PAR ACCOUNT RESTRUCTURING IN CANADIAN COMPANY DEMUTUALIZATIONS

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1. PREAMBLE

1.1 Purpose

This note will outline a model for the structuring of par and Shareholder Accounts after demutualization. The model was developed with a focus on the four large Canadian companies that have announced plans to demutualize. Variations from this model will require substantial justification.

1.2 Guiding Principles

The model recognizes the following objectives relating to demutualization:

- It provides for future policyholder benefits.
- It maintains the company's financial strength.
- It mitigates intergenerational inequities.
- It delivers the entire value of the company to eligible policyholders.
- The resulting company should be on a comparable operating footing with other stock companies operating with par funds.
- The approach should be consistent with demutualization rules in other countries.

2. ACCOUNT STRUCTURE

2.1 Total Par Accounts

The Par Accounts will consist of two distinct components, as explained below. The attached table illustrates this proposed model.

The total par surplus should not be negative at any time over the five years after demutualization. Companies will include in their Conversion-Proposal projections the level of par surplus over the five years after demutualization to confirm that adequate surplus has been retained in, or transferred into, the Par Accounts to cover anticipated strain.

2.2 Dividing Line

Generally, it is expected that the In-Force Component will include all par policies sold up to the time of demutualization. The date of demutualization is the preferred dividing line for six reasons:

a. Up until this date, companies have continued to sell the same policies and policyholders have the same dividend expectations as those prior to the announcement. Therefore, these policies should be afforded the same protection of expectations as those sold before the announcement.

b. Of particular note, policyholder dividend expectations on those policies have not allowed for the shareholder transfers (under section 461 of the *Insurance Companies Act*) that will apply to dividends on policies outside the In-Force Component.

c. The In-Force policyholders funded the new business strain for business after the announcement date, so any repayment of strain on that business should stay in that component.

d. Companies have identified greater administrative ease with this date.

e. The bulk of foreign precedents have used this date.

f. The New-Business Par Component refers to policies outside the In-Force Component.

2.3 In-Force Component

2.3(a) Closed Block

There will be one or more Closed Blocks to provide for existing policyholder benefits. At demutualization, each will contain the following:

- policy liabilities for guaranteed benefits and Policyholder Reasonable Expectations (PRE) on a best-estimates basis; and
- provision for agreed settlements on Market Conduct. It is desirable to separately identify this provision.

If the company anticipates making any artificial dividend support, such as compensating for declining interest rates, the provisions for doing so should be in the Closed Block.

2.3(b) PFAD Related to the Closed Block

Under paragraph 462(d) of the ICA, Provisions for Adverse Deviations (PFAD) on existing business will be transferable to the Shareholder Account as they are released from liabilities. The Conversion Proposal will document the process, including methods, assumptions and related estimates, under which PFAD will be released in the future. Additional supporting detail will be provided to OSFI.

2.3(c) Ancillary Block

The Ancillary Block can include:

- any policies or benefits for which no specific dividend is payable;
- any policies or benefits where the PRE is zero dividends; and/or
- any dividends or other amounts on deposit.

It must be clearly demonstrated that profits on these elements are not required to support PRE in the Closed Block and that the PRE for these elements do not include dividends. The Conversion Proposal must document the process, including methods, assumptions and related estimates, under which profits will be released in the future.

2.3(d) Future Market Conduct Settlements

If Market Conduct disputes are settled in the future, money will have to be transferred to the In-Force Component from the Shareholder Account.

2.4 New Business Par Component

A second par component will be established to cover new business. At demutualization, the component will contain only the seed money to cover anticipated par new-business strain. As the component operates over time, it will include:

- policy liabilities for guaranteed benefits and PRE, including PFAD;
- additional strain support from shareholders (if required); and
- contributions to par surplus from new business profits.

The seed money at demutualization should be sufficient to cover at least five years of new par business. The seed money will be recoverable under paragraph 462(c) of the ICA. Additional seed money contributions could be required, depending on sales and business experience over the five years after demutualization.

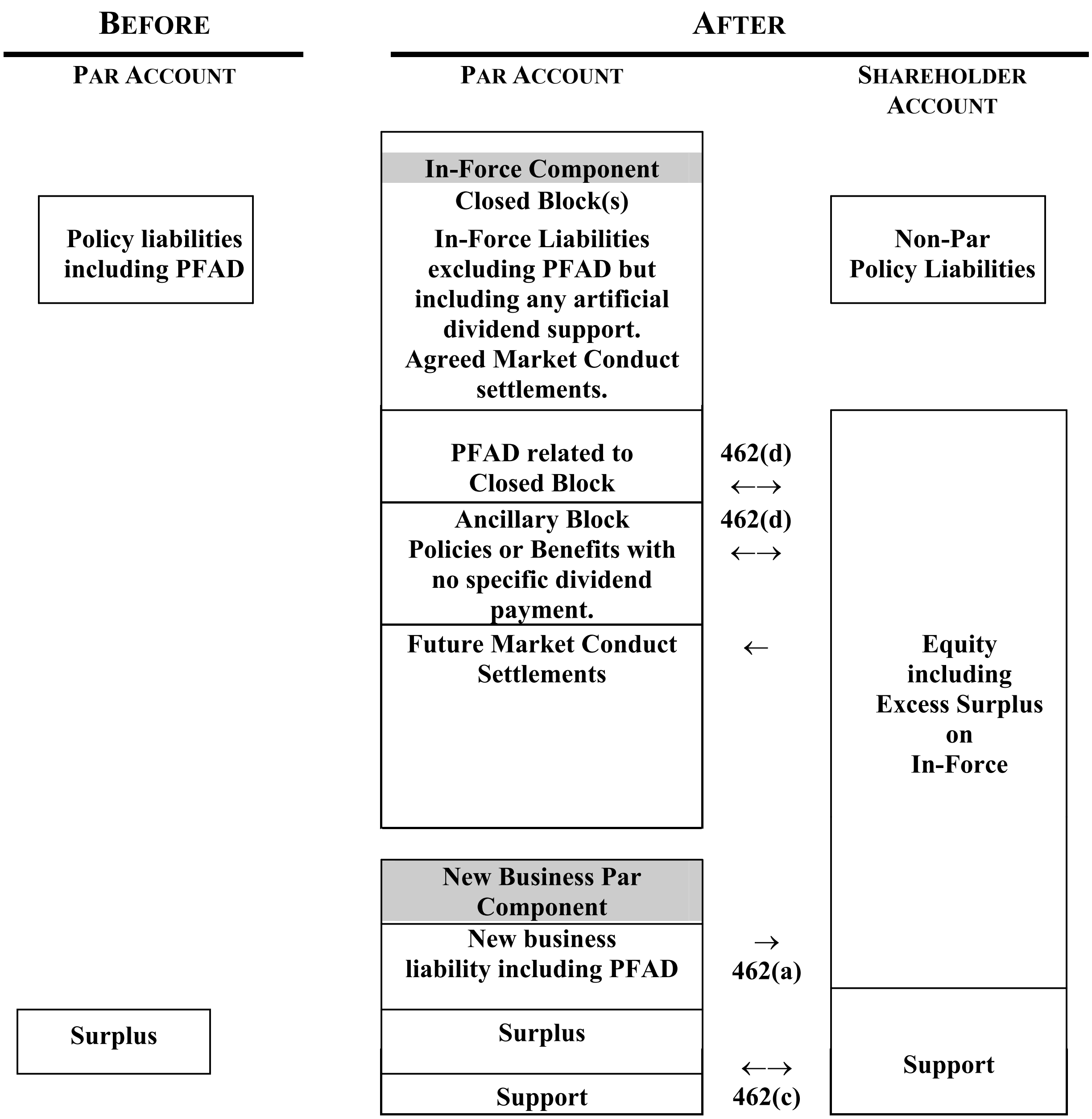
2.5 Shareholder Account

The Shareholder Account at demutualization would have any remaining surplus not required by the Par Accounts.

In future, the Shareholder Account will reflect:

- strain of writing new non-par business;
- future profits on non-par business;
- releases from the PFAD related to the Closed Block and the Ancillary Block under paragraph 462(d) of the ICA, or the cost of any strengthening required;
- repayments to the shareholders of new par seed money under paragraph 462(c) of the ICA;
- transfers to the Shareholder Account under paragraph 462(a) of the ICA; and
- any additional costs of existing or future Market Conduct settlements.

2.6 Structure of Par Accounts



3. RATIONALE AND IMPLICATIONS

3.1 PFAD in Par Account

The PFAD should remain in the Par Account for three reasons:

a. It would be inappropriate to have a negative par surplus, or to sharply reduce the size of the PFAD and hence the Par Account at the time of demutualization.

b. It would be inappropriate to have the demutualized companies operating under different reporting rules than existing stock companies.

c. The proposed mechanism for orderly transfer of the PFAD as released addresses the concerns about ensuring that market participants give adequate value to these provisions.

3.2 Shareholder Mechanism vs. Policy Dividend Mechanism

Share value or share dividends are the recommended mechanism for transferring conversion benefits to policyholders. The dividend mechanism, however, should be used for going-concern gains or losses. Shares offer four advantages over policy dividends:

a. Non-depletion of Company Cash – Use of shares avoids paying out large amounts of the company's surplus cash as policy dividends.

b. Intergenerational Equity – Paying a lump sum value in shares rather than policy dividends allows benefits to be realized in the hands of the current generation of policyholders.

c. Flexibility – The use of shares gives policyholders the option of either holding or selling shares.

d. Tax Effectiveness – Share distributions to policyholders generally have a lower effective tax rate than policy dividend enhancements resulting from a demutualization.

3.3 Shareholder Return on Par Seed Money

Paragraph 462(c) of the ICA allows the shareholders to receive back the seed money they placed in the par component. The Act is silent on the effective rate of return to be paid on that seed money, but the Act allows sufficient discretion to manage the calculations so that a reasonable asset-related rate of return can be paid to shareholders for that capital.

3.4 Acceptability Worldwide

It is assumed that In-Force Liabilities in each jurisdiction are based on the Canadian Policy Premium Method including the PFAD. It is expected to have a separate Closed Block for each jurisdiction.

The Closed Block approach should be acceptable in the U.S. because that has been the normal model there. The U.S. has not had discussions about PFAD because their reserving methods do not make an explicit allowance for PFAD.

In the U.K., the historical practice has been that "excess estates" (surplus) be returned through the policy dividend mechanism over the lifetime of the policy rather than through the share mechanism at the time of conversion. However, there are precedents for using the shareholder mechanism and initial discussions suggest the approach in this document should be acceptable. Minor modifications may be necessary to comply with U.K. legislation.

To the extent that the approach used in any foreign jurisdiction differs from that outlined in this document, the Independent Actuary must comment on the fairness and equity of the Conversion Proposal to all policyholders.

4. Conversion Proposal, Initial Report and Operating Rules

4.1 Initial Requirements

The company's Conversion Proposal will include a report and a statement of Operating Rules for the Closed Block, as explained in this section. Detailed technical and confidential information may be provided in an expanded report to OSFI.

The Proposal, the Actuaries' Opinions and any other information in the Policyholder Information Circular must provide to policyholders a clear description of the proposed transaction and its financial impact to the company and its policyholders. The Conversion Proposal must include estimates of transfers to the Shareholders Account in current and future years, and a description of the methods and assumptions used. Additional material to OSFI should separate these estimates for each of the PFAD related to the Closed Block and the Ancillary Block.

4.2 Definition of Closed Block

The initial report will clearly describe which business is included in the Closed Block, the Ancillary Block and the New-Business Component.

The definition should include a statement of what date has been chosen as the dividing line between the In-Force Component and other business (e.g., eligibility date or conversion date), and explain why the chosen date is considered to be fair.

The Closed Block can either include or exclude Amounts on Deposit and policies or benefits for which no specific dividend is paid, such as term riders or supplementary benefits. The report should include an explanation of why whatever choice was made is considered to be fair and consistent with PRE.

4.3 Direct Cash Flows

Generally, cash flows which can be clearly identified with the Closed Block should be credited or charged to the Closed Block. This would include premium payments, commissions, claims and direct taxes such as premium tax. Some categories of cash flow may be given special treatment, as noted below.

4.4 Asset Quality and Investment Policy

For the sake of consistency with the valuation of liabilities, assets placed in the Closed Blocks of each jurisdiction should be valued according to the Canadian rules.

The company will include a statement of current investment policy which covers specifics of the intended asset mix by asset category, duration and asset quality.

The assets placed in the Closed Block should meet four quality criteria:

a. They should have similar quality, risk and return characteristics to the assets currently backing the business.

b. They should appropriately reflect the nature of the liabilities.

c. They should be supportable by cash flow analysis.

d. They should not include shares of subsidiaries or affiliates.

Where the company will maintain a large investment pool with objectives and disintermediation risks similar to those of the Closed Block, the Closed Block may hold a portion of that pool, provided the criteria for the Closed Block assets can be demonstrably met, management discretion to move assets into or out of the larger pool is appropriately restricted, and so appropriate mechanisms exist to track the holdings of the Closed Block in the larger pool.

4.5 Expenses

Expenses and taxes may be allocated using appropriate techniques.

If administration expenses assigned to the Closed Block are fixed, indexed or zero, the rationale for this and its effect on PRE should be explained.

If expenses charged to the Closed Block will be an allocation of actual expenses, the report should include two factors:

a. the bases for splitting total general expenses between first-year expenses and renewal expenses and between par and non-par policies on all blocks of business.

b. The bases for defining new development expenses and for splitting these between first year expenses and renewal expenses and par and non-par policies on all blocks of business.

4.6 Claims

Normally, a company will charge all relevant claims costs directly to the Closed Block.

Alternatively, where the company has a larger pool of business with mortality or morbidity experience that is expected to be similar to the Closed Block, the company may pool that business with the Closed Block for purposes of charging claims costs to the Closed Block. The following restrictions apply:

a. The nature and extent of the pooling must be consistent with expected claims.

b. Management discretion to alter the pool is appropriately restricted.

c. The mechanism for pooling, including details on how and when transfers to and from the Closed Block will take place, should be described.

d. The pooling mechanism must clearly track the charges to the Closed Block in a fair and equitable manner.

4.7 MCCSR Capital

MCCSR may explicitly be supported by shareholder capital without requiring any transfers into the Participating Accounts. Companies may set their own targets for MCCSR capital in the Par Account.

4.8 Tontines and Terminating the Closed Block

The initial report should generally describe the point or the conditions at which the company expects to terminate the Closed Block and the basis for determining dividends thereafter. For instance, if there is some minimal number of policies or minimal revenue level at which the company would terminate the Closed Block, it should disclose its intentions. The termination procedure should also discuss how the company will avoid a tontine effect to the declining number of Closed Block policyholders. For example, if dividends will be adjusted periodically to ensure no tontine is occurring, the company should explain how it intends to monitor this issue, what corrective actions would be taken, and what conditions would trigger such action.

4.9 Support from Outside the Closed Block

The company should describe conditions under which the Closed Block could get support from the shareholder fund. If the company intends to maintain dividend scales beyond that which could be supported by direct experience of the fund, the company should explain how this discrepancy will be recovered. For instance, if dividends would have to be eventually adjusted to recover the difference, the company should explain how big such a discrepancy could become before dividends would be adjusted. Alternatively, if the plan is to provide such support from outside the Closed Block, the company should explain how much support will be provided and confirm that there is no expectation of eventual repayment to that source.

4.10 Projections

The company must include projections for both the Closed Block component separately and the Par Accounts in total showing future surplus levels. The forecasts must be on both a best-estimates basis and on various plausible adverse scenarios covering a period of at least five years. If the company's intention is to manage policyholder dividends so that the Closed-Block surplus is effectively zero, the company should disclose this information. The company should include forecasts of the amount of dividends to be paid under a best-estimate scenario and various plausible adverse scenarios.

5. ONGOING REPORTS AND OPINIONS

5.1 Changes in Operating Rules

The approval to demutualize is given on the understanding that a company will operate on a basis consistent with the Operating Rules, methods and assumptions included in the Conversion Proposal. It is recognized that changing circumstances may legitimately require revisions to these rules. However, such Operating Rules, methods and assumptions may only be changed with prior approval from the Superintendent based on a report from the company's Appointed Actuary explaining the need for those changes. The Superintendent may require an opinion from an Independent Actuary that such changes are reasonable in light of changing circumstances and that the interests of the Closed Block policyholders are still being protected.

5.2 Reports

An annual report will be required from the Appointed Actuary listing the following:

a. A financial analysis of the experience in each of the participating accounts over the past twelve months.

b. A projection of the surplus in the closed component on its own and the Par Accounts in total.

c. A projection of the gain/loss position of the closed component.

d. The identification of accumulated gains or losses in experience fluctuation accounts (if applicable).

e. The dividend recommendation (or most recent dividend recommendation).

f. A description of other factors influencing the dividend recommendation, e.g. competitors' actions.

g. The ongoing disclosure of par PFAD, and Closed-Block PFAD. If any changes occur in PFAD, a justification for those changes should be included.

5.3 Ongoing Opinions

The Appointed Actuary will be required to give opinions on an annual basis in response to the following questions:

a. Are the participating accounts being maintained in accordance with any commitments made at the time of demutualization, including the Conversion Proposal, the Operating Rules and any related reports?

b. Are the assets in the Closed Block sufficient to provide for the contractual benefits, plus reasonable policyholder expectations of non-guaranteed elements? Are dividends being managed in a way that neither a material surplus (tontine) nor deficit situation develops?

c. Is the dividend recommendation in compliance with the dividend policy (or policies) of the company?

d. Are allocations of investment income, expenses, etc. between the account fair and equitable? Are the allocations being determined on the basis outlined in the Operating Rules?

e. Is the asset mix consistent with the prior period and with the Closed Block investment policy?

If assets are to be withdrawn from the new business par component (paragraph 462(c) of the ICA), an opinion will be required that the remaining assets in the account are sufficient to meet the contractual policy obligations, the reasonable future expectations of the policyholders, and the projected capital requirements of the account.