# POLICYHOLDER CONSIDERATION

DANIEL J. MCCARTHY, F.S.A., M.A.A.A.
and
GODFREY PERROTT, F.S.A., M.A.A.A.

Milliman & Robertson, Inc.
289 Edgewater Drive
Wakefield, Massachusetts 01880
U.S.A.
Telephone: (617)245-4847
Fax: (617)246-3045
e-mail Internet: godfrey.perrott@milliman.com
dan.mccarthy@milliman.com

## Abstract

This paper examines the question of what compensation policyholders of a mutual life insurance company in the U.S. should receive, if that company converts to a stock company (demutualizes).

It considers the origins of the major mutual life insurance companies in the U.S. (including those that have demutualized in the last 15 years), and addresses the original source of risk capital, subsequent source of risk capital, and who (among the potential claimants) can lay claim to the value of the company. Value of the company in this context means the value remaining after a company has raised the capital it needs to survive and prosper at the time it demutualizes. It concludes that the policyholders have the strongest (and sometimes the only) claim to the value of the company. Finally it discusses different ways the policyholders could be compensated for that value and the practical implications of each.

**Mutual Companies Considered**

This paper considers the 17 largest mutual companies in the U.S. (measured by assets at 12/31/95) together with UNUM (formerly Union Mutual), Equitable, and Allmerica (formerly State Mutual) which are mutual companies that have demutualized. These companies, along with certain information on their original formation, are shown in Table 1. Two small companies which have also demutualized (Maccabees and Guarantee Life), and one "Savings Bank" company that converted to stock, are mentioned as examples, but not listed in Table 1.

**Methods of Formation**

All of the companies considered were formed in one of the following ways:

1. The company was formed as an assessment company and converted to a mutual. An assessment company is a company where the risk capital is provided directly by the policyholders whose policies may be "assessed" for additional premium if the original premium was not sufficient. It is, or was, similar on an individual basis to some of the retro-premium structures currently used for commercial general insurance coverages.

2. The company was formed as a mutual company with "guarantee stock" subscribed to (usually) by prominent, local citizens. The guarantee stock had a fixed interest return (apparently, 1% above the then market rate in one case). This guarantee stock was typically retired in less than 20 years after original formation.

3. The company was formed as a stock company and subsequently converted to a mutual company by buying back the stock out of surplus or future earnings. It appears, based on the data that we have been able to uncover, that some of these buyouts provided a market rate of return to the shareholders while others provided considerably less than a market rate.

4. The company was formed as a fraternal insurance company and subsequently converted to a mutual company. A fraternal company is one formed as an adjunct to an organization which in turn guarantees the insurance company. These organizations are primarily social serving particular ethnic or religious backgrounds.

5. The company was formed as a welfare association and subsequently converted to a mutual company. This was a special case to provide non profit organizations with retirement plans, and the risk was implicitly assumed by the State until surplus was built up from existing operations.

**Sources of Subsequent Risk Capital**

All true risk capital after formation or mutualization (if the company was formed as a stock) has come from retained earnings from policyholders and investment returns on other businesses. It is also arguable that investment returns on other businesses are in effect provided by the policyholders since capital provided by them was presumably the investment capital used to start or acquire the other businesses. There have been various amounts of reported capital created through financial engineering such as securitization of future loadings, surplus notes, financial reinsurance, etc. In all cases these sources of reported capital consist of either creating an on balance sheet asset from an off balance sheet asset, or by creating an off balance sheet liability (by in effect pledging future profits) with a matching on balance sheet asset. One mutual company seeking innovative ways to raise capital asked for employee suggestions. On suggestion received was "harvest the unrealized capital gains in the company's art collection."

There does not appear to be any other systemic source of risk capital injected into mutual life companies unlike some other organizations. For example, where the Blue Cross/Blue Shield organizations have considered reorganization either into mutual life insurance companies or into for-profit organizations, States have asserted that they are the source of capital, at least to the extent of premium tax exemptions that the Blues have received. Where the Massachusetts Savings Bank Life Insurance (which was a collection of the insurance divisions of about 80 savings banks) reorganized into a stock life insurance company, the member savings banks asserted that they were a significant source of risk capital due to systematic understatement of expenses allocated to the life insurance divisions particularly during the early years of its existence.

Mutual life insurance companies, in contrast, have in general always been free-standing entities and have not received systematic tax benefits vis-à-vis stock life insurance companies. The battle between the stocks and the mutuals over who receives their fair share of income tax at the federal level, has benefited only the federal government. Both stocks and mutuals assert they are paying more than their fair share, which indicates that a subsidy of either stocks or mutuals has not happened. An historic analysis of the U.S. tax code indicates that it did not favor mutual companies over stocks.

Thus it is reasonable to conclude that the policyholders have the best claim to the company. They are the only candidates for companies formed through the assessment and fraternal route. They contributed the bulk of the value fro companies formed as mutuals, or as stocks that subsequently converted to mutuals. The question of whether terminated policyholders retain and right to the value of the company is a different question.

**Possible Forms of Policyholder Consideration**

There are several possible forms of policyholder consideration including cash, shares in the insurance company or in a holding company formed as part of the demutualization, and enhancements to the insurance policy. Some policyholders will, as a practical matter, always be compensated in cash even if the primary currency of compensation is shares, since they live in a foreign country subject to different securities laws and the cost of determining that the shares meet those securities laws is unreasonable compared to the number of policyholders. Likewise, some policyholders will always be compensated with enhancement to their policies whether the primary compensation is cash or shares of stock, because of the severe tax consequences of their receiving cash or shares of stock. These include pension plans where the insurance policy is held directly by the pension plan and not through a trust, and IRAs in a similar position.

This section focuses only on the primary currency of policyholder compensation. Those forms that have been used historically are listed first, and then other forms that have been discussed. The forms of consideration for policyholder equity that will be considered are:

1. Fixed Amount of Value Distributed in Stock (UNUM)Total value of pre-transaction company distributed in cash (Maccabees)
2. Value of Company Pre-Transaction Distributed in Cash (Maccabees)
3. Entire Value of Company Pre-Transaction Distributed in Stock (Equitable, Allmerica)
4. Fixed Amount of Value Distributed as Enhancement to Policyholder Dividends (SBLIC)
5. Distribution of Entire Value of the Company Pre-Transaction through Stock Options
6. Subscription Rights to Shares

The mechanics of each approach will be discussed first. The mechanics of each method where capital is raised through an IPO will be discussed second (particularly including the effect on the policyholders of an erroneous valuation), and the current regulatory climate will be discussed last.

**1. Fixed Amount of Value Distributed in Shares** (UNUM)

UNUM had originally interpreted the Maine Law as requiring it to pay out the statutory surplus of the mutual company to the existing policyholders to demutualize, and accordingly, it devised a demutualization structure where the policyholders would get shares whose aggregate value (at the IPO price) was equal to statutory surplus on [12/85]. As a result of questions raised during the regulatory review period, UNUM increased the policyholder consideration to approximately the GAAP equity as of [12/85]. That total dollar amount was allocated among eligible policyholders. Each policyholder received an equivalent number of shares at the IPO price.

**2. Value of Company Pre-Transaction Distributed in Cash** (Maccabees)

Maccabees had sought a white knight to buy the company concurrently with its demutualization and had made a deal with Royal Insurance. The value of Maccabees before it became a subsidiary of Royal was established by independent valuations and reviewed by the regulators. That value was distributed to eligible policyholders in cash.

**3. Entire Value of Company Pre-Transaction Distributed in Stock** (Equitable, Allmerica)

In what appears to have become the norm for U.S. demutualizations, an IPO is structured allocating shares to the existing policyholders equal to the value of the company pre-transaction, and shares to the IPO equal to the amount of capital the company desires to raise. The IPO can proceed in one of two ways, the number of shares can be fixed in which case the capital raised is dependent on the IPO price; alternatively (and this is the commonest structure), the capital to be raised is fixed and the number of shares sold in the IPO varies according to the IPO price.

This is the process that was followed by State Mutual as it converted to Allmerica, and Guarantee Mutual as it converted to Guarantee Life. A modified version of this process was followed by Equitable as it demutualized since the debt that AXA owned also converted to a combination of common and preferred stock at the time of demutualization according to a formula based on the IPO price.

**4. Fixed Amount of Value Distributed as Enhancement to Policyholder Dividends** (SBLIC)

This approach was used by SBLIC when it converted from a collection of insurance divisions to an insurance company with restricted stock. The amount distributed was relatively low (reflecting the assertion by the savings banks involved that expenses had been undercharged) and the allocation (in effect allocated in proportion to future policyholder dividends) is unusual.

**5. Distribution of Entire Value of the Company Pre-Transaction through Stock Options**

This approach has been considered by at least one insurance company but not implemented as yet. The company, first of all, establishes its open-market value and determines how much capital it wishes to raise. Having established these two amounts, it distributes in-the-money options to eligible policyholders with the strike price selected so that the value of the options (approximately equal to the expected value of the shares less the strike price) in aggregate, equals the value of the company and the funds raised from exercising the options (strike price x number of options) equals the capital to be raised. If the company works to establish an efficient market in the options policyholders that want stock can buy it for the strike price, but most policyholders will probably sell the option for the option value. A significant advantage of this approach is that it should reduce the number of shareholders after demutualization, and thus, the administrative costs of servicing shareholders.

### 6. Subscription Rights to Shares

Subscription rights have been used primarily in conjunction with conversion of mutual savings banks. If they are not used in conjunction with an IPO, they presumably operate just like an option. If they are used in conjunction with an IPO but at a different price, they can also operate as an option. However, most usually they have been used in conjunction with an IPO at the same price, and thus, do not convey any real benefit to the policyholder.

TABLE 1

| Company | Initial Formed | Date Formed | Capital Stock/ Initial Share Capital | Date Capital Stock Retired | Date Company Converted to Mutual | Date Mutual Company Converted to Stock | 1995 Assets ($ billions) | State of Domicile |
|---|---|---|---|---|---|---|---|---|
| Allmerica | Mutual | 1845 | $100,000 | 1865 | | 1995 | 6.98 | Mass |
| American United Life | Fraternal | 1877 | | | 1836 | | 6.45 | Indiana |
| Equitable | Stock | 1859 | $100,000 | | 1925 | 1992 | 63.78 | New York |
| General American Life | Stock | 1933 | $2,000,000 | | 1946 | | 9.57 | Missouri |
| Guardian Life | Stock | 1860 | $200,000 | | 1945 | | 10.96 | New York |

TABLE 1 (continued)

| Company | Initial Formed | Date Formed | Capital Stock/ Initial Share Capital | Date Capital Stock Retired | Date Company Converted to Mutual | Date Mutual Company Converted to Stock | 1995 Assets ($ billions) | State of Domicile |
|---|---|---|---|---|---|---|---|---|
| John Hancock | Mutual | 1862 | $100,000 | 1872 | | | 50.78 | Mass |
| Massachusetts Mutual Life | Mutual | 1851 | $100,000 | 1867 | | | 50.42 | Mass |
| Metropolitan Life | Stock | 1868 | | | 1915 | | 142.13 | New York |
| Minnesota Mutual Life | Assessment | 1880 | | | 1901 | | 10.06 | Minnesota |
| Mutual Life of NY | | ?1842 | | | | | 11.37 | New York |

**TABLE 1 (continued)**

| Company | Initial Formed | Date Formed | Capital Stock/ Initial Share Capital | Date Capital Stock Retired | Date Company Converted to Mutual | Date Mutual Company Converted to Stock | 1995 Assets ($ billions) | State of Domicile |
|---|---|---|---|---|---|---|---|---|
| Mutual of America | Welfare Association | 1945 | | | 1978 | | 6.98 | New York |
| New England Mutual Life | Mutual | 1845 | $50,000 | | | | 16.26 | Mass |
| New York Life | Mutual | 1845 | $55,800 | | | | 59.41 | New York |
| Northwestern Mutual Life | Mutual | 1857 | | | | 1989 | 54.87 | Wisconsin |
| Pacific Mutual | Stock | 1868 | | | | 1959 | 17.59 | California |

**TABLE 1 (continued)**

| Company | Initial Formed | Date Formed | Capital Stock/ Initial Share Capital | Date Capital Stock Retired | Date Company Converted to Mutual | Date Mutual Company Converted to Stock | 1995 Assets ($ billions) | State of Domicile |
|---|---|---|---|---|---|---|---|---|
| Penn Mutual Life | ? | | | | | | 6.62 | Pennsylvan ia |
| Phoenix/Home<br>Life Mutual | Home Stock<br>Phoenix Stock | 1860<br>1861 | | | 1916<br>1889 | | 12.81 | New York |
| Principal Mutual Life | Assessment | 1879 | | | 1911 | | 51.3 | Iowa |
| Prudential | Stock | 1873 | $25,000 | | 1943 | | 179.73 | New Jersey |
| UNUM Life | Mutual | 1849 | | | | 1986 | 9.93 | Maine |