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Update on Mutual Holding Companies

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Summary: As mutual insurance companies continue to search for ways to access the capital markets, one of the alternatives frequently considered is the mutual holding company. Panelists discuss the activity in this new corporate structure.

Mr. Jeffrey A. Beckley: Carl Harris is a principal with Deloitte & Touche in Des Moines, Iowa. He spends about 95% of his time on mutual holding companies (MHCs) and related issues and has been involved in five transactions. Carl is going to give us some background on recent activities and adoption of MHC laws and variations that exist across the states, as well as some information on MHCs. Tom Hughes is corporate actuary and treasurer with General American. Tom is going to speak from the pro side of MHC laws. Tom Tierney of Tierney & Associates, a consulting actuary from Framingham, Massachusetts, is going to speak on the disadvantages of MHCs.

Mr. Carl Harris: I have been involved in several transactions since 1995. In my 17 years as an actuary I don't think I've ever seen anything hit the market so hard and with so much enthusiasm as the MHC. By the same token, it's also been pretty well criticized. You cannot pick up any industry journal without somebody having a view, either pro or con, about the mutual insurance holding company. So, what I thought I would do is talk a little about it and then jump into some of the regulatory issues, including some of the differences and similarities among all the different states.

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Note: The charts referred to in the text can be found at the end of the manuscript.

I tried to outline some of the external pressures affecting insurance companies today that are forcing mutuals to look at the mutual insurance holding company as a viable alternative to them. One is clearly the economic issues. Mutuals, as everybody knows, can only increase their surplus through gains from operations. They don't have the ability to raise capital in the public sectors, outside of the more obvious surplus notes.

They're clearly facing regulatory pressures today. Regulatory pressures are not going down, but up.

Additional pressures include:
- Competitive pressures
- Changing demographics and market demands
- Distribution channels (Five or seven years ago nobody ever heard of the Internet or Internet sales. Many companies are just starting their own sales through the Internet today.)
- Mutual versus stock insurers
- Industry implications
- Financing activities

This list is not meant to be exhaustive, but to give you some idea of what is affecting both mutuals and stock companies today.

In 1965, there were approximately 152 mutual life companies in the U.S. In 1993, there were around 102. Today, I think, there's somewhere around 80. The number is clearly dwindling, for some obvious reasons. We've seen a couple of large mergers recently, such as Mass Mutual and Connecticut Mutual and Met and New England, and we've also seen some demutualizations and MHC transactions. Some of the demutualizations are Equitable, UNUM, Royal Macabee's, etc. We're seeing some very large demutualizations going through the pipeline now, including MONY, Prudential, and John Hancock, and we've also seen about 12 MHC transactions. So this list is going to continue to dwindle. It wouldn't surprise me if, in about five years, there would be fewer than 25 true mutual life companies left.

Another interesting fact is how the stock and mutual companies stack up in terms of earnings. The stocks have pretty much outperformed the mutuals. There are probably two clear reasons for that. One is that the stock market demands it with its ROE requirements, price earnings ratio requirements, etc. The other is that mutuals tend to be very well-capitalized, but they just don't operate very well. So you've got a numerator that's not that good and a very high denominator, so the ROE or return on capital tends to be fairly low.

In this arena, we're going to define the mutual holding company, the intermediate holding company, and the stock insurance company. A stock insurance company is nothing more than the transformed mutual insurance company. It has changed its structure from a mutual to a stock.

A mutual insurance company currently contains a couple of different rights for the policyholder: the voting right and the policy right. The voting right is the right to vote for the board, for demutualization, or for a merger. Policy rights are the rights inherent in the actual policy itself: the right to pay the premium, the right to get a death benefit if it's a life company, the right to get an auto claim if it's a property and casualty policy, the right to make a cash value, etc. With a couple of exceptions, I won't make any distinction between a mutual life insurance holding company and a mutual property and casualty holding company. A lot of these techniques and definitions apply equally to both.

In an MHC, those two rights are split. The member rights or the voting rights will end up being resident at the MHC level. The policy rights will end up going down to the stock insurance company level. Even though you're a policyholder, you are also a member of the MHC, so you will retain both rights and have rights in both companies.

The MHC itself, though, is a general purpose corporation. It is not a life insurance company, although it is regulated like one. I don't know of any other industry, or any other item, that can be regulated like that. You will also physically transform the company from a mutual to a stock insurance company. You will file different articles of incorporation, deeming yourself a stock insurance company.

One of the biggest overriding factors in the MHC is that 51% of the voting control of the downstream company must remain with the MHC. I emphasize the words "voting control" because that is not necessarily the same as economic control. Voting rights are not the same as economic rights. That means it is potentially possible to sell upwards of 75% of the economic value of the stock insurance company while retaining the majority or 51% of the voting control. You can do that through a series of either super-voting shares or non-voting shares.

The 51% is pretty much regulation-specific, as most regulations use the word majority, although it is not clear whether that means 51% or 50.1%. There was some talk early on, when New York was still debating the issue, about using 60%. But that was quickly changed to the word "majority," although it never passed.

Currently, you can have an unlimited number of intermediate holding companies below the MHC, except in Nebraska, which limits it to one. Nebraska further

requires that the intermediate holding company must own 100% of the stock of the downstream stock insurance company.

In Iowa, there are two types of applications: a limited application and a standard application. I think Iowa is the only state that has this. The limited application is one where a company does not intend to make an initial public offering (IPO). The only thing missing between the limited application and the standard application is all the information about the different classes of stock. But if you file a limited application in Iowa, and you ever want to make a IPO, you will then have to submit a standard application and provide information about the different classes of stock.

One of the differences between life and property/casualty is the concept of a closed block. The closed block usually refers to life insurance, and generally to participating policies on which a current dividend is being paid. It does not always include 100% of the statutory reserves. And it is usually only needed in the event of an IPO. If you look at some of the transactions that have happened recently, not every life company has established a closed block, but it will be required in the event of an IPO. Policies included in the closed block will usually require regulatory approval.

People don't think about a closed block in relation to a property/casualty company, but if you think of a company like State Farm, which issues property and casualty insurance but does have a dividend-paying system, it is potentially possible that such a company would have to establish a closed block. It's never been done before, but that doesn't mean it can't happen.

The overriding issue is fairness to the policyholder. You will not be allowed to do a transaction that is not deemed to be fair to policyholders.

Policies issued after the transformation are issued out of the stock insurance company. You will no longer be a mutual insurance company. In some respects, it also makes future demutualization easier because all the closed block issues have already been dealt with. At this point, only a portion of states have passed the MHC regulation: California, Washington, D.C., Florida, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Michigan, Missouri, Minnesota, Montana, North Dakota, Nebraska, Ohio, Oregon, Pennsylvania, Rhode Island, Texas, Vermont, and Wisconsin.

It is pending in Illinois and currently being reworked in Indiana. It sort of died on the vine in both states last year. And I've been working with Indiana to rework the language for the MHC and also the demutualization statute. Also my understanding is that Illinois is coming out of the grave at the moment.

New York is a real interesting case. I don't think any state has ever debated an issue as much as New York has debated the MHC issue. It is clearly being sponsored by all the big mutuals in New York. At this point, it's probably unlikely that New York will ever have an MHC bill. By the end of 1998, we expect about half the states to have some form of MHC regulation.

Chart 1 is a simple before-and-after pictorial. The mutual insurance company, which is what the companies are today, is on the left-hand side and a fairly typical schematic of what an MHC structure could end up looking like is on the right-hand side.

We talked earlier about the member and policy rights. The member rights would end up going to the holding company up on the very top. And the policy rights would end up going below. This is a general purpose corporation and so is the intermediate holding company.

There is only one insurance company in the chart. This has all the policyholders that used to belong in the mutual insurance company. It now is a stock company and they have member rights here. This is not an insurance company, but it is going to be regulated like one under the control of the insurance commissioner.

If you are going to do an IPO, typically, it'll end up coming out of the intermediate holding company. Should there be outside investors, this is where the money would end up going to and from.

Let me quickly list a couple of advantages of MHCs. First, it is faster and cheaper than a full demutualization because you do not have to deal with the equity share allocation issues. The only time that statement is probably not true is if you went to the MHC and then sometime over the next three to five years also went through the full demutualization. The cost would probably be higher under the secondary transaction. But if you're not looking at an ultimate demutualization, MHC is usually cheaper.

It's also faster. Most of the transactions have been in the six- to nine-month range, whereas, a full demutualization tends to take about 18 months.

You have protection from immediate takeover through the 51% limit on the voting control. Nobody can own an MHC and nobody can take you over because you are controlled by the policyholders.

Another advantage is that the MHC provides a way to reward management for performance through stock options. You have stock as either an acquisition

currency or some sort of a stock compensation plan, which mutuals do not have today.

People view MHC as a creeping demutualization. That is, you are actually one step closer toward it than you were the day before. Most people wouldn't argue with that. For life insurance companies, this could have tax advantages, and I emphasize the word "could." When MHCs first came out, there was a lot of talk about the fact that you no longer are a mutual insurance company, but a stock company. Therefore, these entities should be exempt from the 809 differential earnings tax. Unfortunately, a private letter ruling last year said that as long as you're an MHC, you're still subject to 809 tax. However, I emphasize that that was a one company letter and is not necessarily for all companies and all situations. It is unclear at this point.

Mutuality is a real key concept for a lot of mutual insurance companies, and an MHC can be viewed as a way of retaining the mutuality concept while providing access to the capital markets.

Other advantages include the safety of current employment and the fact that no cash is actually paid out as equity membership to policyholders, unlike in a full demutualization.

What are some of the disadvantages of an MHC? First, the same 51% that protects management from a buyout could also impede access to the capital markets. As an investor, do you want to put money in an MHC or in a company like Aetna, IBM, or Coke, where stockholders own the entire company?

At this point, we've only seen one company go completely through the MHC and then go through an IPO. The result could be a slightly higher cost of capital, but we haven't seen enough to really make a judgment on that.

Another disadvantage is that market receptivity is untested. There have only been 12 companies working toward an MHC.

I think it's more complex to understand than a full demutualization. At least with a full demutualization, once the transaction is over, it's over, and you're now a stock company. With an MHC, there are going to be ongoing issues. You're going to have mutual versus stock issues. And the chief executive officer could be wearing two hats; consumers like to call that a conflict of interest.

There's been limited experience with MHC as opposed to demutualization, although that's probably changing. Until recently, we haven't seen a lot of

demutualization, but that's changing. Another disadvantage is that an MHC may require ongoing separate accounting for the closed block. This pertains to demutualizations as well.

You're going to have statutory, GAAP, and tax issues. In most states, there is a triennial accounting for the closed block. You need an independent actuary to sign off on the closed block as performing accurately. You also have annual reporting on the closed block. When you file your blue book, you will also have to file the front four pages. The assets, liabilities, and summary of operations are specific for the closed block only, so there clearly will be additional accounting issues. Finally, if you're a stock company and an MHC with an IPO, you'll have to keep up with a deferred dividend liability and something called a "glidepath."

When you establish the closed block, you're also going to be establishing a set of anticipated earnings or cash flows for the life of that closed block. That becomes the "glidepath." It's what you expect. If something happens better or worse than that, you'll end up with either positive or negative results on that glidepath. That is that deferred dividend liability. For example, if your closed block performs better than you anticipated, that money cannot revert to the open block or the shareholders. It must remain inside, which means you will then probably have to adjust your own dividend scale upwards. That's where the positive deferred dividend liability comes from.

Mutual management used to think in terms of a 20- or 30-year horizon. Stock management thinks in about a 15-minute horizon. Every time the stock market ticks. The MHC is going to force mutual management to shorten its time horizon in a very long-term business. I consider this a disadvantage.

What is the process of forming the MHC? You're going to go through a bunch of legal documents and plan a reorganization. You have to form all of these companies physically. You have to outline the rights of the mutual insurance company members. You have to outline the rights of the stock insurance company policyholders. You will ultimately need approval of the board of directors and the policyholders. Typically, in all the regulations, the majority of those policyholders voting is required, which is not the same as the majority of all policyholders. The typical policyholder vote runs between 18% and 25% and, of that, about 95% approve all these transactions. Consumer activists have been somewhat vocal about trying to get a majority of the policyholders to approve it, which would make it almost unworkable.

You also have to define the closed block if you're a life company and specify which policies are in and out? These are typically dividend-paying policies. You may be a

mutual that sells participating term insurance, but has never contemplated a change. Typically those policies will end up being outside the closed block. You'll be dealing with all the normal policy assumptions actuaries have to deal with. You'll have to perform an analysis on the class of assets, because you will be walling off specific assets to back up these policies. It's somewhat like opening up a giant box, throwing all your participating business in it, throwing in enough assets to fully mature all this business, and then closing up the box, sealing it, and never opening it up again. Whatever happens inside that box stays there. You'll also have a couple of decisions to make with regard to federal income taxes and maintenance expenses. Should you include or exclude them from the closed block?

These closed blocks tend to be very long in duration. They can easily last 80, 90, or even 100 years, until the last policy is over. Once established, surplus cannot revert to the company. And you have to be careful of something called the "tontine effect." If you don't manage your own dividend scale correctly, you could end up with a huge positive deferred dividend liability sitting out there. And, if all the policies lapse except yours, guess what? It's like winning the lottery. You win everything. So, if all the policies lapse, you just want to make sure that yours is the last one to lapse.

You'll have to file a formal application with the department of insurance (DOI). How many of your companies have the word mutual in it? When companies think about forming an MHC, they often overlook this factor. But there are a couple of states that will not allow you to use the word mutual in the company name unless you're a mutual life insurance company. Iowa is one of those, for example, and I believe California is another one. So, if you have the word mutual in your name, and that's really important to you, be aware that you will probably have to give that up. Pacific Mutual probably spent several million dollars on huge ad campaigns to identify itself as Pacific Life.

What are some of the regulatory issues? Throughout the process, you will need approval from the DOI. A hearing is required in most states. In other states, where a hearing is purely discretionary, most commissioners will mandate a hearing.

Any formation of an MHC must be fair and equitable to the policyholders. That's uniform throughout all of the states. It cannot cause financial impairment to the applicant or its subsidiaries. Kansas has an interesting section in its law that says you cannot allow unjust enrichment of officers, employees, agents, or directors, but it doesn't define what "unjust enrichment" is. I guess they leave it up to the good common sense of the officers, employees, agents, or directors.

The conversion comes about by forming an upstream MHC, and you will merge the member interest into the MHC. That is done through the plan of reorganization. The next step is conversion of the mutual insurer to the stock form. An intermediate holding company is permissible, but not necessary. The only exception is in California, which does require an intermediate holding company, and Nebraska limits you to a single downstream company. My own guess is that probably is going to change next year and will end up being removed.

The plan itself must describe all significant terms of the reorganization in one of the reorganization documents. At all times, the MHC must control the direct or indirect majority of the downstream stock insurance company. You might end up doing an IPO out of the intermediate holding company. You might do part of it out of the stock insurance company. But at all times, indirect or direct, the MHC must control the majority of the vote.

Membership interests are not defined in most states. They will usually be defined by the commissioner with each transaction. The consensus is that the member has the right to vote and participate in any distribution. Membership interests are not security interests. Companies take very good care to make sure that these policies get an SEC "no action" letter. Membership interests cannot be transferred. You are a member as long as you have that policy. Once you lapse that policy, your membership interests cease. You cannot sell your interest.

Initially, all policyholders of a mutual insurance company are also deemed to be members of an MHC. It doesn't state afterwards who then becomes a member. That will be determined on a company-by-company situation. Typically, after the transformation, policies issued out of a stock insurance company will also become members in the MHC to avoid the tontine effect. The closed block is actually a closed system. Those policies in force on the date of transformation will end up leaving eventually, whether it's 80, 90, or 100 years out. This is deemed to be a self-perpetuating system.

Initially, the MHC must hold 100% of the intermediate holding company stock. And the intermediate holding company stock, in Nebraska, must own 100%, but it doesn't have to be that way in all states. Other states are silent on that issue. Thereafter, the MHC must control the majority of the voting control.

A lot of states do not have any regulations specific to the subscription rights issue. However, most regulators are saying that they want policyholders to get the first right of any IPO. If you decide you do not want to offer it to them, you'd better be ready to give your regulator a good reason why.

Mr. E. Tom Hughes: GenAmerica Corporation is the new name for our intermediate stock holding company. I will go over the advantages of the MHC structure from my own company's experience. I'm going to describe the advantages that we saw in the MHC structure originally, and others that we've discovered since adopting that structure in April 1997.

I think the advantages that General American saw in the structure are generally applicable to most companies, but there are all kinds of state-to-state differences. And, of course, companies themselves differ in their approach and structure.

By way of background, General American was formed in 1933. We were a stock company up until 1946 when we became a mutual. We operated on that basis in a fairly traditional fashion for about 50 years.

In the 1990s, General American began a period of very rapid expansion into new businesses. And, like most other companies in the insurance business, we were also placing a great deal of emphasis on our financial results, both on the balance sheet and the income statement. During this period, we began to feel constrained by our corporate structure, which had the mutual life company as the parent and our newly formed or acquired businesses as subsidiaries of the life company.

Chart 2 shows what we looked like in early 1996. We had 30 direct or indirect subsidiaries, but everything was underneath this mutual company parent.

During this growth period, we did not forget or abandon our mutual company upbringing. We remembered that the advantage of mutuality, as we all know, is the ability to provide insurance at the lowest cost to your policyholders, and the ability to run your businesses with a relatively long-term view. But the disadvantages of having the mutual company as the operating parent were becoming more serious and obvious to us in trying to run General American.

I want to focus a minute on the disadvantages of the old structure. We were unable to access capital in a direct fashion. This was, perhaps, the biggest disadvantage. General American had been very creative and successful in raising capital by other means, but those methods aren't as practical or they involve constraints that make them less desirable than public issuance of stock, with a direct interest in your entire enterprise. This is a serious disadvantage because, in the life industry, consolidation, mergers, and acquisitions are a way to try to gain scale. New competitors are entering the business, and everybody is investing heavily in distribution and technology. Mutual companies and anybody else in this business need access to capital to survive.

Another disadvantage of the old structure is that all financial transactions were directly reflected on the books of the parent company. That means that any debt borrowing by the subsidiaries, for example, is shown as such on the books of General American. Second, and most important, subsidiaries having unusual earnings or capital requirements pass those characteristics directly along to the parent company's financials. In an environment where rating agencies and other audiences are attuned to every blip in a company's performance and with the premium being placed on well-behaved earnings and risk-based capital (RBC) ratios, such results were less than satisfactory.

The third disadvantage of the old structure concerned General American's principal capital raising efforts. We made effective use of taking certain subsidiaries public. We've done three such transactions so far, and it's been very successful. While this tactic has been successful, we believe that the investment community has penalized us in these public offerings because of the fact that these public subsidiaries were downstream from a life insurance company. The investment community considers life companies to be in a heavily regulated environment, and Wall Street feels, rightly or wrongly, that our public subsidiaries are going to be constrained in their operations by these life insurance regulatory influences. So there's usually a discount on the value of such subsidiaries, which serves as a disadvantage to our limited capital raising effort.

The last disadvantage of the old structure was that General American had a strategy to become known as a broad-based financial services company. This is not unique, but the effort was hampered by having a life insurance company as a parent. With General American Life Insurance Company as our name, we would forever be considered a life insurance company in the public's mind. We are, in fact, a conglomerate of all sorts of businesses: investment management, government contracting, third-party administration, software development, management consulting, etc. It's in these businesses that General American, the corporation, sees opportunities for significant growth. And we want to be able to advertise and comport ourselves with the public in a way that doesn't limit us to being a life insurance company.

So, for these and a number of other reasons, we were more than happy to begin studying the MHC concept in 1996 and adopting it in 1997.

Chart 3 shows our corporate structure as it looks today. It's still rather busy, but the old life company, which is now a stock company, is no longer king of the mountain. It's a subsidiary to two parent organizations: General American Mutual Holding Company and the intermediate stock holding company, GenAmerica Corporation. I'm now an employee of the latter.

There are other possible structures that a company can adopt as an MHC, but this seems to be the most common of the 12 reorganizations that have taken place so far. One very practical point for all of us who grew up in the mutual life company is that it took us a while to realize we were no longer king of the hill. We're downstream from two other companies now. It took us a while to get used to that and we spent a lot of time and effort in communicating it to all of our publics.

Why did we structure it this way and what are the advantages of this particular structure? There are two types of advantages, and this is an important point. All the press that has been given to date has focused primarily on what I might call a "capital advantage"—the ability to access capital. In General American's case, that was not the situation, and other companies are coming to realize that there are very important structural advantages to adopting this MHC structure.

The capital advantage is the obvious one. You have improved access to capital. You can issue stock, up to 49% voting control directly in the entire enterprise, usually through the stock holding company. The key point here is that the mutual policyholders who are members of that top-level company, must retain at least a 51% ownership in the entire enterprise, and it's much less expensive than a complete demutualization. General American put its MHC together in about eight months. A typical demutualization takes 18 months to two years. We spent about a $1.5 million doing an MHC, including a ton that went to the U.S. post office. Typical demutualizations are much, much more expensive than that.

Your company retains its mutuality under an MHC structure, which it would not under a demutualization. Therefore, you're going to remain immune to hostile takeover, be able to take a longer-term view, and maintain your policyholder as owner. Those are the capital advantages.

With respect to the structural advantages, the list is fairly lengthy. You have a holding company structure now. Forget about mutuality and the ability to raise capital. You have reorganized your corporation. The first important point is that you now have the ability to leverage your debt more effectively. This is a routine concept for financial officers of public companies. It is not a routine concept for those of us who have existed for years under the old structure. What does it mean to be able to leverage debt? Actually we're talking about double leverage, which creates a very useful source of capital in certain situations.

On a statutory basis, the leveraging effect has practically no limits, since there is no filing of financial statements on a consolidated basis. Borrowing at the holding company level can be transformed dollar-for-dollar then into equity capital for your life insurance subsidiaries. On a GAAP basis, this is less effective. Financials are

prepared on a consolidated basis, so both the liabilities and equity are increased when debt is incurred. However, the rating agencies are probably your principal audience in this particular subject. At least some of the rating agencies will allow this double leveraging to take effect. For example, one of the principal agencies allows the ratio of investment in subsidiaries, the total capital, to go up to at least 125% before the double leveraging effect is lost. So this leveraging of debt tool is still an important advantage.

The second structural advantage of an MHC structure involves accounting treatments. Those of you who have labored under statutory accounting for a long time may have run into problems in how certain accounting treatments are regulated. For example, benefit plan costs for employees is an area where you can get into debates about how to cost things on a statutory point of view. A solution presents itself when you reorganize into an MHC or holding company structure, if you can transfer the employment of the life company employees to the holding company and then provide the services back to the life company on a management contract. GAAP accounting regulates the accounting for the benefit costs in the holding company, so the idiosyncrasies of statutory accounting don't apply to benefit costs. That's just one example of the advantages of a holding company structure with respect to statutory and GAAP accounting treatments.

Taxes are an important potential advantage in converting to an MHC structure. Section 809 is an obvious one, because it applies to mutual life insurance companies. But it doesn't apply by black letter law to stock life insurance companies. Beyond Section 809, there are other tax advantages that might exist at your company. Non-taxable, tax-exempt interest is one area where you might find new flexibility from a holding company structure.

Perhaps the most important advantage that the holding company structure provides is the ability to "unstack" your subsidiaries. In fact, I'm chairman of the unstacking committee. Now that I can bring things out from underneath the life company and make them subsidiaries of the holding company, I have new flexibility.

Recall that General American had a habit of taking its subsidiaries public and that Wall Street was discounting us. Well, we'll fool them. We'll make them subsidiaries of the non-life stock holding company that we call General American Mutual Holding Company. They are no longer heavily regulated and we think they're going to become more attractive to Wall Street.

Acquisitions and divestitures will be simplified and enabled. The statutory limit on goodwill, for those of you who have had any merger and acquisition activity, is 10% of statutory surplus. That clearly is not going to apply to an acquisition made

by a stock holding company. GAAP accounting applies there. The statutory maximum 10-year goodwill amortization also will not apply. GAAP goodwill amortization periods are typically 20–25 years.

Changing to a holding company structure may also enable you to make acquisitions that would have otherwise been forbidden—for a life company. For example, there's still hope, faint though it may be, that liberalized financial services legislation will someday be passed by the U.S. Congress. It's not unlikely that such legislation would allow an insurance stock holding company to acquire certain financial services companies, for example, a bank, but it may not allow such an acquisition to be made by a life company. The new structure would enable it.

There are some very practical reasons why some businesses would be better placed as subsidiaries of the holding company. For example, believe it or not, certain businesses can be more effective marketing organizations when they are not operating as subsidiaries of a life insurance company. Some investment management groups and pension organizations make that claim. This gives you more flexibility.

You may also want to distance a certain business from the life company for other reasons. Maybe your new businesses products don't fit well with a life company's image or, perhaps, you want to shield life company assets from claims that may arise from the operation of your new acquisition or subsidiary. Making such businesses subsidiaries of the holding company can help achieve those objectives.

In case you haven't been looking, life company statutory financial statements are closely read by rating agencies and lenders in the insurance community at large. Subsidiaries with unusual earnings patterns or capital requirements can adversely affect the parent's financials. This can be solved by unstacking the offending sub from underneath the life company, thereby making the life company's financials more meaningful, better behaved, and more easily understood. This is particularly true for RBC ratios, where significant attention is paid, not only to their levels, but also to year-to-year movements. There are companies with rapidly growing businesses that have a heavy statutory surplus strain and relatively high RBC requirements. Also, you may have a number of growing non-life businesses, where the RBC requirement is 30% of the non-life company's value—100% if it's a foreign non-life company. By moving these businesses out from under, the life company doesn't change the need for capital. It will allow you to communicate financial results to external audiences better, especially the rating agencies, and it gives your company more flexibility in determining its published capital requirements.

Life insurance regulators are now involved in regulating non-life companies, merely because they are subsidiaries of the life company. While there are no guarantees that will actually happen, this regulation of non-life companies, which in our case includes TPAs, investment managers, software developers, and so on, may be reduced when these companies become subsidiaries of the stock holding company.

The extent to which regulation will be lessened for these non-life companies depends on at least a couple of factors. First, it depends on the provisions of the holding company statutes in your state of domicile. This can include both general holding company statutes and the insurance holding company statutes. It gets fairly tricky.

The final advantage of unstacking is it gives the company the ability to create an offshore reinsurance facility as a member of the corporate family. In other words, you can keep certain types of reinsurance within the corporate family when that reinsurance business has relatively high or excessive capital requirements. Choosing a jurisdiction that has lower capital requirements gives you the ability to better manage your published required capital levels for life companies.

Chart 4 shows the final unstacked model. There's no magic here. I've just moved out those former life company subsidiaries, called GALIC, and made them sister corporations and subsidiaries of GenAmerica Corporation. Leaving the life companies under the existing life company, parent company structure, is probably the way we're going to wind up. But this is just a model. Other considerations may affect how it ultimately looks.

There's one last advantage of an MHC structure that I'd like to point out. Legislation in some states specifically allows mutual companies to affiliate under the network of an MHC. This gives mutual insurers a unique opportunity to affiliate with each other under a common corporate structure. There are a number of different methods for doing this, depending on what the parties negotiate and what the policyholders and insurance department's approve.

The first and foremost advantage is that the affiliating company can remain mutual. We have two mutual insurance companies operating under the common MHC structure of one. Legal interests can remain separate or be combined. The two companies, the original holding company and the affiliating mutual, can have their interests remain separate, both on an ongoing basis or in the case of financial difficulties (also known as insolvency) of either the two systems. Or they may be merged in that event.

In other words, depending upon what's negotiated and approved, the assets of the entire MHC can be used to support the obligations of either of the two parts or kept separate for support purposes.

The affiliating company remains intact. It's not just a shell. It has a board, officers, and employees that remain intact. The affiliating mutual's board members may be granted seats on the MHC board, etc.

Finally, policyholders of the affiliating mutual can be given voting rights in the election of members of the MHC board. Such rights may be weighted in some fashion to reflect various relative values associated with the two policyholder groups.

We recently had our first example of an affiliation called a merger. Two MHC systems, Acacia and Ameritus, merged about two months ago. But that's a different model from what I've been talking about.

Chart 5 shows what the holding company looks like after this type of mutual company affiliation. The new mutual fits in just below the MHC, reflecting its status as having only the MHC superior to it in the corporate structure. It's important to note that the board of the MHC is ultimately responsible for the operation of the entire holding company system, including the affiliating mutual.

This has been a recitation of General American's view of the more significant advantages of MHC structures. There may be others applicable to your company situation. I guess the important point I'd like to leave you with is the fact that the MHC structure gives mutual company managements significant financial, organizational, and strategic flexibility at a time when they surely need it. In the long term, that flexibility may be as important, or more so, than the ability to raise capital, which has been the focus of the entire subject and debate.

Mr. Thomas Tierney: I was intrigued by one of Carl's points. He mentioned there's a tremendous amount of material on this. You are hearing about it, that's true, except there are two very big voids. One is a regulatory void. The NAIC, I think, is still working on a white paper that it probably will publish by the time all of the states are finally finished with their regulatory activity.

The other big void, believe it or not, is within the Society and the actuarial profession. I approached the Financial Reporting Section about four years ago and said, "We have to get this stuff on the agenda for the valuation actuary meetings." If you go through all of the actuarial syllabi, you will not see boo about demutualization or MHCs until the Society's Hawaii meeting in the Spring of 1998.

This was no accident. There is actually a concerted effort, unfortunately, within the profession to suppress talk about this subject, and the regulators are getting beaten up by the editors of this process. They've left the actuarial profession and, in fact, I think I've been the only critic of the Society's management. I filed a complaint with the board of directors saying, "You shouldn't be suppressing this information."

Here's a case in point: I had an article all set for publication in *The Financial Reporter*, and it was quite critical. The editor said, "Wow! This is good, but they're going to kill me when they see this." We went through the editing process, and it was all set to be published last December. Then all of a sudden, in the 11th hour, the thing gets spiked. There was a big news hole, and they filled it with Tom Hughes' article. Tom's article was excellent, as a matter of fact, and it's one of the things that I recommend you read.

The board got back to me after I filed the complaint and said, "Not to worry, Tom, you'll get published." I said, "That is not the problem. It's easy to get published." I quickly found a couple of other outlets. I prevailed upon a distant cousin of mine, who is the editor of *Contingencies*, to put a piece in there and I went to another section, *Small Talk*, which has about one-tenth the readership of *The Financial Reporter*. The former is the small-company section, which quickly published my stuff.

But the problem isn't with me not getting published. I get beat up all the time. The problem is that the informational needs of our members aren't being served. Even more important, the insuring public, which needs protection, doesn't have the resident knowledge within the professional community that can be brought to bear on the subject.

I apologize for getting off the track. I want to talk about what I see as the driving force behind the mutual insurance company procedure and the real problems and disadvantages of the structure. I was very involved in the legislation in Massachusetts and New York. Carl said New York was a disaster, but to me it was our greatest victory. It's all a matter of perspective.

The real driving force behind MHCs is something other than what it's purported to be. The purported reason is the need to access capital. I just roll my eyes. For 160 years, the mutuals have been stumbling along, and they've never had a need for capital. Suddenly, it's contagious, and everybody at the same time has a need for capital.

Carl mentioned one of the big problems with mutuals, their sloppy return on investment, and went on to say the cause was this spongy denominator. They have

so much money, it’s dragging down, out of proportion with the numerator, and affecting the rate of return. And that, in fact, is the truth. The mutuals are swimming in money. I don’t believe the need exists. The products themselves are all self-sustaining.

In talking to several state legislators, when you argue that these companies don't need capital and have ulterior motives legislators ought to be looking at, you have to prove that the companies don’t need capital. The legislators listen, but the bottom line is that, unless you can prove beyond a reasonable doubt that the companies don’t need it, the legislators will give it to them.

If capital needs to be raised, a way of doing it that is protective of the policyholders, the insuring public, and society in general has to be found. And MHCs ain’t it!

Some of the real reasons for forming MHCs, what I call the “quiet” reasons, have been alluded to earlier. The primary one is takeover protection. It’s interesting, during the Massachusetts hearings a year ago, the Massachusetts Life Insurance council sent people to argue its case. The arguments they made in Massachusetts were twofold. One was the inability to compete. A representative of the council said, “We cannot compete with Fidelity, the largest mutual fund organization in the world. They clobber us. We need this legislation.” I was scratching my head. I wondered if he would go to his board of directors and say, “We can’t compete with Fidelity”? If I were him, I wouldn’t do it. And if I were on the board, I might have a message for the gentleman. The other representative there was extremely honest and right to the point. He said, “We need takeover protection. Demutualization logically is the way to go, but if we do it, we’ll get gobbled up in a second.” And the MHC structure has takeover protection. The 51% is not a number chosen by accident. It’s meant to be takeover protection. And that’s really the rationale behind the whole process. It’s a way to, in effect, have your cake and eat it too. You go public, but you’re immune from the investment bankers putting everybody out in the street and giving you severance. But it doesn’t work. There is no something for nothing.

The real problem is that the mutuals need to reinvent themselves. It ain’t working for the reasons that everyone can speculate on, and everyone does. Whatever the problem is, it’s for real. The mutuals’ share is decreasing. In private sector stockholder companies, the boards are very attuned to stockholders needs. They’re concerned with sales. They’re concerned with quarterly earnings. The focus is not five years down the road. The focus is the next quarter. That may be good or bad, but at least there is focus and people are paying attention.

In mutuals, the board is atrophied. There is no fiduciary oversight. If you're a member of a mutual board of directors, for the most part, and there will be exceptions, it's an easy $5,000 a month. You show up once a month, go to a meeting, behave yourself, and listen to a presentation. Everybody votes unanimously to do what management wants and then management shows up, if you're the local bank, a couple of weeks later at your meeting and votes to support you. It's all inbred and very cozy. But it doesn't work because you don't have the oversight.

Here's one glaring example. Scott Paltrow, the insurance writer for *The Wall Street Journal*, did an article about three weeks ago analyzing the salaries at a very large mutual insurance company. The bottom line was company A is the same size as company B, but company A pays its executives 30% more than company B does. To me the telling point was the interviews with the board of directors. Typically there are 23 directors in company A, and Paltrow called every one of them. Twenty-two of them blew him off, but one said, "I've been on the board here since 1990 and, during this time, we have never had a discussion of management compensation at our meetings." That's probably been 80 meetings over eight years and 80 rubber-stamped votes. That is a bit much.

That is where I think the real problems from the mutual insurance company stem—from leadership, and not necessarily the active executive management, but the board of directors. It's a pretty sleepy environment. And that's where I would place the blame.

Where are the regulators? It's interesting that the NAIC is working on a white paper. Steve Bailey, the insurance writer for *The Boston Globe*, attended the NAIC meeting in Boston last June. At that time, the chairman of the white paper committee was saying, "We're almost ready. We should be published pretty soon." Steve published an opinion piece the following day in *The Globe* that was a laugher. He said, "Who are these guys kidding? They're going to have their white paper out when all the states have finally finished all of their activities." Theoretically, the 2% of premiums that goes for taxes is supposed to buy us regulation, but the regulators have all been pre-empted by the politicians. The process isn't working. I'm now working with the Insurance Department and there's a great shortage of resources. It needs and wants help. The difference is that, in the past, there was a zeal, and there wasn't the political involvement. They didn't have the resources, but they wanted to do the right thing.

One more digression. What's needed is an emphasis on policyholder return on investment. We've heard this ever since we got into the business: insurance at cost. The focus has to become, how can we provide policyholders with the best

return? That isn't happening. I cringe every time I read about the XYZ mutual that says, "We hit $0.5 billion in profits." In particular, I read it from one of the companies I'm a policyholder in, and I'm not happy. To me, that says my dividends are a $0.5 billion less than they otherwise should have been.

Again, this relates to the board of directors' syndrome. These people are attuned to thinking that operating gain is what it's all about. Maximizing operating gain only happens in one of two ways, and the bad way is by decreasing dividends payable. The problem is that we're entering the third millennium and operating as if it's the first millennium. We have accounting systems that stand up to the Civil War era of blue-book, single-entry accounting. And there's a business concept called "surplus" that I think is outdated. The people on the street are in a 401(k) term insurance mode, and we're selling them the wrong products with bookkeeping that takes 20 years to get them the return on investment they're looking for.

We need a change in regulation. Right now, we have variable life, universal life, appreciable life, etc. These are, in effect, 401(k) plans with decreasing term mortgage insurance, but the problem is that even the public figures this out. They're buying up 401(k) plans also known as universal life, but they're paying 8% or 10% in commissions and insurance charges that are about 1,000% of what the expected mortality is. That's not a deal. They don't quite understand the mechanics, but they know it's not working. Then, if they choose to leave early, they get hit with a walk-away penalty.

What are the real problems with MHCs? Basically, there is a very strong conflict of interest. You can't have policyholders looking for minimized cost and stockholders looking for maximized returns in the same pot, because the two invariably work against each other. Compounding the problem is that, invariably, you have shared overlapping management. The board of directors of the MHC will 99% of the time be the same as the membership of the stockholder company, except for one or two people. So you have people trying to maximize dividends in the stockholder company. And, at the next tier up, the same people are sitting in an MHC trying to maximize dividends. Even the man on the street knows that's a conflicting interest.

The MHC bifurcation is an organizational monstrosity. Bifurcation is a legal term that means "splitting." If people have an ownership interest in the companies, bifurcation just gets messy. I say it's vote buying. They're canceling someone's vote and receiving no consideration for it.

Another point is that policyholders lose the value of the company. There's an organizational dynamic. Companies should be valued, not on a book basis, but on

a discounted future earnings basis. The way it's set up, they get the surplus on a book basis, but the embedded value of the company disappears.

Finally, poor legislation and the absence of market discipline result in a ticking time bomb. The ticking time bomb problem is a company like General American. It's great on paper, when you have benevolent management. But when Tom retires, the next person could be a Gordon Gekko.

Mr. William C. Koenig: Mr. Harris made a number of observations about mutual life insurance companies that are worthy of further comment, and maybe even a panel discussion in their own right.

First, he noted that mutual company ROEs lag stock company ROEs. Mutuals, of course, only have to be profitable enough after paying policyholder dividends to fund their own growth. Slow-growth mutuals can reduce their ROEs by paying higher policyholder dividends. Good for policyholders, but bad for ROEs. Stocks do not have this flexibility.

He also noted that mutuals do not have access to outside capital, that there are fewer of them than there used to be, and that those remaining are "overcapitalized." It is instructive to put these statements together.

Because they have no access to outside capital, mutuals don't have the luxury of a "second chance" if they suffer a big financial setback that weakens their capital position. At least a few of the former mutuals were not overcapitalized, but rather became woefully undercapitalized and so demutualization was the only hope for survival or resuscitation. Stocks have a way of recapitalizing, assuming a viable business plan that investors are willing to fund. Mutuals don't, and so become former mutuals, thus driving up the average capitalization of the remainder.

Remaining mutuals want to control their own destinies, of course, like everyone else. This goal can be advanced by having surplus positions high enough to absorb at least minor financial setbacks, and better yet, major ones, without impairing capital positions. This is one more reason for the perception that mutuals are "overcapitalized." Current capital is their only safety net, their only margin for error.

This may be one reason some mutuals see appeal in the MHC route. MHCs may provide a means to recover from financial setback through the sale of stock, without abandoning mutuality, which is otherwise inevitable with demutualization.

CHART 1
EXAMPLE OF STRUCTURE

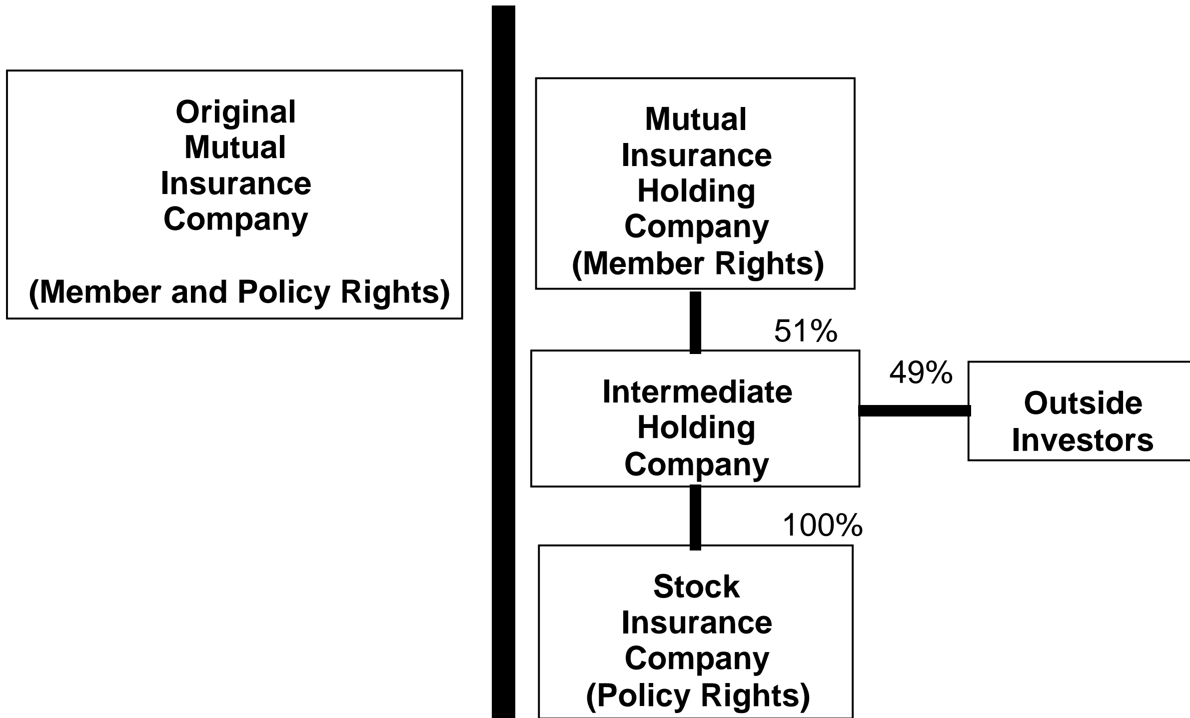

CHART 2
OLD MODEL: MUTUAL LIFE COMPANY AS PARENT

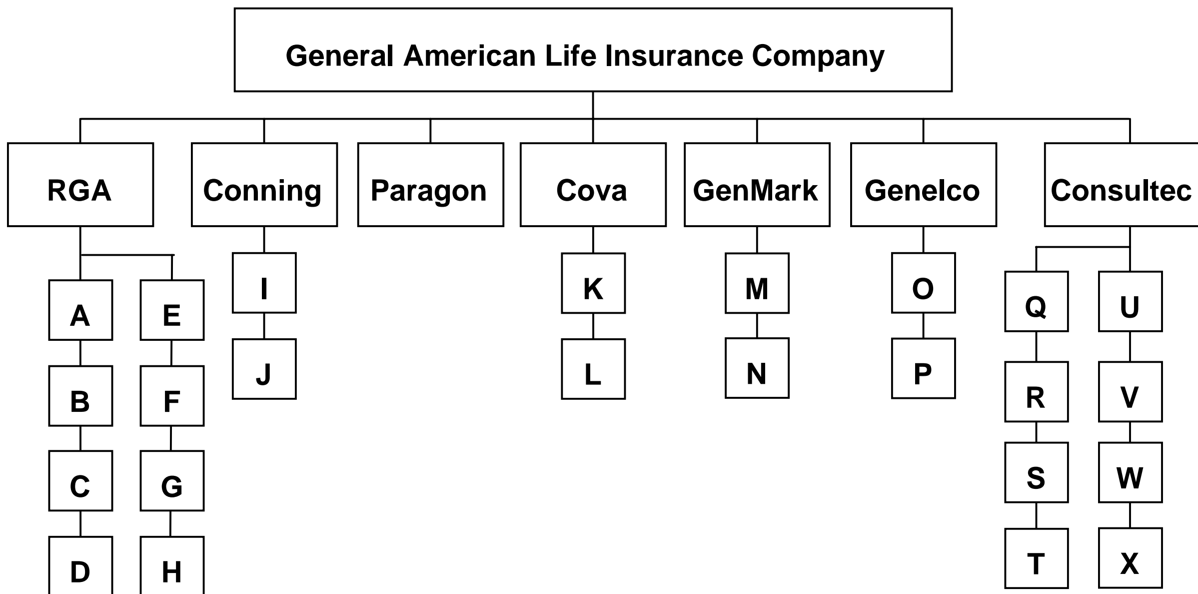

CHART 3
NEW MODEL: MUTUAL HOLDING COMPANY

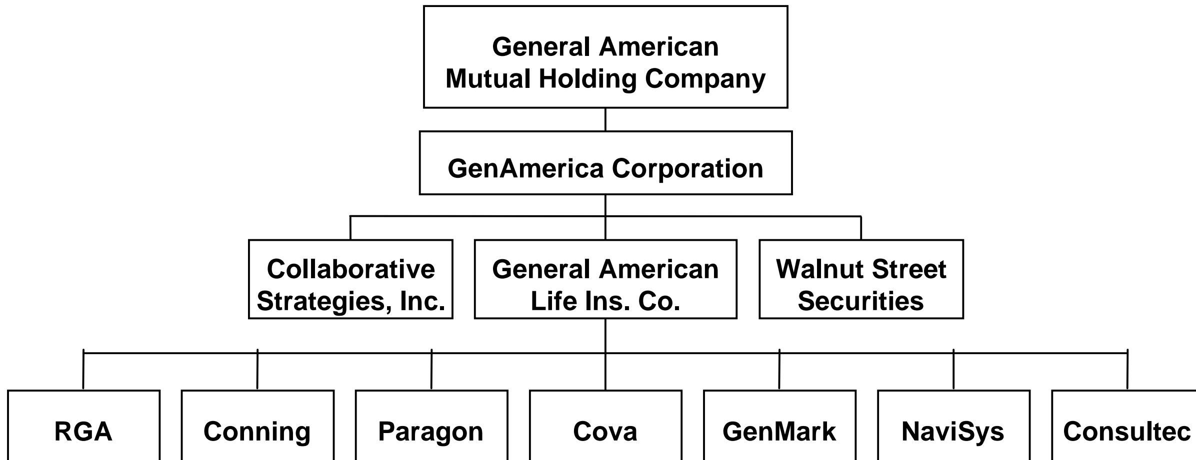

CHART 4
"UNSTACKED" MODEL

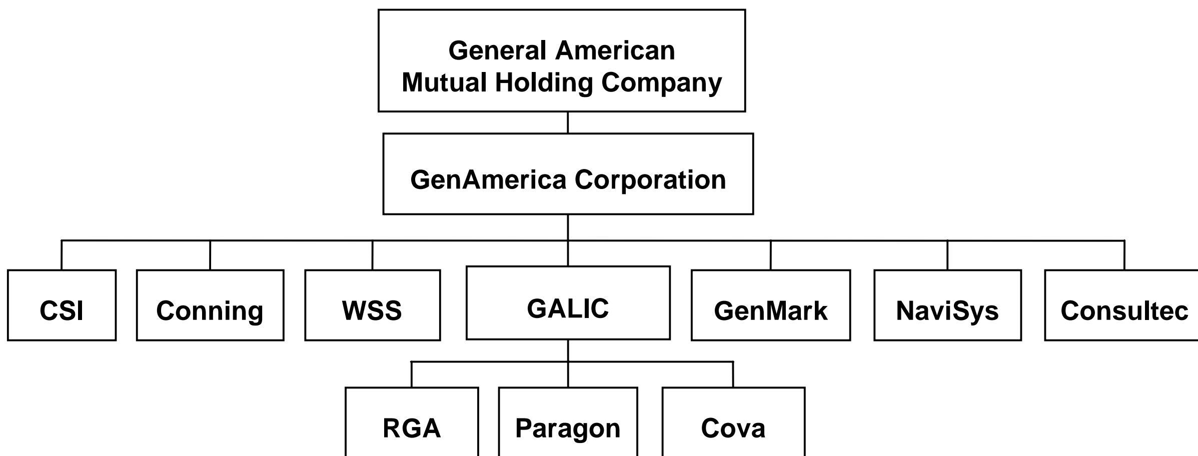

CHART 5
AFFILIATION WITH A MUTUAL COMPANY