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THE CLOSED FUND ALTERNATIVE

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ABSTRACT

Closure of the fund to new business is a strategic option that is not usually considered as a part of the day-to-day running of a life assurance company. The paper explores certain circumstances in which it can be appropriate to consider it, though in the Working Party's view consideration of the closed fund alternative normally arises as a matter of course only in the context of demutualisations, and then as an indicator of the potential value of membership rights.

The topic is discussed in terms of legal, regulatory and professional aspects, and the profession is invited to consider providing more specific guidance for Appointed Actuaries whose companies are faced with demutualisation proposals. A number of practical aspects of operating a closed fund are outlined. The high-level financial considerations are illustrated by reference to a hypothetical case, and the perspectives of directors, independent and Appointed Actuaries and others are considered.

Several recent examples of demutualisations where the closed fund alternative was considered are summarised in appendices, and some examples of closed or virtually closed funds are cited.

KEYWORDS

Closed Fund; Closed Fund Alternative; Demutualisation; Independent Actuary; Mutual; Schedule 2C

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1. INTRODUCTION

1.1 The Working Party on the Closed Fund Alternative was established in 1997 at the request of the Life Board of the Institute and the Faculty. The membership of the Working Party and its Terms of Reference are attached as Appendix A.

1.2.1 'The Closed Fund Alternative' (CFA) relates to the strategic option available to a life assurance company, to be considered in certain circumstances, to close to new business. Formation of the Working Party was prompted, in part at least, by a concern at a possible lack of a consistent approach to the method and disclosure of the evaluation of the CFA in recent life company restructurings.

1.2.2 It has seemed to the Working Party that important issues in relation to the CFA arose, not only as to *how* the CFA was evaluated, but also the more fundamental issue of *whether* and *when* it should be considered. In the current (latter 1990s) context *whether* and *when* relates generally to demutualisations, and

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much of the Working Party's deliberation, reflected in this report, has been concerned with demutualisations and the role of the CFA within the evaluation of a demutualisation proposal. The Working Party also makes reference to other circumstances in which the CFA might be considered, and reports its view as to whether there is any duty on a Board to consider the CFA in a normal day-to-day context of business.

1.3 This Working Party's deliberations have been focused on the situation for life companies subject to relevant English or Scottish law. The Working Party recognises other territories have different legal and regulatory backgrounds which may make the position of policyholders, members and the company somewhat different to the United Kingdom. The comments given in this paper may not be appropriate in such cases.

1.4 The remaining sections of the paper cover the following issues:

Section 2	the CFA in theory;
Section 3	the CFA in practice;
Section 4	evaluation of the CFA;
Section 5	perspectives and commentary;
Section 6	closing remarks and references;
Appendix A	terms of reference and membership;
Appendix B	U.K. legal background;
Appendix C	some recent demutualisations; and
Appendix D	some examples of closed (or virtually closed) funds.

2. CLOSED FUND ALTERNATIVE IN THEORY

2.1 *Circumstances in which the Closed Fund Alternative should be Considered*

2.1.1 It is felt by the Working Party that any consideration of the CFA must recognise where the authority lies to make the decision to close to further new business. In the case of a proprietary company, this authority will, in all probability, be that of the directors of the company acting on behalf of the company. Accordingly, in other than exceptional circumstances, discussed briefly in ¶2.1.5, it would not seem appropriate to require the directors of a proprietary company to consider the CFA when presenting a reconstruction or reorganisation to policyholders.

2.1.2 In the case of a mutual insurance company, typically the authority to close the company to new business lies with the voting members of the organisation acting through the directors and management. Accordingly, when a mutual company proposes to demutualise and create a structure which would result in the removal or material diminution of that right, the Working Party believes that it is appropriate for the board, Appointed Actuary and independent actuary to consider whether, and to what extent, an immediate exercise of the right to close the fund to new business would be a more advantageous course of action than the proposals being recommended. It is also suggested that the financial impact on the

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likely level of benefits to policyholders of the closure to new business could be utilised as one indicator of the value of membership rights. However, as the paper goes on to say, there are many considerations beyond a comparison of the bare aggregate financial numbers, including, but not limited to, various issues of fairness between different classes of members or, indeed, conflicts of interest as to which proposal constitutes the most advantageous course.

2.1.3 In this context, it is important to draw the distinction between the rights of holders of long-term insurance contracts with a mutual insurance company as policyholders and their rights as members. This contrasts sharply with policyholders in a proprietary company where no membership rights are involved, albeit (as of course applies also to mutuals) policyholders' reasonable expectations and contractual rights are required to be considered.

2.1.4 The Working Party has concluded that, in the normal course of events, there should be no compulsory or mandatory requirement on proprietary companies to consider a closed fund alternative. Nor, indeed, should a mutual company feel so obliged where any reorganisation or proposed course of action does not involve the removal or material diminution of voting membership rights (e.g. merger with another mutual with membership rights transferring to the enlarged organisation). It is, though, recognised that circumstances could arise where the consideration of a CFA is appropriate.

2.1.5 In general the circumstances refer to situations, which could apply to proprietary as well as mutual companies, where remaining open to new business could have a detrimental impact on existing policyholders' reasonable expectations. An example of such a situation would be a relatively weak fund where levels of expenses or the terms on which new business is being written are to the potential detriment of existing policyholders' benefit expectations. It is less likely that any such circumstances would arise for a relatively strong fund.

2.1.6 The Working Party has noted the conclusions reached by the Policyholders' Reasonable Expectations Working Party who, in 5(iii) of their report of 25 April 1990, stated that:

> "(iii) in the circumstances of a 'major change' in a life office (such as demutualisation), policyholders may reasonably expect that the proposed new arrangements do not disadvantage them as compared with the option of a closed fund. Our profession therefore should make the advantages and disadvantages of each option clear and recommend a closed fund if it is in the existing policyholders' interests."

While not disagreeing with these conclusions, the Working Party would stress that the responsibility for weighing the pros and cons is with the directors, and that, while there may be situations in which a closed fund is unequivocally in existing policyholders' interests, it will be necessary to look, not only at those interests in aggregate, but also to look at the different groups of policyholders.

2.1.7 The Working Party has concluded that the need for directors to consider a CFA is likely to arise only in the case of mutual companies undergoing a reorganisation/reconstruction that would result in the removal or material

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diminution of the voting rights of members as members of a mutual organisation, and then in the context of measuring the potential financial impact of the loss of those rights.

2.1.8 Proprietary companies, or mutual companies in circumstances different from those described above, faced with material corporate change, are obliged to have proper regard for the interests of policyholders, and, in certain circumstances, the CFA might be an appropriate consideration. While management may consider the closure of the fund as one of its corporate options, there should be no obligation on it to do so. Where the option is considered, however, a number of the points made in this paper may prove helpful.

2.2 *Legal and Professional Background*

2.2.1 The legal background is summarised in Appendix B. This Appendix derives from a letter to the Working Party from Glen James, a lawyer with substantial experience in the types of reconstructions in which the CFA might be considered, who was invited by the Working Party and kindly agreed to comment.

2.2.2 Most reconstructions have involved a transfer of business between companies under the process defined by Schedule 2C to ICA82. Such transfers fall under legislation that does not directly cover (but does not preclude) consideration of the role of policyholders as members, as the wider ramifications of a reconstruction are not directly covered by a transfer process. Thus, while policyholders are privy to the reconstruction as members, insurance legislation does not itself explicitly cover the changes to the constitution of a company that can be involved in a reconstruction. A review of the legislation and guidance does not, therefore, give any insight to the appropriate use of the CFA, which is, essentially, a matter of membership rather than policyholder rights.

2.2.3 However, the formality and publicity of a court process for a transfer is of great value in testing key issues surrounding demutualisations or reconstructions, such as questions to do with membership rights. It also has value in the codification of future rights of policyholders.

2.2.4 The situation has, to some extent, developed over time, and could be characterised as a mix of legal process and current practise within the market and by the regulator. The system generally allows the flexibility to cope with the various idiosyncrasies of the companies and situations involved.

2.2.5 Overall, one could sum up the key features of the current legal and regulatory requirements, where a Schedule 2C transfer is concerned, as the following:

— involving an independent actuary as well as the regulators;
— having a well defined scheme made definite by the court; and
— giving policyholders a reasonable level of publicity about the scheme and its effects on them, and enabling them to make their objections known.

2.2.6 The following aspects have evolved as 'best practice' in the case of mutuals engaging in major reconstructions:

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— a vote by the membership (often as a by product of the company's legal constitution) on the proposals;
— a report by the Appointed Actuary to the board, a summary of which is included in the policyholder circular; and
— consideration of alternative options, including the CFA.

2.2.7 Whilst membership rights are not specifically referred to in the Schedule 2C transfer legislation, the court can be expected to take into account the effect of the scheme on policyholders' membership rights in deciding if the policyholders have been adversely affected by the scheme, and the weight of the majority of members voting in favour will be a significant factor in the court's determination of whether or not to approve the scheme.

2.2.8 Within the process, under U.K. insurance legislation, to oversee transfers of business between companies, the court hearing is not necessarily the best arena for technical negotiation over a complex reconstruction with amendments of financial and other entitlements and rights. The court will only accept or reject the scheme presented to it, and will not change it. The onus is therefore on the parties to the transaction, and the regulator, to ensure that the scheme is capable of passing smoothly through the court process. The court is looking to be assured that there is no significant and soundly-based objection to the scheme as presented. The parties with a right to be heard in the court are the policyholders, members and the regulator (or anybody else who believes that they are disadvantaged by the scheme).

2.2.9 It is important that the policyholders affected by the transfer are properly informed as to the scheme and its effects. Without proper information, a fundamental check on any scheme, objection by the policyholders, is lost. The regulator can state a desire to see further matters, such as a strong vote by the membership for the proposal, before not objecting to the court on the transfer. The check is, however, a slightly negative one, in that the power of the regulator lies in non-objection rather than approval.

2.2.10 The independent actuary has a statutory duty to report to the court, and is also an informant for the policyholders. Professional guidance to the independent actuary has always included the requirement to consider the compensation for loss of membership rights of policyholders, i.e. to consider the position under a demutualisation. The working party looking at the revision of guidance to the independent actuary, GN 15, passed the question of alternatives to the Institute and the Faculty Councils in ¶8.11 of their report. The GN 15 working party felt the prime responsibility for considering the alternatives in the context of a court hearing of a transfer should rest with the directors, advised by the Appointed Actuary, not the independent actuary. The final wording of ¶4.5.13 of GN 15 leaves the independent actuary with a menu option style of report, that may or may not include a review of other arrangements. It is a legal requirement (unless the court rules otherwise) that a summary of the independent actuary's report is sent to all policyholders, and that a full version is available for inspection.

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2.2.11 Even a reconstruction that did not trigger a transfer of business would require consideration of the probity of the directors' actions under company law and the Schedule 2A requirement of insurance law. The Appointed Actuary would naturally be involved in this, and the regulators too, but as part of the continuing activity of a single company. There might be no direct publicity, and the involvement of the members and the policyholders could be limited.

2.2.12 The regulator looks to be well informed over any major reconstruction which might affect policyholders' interests, and a typical scheme for a large with-profits fund reconstruction is very complex. The regulator had hoped that the independent actuary could, as a matter of course, cover a full review of alternatives in his report to reflect the legal requirement for the directors to conduct the business with due regard to the interests of policyholders. In any case one would normally expect the principal alternative options available to the company to have been considered by the board before a demutualisation proposal is put forward. However, the final revision of GN 15 did not go so far as this, on the grounds that it was not for the profession to emphasise requirements borne by the company.

2.2.13 The regulator has made it clear that, even if a major reconstruction was not to involve a Schedule 2C transfer, the regulator would look for a report from an independent actuary on terms of reference jointly agreed by the company and regulator. This use of wider terms of reference than are strictly necessary for a transfer is also the typical approach for any major with-profits reconstruction. Under such an arrangement, the terms of reference can be extended beyond what is necessary to satisfy a court review of a transfer. In a number of recent cases the independent actuary has worked to a wide brief, either at the request of the regulator or the parties involved, or simply as a matter of best practice. The Working Party endorses this approach as best practice, and, indeed, considers that, not only should the terms of reference be set widely, but that they should be interpreted in like spirit, to the extent that the independent actuary considers appropriate and within, of course, his/her areas of professional competence.

2.3 *The Closed Fund Alternative — possible Interpretations*

2.3.1 A review of the publicly available literature and documentation in relation to recent life assurance company reconstructions/reorganisations and demutualisations reveals a wide variation in the approach to the disclosure of any consideration of any type of closure of the fund to further new business as an alternative to the scheme or proposals being recommended. At one extreme, a full description of the impact on policyholders' benefits of closure to new business, together with a description of the assumptions made for the analysis, was provided to policyholders. At the other extreme, no reference to the CFA was made at all. Appendices CA to CC summarise three recent transactions.

2.3.2 Within the U.K. the cases of a stand alone closed life fund are rare, and include companies that have subsequently reopened to business or that have closed the life business, but not the general business — see Appendix D. There is, thus, a limited track record of such funds. What are far more commonplace

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are closed sub-funds within larger life funds. These arise naturally within open life funds where the with-profits business has become a closed class, and within closed life funds whose activity is in running off closed books of business.

2.3.3 The differences between the closure to new business of a with-profits sub-fund within an existing active insurer and the closure of a whole insurer to new business mean that one must be sure what one means by a CFA, both in terms of when it is applicable and what parameters are appropriate for its projected operation.

2.3.4 The impact of life funds that buy up and run off closed or semi-closed books of business could give good insight into the closure process. However, these sales are often exercises in the shareholder closing out his value in the business, with the future operator of the closed fund looking to arbitrage margins between, for example, the previous owner's expense levels and the operator's expense levels. Mutuals are not often involved in such arrangements.

2.3.5 In some cases a fund that one might wish to test on a closed fund basis could have already moved close to closure, having itself reduced costs, with a decline in new business, to modest levels. Thus, exceptional costs may be more modest on final closure, though, conversely, the scope for subsequent expense cuts is less.

2.3.6 A fundamental question remains the appropriate backdrop for setting the parameters of a closed fund test. As noted, most closed funds exist within open long-term businesses or funds. This can be on a partial arm's length basis (as a sub fund), or even an associated closed company.

2.3.7 One must, therefore, ask whether a market test of closure should be a stand-alone test or a test of what might be offered by other insurers to operate a closed fund. The Working Party believes that the test should normally be done against a stand-alone closed fund scenario, on the basis that this is always an option available to the board of a mutual company, without requiring the involvement of a third party.

2.4 *Conclusions*

2.4.1 A consideration of where the authority to close a life assurance fund to new business lies has led the Working Party to conclude that the consideration of a CFA is likely to arise only in the case of mutual companies undergoing a reorganisation/reconstruction that would result in the removal or material diminution of the voting rights of members as members of a mutual organisation, and then in the context of measuring the potential financial impact of the loss of those rights. (We do not support any suggestion that a mutual should regularly review the question of closure to determine if this is more advantageous for members than the 'status quo'.) There are also other circumstances where such considerations are appropriate.

2.4.2 The remainder of this paper focuses on a consideration of the CFA in the context of a demutualisation.

2.4.3 There is no specific legislation governing the conduct of a

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demutualisation process. Typically, in the U.K., demutualisation has involved a transfer of the long-term business of the mutual company into another life company. In this way, members' interests, as policyholders, are 'protected' by the legislation governing transfers of long-term business which requires a full court process, as described above.

2.4.4 Furthermore, general company law governs the activities of mutual insurance companies also, and, in particular, there is a legal requirement on the directors of mutual companies to act in the interests of the company. In the event of a company proposing demutualisation, it is the Working Party's conclusion that the directors, on the advice of the Appointed Actuary, should consider the CFA, principally as an indicator of the value of membership rights.

2.4.5 The Working Party believes that the procedures, which have evolved and are commonly used by mutual companies for demutualisation/restructuring, do provide adequate protection for policyholders and members, incorporating, as they do, a high degree of disclosure, policyholder involvement, regulatory supervision and a report from an independent actuary. In addition, the court process provides adequate legal protection, particularly for policyholder rights. Furthermore, and very importantly, current practice includes a membership vote on any demutualisation/reorganisation proposals, for, even if the Articles of Association of the company would not require such a vote, the regulators would insist on a vote taking place.

2.4.6 With regard to the profession's role in the demutualisation process, the Working Party believes that strengthened guidance to Appointed Actuaries of mutual insurance companies should be considered, with regard to providing advice to directors when considering demutualisation/reorganisation with specific reference to a consideration of the CFA in such circumstances. The Working Party recognises that the recent revision to GN 15 does make reference to the need for the independent actuary to consider the loss of membership rights and includes reference to the CFA, but only in the context of an example.

2.4.7 As a final general point, it is important to stress that one can only go so far with general guidelines, and that each situation must be considered on its merits. Where, for example, members of a company include different classes of policyholder, it may not be the case that all members would benefit, let alone benefit equally, from a fund closure. There may be other options available to a company, such as sale of subsidiaries, transfer of part of the business, etc., which would be more advantageous than the demutualisation proposal. The need to have regard for individual circumstances may well, in particular cases, serve to override concerns as to lack of (apparent) consistency with other cases.

3. THE CLOSED FUND ALTERNATIVE IN PRACTICE

3.1 This section considers the issues which might arise in a stand-alone closed fund, i.e. one which, at least initially, carries out its own administration and investment management. The number of actual closed funds operating on this

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basis is very small — see Appendix D for a summary of the closed funds of which the Working Party is aware. Nevertheless, it is possible to draw parallels from the experience of closed sub-funds and other similar entities, as well as from previous research.

3.2 *Operations and Expenses*

3.2.1 Closure to new business clearly has a major impact on the operations of a life office. With the exception of those to do with administering increments to existing business, most operations relating to the acquisition of business can be immediately dispensed with. These include sales and marketing staff, branch premises, some head office premises, as well as various systems and other parts of the new business infrastructure. It may be possible to sell assets such as a direct salesforce, buildings and rights to certain systems. Nevertheless, there will usually be heavy costs associated with redundancies, the disposal of literature and other materials, and early termination of leases.

3.2.2 The fate of subsidiaries will depend on whether they are viable businesses in their own right, in which case it may be possible to sell them, though, maybe, not at full market value. Subsidiaries which cannot be operationally extracted from the main company may need to be wound up. This is potentially quite significant if they are of major value to the fund.

3.2.3 Many staff and managers may be tempted to find employment elsewhere. This could cause particular problems with key specialists such as fund managers and those with unique knowledge or experience needed to run the business, and it may be appropriate to make 'lock-in' payments to some staff in order to reduce this risk. Remaining managers may end up with broader spans of control and more staff reporting to them, and there is a consequent risk that operational controls may suffer, such as checking and processing documentation, leading to increased operational risks.

3.2.4 Any development work associated with new products or systems related to the acquisition of business could be stopped. It might also be possible to cut back on administration, as the maintenance of high quality service may no longer be necessary to attract new business. This may well lead to deteriorating service standards. However, the significance of business retention for the closed fund may mean that maintenance of high quality service would continue to be a priority.

3.2.5 Some development of systems may continue to be required, to comply with changing legislation and customer requirements, and to ensure that old systems do not become insupportable as skills change with the inevitable advance of technology.

3.2.6 The efficiency improvements from new systems' developments will often be less compelling than for a fund with a growing portfolio of business. Generally, the declining block of in-force business may cause unit administration costs to rise faster than inflation in a closed fund. Outsourcing of administration may well become necessary as the fund declines.

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3.3 *Lapses and Deaths*

3.3.1 It is likely that with-profits policyholders will be happy to remain with a closed fund and benefit from the distribution of the estate, but the same will not necessarily be true of non-profit policyholders. It is unlikely that term assurance and annuity policyholders would have major concerns, but unit-linked clients may be concerned at being part of a declining fund, and may wish to, or indeed be advised to, surrender their policies. This may be particularly relevant for wholesale and corporate clients. Lapse rates in a closed fund are likely to revert to relatively low levels once the initial reaction has died down, although, if service standards do deteriorate, this could cause continuing problems with some types of product.

3.3.2 Over time the significance of mortality and morbidity risks will change, and it may, therefore, be appropriate to review the level and type of reinsurance cover for the fund as the business matures.

3.4 *Investment Management*

3.4.1 The loss of new business strain may result in a closed fund enjoying improved statutory solvency (although this will be partly offset by the costs of closure in the first year), which could be used to invest a larger proportion of the fund in equity-type assets. Depending on the characteristics of the fund, the portfolio of business and the level of reversionary bonuses, this could last for many years or for a relatively short time. The gradual maturing of the fund should normally lead to increasing statutory solvency, provided that reversionary bonuses are managed sensibly. As the outstanding term of the liabilities becomes shorter, it may become necessary to switch more of the fund into matching fixed-interest investments to reduce the volatility of payouts.

3.4.2 Typically, a closed fund will continue to grow for some time, level off, and then decline relatively rapidly. A fund with a large book of regular premium business may well continue to grow for many years following closure. On the other hand, a fund used to a steady flow of new single premium business could suffer from an immediate sharp reduction in cash flow, which may increase the costs of changing investment policy, with a consequent impact on performance. Within a fund in which both life and pensions business has been written, the pensions proportion will tend to increase (as life policies typically run off more quickly, and increments to pensions policies can be significant). In any case, it will be important to project the likely profile of the fund's decline in order to manage investment and bonus policy effectively, as well as to make proper allowance for tax.

3.4.3 Declining funds present a number of issues which can impact adversely on investment performance:

— a reduced ability to defer capital gains, especially for linked funds, and a consequent increase in CGT charges;
— the forced disposal of illiquid assets, such as properties, which may more conveniently be held on a unitised basis and managed by a third party;

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— an increased cost of implementing investment strategy decisions; and
— rising unit costs, which may necessitate the merging of unit-linked funds, or, ultimately, the outsourcing of fund management to a third party.

3.4.4 Declining funds may be more susceptible to adverse investment conditions. Coupled with likely difficulties attracting and retaining good fund managers, this may imply that a closed fund should convert its equity holdings to an 'index tracking' basis at some point, which will also reduce the rate of stock turnover, and hence slow the realisation of capital gains. It may also be appropriate to use derivatives to limit the impact of a significant fall in equity values. It may become appropriate to outsource fund management to a third party.

3.5 *Bonus Strategy*

3.5.1 The bonus strategy in a closed fund needs to strike a balance between:
— high solvency, increasing both investment freedom and the fund's resilience to adverse investment conditions, which will tend to maximise the total amount payable to policyholders; and
— distributing the estate 'equitably' between different classes of policyholders, and between those maturing shortly after closure and those who continue until the very end.

3.5.2 The concept of equity in a closed fund is not clearly defined, although a company's interpretation of equity could be critically important for the financial management of the fund, as could directors' views on the extent to which policyholders should be expected to tolerate greater volatility of payouts. This is beyond the scope of this paper, although the following paragraphs illustrate some of the possible issues.

3.5.3 A method needs to be found for distributing the free estate in a smooth and equitable way. This could be done via an addition to asset shares or as a uniform enhancement to payouts.

3.5.4 On closure, the directors may wish to declare a special reversionary bonus and/or to make a one-off enhancement to asset shares, in order to crystallise, for policyholders, the closed fund benefits maturing shortly after closure. In some cases, it may be appropriate to enhance benefits or to make cash payments to some policyholders, such as non-profit voting members.

3.5.5 In the years following closure, in order to maintain a high level of solvency, reversionary bonus rates may be reduced. Greater volatility of terminal bonuses, perhaps via more frequent declarations, may also be necessary, and the smoothing policy and/or investment policy may need to be re-examined. Policyholders' expectations would need to be managed appropriately.

3.5.6 It is possible, even likely, that a conservative approach to bonus strategy and smoothing will result in the estate continuing to grow as a proportion of the business in force. Corrective measures, such as further special bonus

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declarations and/or asset share enhancements, may be needed from time to time to reduce the tontine effect in later years.

3.5.7 At the very end, with only a few policies remaining in force, it may be appropriate to avoid a tontine effect by converting policy benefits to a guaranteed or formula-driven basis. This will require the co-operation of the regulator as well as assistance from a reinsurer or another fund.

3.6 *Conclusions*

3.6.1 Although there are clearly a number of negative aspects of closing a fund, there are also positive factors, and it is not necessarily the case that closure will be bad news for policyholders, particularly if there is a large free estate at the time of closure.

3.6.2 It is likely that the risk characteristics of a closed fund will be very different from those of an open fund. It may, in practice, be difficult to manage the fund in a conservative way, in order to make some allowance for risk, whilst distributing the estate in an equitable manner and avoiding a large tontine effect in the final stages. The pattern of payments to different groups of policyholders, e.g. according to the length of time that they have held their policies, could be very different as between a closed fund or a demutualisation. Such imponderables make the comparison of the CFA with any other proposal more than just a comparison of bare numbers. This is revisited in Section 5.

3.6.3 It is very likely that the bonus and smoothing policy of a closed fund will be different from that of an open fund. It will be essential to communicate effectively with policyholders to ensure that they are aware of, and prepared for, the implications of closure on their policy benefits.

4. EVALUATING THE CLOSED FUND TEST

4.1 *Introduction*

4.1.1 In this section we consider how the closed fund test might be carried out, illustrating the process for a hypothetical mutual office ('Mutual Co') considering a demutualisation proposal. As well as a comparison of the CFA with the demutualisation proposal, comparison is also made with the status quo, being the operational start point, as well as the benchmark, to define PRE for current with-profits policyholders.

4.1.2 The following example is provided simply to illustrate how an assessment of the CFA might be approached. It is not based on any particular case, and numbers have not been rigorously determined — although, in the text which follows, we refer to 'assumptions', these are to be read only as illustrative of the process, and other than satisfying, in our view, a broad reasonableness test, there is no computational linkage between assumptions and numbers. In a real situation, it would be incumbent on the company and the actuaries involved to ensure that the estimates were soundly based and relevant to the company concerned.

4.1.3 The example considers the policyholders in totality, although the

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directors may well feel it appropriate to carry out further investigations for different groups of policyholders.

4.1.4 The bare numbers are not the whole story, and, in practice, the financial and non-financial issues will be significantly more complex than in this simplified example, which is intended to illustrate only certain of the high-level financial principles involved.

4.1.5 The Working Party considers it to be a fundamental principle, in conducting financial comparisons, that each of the options being considered should be viable in practical terms, and that due enquiry should be made to be satisfied on the point. For purposes of the example, we have sought to propose working assumptions for the status quo such that the company might continue to operate independently and compete for new business. Hence, for example, it has been assumed that the company is writing new business on a profitable basis.

4.2 *Status Quo (Basis of Current PRE)*

4.2.1 *Statutory balance sheet*

The statutory balance sheet of the office is shown in Table 4.1.

Table 4.1. Statutory balance sheet

Assets	£m	Liabilities	£m
Subsidiaries	50	With-profit	6,600
Net current assets	20	Non-profit	1,900
Other investments	9,930	Investment reserve	1,500
Total	10,000	Total	10,000

The minimum solvency margin is £400m, giving a free asset ratio of 11%. Subsidiaries are included at net asset value, and the admissible value of other investments excludes £50 million of non-admissible assets.

4.2.2 *Realistic balance sheet*

The 'realistic' balance sheet, which is used to determine the estate, is shown in Table 4.2.

Table 4.2. Realistic balance sheet

	£m
Total assets (admissible value)	10,000
less Book value of subsidiaries	(50)
plus Non-admissible assets	50
less Non-profit liabilities	(1,900)
Assets attributed to with-profits business	8,100
less With-profits realistic liabilities	(7,200)
	900
Value of subsidiaries (embedded value for life subsidiaries)	150
Embedded value of non-profit business	150
'Estate'	1,200

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The realistic liabilities for with-profits business comprise the amounts considered to be sufficient to meet all future outgoings for current with-profits policyholders to satisfy their PRE, including asset shares and any necessary smoothing or other reserves. The embedded values of the subsidiaries and non-profit business are assumed to be calculated on best-estimate/going-concern bases, using a risk discount rate consistent with a 'market' valuation of the business.

4.2.3 *Profitability of new business*

New business is currently being written on a profitable basis. The present value of new business written in the most recent year is estimated to be £10m, and a total value of £100m is attributed to new business for the purposes of the comparison in Section 4.5.

4.2.4 *Investment and bonus policy*

4.2.4.1 Assets backing with-profits liabilities and the estate are assumed to be invested in equities to the greatest extent possible consistent with maintaining an adequate level of statutory solvency. The equity backing ratio has been reduced, in recent years, to the current level of 60%, to protect the solvency of the office, and the office would expect to increase this as the free asset ratio improved, and vice versa.

4.2.4.2 The company's current smoothing policy is to target payouts on asset shares, and to limit changes in payouts from year to year to within 10%.

4.2.5 *Assessment of PRE*

To illustrate the sorts of areas for due enquiry (see ¶4.1.5), it would be noted that, with an 11% free asset ratio and 60% equity backing, the company may be quite vulnerable under the status quo to a fall in market values, and could be forced to invest yet more in fixed interest. This could lead to less competitive bonus rates, and call into question the company's ability to continue to satisfy PRE.

4.3. *Demutualisation Option*

4.3.1 Mutual Co is assumed to be considering a proposal to demutualise and be acquired by 'Big Fish'. The outline of the example proposal is as follows.

4.3.1.1 Mutual's business will be transferred to a new proprietary life company Newco, owned by Big Fish, which will acquire the following assets on the basis shown in Table 4.3.

Table 4.3

Asset acquired	Price £m	Basis of valuation
10% interest in with-profits surplus	600	Value of shareholder transfers
100% interest in non-profit surplus	150	Embedded value
Subsidiaries	150	Embedded/market value
Infrastructure, operating assets, brand name, etc. (goodwill)	200	Negotiated value
Total price paid	1,100	

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4.3.1.2 The embedded value of the non-profit surplus and the subsidiaries is determined using the same discount rates as under the status quo valuation. The goodwill value of £200m is a negotiated value, which includes an allowance for potential sales and expense synergies.

Table 4.4

The price is to be distributed as follows	£m
Cash payment to with-profits policyholders	200
Payment into with-profits fund	900

4.3.1.3 In addition to the £900m capital contribution into the with-profits fund, a further £100m shareholder capital is provided to support the solvency margin requirements of the non-profit business.

4.3.1.4 A special reversionary bonus costing £100m will be declared, and, in addition, it is proposed that a further £200m will be earmarked, by way of addition, to asset shares to enhance terminal bonuses for current with-profits policyholders.

4.3.1.5 The subsidiaries will be removed from Newco and held directly by Big Fish.

4.3.2 *Revised statutory balance sheet*

4.3.2.1 The revised post-demutualisation statutory balance sheet, prior to any change in asset mix, is shown in Table 4.5.

Table 4.5. Revised statutory balance sheet

Assets	£m	Liabilities	£m
Subsidiaries	nil	With-profits	6,700
Net current assets	20	Non-profit	1,900
Other investments	10,930	Investment reserve	2,250
		Shareholders' capital	100
Total	10,950	Total	10,950

4.3.2.2 The free asset ratio increases to 18% prior to any change in asset mix. A key assumption for evaluating the relative benefits of the demutualisation compared with the status quo or the CFA is the impact of this enhanced financial strength on the security and reasonable expectations of policyholders.

4.3.2.3 The increased statutory financial strength of the with-profits fund will permit a higher equity backing, which is assumed to be 20% higher, on average, than under the status quo. At the date of demutualisation, this increases statutory with-profits liabilities and the solvency margin by £450m, and reduces the statutory free assets to £1,500m, with a free asset ratio of 14%.

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Table 4.6. Revised realistic balance sheet

	£m
Assets attributed to with-profits business (from Table 4.2)	8,100
Contribution to with-profits fund	900
	9,000
less With-profits realistic liabilities (including enhancements)	(7,500)
less Value of shareholders' share of with-profits surplus	(600)
'Estate'	900

4.3.3 The new realistic balance sheet, after demutualisation, would be as in Table 4.6.

4.3.3.1 The residual estate has reduced by £300m (corresponding to the special reversionary bonus of £100m and the further enhancement to asset shares of £200m). This balance is available to support both existing and new with-profits business, but is not intended to be distributed to the current generation of policyholders.

4.3.4 *Impact of future investment policy*

The increased equity backing is assumed to increase future investment returns by 0.5% p.a. (assuming equities outperform gilts by 2.5% p.a. over the long term). Cash flow projections are assumed to indicate additional benefits to current policyholders arising from this increase in investment return, with value, at the same discount rates used in Table 4.6, of £400m.

4.4 *Closed Fund Alternative*

4.4.1 *Distribution of the estate*

4.4.1.1 Under the CFA, it is assumed that the residual estate will be distributed to the current with-profits policyholders as enhanced terminal bonuses.

4.4.1.2 The form in which enhanced benefits are provided (either as additional reversionary bonuses or enhanced terminal bonuses), and the manner in which the estate is distributed between the different generations of existing policyholders, will have important consequences for the future investment policy of the closed fund and the ability both to smooth payouts and to distribute the estate equitably without creating a material tontine situation.

4.4.1.3 Financial projections should be carried out to determine the most appropriate approach and the impact on bonus, smoothing and investment policy.

4.4.1.4 Projections are likely to indicate that, after meeting the costs of closure in the first year, the statutory solvency position improves under the closed fund as a result of eliminating new business strain, and the free asset ratio is likely, gradually, to improve further over the remaining life of the fund, since average duration, and hence terminal bonus content, will (tend to) increase, possibly helped further by decisions to hold down reversionary bonus rates. Cash flow is likely to be positive for at least ten years, and the fund is unlikely to decline rapidly until after 15 years (believed to be true for any typical fund which included a significant proportion of pensions business). Therefore, it is assumed

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that the current equity backing ratio (EBR) would initially increase from 60% to 70%, be maintained at that level for 10 years, and then reduce gradually to 50% over the following ten years, as the fund declines. Note that, as with other 'assumptions', the Working Party has not been in a position to carry out any investigations to determine whether this is a likely conclusion. Much would depend, in practice, on the perceived willingness of with-profits policyholders to accept the extra volatility in payouts that a higher EBR would require.

4.4.1.5 Deferred capital gains will be realised more rapidly, and stock turnover is likely to increase, in order to continue an active investment policy. It is assumed that the effect of these factors, and of realising investments more rapidly as cash flow becomes negative, is to reduce investment performance by 0.25% p.a.

4.4.1.6 Projections would be carried out to determine the overall effect of the above changes. For the purpose of this illustration, it is assumed that this overall effect is a reduction in total benefits to policyholders, with present value of £50m. The impact will, of course, be different for different generations of policyholders.

4.4.2 *Other factors affecting value*

A number of other adjustments may be appropriate (relative to the status quo valuation), in particular:

— The value of subsidiaries may reduce as a result of the parent closing to new business, especially if the subsidiaries are not capable of operating on a fully 'stand-alone' basis, which may preclude their sale or run-off on a fully going-concern value.

— The embedded value of the non-profit business has been reduced to allow for a worsening persistency of the business and for any escalation of renewal costs.

— An adjustment has been made to allow for closure costs such as redundancies, ongoing lease obligations, relocation payments, etc.

4.4.3 *Derivation of the estate under the closed fund alternative*

The estate under the CFA has been set, for the purposes of this illustration, as shown in Table 4.7.

Table 4.7. Adjusted estate under closed fund

Open fund values	£m
Assets attributed to with-profits business	8,100
less With-profits realistic liabilities (including deferred tax)	(7,200)
Total	900
Adjusted values	
Value of subsidiaries	120
Embedded value of non-profit business	130
less Closure costs	(100)
Residual estate	1,050

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4.5 *Comparison of Alternatives*

4.5.1 A summary of the financial comparison of the total value realised by each option is shown in Table 4.8.

Table 4.8. Comparison of total value under each alternative

	Status quo £m	Demutualisation £m	Closed fund £m
Realistic estate	1,200	900	1,050
Goodwill value	100	200	nil
With-profits benefits	7,200	7,500	7,200
Additional value of investment freedom	nil	400	(50)
Total	8,500	9,000	8,200

4.5.1.1 The total benefits received by the current generation of with-profits policyholders is summarised in Table 4.9.

Table 4.9. Total benefits received by current policyholders

	Current PRE £m	Demutualisation £m	Closed fund £m
Current PRE level of benefits	7,200	7,200	7,200
Additional benefits	n/a	500[1]	1,050
Effect of investment freedom	n/a	400	(50)
Total	7,200	8,100	8,200

[1] Cash £200m; special reversionary bonus £100m; additional terminal bonus £200m

4.5.1.2 The demutualisation should increase policyholder benefits by £900m in total. This includes £200m immediate cash payments and £100m special reversionary bonuses. In addition, £200m of the estate has been earmarked for current policyholders to pay higher terminal bonuses, and the increased equity backing is expected to increase payouts to current with-profits policyholders by amounts, assumed to be entirely in terminal form, with a present value of £400m.

4.5.1.3 In comparison, distribution of the estate under the closed fund scenario is expected to result in additional benefits (via increased terminal bonuses) with a present value of £1,000m.

4.5.2 *Commentary on closed fund vs demutualisation*

4.5.2.1 The example is deliberately designed to give close results, with the CFA providing (apparently) somewhat higher benefits for existing policyholders. The closeness of the numbers, though, tends to mask what are, in fact, significantly different propositions as far as the policyholders are concerned.

4.5.2.2 Policyholders' interests can take three forms: cash; reversionary

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bonuses; terminal bonuses. Comparing the two propositions in regard to each element leads to a comparison along the following lines:

	Demutualisation	Closed fund
Cash	£200m	None
Reversionary bonus	£100m special reversionary bonus. Ongoing reversionary bonuses on a 'going concern' basis. A proprietary company may be motivated to increase the reversionary bonus element of benefit, because of the effect on shareholder interests via 90/10 profit-sharing.	In order to prepare for increasing uncertainty, the reversionary bonus content may have to be reduced, to give greater room for absorbing financial shocks.
Terminal bonus	Likely to be influenced by the market in terms of the degree of smoothing applied to payouts, and the extent to which payouts exceed asset shares.	The office is likely to have to choose between smoothing and avoiding an undue tontine effect as the fund gets into serious decline mode. There *may* be some very attractive bonuses in the last years, as the effects of earlier conservatism unwind.

4.5.2.3 The above comparison leads to the conclusion that benefits for existing policyholders are likely to be deferred and uncertain under the CFA, even relative to the status quo, and especially relative to a demutualisation proposal which includes cash and/or a special bonus element. Insofar as with-profits policyholders are somewhat risk averse, they may be prepared to waïve marginal extra benefits apparently available under a CFA as being 'jam tomorrow'.

4.5.2.4 It is, of course, possible to make direct allowance for a degree of risk aversion/preference for cash-in-hand by introducing a risk premium element into the discounting of future benefits. The difficulty is in quantifying a suitable magnitude of risk premium that would attract general support among policyholders and other interested parties.

4.5.2.5 Rather more to the point, when numbers are as close as this, will be the need to take a very critical approach to a review of all the assumptions. There will have been many elements of judgement, some of which will certainly be capable of debate.

4.5.2.6 The approach that the Working Party would recommend, especially when the numbers are close, is a process of sensitivity testing in relation to the key assumptions, combined with dialogue with the board(s) concerned. The outcome of such tests/dialogue is likely to be a much-enhanced understanding of the relative significance of the various factors involved and increased confidence in the final results and quantification.

4.5.2.7 It would, in the Working Party's view, be a common occurrence that the CFA and the main proposal (demutualisation in the present example) would be

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close. A closed fund situation, in isolation, is unlikely to be especially attractive for policyholders, and it would usually be possible to find a more satisfactory solution. However, the CFA *is* an option available to mutual society members and board, and, as such, represents an important point of reference in setting the terms of any alternative offer. Indeed, it may often represent the main determinant of the ultimate size of any offer, and the actuaries involved should be ready to justify and defend their assumptions in whatever depth proves necessary.

5. PERSPECTIVES ON THE CLOSED FUND ALTERNATIVE

5.1 *Directors' Considerations*

5.1.1 The directors' considerations for the CFA are discussed in Section 2 and Appendix B.

5.1.2 The question of the level of disclosure to give to alternative options is a matter for the judgement of the directors. While full and open disclosure is the desirable principle, there are constraints on that principle:

— certain alternatives may be commercially sensitive, and may be subject to confidentiality agreements; and
— disclosure must be relevant to the information needs of members — for example, lengthy or highly mathematical analysis will usually be inappropriate.

Regardless of the level of disclosure, any review of the closed fund and other options must be communicated accurately and effectively to members. An unfair or incomplete analysis and/or presentation of the closed fund option might increase the risk of a successful challenge by a member in the High Court.

5.1.3 Disclosure of the proposals gives an opportunity for other views to be expressed, and for members of the life company to consider if alternative actions are preferable. The directors of the mutual cannot take it for granted that their recommendation will be accepted:

— analysts or a potential acquirer may propose a more favourable deal than that initially put to members; or
— a member, policyholder or other affected person may successfully challenge the deal at, or prior to, the extraordinary general meeting or court hearing.

Where the directors have completed and adequately disclosed a detailed analysis of alternative options, there should be a reduced risk of a successful challenge to the proposal. The risk of challenge cannot, though, ever be wholly eliminated — the risk is an encouragement to the directors to ensure that every reasonable step has been taken to secure the most appropriate deal.

5.2 *The Role of the Appointed Actuary*

5.2.1 The role of the Appointed Actuary in a life office is unique, and encompasses both a thorough technical knowledge of the company and a

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commercial appreciation of the position of the company and the issues that it faces. The Appointed Actuary is, therefore, well positioned to advise both the directors and policyholders of a company on the implications of a particular proposal. It is usual for the Appointed Actuary to play a major role in any demutualisation, and, in recent U.K. demutualisations, a summary of a report to the board by the Appointed Actuary has been included in the material sent to policyholders and members. This position, as referred to in ¶2.2.6, reflects precedent and good practice rather than any legal or specific professional requirement:

— Schedule 2C requires a report on the transfer of business to be prepared by an independent actuary, and does not refer to the Appointed Actuary;
— GN1 states "when a significant change is likely to take place, the Appointed Actuary should take all reasonable steps to ensure that the company appreciates the implications for the reasonable expectations of its policyholders"; and
— GN15 primarily relates to the role of the independent actuary. The Guidance Note indicates that a petition to the court under Schedule 2C is often accompanied by a report from the Appointed Actuary, and that the independent actuary should look to the Appointed Actuary for certain information on the management of the fund.

Beyond the above, we are not aware of any other formal references to the role of the Appointed Actuary in a demutualisation.

5.2.2 The Working Party believes that an Appointed Actuary should advise the directors of a company considering demutualisation on:

— the implications for the company, its policyholders and members of the proposed demutualisation; and
— the possible implications of alternative options, including the CFA, which, in the opinion of the Appointed Actuary in consultation with the board, may be both feasible and appropriate to consider.

The Working Party believes that it is best practice for the directors of a mutual to make available this report, or a summary of it, to members, policyholders and the court, subject, however, to the considerations in the following paragraph.

5.2.3 The extent to which the Appointed Actuary's report, and any connected papers, can be made publicly available is for the directors and the Appointed Actuary to agree. There may be commercial issues mentioned, which should not be disclosed publicly. In reporting to the directors, it is important that the Appointed Actuary does not feel constrained by any need to make public disclosure, though, clearly, what is made public should properly reflect the Appointed Actuary's views. In the event of a dispute, for example if the Appointed Actuary felt that material information was being withheld from members and policyholders, he or she may wish to refer to the Professional Guidance Committee.

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5.2.4 The Working Party believes that the position of the Appointed Actuary in a demutualisation could be strengthened by extending GN1 to require a report to the directors on the implications of demutualisation and other options, and to encourage the Appointed Actuary to seek public disclosure of this paper, at least in summary form. It is already common for Appointed Actuary reports to be prepared and for a summary to be sent to members and policyholders, and, although a change to GN1 would be helpful, to go further and suggest changing Schedule 2C of ICA82 therefore seems unnecessary at present.

5.3 *The Role of the Independent Actuary*

The role of the independent actuary has already been discussed in Section 2 and Appendix B. It is a role that is well established within the contexts described in this paper, both in law and in professional guidance. With regard to the latter, GN15 has recently been updated. The Working Party considers that guidance should continue to avoid being over-prescriptive, and that the independent actuary's brief should be set and interpreted appropriately widely — see ¶2.2.13.

5.4 *How Attractive is a Closed Fund?*

5.4.1 An important question to answer is 'can the closed fund ever be more attractive than a demutualisation proposal?' Of course, in theory, a demutualisation proposal could be pitched at a level clearly inferior to the closed fund for existing members. In practice, such a situation is unlikely, as the proposal could run a high risk of rejection. Thus, on a purely financial analysis, these two options are often of similar value — the benefits under a demutualisation proposal can, and will, normally be set to ensure that this is the case, as was illustrated in the example in Section 4.

5.4.2 The key considerations in determining the relative attractiveness of the closed fund alternative are the strength of the fund, the goodwill value of the business and, in the case of demutualisation, the extent and form in which it is proposed to distribute some of the estate or 'hidden value' of the company. For example:

- a closed fund may be less attractive than demutualising for a weak fund;
- demutualisation may also be more attractive if there is a large goodwill element (e.g. a valuable brand, or a strong new business value) and a relatively weak with-profits fund;
- in situations where there is a substantial estate but limited goodwill, the closed fund may be more attractive unless a large proportion of the existing estate is distributed to members on demutualisation; or
- immediate cash benefits may be deemed to be more attractive than additions to future policy benefits.

5.5 *Possible Implications of using a Closed Fund Test*

5.5.1 The true or 'realistic' financial strength of a demutualised life company (as opposed to statutory financial strength) can come from three sources:

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— any capital injection made by a purchaser, which would normally be in respect of the acquisition of a stream of future earnings from the in force life business, in excess of the value of future transfers to shareholders from the with-profits fund;
— any realistic estate retained within the fund on demutualisation and the return earned on this; and
— any contributions made towards the estate from future new business.

5.5.2 Where a demutualisation proposal has been framed to meet the closed fund test, the realistic estate of a demutualised life company may often be lower than the realistic estate of the mutual company, even though the statutory position may be better. Over time, however, the statutory position of the life company may decline (relative to the position of the mutual) due to:
— the payment of transfers to shareholders (financed from the initial capital injection by shareholders); and
— the distribution of any enhancement to asset shares to policyholders at the date of demutualisation by way of bonus payments on claim.

5.5.2.1 The long-term implications of allocating a significant share of the mutual company estate to policyholders and members on demutualisation may be a decline in the long-term strength of the business on both a realistic and a statutory basis.

5.5.2.2 This need not be the case, and, in some recent situations where demutualisation supports expansion of the office and an enhanced investment strategy, the long-term position of the life office may be much improved.

5.5.2.3 The Working Party believes that, in some instances, allocation of a large element of the estate on demutualisation may not be in the long-term interests of the company and its future policyholders. There is a danger that pressure to disclose the CFA may encourage directors to make significant and excessive allocations from the estate to current policyholders.

5.5.3 Two recent demutualisations, one completed and one under way at the time of finalising this paper, appear to have offered members and policyholders the benefit of a closed fund with the other advantages of demutualisation. The two cases have included:
— closure of the mutual fund to new business;
— temporary capital support from the purchaser to the mutual fund, allowing an improvement in equity backing ratios; and
— a goodwill payment, financing a cash payment to members.

New business has been written through a sub-fund of the purchasing life company. Both cases appear to be more favourable to members than simple closure of the mutual.

5.5.4 To the extent that the CFA has been publicly discussed in demutualisation proposals, there have been few suggestions within the material

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sent to policyholders that this option may prove more financially attractive for some members. With the exception of the Scottish Mutual demutualisation, disclosure of the closed fund option has been in qualitative rather than in quantitative terms. The Working Party notes that disclosure has sometimes focused on the negative implications of the closed fund. Given the range of alternative assumptions that could reasonably be selected to compare benefits under the two scenarios, it is clear that alternative assumptions could lead to a position where the closed fund appears arithmetically better for current policyholders than the demutualisation proposal (underlining the need, see ¶4.5.2.7, for an appropriate statement of, and commentary on, assumptions in the actuaries' reports).

5.5.5 The Working Party believes that great care should be taken to explain the implications of the CFA to the members of a mutual, and the potential that this option may have to produce greater financial benefits. Providing the financial implications of each option are relatively close, the directors of a mutual may have a strong argument for not closing a fund, based on general considerations:

— policyholders will have taken out policies in the expectation that the company will continue in business; PRE considerations for non-profit and with-profits policies, therefore, point to an open fund;
— in general, members are likely to find the immediate benefits of a demutualisation proposal (additional bonuses, shares or cash) attractive, in relation to the uncertain future benefits of closure; immediately realisable non-policy benefits of cash or shares may be particularly attractive to members;
— even though the financial benefits may be close on an overall perspective, it is difficult, in practice, to secure fairness of comparison for all policyholders; and
— where closure is not clearly superior, the directors of the mutual may give weight to considerations of the implications for staff and the wider communities in which the company operates, in framing its recommendations.

The Policyholders' Circular, issued by Norwich Union in connection with its demutualisation proposal, included the statement:

> "the board believes that the closure of one of the U.K.'s largest insurance companies would not be in the best interests of Norwich Union's current and future customers, its employees or the communities in which the Group is a major employer".

The independent actuary also made his views on closure known:

> "it would be perverse to close such a company, with all the inherent consequences for staff and the communities in which it operates, in the absence of a clear and worthwhile advantage to members as a whole".

5.6 *Public Interest Issues*

5.6.1 The large number of life company and building society demutualisations

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has caught the attention of the media, and ensured that there is some recognition of the 'public interest' side of the debate. A number of commentators and proponents of mutual organisations have questioned whether the trend to demutualisation is in the public interest. In relation to this question, and in the context of this paper, should the actuarial profession address questions of public interest in its work on demutualisation?

5.6.2 The actuary may be advising the directors of the mutual, the policyholders and/or the High Court. In each case, the actuary's role is principally to advise on the financial implications of one or more courses of action. The actuary may wish to refer to questions of wider public interest in his report, although it would be unusual for these issues to carry a great weight. Given the relatively large number of life insurance companies in the U.K., it is difficult to argue that closure of any one company has major public interest implications.

5.6.3 The question of the future of a mutual is essentially one for its directors and members, who may also choose to consider the position of future policyholders and the wider public good. Broad public interest questions are also matters for the government, consumer interest groups and the Monopolies and Mergers Commission. An actuary advising the directors of a mutual may wish to bring these broad issues of public interest to the attention of the directors and members, particularly in situations where:

— closure of the mutual might lead to a marked reduction in the availability of life insurance;
— closure of the mutual might lead to loss of a particular product or service not otherwise available to policyholders; or
— where the conversion of a monopoly supplier of insurance from a mutual to proprietary status raises concerns about future policyholders' interests.

The third situation may arise overseas, but is unlikely to arise in the U.K.

6. Closing Remarks

6.1 The Working Party's principal conclusions are as follows:

— Consideration of the CFA normally arises as a matter of course in the context of demutualisations, as an indicator of the potential value of membership rights, but, sometimes, can be appropriate where continuing to write new business would adversely affect PRE. We do not support any suggestion that it should be considered regularly, as a matter of course, within the status quo situation.
— Company legislation places responsibilities on directors of mutual companies to ensure that the company's interests are properly considered.
— Where demutualisation involves a Schedule 2C transfer, policyholders' interests are adequately protected by current legislation, and the practice that has evolved is generally satisfactory.

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— The profession should consider more specific guidance to the Appointed Actuary of a mutual to offer advice to the directors on the CFA when demutualisation proposals are being presented to members. This might be achieved through an extension to GN1 when it is next revised.
— Independent actuaries should interpret their briefs as widely as they consider *appropriate.*

6.2 We have not sought to investigate in any depth the requirements in overseas territories, nor have we attempted any serious numerical research, whether of a stochastic or deterministic nature.

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APPENDIX A

TERMS OF REFERENCE AND MEMBERSHIP

A.1 The Working Party was established at the request of the Life Board Research Committee of the Institute and the Faculty of Actuaries in 1997. At its first meeting on 23 July 1997 it adopted the following terms of reference, which were agreed by the Research Committee:

- Collate and review the existing framework of legal, regulatory, professional and other requirements and references to 'the closed fund alternative', with associated procedures, according to their intended purpose(s), effectiveness and other factors. Any changes to the framework that may seem desirable to the Working Party should be noted, but no detailed work is required.
- What, if any, ranges of views are held as to the meaning of 'the closed fund alternative'? Review, and consider implications.
- Consider the implications of 'the closed fund alternative' according to the situation of the company concerned and from the various perspectives of the different interested parties, including policyholders' reasonable expectations and the general public interest.
- In what circumstances might the closed fund alternative be considered (in relation to other options open to the business)?
- Are there any alternatives to, or variations on, 'the closed fund alternative' that should be evaluated at the same time?
- How should the closed fund option be evaluated, including allowance for:
  - closure costs;
  - diseconomies of scale;
  - impact (if any) of losing good managers/investment managers;
  - changes in investment constraints;
  - impact on persistency, both initially and thereafter; and
  - distribution of estate (including value of non-profit business);

  and what assumptions should be used?

How should the results of the evaluation be compared with other options?

A.2 The membership of the Working Party was as follows: Chris Hairs (Chairman), Mike Arnold, Andrew Gustar, David Hare, Peter Needleman, James Tuley and Jim Webber

The Working Party wishes, also, to record its appreciation to Morgan Jones who served, in its early months, as a member and as secretary of the Working Party.

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APPENDIX B

LEGAL BACKGROUND

COMMENTS PROVIDED TO THE WORKING PARTY BY GLEN JAMES, SOLICITOR

It should be understood that the following comments were provided to the Working Party by Mr James by way of personal commentary on the paper, and not by way of formal professional advice in Mr James's capacity as a partner of the firm for which he works. The comments quoted below are part of a larger commentary, which also included more specific thoughts relating to an early draft of the paper to which the Working Party has had regard in formulating the final version of its paper. While the Working Party acknowledges with gratitude Mr James's comments, which it found most helpful, the Working Party alone takes responsibility for all other parts of the paper and also for its decision to include, with Mr James's agreement, his comments within this Appendix.

GENERAL COMMENTS FROM GLEN JAMES

B.1 "I think the legal position starts with the basic proposition that the directors of a life insurance company (whether it is a mutual or proprietary company) have a duty, just like the directors of any other company, to act in the best interests of that company. The more difficult question is to consider how to balance the various considerations which come into play in determining where the company's best interests lie. That said, it is well established that, except in relatively limited circumstances, the duties of the directors are owed to the company itself, rather than to its members, but that the interests of the company may be equated with the interests of its present and future members. Applying this test requires the directors to give due consideration not only to the interests of the current generation of members, but also to the interests of the corporate entity as a going concern. Thus, the directors would not automatically be obliged to approve a transaction merely because it would enrich the present generation of members, if they considered that it would be detrimental to the on-going business of the company.

B.2 "The duties of the directors have superimposed upon them the regulatory regime of the Insurance Companies Act 1982. The directors are required to have proper regard to the interests of holders of long-term insurance policies, and in particular to see that the rights and reasonable expectations of such policyholders will be protected. These obligations are policed by the appointed actuary to the company and by the Insurance Directorate of the Treasury. The Treasury have extensive powers of intervention which become exercisable where the Treasury forms the opinion that a company may be unable to fulfil the reasonable

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expectations of policyholders or potential policyholders. Failure to have due regard to the rights and reasonable expectations of long-term policyholders would be likely (particularly if this resulted in the exercise of powers of intervention) to have an adverse effect on the business of the undertaking and would, for that reason, be unlikely to accord with the directors' general obligation to act in the best interests of the company.

B.3 "In my view, therefore, there is no automatic legal obligation on the directors of a mutual company to close the company to new business, simply on the grounds that closure will provide greater rewards to the present generation of policyholders than would be the case if the company continued to accept new business but otherwise maintained the status quo. However, in the case of either a mutual or proprietary life company, if the terms upon which new business was being written and administered were such as to compromise the ability of the company to respect the rights and reasonable expectations of the current generation of policyholders, then the duty to consider, and possibly implement, a closure proposal would be much more apparent.

B.4 "Where some fundamental change to the status quo is proposed, it is often the case that the general principles outlined above need to be tempered so that the emphasis upon the interests of the present generation of members comes more firmly into focus. In the context of a takeover of a company (not an insurance company), the Court of Appeal has held that "where the directors must only decide between rival bidders, the interests of the company must be the interests of the current shareholders." It is likely, in my view, that similar principles would apply in reviewing rival proposals to demutualise a mutual insurance company. Of course, demutualisations come in many different shapes and forms. There are those where the business is acquired by a third party and those where the membership interest in the mutual is replaced by a shareholding in the new or converted proprietary company. There again, categorisations of demutualisation proposals can be broken down into those where most, if not all, policyholders are members and those where only certain classes of policyholders are members. So beyond the requirement to focus closely upon the interests of the present members of the mutual company, I think it is difficult to lay down any general guidelines as to the duties of directors in these cases, because much will turn on the individual circumstances. Certainly, in considering any demutualisation proposal, I think the board will have to have regard to other strategic options that are open to the company. This does not mean that the board is required to address its collective mind to every conceivable possibility but, depending upon the specific circumstances, one would expect the principal alternative options to have been considered by the board before a demutualisation proposal is put forward.

B.5 "Closing the policyholders' fund may have advantages from the perspective of with-profit policyholders if distribution of all the assets of the life fund over time to the current generation of with-profit policyholders, to the extent not required to meet non-profit liabilities, would result in greater benefits to those

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with-profit policyholders. Yet it might be argued that such a course of action would give rise to a windfall benefit to the current generation of with-profit policyholders and would not pay proper regard to the interests of the undertaking as an on-going entity. Holders of unit-linked policies, for example, who might also be members of the mutual might be significantly prejudiced by closure for some or all of the reasons which you have identified in the report. The directors would have to consider carefully whether a particular proposal would be in the interests of the present membership taken as a whole, and the financial advantages of closure to part of the membership — the with-profits policyholders — may not be wholly determinative. Certainly, it seems to me that, where the with-profits policyholders are the only members of the mutual company, it is easier to make a direct comparison with the alternative of a closed fund than in a case where the members of the mutual company include non-profit policyholders. Even then, however, there is uncertainty in the benefits which a closed fund offers to with-profits policyholders, since it may be inherently difficult to realise those benefits on an even-handed basis when some policies will mature well before others do.

B.6 "Another point to make is that closure may be only one of various options which, in the particular circumstances, it would be proper for the directors of the mutual company to consider. Thus, it may be sensible for the directors to consider the option of selling subsidiaries, or perhaps transferring part of the business. It may be that in pursuing such a course of action, the directors would achieve greater benefits than would be the case by pursuing closure or demutualisation. On the other hand, I think it would be wrong to suggest that it is incumbent upon directors slavishly to follow whatever option is capable of creating the greatest immediate value in the hands of the present generation of policyholders. If, for example, the directors believe that the long-term business aims of the group would be better achieved by retaining investments and businesses which it might be profitable to sell, it may be legitimate for them to conclude that pursuing the sale option is not the appropriate course (whether or not mutual status is to be retained).

B.7 "As you point out in your paper, most U.K. demutualisation transactions involve an application to the Court under Section 49 of, and Schedule 2C to, the Insurance Companies Act 1982. I think the Courts would be likely to continue to follow the judgment of Hoffmann J. (as he then was) in the London Life case in 1989 when, in a much-quoted part of his judgment, he said:

> "Although the statutory discretion is unfettered, it must be exercised according to principles which give due recognition to the commercial judgment entrusted by the company's constitution to its board. .. .. The Court does not have to be satisfied that no better scheme could have been devised. A board might have a choice of several possible schemes, none of which, taken as a whole, could be regarded as unfair. Some policyholders might prefer one such scheme and some might think they would be better off with another. But the choice is, in my judgment, a matter for the board. Of course, one could imagine an extreme case in which the choice made by the board was so irrational that a Court could only conclude that it had been actuated by some improper motive and had therefore abused its fiduciary powers. In

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such a case a member would be entitled to restrain the board from proceeding. But that would be an exercise of the Court's ordinary jurisdiction to restrain breaches of fiduciary duty: not an exercise of the statutory jurisdiction under Section 49 of the Insurance Companies Act 1982." "What is true of choices as between different schemes is also true of the details within a scheme. There are no doubt few schemes which could not in some respect be improved. . .. .Under the 1982 Act the Court cannot ... sanction the scheme subject to the making of amendments. It must be either confirmed or rejected."

B.8 "The other cornerstone test which any proposal will have to satisfy, besides obtaining the Court's approval, is approval by a sufficient majority of the voting membership. This is not a legal requirement of the S.49 transfer process. However, as you point out in the report, it is inevitable that a proposal as material as demutualisation must be put to the membership for their approval. Wherever the voting autonomy of the policyholders as members is to disappear, it is natural to regard this as requiring positive approval of the members. To gain that approval, the directors will have to put forward convincing arguments in support of their recommendations. These arguments are likely to be the stronger if the demutualisation proposal can be compared favourably with other options which are at least technically available to the company.

B.9 "In the London Life case, Hoffmann J. said that where no allegation was made that the scheme discriminated unfairly between one class of policyholders and another, the size of a majority which approved it at the general meeting would be a weighty consideration.

B.10 "In summary, once circumstances have developed to the point where the directors are taking a new initiative which is sufficiently fundamental to require the approval of the membership, some focus is both technically and practically inevitable upon the question of whether the particular proposal constitutes the best option from the point of view of the present generation of members. This does not, in my view, undermine the general principles which apply so long as the company concerned wishes to maintain the status quo. I believe these are correctly stated as I have described them above. One must also recognise that the catalyst for change is not always within the control of the directors themselves. A group of members may take the initiative. The directors may receive an approach from a third party interested in acquiring the business on terms which are very difficult for the directors not to recommend. The trigger point for focusing on the interests of the existing generation is when the existing generation is being asked, for whatever reason, to give its approval to a particular proposal, whether that proposal has been initiated by the directors, a group of members or an outside third party."

B.11 "I have quoted from the judgment of Hoffmann J. in my earlier remarks. The Court is not concerned to sanction what may be the best scheme. It is a matter for the directors to decide on the proposal which should be put forward. However, the directors are likely to have to consider alternatives in order properly to discharge their duties. The same is likely to be true of the independent actuary in discharging his statutory duty to report to the Court on the effects of the scheme, though that must depend on all the circumstances.

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B.12 "I am aware that the Insurance Directorate of the Treasury likes to widen the terms of reference of independent actuaries on Schedule 2C transfers involving demutualisations. I think this is a perfectly sensible development but on such transactions, I think it is only prudent for independent actuaries to regard their brief as a fairly wide one in any event under the legislation as it stands.

B.13 "The report is introduced by reference to concern at a possible lack of a consistent approach to the evaluation of the closure option in recent life company restructurings. My overall comment is to suggest caution in allowing consistency to become a goal in itself — there are dangers in adopting too prescriptive an approach. The judgments in particular cases will be heavily dependent upon their individual circumstances. Even then, a comparison between a particular proposal and the alternative of a closed fund will, to some extent, be of the 'apples and oranges' variety. Directors, advised by the actuaries, will make their recommendations on the basis of a range of factors. Any one of these factors, such as the comparison with the closure option, may be influential, but I suspect that it will rarely be exclusively so. The Directors ultimately have to make a commercial judgment, weighing up all the factors, in deciding what recommendation to make to their members."

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APPENDIX CA

CLERICAL MEDICAL'S REVIEW OF THE CLOSED FUND ALTERNATIVE

CA.1 *Strategic Background*

CA.1.1 Clerical Medical decided to search for a parent to reduce the risk that its future with-profits investment freedom (and consequently its long-term performance) would be constrained by a weak capital position. It was believed that a wave of rationalisation within the U.K. industry was imminent, and therefore that it was advantageous to proactively seek a parent early from a position of strength.

CA.1.2 Around the end of 1995 a small number of selected parties were invited to put forward proposals to acquire Clerical Medical. In March 1996 it was announced that Clerical Medical would be acquired by Halifax, which took place at the end of 1996. Halifax paid around £800m for a 10% stake in the with-profits sub-fund (WPSF), and 100% of the non-profit business. Policyholders received special reversionary bonuses worth £100m, and an additional £160m was allocated to the asset shares of transferring ex-members.

CA.2 *Consideration of the Closed Fund Option*

CA.2.1 The CFA was considered from early in the process, although the numbers could not be finalised until the detailed Halifax proposals were agreed. Clerical Medical was the first major U.K. demutualisation where the closed fund comparison was potentially significant, and all parties involved were keen to ensure the issue was covered properly. The independent actuary was specifically requested by the DTI to cover the CFA in his report to the court.

CA.2.2 The purpose of the comparison was to value the members' interests in Clerical Medical, so that the board could satisfy itself that, following demutualisation, policyholders would receive benefits at least as high as they could reasonably expect as members of an open or closed mutual.

CA.3. *The Closed Fund Comparison*

CA.3.1 The closed fund scenario assumed that Clerical Medical continued as an independent mutual which was closed to new business. It would continue, at least for the medium term, to carry out its own administration and investment management. This scenario was compared with continuing as an open mutual, and with demutualisation and acquisition by Halifax.

CA.3.2 The comparison was based on quantifying the benefits which policyholders could reasonably expect to receive in each scenario. Specific factors allowed for in the closed fund scenario included:

— the costs of closure;
— the impact of increasing unit costs in a declining portfolio of business;
— future investment constraints on the fund;

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— the impact on investment performance of reduced cash flow and the loss of key managers; and
— the impact of increased lapses on the value of non-profit business and non-insurance business and subsidiaries.

The assumptions underlying the calculations were on a realistic basis. The risks inherent in the three scenarios were assessed, although it was not possible to quantify them explicitly. However, the board concluded that the downside risks to policyholders in the closed fund scenario were very significant compared to those as part of a large and strong financial services group.

CA.4 *Disclosure of the Closed Fund Analysis*

The Appointed Actuary was involved throughout the closed fund analysis. In his report, he mentioned that the closed fund option had been considered:

> "It would also be possible to close the fund to new business, with with-profit policyholders receiving the surplus assets remaining in the closed fund. This would relieve policyholders of the cost of future business acquisition, but would incur substantial costs during the realignment of the business onto a closed fund basis. Although the current strength of the Society means that there would not be any immediate investment restriction on the fund, as the business matures it would become more difficult to pursue a free investment policy and also more difficult to contain unit administration costs. Additionally, it would become difficult to retain key staff, including investment managers, which is likely to have a detrimental impact on future performance."

The independent actuary also covered the closed fund at length in his report.

CA.5 *Impact of the Closed Fund Comparison*

As a result of the closed fund analysis, the additional amount of £160m was allocated to the asset shares of existing with-profits policies when the acquisition by Halifax took place. This ensured that the total expected benefits to policyholders, following the Halifax acquisition, were at least as high as they would have been under either an open or a closed mutual.

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APPENDIX CB

NORWICH UNION'S REVIEW OF THE CLOSED FUND ALTERNATIVE

CB.1 *Strategic Background*

CB.1.1 Norwich Union was a large world-wide mutual life insurance company, with significant assets invested in a subsidiary U.K. general insurance company, and other international life and general insurance subsidiaries. The structure of the company restricted access to capital to develop the business, and created significant investment constraints for with-profits policyholders.

CB.1.2 The advantages of flotation for the company and its members were:

- flotation raised new capital for the group, allowing the exposure of with-profits policyholders to general insurance businesses and other subsidiary companies to be substantially reduced;
- the published financial strength and investment freedom of the U.K. life business improved;
- listing on the London Stock Exchange increased the group's ability to raise external capital, enhancing its scope for development; and
- flotation allowed separation of ownership and customer interests in Norwich Union, and allowed members to retain an ownership interest in the group through the receipt of free shares.

CB.2 *Consideration of the Closed Fund Option*

CB.2.1 The directors of Norwich Union recognised that the demutualisation proposal involved a substantial transfer of value to the existing members of the mutual life insurance company, through the allocation of free shares in Norwich Union plc. It was expected that the majority of members were likely to find the demutualisation option attractive. For these reasons, the directors did not consider the closed fund option at a very early stage of the transaction, and did not use the closed fund option in order to set a 'benchmark' valuation against which other options could be evaluated. Similarly, the CFA was not a high profile issue in discussions with the independent actuary and the regulatory bodies. The directors considered the CFA in order to give additional confidence to their demutualisation recommendation.

CB.2.2 By comparing demutualisation with the CFA, the directors were satisfied that the value of free shares allocated to members was likely to be greater than the value of any increase in policy benefits payable to members and policyholders on closure.

CB.3 *The Closed Fund Comparison*

CB.3.1 The closed fund option was compared to the alternatives of demutualisation and continuing as a mutual company. The comparison was carried out by calculating, in aggregate, the benefits which members could reasonably expect to receive in each scenario. Specific factors allowed for in the closed fund scenario included:

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— the costs of closure;
— the potential impact of increasing maintenance costs in future years;
— the impact of closure on cash flow, consequently reducing investment returns as cash flows become negative; and
— the necessity of selling subsidiary businesses to a third party and the expectation that, in what would be effectively a forced sale, the value realised would likely be at a discount to economic value.

CB.3.2 No allowance was made for any need to decrease the equity backing ratio of the fund in future in order to avoid significant volatility in with-profits payouts. No allowance was made for any deterioration in the value of non-profit and unit-linked business, or for the impact of staff losses on investment performance. It was expected that flotation would permit some increase in the investment flexibility of the with-profits fund, and this was reflected in the evaluation of this alternative.

CB.3.3 In comparing the value of benefits payable to members under the alternative scenarios, allowance was made for the value of free shares allocated to members holding only non-profit policies. On closure to new business, it was recognised that these members would be unlikely to receive any increase in policy benefits. In undertaking the CFA, it was considered appropriate to evaluate the interests of members as a group, rather than simply the interests of with-profits policyholders.

CB.3.4 The comparisons were undertaken on the basis that the with-profits estates of Norwich Union's overseas branches prior to flotation were zero. This simplified assumption was made because of the limited time and resources available to complete the analysis of the closed fund option. Since, prior to the flotation, the major branches were thinly capitalised, with the U.K. business providing the majority of the mutual's financial strength, this assumption was considered justified. In practice, this meant that possible differences in policy benefits between the three scenarios for overseas branch members were not taken into consideration.

CB.3.5 The key issue in the comparison of demutualisation and the closed fund was the value to place on the free shares allocated to members. The debate centred on the size of the potential premium to embedded value in a 'fair market value' position, and a question of whether the price at flotation, or a later 'fair market value' trading value, should be assumed. In practice, a range of values close to embedded value was used to put a value on free shares. At the time of finalising this paper, the approach used appears to have been highly conservative.

CB.4 *Disclosure of the Closed Fund Analysis*

CB.4.1 The Appointed Actuary was closely involved in reviewing the CFA, and other options. In his report, the Appointed Actuary noted that many of the factors which influence the comparison of alternatives are difficult to estimate with certainty, and the relative value of alternative options could not be stated

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with confidence. The Appointed Actuary concluded that "the value of free shares allocated to members together with the value of the additional investment freedoms under flotation, are likely to be greater than the value of increases in policy benefits on closure to new business".

CB.4.2 In the 'Prospectus in connection with the Free Share Scheme' (equivalent to the policyholders' circular) the directors of Norwich Union reviewed the option of closure to new business. The directors concluded that closure to new business was not appropriate for Norwich Union, its members or policyholders, because:

— while closure would lead to higher policy benefits being paid on most with-profits policies, the amount of surplus in the life fund would itself be affected by closure, and, therefore, the level of these additional benefits would be difficult to predict;
— the life fund would be required to adopt a more conservative investment policy in comparison with the policy that would apply under flotation, which could reduce the overall return to policyholders;
— significant redundancy and closure costs would be incurred, which would need to be met from the life fund;
— the value of the Norwich Union Group as a whole, including goodwill and the value of the Norwich Union brand, would be likely to decline on closure to new business; and
— the board believed that closure of one of the U.K.'s largest insurance companies would not be in the interest of Norwich Union's current and future customers, its employees or the communities in which the company is a major employer.

CB.4.3 The independent actuary reviewed the CFA and supported the conclusion reached by the board of Norwich Union that the closed fund option was not appropriate.

CB.5 *Impact of the Closed Fund Comparison*

The closed fund comparison is not considered to have had any material impact on the Norwich Union flotation. The ability of Norwich Union members to exercise voting rights after flotation, through holding free shares acquired on flotation, and the subsequent transfer of value to members on flotation, are believed to be key factors that explain the limited role of the closed fund comparison in the Norwich Union transaction.

CB.6 *Other Issues*

CB.6.1 A number of issues arose in the comparison of the CFA with the demutualisation proposal. These issues arose because the analysis involved, not simply two alternative sets of policy benefits, but a comparison of projected policy benefits with a known allocation of free shares plus projected policy benefits. These issues are discussed below.

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CB.6.2 The closed fund value had been calculated using policyholder after-tax investment returns. It was expected that the vast majority of members would receive free shares without any charge to tax. The tax position of the free shares was, therefore, broadly comparable to the tax position of an additional policy benefit paid to with-profits life policyholders, but not comparable to the position of pension policyholders whose pension payments would, in part, be subject to a tax charge. An adjustment was made to the closed fund value to reflect the potential tax that would be suffered on additional policy benefits paid to pension policyholders in the closed fund scenario.

CB.6.3 The value of the free shares had been, in effect, calculated at an after-tax risk discount rate (the embedded value discount rate) significantly above the after-tax discount rates used to calculate the closed fund entity value. A further adjustment was made to the closed fund value to reflect the impact of discounting additional policy benefits on the same after-tax discount rate as used for the embedded value calculations. This can be interpreted as allowing for the fact that future additional benefits in the closed fund scenario are uncertain, and that a risk discount rate was considered appropriate for valuing these benefits to policyholders.

CB.6.4 Under the flotation option, each member was given a statement of the number of free shares expected to be allocated to the member and an indication of the potential value of each share. This statement was provided as part of the information pack on flotation, on which members were asked to vote. In comparison to the closed fund option, this gave the member two advantages:

- an indication of the additional value that he would receive over and above usual policy benefits; and
- a benefit which could (on flotation) be immediately realised for cash on demutualisation.

No explicit adjustment was made to reflect the higher value that many members were expected to place on the relative certainty provided by the flotation proposal in comparison to the uncertainties of closure to new business.

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APPENDIX CC

SCOTTISH MUTUAL'S REVIEW OF THE CLOSED FUND ALTERNATIVE

CC.1. *Strategic Background*

CC.1.1 The decision of the board of the Scottish Mutual Assurance Society to propose acceptance of the Abbey National scheme was made in the context of a strategic review dating back to 1988. The Society had been considered to be in a healthy financial condition and capable of continuing in its current form for the foreseeable future. However, the climate for such life assurance companies appeared less attractive than it had done for many years, and so alternatives to the status quo had been considered.

CC.1.2 Five options in all were considered: continuing unchanged; closing the fund; opening up new distribution channels independently; opening up new channels through a joint venture; and demutualisation. In 1988 the board of the Society concluded that demutualisation could be an attractive option, provided that the demutualisation resulted in there being a single owner, who could offer an advantage such as access to new channels of distribution.

CC.1.3 Abbey National approached the Society in the first half of 1991, with a view to a proposed association, and detailed discussions between the organisations resulted in the scheme which was put to members for approval in November 1991. The proposals were seen to offer greater security for policyholders, increased with-profits PRE and potential for both greater investment freedom and lower unit costs. In return for a 10% stake in the with-profits business and 100% of the non-profit business, Abbey National paid £285m into the with-profits sub-fund of the new company, Scottish Mutual plc, a wholly owned subsidiary of Abbey National. Policyholders received special reversionary bonuses worth around £70m, and asset shares were increased by just over £100m.

CC.2 *Consideration of the Closed Fund Alternative*

CC.2.1.1 As already mentioned above, the closing of the Society to new business had been one of the options considered on the 1988 strategic review.

CC.2.1.2 When it came to the consideration of the Abbey National scheme, both the Appointed Actuary and the independent actuary referred to the CFA in their reports.

CC.2.2 *The Appointed Actuary's references to the closed fund alternative*

CC.2.2.1 An appendix to the Appointed Actuary's report presented illustrations of the possible financial effects of the scheme for transferring with-profits policyholders, comparing it with the alternatives of closure of the fund to new business and continuation as a mutual insurer.

CC.2.2.2 The comparison centred on bonus reserve valuations using EBR and expense assumptions considered appropriate for each option. Other elements of

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the basis (e.g. mortality and lapse experience, the rate of return on different classes of investment and the valuation basis used to calculate the cost of bonus declarations) were assumed to remain constant across the three scenarios.

CC.2.2.3 The different EBR and expense assumptions used were the following:

	Status quo	Demutualisation	CFA
WP fund EBR	70%	80%	55%
Unit costs	current	savings with present value of £5m	110% of current

CC.2.2.4 No details were given as to the calculations which underlay the selection of values which were different to current levels.

CC.2.2.5 The CFA was presented first. On the basis of the assumptions made, the continuation of current reversionary and accrued terminal bonus levels resulted in a residual surplus of £179m. An increase in the assumed future reversionary and terminal bonus rates of 28.8% would have utilised all this amount, and the other two scenarios were compared on the basis of these higher bonus assumptions, thereby emphasising that closing the fund was not assumed to be preferable for the with-profits policyholders.

CC.2.3 *The Independent Actuary's references to the closed fund alternative*

CC.2.3.1 In the introduction to his report, the independent actuary noted that:

> "By virtue of the above Act [Insurance Companies Act 1982] my report is limited to a comparison of the likely effects on the policyholders of the Society if the Scheme is or is not implemented. It is not concerned with possible alternative schemes. However, since the Scheme involves, *inter alia*, a demutualisation of the Society, it will be necessary in my report to have regard not only to the rights and expectations of the policyholders in respect of their insurance policy contracts, but also to the significance of the resulting loss of their proprietary rights as members of the Society."

CC.2.3.2 The initial aggregate asset share fund (the financial management of which was to be carried out in accordance with principles laid down in the scheme in order to protect the interests of the transferring with-profits policyholders) was set at the bonus reserve valuation calculated on the demutualisation assumptions, including the 28.8% bonus uplift and the special bonus to be declared on demutualisation. The independent actuary noted that this amount was almost identical to the continuing (as at present) fund bonus reserve valuation allowing for the 28.8% bonus uplift, but with no allowance for the special bonus, and that, in effect, therefore, the aggregate asset share start-off value could be considered to be either:

— the 'status quo fund value' of future bonuses at 128.8% of current rates (which were assumed to exhaust the estate on the closed fund assumptions), with no additional value given for loss of future new business profits; or

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— the demutualised open fund value of the same bonus stream along with the special reversionary bonus to be declared as part of the scheme.

CC.2.3.3 He noted that: "the valuations did not take account of the many practical disadvantages of closure for policyholders and the staff alike", and concluded that, amongst other things:

"— In relation to the Society continuing operations as at present, the Scheme is likely to improve the bonus prospects of with-profit policyholders and enhance the security of all policyholders.
— There would seem to be no advantage to policyholders in the Society closing to new business and operating as a closed fund as an alternative to accepting the Scheme."

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APPENDIX D

SOME EXAMPLES OF CLOSED (OR VIRTUALLY CLOSED) FUNDS

D.1 The following sets out some situations within the U.K., known to the Working Party, where many of the features of a closed fund (as discussed in the paper) exist, together with brief thumbnail descriptions. The descriptions are intended to give only the 'flavour' of the situation in each case, and are not intended to be either rigorous or complete. Specific enquiry would need to be made in respect of any case concerning which the reader wished for further detail.

D.2 The situations could be divided between closed sub funds and closed companies within group structures. Another possible division is between truly closed funds and those funds where top ups and extensions are written, or even, in the case of the Gresham closed fund, some with-profits bonds, we think. These distinctions, however, will be irrelevant for many purposes.

D.3 The 'cleanest' closed funds, in the sense of independent closure, may be those closed U.K. branches of overseas companies where the overseas company has no other interests in the U.K.

AMP number 1 statutory fund	Includes the U.K. branch and the London Life business as sub-funds; these transact top up business
Black Horse Life	Closed sub-fund
Canada Life	Includes a sub-fund of the ManuLife business
Century	Runs a number of closed sub-funds of which the most major is from the old NEL business; closed to new business, bar trivial top ups, after attempted sales force operation closed some years back
Criterion	Had a closed with-profits sub-fund, but recently reopened a 100% shareholder sub-fund to sell non-profit business
Cornhill	Closed sub-fund
Crown of Canada	Closed U.K. branch
Friends Provident	Runs the old United Kingdom Provident Institution business in Friends Provident Life Assurance with some other minor business
Guardian	British Equitable, closed in 1948, and company cited in an early legal case, still in existence with around 250 policies

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Hill Samuel	With-profits effectively closed, now in Abbey Life as a sub-fund
Lincoln Assurance	Closed sub-fund
Old Mutual	Closed sub-fund in U.K.
Prudential	Scottish Amicable
Scottish Provident	Old Prolific business
State Life of Pakistan	Closed U.K. with-profits branch
Sun Alliance	Old Phoenix business nearly closed, but some intra-group reassurance
Swiss Life	Closed with-profits industrial business and ordinary business sub-funds from Pioneer Mutual
TSB Life	Closed sub-fund
Wintertur	Closed sub-fund
Windsor Life	Gresham sub-fund still writes some business; also closed with-profits business from N.Z. Life, U.K. Life and Windsor itself
Zurich Life	Closed sub-fund

D.4 There are others that are close to closure, and, of course, deals such as the Axa/Sun Life one, which leaves parts of the funds closed to new business. Similarly, where insurers have withdrawn from the industrial business market there is opportunity for a 'closed fund', but invariably linked to an open ordinary business fund. Similarly, there are numerous semi-closed friendly societies, but their scale and lack of options would make a number of the more substantive points within the paper inappropriate.

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ABSRACT OF THE DISCUSSION

Mr C. J. Hairs, F.I.A. (introducing the paper): Once it was virtually taboo to mention companies by name at Sessional Meetings and in Sessional Papers, but this taboo is far less strong these days. The Working Party certainly felt that, for our report to be useful, we should make it as easy as we could, for those using our work in their own closed fund investigations, to help them to trace cases similar to their own.

One difficulty in referring to particular cases is that one's work can, by omitting well-known recent examples, seem to get out-of-date quickly. Since we completed our report in summer 1998, there have been further examples of situations in which consideration of the closed fund alternative (CFA) would be an expected part of the investigations. One such example is the proposed offer to NPI members that its fund be merged with Australian Mutual Provident. There have also been other well-publicised demutualisations around the world, notably in Canada, in the United States of America and in South Africa.

Notwithstanding the fair number of references to particular cases, we did not seek to cover every case. If any of you who have knowledge of other cases were prepared to mention them and any features of interest to our topic it would be appreciated. The Working Party thank the managements of Clerical Medical, Norwich Union and Scottish Mutual for being willing to have their cases described in some detail in our report.

About two years ago the Research Committee of the Life Board first proposed the formation of this Working Party. It was proposed at a time when a number of demutualisations were in the air, and in the period between then and now most of these have come to fruition. The casual observer could be forgiven for feeling that ours is a paper that is somewhat past its time; how many mutuals are there left? There are still a number of mutual life companies actively transacting business in the United Kingdom — not to mention the considerable number of friendly societies, many of which are already closed to new business. There are also many more in other countries. Although we have not investigated the specifics of the situation overseas, we believe that there are applications of our work elsewhere in the world.

On behalf of the Working Party, I want to make it clear that in no sense are we advocating the dissolution of mutuals, or, to be fair, their non-dissolution. We took it as our given startpoint that a company or its members had, in the usual circumstance in which the CFA had arisen, and for their own good reasons, reached a point at which demutualisation was being considered. We did not apply any value judgement to the situation at that start point. It is the duty, primarily, of the boards of the companies concerned, in suitable consultation with their members, to determine the rights and wrongs of particular situations; and of government and public opinion generally, as to whether there are any public interest aspects. Our views as to the duty of any particular actuary involved in a demutualisation are set out at the end of Section 5.

The Working Party recognised that more work is possible, particularly, as we have said, in the area of the application of stochastic methods. If there is sufficient interest, it may be appropriate to form a successor Working Party for the task. Anyone expressing interest may find themselves co-opted, of course!

Mr D. Murray, F.I.A. (opening the discussion): Recent demutualisations have made the CFA a highly topical issue, and this report will prove an invaluable reference document for anyone working in this area.

Most of the paper is in the context of mutual companies, but, as is mentioned, the closed fund can also arise as an issue for proprietaries. Indeed, the surprisingly long list of existing closed funds and sub-funds noted in Appendix D includes several belonging to proprietaries. I have often thought about the potential problem, that a with-profits fund could run-off leaving a substantial estate. At the extreme, one could imagine a clash of interests between a small number of policyholders hoping for a considerable gain from the tontine effect, ranged against the shareholders. Such a clash should be avoided by early enough preventative action, but that requires the actuary to be aware of the

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possibility many years in advance. It would appear that many of the points in the paper would be relevant where such situations do exist.

Also in the context of proprietaries, a colleague pointed out to me that a decade ago it was impossible to sell a company without a substantial discount to embedded value. How times change. There was, at least, one instance of the directors looking for a buyer, but finally deciding to close the fund instead in order to achieve a better deal. Maybe one day those circumstances could prevail again.

Reverting to mutuals, there have been several recent demutualisations in the U.K. which have required actuaries to determine the benefits due to members and policyholders on various scenarios, including the CFA. Some of these are discussed in the paper. These cases, and the related ones involving the building societies, have received much publicity. The idea of closing a mutual fund and distributing surplus is firmly in the public mind. Given recent financial scandals, the role of the aptly named independent actuary is surely helpful in ensuring fair treatment of the public, and I agree with the conclusion, in ¶6.1, that independent actuaries should interpret their briefs widely.

Sections 3 and 4 lie at the heart of the paper. They explore the practical aspects of the closed fund option, and illustrate the issues with a hypothetical example. Care is taken to emphasise that it is only an example, and that different patterns of numbers do emerge in practice. In this particular case, closing the fund leads to higher expected benefits for the current generation of members, because the estate is being distributed to them. The example goes on to consider the value of the company to both present and future generations. This time, closing the fund leads to a lower total value than the status quo — which is the opposite result. In such a confusing situation, whose interests should have precedence? Appendix B provides a helpful legal opinion. Lest anyone should get the wrong impression, I emphasise that reading legal opinions is not normally top of my priorities, but this one is well worth reading. The conclusion is that, except in limited circumstances, the duties of the directors are owed, not only to the current generation of members, but also to the interests of the entity as a going concern.

This comes as a relief for anyone managing a healthy mutual, where closing the fund would hardly make commercial sense. Unfortunately, it ignores the fundamental practical problem that the voting rights lie entirely with the current generation, and for them closure can be beneficial. The management teams of mutual life offices are left with a difficult problem.

The paper highlights this dilemma to good effect. I mention a couple of additional questions that it raises:

(1) What is an appropriate level of estate for a mutual life office to have? The higher this is, the more beneficial it will be to the present generation to secure its distribution, and the greater the risk that a closure motion could succeed. Similarly, too low an estate may jeopardise the ability of the company to generate good levels of return for its members. So what is an appropriate level? Mutual offices in the U.K. appear to be operating with wide variations in levels of estate, and some are making conscious efforts to distribute excess surplus to members, so the question is a live one.

(2) There is the ease with which a motion can be put, seeking closure of a fund and distribution of the benefits to the present members. Recent Presidents have focused on the profession's role in matters of public interest, and it is certainly a matter of public interest that a group of, say, 50 members out of, maybe 500,000 or more, may be able to call for closure of a fund, and ultimately cause the demise of a long-standing mutual life office. It is interesting to reflect on the response of the building societies. Nationwide has reduced the temptation for members to press for closure by removing rights to any windfall benefits for new members. Other societies will only confer membership rights on certain products, or high levels of investment. Still others are seeking to change voting rules to increase the number of members required to force such a vote. I appreciate that this topic is outside the immediate scope of the Working Party's brief, but I welcome discussion on how membership rights and voting rules might be managed.

I found it useful that the paper described briefly several recent demutualisation schemes. It is striking that each one is different. The recent examples of Scottish Amicable and the NPI, which were not covered — indeed the NPI scheme is still being developed — have added a further dimension. In each case the approach has been to distribute the estate to the current generation, yet to do so in a

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way which maintains or even enhances investment flexibility. Seemingly, this achieves the best of both worlds and appears to have moved the goalposts.

In response, I guess that capital facilities do not come free. Also, one might argue about the extent to which higher assumed equity backing ratios should be allowed for — someone somewhere must be taking additional risks. Nevertheless, the current members appear to do very well from these examples, and some would argue that the companies concerned are now better placed to compete in the future. I am, therefore, interested to hear how actuaries in remaining mutuals should react to this new type of scheme. Is the closed fund comparison still the one that matters, or has a new benchmark been set — possibly a very high benchmark, but nevertheless one which the current generation of members may believe they are entitled to obtain?

Section 4.4.1 and ¶4.4.2 explain some of the ways in which value can be eroded in a closed fund. The likely problems are noted as potential loss of investment freedom, one-off closure costs, increasing unit costs, and tax. However, it is not all doom and gloom. Paragraph 4.4.1.4 points out that investment freedom can actually improve for many years. The possibility of outsourcing administration is quoted, to limit costs and provide a good service — and the same must apply to investment management. The availability of outsourcing may mean that the costs of ongoing administration and management in a closed fund are lower than they once were. There may be others who can comment further from direct experience. How significant are the one-off closure costs? How do members react? How can surplus be distributed at a fair rate?

The paper rightly gives considerable attention to legal and professional guidance. The conclusion is that GN 1 could be extended, so that, when demutualisation is being considered, the Appointed Actuary would be required to produce a report explaining the alternatives and the possible effects on the company, the policyholders and the members. Moreover, it would be hoped that these findings would be disclosed publicly, at least in summary form.

Paragraph 6.1 makes clear that this recommendation is only when demutualisation is being considered, and that there should not be any requirement to review the CFA within the status quo situation. At this point I am not quite so sure. We have already seen that, for the current generation of policyholders, closure could be advantageous. Bearing that in mind, let us consider a company which is failing to deliver reasonable returns to members, perhaps because of high expense levels or a constrained investment position. In manufacturing, it would be plainly and simply loss-making, and there is every chance that it would be closed down. Why should a poor performing mutual life office be any different?

Voices of experience may counsel caution; this is the directors' responsibility, not the actuary's. It is rare for a company never to have a year or two of losses, or never to face the need for change. Yes, it would be wrong to abandon a company's ongoing future just because of a few difficult years. The Working Party has come down on the side of not requiring the actuary to review the CFA. That is right as a matter of course, but when a company is unable to break out of a downward spiral, maybe there are circumstances when the actuary should be pointed towards recommending such a review to the directors.

Mr P. G. Scott F.I.A.: I am one of the directors mentioned in Appendix CB.

The CFA is an important test within a demutualisation process, but is only a part of that process.

A mutual insurance fund is a business enterprise, and, in the event of a change of ownership, the existing owners (the policyholders, however defined) should obtain a fair market value for the enterprise that is being sold. This should include both the mutual fund and any subsidiary businesses that that fund owns. If the discounted value of the benefits under a CFA is the highest value, then it would be appropriate to close for business and to go into run-off. However, in today's marketplace, it is probably most unlikely that the CFA would produce the best value.

All mutual insurance businesses will have some goodwill, whether positive or negative, and the demutualisation process should ensure that the goodwill value achieved is full and fair for the policyholders. It will be difficult to establish the value of such goodwill, but, in reality, this is probably more important than the value of closing the business. Valuable brands cannot be realised in the CFA, only destroyed.

In demutualisations, where full value is being distributed via shares to members or where there is

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an open auction process, then the process itself should ensure an open market value of the business. If, however, a demutualisation is part of an agreed sale to a single purchaser, then much attention needs to be paid as to whether the value of goodwill is full and fair.

I believe that this paper adds much to our knowledge of the CFA in practice, but the profession should be clear that the CFA is likely to be a relatively small part of a demutualisation process in the current market place. Paragraph B.13 summarises the context very clearly — a demutualisation requires directors to exercise commercial judgement in the interests of policyholders. The CFA does provide a benchmark to help in assessing alternatives, but no more.

Mr P. W. Wright, F.I.A.: I agree with most of the conclusions drawn about when it is appropriate to consider a CFA — most notably those related to proprietary companies. However, I believe that there is one additional circumstance in which it is appropriate for a mutual to consider, and implement, this approach, and this was touched on by the opener. This is when new with-profits business can only be written on the basis of 'own charges' which require a permanent subsidy from the estate, and new non-profit business is insufficiently profitable to cover this subsidy. I can see no rational reason why such a mutual should not close to new business, even if it does have the financial strength to subsidise new business for some time.

In ¶3.2 I was surprised that no reference was made to the special problems associated with running off industrial assurance business. These problems are made worse by the delay in implementing the previous Government's proposals to permit a voluntary switch of premium payment to direct debit. It is to be hoped that the Financial Services Authority (FSA) implement this much overdue change as soon as they are constitutionally able.

I was even more surprised by the reference, in ¶3.4.1, to the published solvency of a closed fund being reduced by the costs of closure in the first year. I was under the impression that the Valuation Regulations and GN8 require advanced provisions for this contingency to be established.

In ¶3.5.4, perhaps it could have been mentioned that the achievement of an equitable run-off can be simplified if any penalties incorporated into surrender value and paid-up policy value bases are removed. This removes fluctuations in discontinuance rates from the list of issues which can affect the financial position of the fund and give rise to an unintended tontine effect.

I would disagree with the observation, in ¶4.2.5, that the need to switch assets to protect solvency in the event of a market fall could, of itself, call into question the company's ability to satisfy policyholders' reasonable expectations (PRE), assuming that PRE is used here in the legal sense. If the Court was so to interpret PRE, then all with-profits companies would be potentially in breach of their statutory duties. The commercial problems associated with uncompetitive bonus rates do not, in my view, reflect on the legal position.

The comment, in ¶5.5.3, regarding the writing of new business, is not correct as far as the Prudential takeover of Scottish Amicable is concerned. New with-profits business is written by the new Scottish Amicable Life plc, and reinsured into the main Prudential with-profits fund. I was, incidentally, unsure whether the juxtaposition of ¶5.5.2.3 and ¶5.5.3, together with the use of the word 'appear' in ¶5.5.3, implied that the authors had some objection to the scheme implementing this takeover — if so, perhaps they could elaborate on this. To answer the opener, a payment is made from the closed fund to the open fund for the benefit of the capital support provided.

In Appendix CA I gained the impression that Clerical Medical had rather loaded the dice against the CFA. In particular, to adopt the arbitrary assumption that investment management had to remain 'in house', and then to list as one of the disadvantages of this alternative that the closed fund would be susceptible to the loss of key investment managers, appears disingenuous.

Mr C. W. McLean, F.F.A.: I think that this area is a prudential professional minefield, and it is very much an area of applied professional judgement, rather than academic theory. However, I think that it is right that this topic should now be reopened for discussion.

It appears that much of the analysis and conclusion is based on two key assumptions, and these have already been picked up by the opener. The first is the indivisibility of factors of production, suggesting an excessive cost involved ultimately in the closed fund option, which is presented as a major obstacle, but may not be the case. Increasingly, market factors in the life sector that are giving

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rise to closed fund considerations are also producing excess capacity in many life offices, and there are many ways in which it may be possible to sub-contract administration on a more reasonable basis. The opener has already mentioned outsourcing as, possibly, a benefit rather than just a problem. Section 3.2 could take a more balanced view of this. Indeed, this section seems a little long on assertion and short on academic reasoning. I think that there may be a number of costs and savings involved. This section also seems to echo the Clerical Medical view that loss of investment staff may be a problem. In fact, despite what is said in ¶3.4.4, index tracking may not really be a problem or a loss relative to active investment management. Indeed, it is quite possible that it may improve returns.

The second key assumption is that there is an additional value of investment freedom. The comparison of the alternatives under Section 4.5 shows just how important this is, as a positive contribution to the demutualisation option and a negative one to the closed fund. However, this begs the question of whether this actually reflects recent past experience. That is, should equities out-perform gilts by 2.5% p.a., is it right for this to be factored in? I do not think that there is much evidence, from earlier demutualisations which apparently offered these benefits, that advantage was actually taken of freedom in this way.

There is also an assumption about the non-mutual subsidiaries. Demutualisation is very much a package with one buyer, and it may be that there are different types of unbundling that might raise more value for those subsidiaries in other hands. So, I do not see everything, under this section, as a problem, and perhaps the most overstated part is the suggestion that disposal of literature might be one of the heavy costs. That is stretching a point just a little bit too far.

There is a more fundamental problem about new business. It is not just whether new business can be run. Otherwise, as the opener suggested, some factories would never close until they ran out of money, and it cannot be an excuse for maintaining a life corporate entity just because it has not run out of money yet. It is important that a further generation of members is being created profitably, and in a way that is differentiated from other life offices. Unless there is something distinctive about its competence, there is little argument for maintaining the corporate entity solely for that reason. I think that it is important, therefore, to see how many new with-profits members are being created, and on what basis.

I suspect that, without the assumptions on future investment policy, and with more flexibility in steadily reducing costs in running down a closed fund by outsourcing, the answers might be different. I can accept that it is not necessary for a closed fund option to be assessed daily, and I agree with the authors, as they suggest in ¶4.5.2.7, that one of the main points of evaluating a CFA is to ensure that the right price is paid for the other alternatives. However, it does mention in the legal view, again, the phrase 'commercial judgement'. Increasingly the closed fund option will be just one of many, and actuaries will be brought into contact — perhaps even conflict — with other professional advisers. If actuaries are going to support boards on the commercial judgement decision, they may need to extend their expertise, or, indeed, may need to demonstrate how they can interact in providing their advice on a closed fund option with the other various commercial options. I think that, perhaps, we have stretched the point a little bit too unfairly against the closed fund option by not including outsourcing.

Mr J. A. Jenkins, F.I.A.: I believe that, for the vast majority of policyholders taking out policies with any life assurance company — either proprietary or mutual — there is no expectation of gain as a result of the fund closing to new business. If any policyholder did have such an expectation, it would not, in my view, be a reasonable one. For policies taken out with a mutual, nowadays there may be some expectation of gain as a result of demutualisation, and one can debate whether this expectation is reasonable or not, but this is not the same thing as a gain purely due to closure.

I am, therefore, in agreement with the conclusions reached by the Working Party, the most important of which is that the CFA only needs to be considered, in practice, for a mutual considering demutualisation, and even then the main use of the closed fund option is to assist in quantifying the value of membership rights. Numerical analyses of the type given in the paper are extremely useful in quantifying what the theoretical benefits on closure might be. In addition, there should, in my view, be some minimum value for membership rights, regardless of what the numerical analyses show in any particular case.

One aspect of when the CFA should be considered, which I would have liked to have seen

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included in the paper, is some reference to the position when building societies demutualise. My understanding is that the boards of building societies have a general duty to consider the interests of their members. This is no different to the position for mutual life offices, as is pointed out in Appendix B. However, my understanding is that there is no requirement, nor is it the practice, when building society demutualisations take place, to consider the closed-to-new-business alternative in any shape or form. Arguably, it is more difficult to run a closed-to-new-business building society than its life office equivalent. The probable need to maintain a branch network for existing depositors to use means that significant cost savings will not be available. On the other hand, it seems clear that some building societies which have converted to banks had large estates, even if they did not use the same terminology as we do. I can only assume that the building society regulators effectively take the view that existing members have no right to the surpluses which might be available on closure — which is the view that I expressed earlier in the life office context.

It does concern me that the CFA is effectively imposed on mutual life offices wishing to demutualise, but not on building societies. With the transition to a single financial services regulator, inconsistencies such as this should, in my view, be eliminated.

If any further work is done in this area, I suggest that we should consider how membership rights, and so on, have been dealt with within the building society arena.

Mr J. Young (a visitor, a lawyer)**:** I am always impressed by the extent to which discussions on your papers are actively supported by the profession. I wish I could claim that the legal profession could count on such a sterling attendance at a public debate on this type of topic.

The issue of the CFA is one that, as Mr Jenkins mentioned, straddles legal and actuarial issues in a manner that is by no means satisfactory. More highly regulated jurisdictions, such as the U.S.A., frequently regulate their way out of such issues. In the U.K. such regulation is only resorted to if self-help fails, as I believe was the case with the building societies. Particularly unsatisfactory is the way in which English company law requires us to look at mutual life assurance companies as if they were no different from short-term trading enterprises being operated primarily for the benefit of their current members. The law is brutally mercenary in this regard. This is an issue which is drawn out in Glen James's thorough summary in Appendix B, but I think that a couple of further issues are worth examination:

(1) As has been mentioned, the closed fund has become even more dominant as an issue in recent demutualisations than is suggested in the report, to the extent that the structure of the demutualisation itself has effectively involved closing the fund and buying out its goodwill. This is a topic that has been dealt with by previous speakers, but it is not going to go away.

(2) The report moves very quickly over the extent to which healthy on-going mutuals need to consider the CFA. Unfortunately, I think that the closed fund benchmark has now become so important that, in practice, it needs to be at the back of the minds of the directors of all mutual life assurance companies. I agree that it is very rare that the directors of a successful mutual are likely to give the CFA more than the most fleeting consideration. However, paradoxically, the matter may be most worthy of consideration by the richest mutuals. It also brings into play the rather surprising question: can a mutual be too strong?

The directors of a mutual company are required by law to act bona fide for the benefit of their company, which, in practice, means its members. Although the duty extends both to present and future members, there is no doubt, however unpalatable this may be, that the present members' interests come first, unless the Articles of Association say otherwise — which of course they seldom do. It is something that we may regret that this issue is one that could easily have been avoided by the founding fathers of our mutuals if they had written appropriate rules into their Private Acts of Parliament, but regrettably they did not do this. So, as far as companies are concerned, much as we may regret this, it is, in practice, highly unlikely that either the Government or the members of these companies are now going to change this situation.

It is worth noting that the situation in relation to friendly societies may be rather different. Friendly societies are rather more numerous. The law in relation to friendly societies, and particularly the responsibilities of their directors, is far less clear; and, of course, friendly societies often have custody

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of funds — quite considerable funds — that are for the purpose of discretionary benefits as well as for life assurance. The question of what the law ought to be in relation to the boards of friendly societies is, perhaps, worth further debate, and, ultimately, the consideration of legislation.

This apart, I am afraid that, in these unsentimental times, the directors of a mutual life assurance company are wise to keep an eye on the strength of any argument to the effect that their mutual is so strong that its current members would be better off with a closed fund than they would be with an ongoing mutual. It is obviously highly unlikely that this analysis will lead them to close the fund. However, it may lead them to conclude that they should, at least, deplete the fund by judicious declaration of additional bonuses in favour of the current generation of policyholders rather than taking the risk that a hostile predator will offer to do the job for them.

Mr S. Thompson, F.I.A.: I comment first on the background to the conclusion of the Policyholders' Reasonable Expectations (PRE) Working Party, which is quoted in ¶2.1.6. This was, I think, influenced by a case which was in the public domain at the time that the Working Party was preparing its report. This is the case referred to by Mr James in Appendix B. It involved the acquisition of a mutual by another mutual which would continue to operate the first mutual as an open sub-fund of its main fund. The original proposals were subject to considerable public criticism, as to whether they were in the best interest of policyholders of the acquired mutual. In particular, it was argued that a closed fund might be a better option, but this was not considered in great detail, if at all, in the original proposal. It was only after further information, including an analysis of the closed fund option, was made available that the proposals were accepted by policyholders of the mutual, and the transaction ultimately went through. The conclusion which was drawn, which I think still remains valid, was that if the actuaries involved in a transaction like this do not consider the CFA, then others will certainly raise it as an issue, very possibly to the detriment of the proposals.

It goes without saying that any such analysis must be as objective as possible and able to withstand critical scrutiny. I am sure that the Working Party would accept this. Therefore, I am slightly surprised that, in ¶2.3.7, it dismisses a test of what might be offered by other insurers. If any sort of market were to develop in closed funds, then the value which might possibly be achieved in such a market would seem to be a lower bound for the value which members could reasonably be expected to accept in any alternative proposals.

Even in the absence of such a market, there seem to be a number of market tests which can be applied to some of the key assumptions in a closed fund analysis. Mr McLean made this point earlier. Both the text of the report and Appendix C contain a number of references to 'rising unit costs', 'cost rising faster than inflation' and 'loss of key managers'. However, as was said earlier, there is a growing market in third party administration and an extremely competitive market in third party fund administration. The cost at which these services can be purchased in the open market would seem to be an objective basis for fixing assumptions in a closed fund analysis, and would avoid some of the problems which I have just quoted.

Some recent transactions have shown that there are, currently, buyers willing to put significant amounts of capital into mutuals so as both to allow the estate to be run off for the benefit of existing policyholders and to allow policyholders to realise a substantial price for goodwill. In these circumstances, the CFA seems to be of purely academic interest. The introducer suggested that this alternative way of realising the benefits of a mutual might, at the present time, be an alternative lower bound on the value that could be accepted. However, this state of affairs must surely come to an end, eventually, at which time the CFA could again be much more of a genuine alternative, and in those circumstances it needs as clear and objective analysis as is possible.

Mr C. G. Thomson, F.F.A.: For me, ¶3.6.2 gets extremely close to the heart of the matter. There are those who consider the CFA as a hurdle that a deal must improve on before it can be acceptable. I do not think that this is correct. The CFA is a benchmark against which other alternatives may be judged, but, as the authors say, the risk characteristics of the closed fund will be very different from those of the open fund. If numbers are produced for a CFA to a scheme, it is not particularly those numbers which are important, but the basis which produces them — how reasonable or unreasonable is it? That is the measure of whether or not the CFA suggests that a particular scheme is weak.

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I am intrigued by how practice has developed over the years. Perhaps the current position can be summarised by saying that CFA numbers need to be produced if a particular deal is being struck and no auction is being held. Where there is an auction, then there seems to be no need to produce closed fund numbers in the current market. The presumption, already mentioned, is that goodwill is being paid. In the case of a flotation, it is also assumed that there will be goodwill in the share price. While these assumptions seem almost obvious at present, I do not think that they are necessarily correct; if a company floated at a particularly bad time, or if there were few buyers in the market, the position could be radically different. In those circumstances, it is instructive to revisit the words which, like Mr Thompson, I helped to write in ¶2.1.6. Like him, I am not sure that, nowadays, I would go quite so far or, perhaps, not put it in quite the same words. Perhaps there are certain circumstances when our profession should recommend that a deal does not take place, rather than that the fund be closed and windfall benefits paid out to policyholders. Perhaps I am just growing tired of the public greed which is converting all building societies into banks. We have heard political comment about 'new mutuals'. If all that we do is to wipe out the healthy mutuals of today for the sake of windfalls to the current generation, and all that we leave in their place are organisations like credit unions, then I do not think that we should be surprised if future generations feel that we have not acted in their interests. What we have cannot be built again, because no proprietor nowadays will be prepared to accept less than an investment return on its assets.

The modern world seems to expect to see everything written down, so the suggestion, in ¶5.2.4, that the Appointed Actuary should write a report on the scheme, would simply institutionalise what happens normally, and that would be a benefit. I remain concerned, however, by suggestions that the independent actuary should consider whether the scheme is the best amongst all possible schemes. I do not think that the law requires this, and I think that it puts an unreasonable burden on the independent actuary. I would, however, expect him or her to notice if the scheme appeared to be particularly poor value or to be to the particular advantage of one group rather than another, and, in such circumstances, I would expect the report to say so.

I have similar difficulties with ¶5.6.1. I agree that the actuarial profession should be stronger in its defence of mutuality in the public interest. However, we have not yet managed to produce particularly strong arguments. The building society movement has shown us that the choice between a fitted kitchen now and lower charges in future is an easy one for the public to make. Building societies have started to announce mutuality bonuses, but the life industry has been doing this for over 100 years. The value for money argument is there, but since a large proprietary can be more efficient than a small mutual, it is not easy to show a large difference. Perhaps only the mutuals which are both large and strong can survive, since they can compete with any proprietary, at least in the U.K. context.

I found that Appendix B is a most useful and valuable summary of the legal position. I will question only ¶B.4 (and, following on from the comments of Mr Young, this might be a difference between English law or Scots law, or simply a reflection of my own ignorance of the law). I think that the analogy from the current shareholders of a proprietary company taken across to the current members of a mutual is too strong. In morality, even if not in the law, the ownership of a mutual is generally held in perpetuity, and the directors' obligations are, therefore, not solely to the current generation, although I agree that the directors must pay particular attention to them, but the obligations are also to the future policyholders.

Mr H. W. Froggatt, F.I.A.: I shall restrict my remarks to thoughts on the worked example. I appreciate that it is not necessarily realistic; but I do think that it was intended to illustrate the principles. A number of balance sheets are shown. There are statutory balance sheets with assets on one side and liabilities on the other. These are set out in recognisable balance sheet form (although the statutory numbers are not reported in quite that way). There are also realistic balance sheets. These are set out differently, and, perversely, closer to the way in which statutory items are reported. For example, the status quo realistic balance sheet (Table 4.2) starts with (admissible) assets, adjusts them to a full market value and deducts realistic liabilities. The balancing item is the estate. There is no obvious problem with this, although, in reality, an actuary would like to know the assumptions made in valuing these with-profits liabilities and to consider how reasonable they are in the context of assets taken at market value.

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If we look next at the post demutualisation balance sheet (Table 4.6), in this context the assets are restricted to those purely belonging to the with-profits fund. The assets allocated are already at market value, and therefore need no adjustment. Then a realistic with-profits liability is deducted, which is fine in this context. A value for shareholders' transfers is next deducted, and this is fine in principle. When one looks at the value, it happens to be the same as that which the example says has been paid for the transfers by the purchaser, Big Fish. How would Big Fish have valued the shareholder transfers? For its own internal purposes at least, this is likely to have been at a risk discount rate (based on its view of the risk and its required rate of return on capital or the investments which it makes), and is also likely to be after all tax. Adopting this new point would imply that the Table 4.6 figure is at a risk discount rate and after tax. However, this number is rather different from the amount of money which would be required by the fund, if it were to set aside an amount now, which would realistically provide for the payment of the shareholder transfers and the associated tax.

So one could say that, from the perspective of the with-profits fund, a more realistic 'realistic balance sheet' might, perhaps, have shown a higher value of the shareholders' share of the with-profits surplus than the figure paid by the prospective shareholder, which, perhaps, suggests that, if this were the case, the figure for the estate could have been over-stated.

So one can ask the question of the Working Party: is the figure in the example from the perspective of the prospective shareholder or from the perspective of the with-profits fund? If the values in the example are intended for publication, then perhaps it is appropriate and acceptable (with the appropriate disclosure of the assumptions) to show them from the perspective of the with-profits fund. As a prospective shareholder's perspective is different, this would have implications on the way in which final figures for the deal are negotiated. These differing shareholders' and policyholders' perspectives have to be reconciled, and maybe this is one part of the reason why we have seen the development of different approaches and alternatives to conventional 90:10 structures used in one or two of the more recent demutualisations or proposed demutualisations.

I think that the above analysis shows the importance of stating exactly what the assumptions are; of sensitivity testing and of ensuring that the board understands the nature of these different perspectives. Basically this supports the Working Party approach, which they have set out in ¶4.5.2.6.

Mr A. J. M. Chamberlain, F.I.A.: I am in general agreement with the paper, but perhaps, inevitably, I would take a slightly different approach to a few points. However, these differences are more of emphasis than on substance.

In Section 2.1 the authors have taken as read the right of the regulator to close the company to new business. This can happen for several reasons, listed in the Insurance Companies Act 1982, but amongst them is the failure to fulfil the criteria of sound and prudent management. This would include paragraph 7, which requires the company to conduct its business with due regard to the interests of policyholders. This adds force to the arguments in ¶2.1.5. A similar point arises in ¶2.1.6, where I think that the authors may be moving further from the previous Working Party's statement than I would be prepared to go.

In general, it is accepted best practice for any business to review its plans regularly, and to seek an adequate expected return on capital. This is not only true of shareholder companies, but must also be true of a mutual investing its estate. Such general good husbandry must include, implicitly, a comparison with a closed fund, along the lines touched on in ¶2.1.5. Perhaps this implicit comparison is not truly a CFA, in the sense of this paper, as it is more akin to a project appraisal based on hurdle rates of return, which could possibly be quite modest. It is, however, a very close relative.

It is in ¶¶2.1.7 and 2.1.8 that I find myself furthest from the paper's conclusions. I consider that there are circumstances other than those of demutualisation or other diminution of voting rights where the CFA must necessarily be considered by directors. The circumstances in ¶2.1.5, in relation to expenses and terms of new business, are presumably intended to be read as 'unlikely' exceptions to the limitation to reorganisations, although this is not clear from the paper. Perhaps there is an element of wishful thinking in adjudging these as unlikely. However, I would add at least one significant factor. If a mutual has suffered a significant loss, or series of losses, which have seriously eroded its capital base below that necessary for continuing the operations as before, I do not think that directors should feel free merely to set out to restore that capital base without considering the CFA.

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Whatever course for restoring the capital is intended or chosen, ultimately it must have implications for the policy proceeds of existing or prospective policyholders. Indeed, if regulatory intervention action is to be avoided, then PRE must not be placed at risk of being unfulfilled. Although, in an ongoing mutual, there certainly can be some expectation of contributing to capital as part of the with-profits bargain, this must be subject to tests of reasonableness, and to a presumption of due account being taken of policyholders' interests. If the directors are to be able to meet such expectations, they should, in my view, give consideration to the CFA before setting out on a substantial rebuilding of capital, even if this does not involve demutualisation. I do not, therefore, accept the rather sweeping view expressed in ¶2.1.8.

I am not suggesting that, necessarily, a corporate change triggers such a duty, however. In general I agree with the Working Party in this respect. My concern is that this paper should not be seen as providing a crutch for a weakened and directionless mutual to lean on whilst the policyholders' returns suffer more and more. Preservation of the positions of senior management is not sufficient reason to avoid considering the CFA.

In places the paper touches on wider issues in demutualisations. The Working Party's arguments in ¶5.5.5 are not particularly strong. I think that it stretches PRE too far to say there is an expectation that the fund will remain open. I accept that there is no expectation that it will close, however. This is not quite the same thing. I am particularly concerned at the implication, in the second argument in ¶9.5.5, for not closing the fund, of preferring the demutualisation proposal on a 'bird in the hand' basis, or on preferences of members, presumably by majority. I believe that the primary expectation of any policyholder of a mutual is expressed in terms of his or her policy proceeds. Although there may be certain demutualisation benefits delivered in cash form, I do not think that these are to be given weight in the way implied. I am most unhappy at a suggestion that, even if they are attractive, they are necessarily consistent with PRE. Indeed, the limited extent of these shown in the Working Party's own example, in Section 4, indicates that, perhaps, they do not really mean to imply this preference.

Mr A. J. Sanders, F.I.A. (1979): I support the conclusions of the Working Party in Section 6; in particular with the recommendation that the profession considers more specific guidance to the Appointed Actuary of a mutual in relation to advice to the directors on demutualisation.

The Working Party concludes, in Section 2, that the financial impact of closure on benefits to policyholders is an indicator of the value of membership rights. I have a quibble with the wording here. The financial impact of closing the fund provides a measure by which to gauge alternatives, as others have said. Members should not enter into a demutualisation, which results in their losing their membership and voting rights, unless there are clear financial or other advantages when measured against the closed fund yardstick. However, it does not seem strictly correct to say that the additional value released over and above the members' expectations as policyholders represents the value of their membership rights — even though this is the value that is released when they give up membership. Part of this value can be attributed equally to their rights as policyholders in the changed circumstances, rather than as members.

Demutualisation crystallises and releases some, if not all, of the estate and the goodwill assets. These assets are not directly attributable to any particular group of policyholders or members. There has been little debate within the actuarial profession on the extent to which this windfall should be distributed, and to whom it should go. Alternatives include cash payment, shares, addition to asset shares, and reversionary or terminal bonus. These alternatives require judgement about what is an equitable apportionment between members and policyholders — in circumstances where there is likely to be a wide range of possibilities. How should the windfall be divided between large policies, small policies, non-profit policies, with-profits policies, older policies and newer policies?

One of the key questions in considering this issue is when and where the windfall assets arose. Part may have arisen from the distant past, before the current generation of members and policyholders. For this part, there is no particular justification to any form of distribution — no one group of members or policyholders has any particular claim. In these circumstances, one could argue for identical cash payments to members; or for a greater share for longer-term members; or for a greater share for with-profits policyholders. Other parts of the windfall may have arisen over the lifetime of the current generation of policyholders, and here the source of the windfall will be relevant

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to which group should equitably receive the benefit of it and the method and structure of the distribution. In practice, the historic information available may be limited, as may the time available for consideration of these issues. In the U.K. relatively simple bases have been used for distribution on demutualisation, whereas in North America rather more complex methods have applied, involving complicated policy calculations based on the particular policy's sum assured, premium, surrender value and duration, and related to the contribution to different sources of surplus, such as mortality and investment. This is an area where issues of equity as well as commercial pressures arise, and actuaries are well placed to advise. Consideration should be given to including this area in the proposed extension of guidance.

In ¶5.5.2.3 it is stated that the Working Party believes that, in some instances, allocation of a large element of the estate on demutualisation may not be in the long-term interests of the company and its future policyholders. Whereas I do not disagree with this statement, the world has been changing. There is much greater commercial awareness of the underlying issues than there was a few years ago. Any demutualisation proposal which does not distribute the majority of the estate to members and policyholders will run the risk that a counter proposal will be made by another organisation which members will find more attractive. This poses particular issues for a with-profits mutual which is contemplating sale or flotation, and wishes to preserve the financial strength of the fund so that it can write new with-profits business in its existing fund in future.

Some speakers have suggested that, in current conditions, the CFA is academic, due to the substantial amounts of goodwill being paid. However, if you look down the list of remaining U.K. mutuals, they are by no means all national IFA offices as in the recent demutualisations, and positive goodwill cannot be assumed. Companies, including mutuals, have been floated overseas at less than embedded value. So, although the CFA may seem academic, in the light of recent events, I think it is still a very real issue.

Mr R. E. Snelson, F.I.A.: I support the speaker who made the remark about the independent actuary not having to consider all possible alternatives. My understanding of the position is that the independent actuary has to take into account the proposition which is on the table. However, it is prudent for most organisations to involve the independent actuary at as early a stage as possible in the development of the scheme, so that the independent actuary is aware of why a particular route is chosen compared with something else.

In ¶3.5.7, it is stated: "At the very end, with only a few policies remaining in force, it may be appropriate to avoid a tontine effect by converting policy benefits to a guaranteed or formula-driven basis. This will require the co-operation of the regulator as well as assistance from a reinsurer or another fund." When a CFA is decided upon, great care should be exercised in working out what the likely end game is going to be. I have seen two such companies. One is a proprietary company with fewer than 1,000 policies, which has virtually no embedded value, and so it is quite impossible to sell, as no other company would be interested. That is posing real problems for the existing management. The second case is more cheerful. It is a with-profits fund with fewer than 200 policies in force, and it is reducing at about the rate of 10 a year. There are two groups of policyholders, one group stretches from about age 60 to age 96, and the average is about 83. The other group stretches from age 45 to about age 85. So that group is going to go on for quite a long while, and one could envisage a situation arising, in about 20 years' time, where there are still a few policies in force, and yet it does not seem to be a viable fund to manage at that stage. Just to give some sort of idea of the problems that arise, as I said, it is a with-profits fund, so who gets the mismatching reserve? That is now about 10% of the total liabilities. Who gets the statutory solvency margin? That is another 10% of the liabilities. There is an expense reserve on the basis that expenses will go on for ever. That is another 10% or so. It would be possible to give a once-and-for-all bonus to everybody of at least 50% — perhaps 100% — of existing benefits, if it were to be merged with some other fund which would take it on board for a relative modest benefit to the fund taking it over.

So that is the kind of situation that can arise in practice. Much thought needs to be given to where a fund is likely to finish up when the CFA is being considered.

Ms M. Pell (a visitor, a lawyer): An earlier speaker talked about the ability to change voting or

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membership rights, as some of the building societies have been doing, in order to try to avoid carpet baggers. This can be divided into two categories: voting rights or membership rights being restricted after the announcement of a transaction that is going to take some while to take place; and restrictions that are made before the announcement. The former, where restrictions are made to benefits that apply to members after an announcement has been made are, of course, quite commonplace now.

In relation to pre-announcement changes to membership rights, there is no reason why, in theory, it is not possible for a mutual to propose to its members a change in its rules, which would, for future membership, provide a qualifying period prior to any vote being allowed on any resolution; or for a change in the right to participate in demutualisation benefits; or for some other restriction on voting which may be related to a qualifying sum on policy benefits (if it is possible to provide a qualifying sum that will make sense in the context of a wide variety of policies); or, indeed, would provide a general ability, which I think I have seen, to close membership altogether for a particular period, and which the directors could operate in times of crisis.

All these kinds of provision are likely to require a change in the rules. There may be a reluctance by some mutuals to take what will be a fairly public defensive action of this kind, and to raise their heads above the parapet, as by doing so they may provoke the very activity which they are trying to avoid.

I agree with earlier comments about the interests of the company and their meaning in relation to the interests of members, present and future. I now comment, in particular, on the reference to when the CFA should be considered, as discussed in ¶2.4.1. Any proposal which involves seeking membership approval, whether or not it involves a considerable diminution in membership overall, is, in practice, going to involve the directors in making a recommendation to the members as to how they should vote and a statement as to what is in the best interests of those members. It is difficult to see, in those circumstances, how the directors can avoid looking at all the alternatives in order to make up their minds, and to recommend to the members how they should vote.

I agree with Mr Young that this is likely to be an issue, particularly for strong mutuals. If two strong mutuals wish to merge in the future, they are, in practice, going to have to compare their proposal with a CFA, if only in order to persuade policyholders that they should vote in favour of merger. It may now be difficult, with the past precedents that have occurred, to effect such a merger without involving a substantial distribution of the estate at the same time.

Mr M. N. Urmston, F.I.A.: I support the view expressed by Mr Chamberlain. It seems to me that the CFA is something that all Appointed Actuaries should consider, and, indeed, might well wish to consider as part of their financial condition report. It is not necessarily the duty of the boards of those companies to follow that course, but it does seem to me to be instructive to do that calculation, and make that sort of assessment. That may give rise to the company or the board taking a view on the inherited estate or, indeed, on PRE, but that is no bad thing.

The Working Party missed any reference to the General Accident takeover of Provident Mutual. When it comes to expenses, several speakers have made some comments about outsourcing. It would seem to me, whether you are running a proprietary or a mutual office, whether it is closed or open, the possibility of third party administration of any form, whether it be investment management or running the back office, is surely something that all the boards of life offices should be considering and should consider as an alternative to closure.

I make a plea, perhaps, the other way: to think rather carefully about closed funds. The paper does not bring out the dangers of insecurity and insolvency which may arise from running a closed fund. We are very conscious of the cost of guaranteed annuity options, the impact of lower interest rates, the impact of improving mortality on annuitants, and many of the losses that the industry is suffering at the present time. Many mutuals, if they went to closed funds — certainly if they were weak — could be in serious difficulty. Demutualisation gives an opportunity to shareholders or for the managements of those companies to get out of that problem.

Mr R. Allen (a visitor, from the Financial Services Authority): I find it somewhat distressing that the popular debate about demutualisation does seem to be expressed, largely through the financial pages of the newspapers, in terms of how big a particular windfall might be. That is probably largely

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because public debate has focused more on building societies than it has on life offices. There is a danger that the debate will mix the two together. There are differences which are important about life office demutualisations — not least the long-term nature of a life office contract. That is something we need to have firmly in mind in considering how demutualisations of life offices take place. I heard with interest, and indeed recognise, the points made about the limited extent to which the current legislation deals with demutualisations of life offices — at least, deals with them directly. I cannot offer any immediate hope that there will be legislative change in that direction. The pressures on the legislative timetable are as great as ever, even if there is a Bill in prospect dealing with financial services. So, we have always adopted the typically British approach of being pragmatic about it, in using the legislative vehicles available as creatively as possible. On the whole, that has worked very well — not least because of the co-operation of the profession in building on the Schedule 2(c) process.

As regulators we are — as indeed the Working Party is — neutral about the value of demutualisation as such. Our concern is properly with the process. We want it not only to be fair, but seen to be fair. In that context, perhaps, I make a reference to a passage in the paper in which I think I recognise myself — where there is a discussion of correspondence with the regulator over the extent to which the independent actuary should look at the CFA.

What the regulator would like to see is that all the options within reason are considered, so that it is not simply a matter of the management of a mutual putting forward a proposal and getting an independent actuary to say: "That is not unreasonable, so it is all alright". I think that the paper recognises that there needs to be more than that. At the same time, we recognise that there are practical limits on how far it can be expected that the profession can go, and I think that the paper gets the balance about right in saying that they would encourage the independent actuary to take a wide view of his responsibilities, and, at the very least, draw attention to the fact, if, in his view, it is the case that a sufficient range of alternatives has not been taken into account. That is certainly something which the regulator will look at in reviewing the reports of both the Appointed Actuary and the independent actuary on any demutualisation proposal, and, indeed, that is something which we will take our own view on if we, in turn, think that the range of options may not have been as wide as we would have liked to see.

Mr W. B. McBride, F.F.A.: My first reaction to that part of the paper, ¶2.4.1, where it says: "We do not support any suggestion that a mutual should regularly review the question of closure to determine if this is more advantageous", was something of a shock. Coming back to it, ¶2.1.5 makes clear the circumstances where this would be a reasonable thing for an actuary to do. The Working Party is quite right about that, in my view.

This point has been taken up in the discussion by a number of speakers. The opener started the ball rolling. Now, I cannot see that the size of the estate has anything to do with the point. Mr Wright mentioned the circumstances in which a life office ought to be able to justify the transaction of new business. If it cannot satisfy those conditions and has a large estate, it may be a rather longer time before circumstances catch up with it than if it is weak, but nemesis is still awaiting it. The Appointed Actuary to a life office has a continuing responsibility to examine, on behalf of the directors, just what the office is up to. Maybe writing new business is not going at all well. He would have to report that, and they would have to think what to do about it. The immediate alternative to not going on writing new business under the status quo is not necessarily, as Mr Chamberlain said, shutting up shop at once. There are various alternatives. Perhaps writing new business in partnership with somebody else, as happened in a certain case with which I was associated 10 years ago, is one way of doing it. Perhaps quietly closing and seeing what happens is another, although I do not know, in today's terms, whether one can shut a life fund quietly for a while and see if new ideas to pick up new business emerge. A decade ago the thought of working on execution-only was not an available technique, but I know one life fund which effectively shut for a while, and is now doing that and benefiting from it quite well.

Whatever the directors of the life company concerned decide to do, if they decide to go into partnership or demutualise, then Section 49 comes into play, and a great barrage of publicity will descend upon the organisation when this happens. Here I disagree with Mr Allen, not in what he

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wants to see achieved, but in the manner that he wants to see it achieved. He wants to see the role of the independent actuary, as I think the paper suggests, widened, strengthened and evaluating a variety of options that the company had considered before. I have felt, for some time, that this is fundamentally the responsibility of the Appointed Actuary, and that, to the extent that the independent actuary gets involved with a variety of alternatives, he undermines the position of the Appointed Actuary of a life office. I have always held the view that the Appointed Actuary should be the chief actuary, and that his advice is the prime advice.

It is entirely right that, when the matter goes to Court on a Section 49 transfer, there should be an independent actuary's report. Not only is it legally necessary, but it is right. Moreover, the independent actuary gives a second opinion; and the prime opinion is that of the Appointed Actuary. This matter was discussed at the last Institute meeting (see *B.A.J.* **5**, III, 59-574). I did not make a contribution then, but it is still relevant. I, too, would like to see the issues that Mr Allen described properly aired, and I think we all do, but it is primarily the role of the Appointed Actuary, not of the independent actuary to do this.

Mr G. James (a visitor, a lawyer): I am responsible for Appendix B. When it is proposed that the status quo of an organisation like a mutual company is to change, it is the members who are going to have the final say on what happens, and the fiduciary duties of the directors to look at the wider interests of existing and future generations of members have to give way to the narrower self-interest of the present members. That is just a fact of life. We have to accept that.

The comments that have been made about strong mutuals possibly having to look at their strength and consider how the interests of their existing members are best served are fair. It is not a point which occurred to me when giving my comments in Appendix B, but I think that, at least for the moment, it is also true and fair to say that the benchmark is how much the strong mutual should distribute to be able to compete, and compete effectively, in the market place.

An issue which, perhaps, has not attracted much attention in this discussion has been the fact that, sometimes, there can be a conflict between the interests of policyholders and the interests of members when you are looking at the CFA as a benchmark for comparison with, say, demutualisation. It is important to remember that it is not always just the with-profits policyholders who are the members of the organisation. I have certainly seen a number of mutual organisations where the with-profits policyholders have been only part of the membership. Clearly, when you are trying to compare the benefits of closure with the benefits of demutualisation, there is a real conflict there which has to be resolved.

I have had some recent experience of how other jurisdictions tackle some of the legal moves that arise in this area. One, in particular, has recently enacted some demutualisation legislation for insurance companies. I would like to put Mr Allen's mind at ease. I do not think that we need more legislation. I think that this is an area where pragmatism, rather than legal prescription, is a better solution. There are very many competing factors which need to be taken into account in these transactions. In my experience, the circumstances with which one is dealing are often very different, case to case. An overly legislative, and overly prescriptive, approach is not one I favour personally.

Mr N. H. Taylor, F.I.A. (closing the discussion): Throughout my actuarial career I have lived with the CFA. When I started, the office that I had joined had just become a mutual — in fact, it has now just become a non-mutual. The wise old bird of a barrister who was company secretary took great joy in telling the actuaries that we should now close the office so that the with-profits policyholders could get all the money. I never fully agreed with him, but the actuaries were cautious enough never to do any figures that might prove him right!

My view then was that it was the unquantifiables, such as investment policy and management difficulties, that could be the real problems. These days the latter can certainly be outsourced. We have had mention of that from the opener, and Mr Thomson commented on that in more depth. Mr Urmston said it should be considered by an office at all times.

The paper has also brought up what seems to be the old chestnut of the role of the independent actuary and how wide it should be. I have undertaken this role on quite a number of occasions in the last few years, and I was also a member of the GN 15 Working Party. That was supposed to get the

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work done in about three months, but we took about three years. The problem, as I see it, is that the Act makes it quite clear that the duty is to report on the scheme, and it goes no wider than that. GN 15 puts some icing on the cake, and quite rightly suggests that we should look a bit more widely. Whether we should extend this to looking at CFAs, or any other alternatives, was a point that the GN 15 Working Party debated, and then threw it back to the Councils.

My view is that there are really two roles for an independent actuary. There is a formal one of preparing a report on the scheme in accordance with GN 15, and the other role is to consider the alternatives, and that includes the CFA, as Mr McLean pointed out, and this is where the terms of reference may well be set by the parties involved together with the FSA. Mr Allen was keen on that.

What the FSA should certainly not do is to interfere with the terms of reference of the independent actuary's statutory role. What generally happens is that the whole thing gets rolled into one. The independent actuary writes one comprehensive report. I have met some strong resistance from lawyers to companies regarding the wider role. They believe that the alternatives are the responsibility of the directors and their advisers and, as Mr McBride said, also the Appointed Actuary. I have also met the absolute opposite. I cite one of the current major demutualisations, where, very early in the bid process, I was asked to consider the advice given by the office's advisers to confirm that I believed the decision to accept a particular proposal was appropriate. There was no doubt in my mind that this office wished to add an additional layer of protection to their policyholders' interests which an independent actuarial review would bring. Mr Thomson suggested that this might be a burden on the independent actuary. It was not. I have to say that I found it most interesting.

Confidentiality is a problem here. In this particular case I got full information on all the bids; I got papers that went to the board; I got the merchant bank reports; but my report is not in the public domain. What worries me somewhat is that it could go into the public domain because, as the transfer goes ahead, I refer to it in my independent actuary's report on the transfer. Therefore, I had to be careful how I wrote it.

Moving on to the CFA. In theory, we tend to think of looking at this when other ideas are put forward for the future of an office, but I see this as but one option. There is the status quo; demutualise with a choice of bidders, and I have to say that the top bidder might not always be the preferred choice; and the CFA. I believe that directors should regularly review these options as part of their planning process. They should not wait until someone knocks on the door with a promise of many Australian dollars, or, even worse, let the office weaken until action is vital. Mr Chamberlain hinted that, as an adviser to the FSA, the GAD might well take a pretty tough line on this. Mr Wright suggested that mutuals that have to subsidise new business should think seriously about closing.

Certainly, when I was planning manager of a mutual life office these issues were on the table, and I know that they were on the table in a number of other offices, because the planning managers used to discuss the types of things that we were looking at. I am pleased to note that Mr Chamberlain suggested that this is something that the GAD would look at as regards sound and prudent management.

I add a note of caution. Mutuals are jealous of their status, and it fits well with some of the current Government's views. Policyholders do not expect windfall gains. Mr Jenkins pointed this out. You realise from my remarks that I do not agree that the CFA should only be considered at the time of demutualisation, which he did.

I am involved in one of the current demutualisations. That effectively closes the fund, and this is where the paper is possibly a little bit behind the times. There are sums paid for goodwill, and capital support is available. It is interesting to discuss how this fund will be managed, allowing for an asset share increase at outset, and with the need to distribute the estate equitably. This gets you into real time, rather than the example in the paper. It is difficult to distribute the estate, and it certainly has taxed the Appointed Actuary and his team, with a knock-on effect to me. Obviously, certain CFA problems disappear in this case. The operations become part of the new owner; there is a new office to write new business; expenses get guaranteed; and the staff have good or even better prospects. However, in a closed fund with target solvency, what target solvency do you go for when you are trying to distribute the estate equitably? Investment management and bonus strategy have to be sorted out. What is important is the provision to merge the closed fund, or to switch it to a non-profit basis, when it falls to a given size. This helps to avoid getting into the tontine effect. I was glad that Mr

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Snelson developed this subject. I regard it as a most important one, which should always be covered in a comprehensive document setting out the principles of the future management of the business.

The other thing is compensation for loss of voting rights. There seems to be a small cash sum — £250 to £500 seems to be the going rate — and it is difficult to comment on this subjectively. Then there are the other membership rights which, possibly, are a share-out of the surplus on a wind-up for the with-profits policyholders.

In the evaluation, I liked the closeness of the example, although this sort of analysis is likely to go over the heads of policyholders. Thus, it is important that we take great care and encourage directors to ask the right questions. Some cases may show the CFA in a favourable light, although we have had speakers suggesting that it would not. The Clerical Medical circular seems to suggest that it could have been a close run thing. In others it is perhaps more obvious, but a full analysis should still be made. I agree with Mr Thomson that, to some extent, the CFA probably provides a benchmark.

Providing information to policyholders is a problem. In the merger cases that I have been involved in, the information has run from just a couple of sheets with a letter from the managing director, a summary of the scheme and a summary of my report, usually just the conclusions — and that really is the statutory minimum — right up to more than 100 pages.

Guidance is a subject that has not really come into the discussion, but it has certainly been questioned: do we want to give more professional guidance to the Appointed Actuary? Is it necessary? Should we insist on the CFA being looked at? If we give guidance, should it be more like GN 15, where we use examples?

As a matter of course, an Appointed Actuary will prepare a report for the directors. I suppose that it is this that the guidance would turn its attention to. Again, if this is going to go into the public domain, the Appointed Actuary is going to write it with the policyholders in mind more than the directors, or, perhaps, prepare two reports: one for the board; and one for the public. I am none too sure about public Appointed Actuary reports, despite the tradition that has been built up in the major cases. It could be just another document that the public feels that it has to read.

There is a question on policyholders' perspectives of the attractiveness of the closed fund. Do they feel comfortable sitting in a closed fund? That is where the new approaches used by Scottish Amicable and the NPI, which were effectively closed, but are part of a major thriving organisation, may be seen differently by the policyholders.

Some of my conclusions tend to be a little different from those of the Working Party's. I believe that the CFA and the other alternatives should be considered regularly as part of the proper strategic planning process. I am not sure whether Appointed Actuaries need more guidance. The independent actuary's interpretation should be as wide as appropriate.

Concerning the appendices, I was fascinated by Appendix B, where Mr James wrote that the directors owe a duty to the company rather than to its members, and must also consider future members. Certainly this does not seem to be in line with traditional thinking, but I guess that it is in line with modern corporate interpretations of the law. It certainly means that my view that the largest mutual in the country should wind up is no longer such a viable suggestion.

I was interested in the comments of Mr Young on the problems of U.K. company law. Ms Pell kindly gave us the legal position on changing voting rights, both pre and post announcement. That was partly to avoid some of the carpet bagging. She also commented that, if directors require members to vote, they will need all the options set out.

It behoves us, as actuaries involved in a demutualisation, to look widely at all the issues and all the alternatives: the Appointed Actuaries; the consulting actuaries; and the independent actuary. The company's actuaries must look after their policyholders' interests, and they must also make sure that communications to policyholders are intelligible — and that is something that the independent actuary has a role in as well. The independent actuary should make sure that all the alternatives — and that includes the CFA — have been properly evaluated. However, the decision on what to include in his or her report on anything other than the scheme will depend on each case, the independent actuary's own views, what the directors would like, and partly what the FSA would like. Certainly, as a profession — and I am glad that we have FSA backing on this — we should encourage, but I do not think force, directors to ask the independent actuary to review the alternative proposals.

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Mr M. Arnold, F.I.A. (replying): I think that the amount of support we have had for most of the comments included in the paper is generally reassuring. There have been a relatively few serious differences of view coming from those who have spoken in the discussion. Where there were differences, I felt that they were mainly of emphasis rather than of fundamental principle. I think that the majority of the Working Party would agree with virtually all of the circumstances raised by the various speakers, where they felt that the CFA should be considered. They would agree that there are circumstances, other than demutualisations, when directors and actuaries involved should consider the CFA. Comments in the paper, in particular in ¶2.1.8, were not meant to exclude the circumstances to which Mr Chamberlain or Mr Wright referred.

In terms of some of the points that were raised on the CFA, in practice we would want to emphasise the point about the risk profile of closed funds. There is brief mention in ¶3.6.2 — and Mr Thomson referred to it — and maybe we could have made more emphasis on placing sufficient recognition on the riskiness of running a closed fund. Mr Snelson raised some interesting points about what happens when funds are allowed to run closed for long periods of time. That highlights the point that the end game should be considered sooner rather than later when considering the closure of the fund, and the option of transferring to other insurers should be considered at as early a point as possible.

There were not many comments on the numbers. We should take on board Mr Froggatt's comments, and look again at the value placed on the future of shareholders' transfers. Maybe there is a point there. We should have highlighted the fact that the value of the shareholders' transfers could be different from the policyholder's perspective as compared to the shareholder's perspective.

There were a number of comments on recent demutualisations, particularly Scottish Amicable and the NPI. They may well set a new benchmark for CFAs, particularly while there are enough 'Big Fish' around to provide the support that has been provided in those two cases. Those are two particular forms of CFA which are not in a form which we, as a Working Party, would probably propose should be the benchmark against which other alternatives are considered.

I should like to reassure Mr Wright that the comment, in ¶5.5.3, was not intended as any form of criticism of any particular transaction.

The President (Mr P. N. Thornton, F.I.A.): We are living through a consumer era in which the degree of interest of policyholders in how their funds are managed is probably higher than ever before. The experience of building society demutualisations has led to almost an expectation of windfalls, which is obviously a contradiction in terms. I believe that it is essential for our profession to be very clear about how we deliver value to policyholders. I speak as a policyholder in what I hope is at least one large, strong mutual company, one closed fund, as well as what I hope is a large, strong proprietary company. It sounds as if I have hedged my bets alright!

The paper throws light on the question of policyholder value, and is very welcome. It has generated a good discussion. I express my own thanks and, I am sure, the thanks of us all, to the authors, the opener, the closer and all who participated in the discussion.

WRITTEN CONTRIBUTION

The authors subsequently wrote: The Working Party is very grateful to all who took the trouble to prepare and deliver comments on the paper, with particular thanks to the contributions from our visitors from the legal profession and from the government. Many helpful and thoughtful points were made. Some speakers differed with us according to the degree of emphasis placed on various aspects of the issue. We believe that these differences will be helpful to the reader new to the subject, in seeing more clearly the various issues and scope for judgement.

We reiterate the points made by Mr Arnold of our Working Party in his response on our behalf at the end of the discussion. The paragraphs that follow amplify and extend his remarks.

We recognise that the topicality of the subject made it almost inevitable that the discussion was somewhat more wide-ranging than our paper. This was to be welcomed, and members of the Working

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Party have sympathy with many of the points raised. However, we confine ourselves in our comments to matters within our terms of reference.

The opener and others wondered whether some of the 'deals' that have been struck for policyholders in certain recent demutualisations mean that the CFA should be replaced with a different test that combines its advantages with other features that mitigate its disadvantages. The Working Party would not agree with this. A key feature of the CFA is that it is a strategic option that is available at the sole initiative of the company. These other deals are not within the power of the members and directors, acting on their own, to deliver, and we do not feel that it could be said that instances of these deals are now sufficiently numerous that they constitute a sort of generic benchmark. Of course, if the company has built up a valuable brand, salesforce or other advantage, it may be able to 'trade' this for extra features in the final 'deal', such as those that have appeared in recent demutualisations. Recent demutualisations have probably raised policyholders' aspirations, but they have not, in our view, raised fundamental entitlements. Such matters are, however, beyond the scope of our paper.

Some confusion seems to have existed as to the Working Party's views on application of the CFA in circumstances other than demutualisation. Maybe we should have extended our comments in ¶¶2.1.4 to 2.1.8, where we refer to circumstances in which remaining open to new business could have a detrimental impact on existing policyholders' reasonable expectations, but we do draw readers' attention to these paragraphs. We should, perhaps, stress that ¶¶ 2.1.7 and 2.1.8 are not intended to be read independently of our comments in ¶¶ 2.1.4 (last sentence) and 2.1.5. These refer to circumstances where remaining open for new business could have a detrimental impact on existing policyholders' reasonable expectations, and in which consideration of a CFA is appropriate. We re-emphasise our view that it is the duty of directors to weigh and act on such matters. We understand that, at any time that new business was being written at a loss, the directors would want to consider many related matters, including whether such a situation was likely to be long lasting or short term, and whether it was sufficiently severe to impact adversely the adequacy of the company's capital. We would agree than an Appointed Actuary who came to the view that the company showed no prospect of breaking out of a spiral of never-ending losses on new business should make suitable representations to his/her board. We would share Mr Chamberlain's concern that the paper: "not be seen as providing a crutch for a weakened and directionless mutual to lean on whilst the policyholders' returns suffer more and more". We have never so regarded the paper.

In his remarks, Mr Wright made the point that the valuation requirements to make advance provision for first-year costs of closure (Regulation 71(1)) would surely be released on the company ceasing to write new business, thereby substantially mitigating the effect of incurral of those costs in practice. We understand the point, and agree that, in a number of cases, it would be valid. We should, though, draw attention to paragraph 3.5.4.1 of GN 8, which sets out circumstances in which no explicit Regulation 71(1) reserve would need to have been established in respect of an acquisition expense overrun, and hence in which there would be some reduction in free assets, as described in the paper.

We had no intention, by the use of the word 'appear' in ¶5.5.3, of signalling objection to any particular scheme. The word simply indicated that a conclusive comment would require greater in-depth examination of the particular circumstances than we had given.

We are grateful to those speakers who drew attention to various practical issues: to the risks and different risk profiles inherent in the closed fund situation (albeit there are plenty of risks in continuing to transact new business!); to the importance of giving substantial consideration from outset to what Mr Snelson described as the 'end game'; and to the availability of outsourcing services (though decisions on whether, and in what, aspects of the business to outsource will depend on the circumstances, e.g. the size of the company). Perhaps we were a little light on these aspects in our paper, and, if so, the discussion has provided a welcome strengthening of emphasis.

We were grateful to Mr Sanders for his points on managing benefits once one is in a closed fund situation. Although we touched on this in Section 3.5, we, of course, recognise that this is a substantial subject capable of considerable further development. We would like to draw attention to our remark, in ¶3.5.5, about managing policyholder expectations in the new situation, most especially within the consultations that would have taken place at and around the time of fund closure. PRE may

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well change on conversion to a closed fund, not least in respect of the form in which benefits are provided, and in the prospect (for policyholders with many years to go before maturity) of whatever arrangements may be appropriate for 'the end game'.

Mr Froggatt's point about the need for care with risk discount rates is of course wholly valid. The figure for the value of shareholders' share of with-profits surplus is, within the scope of the example, a 'realistic' value from the fund/policyholder perspective, and it is certainly the case that shareholders could take a different view. The issue was discussed within the Working Party, and it was felt that we should keep the example reasonably simple, with symbolic numbers only. Our comment, in ¶4.1.4, that: "in practice, the financial and non-financial issues will be significantly more complex than in this simplified example, which is intended to illustrate only certain of the high-level financial principles involved", was intended to convey a suitable warning of the presence of a number of simplifications. In actual cases such real complexities would, of course, have to be given due consideration.

Although our terms of reference were not explicitly limited to life business, we did understand that our brief did not extend to building societies. We would welcome seeing some consideration of whether a parallel to the CFA was appropriate to such institutions, though a mutual building society is, in many ways, a very different animal to a mutual life insurer. A difficulty would be the open-ended nature of a building society savings account.

Several speakers touched on a few 'professional' points. We do not feel that Appointed Actuaries and independent actuaries, in practice, have any undue problems working together — in any case, they have different reporting lines; and, while we support strongly the concept that independent actuaries should interpret their brief widely, this is not at all the same as suggesting that the independent actuary has to consider whether the scheme is the best among all possible schemes. It is, in our view, clearly the directors' role to take every reasonable step to secure the most appropriate deal.

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