New Developments in Demutualization Among Life Insurers in the U.S. and U.K.

By Hiroshi Matsuoka
Insurance Research Group

Introduction

The main points of the recently revised Insurance Business Law concern bankruptcy procedures for life insurance companies and stipulations for demutualization (conversion to stock company). The mutual company is a form of organization unique to the insurance industry wherein participating policyholders (those with membership rights) own the company instead of stockholders. Major decisions for the company are decided at a general meeting of members (or in Japan's case, of representatives chosen by the members). Most life insurance companies in Japan are mutual companies.

In line with a growing trend in other countries, the revised law makes demutualization — the conversion of a mutual company into a stock company — a more viable alternative for mutual companies in Japan. In fact, Daido Life has already set up a working level team to complete demutualization and carry out an initial public offering by April 2002.

Overseas, demutualization has been accelerating, particularly in the United States, United Kingdom, and Canada. In Canada, four of the top five life insurers who had not already demutualized did so from the second half of last year to this March. In the U.S., the second and thirteenth largest mutuals in assets under management completed their demutualization this year, while the largest mutual company is currently undergoing demutualization. In the U.K., major mutual life insurer Scottish Widows is demutualizing in preparation for joining the Lloyds TSB group. A new development of growing interest is the rise of members' groups calling for demutualization.

In this paper, we examine two demutualization cases thought to be particularly relevant to Japan — MetLife in the U.S. and Standard Life in the U.K. Both are second ranking in their respective markets, and offer interesting implications.

1. MetLife Trust

(1) Background and Outline of Demutualization

Metropolitan Life, headquartered in New York, announced its intention to demutualize in November 1998. Although unable to meet its original deadline for listing during 1999, good progress had been made. The board of directors approved a detailed plan for demutualization in September 1999, and a 360-page reorganization proposal was distributed to all policyholders in late November.

The New York State Insurance Board conducted a public hearing on January 24, 2000, and participating policyholders voted on the reorganization proposal on February 7. Of the 11 million participating policyholders, 2.76 million cast a vote, and an overwhelming 2.57 million voted in favor of the proposal (93.2%). Following approval from the Insurance Board, demutualization was completed in early April, and an IPO was carried out.

Policyholders were distributed shares in Metropolitan Inc., the newly created holding company of the MetLife Group. The distribution consisted of a guaranteed minimum fixed portion, and a variable portion proportional to policyholders' contribution to surplus earnings.

(2) Accommodating the Large Number of Policyholders

MetLife's demutualization was closely followed because its 11 million policyholders was the largest to date. Thus it is an especially instructive case for Japanese life insurers, who also have a large number of policyholders.

1. Outsourcing of Operations

The large number of policyholders that life insurers have can create enormous logistical problems for demutualization. In MetLife's case, the simple process of mailing informatio booklets to policyholders alone took three weeks; mail trucks had to be loaded in assembly line fashion.

To handle the massive scale of operations, MetLife outsourced the mailings, telephone call-in centers, and related operations to Chase Melon Shareholder Services. Chase purchased an office building in New Jersey and set up a call-in center in Florida especially for this purpose. The 24-hour call-in center was constantly staffed with 100 operators and up to 700 operators during peak hours to answer questions from policyholders free of charge.

2. Adoption of Trust for Stockholder Management

As compensation for losing their rights as stakeholders, policyholders receive a stock distribution from the demutualized company (or from the new holding company). In contrast to Japan, where the revised Insurance Law seeks to reduce the number of stockholders by forcing recipients of odd lots to sell their shares,[1] there are generally no restrictions in the U.S. to limit the number stockholders, regardless of their total size.[2] With regard to MetLife's keenly watched decision on how to manage its vast number of stockholders, the company took an unprecedented step by adopting a trust. As of April, MetLife has 9 million stockholders — the largest number of any company in the U.S.

First, all shares allocated to members as a result of the conversion are issued to the trust, which issues trust interests to members. As beneficiaries, members receive stock dividends, and can withdraw shares from the trust, sell them, or add to their holding. One advantage of the trust for members is that transaction costs are paid by the MetLife holding company. On the other hand, some rights associated with shareholding are reduced by the trust. The holding company's annual report and proxy statement for the general meeting are in principle not sent to beneficiaries (the annual report is sent upon request). Beneficiaries also do not have voting rights at general stockholders meetings except on certain matters.

Previously, the use of a trust for stockholder management was thought to be difficult due to double taxation. Dividends paid on shares held in the trust are taxed. When the trust then pays out the same dividend to the beneficiary, it is taxed again as a dividend from the trust. MetLife solved this problem by adopting a grantor trust, which is a commonly used investment vehicle in securitization.

From a Japanese perspective, the practice in which the holding company pays all stock transaction costs would be viewed as a form of preferential treatment for designated stockholders and hence a problem. However, this practice is fairly common in the U.S., as it is based on the practical observation that doing so reduces overall stockholder management costs and thus benefits all stockholders.

In addition, issuing shares to the trust at first looks like a problem, but this is solved by allowing withdrawals and making transaction costs free, thereby creating an open situation.

In choosing to manage voting rights of stocks held in the trust, MetLife solved to its advantage the problem of quorem formation and voting procedures at general meetings. While this solution is almost unbelievable from the standpoint of corporate governance in the U.S., it was not addressed in either the public hearings or media coverage.

2. Demutualization of Standard Life

(1) Windfalls and Carpetbaggers

When a company demutualizes and allocates shares or cash, members (policyholders who own with-profits policies) can realize a one-time income as compensation for the loss of membership rights. Because present members are also allocated gains derived from "orphan" assets (profits accumulated over the years from policies that have already paid out) their total allocation will be greater than the proportion they contributed to surplus earnings if the company has accumulated net assets. This one-time gain is called a windfall. If the stock price subsequently appreciates by acquiring a premium, stockholders could realize further gains.

Since the late 1990s in the U.K., a number of building societies (housing loan associations) have demutualized and become ordinary banks, as a result of which depositors and borrowers received large windfalls. These cases convinced the general public that demutualization was like winning the lottery; some went so far as to equate mutual companies with cash dispensers.

Persons who campaign for demutualization in the hope of realizing a windfall are called carpetbaggers in the U.K. They target potential windfall-producing mutual financial companies, and become policy-holders to qualify them to present a demutualization resolution. Whereas they had targeted building societies in the past such as Nationwide and Chelser & Skipton, their attention has turned to mutual life insurance companies.[3] Several mutual life insurers are currently dealing with such demutualization proposals.

(2) The Campaign Against Standard Life

Based in Scotland, Standard Life is Europe's largest mutual company in assets under management. While many small and mid-sized mutual companies are starting to demutualize in the U.K., Standard Life has insisted that its present mutual organization is in the best interest of policyholders. Being financially strong, the company enjoys Moody's and S&P'S highest possible credit rating of AAA, and is not in need of a capital increase. However, this financial strength is what made the company an enticing target.

The carpetbaggers launched their campaign on February 9 of this year. A policyholders' group called the Standard Life Members Action Group (SLMAG) presented a demutualization resolution at the company's annual general meeting. The resolution was signed by 89 members; under the company's regulations, the board of directors must call a general meeting to vote on any resolution signed by at least 50 members.

This activity is closely tied to the well developed secondary insurance markets in the U.S. and Europe. In the U.K., people can buy insurance policies from policyholders by offering higher prices than could be obtained from terminating the policy. Usually, these people will buy policies with the aim of receiving the large terminal bonuses that investment trusts pay out at maturity. In the present case, carpetbaggers seeking windfalls are thought to have purchased a substantial amount of policies before launching their campaign.

The man said to be behind SLMAG, Mr. Danny Hill (the present leader used to work for him), is known for his role in the 1998 demutualization of AMP, Australia's largest mutual company at the time. According to some sources, Mr. Hill bought a large quantity of insurance policies before the company demutualized, and subsequently sold his allocation of 600,000 AMP shares for a profit of A$15 million.

The demutualization resolution that SLMAG lodged to Standard Life on February 9 called for the conversion to a shareholder-owned company, and for the following share allocations.

- First, that 1% of the shares be allocated to Standard Life's Anniversary Appeal for distribution to charities.

- Second, that 1.5% of the shares be allocated to employees of Standard Life and its subsidiaries.

- Third, that shares valued at 500 pounds be allocated to all participating policyholders.

- Finally, that the remaining shares be allocated to participating policyholders in proportion to their respective asset shares.

SLMAG claims that if Standard Life is converted and its shares are listed on the London Stock Exchange, the company would be valued at 12 to15 billion pounds and be among the largest companies in the U.K. Given the company's 23 million participating policyholders, this implies a windfall of 5,000 to 6,300 pounds per person. In addition, SLMAG says that if the conversion proceeds as proposed, Standard Life's 11,000 employees would each receive an allocation valued at 16,000 to 20,000 pounds, and the Anniversary Appeal would receive an allocation valued at 120 million pounds. These numbers, while rejected by Standard Life as baseless, have been widely quoted.

The resolution, however, was flawed from a legal standpoint. On February 28, acting on the advice of its legal counsel, Standard Life rejected the resolution on a technicality: since the resolution contained instructions to the board regarding specific actions, which members do not have the authority to give, it was thus was invalid and a vote would not be called. To thwart the carpetbaggers and discourage

people from taking advantage of a possible conversion, the company declared that new policies and additions to existing policies will not benefit from any conversion windfall occurring in the next three years. The company also explained that a conversion would reduce distributions of earnings in the future by 10%.

In response, SLMAG hired two law offices specializing in insurance, and issued a new and legally sound resolution, and published it on its web site on April 17. It decided to submit the new resolution immediately before Standard Life's annual general meeting on April 25. In the interim, Standard Life was able to study the resolution without its being formally submitted. On April 21, SLMAG released the results of an opinion poll conducted by NOP, an external pollster, saying that 90% of Standard Life policyholders were in favor of conversion. In addition, a number of investment trusts holding a large number Standard Life policies began coming out in support of SLMAG, including Barclays Endowment Fund for old-age insurance.

The new resolution called for a special meeting and presented an agenda to be considered and voted on. Its content, which was carefully checked by legal advisors, distinguished between items requiring a simple majority vote and a more stringent 75% majority vote.

- To consider whether to demutualize the company

- To enable members, by an ordinary vote at the general meeting, to give instructions to the board

- That the company take steps toward demutualization

- In doing so, that the company take allocate 1% of the shares to Standard Life Anniversary Appeal, and 1.5% to employees of Standard Life and its subsidiaries

- To grant those who have acquired with-profits policies by purchase or transfer prior to February 8 the same rights as members

On April 25, the day of the annual general meeting, the new resolution was submitted. Standard Life, which at the meeting was expected only to take questions regarding the financial statements, made a major concession by releasing results of its own opinion poll conducted in February among 1,500 members. The company reported that 25% were in favor of demutualization, 23% were opposed, and the other 49% were undecided. In addition, the company acknowledged the validity of SLMAG's new resolution, and announced that a special meeting would be held within three months to vote on it.

At a press conference following the meeting, Standard Life explained that while the board of directors had considered demutualization the previous September, but committed to mutuality after deciding that this was in the best interest of members. Moreover, because conversion would require a three-quarter majority, the company believed that in the three months to the vote, it could persuade enough of the 49% undecided bloc in the February poll to vote for mutuality. The meeting date was set for June 27.

Figure 1 Opinion Poll Results of Members

	SLMAG survey	Standard Life survey
Approve	57.20%	25.50%
Oppose	10.60%	23.30%
Will not vote	4.40%	1.70%
Don't know	27.80%	49.60%
Sample size	500	1,500
Survey date	April 16-17	February

(3) Effect on Other Life Insurers

At the same time Standard Life was dealing with this issue, carpetbaggers had moved into action elsewhere in Scotland. On March 28, the Scottish Provident Members Alliance Group (SPMAG) submitted a similar demutualization resolution to Scottish Provident. Unlike Standard Life, Scottish Provident is a mid-sized company with a mediocre earnings record. For this reason, the SPMAG resolution asserted that the members would be best served by the company's demutualization as well as acquisition by a larger company. The windfall in this case would be used to compensate for poor earnings in the past. When the company balked, SPMAG applied pressure on the company ahead of the May 30 annual general meeting by hinting that its leader would run for board member. In response, Scottish Provident announced that it had begun reexamining its mutual company organization. When the two sides then met on April 20, SPMAG agreed to withdraw its resolution until the company completed its study of mutuality. SPMAG then issued a declaration of victory and became dormant.

On April 26, SPMAG's leader shifted gears and targeted Friends Provident by launching the Friends Provident campaign (FPVOTE) and recruiting 100 members. The leader claims not to be a carpetbagger. The members are long-term policyholders whose stated aim, as with the Scottish Provident case, is to seek compensation for the company's poor performance in old-age insurance in the form of the conversion windfall.

(4) Use of the Internet

What is new in the recent spate of carpetbagger activities is their use of the Internet as a medium for public relations and to win over sympathizers. Moreover, their resolutions are well researched and substantive. For example, the SLMAG web site contains extensive information including the full text of the resolutions and chronology of events in their dialogue with Standard Life.[4] Because Standard Life provided little information in rebuttal, the SLMAG web site gained considerable credibility. Many mass media commentators and industry analysts sided with SLMAG on the grounds that Standard Life would make a strong competitor as a proprietary company.

A web site called "The Money Bag" has set up a bulletin board to discuss carpetbaggers.[5] The revealing discussions give a clear picture of the exchange of information and development of organized groups. SPMAG has declared that fully researched the grounds on which Standard Life rejected SLMAG, indicating that collaboration over the Internet plays a major part in advancing the carpetbagger's cause. In this way, the Internet is becoming a serious tool in the hands of organized pressure groups intent on converting the U.K.'s mutual companies into proprietary companies.

(5) Status of Mutual Companies in the U.K.

Figure 2 contains a ranking of mutual life insurance companies in the U.K. by assets under management in 1997. Of these, number three Scottish Widows and number five NPI have already completed demutualization, while the first, fourth and sixth ranked companies are presently being targeted by carpetbaggers. Like Standard Life, second-ranked Equitable, the world's oldest mutual company, has announced its commitment to remain a mutual company. The company has a low equity ratio due to efficient management (with a superb expense ratio) and a devotion to the mutual company philosophy of distributing all earnings to members. For this reason, Equitable has not attracted the interest of carpetbaggers. However, because of its weak internal reserves, the company has been struggling financially with problems derived from negative spreads, and is rumored to be eyeing demutualization as a method to raise capital.

As the above indicates, mutual companies in the U.K. who wish to retain their mutual form are confronting an increasingly harsh environment.

Figure 2 Mutual Insurance Companies in the U.K. (1997)

Rank	SLMAG survey	Standard Life survey	UK life insurer ranking	Equity ratio	Expense ratio
1	Standard Life	£45,459 mil.	2	19.2%	11.1%
2	Equitable Life	£23,828 mil.	5	6.0%	4.0%
3	Scottish Widows	£20,074 mil.	7	15.9%	11.9%
4	Friends Provident	£13,874 mil.	11	15.2%	14.5%
5	NPI	£10,406 mil.	14	9.9%	13.9%
6	Scottish Provident	£7,532 mil.	26	15.9%	28.9%
7	Royal London	£6,455 mil.	32	26.7%	29.8%
8	Scottish Life	£6,261 mil.	33	8.9%	15.9%
9	Liverpool Victoria	£3,714 mil.	41	24.3%	28.8%
10	National Farmers	£3,603 mil.	42	12.2%	11.6%

Source: Compiled from Moody's Investors Service

Conclusion

Since the life insurance industry is a domestic industry, the ideal forms for mutual companies are strongly influenced by country-specific characteristics. This tends to complicate comparisons between the above cases and Japan. However, MetLife is instructive for the advanced methods it adopted with its trust, and Standard Life is intriguing particularly because of its leadership position among mutual companies.

Perhaps the most significant aspect of demutualization in the U.S. and Europe has been the vital importance of interaction with the stock market. Demutualization is obviously affected by stock market conditions, and has flourished in large part on the strength of the stock market. This underlying premise, however, has begun to deteriorate recently.

In contrast to the highflying Internet and biotech stocks of America's new economy, this year's insurance IPOs are occurring at a time when insurance stocks — which belong to the old economy — are floundering. John Hancock (ranked 13), who carried out an IPO on January 27, could not move above its IPO price for a considerable time. Then came two large IPOs for MetLife and Sun Life (Canada) in quick succession. Later this year, top life insurer Prudential is also expected to carry out an IPO. The market, however, appears unenthusiastic about this spate of insurance IPOs.

Given these circumstances, MetLife's conversion was taken lightly by the market. When the company announced its IPO plans last November, it expected the IPO stock price to be in the $14 to$24 range.

Immediately before execution, the IPO plan was reduced significantly by dropping the expected IPO price to the $13 to $15 range and curtailing the number of shares offered. To compensate for the shortfall, a separate private offering was also made to the Credit Suisse Group (who was also the underwriter). Partly because of this, the IPO price of $14.25 rose to $15.50 by the end of the day. Ironically, Internet stocks at this time were reeling from the Microsoft antitrust ruling, and one newspaper commented that MetLife would have courted disaster had it made its IPO as a dot-com company.

Standard Life's demutualization was also premised on the sustained strength of the stock market. The carpetbaggers went so far as to issue stock price projections, which strangely enough were accepted without question by market analysts.

The financial services industry as a whole is undergoing competition that transcends national borders as well as industry borders. Companies must compete side by side under the same conditions whether they are mutual companies or proprietary companies. As with recent conversions of mutual holding companies in the U.S., which form is best ultimately depends on how companies define their business vision. If anything is certain, it is that developments in demutualization will continue to be watched with keen interest by the insurance industry.

Notes

1. The stock distribution is based on the amount contributed by policyholders to the company's surplus earnings. But since Japan's Civil Code stipulates a ¥50,000 minimum par value for the issue of stock, stakeholders entitled to a distribution of less than ¥50,000 will receive an odd lot. One problem of demutualization had been how to manage the massive number of odd lot stockholders expected to emerge. The Insurance Business Law amendment addresses this problem through a special provision that pays odd lot recipients in cash rather than stock. Incidentally, the par value of stock in the U.S. can be as little as one dollar or even one cent.

2. For demutualization in the U.S., with the exception of pension holders subject to tax rules, there is no restriction in general to reduce the number of stakeholders receiving a stock distribution. Companies can try to reduce the number of stockholders by offering to compensate stakeholders in cash, or allowing them to either to sell their odd lot or round up to 100 shares without charge.

3. However, in the Nationwide proposal, the general meeting of stakeholders ultimately voted to maintain the mutual company organization. Thus carpetbaggers do not have their way in all cases.

4. See http://www.slmag.co.uk

5. See http://www.themoneybag.com/cgi.Ultimate.cgi