Article from:

Small Talk Newsletter

May 1998 – Issue No. 11

Proposed Mutual Holding Company Legislation for Life Insurers

by Thomas P. Tierney

Editor's Note: *The following is testimony presented by the author to the New York State Assembly Standing Committee on Insurance.*

The legislation proposed by New York Governor George Pataki (A.7057–A/S.5628) to allow a domestic mutual life insurer to reorganize as a stock company that is owned by a mutual holding company (MHC) should be rejected.

There are three general reasons why this proposal, if it were to be enacted, would be bad for the State and for the People of New York. They are:

1. The *question of who the current owners are, and in what proportions, of the mutual insurance industry needs to be answered* before a further modification (beyond the current Section 7312 demutualization provisions) of this ownership status question is addressed.

   In addition to current policyholders (whose ownership rights are acknowledged, albeit vaguely and without quantification, in the proposal), legitimate ownership claims could also be asserted (under equitable, abandoned property and other theories) by former policyholders, the insuring public, the State, and other governmental jurisdictions.

   With regard to current policyholders, note that there are problems in the proposed legislation with current voting rights and with ownership assignation.

   - Current voting rights, even if it is agreed that they are not inalienable (that is, it is agreed that current policyholder voters can collectively vote to extinguish or modify their future right to vote), should not be eliminated, a priori, before they are exercised one last time during a MHC reorganization election. This ex post facto approach, however, is exactly what will happen under the proposed "weight given to … vote" provision contained in the newly proposed Section 7908(b) of the Insurance Law. It could be argued that this section is, in effect, a "taking without compensation" of policyholder property and the subsequent giving of this property to the Superintendent. Moreover, once a new MHC is created, the new MHC voting rights referenced under Section 7910(b) will not be quantified on a policyholder-by-policyholder basis [as the Section 7917(c)(5) "specified" comment anticipates and as they must be if they are ever to be used thereafter]. The question should also be asked if the widows-and-orphans and mom-and-pop policyholders who now have the lion's share of voting power will be keeping same or will they be ceding it to the larger rich-individual and corporate policyowners.
   - Ownership assignation is totally ignored under the proposed law. More specifically, the question of how the property that the MHC owns (and, in particular, the 51%–100% stake in the new stock insurer) is allocated among the MHC's members is not addressed. The argument that this question can be answered later ignores the equity forfeiture and tontine implications that such a postponement would ultimately entail.

   With regard to former policyholders, the insuring public, the State, and other governmental jurisdictions, note that the proposed legislation presumes, in what appears to be an arbitrary manner, that these entities will never have any MHC membership interests. Consider that:

   - Former policyholders, under many reasonable ownership schema, could be considered as having left excess assets behind at the MHC predecessor, when their coverage ceased, and it could be argued that these remainder assets confer a MHC membership interest; this concept is more than just abstract theory since ERISA-qualified pension plans (which are in many ways economically similar to the cooperative nature of mutual insurance companies) will often grant surplus benefits to prior pension plan participants during a pension plan termination.
   - The State and other governments (as the recipients of escheated property of former policyholders and as the grantor of tax concessions and other benefits) and the insuring public (under social easement theory) could also lay a defensible (albeit one that is not necessarily irrefutable) ownership claim on a new MHC.

   Also note that the "we're an ownerless company" logic being proffered by the management of some mutual insurance companies could buttress an "if nobody owns them, everybody owns them" public facility ownership argument.

2. The *purported reason* that is usually advanced *for reorganization* as a domestic stock company, *access to capital markets, is bogus; the need simply does not exist*.

   In the grand economic scheme of things, the insurance industry is a supplier, not a demander, of capital and should not, at least permanently, be on both sides of the fence—nor does it have to be because a need for outside capital has never been demonstrated. Experience has proven that outside financing requirements, in those very rare occasions when they do arise, are always temporary and that they can be easily handled via a stock subsidiary, a bonding, or a surplus notes process.

   The concept of mutual insurance, in particular and almost by definition, precludes the need for outside capital since the premium structure of dividend-paying policies

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will normally have adverse-experience reserve capital built into it. Insurance policies premiums (according to actuarial science, good economics and the New York State Insurance Law) must be self-sufficient; and this means that outside capital, by design, should not be necessary. The premiums will deliver to the insurer whatever capital is needed to get the job done.

The real reason for the Article 79 reorganization proposal is to position the current mutual insurance industry management for a stock market killing (which would occur at policyholder and public expense), and the Assembly, I believe, should not allow such a perversion of the current not-for-profit mutual insurance process to happen.

3. The *mutual holding company concept itself is an organizational monstrosity*. It pits stockholders and the owners of mutual policies in a severe and nonsolvable conflict of interest; it effectively insulates company management from any reasonable accountability or outside oversight; and it is operationally awkward and comparatively expensive.

   The management that is running an MHC and its stock subsidiary management will always be torn between their opposing duties to participating policyholders (minimizing their premium outlay) and to company shareholders (maximizing their share value)—one contradicts the other and you cannot have both simultaneously. It is a fish-or-fowl situation; a company has to be either totally stock or totally mutual; in the former case, management has a debtor-creditor contractual relationship with its policyholders and a fiduciary duty to its shareholders; in the latter case, management's fiduciary obligations run to its policyholders and the relationship between them is of a trustee-and-beneficiary nature. Both approaches are valid, but the conflicting demands on management are such that they can not viably exist together at the same place and time.

   The "closed block" approach to dividends that is outlined in Section 7903(b)(1) of the proposed legislation is a good example of an idea that will never work because of an inherent policyholder/stockholder conflict of interest. Management cannot work to increase participating policyholder dividends (which will inevitably suppress stockholder profits) and, at the same time, be laboring under a duty to augment stockholder return.

   The 51% ownership requirement specified in Section 7917(c)(2) of the proposed legislation is another example of organizational inappropriateness. The purported "independence" rationale is a sham; if an unfettered and free market dictates that an acquisition is appropriate, then so be it. General superintendency powers and judicial review, as they now exist, ought to be sufficient to provide any extraordinary protection that might be needed. The real purpose of the 51%-ownership requirement is to insulate management from any takeover attempts. Think about it—they will have lifetime sinecures, be paid handsomely, and be granted get-rich stock options to boot. It is a great deal if you can get it, but the NYS Assembly should not be playing Santa Claus to a timid management that wants real-world rewards but without any of the attendant risk. By way of analogy, it is comparable to an election law change that would vest 51% of a district's voting power in a member and the member's friends and family.

What would really serve the public, and what I hope the assembly will consider, is a complete reworking of the current Section 7312 demutualization law. Such a review would be topical (given the pending Mutual of New York action) and it could address some very critical problems that Section 7312 shares with this proposal (such as the "who the current owners are," ownership assignation, and voting rights problems detailed above).

I thank this honorable committee for receiving this comment and would be happy, if requested, to assist it in any way.

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