
Actuarial Standards Board

Adopted by the
Actuarial Standards Board
June 2000

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ASOP No. 37—June 2000

T A B L E O F C O N T E N T S

APPENDIXES

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June 2000

TO: Members of Actuarial Organizations Governed by the Standards of Practice of the Actuarial Standards Board and Other Persons Interested in the Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations

FROM: Actuarial Standards Board (ASB)

SUBJ: Actuarial Standard of Practice (ASOP) No. 37

This booklet contains the final version of ASOP No. 37, *Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations*.

Background

In the past decade, an increasing number of mutual life insurance companies have converted to stock life insurance companies, sometimes including the formation of a mutual holding company. Demutualizations present important actuarial issues, including the preservation of reasonable policyholder dividend expectations, and the allocation among eligible policyholders of the consideration that may be due them in exchange for their membership rights.

This ASOP deals with actuarial responsibilities with respect to the allocation of policyholder consideration. Actuaries are often involved in many aspects of such allocation, including advising on the actuarial aspects of eligibility of policies for consideration, as well as the allocation of consideration to eligible policyholders.

Exposure Draft

The first exposure draft (published in May 1999) received eighteen comment letters. These comments and the Task Force on Allocation of Policyholder Equity responses were summarized in appendix 2 of the second exposure draft published in December 1999. Eight comment letters were received on the second exposure draft. For a summary of the substantive issues contained in these eight comment letters and the task force's responses, please see appendix 2.

The key change from the second exposure draft was additional clarification regarding the treatment of reinsurance in calculating the actuarial contribution (section 3.2.4(g)).

The Task Force on Allocation of Policyholder Equity and the Life Committee thank all those who commented on the first and second exposure drafts.

The ASB voted in June 2000 to adopt this final standard.

ASOP No. 37—June 2000

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ACTUARIAL STANDARD OF PRACTICE NO. 37

ALLOCATION OF POLICYHOLDER CONSIDERATION IN MUTUAL LIFE INSURANCE COMPANY DEMUTUALIZATIONS

STANDARD OF PRACTICE

Section 1. Purpose, Scope, Cross References, and Effective Date

1.1 Purpose—The purpose of this standard is to give actuaries guidance in determining the allocation of policyholder consideration when a mutual life insurance company or mutual holding company demutualizes, or in reviewing, advising on, or opining on the actuarial aspects of a proposed allocation; such aspects may include policyholder eligibility.

1.2 Scope—This standard of practice applies to actuaries who are determining, reviewing, advising on, or opining on the allocation of policyholder consideration during the demutualization of a U.S.–domiciled mutual company. The standard also applies to actuaries performing this work in the demutualization of a non–U.S. mutual company with respect to the U.S. operations of that company in the absence of authoritative guidance in the company's country of domicile.

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.

1.3 Cross References—When this standard refers to the provisions of other documents, the reference includes the referenced documents as they may be amended or restated in the future, and any successor to them, by whatever name called. If any amended or restated document differs materially from the originally referenced document, the actuary should consider the guidance in this standard to the extent it is applicable and appropriate.

1.4 Effective Date—This standard will apply to any actuarial work performed or opinions issued on or after December 15, 2000.

Section 2. Definitions

The terms below are defined for use in this actuarial standard of practice.

2.1 Actuarial Contribution—The contribution a particular policy or class of similar eligible policies has made to the company's statutory surplus and the asset valuation reserve, plus the present value of contributions that the same policy or class of similar eligible policies is expected to make in the future.

2.2 Consideration—The consideration a policyholder receives in a demutualization in exchange for relinquishing membership rights (sometimes referred to as *policyholder consideration*).

2.3 Demutualization—The conversion of a mutual company to a stock company.

2.4 Eligibility Date—Date (or dates) as of which a policy must be deemed in force, according to the plan of conversion, for the policyholder to be eligible to receive consideration.

2.5 Eligible Policyholder—The owner of one or more policies eligible to receive consideration under the plan of conversion.

2.6 Historical Contribution—The contribution a particular policy or class of similar eligible policies has made to the company's statutory surplus and asset valuation reserve in a given year.

2.7 Membership Rights—Any rights a member of a mutual company has by virtue of ownership of an insurance policy, other than the contractual insurance rights under the policy. Typical membership rights include voting rights and the rights, if any, the member has upon liquidation of the company.

2.8 Mutual Company—A mutual life insurance company, or a mutual holding company formed in conjunction with the demutualization of a mutual life insurance company.

2.9 Plan of Conversion—The plan under which a mutual company converts to a stock company.

2.10 Policy—Unless otherwise specified, the term *policy* (and its plural form, *policies*) in this standard includes both an insurance policy and an annuity contract. In some demutualizations it may also include supplementary contracts.

2.11 Voting Rights—The right to elect members of the board of directors of the mutual company and the right to vote on any proposed reorganization (including demutualization).

Section 3. Analysis of Issues and Recommended Practices

The actuary may be requested to determine the allocation of policyholder consideration, or to review, advise on, or opine on the actuarial aspects of policyholder consideration in a demutualization. In doing so, the actuary should be guided by the following:

3.1 Policyholder Eligibility—Generally, eligible policyholders receive consideration in exchange for relinquishing membership rights. The plan of conversion will define which policies are eligible (which might include policies in subsidiaries under certain circumstances). The actuary may be involved in drafting this aspect of the plan of conversion. Sections 3.1.1–3.1.2 present issues the actuary should consider in determining, reviewing, advising on, or opining on the actuarial aspects of policyholder eligibility.

3.1.1 Components of Consideration—Plans of conversion generally express consideration as the combination of a fixed component and a variable component. A policyholder may be eligible for a fixed component, a variable component, or both. Although eligibility for the fixed component may be related to eligibility to vote in some plans, the fixed component is not necessarily allocated in proportion to voting power. Although eligibility for the variable component may be related to eligibility for dividends or for a distribution upon liquidation in some plans, the variable component is generally not allocated in proportion to dividends or to what would be paid upon liquidation.

3.1.2 Reinsurance—With regard to how reinsurance affects eligibility, the actuary should note, in particular, the following:

a. Policies transferred to another company through assumption reinsurance prior to the eligibility date generally are not eligible for any consideration unless particular facts and circumstances indicate otherwise (for example, if commitments were made to the policyholders or to regulators as part of the assumption reinsurance transaction).

b. Policies transferred to the demutualizing company from another company through assumption reinsurance or as part of a merger prior to the eligibility date generally are eligible to receive consideration unless particular facts and circumstances indicate otherwise.

c. Indemnity reinsurance, assumed or ceded, does not affect eligibility.

3.2 Basis of Allocation—The actuary is usually responsible for determining that eligible policyholders are treated appropriately in the allocation of consideration. The share of the fixed and variable components of consideration that any one policyholder receives should reflect both equity and practicality. Equity requires that actuarial contributions of policies be adequately recognized. Practicality requires that the proposed allocation take into account both administrative feasibility and imperfections in available data. The actuary should consider the following sections concerning the basis of allocation.

3.2.1 Basis for Allocating the Fixed Component—The fixed component of consideration should be allocated on a basis that produces a reasonable result in view of the specific circumstances of the converting company. Among other factors, the actuary may consider the company's voting policy. This may entail the following: a review of the voting provisions contained in the company's bylaws, charter, or domiciliary state's law; the way the company has managed voting in practice; and the communications that have been made to policyholders. These factors usually mean that the fixed component is allocated based on each eligible policy (regardless of the size of the policy) or each eligible policyholder (regardless of the number of policies or size of policies).

3.2.2 Amount Allocated as the Fixed Component—The actuary should ascertain whether the amount allocated as the fixed component has been determined in a reasonable manner. The determination of the amount to be allocated as the fixed component is a matter in which judgment and practical considerations play a significant role. The actuary should consider whether the total amount to be allocated as the variable component (which is determined as the total amount of consideration less the total amount allocated as the fixed component) is reasonable in relation to the total actuarial contribution for eligible policies. The actuary may also consider the percentages of total consideration that were distributed as fixed consideration and the specific dollar values of fixed consideration allocated to each policy or policyholder in prior demutualizations.

The following approaches to determining the fixed component would usually produce a result that would be consistent with these concepts:

a. determining the aggregate dollar value to be allocated as the fixed component so that the variable component approximates the value of the total actuarial contribution for eligible policies; or

b. determining the aggregate dollar value to be allocated as the fixed component so that it approximates the value of the total actuarial contribution for policies not eligible for consideration, including terminated policies.

3.2.3 Basis for Allocating the Variable Component—The variable component of consideration should be allocated on the basis of the actuarial contribution. For this purpose, actuarial contributions may be calculated on an individual policy basis or for classes of similar eligible policies. When actuarial contributions are calculated for classes of similar eligible policies, they should be allocated to individual policies within classes using parameters that are reasonably obtainable and that tend to drive the primary sources of contribution, such as face amount, reserves, premium, or policy count.

When actuarial contributions are calculated for classes of similar eligible policies, professional actuarial judgment is required in defining the classes. In this regard, the company's financial management practices should be given appropriate weight. The actuary should consider the following in deciding whether to group policies into one class:

a. Policies that have been priced and managed together should be grouped into one class. For example, it may be appropriate to group all policies within a given premium rate, dividend era, or valuation basis.

b. Policies that are priced on a contract-by-contract basis, such as group contracts whose terms are individually negotiated between the insurance company and the policyholder, should not be grouped with other policies.

3.2.4 <u>Calculating the Actuarial Contribution</u>—The actuary should design a practical methodology for calculating the actuarial contribution that makes use of available historical and current data. In most cases, there will be periods for which historical studies or data are no longer available. The actuary will have to use approximations for these periods. The actuary should consider what approximations will be needed and the effect of such approximations on the calculated actuarial contribution in designing an appropriate methodology.

The actuary should consider the following in calculating the actuarial contribution:

a. Historical Contributions—The actuary should accumulate the historical contributions with the historical after-tax investment returns on surplus consistent with the way the company managed the assets corresponding to surplus generated by each line of business.

b. Discount Rate—The actuary should calculate the value of future contributions using an appropriate discount rate. The actuary may use the net investment income rate on surplus (net of default cost, investment expenses, and taxes), consistent with projections of future contributions to surplus, or a risk-adjusted discount rate appropriate for the line of business or type of policy involved. The actuary should explain in the actuarial report or opinion the basis for selecting the rate.

c. Non-Par Lines—The actuary should consider the treatment of earnings on non-par lines in the calculation of contributions made by par policies. One factor to consider is the extent to which dividends on such par policies reflect the earnings on non-par lines.

d. Individual Equity—The actuary should be mindful that the objective of the calculation of the actuarial contribution is to address individual equity, much like what is done in the determination of premiums and dividends. This means that the actuary should consider techniques such as interpolation within classes of business. It also means that all eligible policies should be included.

e. Prior Mergers—If the mutual company that is demutualizing is itself the result of a prior merger of two (or more) mutual companies, the actuary should recognize the pre-merger contributions by current policyholders to the prior merger partners. In deciding whether to recognize the relative surplus positions of the prior companies at the time of merger, the actuary should consider any relevant provisions in the merger agreement, the length of time since merger, the amount and nature of new business since merger, and the practice of the company as to commingling the interests of policyholders of the predecessor companies.

f. Acquisition Price—Where blocks of business have been acquired through assumption reinsurance, the actuary should consider the acquisition cost of the block (as a negative contribution) when determining the actuarial contribution.

g. Reinsurance—The characteristics of each reinsurance program should be considered in light of the purpose of the program and the long-term economic impact on a block of business and the company as a whole. Reinsurance is usually reflected in the calculation of the actuarial contribution if it is risk reinsurance. However, reinsurance whose primary purpose is surplus relief is usually ignored.

3.2.5 Treatment of Negatives—Actuarial contributions may be positive or negative. The actuary should consider the following:

a. Where the actuarial contribution for a policy is negative, it is set to zero before performing the allocation so that the policy does not receive a variable component of consideration. Where the actuarial contribution of the policy is calculated in separate pieces (such as base policy and rider), the pieces may be combined algebraically and any negative sum set to zero, or negatives may be individually set to zero. The company's practices as to calculating dividends in pieces or in combination should guide this choice.

b. Where two or more policies are linked for experience-rating purposes, either prospective or retrospective, they are usually linked for allocation purposes. Where one or more of such policies has terminated, the actuary should be careful to determine the actuarial contribution of the remaining policy since cross-subsidies usually will not have been recorded.

c. Where the total actuarial contribution for a line of business is negative (before any adjustments described in section 3.2.5(a)), different practices have been used. Most prior demutualizations have left any positive actuarial contributions in that line unchanged (so those policies received a variable component of consideration), but in certain circumstances no variable consideration has been given to any policy in that line. In deciding which approach to use, the actuary should consider the company's financial management of the line and the pooling of risks across years. (*Line of business* is used here to reflect the way the company has categorized its business for management purposes, as opposed to those lines of business shown in the annual statement.)

3.3 Experience Factors—In calculating actuarial contributions, the actuary may use experience factors determined for various classes of eligible policies. These experience factors fall into two distinct categories: experience factors related to past experience, which would be used to calculate historical contributions; and experience factors related to anticipated future experience, which would be used to calculate prospective contributions to surplus.

The actuary should bear in mind the guidance given by ASOP No. 23, *Data Quality,* when performing this work. Establishing the appropriate historical experience may raise issues that are not considered in ASOP No. 23. In these cases the actuary should obtain appropriate data reasonably available under the circumstances.

3.3.1 Experience Factors Related to Past Experience—In selecting experience factors related to past experience, the actuary should take into account the company's past practices with respect to determining the actual experience that served as the basis for dividend allocations, or to determine other nonguaranteed elements. The actuary should review available historical records of experience studies, actuarial analyses, and other reliable information. The historical experience factors should represent the actual experience of the company, without any implicit or explicit margins for conservatism.

To the extent that reliable company data or the experience of a policy or block of policies are not available, the actuary may have to refer to indirect sources of data for guidance in the selection of historical experience factors. These might include historical annual statements, reserve valuation tabulations, contemporaneous pricing assumptions, or industry-wide experience studies. It is appropriate to reflect the pooling of experience data across various classes of policies (such as mortality experience data) in determining historical experience factors, particularly if such pooling was used historically in the dividend allocation process.

Generally, expenses, investment income, and federal income tax are allocated items rather than items directly charged to lines of business. The actuary should understand how the allocation was performed at different times in the past. The actuary should generally accept the allocation to the annual statement line shown in the annual statement, although in particular circumstances there may be reasons to modify it. However, the actuary will still have to perform allocations within a line. The actuary should try to determine how the company previously approached allocation and use that approach within a line, unless there is reason to modify it.

3.3.2 Experience Factors Related to Anticipated Future Experience—The considerations the actuary should use to select experience factors related to anticipated future experience may differ between policies included in a closed block and policies not included in a closed block, as noted below.

a. Experience factors for classes of policies included in a closed block should be consistent with the assumptions used to calculate the funding of the closed block (see ASOP No. 33, *Actuarial Responsibilities with Respect to Closed Blocks in Mutual Life Insurance Company Conversions*). Actual experience will almost certainly be different from that assumed in funding the closed block.

   To the extent that such differences accrue to the closed block policyholders (because of the closed block mechanism), the funding assumptions should be used without change for the actuarial contribution assumptions. Examples of these assumptions include anticipated future mortality, morbidity, termination, investment income rates, and policyholder dividends.

   To the extent that such differences do not accrue to the closed block policyholders, best-estimate assumptions should be used for the actuarial contribution assumptions. An example is expenses, because actual expenses are often not charged to the closed block. Income tax is an assumption that might fall into either category depending on how the closed block was constructed.

b. For policies not included in a closed block, the actuary should generally select experience factors that are best-estimate assumptions for anticipated future experience. (For a discussion of the meaning of *best-estimate assumptions*, see ASOP No. 10, *Methods and Assumptions for Use in Life Insurance Company Financial Statements Prepared in Accordance with GAAP*.) Where applicable, anticipated future experience should be based on recent experience and expected trends in experience in the company that is demutualizing (or in the industry in general, if the company's own experience is not credible).

For lines of business that exhibit cyclical trends in experience, the anticipated future experience should reflect past results over at least one complete experience cycle. The calculation of the value of future contributions to surplus should take into account any material restrictions on future profits or margins imposed as part of the plan of conversion or otherwise.

3.3.3 Other Approaches—In some circumstances, the actuary may calculate the present value of historical or future contributions to surplus directly, using a formula for calculating annual or cumulative contributions to surplus that reflects the company's approach to assessing risk or profit charges in its pricing or dividend allocation methodology.

Such an approach might be appropriate, for example, in the case of a class of large group policies where explicit risk or profit charges have been made at the individual contract experience fund level. In such circumstances it will not be necessary for the actuary to select specific experience factors other than those needed prospectively to project the persistence and growth of such charges. However, the actuary should consider whether the company has used credible and realistic experience data to reflect the actual cost of claims and expenses in determining policyholder experience funds.

3.4 Continuity Issues—When addressing eligibility and calculating actuarial contributions, the actuary should take into account the effect of status changes for any policy that has changed status since its original issue date. Some companies effect these changes in status by amending a policy, and others by terminating one policy and issuing a new policy. Subject to the limits of practicality and the availability of data, the actuary should consider the following:

a. the current status (for example, participating or nonparticipating) and the prior status;

b. the circumstances of any company-sponsored program allowing or encouraging policyholders to change or replace their policies;

c. the issue date of the original policy and the issue date of the new policy, as appropriate;

d. charges or assumptions specific to the type of policy change (for example, term conversion costs or provisions for adverse mortality in the case of conversions, as appropriate);

e. whether the new policy was issued at market price or reflected gains or losses in the old policy; and

f. changes in coverage (for example, changes in death benefit, mandated changes to individual health policies, or termination of part of a group contract).

Section 4. Communications and Disclosures

4.1 Reliance on Data Supplied by Others—The actuary may rely on data supplied by another. In doing so, the actuary should disclose both the fact and the extent of such reliance. The accuracy and comprehensiveness of data supplied by others are the responsibility of those who supply the data. However, the actuary should review the data for reasonableness and consistency to the extent practicable. For further guidance, the actuary is directed to ASOP No. 23.

4.2 Reliance on Asset Cash-Flow Projections Supplied by Others—The actuary may rely on cash-flow projections or other analyses of assets supplied by others—for example, projections of real estate or equity assets. In doing so, the actuary should disclose both the fact and the extent of such reliance. The accuracy and soundness of projections supplied by others are the responsibility of those who supply the projections. However, the actuary should review the projections for reasonableness and consistency to the extent practicable.

4.3 Law and Regulation—If applicable law or regulation conflicts with this standard, the actuary should disclose in the actuary's opinion or report the existence of such conflict and the actuary's compliance with applicable law or regulation. If applicable law or regulation differs from, but does not conflict with, this standard, the actuary may choose to practice in accordance with the law or regulation alone, but should disclose such practice as a deviation from this standard in accordance with section 4.6 below.

4.4 Actuarial Report or Statement of Actuarial Opinion—An actuary who performs professional services subject to this standard should issue a written actuarial report or statement of actuarial opinion to the employer or client concerning the allocation of policyholder consideration, unless another actuary advising the same entity is issuing such a report or statement. This actuarial report or statement of actuarial opinion should express an opinion on the appropriateness of the allocation, and may express an opinion concerning the classes of policies deemed eligible to receive consideration in light of the provisions of this standard.

4.5 Prescribed Statement of Actuarial Opinion—The actuarial communication described in section 4.4 is a prescribed statement of actuarial opinion as described in the *Qualification Standards for Prescribed Statements of Actuarial Opinion* promulgated by the American Academy of Actuaries, whether or not it is issued for purposes of compliance with law, regulation, or other standards. In addition, law, regulation, or accounting requirements may also apply to another actuarial communication prepared under this standard, and as a result, such other actuarial communication may be a prescribed statement of actuarial opinion.

4.6 Deviation from Standard—An actuary must be prepared to justify the use of any procedures that depart materially from those set forth in this standard and must include, in any actuarial communication disclosing the results of the procedures, an appropriate statement with respect to the nature, rationale, and effect of such departures.

Appendix 1

Background and Current Practices

Note: This appendix is provided for informational purposes, but is not part of the standard of practice.

Background

When a mutual life insurance company demutualizes fully (rather than converting to a mutual holding company structure), or when a mutual holding company demutualizes, the value of the mutual entity, generally in its entirety and before any external investment, is distributed in some form to the eligible policyholders or members of that entity. The Society of Actuaries Task Force on Conversion of Mutual Life Insurance Companies identified the allocation of policyholder consideration as an actuarial matter in its 1987 report, "Report of the Task Force on Mutual Life Insurance Company Conversion" (Society of Actuaries, *Transactions* 39 (1988): 295–391) (hereafter referred to as the *Garber Committee Report*). The Garber Committee Report considered the determination of the aggregate *amount* of policyholder consideration to be a nonactuarial matter. A number of U.S. life insurance companies have demutualized fully to date, and several more have announced their intent to do so. In almost all of these demutualizations, an actuary has been responsible for the allocation of policyholder consideration and has provided an opinion that the allocation is fair.

This actuarial standard of practice (ASOP) reflects what is considered good practice used in the allocation of policyholder consideration up until this time. The unique circumstances and characteristics of each mutual company, however, make it impossible to state with confidence that the goal of determining an equitable allocation can be met in all future transactions without deviating from this standard in some way as yet unforeseen. The actuary is best qualified, of all participating professionals, to assess and analyze the particular circumstances and operating philosophies of the mutual company, as demonstrated over its history, in determining what actually constitutes adequate recognition of a policy's contribution to company value and to recommend an allocation with due recognition of all pertinent facts.

Current Practices

Actuarial Contribution—Some early demutualizations calculated the actuarial contribution on a historical basis only; most recent demutualizations have used the historical plus prospective basis for the actuarial contribution.

Eligibility—To be eligible to receive any policyholder consideration, a policy must be in force on a specific date (or dates) or be in force within a specific range of dates. The date or dates will be defined in the plan of conversion and may be influenced by any applicable state statute. Typical examples of eligibility dates include the following:

1. The policy must be in force on the date that the board of directors adopts the plan of conversion.

2. The policy must be in force on the effective date of conversion.

3. The policy must be in force on both the date that the board of directors adopts the plan and on the effective date of conversion.

4. The policy must be in force on the date that the board of directors adopts the plan or must have been in force on any prior date within a fixed period (for example, two years).

Unless the eligibility date is defined in a manner similar to that in (4) above, terminated policies do not usually qualify as eligible.

Amount Allocated as the Fixed Component—Virtually all past demutualizations in the U.S. have featured an allocation of policyholder equity in part based on a fixed amount per policy or per policyholder. The fixed or per capita component of consideration in past demutualizations has had values ranging from approximately $25 to over $1,000 per policy or per policyholder. The total value of the portion of consideration allocated as a fixed component has represented from about 10% to about 25% of the total value of the consideration in these same demutualizations. The fixed component of consideration has often been considered to be compensation for the loss of the policyholders' right to vote for directors and to vote on other important matters, such as a merger with another mutual company. The Garber Committee Report noted that "these values [i.e., membership values] might reflect some compensation for the cancellation of the less tangible attributes of membership, the right to vote for directors, and so on." In mentioning compensation for less tangible membership rights, the Garber Committee Report clearly referred to the concept of the fixed component. Nevertheless, there has not always been an exact proportional relationship between a policyholder's voting power and the amount of fixed component he or she receives. Moreover, eligibility for the fixed component may not be directly related to eligibility to vote in some plans.

Amount Allocated as the Variable Component—The variable component of consideration has often been considered to be compensation for policyholder rights, other than voting rights, that are relinquished in a demutualization. This would include the right to receive a share of the net value of the company in the event of a liquidation. Probably the most significant right that participating policyholders have is the right to receive dividends as declared by the board of directors. This right is generally contractual and is not canceled as the result of a demutualization.

Legitimacy of Historical Practice—The calculation of the actuarial contribution by dividend class is often accomplished by calculation of historical asset share accumulations. These calculations typically have been made for pivotal issue years and issue ages. Until recently, these calculations have not differentiated between such factors as gender, smoking status, or premium band, on the implicit assumption that the contribution principle would tend to equalize profit results over time for the various dividend classes. Generally, an existing dividend class has not been split for the purposes of calculating the actuarial contribution in the context of demutualization to recognize factors that have not been recognized historically by the company in determining dividends.

Even though asset shares calculated to set dividend scales for individual participating business normally reflect lapses and other terminations in all years, the effects of past lapses generally have been ignored or removed from the calculation of actuarial contributions for all lines of business. This follows from a general feeling among practitioners who have worked with demutualizations that survivorship gains and losses from the past should not accrue to a particular policy, but rather should be spread over all eligible policies. Some other considerations that led to deciding not to recognize past lapses in such calculations include the following:

1. the unavailability of accurate and detailed historical lapse studies;

2. the anomalous pattern of actuarial contributions by issue age, issue year, plan, and rate book that would result; and

3. the precision and uniformity, over time, of class delineations, the lack of which might result in significant variations between adjacent cells.

Converted Policies, Replacements, and Policy Exchanges—In calculating actuarial contributions, actuaries have generally considered some or all of the following aspects of converted policies, replacements, and exchanges:

1. the nature of the current policy;

2. charges assessed by the company in connection with the conversion, replacement, or exchange; and

3. any differences in experience (for example, mortality or morbidity) that are observed or expected as a result of the conversion, replacement, or policy exchange.

If the current policy has been promised dividends and related treatment accorded an otherwise similar policy that did not result from a conversion, replacement, or exchange, the actuarial contribution generally will have reflected only (1) above, and not (2) or (3).

Supplemental Contracts and Settlement Options—In calculating actuarial contributions, actuaries have generally considered the status of the current policy (participating or nonparticipating) and the date the current policy was issued. If no new policy was issued when the supplemental contract or settlement option was purchased, actuaries have sometimes considered the appropriateness of using a basis that considers the original policy.

Change in Policy Conditions Due to Update Programs—In calculating actuarial contributions, actuaries have generally considered the changes to policy conditions as a result of update programs and, where practicable, reflected them, as appropriate, in the actuarial contribution calculations.

Non-Par Coverages Associated with Terminated Group Contracts—In calculating actuarial contributions, actuaries have generally considered the status of the original group contract, the owner of the contract, the company's approach for calculating actuarial contributions for current group contracts, and the beneficiary of the actuarial contribution associated with current group contracts. In some cases, actuaries have decided that no actuarial contribution should be calculated with respect to run-off coverages on terminated group contracts.

Data Problems—Some of the particular data problems that actuaries have encountered include the following:

1. Group annuity policies may have been in force for fifty years or more, but detailed records in some cases have not been available back to the issue date of the older policies. Actuaries have had to determine some equitable method of estimating actuarial contributions for periods before individual policy records were available.

2. The problem of unavailable records in some cases has been extensive with group term and health insurance, where it is not necessary to keep a long-term history of asset fund build-ups. Although group insurance policies will usually have an experience fund (if the policy is dividendable), companies may not have retained the history of this fund for more than five to ten years.

3. In some cases, the experience studies to support mortality and pricing philosophy have been difficult to find.

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.**

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.**

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.**

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.**