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Mutual Insurance Holding Company Conversions: Lessons Learned

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Summary: Panelists address the various issues surrounding the conversion of a mutual insurance company to a mutual insurance holding company structure. Actual experiences are discussed, presenting the perceptions of company management, the regulators, and their advisors.

Mr. Carl M. Harris: Over the past few years, we have seen a proliferation of mutual insurance companies going through various types of conversions. Equitable of the U.S., UNUM, Royal Macabees, Guarantee Life, All America, Littleton Mutual, and Old Guard have all demutualized. Standard Insurance Company, Prudential, John Hancock, and Mutual of New York have announced their intentions to demutualize. AmerUs Life, Acacia Life, Ameritas Life, General American, National Chiropractic and Pacific Life have all formed mutual insurance holding companies (MIHCs). Principal, Ohio National, Minnesota Mutual, Security Benefit and National Life of Vermont have announced their intentions to form MIHCs.

In 1963, there were approximately 153 mutual life insurance companies in the U.S. By 1993, there were approximately 100 left, and today, there are about 90. If this trend continues, the extinction of mutual life insurance companies is definitely possible. Rather than just talking about the concepts, panelists in this session will discuss lessons they have learned throughout their processes.

Our first speaker will be Barbara Snyder, who is the vice president of the Individual Production Division at General American. She is responsible for all aspects of individual product development, including determining and developing the products offered by General American as well as providing market research on the individual product lines.

Paul Ochsner is senior vice president of the Employee Benefits Division/Finance at Guarantee Life Insurance Company. He is responsible for strategic financial management, including the preparation of financial projections and other analyses.

Terry Vaughan is commissioner of insurance for the State of Iowa. She is the chairperson for the Life Committee of the NAIC, the Financial Reporting Working Group, and a member of the Mutual Insurance Company Working Group Task Force. She will give us the regulator's perspective of these transactions, particularly the MIHC transaction.

Ms. Barbara Snyder: I want to mention something that I saw recently. We're all used to seeing insurance in *Best Review* and *National Underwriter* and occasionally, *The Wall Street Journal*, but we recently made the popular press. "The Feeling Isn't Mutual," an article by Alan Sloan in the June 8, 1998 issue of *Newsweek* magazine, says big insurers want to change how they're owned—some the right way, some the other way. I don't always agree with Mr. Sloan, but he states that, until recently, it looked like most policyholders were going to get the mushroom treatment: kept in the dark and covered with manure. I don't think any of us intend to keep our policyholders in the dark, but we do need to remember that the policyholders are who we're in business for.

My presentation deals with General American's experiences with the MIHC structure. We saw many advantages in it and have discovered more since April 1997, when we adopted it. I'll also briefly describe how the Missouri MIHC statute recognizes and facilitates affiliations between mutual life insurance companies.

In the 1990s, General American began a period of rapid expansion in insurance and many other businesses. Like most other companies, we place a lot of emphasis on financial results but began to feel constrained by the corporate structure. The mutual life company was the parent and all our newly formed or acquired businesses were subsidiaries. This led to a pretty cluttered structure. We didn't want to abandon our mutual company upbringing, but the disadvantages of having a mutual life company as the operating parent started to become obvious.

The first disadvantage was that all the financial transactions were reflected on the parent's books. Any debt borrowing of any subsidiaries, unusual earning patterns, and unusual capital requirements all were passed along to the parent company's financials. This creates problems with rating agencies because they are attuned to every blip in a company's performance. They want very steady performance measurements and have a very hard time understanding when those blips are caused by something that's not in the insurance company. They're also very concerned about the risk-based capital ratios.

The second disadvantage involved the traditional capital raising efforts. We differ from many mutual companies in that we have been very successful in accessing the capital markets. We've made effective use of securitized borrowing, sale and lease back, surplus notes, and financial reinsurance. But our most successful capital-raising results derived from taking our subsidiaries public. So far we have done that with three subsidiaries. The investment community, however, had been penalizing us because the public subsidiaries were downstream from a life insurance company. Not surprisingly, the investment community considers life insurance to be a heavily regulated industry. Whether Wall Street was right or wrong, it felt that our public subsidiaries were constrained in their operations.

The third negative was the limitations of the name and identification as a life company. It's difficult to become known as a broad-based financial services company with the name General American Life Insurance Co. Our noninsurance businesses were forever aligned with a life insurance company. For these and a number of other reasons, we adopted the MIHC structure.

Today, we have the General American Mutual Holding Co. at the top of the organizational structure. Downstream from that is the stock holding company GenAmerica Corporation., the name around which we're building our corporate identity. General American Life Insurance Company is now a stock subsidiary of GenAmerica Corporation.

This corporate identity is mainly for the investment community, the source of capital that we access to take our subsidiaries public. We haven't been simply a life insurance company for some time, and GenAmerica Corporation allows us to do a much better job of talking about that. We did not, however, adopt the MIHC structure to be able to issue stock in order to raise capital. Our capital needs are being met by other means. What did appeal to us were the other advantages of the MIHC structure. First, the use of leveraged debt is a significant new tool for us, and the ability to borrow at the holding company level and transfer the proceeds into equity for subsidiaries is a very useful source of capital.

The second positive result has to do with some statutory and GAAP accounting rules. Statutory rules limit a company's range of options for certain accounting practices; in particular, the benefit plan cost for employees have very restrictive statutory accounting rules. Now we are able to transfer the employment of some current life company employees to the holding company, which we intend to do this year. There also are potential tax advantages. We didn't adopt the MIHC status to get tax relief, but these tax advantages may exist, depending on the company structure and circumstances.

More significant is the fourth advantage: the unstacking ability. The subsidiaries can be transformed into subsidiaries of the stock holding company and become sister companies to the life company, which gives us a number of positive results. One is that the ability to move these companies out from under a heavily regulated life insurance company parent gives us more attractive initial public offering (IPO) opportunities. Two, we believe that acquisitions and divestitures will be simplified because there are statutory limits on goodwill, amortization periods, and so forth. Changing to a holding company structure might enable us to make acquisitions we couldn't have made under the old structure.

There are a number of practical reasons why some businesses would be better placed as the subsidiaries of a holding company. One is that the subsidiaries are more effective marketing organizations when they're not part of a life insurance company. We feel this is particularly important to our investment management company and our pension operations. And, again, prospective clients are sometimes adverse to doing business with these entities as subsidiaries of a life insurance company. Life insurance company statutory financial statements are closely read by the rating agencies, lenders, and the insurance community at large. To make the insurance company's financials "better behaved" and more easily understood, we have brought the subsidiaries out from under the life parent.

We are also looking at lessened regulation, though not from the insurance company standpoint But life insurance regulators are involved in regulating non-life insurance companies simply because they are subsidiaries of the life company. There are no guarantees about what will actually happen, but some regulation of non-life companies could be reduced when the companies are pulled out from under the life company. The rating agencies that we are dealing with are very positive about this.

Another benefit of unstacking is that a company can create an offshore reinsurance facility, a member of the corporate family with which to reinsure business. Choosing a jurisdiction where lower capital requirements are in place gives you the ability to manage your required capital levels better. We have six sister nonlife companies, and we're in the process of unstacking. It's likely that we'll keep all of our life companies together under General American Life.

The final advantage of this structure is that it gives us the opportunity to affiliate with mutual companies, and the Missouri statute expressly permits such affiliations. The affiliating mutual can retain its mutual company status. In the event that either the original holding company system or the affiliating mutual system becomes insolvent, their legal and financial interests can remain separate or be merged together. The arrangement can be set up such that the assets of the entire MIHC can be used to support the obligations of either of the two parts, or they may be kept separate for support purposes. The board, officers, and employees of the affiliating mutual can be kept intact. Certain board members may be granted seats on the MIHC board, and policyholders of the affiliating mutual can be given voting rights in the election of members to the MIHC board. Such rights might be weighted in some fashion to reflect various relative values associated with the two policyholder groups. The board of the MIHC is ultimately responsible for the operation of the entire holding company system including the affiliated mutual.

Note that there is no cookbook for MIHC affiliations, and the working structure will depend on negotiations and approval by the insurance departments involved. It is not necessary to have the MIHC structure to effect these types of alliances, but it tends to facilitate them and give them a more formal structure. Rating agencies, in particular, favor such alliances, which have been known to impact the ratings of both parties positively.

There are some disadvantages of the MIHC structure as well. First, the holding company statutes in most states require approval of intercompany transactions by insurance regulators. While this is normally not a problem, the current focus of such transactions, heightened by the recent activities of consumer advocates, has made this a more difficult process. We expect that the scrutiny on such transactions will return to more normal levels with the passage of time.

Taxes can be a consideration when moving companies around under the holding company system. The five-year seasoning requirement is one principal complication, and there may be others. Depending on how sensitive your publics are to your statutory financial statements, moving subsidiaries from under your life company also could be a problem. Capital and assets will be reduced and, even though they will be available to support the life company in the event of financial difficulty, the life company will appear to be diminished in size and relative importance.

Finally, your state of domicile might pose special complications for its MIHCs. That's true in Missouri, although we feel these disadvantages are minor compared with the flexibility and opportunity given to a company when it adopts the MIHC's structure. General American did not and does not anticipate needing the capital-raising capability that many people see as the principal advantage of a holding company structure, and this is one of the issues that separates General American from many of the other MIHC structures. However, this corporate structure is a very valuable tool for dealing with the uncertainties of the future. And we can still retain the mutuality concept that's beneficial to our policyholders. We feel like we have the best of both worlds, and this is why we chose to go to the MIHC route as opposed to demutualization.

Mr. Paul D. Ochsner: Guarantee Life is a medium-sized life and health insurer located in Omaha, Nebraska. We have grown significantly over the past several years and our growth continues. In 1997, we had $348.9 million in revenue, $209.2 million in shareholder equity, and $1.5 billion in assets. We are in three different insurance businesses, two of which are group related along with the individual life and annuity business. All of our businesses are pursuing relatively aggressive growth strategies either internally or by acquisition. Prior to our demutualization in December 1995, we had accomplished six acquisitions and have subsequently accomplished four more, the most recent of which was the acquisition of a company in Ohio, Westfield Life, which brings our total assets up to almost $2 billion.

Looking back to the world in the early 1990s gives you the context in which we made our decision to demutualize. We saw:

- Radically changing industry fundamentals, such as increasing market pressures, the breakdown of financial barriers, and heightened mergers and acquisitions activity.
- The certainty that only value-added/cost-efficient providers would survive.
- The emphasis on "bigger is better."
- The concept of restructuring as enabler.

Many of these remain true today, which accounts for the continuing interest from a number of mutuals in the topic of restructuring. At our size range, the rating agencies remind us regularly that bigger is better in our business. We knew we needed to grow significantly to remain a competitive and effective insurer and financial services company in the millennium to come. And we knew that, in order to do that, we were going to need access to capital. That was a major motivator for us, and the restructuring was simply a way to for us to access capital.

There are several requirements for a successful restructuring, not the least of which is to have a good reason for doing it. In our case, the reason was a long-term strategic need for capital and the ability to access the capital markets in all their various forms. Over time, we expect significant amounts of equity capital. It's also vital to have an independent and informed board. There are a lot of tough calls and this type of board helps make good decisions for the policyholders throughout the process. It's important to have a very talented CEO who understands what being CEO of a publicly traded company is all about. We're fortunate to have one who has helped build a management team that developed and executed a strategy and also possessed the needed transaction skills. It's important to have some folks involved who can pull off major transactions because this is the mother of all transactions. You also need a management team that can implement major cultural change within the organization.

In February 1994, we made our first public announcement of an intent to develop a demutualization plan. But starting as early as 1988, we developed our first formal strategic plan. We recruited and retained a new CEO to replace a retiring CEO in 1989, continued development of the strategy, executed an acquisition strategy, and evaluated structural options to be able to finance our acquisition strategy. That work was completed in 1994, and December 15 was the adoption date for our plan. That was a magic date because it fixes the voting and compensation rights of policyholders under Nebraska law. The rest of the process followed the sequence and timing of events required under the Nebraska statute. As a part of our process, we had an IPO that closed in December of 1995.

Here are some key facts about our transaction. It was expensive. It cost us approximately $17 million net of federal income taxes to complete the transaction. Keep in mind that we are a small insurance company and did not have a lot of internal staff to do the work. We outsourced everything about the transaction beginning with the GAAP conversion effort. We had not prepared GAAP financial statements and had to do that on a very accelerated time frame, which added to the cost. We needed to develop a lot of actuarial models, both for the transaction itself and for business projections. A different pace and a little more preparatory work can help whittle down that cost for others.

We allocated eight million shares, representing 100% of the ownership of the company, to policyholders prior to the IPO. A little over seven million of those shares were issued, and about one million were distributed in either cash or policy credits. We sold approximately a 30% interest in the company to outside shareholders at an IPO price of $13 a share.

If you put some of those numbers together in a source and use-of-funds statement, the offering raised approximately $32.5 million after expenses. That, plus the cost of the transaction and the policy credits, left us with a net capital increase of $3.4 million. It's important to note that the public offering, as part of our demutualization, was not done as a big capital raising device. It was done to create a more liquid and orderly market for the stock and put real value on the interest of the shares that we were distributing to policyholders. Our objective was actually to minimize the size of the offering, but still have it big enough that it carried some market presence and weight. That's the balancing act you must go through. We were currently a well-capitalized company, but knew our capital resources would run out within the next several years, considering the kind of growth strategies that we had in mind.

Cost is an issue. It has been pointed to as a distinguishing characteristic of the transactions, but I would offer this policyholder perspective on the cost of our particular transaction: At the end of the day, the company in combination with its holding company parent, was better capitalized than it was when we started. The capital increase was a very modest $3.4 million dollars, and we had the financial flexibility to tap other capital resources as needed. But the policyholders came away with significant value in this transaction, depending on exactly what value you want to ascribe to the shares that were distributed. At the IPO price of $13 a share, it was more than $90 million. Recent experience shows it trading at $27 a share, or almost $200 million of value. We think, it would probably be considered a good opportunity to spend 20¢ to get $1 in return. In round number terms, that's the economic transaction that the policyholders experienced in doing the demutualization. It was costly, but they received significant value from it. We believed in policyholder ownership and put our money where our mouth was, so to speak, and shared that with the policyholders at the end of the day.

We learned many lessons through the process. Any restructuring process begins with an examiner's governing law. I would encourage any of you who have an opportunity to work with your state legislator or regulator to help modify or develop a law. The Nebraska law is an excellent, flexible law that worked very well for us. It expressly permitted equity incentives as a part of the statute.

You have a whole host of key advisors that you need to bring into these kinds of transactions. You need legal talent, both home-state corporate and insurance law-related. Having other legal counsel with demutualization experience, significant transactional experience, and an insurance contact with SEC experience also was very important. You need actuarial talent experienced with the issues that arise in the demutualization, accounting and investment banking advisers, and compensation consultants because we had equity-based incentives. Their counsel to the Department of Insurance in Nebraska allowed them to get comfortable with elements of the transactions that were outside their normal bailiwick.

There are a lot of issues to deal with, such as corporate governance and shareholder protection provisions. We had the pleasure of learning about this sooner, rather than later, in our process. These are very important. I think that's some of the interest that is shared in doing an MIHC, and one of the advantages it does present. This is a little less of an issue up front than it can be with a brand new publicly traded company, as we are. The preliminary prospectus that you develop as part of the offering is an SEC filing done on a form S-1. In the art and science of demutualization, essentially the same disclosure is assembled for the policyholders as part of their voting materials. I would encourage anybody going this route to get an early start working with the SEC to nail down what that disclosure will look like and resolve any accounting issues, such as discontinued operations.

We did not go through a major identity change, but we did have to change the name of the company. Again, what we learned was probably to do that sooner in the process. If you have a major identity change, you probably will have even bigger issues along the way.

"Closed block" is an actuarial topic. It is used in both MIHCs and in demutualizations and is applied largely to protect policyholder dividend expectations. One of the issues we wrestled with a great deal was whether a closed block was really necessary. We had heard that Equitable had some difficulties explaining their closed block to investors, and it created a lot of contention at the time of their IPO. Maybe it had become old hat by the time we got there, because the issue never came up with investors. Because the closed block is designed to protect policyholder dividend expectations, we found it very useful in talking to our individual insurance agents and individual policyholders about the demutualization.

If one said, "I don't want stock, I just want my policy and I want my dividends," we said, "Don't worry about it, your policy and dividends will remain unchanged because of the restructuring. They will change based on future experience," which is largely what the closed block is trying to measure. We had to decide if our nominally participating universal life block of business belonged in or out of the closed block.

Even though there was a participation provision in the policy, we neither illustrated nor ever expected to pay dividends on that block of business. It's hard for policyholders to understand how dividends are calculated, but we decided to protect the elements that were far more visible than the universal life case. By and large, the closed block is 100% pass-through of the investment performance of the underlying assets. If you think about the open block in a shareholder-owned company as, essentially, the manager for those assets, there's little incentive there to do the work to select asset classes that might optimize returns to policyholders. Keep in mind that these are generally long-term liabilities where perhaps a longer asset might be appropriate with higher returns. There's less incentive to do that in a structure that's 100% pass-through. Developing some form of incentive that would allow both the open block to share on an appropriate basis with the good investment results of the closed block might be an appropriate thing to consider. But I'll leave it for others to try to figure out how one might do that in a fair way.

It's important to know what the equity share process is not. It's not a determination of what policyholders get as a whole—how big the pie is. It is a determination of what share of the pie each individual policyholder gets. Of the 8 million shares, the questions is "Who gets how many?" It's not "What are those 8 million shares worth?" or, "Is 8 million the right starting number? It is an allocation of value among policyholders and at the end of the day, it's a zero-sum game.

Ms. Therese M. Vaughan: The MIHC concept was presented to me in Iowa and my first reaction was to say, it's an interesting idea but let's study it for a while. Let's look at what the problems are, figure out how we're going to resolve the problem, and then talk about introducing a law in Iowa. That was not the way things were going to happen in Iowa. Our legislature is very interested in new ideas and gave me very broad authority. MIHCs are a brand new concept. There are very significant regulatory issues here, and we have passed a statute that gives me tremendous authority to establish rules that protect policyholders. The Iowa statute is only about two paragraphs long. The meat of the law is in our rules, which address some of the regulatory concerns we identified:

- We need to maintain the financial stability of the insurer. This involves all of the typical concerns that you have with solvency as well as the additional risks that result because of the holding company structure. For example, you have the possibility of movement of assets within the holding company system. How should you address those issues?

- We need a regulatory scheme for the holding company. The MIHC is regulated by the state, but we need some kind of a system for regulating the investments, examination authority, financial reporting requirements, insolvency and anything else we think should be in place.

- We need to decide how to handle potential demutualization of the holding company. Most states apply the demutualization statute to holding company demutualization.

- We need to address all the issues involved in potential insolvency, either of the MIHC parent or the intermediate holding company. Would federal bankruptcy law apply? If so, was that going to be a problem? If the company became insolvent, what would happen to the stock that was owned by the MIHC? For example, an MIHC is required to own 51% to maintain voting control of the shares in the subsidiary converted stock insurer. If the MIHC were to become insolvent, you can have, in effect, a forced demutualization of this insurance company. If the MIHC has to release the assets it owns in the downstream insurance company, the control no longer rests with the MIHC.

- We need to examine the potential for policyholder or consumer confusion. It's now a stock company, not a mutual company, so how do you address a potential policyholder conversion?

- We need to address whether the structure creates the possibility for a tontine.

- We need to address the potential conflicts between policyholders, shareholders, and management in this structure—during the sale of the stock and going forward.

We spent a number of months talking to theoreticians and practitioners about these issues, and decided to adopt two basic premises in designing the regulatory scheme for an MIHC structure. The first is that policyholders own a mutual insurance company and that the regulatory scheme we designed must protect their interests. This issue was debated widely.

The second basic premise we adopted was that, whenever possible, we would use the existing regulatory framework as a guide. In retrospect, this was a very critical principle that led to the way that we resolved most of the issues that we identified. It turns out that a number of the MIHC issues are addressed in other structures. For example, in addressing the issue of conflict between policyholders and shareholders, we looked at regulations for stock insurance companies that are owned by holding companies. Many mutual insurance companies have downstream stock companies that are publicly traded. It's very common on the property and liability side, in particular. We also have demutualization regulations, and some systems have been developed for how regulators would engage in oversight of an IPO.

We decided to create a regulatory system that would provide for two phases of approval: (1) a limited application as a reorganization *without* sale of stock to third parties, and (2) a standard application as a reorganization *with* sale of stock to third parties. The issues involved when stock is sold to third parties are significant and, therefore, required additional safeguards to protect policyholder value.

The regulatory schemes that other states are developing look remarkably similar to what we have done in Iowa. There are some differences across states, which you would expect given our state-based system, but we all tended to identify the same regulatory problems and solutions.

The NAIC MIHC Working Group's white paper also talks about some of these regulatory solutions. In June 1997, the NAIC adopted a charge to evaluate the need for a model law for demutualizations and/or MIHCs. A working group was formed in August 1997 and decided to create a white paper for MIHCs because that is where the bulk of the activity is. We wanted to give some guidance to those who were looking at the pros and cons of these statutes. A partial draft was released in March, and a revised draft was released in May.

The first section of the white paper addresses justification of the MIHC option, including why the structure makes sense. It talks about changing market conditions, financial services modernization, globalization, changing demographics, the relatively low premium growth for life insurers in recent years, and consolidation of the industry. It cites the fact that mutuals have participated in this consolidation on only a limited basis and discusses financial ratings issues, such as how rating agencies focus more on diversification of revenues and prospects for growth.

It points out that not all mutuals are negatively affected by these trends, and that some mutuals will remain mutual. I don't think we're going to see a complete death of the mutual industry. Management should have a solid rationale for converting. The paper also discusses the advantages of structural flexibility, access to capital, some of the other ways that mutual companies can access capital and the limitations in those ways, premium policyholders, the regulatory approval process, the vote by the board of directors, information to policyholders, vote by policyholders, whether a public hearing is conducted, what information should be contained in the plan that's filed with the regulator, whether the public should have access to that information, the regulator's ability to retain experts, and the standards for approval by the regulator. These standards typically state that the plan must be fair and reasonable, and that policyholders' answers must be properly protected. Sections 4, 5, and 6 deal with regulatory issues unique to the MIHC system and retention of state authority. Those are the areas I would like to focus on. The basic regulatory safeguards are that the MIHC must maintain a majority of the voting shares, and the converted stock insurer must meet all the requirements for a stock insurance company.

Regarding the unstacking of assets, the white paper suggests that regulators need to look very closely at this. When a company wants to unstack assets to move subsidiaries out from under the insurance company, they need to look at the impact on risk-based capital, financial ratings, and capital in the insurance company. How attractive is the entity as an investment? Is the company trying to move just the good business out from under the insurance company? Typically, the regulator will require that the value of the unstacked assets be replaced in the insurance company. Significant control over the closing company is recommended and, in fact, that is what states have done, although different states have used different approaches.

To what extent should the MIHC be regulated as an insurance company? The MIHC is not a risk-bearing entity, so some of the insurance requirements that we have, like risk-based capital, for example, may not make complete sense. But the more an MIHC is regulated as an insurer, the less likely we will have problems with federal preemption, so there's a little difference of opinion over this. There is clear agreement, however, that the commissioner should have significant control over the holding company and that there should be significant corporate regulation that involves regulatory approval of articles, incorporation and bylaws. In future corporate changes, reorganizations would be subject to regulatory approval. Also the MIHC should be subject to the Insurance Holding Company Act. That would result in oversight of future mergers, authority for exams, certain reporting requirements that could be on a GAAP basis, and application of demutualization laws to subsequent demutualizations and MIHCs.

The white paper also discusses "reach up" provisions. If the insurer gets in trouble, it could reach up to the assets of the holding company to help meet policyholder claims. Regulation of intermediate stock holding companies and other affiliates is another area where regulators differ. Most MIHC laws give the commissioner authority over intermediate companies, but it's not clear to what extent regulators will exercise this jurisdiction. Will they treat the intermediate insurer essentially as an insurance company subject to all the regulatory safeguards in the holding company statute? Some regulators do not believe that this is necessary. In all states, the Insurance Holding Company Act applies at least to the MIHC and to the stock insurer. It now would address all transactions between affiliates that involve those entities and is covered by this insurance holding company statute. It addresses extraordinary dividends, exam authority, and so forth.

There are a number of issues involving potential conflict. Those that the white paper terms "unique" to MIHC structures primarily relate to the conflict between shareholders, management, and policyholders. The paper notes that the MIHC should get its fair share of any dividends that are paid; in other words, if dividends are paid on shares that are owned by outside shareholders, dividends must be paid on the shares that are owned by the holding company, to the holding companies.

In Iowa, the way we address that is to require that if there's more than one class of stock, the class of stock that's owned by the MIHC must have dividend rights that are at least as favorable as any other class of stock. And we prohibit the MIHC from waiving dividends without permission of the insurance commissioner. That is a very common type of requirement.

Other areas covered in the paper are limitations on participation by the director and officers in the IPO. Typically, you'll see limits on the period of time during which directors and officers can own shares of stock. It might be that they can't own shares for six months following an IPO. Closed block or some other mechanism for protecting policyholder dividend expectations has already been mentioned. With respect to the structure of the board of directors, the paper gives examples of things that could be done. Should we require MIHC board members to be policyholders? Should we require a specified number of outsider independent board members? Should we require that transactions between affiliated entities need the approval of a conflict committee made up of independent and non-overlapping directors? Should we review the placement of future insurance sales to prevent a tontine—the diversion of attractive business to affiliated companies instead of to the converted insurance company?

The paper talks about ensuring that accumulated earnings inure to the exclusive benefit of policyholder members, requiring policyholder subscription rights and regulatory oversight of the IPO. For example, in Iowa, we require a fairness opinion from independent investment bankers, a pricing committee composed of disinterested directors, and we permit a simplified process for subsequent sales where the stock is already trading on a national exchange and, therefore, has an established market price. It's common to prevent the payment of commissions or special fees to insiders.

Finally, the paper talks about preemption issues. There's a very good discussion about issues related to bankruptcy. What happens if an intermediate holding company or MIHC becomes insolvent? In the case of an intermediate holding company, federal bankruptcy law would likely apply. In the case of a MIHC, it's less clear. The parent mutual would be subject to federal bankruptcy law unless it's viewed as essentially equivalent to an insurance company. The courts would look at a number of things, including the essential attributes of the company: whether it is primarily engaged in insurance type activities, the degree of state regulation, the existence of some statutory scheme for liquidation, and the quasi-public nature of the business. I think it is at least arguable that the MIHC would be subject to the state's liquidation statute.

The second area is securities regulation, and this has been an issue of great concern, debate, and discussion. One issue from the beginning was whether the SEC would treat the membership interest in the MIHC as a security. In other words, when you buy a policy from a mutual insurance company, you get the policy and a membership interest in the company. Now that we have separated those, when you buy a policy and get this membership interest in a different company, will that membership interest be viewed as a security by the SEC? If so, it creates some real marketing challenges, and this has been a concern to companies that have looked at converting. In most MIHC conversions to date, the company has sought and received a no-action letter from the SEC indicating that these structures would not be considered to be securities.

The working group was making pretty good progress on the white paper draft, but we ran into some difficulty with Section 2. Even though a version of the paper has been released, it's important for you to know that it is not one that had been reviewed by the working group. As originally envisioned, Section 2 was going to be a discussion about the treatment of policyholders including their rights before and after conversion to a MIHC, as well as how the conversion affects those rights.

The draft of Section 2 that was released in March took a radically different direction, focusing on whether policyholders *own* a mutual insurance company. It essentially equates policyholder membership interest with shareholder equity interest in a stock company. With one or two exceptions, the regulators on the working group were very strongly opposed to that draft of Section 2, its tone, its style, and its conclusion. Section 2 was rewritten by another group of regulators and presented it at the May 1998 meeting, but a small group of regulators thought it did not emphasize the ownership issue enough. The Commissioner of Colorado, who chairs the working group, has asked Missouri to redraft a portion of this Section 2, but the group has not seen this revision yet.

I've listened to hours and hours of debate on whether policyholders own a mutual insurance company and I don't think it helps us address the regulatory challenges that we face both in demutualizations and MIHC structures. My answer to the question of whether policyholders own a mutual insurance company is, "Yes, of course they do. If not the policyholders, who else would it be?" Clearly equating policyholder membership interest in a mutual to shareholder equity interest in a stock company is absurd. What we should be looking at is what rights attach themselves to the type of ownership interest that policyholders have in a mutual and how those rights are affected by the conversion. I believe that, ultimately, this is what we are going to see in Section 2, and I expect the paper to be completed in September 1998.

Mr. S. Frederick Townsend Jr.: Will the panel express an opinion on whether or not the move towards MIHCs will be slowed by the impact of critics reacting to acquisitions such as Allied by Nationwide.

Ms. Snyder: First of all, I don't think Nationwide's acquisition or merger with Allied has anything to do with MIHCs. Allied is a mutual insurance company (property and casualty), with a downstream stock company, and there are some unique issues involved there. I do think that companies are going to think carefully about going into an MIHC structure because the political environment today is more difficult than it was two years ago. I don't think it is going to stop companies from converting to a MIHC because that structure for some companies does make sense. But large companies that are likely to see significant activity at hearings and so forth will probably step back, thinking, "that if they convert to an MIHC today and five years down the road go through a full demutualization, we'll have to go through this whole circus again." These companies will probably jump in and do a full demutualization immediately, if that's where they think they're eventually headed.

Mr. Ochsner: I tend to agree. It's going to be company-specific in each situation. There are many pros and cons of going both ways. For some companies, as in Barbara's case, the MIHC may have a lot of practical utility in complex situations. Although the MIHC wasn't an option for Guarantee Life, we hadn't heard about the idea before demutualizing, so we never had to wrestle with it. Early on, a lot of people were critical of our demutualization, largely because of the cost. I think the trend is toward balance, and each company will have to arrive at a solution unique to their circumstances.

Ms. Vaughan: I think it depends on how you treat your policyholders. Each company is unique, and some of the criticisms that have come up are probably justified, others are not, but you have to treat policyholders right.

Mr. S. Michael McLaughlin: Is the MIHC structure so successful and so beneficial that a company would regard it as a permanent state of being, with no anticipation of a need to fully demutualize later on?

Ms. Snyder: It's early in the process, but we are very happy with the MIHC structure and do not anticipate going to a full demutualization. Again, we did not issue stock in the insurance company and don't intend to at this point. We formed a closed block so that policyholders are owners of the MIHC and fully participate in the benefits from the subsidiaries.

Mr. Ochsner: If you're looking at this as a five-year transaction or less, don't bother doing it. Just go straight to the demutualization. I would say that, by and large, most of the companies view conversion to an MIHC as at least a 20-, 30-, or 40-year venture.

Mr. McLaughlin: Would you have any problem accumulating dividends in the MIHC? Would there be any long-term plan to use those dividends?

Ms. Vaughan: This has been one of the issues that sparked the SEC no-action letters. There was a perception that the MIHC could not pay dividends to policyholders; if it did, the membership interest would be treated as a security, and all bets are off. I am confident that that is simply not true. As long as these structures are subject to regulation by the state insurance regulator, and those dividends are regulated, the SEC is not going to considered them to be securities. My view of this situation is that, in a mutual insurance company, the board of directors determines when dividends are paid, and it's the same situation at an MIHC. The only difference is that there's a lot more regulatory oversight of the dividend paying process at the MIHC, but those dividends can be paid.

Mr. Alan W. Finkelstein: I take great comfort from hearing about this working group addressing the regulatory issues, but it appears that there's at least one actuary who doesn't have a great comfort level. His name is Thomas R. Tierney, and he wrote an article, "Watch Out for Mutual Holding Companies," in the May/ June issue of *Contingencies* in which he stated, "The normal insurance professional and regulator defenses have almost totally collapsed in the face of this unusual from-the-inside proposed rip-off of policyholders by management. The final rounds are now being waged by Robert Bear and industry types against legions of bewildered state legislators." Is the working group preparing a response to this in *Contingencies* magazine?

Ms. Vaughan: I have not seen it and would like to read it before I comment, but clearly this situation has become more political and more difficult than it was two years ago. When we did the AmerUs conversion, nobody showed up for the hearing in the fall of 1995, except one policyholder who talked about what a great deal this was.

Mr. Charles Robert Dolezal: My question is directed to Paul. In part of your presentation, you talked about the closed block, and I think you were talking about the pass-through investment income. Will you expand on that opportunity you mentioned a little bit?

Mr. Ochsner: Based on your projections, you set aside assets in the closed block that, coupled with the future premiums and net investment income, are sufficient to pay the future expenses, benefits, and current dividend scale of those policies. As you gain experience, differences emerge over time. Your investment income results might go up or down, so you change the dividend scales on literally a dollar-for-dollar basis to reflect that actual experience. For instance, we had not funded our closed block with significant mortgage loans. We'd had some success in commercial mortgage loan lending and thought this could be a very good asset class for that block, but why do it there when it's going to be 100% pass-through? Instead, it might be nice to put some performance-based sharing there. Then, rather than 100% of the net investment income passing through, you might have 90% or

95%. It was subject to a lot of debate about what's right and fair. We chose not to wrestle with those issues and did the traditional thing, which is the 100% pass-through. But, given the rapidly changing asset classes that are available to us, and interest in putting some mechanism into place, that would be a creative area to consider.

From the Floor: Terry, I believe you said that the policyholders have the same claim to dividends as any other class of stock in the company. If you're a class A stockholder in one of these companies, wouldn't that give the policyholder the same right to dividends, but a superior right to collateral, considering that class A stockholders are the last in line in the event of an insolvency?

Ms. Vaughan: What we're trying to ensure with our dividend requirements is that the policyholders do not lose anything in the conversion—if a portion of the company is owned by outside shareholders and those owners are receiving earnings based on their equity, the shares that are owned by the policyholders also receive earnings. All that requirement talks about is the dividend payments to the shares owned by the policyholders through the MIHC. The dividend payments on the shares owned by the MIHC have to be at least as great as the dividends on the shares owned by outside shareholders. The point is to preserve the equity ownership rights of the MIHC, which is owned by the policyholders.

From the Floor: In the event of an insolvency of the MIHC, who is first in line for the assets of the company?

Ms. Vaughan: In the Iowa statute, we have a provision that says the MIHC cannot pledge any of the shares of collateral or otherwise create conditions that could lead to the disposal of the shares. The MIHC cannot get into a situation where it can lose that 51% of the shares it controls. Does that answer your question?

From the Floor: I'm still confused about the claim of the stockholders versus that of the policyholders.

Ms. Vaughan: The MIHC is owned by the policyholders in a mutual-type setting. The insurance company owns 100% of the stock insurance company at conversion. The outside shareholders come into play when that company does an IPO. This brings in more capital, and you now have outside shareholders who own shares in this intermediate holding company. You've merely created ownership through shares of stock.

Ms. Snyder: Excess accumulated earnings means money that had accumulated for the holding company that the board now determines is excess and is, therefore, divisible surplus. We want the company to ensure us that, when they identify excess accumulated earnings of the holding company, there's a way to distribute that to the members. There has also been some discussion in the working group about whether a company that converts to a MIHC should be a stronger company and, if so, policyholders should be able to get more. Nothing in a closed block prevents the payment of additional dividends to policyholders. The closed block protects against a reduction in dividends. The company could still determine that it has additional money to pay a higher level of dividends and to pay those even to the policyholders that are in the closed block.

Mr. Townsend: Mr. Ochsner, you said the IPO was at $13 per share. Prior to that, what was the book value per share of the 8 million shares that the policyholders had received? Was the IPO done at a premium or a discount?

Mr. Ochsner: The IPO was offered at a discount to book value. My recollection was a 30% discount. It was sold at 70% of book value order of magnitude. The stock has performed well and is trading at approximately book value today.