

SUBMISSION

BY

ECONOMICAL MUTUAL INSURANCE COMPANY

TO

THE DEPARTMENT OF FINANCE CANADA

WITH RESPECT TO

THE CONSULTATION ON A DEMUTUALIZATION

FRAMEWORK FOR FEDERAL PROPERTY &

CASUALTY INSURANCE COMPANIES

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A. Policy Objectives

The policy objectives for life companies were: a) providing fair and equitable treatment to policyholders, b) maintaining safety and soundness, c) fostering a competitive and efficient sector, and d) establishing an orderly and transparent process.

- 1. What should be the policy objectives for the demutualization of P&C companies?*
- 2. Are these also appropriate in the P&C context, and if so, should they be applied to P&C companies in the same manner or differently?*

Discussion

The Canadian P&C insurance industry traces its roots back to the early 1800s, when insurance protection against fire and weather became of increasing concern among farmers and merchants. As fire insurance in small communities was expensive and difficult to obtain, groups of similarly-situated and like-minded business interests pooled their resources to create “mutual” insurance companies to offer one another protection against catastrophe. With this backdrop, Economical was founded in 1871 as The Economical Mutual Fire Insurance Company of Berlin. Similar to other mutual companies at the time, Economical was a community-based insurer offering protection to its members (who shared in the mutual risk of loss) against the danger posed by fire to properties and businesses.

For more than 120 years, Economical has offered both mutual policies and cash policies to its customers. A mutual company with limited access to external capital would look to its mutual policyholders to underwrite the risk associated with its operations. By-laws were enacted by mutuals that required all mutual policyholders to sign a promissory premium note (a "Premium Note") that obligated mutual policyholders to meet future capital calls. In Economical’s case, mutual policies were written for a three-year period instead of the one-year period for cash policies. The terms of the Premium Note provided that a mutual policyholder was liable for up to three years of additional fire premium in the event that Economical needed additional funds to pay its claims. Economical’s directors had the right to demand payment on the Premium Notes at any time. This was a court-enforceable obligation. It exposed mutual policyholders to the risk of financial loss if the mutual insurer suffered a financial loss, and was consistent with the mutual self-insurance feature that caused mutual insurers to be formed.

As a result of provincial restrictions in the *Insurance Act* (Ontario) which restricted the sale of policies on a Premium Note system to fire, livestock and weather, the amount of the Premium Note was based on the fire component of a typical homeowner’s mutual policy that also includes liability and other coverages.

Historically, mutual insurance and Premium Notes were inextricably linked. An early definition of "mutual insurance" in section 11 of *An Act respecting Insurance Companies*, R.S.O. 1887, c.167, is "insurance given in consideration of a premium note or undertaking...". A more recent definition in section 1 of the *Insurance Act*, R.S.O. 1980, c.218 1990 is "a contract of insurance in which the consideration is not fixed or certain at the time the contract is made and is to be determined at the termination of the contract or at fixed periods during the term of the contract according to the experience of the insurer...". However, in 2000, the *Insurance Act* (Ontario) was amended to repeal the provisions dealing with Premium Notes. Thus, the very essence of mutual insurance was in its origins the assumption of contingent risk, in exchange for which the mutual policyholder received ownership rights, including the right to vote and the right to receive surplus distributions, as determined from time to time by the Board of Directors.

Those who elected to purchase a mutual policy, in spite of its obligations, sought to have direct ownership in Economical, voting rights over Economical's affairs and some level of stewardship over its operations. By purchasing a mutual policy, mutual policyholders demonstrated their support for their insurance provider, their commitment to the Kitchener-Waterloo region in which many lived and worked, and served as backers of one of Canada's leading insurance entities.

Since at least the 1930s, Economical as a mutual company has had to compete with stock companies which issue only cash policies. The Premium Note feature proved to be a major impediment to brokers' efforts to sell mutual policies relative to the pure insurance features of a cash policy. The reason is simple. The premiums for a cash policy and a mutual policy covering the same property risk are the same. However, to purchase a mutual policy, a customer had to also sign a Premium Note obligating the customer to pay up to an additional three years of fire premium should Economical need additional funds to pay its claims. As a result, in order to remain competitive with stock companies, cash policies became Economical's predominant method of selling insurance.

In Economical's case, the change in the *Insurance Act* (Ontario) which removed the requirement for Premium Notes, the significant growth in its surplus starting in the 1990's and the fact that the amount of extra capital that could be raised by calling on the Premium Notes no longer justified the administrative burden of obtaining these notes, allowed the Company to consider discontinuing the use of Premium Notes. In 2008 the Company brought forth a recommendation to the mutual policyholders to amend the by-laws and eliminate the requirement for the Premium Note. The mutual policyholders voted in favour of this by-law amendment. However, 88% of Economical's current mutual policyholders became mutual policyholders before 2008 and were required to sign Premium Notes in respect of their mutual policies prior to 2008. Over 75% of Economical's mutual policyholders have held mutual policies for over 10 years and 45% have held mutual policies for over 20 years. Accordingly, a large majority of Economical's mutual policyholders were exposed to the risk of financial loss for many years.

Concern has been raised that some P&C mutuals, like Economical, have a small number of mutual policyholders as compared to their cash policyholders. The inference is that this situation is quite different from the situation of the federal life mutuals that demutualized in 1999 and 2000. There are good and valid business-related reasons for the differences between the voting policyholder bases of the federal P&C mutuals and federal life mutuals. Of the four large federal life mutuals that demutualized in 1999 and 2000, only one (Mutual Life) was originally established as a mutual insurer. The other three converted from stock companies to mutuals in the late 1950's and early 1960's to avoid foreign takeovers. These companies operated in a different competitive environment than the P&C mutuals. Firstly, they were the dominant players in the Canadian life insurance market. Secondly, their stock life company competitors also issued participating (and, therefore, voting) policies. Thirdly, participating policyholders were not required to sign Premium Notes and, as a result, they were not exposed to the risk of financial loss. Accordingly, the life mutuals could continue to offer participating policies at no competitive disadvantage. As noted above, P&C mutuals like Economical could only compete effectively against P&C stock insurers by offering cash policies which did not require that policyholders undertake the financial risks of signing Premium Notes. Life mutuals were not subject to this competitive pressure, and so developed their base of participating policyholders very differently.

Moreover, as will be discussed in more detail in the next section of this letter (Section B: Demutualization Process), it appears that, with the exception of Mutual Life, participating policyholders represented a small minority of the customers in these life mutuals and that they did not contribute a majority of the surplus in these companies.

Our review of the legislation governing mutual companies (including life and P&C insurers, co-operatives, caisses populaires and building societies) in different jurisdictions in Canada and around the world indicates that there are many different varieties of mutualism. In some jurisdictions, all policyholders or depositors are entitled to vote, while in others only participating policyholders or members are entitled to vote. In some jurisdictions surplus assets upon dissolution are distributable only to voting policyholders or members, while in others such assets are distributable only to an industry association or government fund.

The *Insurance Companies Act* (Canada) (the "ICA") has allowed a specific type of mutualism to develop. This type of mutualism has allowed federal P&C mutuals the flexibility to develop from companies that issue only mutual policies primarily to customers in their place of origin to companies like Economical that have been able to diversify their risk by expanding beyond their geographic origins and compete with large stock P&C companies by being able to offer and issue cash policies. However, as discussed above, competitive pressures have meant that companies like Economical that chose to compete with stock companies could not sell many mutual policies. Only those policyholders who wanted to participate in the P&C mutual by acquiring mutual ownership rights, and assuming the risks associated with signing Premium Notes, would purchase a mutual policy.

Accordingly, while there are differences amongst and between P&C and life mutual insurers, and the composition of their voting policyholders bases, these differences are primarily due to competitive pressures and to the decisions by P&C mutuals to either serve a local community or to grow their businesses and diversify their risk by expanding beyond their geographic origins.

Another important difference between P&C mutual policyholders and participating policyholders of the life mutuals is that P&C mutual policyholders are subject to different risks.

Participating policyholders of federal life mutuals enjoy the right to vote and the right to participate in profits (in the form of policy dividends) and have a right to surplus assets on dissolution, but they are not required to participate in the losses of the life mutuals.

The mutual policyholders of Economical, on the other hand, enjoy the right to vote, the right to receive distributions (such as policy refunds) and the common law right to receive surplus assets on dissolution. Furthermore, a large majority of our mutual policyholders have been exposed to the risk that Economical would need to make capital calls under the Premium Notes. In exchange for this increased risk, the owners of mutual policies received the right to vote and the right of ownership in the surplus of the mutual P&C insurer.

Accordingly, we believe that Economical's mutual policyholders have at least as strong ownership rights in Economical and its surplus as the participating policyholders of life mutuals have in the life mutuals and their surplus.

According to the Department of Finance's August, 1998 *Consultation Paper on the Demutualization Regime for Canadian Life Insurance Companies* (the "Life Consultation Paper"), the key policy objectives that underpinned the new demutualization regime for Canadian mutual life companies were as follows:

(i) Providing Fair Treatment to Policyholders

Converted companies must ensure that all policyholders' benefits and coverage are preserved after demutualization. Furthermore, voting policyholders, who are responsible for electing the directors of the board and approving all fundamental changes, including demutualization proposals, will be allocated the value of the company in exchange for their ownership rights and interests in the mutual company. It is essential to ensure that conversion to a stock company is fair and equitable to policyholders.

(ii) Enhancing Efficiency and Competition

After demutualization, the companies should achieve greater efficiency and competitiveness. As well, the demutualization process must not be too complex, time consuming or costly for the companies to undertake.

(iii) Maintaining Safety and Soundness

The safety and soundness of converted companies must also be sustained. Specifically, converted companies must maintain sufficient capital to support both current and future insurance business. Converted companies will continue to be regulated by the Office of the Superintendent of Financial Institutions (OSFI) and will remain subject to all provisions of the federal *Insurance Companies Act* and related rules and regulations. As a result, the full range of prudential rules, including the requirements to maintain adequate capital and to conform to standards of sound business and financial practices, will continue to apply and be monitored by OSFI.

(a) **Providing Fair and Equitable Treatment to Policyholders**

In the case of the life mutuals, which issued participating and non-participating policies, the Life Consultation Paper made it clear that:

- (i) all policyholder benefits (i.e. under both participating and non-participating policies) must be preserved after demutualization; and
- (ii) voting policyholders (i.e. participating policyholders) must be allocated the value of the company in exchange for their ownership rights and interests in the mutual company.

We believe that both of these principles should apply to the demutualization of federal P&C mutuals. No policyholders (cash or mutual) should lose any of the benefits under their policies as a result of a demutualization.

We would note, however, that whereas the rights of participating policyholders to participate in the profits of the life mutuals are provided for in the terms of their policies (and are, therefore, part of their policyholder benefits), the rights of mutual policyholders to participate in the profits of the P&C mutuals arise from their membership rights provided for in the by-laws of these mutuals and not from the terms of their mutual policies. Accordingly, the participation rights of mutual policyholders are not policyholder benefits. Their policyholder benefits are confined to insurance benefits and are exactly the same insurance benefits as are provided under cash policies.

As discussed above, we believe that the mutual policyholders of Economical enjoy at least as strong ownership rights as participating policyholders of the federal life mutuals. Accordingly, we do not believe that any of the value of a demutualized P&C company should be allocated to any policyholder other than a mutual policyholder, or to any entity or fund.

(b) **Maintaining Safety and Soundness**

We agree that the safety and soundness of demutualized federal P&C mutuals should be maintained. In this regard, we believe that the *Mutual Company (Life Insurance Conversion Regulations)* (the "Life Regulations") provide an excellent template for the demutualization

regulations for the federal P&C mutuals (the "P&C Regulations"). In particular, the safety and soundness of demutualized federal P&C mutuals should be maintained by:

- requiring that any proposed demutualization be subject to regulatory supervision by the Office of the Superintendent of Financial Institutions;
- requiring that the Minister of Finance approve any proposed demutualization;
- ensuring that none of the surplus of a demutualized P&C mutual is distributed to any stakeholder as a result of the demutualization;
- requiring that expert opinions be obtained from the appointed actuary of the demutualizing P&C mutual and an independent actuary stating that the future financial strength and vitality of the company and the security of policyholders will not be materially adversely affected by the demutualization;
- prohibiting the payment of any fee, compensation or any other consideration in relation to the demutualization of a P&C mutual to any director, officer or employee of the company, other than regular compensation and demutualization benefits provided to the person as a mutual policyholder;
- providing ownership rules that will allow a demutualizing P&C mutual to either become a public company or to effect a sponsored demutualization; and
- providing two years of takeover protection to any P&C mutual that chooses to become a public company in order to enable such company to adjust to its new structure and create value out of this structure for its stakeholders (including mutual policyholders who received shares upon demutualization).

We address these issues in more detail in the next section of this letter (Section B: Demutualization Process).

(c) Fostering a Competitive and Efficient Sector

The Board of Economical has concluded that in order for Economical to compete more effectively over the long term with the large stock P&C companies that operate in Canada, many of whom are affiliates of large international insurers, Economical must demutualize. Economical needs to be in a corporate structure that will allow it to have access to equity capital to grow its core business, to participate in the consolidation of the Canadian P&C insurance industry, to develop its systems and risk management structures to remain competitive in a changing industry, and to protect its solvency in difficult business and investment markets. In addition, because P&C mutual companies cannot raise capital, they are required to maintain excess surplus in order to weather times of financial stress. Carrying excess surplus puts pressure on insurance prices as returns on the underwriting operations of the company must be higher in order to achieve reasonable returns on equity (i.e. surplus). As

a result, demutualization should allow Economical to be even more competitive in pricing its products to customers.

As discussed below (see Section C - Impacts of Demutualization), the productivity of the Canadian financial services sector has been declining. The reasons for this decline include inadequate investment in technology, inadequate innovation and a need to reallocate capital and labour across industry participants. The eventual consolidation of the P&C insurance industry will likely improve each of these factors influencing productivity growth. The largest of these is likely to be a reallocation of capital and labour to higher overall returns – which is difficult to achieve under the mutual insurance company model.

A number of other benefits to demutualization were identified by the life mutuals when they demutualized. These include:

- greater financial flexibility
- the ability to issue shares as acquisition currency
- the desire for modern corporate governance
- the benefits of greater financial discipline and public scrutiny
- the ability to attract and retain top management talent; and
- a better alignment of the financial interests of owners and management

We believe that these benefits are equally applicable in the context of the demutualization of federal P&C mutuals.

We also believe that, as with the life demutualizations, the demutualization process for P&C mutuals should not be too complex, time consuming or costly for the P&C mutuals to undertake.

(d) Establishing an Orderly and Transparent Process

We agree that the process for demutualizing the federal P&C mutuals should be orderly and transparent. We also believe that the Life Regulations provide an excellent precedent for the process that should be used in demutualization regulations for federal P&C mutuals. In particular, the orderliness and transparency of the process should be maintained by:

- establishing clear rules concerning which policyholders of a P&C mutual are eligible to vote on a demutualization and receive demutualization benefits (the "Eligible Policyholders")
- establishing clear guidelines concerning the allocation of demutualization benefits amongst Eligible Policyholders; and
- requiring that Eligible Policyholders be provided with comprehensive information concerning the demutualization proposal

We address these issues in more detail in the next section of this letter (Section B: Demutualization Process).

Conclusion

Economical believes that the policy objectives for the demutualization of federal P&C mutuals are the same as the policy objectives for the demutualization of federal life mutuals and are as follows:

- providing fair and equitable treatment to policyholders by ensuring that:
 - all policyholder benefits (i.e. under both mutual and cash policies) be preserved after demutualization; and
 - voting (i.e. mutual) policyholders be allocated all of the value of the demutualizing company in exchange for their ownership rights and financial interests, as those entitled to residual property allocation rights, in the mutual company;
- maintaining the safety and soundness of demutualized federal P&C mutuals;
- enhancing efficiency and competition by allowing demutualized federal P&C mutuals access to the public capital markets; and
- establishing an orderly and transparent process.

Economical also proposes that these key policy principles should be applied to federal P&C mutuals in the same manner as they were applied to federal life mutuals by the Life Regulations. The demutualization process provided for in these Regulations has proven to be robust and effective.

B. Demutualization Process

1. ***What should be the process for allowing a P&C company to demutualize? In particular, what should be considered in determining who should have the right to vote on, and receive the benefits of, demutualization?***
2. ***What should be considered in ensuring that policyholders are treated fairly and equitably, including for determining the value of the company and apportioning the benefits of demutualization?***

(a) **Who Should Have the Right to Vote and Receive Demutualization Benefits**

Discussion

We believe that the law is clear that mutual insurance companies are owned by their voting policyholders.¹ We also believe that this principle has been entrenched in the ICA and the Life Regulations, a fact that was noted in *Bill C-59: An Act to Amend the Insurance Companies Act - The Issues (Notes)* as follows:

The government, in its discussion paper on conversion of mutual insurance companies of 21 May 1992, adopted the approach that a mutual conversion proposal must be approved by current policyholders of a mutual company who are entitled to vote at a meeting called to consider the proposal. Further, the entire amount of the distributable surplus (to be determined) must be allocated to a stated group of eligible policyholders - excluding non participating and non-voting policyholders. And the terms of the common shares issued to eligible policyholders must include a pre-emptive right to acquire any common shares issued by the company within two years following the conversion. Implicitly, then, the government was working on the basis that current "eligible" policyholders own the company. [Emphasis added.]

This position is reinforced by the statement of the Honourable Jim Peterson, Secretary of State (International Financial Institutions) in his testimony before the Standing Senate Committee on Banking, Trade and Commerce on February 9, 1999, as follows:

"...demutualization benefits may be allocated only to the company's voting policyholders who are, in fact, the true owners of the company..." [Emphasis added.]

In Economical's case, the source of voting rights for policyholders is its by-laws. To the best of our knowledge, this is consistent with the other Canadian property and casualty mutuals.

Economical's by-laws provide that:

- any person insured under a policy issued by the Company on the mutual system shall be a member of the Company from the date upon which the insurance becomes effective and so long as such insurance remains in force
- each member of the mutual system shall be entitled to one vote, and one vote only, regardless of the number of policies which the member holds
- the directors may, from time to time, out of the earnings of the Company, distribute equitably to members of the mutual system, such sums as in the judgment of the directors are proper and justifiable; and
- no insurance policy on the wholly cash plan shall make the insured a member of the Company or give the insured any right to participate in the profits or

¹ Bradley Crawford Q.C., *The Nature, Source and Extent of Participation Rights in Mutual Insurance Companies*, 25 Can. Bus. L.J. 337 1995; Bradley Crawford Q.C. and John R. Jason, *Fair and Equitable Treatment of Participating Policyholders Upon Demutualization*, 11 B.F.L.R. [Crawford & Jason].

surplus funds of the Company.

When the large federal life mutuals decided to demutualize, the federal government decided that only participating policyholders should be entitled to receive demutualization benefits. This decision was evidently made on the basis that only the participating policyholders of the life mutuals could vote and participate in profits. In other words, by process of elimination, they were the only stakeholders of the life mutuals who had any ownership rights. As the exact same situation applies to P&C mutual policyholders, the same conclusion should apply - that the mutual policyholders, as the only stakeholders with ownership rights, should be exclusively entitled to vote on demutualization and receive demutualization benefits.

According to *Report on the Conversion of Mutual Insurance Companies in Canada* dated June 22, 1992 prepared by the Standing Senate Committee on Banking, the reason why the federal government decided that only the participating policyholders of the life mutuals would be entitled to vote on demutualization and to receive demutualization benefits was as follows:

...policyholders make a rational decision when they purchase a policy. A par policy and a non par policy are priced differently to reflect differences in the terms and conditions that are presented to the policyholder. A par policyholder is consciously choosing to participate in the company; a non par policyholder is simply selecting a product which is available at the most attractive terms - with no interest in participating in the company [sic.]. There is no reason to change these rights when a conversion is being considered.²

We believe that this logic is equally applicable to the rights of mutual policyholders of a P&C mutual. While the explicit policy premium for a cash policy and a mutual policy are the same, the implicit premium is higher for a mutual policy because the mutual policyholder assumed financial risk by signing the Premium Note. In Economical's case, mutual policyholders had to commit to purchase 3-year policies, and their Premium Notes made them liable for an additional 3 years of fire premium. This demonstrates an even stronger commitment to Economical by those who purchased its mutual policies. While Economical ceased to require Premium Notes from mutual policyholders in 2008, a large majority of Economical's mutual policyholders were policyholders prior to 2008 and did sign Premium Notes. Moreover, the mutual policyholder is making a conscious decision to participate in the affairs of the company, and not simply selecting a cash policy available at the most attractive terms, competitive with cash policies issued by stock and mutual companies, and with no interest in participating in the company. This decision should be respected when there is benefit to be received from owning a mutual policy.

If there was no reason to change the rights of participating policyholders when a conversion of a life mutual policy was being considered, there is similarly no reason to change the rights of mutual policyholders when a conversion of a P&C mutual is being considered.

Concern has been raised that some P&C mutuals, like Economical, have a small number of mutual policyholders as compared to their cash policyholders. As discussed above, there are good and valid business reasons why this situation has evolved. In this regard, it is worth

² At p. 22-6-92

noting that participating policyholders of some of the demutualized life mutuals also represented a small minority of these companies' policyholders. In his testimony before the Standing Senate Committee on Banking, Trade and Commerce on February 9, 1999, Mr. Don Stewart, President and Chief Executive Officer of Sun Life Assurance Company Canada, stated that:

...we have approximately 1 million voting policyholders and the total number of customers of the corporation is well above 12 million.

Thus, less than 10% of Sun Life's customers were participating policyholders, yet only Sun Life's participating policyholders voted on its demutualization and only they received demutualization benefits. Over 90% of Sun Life's customers did not vote on the demutualization and received no demutualization benefits. We believe that a similar situation applied in the cases of Manulife and Canada Life. These examples may not be quite as extreme as the situation with P&C mutuals like Economical, but the principle and the precedent are exactly the same.

We understand that some are arguing that Economical's small number of mutual policyholders have not contributed in any meaningful way to Economical's surplus and, therefore, do not deserve to receive the entire value of the company upon demutualization. The implication is that, if they did, they would be receiving an undeserved "windfall", and that other policyholders who contributed to surplus accumulations should have some entitlement to demutualization benefits.

The fallacy of this argument is that ownership rights in a company do not arise from how much a member, in the case of a mutual company, or a shareholder, in the case of a stock company, has contributed to surplus.

Take the case of a shareholder of a stock company who purchases 100 shares for \$1,000 from treasury. This \$1,000 is the entire amount that this shareholder contributes to the company. If the company prospers and builds up a surplus, it does so from profits, not from additional contributions made by the shareholder. Nevertheless, the fact that the company has built up a surplus will mean that the shareholder's shares will have increased in value. No one would argue that the shareholder is not entitled to this increase in value or that this increase in value is a "windfall".

In the case of P&C mutuals, mutual policyholders have historically allowed their companies to accumulate surplus not by paying higher or redundant premiums (as in the case of participating policyholders of life mutuals), but instead by providing credit to their companies through the vehicle of Premium Notes, and by not having surplus amounts released to mutual policyholders annually. In effect, mutual policyholders deferred surplus distributions and allowed the capital surplus in their mutual companies to increase. This deferred distribution and capital call system is simply another way of capitalizing a company and is analogous to the capital contributed by shareholders of a stock company.

This very issue was analyzed in a U.S. case that considered the tax implications of the Sun Life demutualization, where the Court had this to say:

If nothing else, these facts are antithetical to the claim that the stock distributions made with respect to the ownership rights were a "windfall". Defendant's repeated and pejorative use of that term seemingly proceeds from the notion that, as in Orphic hymns, the value associated with the ownership rights here sprung from the aether, somehow sparked by the demutualization itself. As characterized by Mr. Scanlon, one of defendant's witnesses, these rights were "embedded values" that were not "monetized" until the demutualization occurred. But, if there is any meaningful distinction to be made between "embedded values" that were not previously "monetized" and ownership rights that were "impossible or impractical" to value at the time they were first acquired, it is almost certainly one without a difference. Nor is there the slightest support for the suggestion, again made by one of defendant's witnesses, that the allocation of stock here was a "windfall" because it was mandated by Canadian and state regulatory agencies. A silent premise in this argument, of course, is that those agencies acted arbitrarily or at least with considerable largesse in requiring compensation to be paid for the loss of ownership rights that - in defendant's view - were valueless. But, the court is no more inclined to believe this charge, sans any shred of evidence to support it, than it would be to ascribe similar conduct to Congress and Federal agencies. Without any evidence to the contrary, the more logical conclusion is that such agencies, and the legislatures that empowered them, sincerely believed that the ownership rights had value and that the policyholders were entitled to be compensated for their loss. The "windfall" tag, therefore, lacks evidentiary adhesive and does not stick.

Another recent U.S. case, which considered the rights of group policyholders in the demutualization of Standard Life Insurance Company, confirmed that demutualization benefits are compensation for the extinguishment of membership rights (i.e. the right to vote and receive distributions) and not reimbursement for a share of the surplus of the demutualizing company:

Sundermier contends that the demutualization consideration belongs to the individual state employee insureds because, as the persons who paid the premiums, the individual insureds owned Standard's surplus, on which the consideration was based. Sundermier's theory finds no support in the statutes. There is no dispute that money for payment of Standard group insurance premiums came from state employee insureds' contributions, and that portions of those premiums accumulated and were invested by Standard as "surplus". As our survey of the statutes shows, however, Sundermier is mistaken in his view that the payment of premiums translates into an ownership interest in Standard's surplus or in the demutualization proceeds. Mutual insurers are owned by their members. A "membership interest" in a mutual insurer is defined as "any right that a member of the mutual insurer may hold by virtue of membership in the mutual insurer". PEBB, as the group insurance policyholder, was the "member" of Standard, with the attendant membership interest. The demutualization consideration was paid to PEBB for the extinguishment of its membership interest, not for the reimbursement of premiums or a share of the surplus. Although premium payments gave rise to Standard's surplus, contrary to Sundermier's view, the individual insureds have no membership or ownership interest in Standard. [Emphasis added]

Advocates of this "windfall" argument erroneously, in our view, assume that the participating policyholders of the demutualized federal life mutuals contributed a majority of these companies' surplus. That was certainly not in fact the case with Canada Life. In his Appointed

Actuary's opinion with respect to Canada Life's demutualization, Mr. D. Allen Loney stated that,

In particular, I considered the "contribution of in force policies method" that has been used in U.S. demutualizations. Insurance companies that have demutualized in countries other than the United States have not used this method. This method was not considered to be appropriate for Canada Life because...

eligible policyholders [i.e. participating policyholders] have not contributed the majority of the value of Canada Life...[Emphasis added]

We thus conclude that the correct analysis, at law as well as under Economical's by-laws, is that the right to receive demutualization benefits relates exclusively to the extinguishment of accrued ownership rights, and not to any notion of contribution to surplus or other metric.

We understand that some are advocating that a P&C mutual insurer's surplus should be transferred to a government fund or distributed to other similar mutuals or a charity. We believe that the pith and substance of regulations establishing such a scheme would concern the operation of the insurance industry rather than the status of a federally incorporated insurance company. It has been definitively established that the regulation of the insurance industry and an insurance company's operations is within provincial jurisdiction. As a result, we do not believe the federal government has the constitutional power to establish such a scheme. Furthermore, no federal power exists which authorizes expropriation at large for any public purpose. Federal expropriation of the property rights of a P&C mutual insurer's surplus from the mutual insurer's owners (i.e. its mutual policyholders) would have to be justified as a law in relation to some head of federal power within s.91 of the *Constitution Act, 1867*. The federal power of expropriation is limited to the taking of property for purposes otherwise falling within its legislative authority. It is clear that the federal Parliament does not possess power over the regulation of the insurance industry. Therefore, we do not believe that the federal government has the power to expropriate to a new owner or group of owners the ownership rights of mutual policyholders in the surplus of a P&C mutual insurer. This same argument is also relevant to any legislation or regulation that might result in the taking of the ownership interests of the mutual policyholders without compensation, and the distribution of the value of this interest to other constituents, including a broader group of policyholders.

We have also reviewed a number of Canadian, Australian, U.K. and U.S. demutualization precedents. We have observed that a common feature in all these precedents is that only those policyholders or depositors who enjoyed ownership-like rights prior to the date on which their companies or societies announced their intention to demutualize were entitled to receive demutualization benefits. In other words, the statutes or court-sanctioned schemes that allowed these demutualizations to proceed did not confer demutualization benefits on any stakeholders who did not enjoy ownership-like rights prior to their respective announcement dates.

The one apparent exception might be the demutualization of MBF in Australia where benefits were required to be distributed to approximately 800,000 policyholders even though the company only had 195 voting policyholders. However, under the *Private Health Insurance Act, 1997* (Australia), these voting policyholders had no rights to the company's capital prior to demutualization, as the statute required that the distribution of demutualization benefits not be inequitable between all policyholders and insureds, not just voting policyholders, and also required that any remaining assets on dissolution be paid to other private health insurers or the State's risk equalization scheme.

Accordingly, based upon the literature and precedents we have reviewed, we believe it is clear that Economical's voting policyholders, and only Economical's voting policyholders, are the owners of Economical. As a result, we believe that, as the owners of Economical, only Economical's voting policyholders should be eligible to vote on demutualization and to receive demutualization benefits.

We believe that our conclusion concerning the ownership of Economical is consistent with the Federal government's long-standing policy on the ownership of mutual insurers. For example, in the May 21, 1992 *Discussion Paper on the Conversion of a Mutual Insurance Company* (the "Discussion Paper"), the Department of Finance proposed that it would be a requirement of any demutualization that the entire amount of the distributable surplus of the mutual company be allocated to:

"a stated group of eligible policyholders (excluding non-participating, non-voting policyholders)." [Emphasis added.]

It is noteworthy that the Discussion Paper dealt with the demutualization of both life mutuals and property and casualty mutuals.

The foregoing requirement was implemented in the Life Regulations.

Conclusion

Economical proposes that the P&C Regulations deal with the policy issue of who should be eligible to receive demutualization benefits in a manner that is consistent with the law, the Life Regulations, the by-laws of property and casualty mutuals and the Government's long-standing policy in this regard. All of the foregoing support a policy that the only policyholders who should be eligible to vote on demutualization and to receive demutualization benefits are the voting (i.e. mutual) policyholders.

(b) How should Demutualization Benefits be Allocated?

A demutualization requires an allocation of the value of the enterprise's equity amongst the owners of the mutual enterprise. Such allocations have been made for demutualizations and similar transactions that have taken place in Canada and abroad, most notably as a result of widespread demutualizations of life insurers in the last 15 years. However, there have been few precedents globally that involved property and casualty insurers in general, and some or

perhaps most of those must be considered carefully as they involved either distressed companies or reorganizations that moved ownership to mutual holding companies rather than distributing value to the mutual policyholders. In addition to the few precedents that exist in property and casualty insurance, there are examples for other types of business organizations, such as for UK building societies.

The demutualizations of the Canadian life insurers are important precedents but must be considered carefully due to the differing economics and circumstances. The life mutuals had well-established policy dividend policies and practices that reflected detailed actuarial analysis and allocation of economic benefits for each policy, which made for a good foundation in allocating demutualization benefits to the mutual policyholders. In contrast, policy dividends/rebates paid to mutual policyholders of property and casualty mutuals, and Economical in particular, have been determined in a relatively simple fashion, as a flat percentage of premiums.

While the possibility of using some form of actuarial “contribution to surplus” approach, similar to the Canadian life insurer demutualizations, has been considered, it is not clear that a sophisticated basis of allocation is necessarily preferable or desirable for property and casualty mutuals. Given the lack of precedent or track record for such calculations, a sophisticated or complex model might be less transparent, less understandable or more susceptible to misunderstanding or debate, and may have practicality problems due to data issues, time and cost. A complex model should meet the test that it would clearly be fairer than a simpler one, in fact or appearance. As we do not believe that a complex contribution to surplus model would be any fairer than a simple allocation model, we would propose that contribution to surplus not be included as a factor in apportioning the value of the converting company among Eligible Policyholders.

A review of precedents for demutualizations outside the life insurance industry suggests that simpler bases of allocation have been used, based on metrics such as duration of membership, and amount of insurance coverage or premium. Both in precedents and in some available literature concerning demutualizations, notably US actuarial standards of practice, a concept of allocating both fixed and variable benefits is relatively common.

(i) Fixed Amounts of Benefits

Discussion

A fixed component, as the name suggests, allocates a portion of the benefits *pro rata* to all voting policyholders irrespective of volume or tenure characteristics, and it has been suggested that such fixed amount be attributable to per-policyholder voting rights. For example,

The fixed component, a flat number of shares for every eligible policyholder, compensates for their loss of voting control of the company.³

US actuarial standards on the Allocation of Policyholder Consideration in Mutual Life Insurance Company Demutualizations would appear to us to be appropriate in the case of P&C companies and for Canadian P&C mutual companies. They state:

The fixed component of consideration should be allocated on a basis that produces a reasonable result in view of the specific considerations of the converting company. Among other factors, the actuary may consider the company's voting policy. This may entail a review of the following: a review of the voting provisions contained in the company's bylaws, charter, or domiciliary state law; the way the company has managed voting in practice; and the communications that have been made to policyholders. These factors usually mean that the fixed component is allocated based on each eligible policy (regardless of the size of the policy) or each eligible policyholder (regardless of the number of policies or size of policies).⁴

Conclusion

Economical proposes that it would be fair and equitable that a fixed amount of benefits be allocated to each Eligible Policyholder for his or her loss of voting control of the demutualized P&C company.

(ii) Variable Amounts of Benefits

Discussion

The variable component recognizes the ownership interests other than voting rights. In Canada, as in other non-U.S. demutualizations, the variable allocation does not follow the contribution to surplus method as strictly as is done in the U.S. Instead a more general "fair and equitable" allocation formula is used. Reasons for not using the "contribution-to-surplus" approach include the fact that surplus may have been generated, in part, by previous generations of policyholders or ineligible non-participating policies which do not share in the demutualization proceeds. In addition, some blocks of business, policy groups or policies issued in specific geographic areas may have generated a cumulative loss or a negative contribution to surplus.

The Canadian allocation formulas for life mutuals, while indirectly linked to profitability analysis, tend to be based on factors applied to more easily identified proxies or "policy metrics" such as duration, premiums, cash values, or face amounts.⁵ In practice, in the US life insurance industry, it is not uncommon that certain product lines use simpler models: "For individual annuities and individual health products, models often are based only on policy form and issue year".⁶ For the reasons set out previously, we do not believe that it would be appropriate to include contribution to surplus as a variable in determining the

³ "Demutualization in Canada - Toward Growth and International Competitiveness", The Actuary, Jan 2000, at p.3.

⁴ ASOP 37 3.2.1.

⁵ *Supra*, note 6.

⁶ AAA Practice Note "Distribution of Policyholder Equity in a Demutualization", 1999.

variable amount of benefits in a property and casualty demutualization.

Factors such as claims experience or policy reserves of the specific member, appear to be inappropriate and should not be considered as they could be considered fortuitous, and contrary to the concept of insurance. It would not be fair to penalize a mutual policyholder because of an unfortunate claim event. Unlike life policies, property and casualty policies do not have cash values.

We believe that it would be fair and equitable that the following variables be considered in determining the variable amount of benefits in a property and casualty demutualization: premium, policy coverage, duration and type of policy. Due to the differences between life policies and property and casualty policies, we do not believe that the following factors included in the Life Regulations should be considered in a property and casualty demutualization: contribution to surplus, policy reserves and cash values.

Practical considerations or data constraints may indicate that the actuary modify some variables in the model by subjecting them to scaling factors, grouping similar values, maximums or minimums as opposed to actual values. An example might be to use a maximum number of years in the allocation formula related to duration because of limitations on data available.

Property and casualty mutuals may have acquired voting policyholders, either through amalgamation or acquisition. Each such transaction is unique and, as a result, it would be difficult to draft a provision in the P&C Regulations that would successfully deal with such acquired voting policies. Accordingly, we believe that the treatment of such acquired voting policies should be left to the discretion of each demutualizing property and casualty insurer and their actuaries. This is consistent with how this issue was handled in the life demutualizations.

Conclusion

Economical proposes that it would be fair and equitable that variables to be considered in the variable amounts of benefits should include:

- (i) premium;
- (ii) policy values/amount of coverage;
- (iii) duration of voting policy; and
- (iv) type of voting policy/line of business.

Practical considerations or data constraints may indicate that some of these variables may be subject to scaling factors, grouping similar values, maximums or minimums as opposed to actual values.

(c) **Protection of Current Policyholders and of the Safety and Soundness of Demutualizing Insurers**

Discussion

The Life Regulations require that all policyholder benefits and coverage will be preserved after demutualization and that Eligible Policyholders will be allocated the total value of the demutualizing company in exchange for their ownership interests in the mutual company. We would like to make it clear that, under the Life Regulations, the demutualized life mutuals did not distribute any of their surplus to their mutual policyholders. The participating policyholders received their demutualization benefits in the form of shares of the demutualized companies which they could sell on the public stock market, or cash provided by public shareholders who subscribed for shares issued by the demutualized life companies or their newly created public holding companies.

Economical believes that the P&C Regulations should provide the same protections in this regard as the Life Regulations in order to preserve the safety and soundness of demutualizing property and casualty insurers and to ensure that their conversion proposals are fair and equitable.

Conclusion

Economical proposes that the P&C Regulations require that:

- all policyholders' benefits and coverage should be preserved after demutualization
- Eligible Policyholders be allocated the total value of the demutualizing company.

We also propose that none of the surplus of a demutualizing P&C mutual be distributed to its policyholders.

This is consistent with the Life Regulations.

(d) **Voting Rights**

Discussion

Policyholder voting rights under the ICA can arise because a policy is a "participating" policy (only issued by life insurers) or because of the terms of the mutual company's by-laws or where the voting right is embedded in the terms of the policy itself.

In the case of Economical, all voting rights are conferred on members by its by-laws. No policies issued by Economical confer voting rights by their contractual terms and conditions.

To the best of our knowledge, this is consistent with how voting rights are conferred by the other Canadian property and casualty mutuals.

In the context of the life demutualizations, voting rights with respect to participating policies are deemed by the ICA to be part of the policy benefits. As a result, these voting rights needed to be preserved post-demutualization. This led the demutualizing life insurers to incorporate holding companies under the ICA, which then became the public issuers of the shares distributed to Eligible Policyholders upon demutualization. Participating policyholders retained their policyholder voting rights with respect to the demutualized life insurance company, but were not given policyholder voting rights with respect to the holding company.

In the case of property and casualty demutualizations, voting rights are not part of the policy benefits. Accordingly, Economical believes that preserving these voting rights should not be required, particularly since Eligible Policyholders will, as members of the mutual company, receive compensation for the loss of their voting rights.

Finally, we would point out that, whereas non-mutual life insurers ("stock insurers") commonly issue participating policies (i.e. voting policies), stock property and casualty insurers have no history of issuing voting policies to their policyholders.

Conclusion

Economical proposes that voting rights granted to the members of a property and casualty insurer in its by-laws be extinguished upon demutualization, which would be accomplished by an amendment to the by-laws approved by the voting policyholders as part of the demutualization.

This proposal would not require a change from the Life Regulations, as voting rights are not part of the policy benefits of a property and casualty insurance policy.

(e) Rights to Distributions

Discussion

Rights to receive distributions of the profits of a mutual company can arise because of the terms of the mutual company's by-laws or the terms of the policies issued by the mutual company.

In the case of Economical, all distribution rights are conferred on members by its by-laws. No policies issued by Economical confer distribution rights by their contractual terms and conditions.

To the best of our knowledge, this is consistent with how distribution rights are conferred by the other Canadian property and casualty mutuals.

In the context of the life demutualizations, distribution rights with respect to participating policies were conferred by the terms of these policies and, as a result, were part of the policy benefits. As a result, these distribution rights needed to be preserved post-demutualization, which resulted in the need to maintain funds in "participating accounts" to support future policy dividends. Participating policyholders of the demutualized life insurers retained their policyholder distribution rights with respect to the demutualized life insurance company, but were not given distribution rights with respect to the holding company.

In the case of property and casualty demutualizations, distribution rights are not part of the policy benefits. Accordingly, Economical believes that preserving these distribution rights should not be required, particularly since eligible policyholders will, as members of the mutual company, receive compensation for the loss of their distribution rights.

Finally, we would point out that whereas non-mutual life insurers ("stock insurers") commonly issue participating policies that by their terms confer distribution rights, stock property and casualty insurers have no history of issuing such policies to their policyholders.

Conclusion

Economical proposes that distribution rights granted to the members of a property and casualty insurer in its by-laws be extinguished upon demutualization, which would be accomplished by an amendment to the by-laws approved by the voting policyholders as part of the demutualization.

This proposal would not require a change from the Life Regulations, as distribution rights are not part of the policy benefits of a property and casualty insurance policy, and the implementation of this proposal would require a simple by-law amendment that would be approved by the mutual policyholders as part of the approval of the plan of demutualization.

(f) Market for Shares

Discussion

The Life Regulations require that a demutualizing life insurer take measures, in the two years following the effective date of demutualization, to ensure that Eligible Policyholders who receive shares will be able to sell them on a public market.

Economical believes that demutualizing property and casualty insurers should be required to take the same measures, except in the case of sponsored demutualizations as discussed below (see Constraints on Ownership).

Conclusion

Economical proposes that it would be fair and equitable that demutualizing property and casualty insurers be required to take measures in the two years following the effective date of demutualization, to ensure that Eligible Policyholders who receive shares will be able to sell

them on a public market. This is consistent with the Life Regulations which have proven to be robust and effective.

(g) **Expert Opinions**

Discussion

The Life Regulations require that a demutualizing insurer provide the Superintendent of Financial Institutions with the following expert opinions:

- an opinion of the appointed actuary of the company and an opinion of an independent actuary:
 - stating that the demutualization benefits and method to be used to apportion the value of the company among Eligible Policyholders are fair and equitable to these policyholders
 - providing an explanation of how the assets in the company's "participating accounts" are expected to be adequate to meet policy obligations and support any future participating policies
 - stating that the future financial strength and vitality of the company and the security of policyholders will not be materially adversely affected by the demutualization
- an opinion of a valuation expert that the methods and assumptions employed to estimate the value of the company are appropriate and that that value reasonably reflects prevailing market conditions as at the day it was estimated.
- where, in respect of a demutualization, other benefits are to be provided in lieu of shares, an opinion from an independent actuary, or from a valuation expert, that those benefits are appropriate substitutes for the shares as at the day the value of the company was estimated
- an opinion from a financial market expert that the measures to be taken by the company, in the two years following the effective date of demutualization, are likely to ensure that the Eligible Policyholders who receive the shares will be able to sell these shares on a public market.

We believe that these are the appropriate expert opinions for the protection of the policyholders of a demutualizing property and casualty insurer, with one exception. As property and casualty insurers do not maintain "participating accounts", the actuaries should not be required to opine on such accounts.

Conclusion

Economical proposes that, in order to preserve the safety and soundness of demutualizing property and casualty insurers and to ensure that their conversion proposals are fair and equitable, a demutualizing property and casualty insurer be required to provide the Superintendent with the same expert opinions required under the Life Regulations, with the exception that the actuaries should not be required to opine on "participating accounts".

(h) Restrictions on Compensation and Stock-option and Stock-incentive Plans for Directors, Officers or Employees

Discussion

The Life Regulations prohibit the payment of any fee, compensation or any other consideration in relation to the demutualization of a company to any director, officer or employee of the company, other than regular compensation and demutualization benefits provided to the person as an Eligible Policyholder.

The Life Regulations also prohibit the issuance of shares, share options or rights to acquire shares of the demutualizing company to any director, officer or employee prior to the listing of its shares on a recognized stock exchange and for a period of one year after such a listing, other than shares issued to that person as an Eligible Policyholder.

Economical supports the policy rationale for these provisions, which are intended to minimize any conflicts of interest between the demutualizing company and its directors, officers and employees.

Conclusion

Economical proposes that the P&C Regulations contain the same restrictions on compensation and stock-option and stock-incentive plans for directors, officers and employees as the Life Regulations in order to ensure that Eligible Policyholders are treated in a fair and equitable manner.

(i) Information to Policyholders

Discussion

The Life Regulations stipulate that Eligible Policyholders must be provided with comprehensive information concerning the demutualization proposal, including:

- a description of the advantages and disadvantages of the proposed demutualization to the company and its policyholders
- a description of the alternatives to demutualization considered by the directors and the reasons why, in their opinion, demutualization is in the best interests of the company

- a description of the form, amount and estimated value of the demutualization benefits
- a description of any right of policyholders to vote after demutualization
- the income tax treatment accorded to demutualization benefits
- the demutualization proposal
- summaries of the expert opinions (see Expert Opinions); and
- financial statements.

Economical believes that the information required to be provided to policyholders under the Life Regulations is comprehensive and applicable to property and casualty demutualization. Economical does not believe that any changes are required to these information requirements for property and casualty insurers.

Conclusion

Economical proposes that the P&C Regulations include identical requirements with respect to information to be provided to Eligible Policyholders as the Life Regulations.

(j) **Constraints on Ownership**

- (i) Permanent

Discussion

Section 407(1) of the ICA requires that demutualized insurers having an aggregate of surplus and minority interests of five billion dollars or more according to their last annual statement dated before the effective date of demutualization be widely held. This treats such large demutualized companies in the same manner as the large banks.

As Economical is not aware of any Canadian mutual property and casualty insurer with an aggregate of surplus and minority interests of five billion dollars or more, Economical does not believe that this requirement should apply to demutualizing property and casualty insurers.

Conclusion

Economical proposes that the permanent widely held requirement not apply to demutualizing property and casualty insurers.

(ii) Temporary

Discussion

Unlike the Canadian life insurance industry, a majority of the Canadian property and casualty industry is controlled by foreign financial institutions. Many of these are large, global competitors that benefit from risk diversification by their presence in many countries. It is essential, therefore, to the best interest of the Canadian financial system that demutualized property and casualty insurers have the flexibility to effect a sponsored demutualization with one of such entities, a Canadian insurer or a financial investor, or to demutualize through an initial public offering (an "IPO").

A sponsored demutualization might result in a higher valuation of the demutualizing company and the combination of the sponsor and the demutualized insurer might result in a stronger insurer able to compete better with large and well-capitalized Canadian and global competitors. On the other hand, an IPO might be a better option for a demutualizing company that wants to gain access to capital but maintain its autonomy. One IPO option might involve the support of a significant investor that might wish to acquire a significant interest in the demutualized company.

If the demutualizing property and casualty insurer chooses the IPO route, we believe that the demutualized insurer will need a period of time to adjust to its new corporate structure, and create value out of this structure change for its stakeholders (including mutual policyholders who received shares upon demutualization). In the case of the life insurers that demutualized in and around 1999, subsection 407(11) of the ICA provided that no person could have a significant interest in such a demutualized insurer until a day that was two years after December 31, 1999. However, this subsection only applied to demutualized companies with an aggregate of surplus and minority interests in an amount that was one billion dollars or more but less than five billion dollars ("mid-sized" demutualized life insurers). To our knowledge, the only Canadian mutual property and casualty insurers with more than \$1 billion in surplus are Economical and The Wawanesa Mutual Insurance Company. Accordingly, we believe that this monetary threshold may need to be adjusted lower or to be eliminated in the case of property and casualty insurers. We would also propose that an investor be permitted, subject to the approval of the Minister of Finance, to acquire a significant interest in the demutualized insurer, if such interest is acquired contemporaneously with the closing of the IPO. This could allow the insurer to attract a better IPO price for its shares, and to ensure a proper raising of cash to provide liquidity to policyholders who wish to sell their shares, and/or to provide equity to the insurer for its general corporate purposes. We suggest that this transaction, which would, in effect, be a partially-sponsored demutualization, would have to be disclosed in the insurer's Plan of Demutualization, so that it could be vetted and approved by the Office of the Superintendent of Financial Institutions and the Minister of Finance as part of the demutualization process, and be voted upon by mutual policyholders as part of the approval of the Plan of Demutualization.

We are unsure why the restriction concerning significant interests in subsection 407(11) applied only until two years after December 31, 1999. One possible reason might have been to give each of the mid-sized demutualized life insurers (and their shareholders, many of whom would be Eligible Policyholders) equal opportunity to sell to the best buyers and to attract the best control premium. This common date approach was facilitated by the fact that all of the life companies that demutualized in or around 1999 announced their intention to demutualize within 6 months of each other.

However, it is not clear whether the same common date concept should apply in the case of demutualizing property and casualty insurers, as property and casualty mutuals that choose to demutualize may decide to do so over a longer period of time than did the life mutuals. Accordingly, we believe that it would be in the best interests of the financial system that no person may have a significant interest in a demutualized property and casualty insurer that demutualized through an IPO for a period of 2 years from the date such insurer demutualized, other than a person who acquires a significant interest as part of an approved IPO structure. This would provide each such insurer a full 2-year period to adjust to its new corporate structure.

Our reading of subsections 407(12) to (16) of the ICA is that they allow a sponsored demutualization, notwithstanding the restriction in subsection 407(11), provided that no person owns a significant interest in the sponsor and the sponsor continuously controls the demutualized company from the date it demutualized. It would also appear that the sponsor may only be a "company" (i.e. an insurance company incorporated under the ICA), a "holding company" (i.e. a holding company incorporated under the ICA) or an entity (which could be an ordinary business company or an insurance company incorporated in a jurisdiction outside Canada) provided that the entity is controlled by a "company" or a "holding company". The latter appears to prevent a foreign insurer from being a sponsor, unless the foreign insurer happens to be controlled by a "company" or "holding company" incorporated under the ICA.

If our understanding of the intent of these subsections is correct, we have the following comments concerning the restrictions on who could be a sponsor. We do not believe it would be in the best interests of the financial system that sponsors of property and casualty demutualizations should be restricted to "companies" or "holding companies" in which no person owns a significant interest or to entities controlled by "companies" or "holding companies" incorporated under the ICA in which no person owns a significant interest. Such restrictions would limit the number of potential sponsors, which could adversely affect the market value of a demutualizing insurer as well as eliminate potentially attractive sponsors that might otherwise provide the most beneficial fit with the demutualizing insurer.

As noted above, there are many large, global foreign controlled insurers active in the Canadian property and casualty insurance market, usually through wholly-owned Canadian subsidiaries incorporated under the ICA. These foreign institutions are not "companies" or "holding companies" under the ICA and they may have significant shareholders.

The Minister of Finance has control over who can own a significant interest in a Canadian property and casualty insurer through section 407 of the ICA. We believe that this control provides sufficient protection for the Canadian financial system. Limiting sponsors to "companies" or "holding companies", or entities controlled by "companies" or "holding companies", and prohibiting any person from having a significant interest in any of these sponsors, would be inconsistent with the fact that many foreign institutions wholly-own their Canadian property and casualty insurers. Such rules would create an unlevel playing field, tilted against the demutualized property and casualty insurers.

While the ownership restrictions related to demutualized life insurers were implemented in amendments made to section 407 of the ICA, Economical believes that, pursuant to paragraph 237(2)(c) of the ICA, the Governor in Council has the regulation-making authority to include similar ownership constraints in the P&C Regulations.

Conclusion

Economical proposes that the P&C Regulations include temporary ownership constraints similar to those found in section 407 of the ICA with respect to "mid-sized" demutualized life insurers.

However, Economical proposes that the life ownership constraints be adjusted slightly to accommodate better the circumstances of property and casualty insurers as follows:

- except in the case of an approved sponsored demutualization, or the acquisition of a significant interest as part of an approved IPO structure, the two-year restriction on any person having a significant interest in a demutualized property and casualty insurer should commence on the date such insurer demutualizes
- except in the case of a sponsored demutualization, or the acquisition of a significant interest as part of an approved IPO structure, the two-year restriction on any person having a significant interest in a demutualized property and casualty insurer should apply to all demutualizing insurers, not just those with between \$1 billion and \$5 billion in surplus.
- the restrictions on a sponsor being a "company" or a "holding company", or an entity controlled by a "company" or a "holding company", and having no significant shareholder should be eliminated
- entities incorporated or controlled outside Canada should be permitted to be sponsors.

Economical believes that these measures would allow demutualizing property and casualty insurers time to adjust to their new corporate structure and create value out of this structure change for its stakeholders (including mutual policyholders who received shares upon demutualization), and would be in the best interests of the financial system.

C. Impacts of Demutualization

1. *What impacts could demutualization have on the P&C sector?*
2. *Would these need to be addressed, and if so, how?*

Discussion

The following is a summary of our detailed analysis (which follows) of the impacts that demutualization could have on the P&C sector:

- The Canadian property and casualty (P&C) insurance industry is a vibrant and competitive marketplace with a substantial number of large and small, domestic and foreign, stock and mutual competitors;
- The industry is an important direct and indirect employer (more than 44,000 Canadians directly employed).⁷ It is challenged with significant volatility in profitability and low investment returns;
- The industry in Canada started with the mutual form of organization but has largely migrated into stock and foreign companies. With the exception of Economical and a single other mutual insurer (and the cooperatively-owned Co-operators Group Ltd.⁸ (Co-operators)), there are no Canadian mutual P&C insurers of significant national scale;
- Of the 223 Canadian P&C companies comprising the MSA Research Inc. ("MSA") database only 14 are federally-regulated, Canadian-domiciled mutual companies⁹ subject to the ICA, and thus potentially affected by federal demutualization regulations (Co-operators is subject to the *Canada Cooperatives Act* – which we do not discuss here);
 - We note that MSA's total of 14 includes Economical's five member companies (Economical, Federation, Missisquoi, Perth and Waterloo). Therefore, in considering Economical a single entity, there are actually only 10 federally- regulated, Canadian-domiciled mutual companies that would be affected by federal demutualization regulations. Collectively, these companies account for less than 10% of the Direct Premiums Written ("DPW") in the Canadian P&C industry (see Figure 2);

⁷ IBC, 2009 Facts of the General Insurance Industry in Canada.

⁸ Co-operators Group Ltd. falls under the Canadian Cooperatives Act and is regulated under this act through the Minister of Industry. Its subsidiary, Co-operators Group Insurance, is a publicly-traded stock company incorporated under the Insurance Companies Act (Canada) and regulated under OSFI. Neither Co-operators Group Ltd. nor Co-Operators Group Insurance nor any of its subsidiaries is a mutual company.

⁹ In addition to the 14 Federally-Regulated, Canadian-Domiciled Mutuals, another 15 are Federally-Regulated, Non-Canadian-Domiciled Mutuals and an additional 15 mutuals are provincially licensed, according to MSA. Note that MSA's database excludes several small, provincially incorporated farm mutuals in Ontario and Quebec.

- Of the 14¹⁰ federally-regulated Canadian-domiciled mutuals, Economical (and its member companies), and two other federal mutual companies, account for approximately 93%¹¹ of the DPW within this cohort (see Figure 2);
- On several important metrics, mutual companies lag the rest of the overall P&C industry, making them less competitive, especially when examined in the context of relative performance over the last decade; and
- From our review, the introduction of demutualization regulations for P&C insurers would be unlikely to change the complexion of the industry to any noticeable extent. Since most of the mutual companies by number and employment are not Canadian or fall outside of federal regulation, any new federal regulations relating to demutualization would not apply to most P&C mutuals.

Accordingly, we do not believe that there would be any material adverse impact from the adoption of a regime that permits federal P&C mutuals to demutualize and, as a result, we do not believe that any steps need to be taken in order to deal with such potential impacts.

We believe that participants in a competitive marketplace must have the strategic ability to decide the most appropriate means of capitalizing their businesses and the optimal path to achieve their corporate objectives. A key consideration among mutual P&C insurance companies is the need for capital to compete with Canadian and global players. In many respects, the lack of regulations governing the choice to demutualize in the P&C industry serves as a hindrance to the competitiveness of those mutuals who would otherwise choose to go public or engage in a strategic transaction as Economical's Board has elected to pursue.

(a) Structure of the Canadian Insurance Industry

(i) Key Statistics

¹⁰ Including Economical's five member companies.

¹¹ OSFI (based on 2010 year-end data). MSA. Premiums written by regulated entities in the MSA database.

Figure 1 – Composition of the Industry

	Federally Regulated			Total
	Canadian Domiciled	Foreign Branch	Provincially Licensed	
<i>(# of Companies)</i>				
Mutual	14	15	15	44
Non-Mutual	77	73	29	179
Total	91	88	44	223

	Federally Regulated			Total
	Canadian Domiciled	Foreign Branch	Provincially Licensed	
<i>(Direct Premiums Written, billions of C\$)</i>				
Mutual	4.3	2.6	0.4	7.3
Non-Mutual	24.7	4.8	9.5	39.1
Total	29.1	7.5	9.9	46.4

Source: MSA

As noted, 14 of the 44¹² P&C mutual companies operating in Canada are Canadian domiciled and subject to the ICA, and in actuality, this number represents only 10 P&C companies, as Economical is made up of five entities. In 2010, the three largest of these were Wawanesa, Economical and Gore Mutual Insurance Company ("Gore"). These three mutuals rank as the seventh, eighth and 27th largest P&C insurance companies in Canada by DPW¹³, respectively, and generate approximately \$4.0 billion of DPW. Below, we present a summary of the Canadian-domiciled mutuals that we believe are subject to federal regulation (note that only 10 companies are listed as Economical comprises five entities):

Figure 2 – Federally-Regulated, Canadian-Domiciled P&C Mutual Companies

Federally-Regulated, Canadian-Domiciled P&C Mutual Companies <i>(in \$millions)</i>	As of Dec 31, 2010		
	Total Assets	Equity	DPW
Top Three			
Wawanesa Mutual Insurance Company	5,633	2,227	1,991
Economical Mutual Insurance Company	4,633	1,258	1,704
Gore Mutual Insurance Company	607	169	304
Top Three Total	10,873	3,654	3,999
<i>Top Three % of Total Federally-Regulated, Canadian-Domiciled P&C Mutual Companies</i>	94.5%	93.9%	92.6%
<i>Top Three % of Total P&C Industry</i>	7.1%	8.1%	8.6%
Remaining Seven			
The Portage la Prairie Mutual Insurance Company	355	120	189
The North Waterloo Farmers Mutual Insurance Company	122	35	69
Saskatchewan Mutual Insurance Company	90	34	46
The Kings Mutual Insurance Company	37	27	7
Antigonish Farmers' Mutual Insurance Company	15	10	5
Clare Mutual Insurance Company	5	2	3
Pictou County Farmers' Mutual Fire Insurance Company	10	8	2
Remaining Seven Total	632	237	319
Total Federally-Regulated, Canadian-Domiciled P&C Mutual Companies	11,505	3,891	4,318
<i>Federally-Regulated, Canadian-Domiciled P&C Mutual Companies % of Total P&C Industry</i>	7.5%	8.6%	9.3%

Source: OSFI, MSA. Economical has been consolidated. DPW includes all premiums written by regulated entities in the MSA database.

12 As noted, MSA counts every reporting entity within an insurance company separately, such that the total number of mutuals within the MSA database is actually only 37.

13 Canadian Underwriter Statistical Issue – Excludes ICBC, SAF as well as A&S and Reinsurance Companies. Also assumes that Intact completes its announced acquisition of AXA.

It would therefore appear as if the changes relating to demutualization under federal legislation would apply to a relatively small number of companies and have a modest economic impact overall.

(ii) History of the P&C Insurance Industry in Canada

The early 1800s marked the beginning of the P&C insurance industry in Canada, as insurance protection against fire and weather became of paramount concern among entrepreneurs, merchants and farmers. Small and growing cities faced the destruction of property by fire, usually accompanied by heavy loss of human life and destruction of wealth. In Canada, these episodes included the near-destruction by fire of St. John's, Newfoundland in 1816; two great fires that swept through the City of Quebec in 1845; and an 1852 conflagration in Montreal that left 10,000 individuals homeless.¹⁴

Insurance protection first became available to Canadians by the turn of the 19th century. In 1804, the Phoenix Assurance Company opened its doors in Montreal and in 1809 a similar insurer was formed in Nova Scotia called the Halifax Fire Insurance Association. In 1819, the Quebec Fire Insurance Company became Quebec's first domestic insurer.

By 1836, mutuals were being created in Upper Canada. For the most part, these mutuals were community-based insurance companies that would typically offer P&C insurance focused on the agricultural industry. By way of example, in 1839, the Gore District Mutual Fire Insurance Company was created, the precursor to today's Gore Mutual Insurance Company. Similarly, The Economical Mutual Fire Insurance Company of Berlin was founded in 1871 in what is now Kitchener-Waterloo and also offered coverage against hardships caused by fire and lightning. By the 1880s, more than 70 mutuals were in operation in Ontario.

A 1905 report published by the Superintendent of Insurance indicates that 40 companies offered fire insurance in Canada in that year.¹⁵ Of these, 17 were British, 13 were Canadian and 10 were American. For illustrative purposes, premium income in 1905 amounted to \$14.3 million against claims paid of \$6 million – by comparison to the \$46 billion-dollar industry that we know today. Fire no longer remains the major threat among businesses or individuals (supplanted by the financial risk associated with running a business, driving a car or owning a home).

(iii) Overview of the P&C Industry Today

The Insurance Bureau of Canada (IBC) reports that the P&C insurance industry directly employs approximately 44,000 Canadians and has a total premium base in excess of \$46 billion, representing approximately 3% of GDP.¹⁶

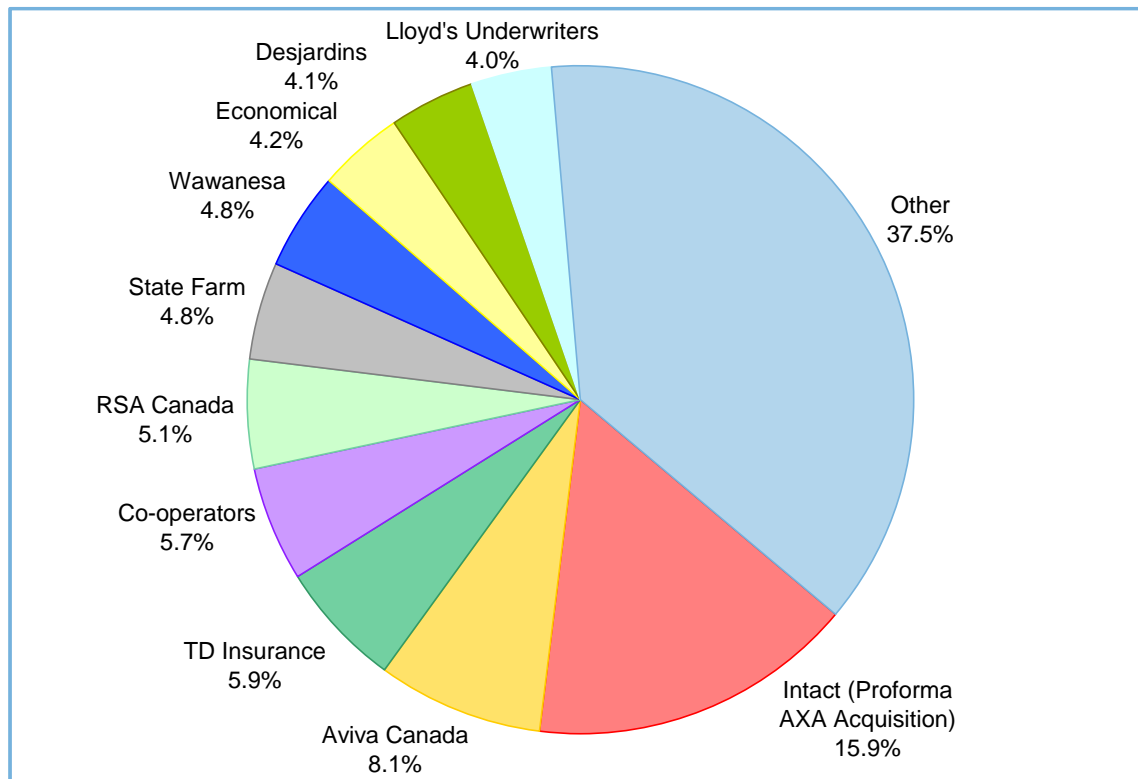
¹⁴ The Economical Insurance Group - *A Glimpse of the Past*.

¹⁵ IBC. 2009 Facts of the General Insurance Industry in Canada.

¹⁶ MSA Benchmark Report – Property & Casualty, Canada 2011 and IBC - 2009 Facts of the General Insurance Industry in Canada.

The following graphic depicts the market share of various participants within the total P&C industry. The Top 10 participants control approximately 62% of the market, with the largest single participant currently having less than 16% of the total market.¹⁷ Federally-regulated, Canadian-domiciled mutuals represent approximately 9% of the total market.¹⁸

Figure 3 –Top 10 P&C Insurers and their Market Share by DPW



Source: Canadian Underwriter Statistical Issue, excludes ICBC, SAF as well as A&S and Reinsurance Companies

According to MSA, in 2010 the Canadian P&C industry comprised 223 companies (both Canadian domiciled and foreign branches), down from 232 in 2000. In 2010, 176¹⁹ were stock companies, while 44²⁰ were mutuals (compared to 198 and 33²¹, respectively in 2000).

17 Canadian Underwriter Statistical Issue, excludes ICBC, SAF as well as A&S and Reinsurance Companies. Intact has announced the acquisition of AXA Canada. Upon close, Intact will have 15.9% market share.

18 OSFI, MSA. Economical has been consolidated. Includes all premiums written by regulated entities in the MSA database.

19 Numbers do not add to 223 due to reinsurers and reciprocals being excluded from the list of stock companies and mutuals.

20 MSA. As noted, MSA counts every reporting entity within an insurance company separately, such that the total number of mutuals within the MSA database is actually only 37. For example, MSA lists five companies that make up Economical. Similarly, MSA lists the two companies that form State Farm (State Farm Fire & Casualty and State Farm Mutual Auto), the two that comprise FM Global (Factory Mutual and Affiliated FM) and the two members of Liberty Mutual (Liberty Mutual and Employers of Wausau). Consequently, according to MSA, there are actually only 37 mutuals in MSA's database.

We also note that by comparison to MSA, The Canadian Association of Mutual Insurance Companies (CAMIC), an association of mostly farm-oriented mutual insurers, reports a larger data set of 91 federal and provincial mutual insurance companies underwriting \$4.6 billion in premiums. We believe the variance between MSA and CAMIC is due to the fact that MSA's database does not include the very small insurers who primarily service the agricultural sector and who collect a very small premium base.

21 Increase in mutuals from 2000 to 2010 is mostly related to an increase in the number of provincially-licensed individual mutual companies providing data to MSA.

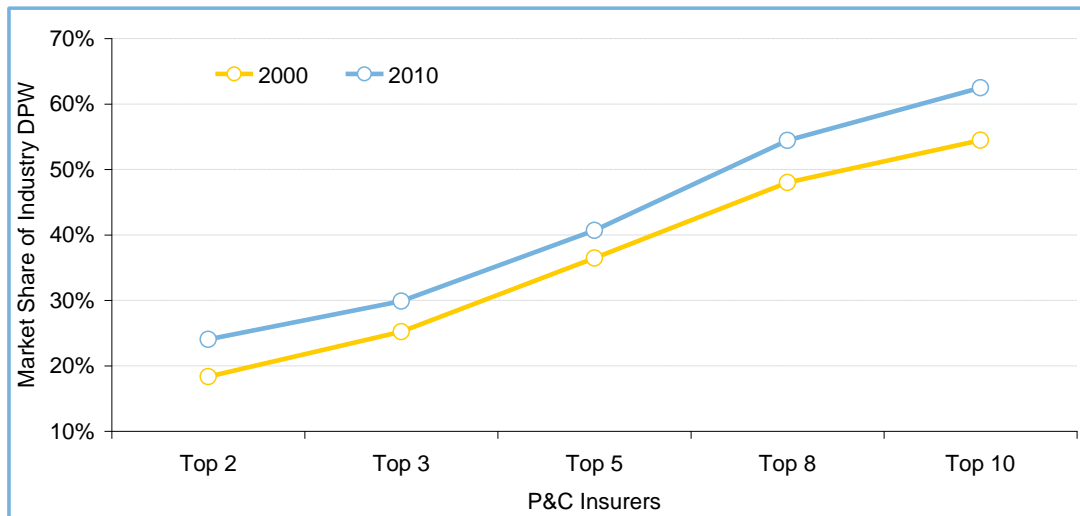
Below, Figure 4 presents a list of the top 10 largest P&C companies operating in Canada overall by DPW in 2000 and 2010, with Economical having fallen to eighth position from fifth overall in the P&C industry in Canada during that period. Figure 5 demonstrates that, over the last decade, the largest P&C companies operating in Canada have steadily increased their market share (as measured by DPW). The recent acquisition of AXA by Intact suggests that the large P&C companies will continue to get larger as the industry consolidates.

Figure 4 – Top 10 Largest Canadian P&C Companies – 2000 vs. 2010

2000	2010
1) ING Canada (Intact)	1) Intact (Proforma AXA Acquisition)
2) CGU Canada (Aviva Canada)	2) Aviva Canada
3) Co-operators	3) TD Insurance
4) Royal Ins. (RSA Canada)	4) Co-operators
5) Economical	5) RSA Canada
6) AXA Canada	6) State Farm
7) State Farm	7) Wawanesa
8) Zurich Canada (Intact)	8) Economical
9) Allianz Canada (Intact)	9) Desjardins
10) Wawanesa	10) Lloyd's Underwriters

Source: Canadian Underwriter Statistical Issue, excludes ICBC and SAF, as well as A&S and Reinsurance Companies. Also assumes that Intact completes its announced acquisition of AXA.

Figure 5 – Increased Market Share of Largest Players from 2000 - 2010



Source: Canadian Underwriter Statistical Issue, excludes ICBC and SAF, as well as A&S and Reinsurance Companies. Also assumes Intact completes its announced acquisition of AXA.

Current Industry Conditions in the Canadian P&C Industry

Canadian markets are similar to other global markets, characterized by substantial swings in capacity leading to deep cyclicity of returns and loss experience. In 2010, P&C insurers operating in Canada generated \$3.6 billion in net income on assets of \$154 billion. We also note that underwriting income was only \$161 million for the Canadian industry, with the balance being investment income.²²

The current challenges affecting the industry fundamentals in Canada are:

- Fraud and claims costs in the Ontario auto insurance market
- Excess capacity
- Volatile investment returns
- High cost distribution models; and
- Sub-scale companies.

Industry Profitability

In recent years, the industry's profitability has been negatively affected by volatile investment returns and low interest rates (which have increased reserve requirements). Low interest rates have also hurt the Canadian P&C industry in recent history as a large portion of insurance and surplus funds are invested in corporate and municipal bonds. Of note, a drop of 100 basis points in investment income can be more costly to earnings than a 2% - 3% increase in the combined ratio.

Position of the Mutual P&C Business in the Industry

In 2010, the Canadian P&C mutual industry included a total of 44²³ companies, including 14²⁴ federally-regulated, Canadian-domiciled mutuals, 15 federally-regulated, foreign branch mutuals and another 15 provincially-licensed mutuals.²⁵

Relative to the general P&C market, the mutual industry has been less profitable over the last 10 years, as illustrated in Figures 6, 7 and 8 below. In 2010, mutuals generated \$7.3 billion in DPW, experienced a loss of \$1.3 billion in underwriting income and lost \$570 million in net income on assets of \$25.2 billion.²⁶ In 2010, ROE was 8.1% for the P&C industry as a whole, but -7.2% among the mutuals.

22 MSA.

23 As noted, MSA counts every reporting entity within an insurance company separately, such that the total number of mutuals within the MSA database is actually only 37.

24 Including Economical's five member companies.

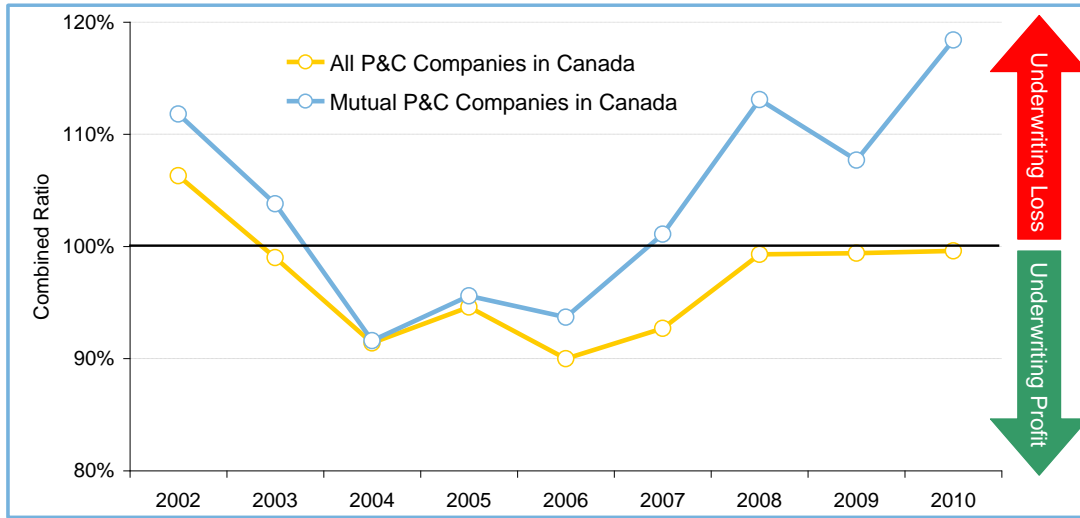
25 Certain provincially-licensed, small-scale farm mutual companies do not offer information to MSA and are excluded from metrics.

26 MSA.

Mutuals vs. Total Canadian P&C Industry 10-Year Performance

The graph below demonstrates that among P&C mutual companies operating in Canada, combined ratios have increased, reflecting weaker underwriting performance relative to the Canadian P&C industry as a whole.

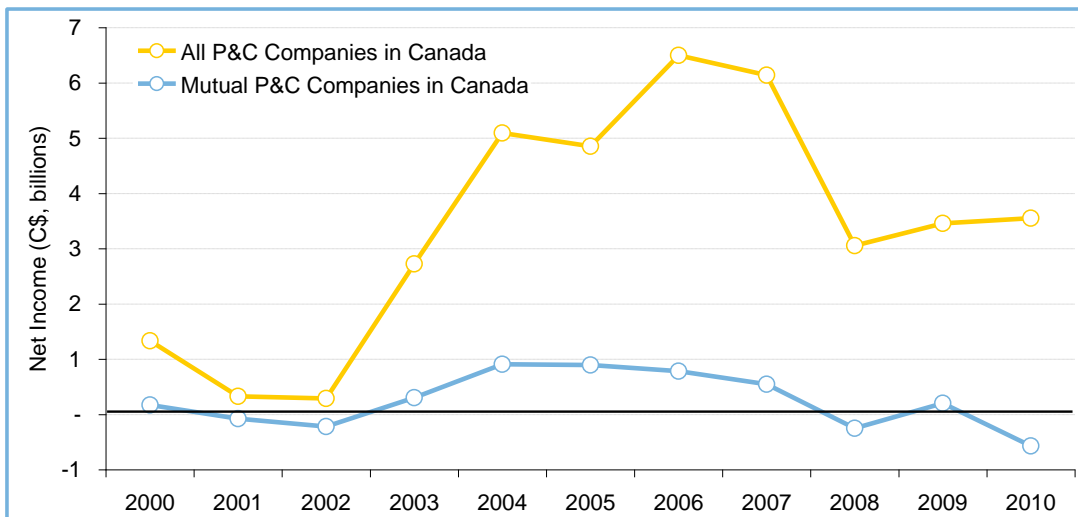
Figure 6 – Combined Ratio – Mutual P&C Companies vs. All P&C Companies in Canada 2000- 2010



Source: MSA

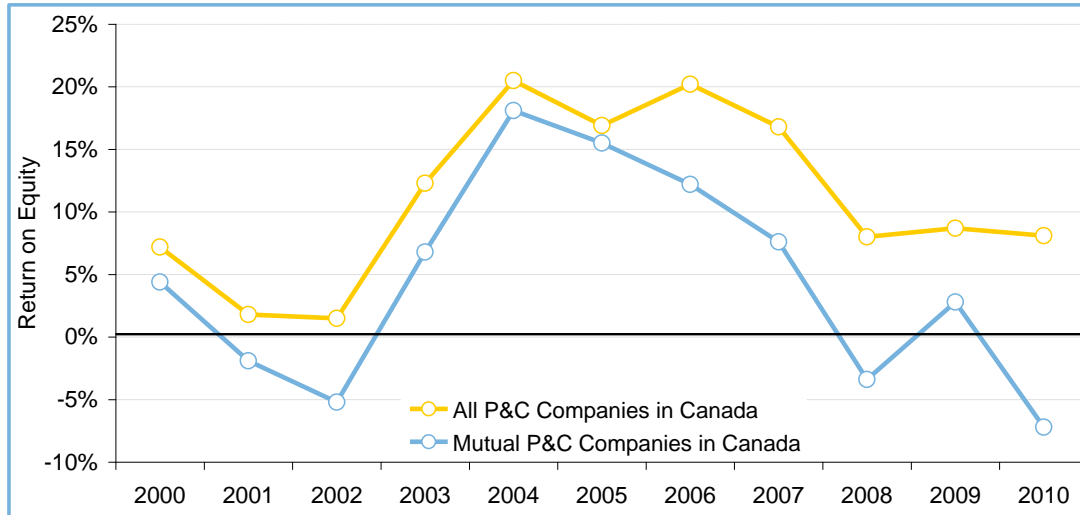
As shown below, net incomes have fallen considerably among P&C mutuals operating in Canada relative to the Canadian P&C industry as a whole. ROE, which is a function of net income, has also been appreciably lower among P&C mutual companies operating in Canada over the last 10 years, falling to negative levels in two of the last three years, bringing it to unsustainable levels for any industry.

Figure 7 – Net Income – Mutual P&C Companies vs. All P&C Companies in Canada 2000 - 2010



Source: MSA

Figure 8 – Return on Equity – Mutual P&C Companies vs. All P&C Companies in Canada 2000 - 2010



Source: MSA

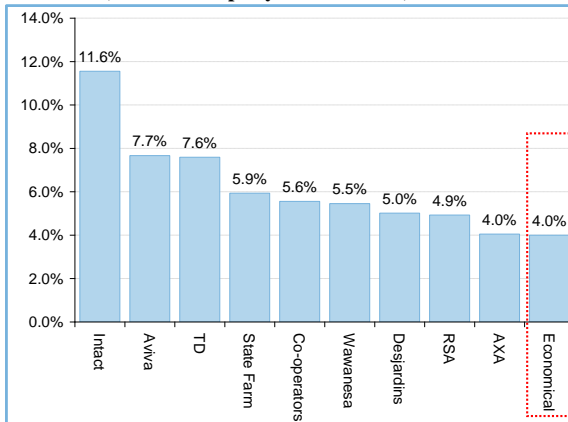
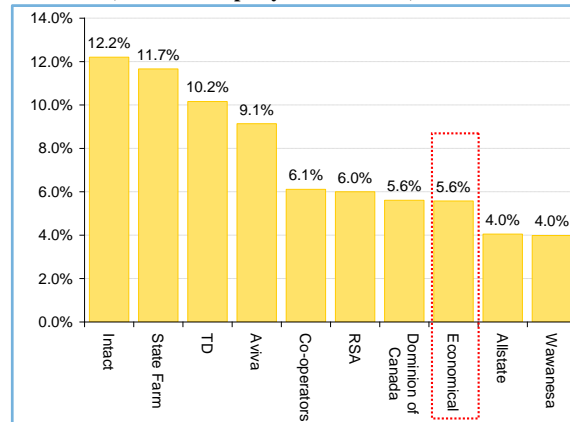
In explaining why mutual companies do not perform as well as the rest of the Canadian P&C industry, it is helpful to examine premium-to-equity ratios. As with many other mutuals, Economical operates at a lower premium-to-equity (surplus) ratio as, without ready access to external capital and in the interest of fiscal conservatism, it generally carries additional capital to support its business. As a consequence, profitability is insufficient for the amount of surplus held, which results in lower ROE compared to many stock companies and is an inefficient use of capital. For example, if mutual companies, such as Economical, priced their policies with an objective of achieving a 10% ROE (comparable to industry returns), their premium prices would likely be uncompetitive given the level of surplus they hold.

(b) Economical's Position in the Canadian Insurance Industry

Economical has approximately \$4.6 billion in assets, DPW of \$1.7 billion, surplus of \$1.3 billion and an investment portfolio valued at \$3.7 billion as at December 31, 2010²⁷. It has more than one million policyholders, 2,600 employees and 900 independent insurance broker partners. The Company relies almost exclusively on brokers to distribute its insurance products.

As demonstrated below in Figure 9, Economical is the smallest of the top 10 P&C companies in Canada by DPW in the personal property and auto segment. However, in Ontario, Economical ranks eighth in the personal property and total auto segment.

²⁷ As of the December 31, 2010 balance sheet, assets were \$4.6 billion, surplus was \$1.3 billion and the investment portfolio and cash equivalents were valued at \$3.7 billion.

Figure 9 – 2010 Canada Market Share (Personal Property & Total Auto) - DPW

Figure 10 - 2010 Ontario Market Share (Personal Property & Total Auto) - DPW


Source: MSA, excludes ICBC and SAF and premiums written outside of Canada.

(c) Impact of Federal Demutualization Regulations on the P&C Industry

While a small number of companies (such as Economical) are federally regulated and thus file financial reports and statements with OSFI, a number of mutuals are provincially incorporated and, for the most part, their individual financial statements are not available from their regulators. We believe that the vast majority of mutuals in Canada are small and locally based.

As noted, there are only 14²⁸ federally-regulated, Canadian-domiciled mutuals. Consequently, we believe that structural issues within the insurance industry relating to demutualization under federal legislation would apply to a relatively small number of companies and therefore have a modest economic impact overall.

From a number of perspectives, we believe that Economical is a unique situation in the industry. The company has a small number of mutual policyholders (fewer than 1,000) who effectively control a surplus of approximately \$1.3 billion.

Economical is also a unique situation as it is one of the largest of the mutuals and has a portfolio of businesses that is national in scope and substantially more diverse than most of the other mutuals. This means that Economical has to compete directly against the largest Canadian and global insurance companies. In addition, because Economical has a significant portfolio of commercial insurance lines, it is required to compete both on price (in part a function of its cost of capital) and ratings. Economical is not rated by A.M. Best or other rating agencies because, as a mutual, it has limited access to capital to allow it to recapitalize, putting it at a significant disadvantage to public competitors as well as foreign-controlled companies. Without market access to capital, Economical has limited options to ensure adequate capital reserves in the event of significant claims loss or extraordinary events, or to allow it to improve productivity by making further significant investments in systems and

²⁸ MSA, Including Economical's five member companies.

processes.

For all of these reasons, the logic of demutualization is very strong for Economical and this has driven its Board's strategic decision to demutualize.

As noted above, the P&C insurance industry in Canada is significantly fragmented, especially compared to the balance of the financial services industry in Canada. The announced acquisition of AXA Canada by Intact serves to highlight the ongoing levels of consolidation in the industry. Interestingly, and unlike the life insurance and banking sectors, there is a substantial market share held by companies controlled by foreign parents. Also interesting is that with the exception of Fairfax Financial Holdings, a financial holding company based in Toronto engaged in insurance and reinsurance, very few Canadian-controlled companies have any significant footprint outside of Canada – again unlike the life insurance and banking sectors. While there are likely many reasons for the lack of globally-significant P&C insurance providers controlled in Canada, the mutual origins of the industry and the consequent lack of access to capital may be a determining factor.

While we do not see a groundswell of interest in demutualization – especially amongst the smallest of companies – there is likely an advantage to Canada's prosperity, growth and productivity from a further consolidation of the industry, especially under Canadian control.

(d) Economic Impact of Possible Demutualizations

As noted above, we do not see a significant wave of demutualizations. Even if we assume that all of the federally-regulated mutual companies in Canada (with the exception of Co-operators Group – not a mutual insurance company) were to demutualize, the effect on the industry would, we believe, be modest.

(i) Effect on industry concentration and competition

As mentioned, of the approximately \$46 billion in annual premiums within the P&C insurance industry in Canada, we estimate that the 14²⁹ federally-regulated, Canadian-domiciled mutuals amount to \$4.3 billion or approximately 9.0% of the Canadian P&C industry's total premiums. In the extremely unlikely event that all of these mutual companies were to demutualize on a sponsored basis and be absorbed by other participants, the effect on competition in the industry would be rather small.

(ii) Impact on safety and soundness

As noted above, the \$4.3 billion of annual premium is spread across approximately 14³⁰ federally-regulated, Canadian-domiciled mutuals, with average annual premiums of approximately \$310 million per mutual. Excluding the three³¹ largest mutuals' premiums, this

²⁹ MSA, Including Economical's five member companies.

³⁰ MSA, Including Economical's five member companies.

³¹ Including the member companies in the top three.

figure drops to an average of less than \$47 million in premiums across the remaining federally-regulated, Canadian-domiciled mutuals. One might have to conclude that the size of companies when combined with the local nature of their underwriting would imply risks that would exceed those of a more diversified book of business. A further consolidation of the industry would likely reduce event risk and reduce costs of regulation and inspection.

(iii) Impact on productivity

A significant issue within the Canadian economy is productivity, especially within the financial services industry. Deputy Governor of the Bank of Canada Timothy Lane said in a 2009 speech:

“How productive is the Canadian financial services sector? Data from Statistics Canada point to a possibly worrisome trend. Productivity growth in this sector has declined from an average of 2.8 per cent per year in the 1990s to just over one-half per cent in this decade.”

While there are many explanations posited from these trends, we believe several have substantial resonance. Mr. Lane outlined three significant factors as investment in technology, innovation and (emphasis added) “reallocation of capital and labour across firms”.

All three of these factors can positively impact productivity. The eventual consolidation of the P&C insurance industry generally will likely improve each of these factors influencing productivity growth. The largest of these is likely to be a reallocation of capital and labour to higher overall returns – which is difficult to achieve under the mutual insurance company model.

(iv) Impact on employment

It is difficult to predict the outcome of demutualization with respect to employment as reliable employment data within the P&C industry is not available. However we estimate that on average, the industry as a whole writes approximately \$1 million worth of premium for every employee in its direct workforce. The impact on employment at the remaining small, federally-regulated, Canadian-domiciled mutual companies will be negligible given the concentration of employment among the aforementioned top three players. Any consolidation of the P&C insurance industry could therefore have a negative effect on employment in the near term, but, as noted above, a longer-term positive effect on productivity.

D. Number of Voting Policyholders in Some Mutual Companies

- 1. *What implications does a small and declining voting policyholder base have for the effective governance of a mutual company?***
- 2. *How can companies with a dual policyholder structure ensure that they continue to have effective governance structures?***
- 3. *Should measures be taken to increase the number of voting policyholders, and if so, what should those measures consist of?***

Our answers to the above three questions are brief. While we have a small voting policyholder base, we have not found this to be an impediment to effective governance. However, as Economical fully intends to demutualize, we have no suggestions on how P&C mutuals that choose not to demutualize should ensure that they continue to have effective governance structures or on whether measures should be taken to increase the number of voting policyholders.