Small Talk Newsletter

May 1998 – Issue No. 11

Mutual Insurance Holding Companies: An Update

by Christian J. DesRochers

The widespread adoption of mutual holding company legislation and the recently released NAIC Draft Report on Mutual Insurance Holding Company Reorganizations have focused increasing attention on the issues surrounding the mutual holding company structure and the future of mutual life insurance companies generally.

In 1996, approximately 90 mutual life insurance groups filed life insurance NAIC annual statements. Mutual life insurers make up approximately one-third of the U.S. life insurance industry when measured either by assets or capital and surplus. Although the 10 largest mutual insurance groups hold approximately 85% of total mutual assets, small companies are a significant segment of the total mutual population. For example, half the total number of mutual groups have assets of $500 million or less.

The management challenges faced by mutual life insurance companies generally, and small mutual life insurance companies specifically, are well-documented. Access to capital continues to be a critical issue. Because mutual life insurance companies are owned by their policyholders, mutual life insurers have few options to raise capital other than that internally generated by operations. These options may include the issuance of surplus notes, the formation of downstream subsidiaries, financial reinsurance, and demutualization.

However, the alternatives outlined are not generally viewed as solutions to the long-term capital needs of mutual life insurance companies. Downstream subsidiaries are limited in their ability to pass capital upwards to the parent insurer and require that profitable nonmutual subsidiaries be available to put in the downstream company. Surplus notes are restricted to a percentage of surplus and ultimately must be repaid. Demutualization, in which a mutual life insurer is restructured into a stock company, is time-consuming, administratively complex, and expensive. For example, it has been reported that Equitable spent more than $40 million on demutualization. Demutualization also forces the timing of an initial public offering (IPO) to recapitalize the company, and little new capital (that is, in excess of that distributed to policyholders) is generally raised in a demutualization. Finally, demutualization changes the character of the organization from a mutual company to that of a stock life insurer.

Mutual Insurance Holding Companies

In the last two years, several states have enacted legislation permitting mutual insurers (both life and property/ casualty) to form mutual insurance holding companies (MIHCs). These states include California, Florida, Iowa, Kansas, Louisiana, Minnesota, Missouri, Montana, Ohio, Oregon, Pennsylvania, Rhode Island, Texas, Vermont, and the District of Columbia. Legislation is pending in Illinois, Indiana, Massachusetts, New York, and Wisconsin.

The first MIHC statute was passed in Iowa in 1995, so mutual insurance holding companies are relatively new phenomena. The statutes are generally patterned after the process of reorganizing mutual savings associations. Companies that have either adopted or announced that they are adopting the MIHC structure include AmerUS (formerly American Mutual), Principal, Acacia, General American, Ohio National, Ameritas, and Pacific Life (formerly Pacific Mutual).

Mutual insurance holding companies may prove to be a key capital restructuring tool available to mutual life insurance companies. Because of their advantages over a traditional demutualization, MIHCs may also be a way for smaller mutual life insurance companies to gain needed flexibility in their capital structure, without the time and cost of full-scale demutualization. At the same time, however, opposition to MIHCs has arisen from some consumer advocates and others, and the threat of class-action litigation is present in MIHC conversions. Recent legislative activity has been marked by increasing debate between proponents of MIHCs and their critics over the rights of policyholders under the mutual holding company structure. The outcome of the debate may ultimately determine the viability of the mutual holding company as an answer to the capital needs of mutual life insurance companies.

Policyholder Rights under an MIHC

A policyholder of a mutual life insurance company is traditionally considered to have three separate interests in the company:

- Membership rights, which include the right to receive dividends and to elect the company's board
- Ownership rights, or the right to receive the value of the company in a liquidation (that is, a demutualization)
- Contractual rights, which include the right to receive benefits guaranteed in their policies, and "reasonable dividend expectations."

Under an MIHC restructuring, the (former) mutual life insurance company is split into two entities, an upstream general purpose corporation and a stock insurance company subsidiary. A variation is to create three entities, with an intermediate holding company between the MIHC and the stock life insurer. This allows the intermediate holding company, rather than the stock life company, to issue stock. The MIHC is a shell that does not engage in the business of insurance, but holds the shares of the stock life insurance company subsidiary that serves the members of the MIHC.

Policyholder rights are also separated. In an MIHC, the membership and ownership rights are transferred to the MlHC, while the contract rights reside in the newly converted stock life subsidiary of the MIHC. THE MIHC does not issue stock. Rather, the ownership of the MlHC is represented by the membership rights that the policyholders of the former mutual life insurer receive, which entitle the members to vote for the members of the board of

continued on page 13, column 1

An Update
continued from page 12

directors of the MIHC. After the restructuring, all the life insurance is issued in a stock life insurance company. New policyholders may or may not have the same membership rights as the old policyholders. Typically, states require that the MIHC hold at least 51% of the (restructured) stock life insurance company. After conversion, the MIHC holds all the stock of the downstream companies; future stock sales are carried out by an IPO.

The contractual interests of the existing participating policyholders are often supported by a "closed block" of assets held in the stock life insurer. The closed block involves an allocation of assets that, with future premiums, is sufficient to pay the policies' guaranteed benefits and the dividend scale, in effect, at conversion if the current experience remains unchanged. A closed block is a device that has been used in a traditional demutualization to support the future dividend expectations of the policyholders at the time of demutualization. The policyholders are also given priority on the assets of any intermediate holding company in an insolvency.

Advantages

Proponents of the MIHC structure see it as an ideal method of providing needed access to the capital markets for mutual life insurance organizations, while preserving the basic mutual structure of the organization that would be lost in a demutualization. The formation of a MIHC is faster and less costly than a traditional demutualization. Because the MIHC restructuring retains existing surplus in the stock life company without a distribution to policyholders, they retain their majority interest. This reduces the threat of a takeover and allows the MIHC to retain its mutuality while providing access to capital. Thus, the MIHC structure allows the former mutual life insurer to enter capital markets and preserve its mutual heritage and independence.

An MIHC retains the flexibility to demutualize in the future. However, it does not force timing of an IPO as in a demutualization. This is said to be better for policyholders because the stock of demutualized insurers has at times come to market at a significant discount to total book value. If policyholders who receive stock sell their shares immediately, they do not realize the full potential value. Therefore, an MIHC allows better selection of market timing for demutualization. Under an MIHC, an IPO could also be done at the intermediate (stock) holding company level, so all the proceeds need not to go to a life company. Any capital raised by the MIHC is in addition to existing surplus. Unlike a traditional demutualization, the stock insurance company has no need to recapitalize after a MIHC conversion.

In addition, the MIHC structure provides flexibility in acquisitions, mergers, and other corporate transactions. For example, it may simplify acquisitions of other companies using stock rather than cash. In addition, the MIHC structure will better prepare mutual life insurance companies for broad-based reform of financial services (for example, the merger of Travelers and Citicorp), as it provides the ability for a MIHC to restructure into affiliated groups that contain insurance and noninsurance companies, thereby decreasing regulatory costs. Currently, downstream companies are generally direct subsidiaries of the parent mutual life insurance company.

Finally, an MIHC structure can facilitate cultural change as it allows for the compensation of management with stock and stock options, thus retaining key managers.

Criticisms

Opposition to the MIHC legislation has generally come from consumer advocates. However, in early 1998, a group of stock life insurers formed a group called Companies for Demutualization Fairness to lobby against the MIHC legislation. These stock companies view MIHCs as unfair to stock companies because they cannot be acquired and potentially dilute the value of other insurers' stock. In addition, the stock companies argue that mutual conversions are unfair to policyholders and are not necessary because the option of a traditional demutualization still exists.

The key issue in the debate over mutual insurance holding companies is the nature of the policyholders' interest in the (former) mutual life insurance company after restructuring. When a mutual company is demutualized, policyholders receive a distribution of cash and/or stock that represents their equity interest in the company. Critics of the MIHC structure, which include Joseph M. Belth, professor emeritus of insurance of Indiana University, and Jason B. Adkins, formerly executive director of the Center from Insurance Research in Cambridge, Massachusetts, point out that although the former mutual has been converted to a stock company, policyholders receive none of the stock. While the surplus of a mutual life insurer is held for the sole benefit of the policyholders, the equity shareholders of an MIHC have a claim on the insurer's surplus that is no longer held for the exclusive benefit of the policyholders.

Although the closed block of assets is designed to preserve dividends on policies, critics argue that it represents only part of the value that policyholders receive in a demutualization. The benefit of an increase in share price only goes to those policyholders who were offered and subsequently purchased the stock. In their view, the closed block does not give policyholders the financial benefits of the new company that they would receive in a demutualization. Thus, say the critics, while the ultimate outcome of a demutualization and a conversion to an MIHC are the same, the policyholders in an MIHC conversion do not receive any compensation for the loss of value. Compared with demutualization, no cash is distributed. Thus, say the critics, in an MIHC the closed block operates to the detriment of the policyholders and not to their benefit.

Critics also argue that the MIHC statutes effectively deregulate much of the MIHC activities. By allowing a more complex corporate structure, the MIHC structure further weakens the ability of policyholders, regulators, and the courts to hold management accountable. A conflict of interest may exist because, unlike a typical stock corporation, the MIHC has two distinct sets of owners and one management group. In theory, the goals of the equity shareholders may conflict with those of the policyholders. The policyholder/owners want higher dividends, while shareholders want higher profits.

continued on page 14, column 1

An Update
continued from page 13

In response, proponents of the MIHC structure point out that the ownership interests are not extinguished, and therefore policyholders have not lost any value. Ultimately, the success of the insurance company depends on the values that it provides to its policyholders. Therefore, shareholder interests and policyholder interests are aligned.

The March 1998 draft NAIC report, "Mutual Holding Company Reorganizations," appears to adopt a view that is aligned with that of the critics of mutual holding companies. Telling comments in the NAIC report include "on its face it seems that having a right to cast votes for management of a MIHC is inadequate compensation, by itself, for total extinguishment of members numerous rights in the mutual insurer" (p. 32) and "proponents of an MIHC option have been unable to identify a legal means to send the profits of those companies on top of the stock insurer back down to the policyholders of the stock insurer who also comprise 100% of the membership of the MIHC" (p. 33). The NAIC draft is not without its critics, even within the NAIC, and may not be finalized in its current form, but it seems to take a strong position in favor of some participation in the profits of the downstream companies by the owners of the MIHC. Were this position to ultimately prevail, it would remove one of the major cost advantages of the mutual holding structure over full demutualization, as some means would be needed to allocate the ownership of the MIHC to individual members, a process that can be very time-consuming and expensive.

The Future

Recent developments have signaled that a major restructuring of mutual life insurance companies is under way. However, even before the NAIC draft report, there were mixed signals about the future of MIHCs. Several large mutual life insurers, including the Prudential, Standard Life, and Mutual of New York, have indicated their plans to go with traditional demutualization and not an MIHC. At the same time, Principal Mutual and others are continuing toward adoption of an MIHC structure, and the Metropolitan has shown a strong preference to restructure using an MIHC.

One proposal made during the debate over MlHCs in New York would restrict the use of the MIHC structure to a limited period as an interim step toward demutualization. An MIHC would be required to have an IPO within three years of its formation. The proceeds of the IPO would be distributed to the policyholders. Supporters of the proposal argue that the method allows the market to establish the value of the ownership interests, while allowing management to control the timing of the public offering.

Although several of the Canadian mutual life insurance companies, including Manulife and Mutual Life of Canada, have announced their intention to demutualize, these appear to be traditional demutualizations.

Whether the threat of policyholder class-action lawsuits, the actions of Prudential and others in moving toward a tradition form of demutualization, or additional restrictions imposed by the NAIC will affect other mutual companies restructuring under the MIHC form remains an open question. However, it is safe to predict that the debate will continue as will the pressure on all mutual life insurers, both large and small, to find the capital structure that is appropriate for their policyholders as they prepare to enter the 21st century.

Christian J. DesRochers, FSA, is a Partner at Avon Consulting Group LLP in Avon, Connecticut and Vice-Chairperson of the Smaller Insurance Company Section Council.