Reorganization of Financial Services and Life Insurance Demutualization — The View from Abroad

by Hironobu Murakami
Life Management Research Dept.

1. Introduction

The implementation of financial reforms continues steadily in Japan's Big Bang. Meanwhile, financial institutions are maneuvering with increasing intensity to prepare for the highly competitive post-Big Bang era.

The revised Anti-Monopoly Law lifted a half-century old ban on pure stock holding companies in June 1997, and a ban on financial holding companies in March 1998. Furthermore, the Financial System Reform Law enacted in December 1998 allows banks and life insurers to sell mutual funds, and eliminates entry restrictions between the insurance and securities industries.

Meanwhile, at the company level, we see movements to regroup former zaibatsu members as well as to form new extra-group alliances such as the comprehensive tie-up between Daiichi Life Mutual Company and the Japan Development Bank.

The Big Bang is encouraging cross-industry alliances in financial services. But in trying to form corporate groups with various forms of capital participation, major life insurers run into limitations peculiar to mutual companies. A mutual company is a form of organization stipulated under the Insurance Business Law, and is unique to insurance companies. In a mutual company, policyholders automatically become owners much like stockholders in a stock company, and thus enjoy rights as both policyholders and as owners. Mutual companies thus do not have common stock that can be held by a holding company.

However, in recent years other countries are seeing a shift toward demutualization, the process of reorganizing mutual companies into common stock companies.

2. The Global Shift Toward Demutualization

(1) Company Organization of Life Insurers Abroad

The top companies in Japan's insurance business are all mutual companies. Until recently, this was also true of the U.S., Canada, England, Germany, France, and Australia.

In the past few years, major life insurers in these countries have been rapidly converting into stock companies. Today, most of the top life insurance companies are stock companies.

Table 1 lists the world's major life insurers by country and company organization. The mutual companies marked with one asterisk have announced plans to demutualize, while those with two asterisks have already completed the process of demutualization. The number in parentheses shows the year of announcement or completion.

Table 1 Company Organization of Major Life Insurers

Rank	Company	Status
	U.S.	
1	Metropolitan	Mutual (98) *
2	Prudential	Mutual (98) *
3	Connecticut General	Stock
4	Principal Mutual	Mut. holding (98)**
5	Nationwide Life	Stock
6	New York Life	Mutual
7	Equitable Life	Stock (92) **
8	Hartford Life	Stock
9	John Hancock	Mutual (98) *
10	Northwestern Mutual	Mutual
	U.K.	
1	Prudential	Stock
2	Standard Life	Mutual
3	Commercial Union	Stock
4	Norwich Union	Stock (97) **
5	Legal & General	Stock

Rank	Company	Status
	Canada	
1	Sun Life	Mutual (98) *
2	Manulife Financial	Mutual (98) *
3	Laurentian	Stock (90) **
4	Great West Life	Stock
5	Canada Life	Mutual (98) *
6	London Life	Stock
7	Mutual Life	Mutual (97) *
	Germany	
1	Allianz Leben	Stock
2	Hamburg Mannheimer	Stock
3	R+V Leben	Stock (89) **
	Australia	
1	AMP	Stock (98) **
2	National Mutual	Stock (95) **

Note: Shows 1997 premium revenue ranking for the U.S. and 1996 ranking for other countries.
Sources: *National Underwriter, Canadian Insurance*, others.

(2) Developments in Demutualization

Demutualization received a big push in February 1998, when Prudential of the U.S. announced its plan to become a stock company. Then in late November Metropolitan Life unexpectedly disclosed its intention to become a stock company. With this shift among the nation's top two insurers, only two of the top ten insurers in premium revenues are expected to remain mutual companies in the next few years, down from six in 1990. In addition to stock companies, mutual companies also have the option in some states of converting into mutual holding companies that own stock company subsidiaries. Since 1995, a number of mutual life companies have adopted this method. The leading mutual holding company is Principal Mutual.

In Canada, new demutualization regulations will be established in 1999. Soon none of Canada's largest life insurers will be mutual companies.

In the U.K., while Norwich Union is the best known instance of demutualization, other smaller mutual companies have demutualized in the late 1980s and early 1990s. The number of mutual life companies has thus declined significantly.

While Germany has 25 mutual life insurers, with the demutualization of R+V Leben, no mutual companies exist among the top ten insurers.

The demutualization of Australia's top three life insurers – AMP, National Mutual, and Colonial – has left only one minor mutual life insurer.

France is excluded from the table because it does not recognize demutualization. Overall, however, mutual companies are fewer in number and smaller in premium revenue share than stock companies. A major exception is the AXA Group, which has partially retained a mutual company format. The mutual company group called the MutuellesAXA has AXA stock companies under it who oversee the insurance business, so that in effect the mutual company group controls the AXA Group. However, in recent years, the mutual company's stock holding ratio has declined, reducing the Group's mutual company characteristic.

3. Backdrop to Demutualization

Behind the rapid demutualization of major life insurance mutual companies has been the growing competition in the financial services industry.

The main factor stimulating competition in financial services has been the lifting of regulatory barriers that have segmented the industry. In the U.S., a financial reform bill was debated in 1997 and 1998 that would allow banks, securities companies, and insurance companies to enter each other's business through holding companies. Travelers, a major insurance and securities holding company, and Citicorp, a major bank holding company, were the first to move in this direction by merging and forming Citigroup in 1998. Some insurance companies circumvented the barrier between banking and insurance by acquiring thrifts. Although the bill was rejected, intense competition in the financial services industry is well under way. In Canada, England, and Australia, deregulation since the late 1980s has eradicated segmentation of the financial industry.

Another factor encouraging competition has been a shift toward savings instruments as aging progresses in industrialized countries. Customers are shifting away from traditional death insurance products and toward products that pay out money prior to death such as annuities, mutual funds and other managed savings instruments. For example, the premium revenue composition of U.S. life insurers indicates that annuities are steadily growing: life insurance now accounts for 30 percent, health insurance for 20 percent, and annuities 50 percent. Moreover, within life insurance, there has been a gradual shift in individual insurance from traditional whole life insurance to savings instruments such as variable life and universal life. These trends are also occurring in different degrees in Canada, Europe, and Australia. Since the savings products offered by life insurers compete head on with those of banks and securities companies, the competition is all the more intense.

Table 2 Composition of Premium Revenue for New Individual Insurance Policies

	1983	1991	1996
Traditional whole life	65%	55%	41%
Variable / universal	20	32	42
Term life	15	13	17

Source: *Limbra's Market Trends*

Another factor spurring competition is Europe's market integration. The European Third Directive in 1994 allows insurance companies that have received approval in their home country to do business throughout the EU. In addition, the monetary unification in 1999 will stimulate transborder competition in financial services.

The business environment changes mentioned above have propelled M&A activity among financial institutions. In the U.S., newcomer and major nonbank GE Capital, Citigroup, and oth-

ers are using an aggressive M&A strategy to expand quickly into new areas, and are growing faster than mutual life insurance companies. In Canada, Great West Life, a life insurance stock company, acquired another stock company, London Life Insurance in 1997, becoming the country's top life insurer. In Europe, Germany's Allianz, a life insurance stock company, expanded its regional presence by acquiring France's major insurance group AGF in 1997, becoming one of the top five life insurers in France, Belgium, Spain and Ireland. There are many other cases of group expansions involving major financial institutions.

In all of these cases, the aim of expansion is to improve earnings strength: either expanding in scale to achieve more efficient asset management, expanding in scope to provide more financial products, or expanding regionally to open up greater business opportunities. M&A activity as an effective and speedy method for such expansion.

Mutual life insurance companies have also recognized the importance of an M&A strategy. However, they are at a disadvantage because M&A's commonly involve the exchange of stock, which mutual companies obviously cannot do, nor can they easily finance such costly deals with cash. To overcome this handicap and remain competitive, many mutual life insurance companies thus began converting into public stock companies.

4. Objectives of Demutualization

The demutualization cases abroad suggest two major types of objectives: first, to restructure the company in anticipation of being acquired by another company, and second, to pursue growth.

(1) Demutualization as a Survival Strategy

Some mutual companies have turned to demutualization as a last resort in a crisis. By converting into a stock company, they can relinquish stock ownership to a stronger company, and thereby survive under its protective umbrella.

In the U.S., during the high interest rate period of the late 1980s, Equitable Life sold a vast number of high-yield products, which were to be funded by aggressively investing in real estate. The investments defaulted and the company's capital was exhausted. As a last resort, the company converted into a stock company in 1992, and was subsequently acquired by AXA of France. After the conversion, the company overcame its crisis of 1991, and gradually recovered in performance and Moody's rating.

Table 3 Equitable's Performance and Rating

($ million)

	1991	1994	1997
Premium revenue	3,452	4,685	7,843
Rating	A3	A2	Aa3

Source: *National Underwriter*

In the U.K., from the late 1980s to 1990s, a number of smaller life insurers such as Clerical Medical and Provident Mutual converted into stock companies, and were subsequently acquired by banks, housing finance associations, and major foreign and domestic life and property/casualty insurance companies. National Mutual of Australia demutualized in 1995 and was acquired by AXA. All of these companies were in a situation similar to Equitable Life.

These cases clearly indicate that demutualization is a viable alternative for life insurers when confronted by a serious crisis. Conversion to a stock company introduces outside capital and bolsters the company's financial health. If this in turn leads to performance improvement, policyholders also stand to benefit because their policies can stay in force.

(2) Demutualization as a Growth Strategy

In the past, restructuring for survival was the main reason companies pursued demutualization. Recently, however, the main companies doing so are financially healthy, major life insurers whose objective is to pursue growth. These include Metropolitan and Prudential in the U.S., Norwich Union in the U.K., Manulife and four major mutual life insurers in Canada, and AMP and Colonial in Australia.
Aside from minor differences, the aims of these companies can be classified into the following areas.

1. Access to Capital Markets

Mutual companies basically obtain their earnings from premiums and returns from investment activities. By converting into a stock company, they can obtain financing more actively through capital increases. It is not uncommon for a mutual company converting into a stock company to simultaneously solicit a capital increase and become listed on a stock exchange.

However, in actuality most of the growth-oriented new stock companies already have adequate

capital, and are instead looking ahead to their long-term strategic demand for funds. Prudential says its objective in converting into a stock company is to prepare for future financing needs as competition intensifies in the financial services industry; it anticipates a huge demand for funds to finance growth through M&A activity and the development of new technologies and products.

Demutualization has two major advantages: it facilitates financing, and enables M&A activity through stock exchanges.

2. Structural Flexibility of Holding Companies

After demutualizing, a common characteristic of companies in all countries is to convert into a structured group with a holding company at the top. Experience seems to indicate that this an optimal structure for efficient management. Some insurance companies such as Norwich Union prefer this structure to deflect the risk of directly holding the stock of p/c insurance subsidiaries.

3. Use of Stock Options

Public stock companies in Europe and the U.S. commonly use stock options as an incentive in compensation schemes for executives and employees.

This feature is advantageous not only for life insurance stock companies, but for policyholders as well. A common feature in cases abroad is that through demutualization, policyholders can receive economic profit such as free stock. When a mutual life insurance company becomes a stock company, its ownership changes hands from policyholders to stockholders. To compensate policyholders for losing their membership rights in the company, they are given company stock for free. For example, when Canada's four major mutual life insurers become stock companies, at least ten billion Canadian dollars will be distributed to approximately two million policyholders. Prudential will distribute its surplus in the form of stock and cash to approximately 11 million policyholders.

This distribution of surpluses has a measurable economic impact. For example, by some calculations, the demutualization of life insurance companies and Building Societies in England during the 1990s contributed over 1 percent annually to domestic demand.

In addition, if life insurers become more competitive as stock companies, policyholders stand to benefit from the company's long-term stability in ensuring the safety of their insurance policies.

5. Conclusion

Other countries see stock companies as the main players in the insurance business of the 21st century. But are mutual companies anachronistic and at a competitive disadvantage in the financial services market?

Not completely. Standard Life, England's second largest mutual life insurer, has no plans for demutualization because it believes that remaining a mutual company is in the best interest of its policyholders. State Farm, America's top property/casualty insurance company, also does not intend to become a stock company.

Nonetheless, it is also true that demutualization has successfully turned around troubled mutual life insurance companies, and is a viable alternative for survival in the increasingly competitive financial services market.

For Japan, the financial Big Bang will clearly intensify competition in all financial services. In this environment, mutual life insurers will need to either raise capital from external sources for timely investment in new growth areas, or adopt a holding company strategy and combine forces with other financial companies. Demutualization, which would facilitate either strategy, is becoming an increasingly important business alternative.

Moreover, not a few mutual life insurers were hit hard by last year's tough business climate of low interest rates and flaccid stock market. Even under these conditions, demutualization would be effective in helping companies achieve adequate solvency through financing and effect capital tie-ups with stronger companies. If demutualization can prevent needless failures, it will also greatly benefit the national economy.

However, there are many problems in promoting demutualization under the Japanese Insurance Business Law. While the 1996 revision addressed demutualization, mutual life insurance companies are in reality impeded from pursuing this alternative. Since the law stipulates that policyholders be compensated with stock, a vast number of stockholders would suddenly emerge. As a practical problem, it would then be possible to hold annual stockholders meetings or actually manage all these stockholders.

We would hope that priority is given to resolving the issues in the Insurance Business Law and enabling demutualization as soon as possible. In that event, the mutual holding company format commonly used in the U.S. should also be seriously considered.