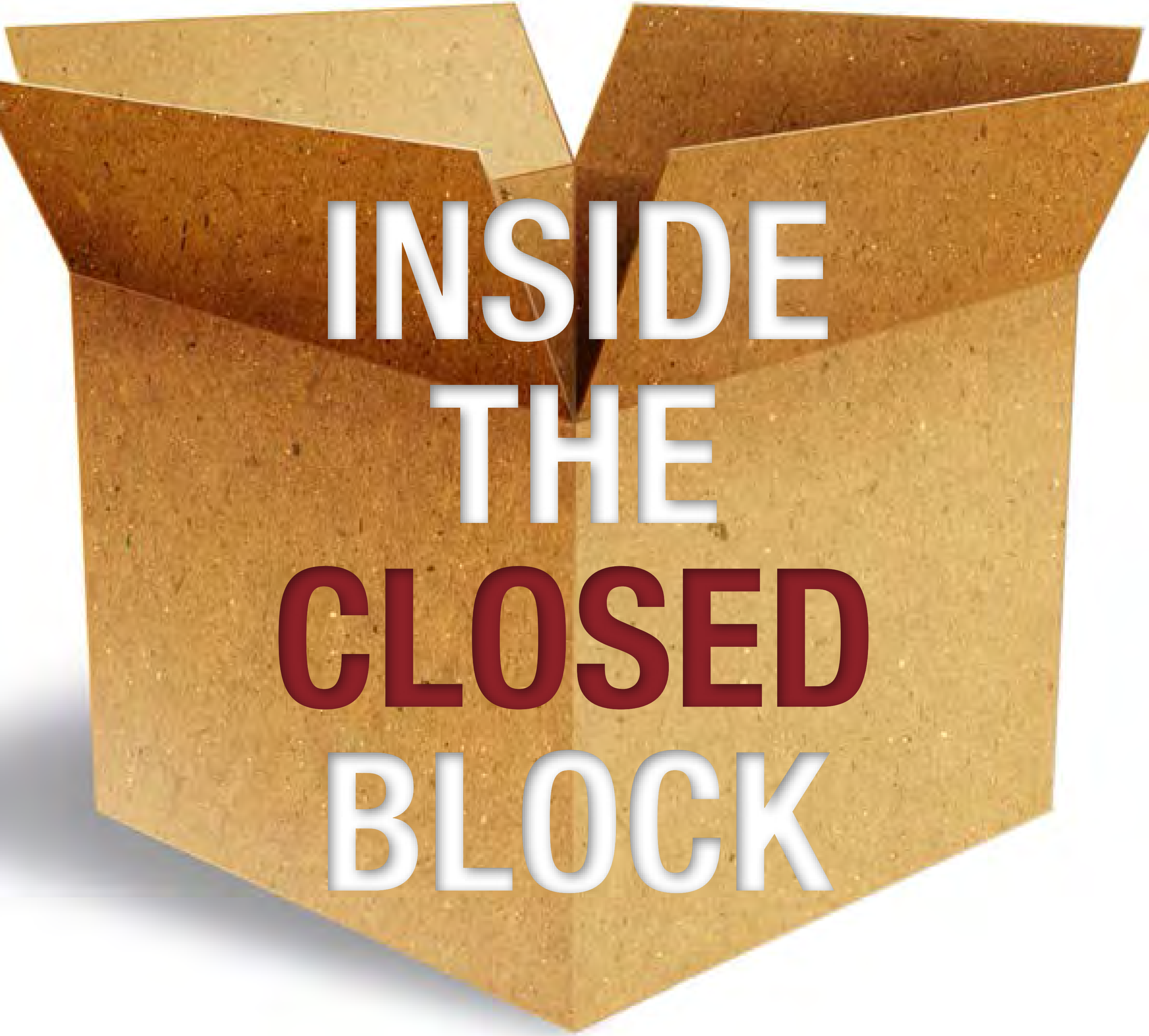
How Mutual Insurance Holding Companies *Really* Work

Part II



INSIDE THE CLOSED BLOCK

by: L Carlos Lara

We all know that long ago the Church condemned usury. As a result a special monetary device was conceived that allowed religious institutions to borrow great sums of money from the public without committing this sin. That peculiar financial instrument was the *annuity*. Its features worked so well that governments soon began using it too. In fact, in 1689, King Louis XIV of France used an annuity scheme devised by *Lorenzo Tonti,* a Neapolitan banker, to raise needed funds for the state. It was immensely successful and the plan was quite simple. Money was set aside yearly for the contributing participants. As participants died and their annuity obligation ceased, ever-larger annuity amounts became available to the survivors. The longer one lived, the larger grew the annuity payout. Two centuries later, Henry B. Hyde, President of the Equitable Life Assurance Society of the United States, revived the use of this *"tontine"*[1] concept and in doing so completely revolutionized the industry. This one apparatus made the life insurance companies in the United States the most powerful financial institutions in the world until the twentieth century when it was outlawed. In this article we will explore why, and what all this has to do with the ***"closed block"*** in a mutual insurance holding company (MIHC).

In this second section of a two-part *LMR* series on *How Mutual Insurance Holding Companies Really Work* we elaborate further on this unique mutual insurance hybrid, which has become the most sought after method to reorganize a mutual insurance company in modern times as opposed to simply demutualizing it. Since 1995, over 70% of insurance company mutual reorganizations have used the MIHC structure. As we explained in Part I, the impetus to reorganize in the first place was generated by the onset of the *Financial Services Modernization Act.*[2] This law eliminated many of the 20th century barriers that once separated banking, investments, and insurance. Once passed it unleashed a conglomeration of financial services giants seeking to merge or acquire one another. In the insurance sector, the larger mutuals now found themselves with a definite advantage to fully demutualize and many did. On the other hand, the smaller mutual was placed at a distinct disadvantage and became vulnerable to a take-over. The idea that the mutual may be going away permanently

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is startling to many, but the facts are clear: We now have only approximately 13 pure mutuals, down from 150 back in 1965. But it has actually been the MIHC form of reorganization that has stopped the complete evaporation by allowing a mutual company to be split into a tiered edifice containing both a mutual holding company and a stock company, while at the same time holding onto its cherished *mutuality*. One of the most significant factors in the MIHC structure is that 51% of the voting control of the downstream stock company remains (by statutory law) with the mutual holding company. This is where the policyholders maintain their ownership and membership rights. (SEE Diagram A.)[3]

The Conversion Process: Diagram A

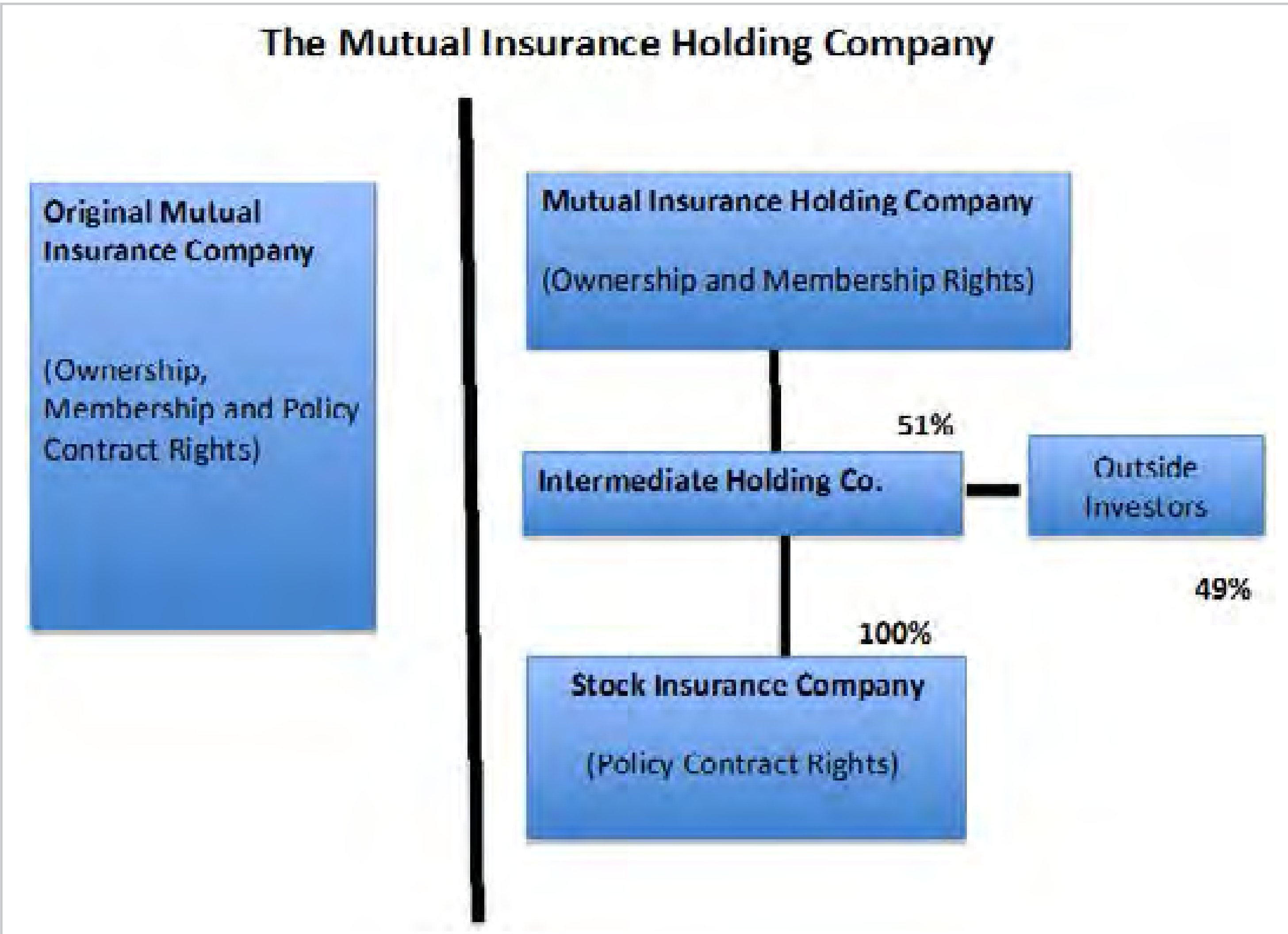

Diagram A is a re-creation from a similar diagram presented at the New York Annual Meeting of the Society of Actuaries October 18-21, 1998, Panelist and Presenter, Carl M. Harris, Principal with Deloitte & Touche in Des Moines, Iowa.

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Mutuals in the United States

For those of us that mourn the loss of so many of the mutuals it may be comforting to know that mutual insurance companies have always been few in number. In one very important sense the mutual was originally—more or less—forced into existence here in the United States. To fully understand why, we have to trace the early beginnings of the life insurance business in this country. Basically, it was illegal to launch the easier and more preferable stock company because there was a monopoly on corporate formation for insurers, granted by the English Crown in 1720.[4] This had a negative effect on the development of the insurance business in the American colonies, making it impossible for new entrants into the business to compete against the more established London stock insurers. The mutual concept was the only viable choice available.

The first life insurance corporation in the United States was a *mutual* established in 1759 in Philadelphia by the synod of the Presbyterian Church as the *Corporation for the Relief of the Poor and Distressed Presbyterian Ministers and for the Poor and the Distressed Widows and Children of Presbyterian Ministers*—known today by the shorter title—*The Presbyterian Ministers' Fund.*[5] Undergirding the establishment of this first life insurance organization by a religious group is the recognizable scripture verse taken from the New Testament, which says:

"Religion that God our Father accepts as pure and faultless is this: to care for orphans and widows in their distress." — James 1:27

Foundationally, the desire for security is one of the most potent motivating forces of human history. Early societies relied on families for this security, but with economic progress and growing financial sophistication, a more formalized and structured source of security is contractual insurance. For this universal reason, those who fully understand the nature of insurance tend to view it as a noble institution. The mutuals, because of their reliance on membership in order to form their infrastructure, best fit the description of a system of organized benefits.

The Tontine Annuity

The first stock proprietary corporate insurer in the United States was founded soon after the colonies won their independence from England; it was *The Insurance Company of North America* chartered in 1794. With the English monopoly on stock insurers having been broken, most of the new companies formed were stock companies. In the mid 1800s more mutuals emerged and gained in popularity with the advent of policy *dividends*. Then a New York State Law passed in 1849 (prompted by the more established mutuals) required a $100,000 security deposit for all new insurers. This would have been a substantial monetary barrier at that time so the numbers of new mutuals were contained, but it naturally paved the way for new stock company formations. From 1853 to 1865, 41 new stock insurers were organized. By then competition in the insurance business had grown fierce. Only 11 of those stock companies survived, but it was one of those survivors who brought back the centuries old *"tontine"* concept in 1868, as a marketing strategy to compete against the larger stock and established mutual companies. It worked beautifully, just as it had in the past for both religious institutions and governments. "Under tontine policies, premiums were split between ordinary insurance that paid a death benefit and a limited group investment fund that deferred dividend payments for a term of usually 10-20 years. At the end of the term, only the surviving participants received the *deferred dividend* proceeds as either a lump sum or an annuity."[6] The incentive to take part in this scheme was tremendous and demand for these types of policies soared. The emerging middle class, eager to get involved in investment options, poured huge amounts of money into life insurers who were amassing these large quantities of funds without the need for mandatory reserves. Insurance companies grew rich and powerful—more so than any other financial institution of that time.

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The 1905 Armstrong Investigations

According to a recent CIPR study put out by the National Association of Insurance Commissioners dated August 2013, it was *tontine deposits* and the effects it had on the industry that eventually led to accusations of insurer mismanagement and corruption, culminating in the 1905 Armstrong Investigations held first in New York and later in many other parts of the country. The report goes on to state that prior to this investigation insurers were using these large amounts of money to buy controlling shares in banks and other corporations. They participated in investment syndicates to buy bonds at cheaper prices, underwrote securities, sat on the boards of banks, and influenced politics. The Armstrong Investigation was mostly concerned that insurers had grown to such proportions that their failure would wreck havoc on the economy. Most of the criticism for financial misbehavior was centered on the stock companies, which ultimately lost substantial market share. *"As a result, three of the then largest U.S. stock insurers—The Equitable, The Metropolitan and the Prudential—converted to the mutual form of insurance thereafter."*[7]

The aftermath of the Armstrong Investigations were sweeping. States assumed much broader and more comprehensive regulatory control of the industry from that point forward that still remains in place today. Dividends, for example, were required to be paid annually ending forever the *"deferred dividends"* of the tontine system. Additionally, insurers were prohibited from owning common stock and underwriting securities. So even before the enactment of the *Glass Stegall Act of 1933* that came down hard on commercial banks for the same type of financial misdeeds, insurance companies were prohibited from co-mingling with banks and investments firms 28 years earlier.

During the "Roaring '20s" and before the onset of the Great Depression, the life insurance industry had completely rebounded financially with new all-time sales records. With investor confidence in insurance restored and the industry completely detached from stock market

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investments, the Crash of 1929 did not have the same devastating impact on insurance companies as it did on banks and investment firms. Only 20 of the 350 insurance carriers in operation, or about 5%, went into receivership. Even so, reinsurers honored all policyholder claims. Banks, on the other hand, had over 4,000 failures out of 25,000 banks, or a 15.5% failure rate, with a loss to depositors of $1.3 billion.

In spite of this glowing episode in favor of the life insurance companies, the industry did not escape unscathed. The Great Depression wore on for years, generating mortgage defaults and policy surrenders that drained cash flows. (Insurance companies were partially invested in mortgages.) A low interest rate environment very similar to that of our own current times hurt both asset valuations and earnings. Credit ratings also suffered and caused insurers to shift their investment strategies to deal with the economic environment of the times. This is, of course, a historical portrayal of the profound effects of a classic boom-bust cycle, as Austrians would depict it.

The "Closed Block," Its Significance, and the Future

Following enactment of the *Financial Services and Modernization Act of 1999,* mutual management had to make drastic changes, once again, in its governing strategy in order to align with the new economic environment. For many of them this meant demutualization. For those that chose the mutual holding company route a different sort of challenge lay in store. The process is rigorous and expensive although not as much as that of a complete demutualization. One example of the technical processes of forming a mutual holding company is the need for on-going separate accounting of the *"closed block"*[8] that has to be reviewed annually. To fully understand this requirement, we have to keep in

mind that the pure mutual is changing over to a stock company. In order to be fair and equitable to the policyholders of the pure mutual that is going away, an initial separation must take place since no cash or shares of stock were distributed as compensation as in the normal process of a complete demutualization. Therefore, the closed block insures the mutual policyholders of their future dividends and is like a giant box you open and throw in all of your (participating) dividend-paying policies along with all of the matching assets required to fully mature that business—then you close it permanently. In other words, it is like walling off the liabilities and assets for that entire block of business and never reopening it again for as long as possibly 100 years. What goes in the box at the time of the reorganization stays in there. It is especially noteworthy that if by chance the closed block performs better than anticipated (a very real possibility since those assets are probably paying 8 and 10% interest), then the money cannot revert to the company or shareholders in case of an IPO. At the same time any stored-up surpluses can create, if management is not careful, a huge *"deferred dividend liability"*[9] or what we have already learned is an illegal *tontine*. Since the closed block is a *closed system* and if such an accumulation of dividends were allowed to happen, then we could say that if everyone's policy lapsed inside the closed block with the exception of yours—you would win the lottery! So of course, those surpluses must be carefully managed, accounted for, and distributed over time to the mutual policyholders to prevent that from happening.

The additional good news is that the MIHC structure is set up to be a self-perpetuating system. Initially, all of the policyholders of the pure mutual at transformation are deemed to be also members of the new mutual holding company

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(MHC). After the transformation, policies issued out of the stock insurance company will also become members of the MHC to avoid the tontine effect. The policies inside the closed block will eventually leave the box whether it's in 80, 90 or 100 years, leaving only the policyholders of the stock company who each have membership rights in the MHC, and (by law) must always own 51% of the stock company.

If the MIHC ever wants to fully demutualize, the policyholders as members have a say in that decision and can expect to be compensated accordingly for their membership interest. If the MIHC wants to issue an IPO, policyholders have the option for first rights to subscriptions of such an offering. So in effect, policyholders in a MIHC—as in a pure mutual—are not simply owners of a financial product as in a pure insurance stock company, but also actual owner/members of the entire financial structure.

Conclusion

In light of all these changes one thing can be said for certain: Mutual management can no longer think in terms of a 20- or 30-year horizon. Stock management, the type found in the MIHC, is now forced to think every time the stock market ticks, central bankers tinker with interest rates, or whenever massive amounts of money are moved through our banking systems. This could be a huge disadvantage since insurance by nature is a long-term business. On the other hand, it could be the best thing that could have happened to the industry. The history of life insurers demonstrates that in spite of changing economic times, its reason for being has never been ignored. Its most important element is providing either total or partial relief from the potential burden of financial loss, commonly known as the transfer of risk. In order to hang on to this important feature, which encompass-

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es the very heart of the life insurance business, insurers have always been ready to try, fail, and try again to maintain their market share.

In the wake of the 2008 financial crisis, all of the players in the insurance sector—as all other sectors of our economy and of the world at large—are being forced to evaluate their possible options in navigating the uncertainty of our interconnected, yet fragile financial systems. The challenge is great for these are exceptional times.

This two-part exposé has been written solely for educational purposes. It is directed in particular to my fellow Infinite Banking Concept (IBC) Practitioners, who utilize the insurance sector in our personal lives and in our work. As far as a plan of action in light of present circumstances and especially with regards to mutuals and mutual holding companies, our message remains the same. It does not change. Like all those who are properly schooled in Austrian economics, we—the Authorized IBC Practitioners—of all people are in the best position to stand back and see all this for what it means. Our current economic environment should not surprise us. We predicted it. What Nelson Nash wrote in his book, Becoming Your Own Banker, and what Robert Murphy and I wrote in ours, How Privatized Banking Really Works, is still true and foundational—every word of it. Teaching Austrian economics to the public while continuing to implement IBC actually helps people immediately and gets us closer to our 10% mark of helping all of society. For this reason we must never stop.

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