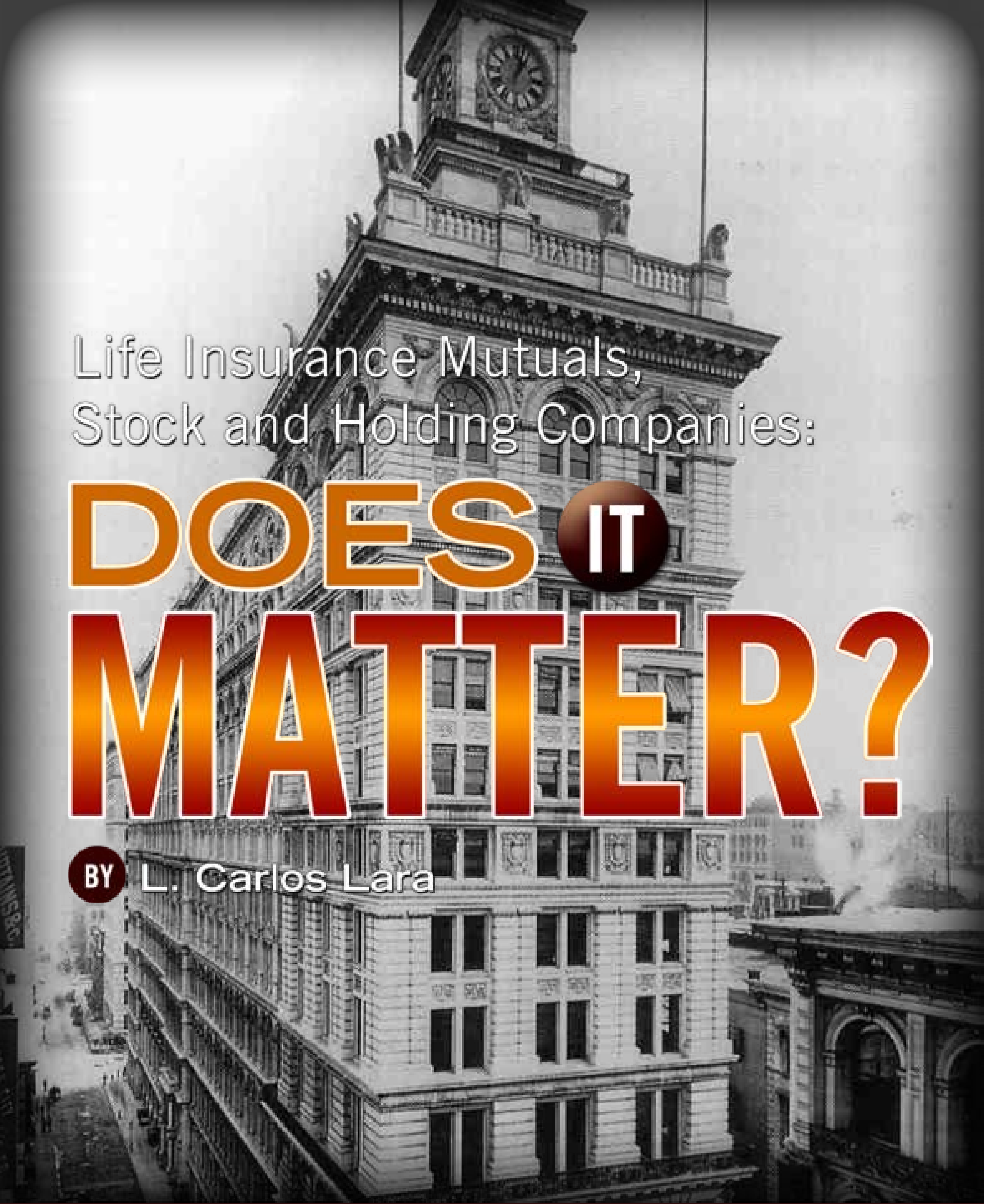

Life Insurance Mutuals, Stock and Holding Companies:

DOES IT MATTER?

BY L. Carlos Lara

In approaching this subject I need to admit right now that I am biased. But in order to be equitable with my stance, it is best to evaluate the facts about these institutions against the context of a broader sphere that takes into account historical evidence matched with our current economic, social and moral climate. In the end, it is the head of a household or an entrepreneur heading up a business enterprise who must ultimately make use of these institutions to navigate the uncertain future. If these institutions fail at this basic level of service, then practical consumers will choose neither one and turn to other alternatives.

Our readers know that our study and exhortations about the insurance industry go beyond the simple purchase of a policy for life insurance needs. As students and informal specialists of the Federal Reserve and its dangerous fractional reserve banking practices, we were compelled to seek, and have actually found, a more conservative financial strategy utilizing the insurance sector and, in particular, a certain financial product: dividend-paying Whole Life insurance. Austrian scholars of the past such as, ***Ludwig von Mises, Murray Rothbard*** and ***Jesus Huerta de Soto,*** not only believed in the conservatism of the institution of insurance, but also helped point the way to our own discovery through their writings. Although they did not specifically name this product in their books, the dates of their writings tell us they were speaking of the very same one.

We turned to the insurance sector for a solution when we saw that nothing else in the other financial sectors was working. Shortly after the crisis people everywhere were in genuine pain. Robert, as an economist, and I as a workout specialist for firms in financial trouble, came to the same conclusion after much research on how best to advise people with a legitimate economic solution.

Intuitively, the average person already knew that big banks and Wall Street were somehow responsible, but many didn't understand exactly how the commercial banking system had failed us. The case is not that something is inherently wrong with the institution of *banking*, but rather that our current monetary policy and regulatory framework has corrupted it and turned it against us. Borrowing from commercial banks now only serves to contribute to the problem of inflation, deepening our individual and national economic problems.

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with the institution of banking, but rather that our current monetary policy and regulatory framework has corrupted it and turned it against us.

Many still don't quite understand this fact, and so obviously the problem persists.

The only *final* answer to this problem is in returning to the gold standard, returning to privatized banking and closing the central bank altogether. Most Austrians recognize this as the *Sound Money Solution*—a solution that can only be implemented by a change of public opinion. But think about it—if only the 750,000 licensed financial advisors practicing in the U.S. who daily are speaking to people about their money could come to understand this and see the significance of its implications, the goal of changing public opinion could be achieved. With the help of an intermediary financial solution, the goal could be reached quite rapidly.

In our book, *How Privatized Banking* ***Really*** *Works,* Robert and I examined the facts surrounding this unique life insurance product in this broader context. We found that when measured against all other financial strategies, dividend-paying Whole Life insurance functioned as a form of *privatized banking*. Furthermore, we witnessed that it accomplished every bit of what Nelson Nash talks about in his famous book, *Becoming Your Own Banker*.

In this article we now turn our focus to the insurance companies that distribute this marvelous instrument. The attempt will be to highlight only some of the more relevant aspects of our subject. A full discussion, of course, is beyond the scope of this brief report and will need to be expanded further in future issues of the ***Lara-Murphy Report***. What is most important to understand at the outset is that life insurance, like everything else in our economy, suffers from the stronghold of government intervention. However, there are still some aspects of this institution that remain untouched and allow us to use it for *privatized banking* purposes.

DEREGULATION

The insurance sector, like the banking sector and Wall Street, has been among us since the formation of this country. *Deregulation* is when government reduces its role and allows industry greater freedom in its operation. Keep in mind, however, that government never fully releases industry so it isn't exactly the opposite of *regulation*, which refers to written law and judicial decisions. Up until recently the U.S. legislatively required substantial separation among the major components of the financial services industry—commercial banking, investment banking, and insurance. Much of this separation came from government regulation imposed on

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many industries back in the early 1900s that totally restricted the entry of certain financial sectors into some markets.[1] But the bulwark of this separation in the financial services sector came amidst the Great Depression. Congress determined that commercial banks had excessively recommended, invested and extended credit for stock market trading, and eventually precipitated the stock market crash of 1929. To resolve this perceived banking abuse, a permanent wall was erected between commercial banks and investment banks, in the form of the Glass-Steagall Act.

As expected, banks began pushing unsuccessfully for the repeal of this Act soon after it was enacted *"…contending that such limitations harmed bank competitiveness, profitability and limited consumer choice."*[2] The intensity of that *push* grew in the 1970s and 1980s. While Congress stood firm on the banking boundaries of the Glass-Steagall Act, by 1990 bank regulators were able to circumvent the law, by *regulatory interpretation* allowing banks to underwrite securities using bank subsidiaries. This allowed banks to acquire the largest brokerage firms and engage in securities activities whereas the Glass-Steagall Act continued to bar brokerage firms and insurance companies from acquiring banks.[3] If this makes no sense to you or seems unfair—*"move to the head of the class."* This type of disparity should come as no surprise, for this type of thing happens often in our overly regulated economy.

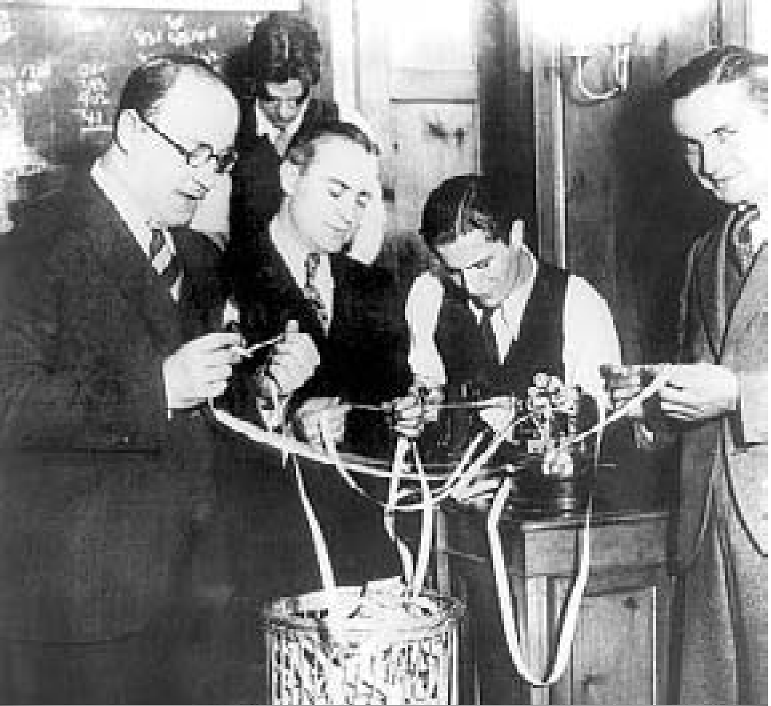
Once commercial banks began moving into the brokerage business via subsidiaries, the financial markets began moving faster than government regulation could keep up with. Manufacturing was no longer the country's bedrock and the financial services industry was seen as what would replace it. The merger of Citicorp Bank and Travelers Insurance in 1998 is an example of banks continuing to push the issue of what they believed was already a *"dead law."* The promoters of this merger felt comfortable that The Glass-Steagall Act would soon change in their favor and *it did.* In 1999 the Gramm-Leach-Bliley Act **(The Financial Services Modernization Act),** repealed crucial parts of the Glass-Steagall Act and legally took down the wall between commercial banks and investment banks altogether. But it also went further by opening up interactive competition among all financial sectors, including insurance.[4] At the time, I was a securities Principal and owner of a Broker-Dealer firm and member of the NASD, in addition to my consulting practice. There was a sense that if you didn't quickly diversify into all areas of the financial services business, to become a sort of *"one-stop financial product shopping mart,"* you were going to get left behind. To accomplish this you needed huge amounts of capital to expand your operations. The adrenaline felt behind this movement was prevalent everywhere.

Austrian Mark Thornton, (interviewed here in the December 2010 issue of the *LMR*) severely criticized this Act as contributing to the 2008 financial crisis, as did other well-known economists. But notice that Mark is careful to qualify in what way he believes it precipitated the crisis. His statement below explains the crucial difference that separates him from mainstream economists and that we wholeheartedly endorse.

"In a world regulated by a gold standard, 100% reserve banking, and no FDIC deposit insurance the Financial Services Modernization Act would have made perfect sense as a legitimate act of deregulation, but under the present fiat monetary system it amounts to corporate welfare for financial institutions and a moral hazard that will make taxpayers pay dearly."

—Mark Thornton[5]

This Act opened the door for many changes in the financial services industry. Since it made possible the integration of mixed services from commercial banks, investment banks and insurance companies, it served to spawn countless mergers, acquisitions and IPOs as financial institutions scrambled to tap the capital markets and reposition themselves in the new marketplace. Interesting is the manner in which the insurance sector was impacted by all of these changes, especially when it came to the mutuals. Mutuals, you see, are denied access to capital markets on account of their operating structure as mutuals. Mutuals have no stock to sell. Stock insurance companies, on the other hand, are



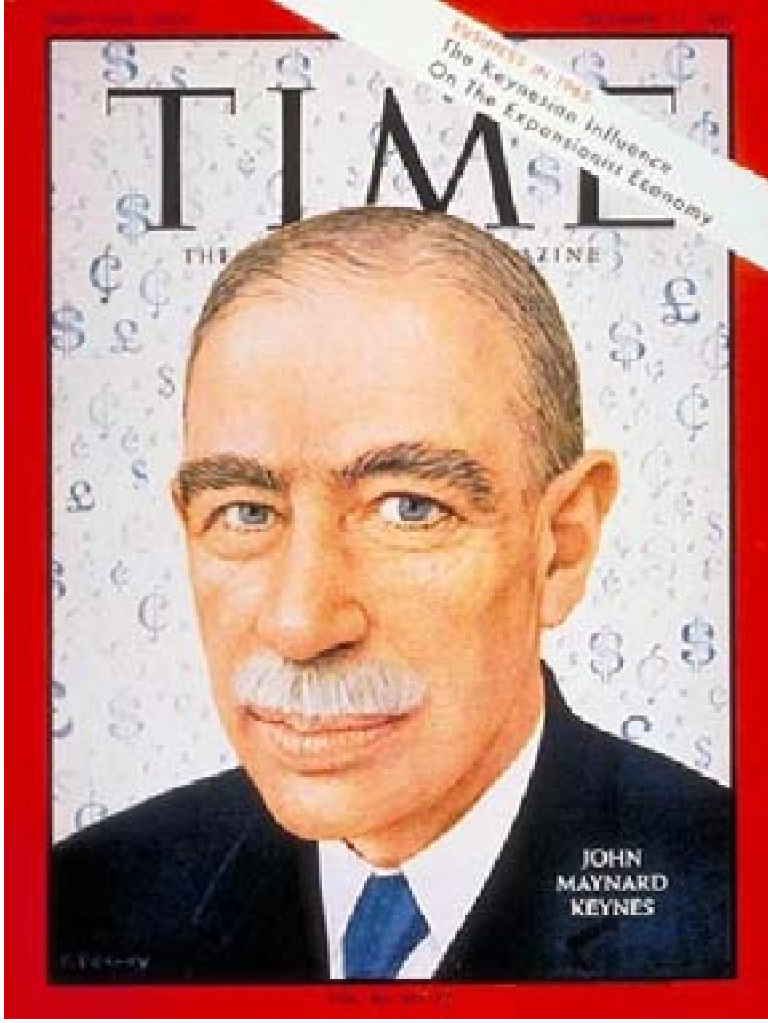
SINCE A STOCK COMPANY can sell shares for its stock in return for capital, the stock company is more agile as either a start-up or in the mergers and acquisitions arena.

not restricted by these changes and can raise capital much more easily—hence, what we witnessed was a sharp rise in *demutualization* of mutuals and the increase in stock companies.

There was also the issue of banks selling insurance. One of the biggest concerns for insurers is *market power.* Dominant firms, such as commercial banks, can easily influence the market price of the insurance product through the strength of their banking and brokerage positions. Although banks have not yet gone full throttle since the repeal of this law, it is easy to see why insurers are not anxious to further incite a hornet's nest of competition.

Amidst this heightened onslaught of *so-called* deregulation, banking laws to this date still prohibit banks from actually selling the *traditional* type of insurance products, but it is also true that those regulatory strongholds are constantly being scrutinized and prodded. Several recent court cases such as the *Barnett Bank vs. Nelson* have served to weaken these boundaries. (Even the McCarren-Furgeson Act of 1945, which exempts the business of insurance from federal regulation, is frequently reviewed by lawmakers.)[6] Yet, there are also plenty of regulatory concerns countering all this *integration*, and *mixed services* that have occurred, especially since the 2008 financial crisis. Again, this should come as no surprise in a planned and regulated economy such as ours. The IPOs, mergers and acquisitions of the various financial sectors leading in the formation of giant conglomerates have not necessarily had positive effects for consumers and taxpayers. The recent big bank bailouts are prime examples of this and only serve to underscore Mark Thornton's ominous predictions.

It is difficult to judge what will ultimately happen in the ensuing years as financial markets continue to heat up under government's design for the economy. But when it comes to the insurance sector specifically, the net results have been dramatic up to this point. Shifts in its size, configuration of ownership structure, and market share have completely reshaped the life insurance industry. We'll look at these in the next section.



STOCK VS. MUTUAL

Most of the life and health insurance in the United States is still issued by commercial life insurance companies. Commercial life insurance companies are of course corporations that are federally taxed in much the same way as all other U.S. corporations with some exceptions. Only fraternal societies, savings banks, and the Veterans Administration which issue life and health policies have a federal tax exemption, but they issue less than 2% of policies in force in the United States. Commercial life insurance companies, which issue the remaining 98% of all life and health policies in the nation, are also taxed by the states. This is because the life insurance industry is a state-regulated industry. The state tax is actually levied on the insurance premium. The *state premium tax* is 1%- 4% depending on the state and whether or not the insurer is out-of-state or domestic.

Commercial life insurance companies are organized as either mutual or stock corporations. But mutuals are special corporations that own no stock. The most distinguishing characteristic of the stock company is that its owners are *stockholders.* Alternatively, *policy owners* **own** a mutual life insurance company. Today, stock insurers outnumber the mutuals by a wide margin. In the past, mutuals were dominant with respect to life insurance policies in force, but their share has declined to less than 40% from 62% in 1960. Irrespective of this statistic, mutual companies are still generally larger than stock companies.

The primary reason for this shift in the increase of stock companies has been the stock company's ability to respond more advantageously to *The Financial Services Modernization Act.* Since a stock company can sell shares for its stock in return for capital, the stock company is more agile as either a start-up or in the mergers and acquisitions arena. Additionally, stock insurance companies can be owned by other stock companies whether or not they are in the insurance business. A mutual company, on the other hand, is owned solely by its policy owners and cannot be owned by any other entity. This presents a special problem for mutuals and their ability to access outside capital. Instead, growth must take place either from within or by merging with another mutual. Several mutuals have been enormously successful following this internal growth approach. Recently, however, the mutual insurance holding company concept, has presented

ALSO MUTUAL LIFE INSURERS CAN ONLY OFFER TO PAY

in cash—a very expensive and impractical way to transact business on the one hand, but also a superb example of what 100% reserves really mean.

an additional method for mutual companies to access capital. We explain this more fully shortly.

We should also mention that the lack of profit incentive also makes starting up a new mutual quite challenging. This is because mutuals are similar to non-profits. But unlike a true cooperative, members do not contribute to the capital of the company by direct investment, but rather derive their rights to profits and votes through their customer relationships. Unfortunately, growing regulation only serves to make the forming of a new mutual even more problematic.

As already stated, a new stock insurance company start-up can meet the state's requirements of ready capital for expenses and contingency reserves by selling shares of their stock. Under New York State law, a stock company must have a minimum of $2 million capital and a paid-in initial surplus of the greater of $4 million or 200 percent of its capital. The minimum capital requirement *after* formation is regulated by a formula developed by the NAIC. After it has been fully established and has attained adequate financial stability, a stock insurer can then be converted into a mutual company.

The mutual start-up, because its original intentions are to be a mutual, *"must have policy applications in-hand of not less than $1,000 each from 1,000 persons, accompanied by the full amount of one annual premium for an aggregate amount of $25,000, plus an initial surplus of $150,000 in cash."*[7] Obviously, the cash portion of the money can be borrowed, but how does one accomplish getting policy applications from a thousand people, when the company has not even been formed and is not

HOW THIS EFFICIENCY IS ULTIMATELY ACHIEVED HAS BEEN the continuous struggle of stock and mutual companies in the life insurance industry for nearly two centuries. Their long history shows that they have been successful in meeting this consumer demand quite adequately.

legally able to issue policies? It is for this reason that not a single mutual has been formed in a very long time (world-wide) and no new ones are likely to ever be formed. This makes mutuals unique and prized companies. Their ownership structure is unlike no other corporation.

Before we leave this subject entirely we should clarify one other very important and distinguishing item. As already stated, mutual companies have no stockholders Consequently, the policy owner is both a *customer* and at the same time, an *owner* of the insurer. In a stock company a policy owner is a customer ***only.*** Mutual company's assets are held for the benefit and protection of the policy owners in the form of reserves, surplus, or contingency funds. Or, they are distributed as dividends upon the discretion of the mutual's board of directors. Mutuals primarily issue *"participating"* policies. Sometimes they will issue *non-participating* policies, but as is the case for policy owners of a stock company, these are simply *customers* of the mutual company. Stock companies are organized for the purpose of making a profit for their stockholders and mostly issue *"non-participating"* policies.[8]

Today, life insurance company managers that have to contend with these new market forces must be deliberate in structuring an organization that will provide the most efficient means of meeting their goals. Recognizing the supreme value of the mutual organization, the *Mutual Holding Company* concept has been born and has become a significant factor in determining life insurance ownership structure.

HOLDING COMPANIES

Holding companies are corporations that own or control one or more insurers, broker-dealer organizations, investment companies, and other financial services corporations. A holding company works differently with a stock company than with a mutual. A holding company formed by a stock company is known as an *"upstream holding company"* because it sits at the top of the intercorporate structure. The stockholders own it and it in turn owns subsidiaries.

A *"downstream holding company"* is usually formed by a mutual because it sits in the middle of the intercorporate structure and the subsidiary is beneath it. The mutual sits on top. It is owned either in part or whole by the mutual. Although this can allow the mutual to expand by acquiring subsidiaries, it is still limiting. Statutory accounting and legal investment laws limit the amount an insurer can invest in a subsidiary. Also, mutual life insurance insurers can only offer to pay in *cash*—a very expensive and impractical way to transact business on the one hand, but also a superb example of what 100% reserves really mean.

In 1995, new state laws were adopted and a different form of holding company was introduced known as the *Mutual Insurance Holding Company* (MIHC) *"…making it possible for a mutual to form a mutual holding company with an active stock company subsidiary. Policy owners become members of the "up-stream" mutual insurance holding company and have their policy relationship with the stock insurer subsidiary of the new holding company. Initial shares of the subsidiary's capital stock are issued and held by the mutual holding company. Then the mutual holding company, acting through the stock subsidiary, can access the public markets."*[9]

In evaluating all of this we must never forget that the primary reason mutuals demutualize or form holding companies in the first place is to access equity capital. This is a function that has become increasingly important, as the integration of the financial services industry has accelerated. Money is needed for new equipment, space, sales and distribution capabilities, in essence for *growth.* Naturally, the question arises as to how these expansive moves will ultimately affect the insurance coverage of persons with participating policies. If we understand the conservative methods used by insurance companies in building their participating policies along with their statutory reserves (as we detailed in last month's issue of the *LMR*) we should be able to reasonably determine that there should be no adverse impact on the insurer's ability to meet the policy guarantees on its policies, or pay the dividends on the same scale prior to these financial moves. We will look deeper into this subject later here in the *LMR* in upcoming issues.

CONCLUSION

Of course, the importance of insurer selection must not be underestimated. Life insurance involves a long-term *guarantee.* This guarantee is unlike the guarantee of any other consumer product on the market. Since it is *life insurance*, the guarantee *is* the product. There is no value in the paperwork; only the guarantee embodied in the policy has value. Likewise, it is a guarantee that must be there for a very long time. The insurance company is contracting to deliver this guarantee when needed, whether it is right now or fifty years from now. It is imperative, of course, that the insurance companies have the financial strength and integrity to meet this guarantee. This prerequisite applies to both stock and mutual companies alike.

In addition to the issue of financial strength, managers of well-run companies realize that ultimately the consumer is sovereign. What life insurance purchasers have made known is their interest in *product value.* Efficiently operated insurers will always be in a better position to deliver this product value to their customers. How this efficiency is ultimately achieved has been the continuous struggle of stock and mutual companies in the life insurance industry for nearly two centuries. Their long history shows that they have been successful in meeting this consumer demand quite adequately.

What we also know from historical experience is that life insurance companies in general are very conservatively managed corporations. This can best be seen in the manner they construct their product. Life insurance companies that issue participating policies, in particular, traditionally over-charge policy owners on the front end, *not to gouge them,* but to fully insure the payment of the guarantee, which coincidently, also serves to insulate the policy owner from market volatility. If this is important to you, take note. Later, the premium is returned to the policy owner in the form of tax-free dividends. The net result is a less expensive product of remarkable quality.

But at the end of the day here is the one question you should be asking yourself as a policy owner. *"Do I like the idea of being a source of profit for investors?"* For those of us endeavoring to utilize a policy for *privatized banking* purposes, your answer to this question is ultimately determined by your choice of one company over another. The main difference in using a mutual company over a stock company is that YOU are the owner, whereas in a stock company someone else is. That *difference* makes all the difference. So, yes, *it does matter.*

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