The Strategic Role of Ownership Structure for Insurance Companies

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Abstract

This paper is divided into two parts; the first describes the role that ownership structure plays in the insurance business; the second, the strategic considerations behind the demutualization of Scottish Widows. In the first part, the paper shows that the ownership structure of an insurance company is helpful for understanding the forces that made possible the creation of mutuals and explaining why they have been successful. The paper analyzes the competitive role that ownership structure confers and the conditions that favor either mutuals or stocks. It also analyzes the drivers for conversion, makes inferences from the Managerial Discretion Hypothesis and the Differentiated Bertrand Model, and compares predictions with historical results. The market under consideration consists of the major lines of business of mutual and stock companies in the European Union, Canada and the USA and does not focus on any particular country or product.

In the second part, the paper describes the strategic considerations behind the demutualization and acquisition of Scottish Widows by Lloyds TSB. This case illustrates the metamorphosis that mutuals must undergo to become global competitors while affording an example of integration in the financial sector.

Executive Summary

The mutual form of ownership, although declining, has been conspicuous in the insurance industry. Its early success was based on the mutuals' ability to select better risks, make credible commitments to solvency and product value, and align owners and customers interests. With the passage of time these advantages have become less accentuated: solvency regulation applies to all insurers, making them roughly equivalent in their ability to fulfill future obligations; technology has allowed stocks to improve their risk selection abilities and product offerings; the image of mutuals has changed from that of a small company formed to serve the community to a big corporation with as much or little sense of social responsibility as stocks. On the other hand, competitive forces have fueled mergers and acquisitions as insurers seek to take advantage of economies of scale, economies of scope and complementarities, transactions for which the mutual ownership model places insurers at a disadvantage over their stock counterparts. It is not surprising, then, that mutuals are converting to enjoy the same structural flexibility.

Scottish Widows, a provider of life and pension products, affords an interesting case study. In order to be acquired by Lloyds TSB, a bank with a portfolio of personal investment products, it first demutualized then to take advantage of economies of scale, economies of scope, and complementarities between the actuarial and investment functions. Lloyds TSB also expected to improve its portfolio management by combining actuarial and banking talent. Whether or not the new entity is more efficient remains to be seen; it is clear, however, that without economies of scale no firm will be able to compete globally.

Company Structure

Insurance firms can be structured as stock, mutual, or non-for-profit companies. A mutual company is a corporation that has no shareholders; instead policyholders, as long as they remain alive and keep their policies in force, have the following membership rights:

- Contractual benefits, which vary depending on the policy in force (e.g., life insurance protection and dividend payments for a whole life insurance product).
- The assurance that the corporation will be run primarily for the benefit of the members
- The right of participating in corporate governance, usually by electing directors to oversee the operation of the company
- The entitlement to bring legal action against the directors and officers for violating their fiduciary duties
- Receipt of any remaining value if the corporation is liquidated or demutualized

A stock company is a corporation that serves customers (policyholders) who have no ownership rights or interests in the enterprise. Subject to a fair amount of regulation, the company is run for the benefit of its shareholders

In 1997, six of the ten largest insurance companies in the world were mutuals[1]:

Rank	Company	Country	Assets*	Form of ownership
1	AXA	France	407.9	Stock
2	Nippon Life	Japan	323.3	Mutual
3	Allianz	Germany	293.7	Stock
4	Prudential Ins Co.	USA	259.5	Mutual
5	Zenkyoren	Japan	245.4	Mutual
6	Dai-Ichi	Japan	219.6	Mutual
7	Metropolitan Life	USA	201.9	Mutual
8	AIG	USA	194.4	Stock
9	Sumitomo Life	Japan	181.6	Mutual
10	Prudential	UK	178.9	Stock

*** 1997 USD billions**

Although the prevalence of mutual ownership varies widely by country, they have played a major role in international insurance business. Their presence, however, has been reduced over the last three decades due to conversions to stock ownership triggered by two forces: competition and consolidation.

The reasons behind demutualization

Competition

The old model under which mutuals enjoyed the advantages of strong horizontal differentiation[2] via local recognition and substantial market share penetration has been transformed with the advent of technological advances (e.g., internet services, efficient mass marketing) that reduce search costs and allow insurers to serve customers regardless of place of residence. Furthermore, consumer tastes have changed rendering typical mutual products less appealing, forcing insurers to continuously innovate. In the life/pension arena, for example, the emphasis has shifted from saving to investment products; in the health arena from indemnity to complex managed care to fee-for-service plus investment accounts. This alteration in demand has prompted many insurers to develop or purchase asset management tools, expand the scope of their horizontal boundaries, and consider options for enlarging their geographical reach. Companies wishing to compete must make extensive technological investments that mutuals sometimes cannot afford.

To summarize, technology has reduced entry barriers in what once were niche markets for mutual insurers while at the same time, together with shifts in consumer demands, increased the needs for capital investments, an activity in which mutuals are at a disadvantage compared with their stock counterparts.

Consolidation

In reaction to competitive forces, more and more insurers are merging with one another and with other types of financial service providers, as they see opportunities for complementarities, economies of scale and economies of scope. The argument for complementarities, typically elusive, is better understood through an example: an investment bank could acquire a life insurance company with a large pension portfolio, giving rise to the following opportunities for improvement:

- Fund managers would enjoy added financial latitude in their investment decisions as the matching of assets and liabilities could be integrated or fragmented, subject to company needs and regulation
- The pool of specific human assets, particularly actuarial and investment talent, would be enlarged and diversified
- The good reputation and strong brand recognition of the acquirer or acquired entity could result in umbrella branding

Economies of scale are expected to translate into lower unit costs achieved mainly through reduced overhead and enhanced distribution channels[3]. Economies of scope are expected to result in the introduction of new financial products (a key advantage in a dynamic, growing industry) and cross-selling, which increases revenue and decreases lapse rates. The strategic importance of consolidation has been fueled by record high stock prices (the percentage of insurance acquisitions that have been funded entirely with cash have fallen sharply in recent years, from over 70% in 1993 to under 40% in 1998[4]), deregulation and, in Europe, the introduction of the Euro. But consolidations and acquisitions are much more difficult transactions for mutual insurers[5], which must rely entirely on retained earnings and debt financing.

In the US, a more liberal regulatory stance has softened banks' entry barriers into the insurance market; in Europe, the focus of insurance supervision has shifted from regulating rates to preventing insolvencies, also lowering entry barriers. Proactive insurers can seize new opportunities by expanding their business into markets and activities that were previously off limits; insurers that do not react run the risk of falling out of step with a rapidly changing market. Mutuals are at a competitive disadvantage to expand, merge or acquire due in part to the stringent regulatory environment in which they operate.

The adoption of the Euro paved the way for a unified European capital market that is much broader and deeper than the capital market of any individual European country. The resulting expansion in the scope of investments from a national to a pan-European scale has increased the demands on asset managers. Insurers that can quickly adjust their asset management to a unified European capital market will be able to reap the gains of diversification. Those who maintain a national focus, such as mutuals, will lose ground.

Does it make sense to go from stock to mutual status?

The wave of demutualizations has been a response to market conditions, which presently make the mutual ownership model attractive again. For example, stock companies may want to mutualize to avoid being acquired. Furthermore, the possibility of stock companies not controlling the customer-owner conflict to the satisfaction of regulators could also trigger mutualizations, as it happened in the early part of the 20th Century when the Armstrong Commission, after finding evidence of outrageous abuses within the industry, recommended- and the State of New York adopted -the statute that allows stock companies to convert to the mutual form. Sequels of that event have been long lasting; for example, in 1978, Richard Schinn, the CEO of Metropolitan Life (a company that mutualized in 1915) stated before the US Senate Judiciary Committee Subcommittee on Citizens and Shareholder Rights and Remedies[6] that "no longer would the board be subject to the conflicting interest of shareholders and policyholders- their primary responsibility would now be to the policyholders… Let me emphasize that Metropolitan's conversion to a mutual company benefited the policyholders by insulating them from possible attempts to raid the large pools of marketable assets, representing policy reserves and surplus."

The absence of shareholders provides mutuals with a pricing advantage[7]

This is a key consideration and a reminder that lower prices not necessarily translate into optimal profits. To analyze it and make inferences, note that it is reasonable to think of mutuals and stocks as oligopolistic companies engaged in a *Differentiated Bertrand Competition*, either locally, nationally, or internationally. The economic model is as follows:

- Let i represent stock companies and j mutual companies.
- Let $Q_i = \alpha_i - \beta_i P_i + \gamma_i P_j$ be the stock demand function and $Q_j = \alpha_j - \beta_j P_j + \gamma_j P_i$ be the mutual demand function.
- Let k_i and k_j be the respective marginal costs
- Then, the profit function becomes

$$\begin{aligned}\pi_i &= (P_i - k_i)Q_i \\ &= (P_i - k_i)(\alpha_i - \beta_i P_i + \gamma_i P_j) \\ &= -(k_i\alpha_i + k_i\gamma_i P_j) + (\alpha_i + k_i\beta_i + \gamma_i P_j)P_i - \beta_i P_i^2\end{aligned}$$

- Profit maximization conditions:

$$\frac{\partial \pi_i}{\partial P_i} = \alpha_i + k_i\beta_i + \gamma_i P_j - 2\beta_i P_i = 0$$

$$\frac{\partial \pi_j}{\partial P_j} = \alpha_j + k_j\beta_j + \gamma_j P_i - 2\beta_j P_j = 0$$

- Solving for P_j

$$P_j = \frac{2\beta_i P_i - \alpha_i - k_i\beta_i}{\gamma_i} = \frac{2\beta_i}{\gamma_i}P_i - \frac{\alpha_i + k_i\beta_i}{\gamma_i}$$

$$P_j = \frac{\alpha_j + k_j\beta_j + \gamma_j P_i}{2\beta_j} = \frac{\gamma_j}{2\beta_j}P_i + \frac{\alpha_j + k_j\beta_j}{2\beta_j}$$

Note that by symmetry,

$$P_i = \frac{2\beta_j P_j - \alpha_j - k_j\beta_j}{\gamma_j} = \frac{2\beta_j}{\gamma_j}P_j - \frac{\alpha_j + k_j\beta_j}{\gamma_j}$$

$$P_i = \frac{\alpha_i + k_i\beta_i + \gamma_i P_j}{2\beta_i} = \frac{\gamma_i}{2\beta_i}P_j + \frac{\alpha_i + k_i\beta_i}{2\beta_i}$$

- Solving for P_i from the equations for P_j

$$P_i = \frac{2\beta_j(\alpha_i + k_i\beta_i) + \gamma_i(\alpha_j + k_j\beta_j)}{4\beta_i\beta_j - \gamma_i\gamma_j}$$

Finding the values of the parameters would require an econometric study which is beyond the scope of this paper. However, it is reasonable to speculate that demand at the local level was initially greater for mutuals than stocks[8] and that, over time, it has been equalized by the forces described above. Marginal costs, defined in this case as the expenses incurred by the firm to provide services, including distribution costs, the cost of capital (e.g., dividend payments to shareholders) and agency costs, are higher for stocks, that is, $k_i > k_j$. In this scenario, the Nash equilibrium point (the intersection of the best response functions) is such that the price charged by mutuals is slightly lower than the price charged by stocks for the same product. This result is consistent with the lower cost coverage provided by mutuals, typically expressed in actuarial terms as higher loss ratios.

With the introduction of new products, cross-selling, and integration of banking and insurance services, the demand for stock products could exceed the demand for mutual products. The Differentiated Bertrand Model indicates that, in this scenario, the Nash Equilibrium Point would be such that the price gap between stocks and mutuals widens, with mutuals reducing premium rates to defend market share and stocks increasing premium rates to maximize profits. This tendency would be less apparent in offerings that do not enjoy a great deal of horizontal differentiation such as medical policies, but even in the healthcare sector companies are working diligently to develop products with unique features[9].

Best Response Functions for Stocks and Mutuals

Countering the pricing effects of increased demand for stock products are the efforts of stocks to become more efficient, particularly with regard to distribution channels[10] (the second part of this paper explains that strategic role that an improved distribution system played in the acquisition of Scottish Widows by Lloyds TSB). If stocks manage to reduce marginal costs, that is, if the difference between k_i and k_j shrinks, then the prices charged by both stocks and mutuals would decrease (more so for stocks), but the amount of insurance sold would increase (again more so for stocks)[11], resulting in more profits for stocks and less for mutuals.

Agency Theory and the ownership structure of insurance companies

It is interesting to point out that in 1997 the three largest American mutual insurers (Prudential, Metropolitan Life, and State Farm) together had more assets than any industrial corporation in the US with the exception of General Motors, Ford and General Electric. Does this mean that mutuals have been as efficient as stock companies? If so, how have they been able to overcome their corporate structural disadvantages that seem so daunting?

When attempting to measure efficiency, actuaries typically focus on production costs which include direct costs (e.g., reimbursement to hospitals in the case of health insurance) and indirect costs (e.g., staff salaries). Some actuaries believe that mutuals and not-for-profits are less efficient than stock insurers. Their opinion, validated by various studies, conforms to economic thinking[12]. However, mutuals can be, and in some cases have been, at least as efficient as stock companies despite their higher production costs. *Agency theory*[13] can explain this apparent contradiction: firms that successfully compete have ownership structures that help them to minimize total costs, which are the sum of production costs and agency costs. Production costs have been the subject of numerous studies and are the typical basis for assessing efficiency. Agency costs, on the other hand, are a relatively new development in economics and are not as well known in actuarial literature.

	Management	Ownership	Customer Base
Stocks	Manager	Stockholder	Policyholder
Mutuals			

Agency costs arise from conflicting incentives within an organization and are defined as the sum of the expenses for reducing conflicts plus the value of output lost by not eliminating them. To understand the conflicts that arise in the insurance industry, note first that mutual and stock companies have different stakeholders: managers and owners (policyholders) for mutuals; managers, stockholders, and policyholders for stock companies.

The customer-owner conflict

The management of a stock insurer sets dividend, financing, and investment policies in ways that benefit stockholders at the expense of policyholders. On the other hand, the management of a mutual insurer has the flexibility to undertake initiatives in the long-term interest of policyholders that may not bear fruit initially. The mutual form of ownership mitigates the customer-owner conflict by merging the owner and customer functions, thus eliminating policyholder subsidies to shareholders. A major rating agency noted this potential for conflict: “Moody's believes that mutual life insurers that change their corporate form are likely to become more focused on increasing their return on equity and improving shareholder returns, and that this focus will often cause a reduction in creditworthiness”.[14] [15]

The owner-manager conflict

The separation of ownership and control raises concerns about the extent to which management might pursue its own interests at the expense of the owners of the firm. The ownership form of an insurer can either mitigate or aggravate the owner-management conflict. If an insurer is a publicly traded stock company, its management must concern itself with the performance of the stock. Mutual insurers, by contrast, generally cannot issue stock or options to align managers' and owners' interests[16]. Most policyholders lack financial awareness and have no convenient way of assessing how well their mutual is being run; thus, management faces no effective market for corporate control. To summarize, mutual ownership is more effective in controlling the customer-owner conflict and less effective in controlling the owner-manager conflict. These costs are difficult to assess but significant.

Agency theory and the existence of mutual insurance companies[17]

European life mutuals have their roots in the Middle Ages, when guilds protected members and their families in the event of sickness or death[18]. After the guilds disbanded, member protection continued through the establishment of mutual insurers who, by virtue of their ownership structure, could make commitments of financial stability and concern for its policyholders[19]. In the US, the insurance industry's early history is plagued with examples where mutuals succeeded while stocks did not, as stocks could not make credible commitments on solvency matters, and consequently were relegated to offering only term life insurance for short time horizons (one to seven years). In short, the mutual ownership structure decreases the probability of insolvency by minimizing management's incentives to behave opportunistically (through low claims reserves[20] or aggressive investments), and by giving managers latitude to set adequate premiums. Oddly enough, regulation, by constraining the behavior of managers and setting solvency standards, improved the credibility of stock insurers, thereby slowly leveling off the playing field[21] [22] . In contrast to life insurance, solvency considerations are less relevant in property/casualty, where policies are in force for short durations. The early advantage of mutuals was due to superior underwriting information (i.e., minimization of the asymmetric applicant-underwriter information problem) and reduced moral risk, both the result of the ownership structure. Mutuals, which were started by groups of people or businesses in a given region or industry, had as customers policyholders who were less likely to cheat peers than to defraud a stock company. Also, mutuals often possessed clearer insights into local risk identification and assessment than remotely located stock insurers.

The Managerial Discretion Hypothesis[23]

Mayers and Smith have derived a prediction based on agency theory known as the managerial discretion hypothesis. It states that mutuals will tend to specialize in lines of business where management has limited discretion in order to compensate for the limited control that owners exercise over management. Empirical research on the US property/casualty market confirms that this is the case. Research also shows that stocks operate on a more geographically diverse basis than do mutuals (geographic diversity requires greater managerial discretion with regard to resource allocation and similar issues). Thus, ownership structure influences market positioning in terms of product offerings and geographic reach.

The evidence

Lamm-Tennant and Starks examine the risks underwritten by US property/casualty insurers[24]. They find that, controlling for firm size, the loss ratios of stocks vary more than the loss ratios of mutuals, and that mutuals concentrate in homeowners multiple peril, automotive liability, and automotive physical damage, while stocks concentrate in workers compensation and other liabilities. In particular, mutuals have been most conspicuous in automotive lines, which have low underwriting risk and therefore require limited managerial discretion. In the life/health market, mutuals have been most active in health lines and in the provision of ordinary life products such a whole life insurance and endowments. In the US pension business, mutuals have been relatively late adopters of in-house asset management capabilities, which are crucial for entering the rapidly growing annuity business. These findings are consistent with agency theory and the managerial discretion theory: mutuals have less incentive to direct their attention to riskier lines of business. In terms of operational efficiency, loss ratios and cost ratios[25] are the best metrics. Typical financial measures such as return on investment provide a distorted view because mutuals offer lower cost coverage to members and naturally under-perform when measured in terms of earnings[26]. As expected, property/casualty and health mutuals have had higher loss ratios than stock insurers; surprisingly, however, mutuals have had lower cost ratios. This result may be partly due to the use by mutuals of more efficient distribution channels and their ability to better control agency costs, which remain elusive but can be substantial. In the life segment, the cost ratios of mutuals and stocks are roughly the same although there are variations by field of specialty; loss ratios are less informative due to the long-term nature of the contracts and the difficulty in assessing the performance of the savings component.

SCOTTISH WIDOWS DEMUTUALIZATION AND ACQUISITION BY LLOYDS TSB

The Players

Scottish Widows[27]
Scottish Widows is an investment company located in Edinburgh, Scotland, now a subsidiary of the Lloyds TSB Group. The Scottish Widows Fund and Life Assurance Society opened in 1815, as Scotland's first mutual life office with the purpose of providing for widows, sisters and other female relatives of fund holders. One of the most recognizable brand icons in Britain, the Scottish Widow first appeared in a television advert directed by David Bailey in 1986. There have been three "widows" to date: Deborah Moore (daughter of Roger Moore) from 1986 to 1994; Amanda Lamb from 1994 to 2005, and Hayley Hunt from 2005 to the present.

Lloyds TSB[28]
Founded in 1765, Lloyds Bank was one of the oldest banks in the UK and by 1995 one of the largest after a series of domestic and international acquisitions, including Lloyds Abbey Life. The Trustee Savings Bank (TSB) was formed by Henry Duncan in Scotland in 1810 with the intention of helping poor parishioner save money for times of hardship. The success of the scheme led to the establishment of similar banks throughout the country and to the creation of The Trustee Savings Bank Association. Eventually, the various banks consolidated into TSB England and Wales, TSB Scotland, TSB Northern Ireland, and TSB Channel Islands. Years later, the Trustee Savings Bank Act of 1985 allowed the merger of the Scottish and Channel Islands operations into TSB England and Wales under the name TSB Bank plc. The new bank was floated on the London Stock Exchange, TSB Northern Ireland was sold to Allied Irish Banks where it was re-branded as First Trust Bank. Lloyds TSB Group plc, a bank based in the United Kingdom, was created in 1995 following the merger of the TSB Group and the Lloyds Bank Group. The head office is in London but Lloyds TSB operates globally. The group contains companies that provide banking services for individuals and businesses, mortgages, investment and, after the acquisition of Scottish Widows, life assurance. Lloyds TSB Group ranks fifth in the UK and has the largest share of personal and business banking in the UK.

Demutualization and acquisition

Members of Scottish Widows at a special general meeting held on December 22, 1999, overwhelmingly approved the proposed demutualization and acquisition of Scottish Widows by Lloyds TSB. The UK courts approved the transaction on February 28, 2000, which became effective on March 3, 2000. Scottish Widows became a fully subsidiary of Lloyds TSB in exchange for a cash payment of 5.7 billion pounds sterling to policyholders based on the following business valuation:

- Estate (assets in excess of those required to meet policyholders' reasonable expectations): 2.8 billion pounds
- Business in force: 1.1 billion pounds
- Infrastructure, operations, and brand name: 1.8 billion pounds

Every policyholder received a fixed allocation of 500 pounds to compensate for the loss of voting rights, for an estimated cost of 0.8 billion pounds. In addition, qualifying members that held participating policies were entitled to a variable allocation to compensate for the loss of rights to surplus on dissolution of Scottish Widows, costing 4.9 billion pounds. The average windfall (including the fixed amount) to participating policyholders was 5,600 pounds; some received up to 25,000 pounds.

Strategic considerations of the acquisition

Each of the four biggest UK banks had tried to sell its own brand of life insurance and pension products with little success because banks were perceived as providers of low value offerings. According to Lloyds TSB, for example, only 4% of its customers were willing to purchase life or pension schemes from a bank. The best solution, judged by the actions of industry participants, was to expand horizontally through the acquisition of insurance companies. The idea was to enlarge scale and scope in light of government's pressure to lower the costs of financial products, which by 2000 were already at historical lows as the result of fierce competition. With an annual fee limit of 1% of the product's value, economies of scale were required to spread fixed costs, and economies of scope to cross-sell. Persistently low bond yields forced customers to pay attention to the eroding effects of commissions and fees, encouraging them to shift their investments from fixed-income instruments to equities. Finally, banks realized that life insurance and pension were among the few financial products with significant growth potential. The acquisition of Scottish Widows by Lloyds TSB must be understood in this context.

Economies of scale
Economies of scale were expected to save 60 million pounds as a result of a new cost structure[29] and an improved distribution system that combined the largest bank network in the UK with a broad agent infrastructure. A wide distribution and service network[30] were expected to facilitate customer transactions and signaled that Lloyds TSB was the company committed to providing personal financial products backed by a large pool of assets. Finally, with the European integration, economies of scale became part of the admission ticket to engage in global competition.

Economies of scope

The new firm is expected to offer a wide array of investment and pension products, as well as the "independent" financial advice that was part of Scottish Widows. Customers will enjoy the convenience of "one stop shop" while providing -perhaps unknowingly- marketing information that the bank will employ to create its next generation of products and services. Additionally, an ample portfolio of insurance and investment products opens the possibility for bundling, which has three important benefits: increased sales, lower lapse rates[31], and for product cross-subsidies.

Horizontal differentiation

Participating life and pension products are not easily comparable due to the long term nature and uncertainty of their cash flows. Thus, customers, even sophisticated shoppers, cannot ascertain whether a high cost life and/or pension product provides high or low value. Under these circumstances, a popular icon such as the Scottish Widow[32] can easily become a great asset to Lloyds TSB by horizontally differentiating insurance products and creating an umbrella branding effect on banking services.

Complementarities

Sophisticated asset/liability management in the banking and life/pension arena is a factor for success in the current environment of low interest rates, razor-thin commissions and intense competition. Lloyds TSB expects to unlock the elusive synergies of actuarial and banking expertise to improve risk management and investing functions. The objective is to create value for customers (not to redistribute it), which should translate into higher profits. If this experiment turns out to be successful, Lloyds TSB will be ahead in the learning curve over banks and insurers that, while growing, do not develop core competencies[33]. At the end, the importance of strategic management will only increase as new products mingle elements of investment with elements of financial security.

Conclusion

The corporate structure of insurers furthers or hinders their competitive position, depending on the prevailing economic, technological, and legal environment in which they operate. Mutuals have enjoyed advantages over stocks such as better risk selection, a high level of credibility with the public, alignment of owners and customer incentives and, in the absence of shareholders, better value to customers. With the passage of time, the playing field for mutuals and stocks has leveled off while access to capital, indispensable for growth, has become a paramount consideration. Current market conditions favor stocks over mutuals due to their ability to raise capital, hence the wave of conversion. Despite this, mutuals have been able to compete successfully with stocks and their share of the worldwide insurance market remains substantial.

The acquisition of Scottish Widows by Lloyds TSB reflects the current view that horizontal differentiation, economies of scale, economies scope and complementarities are the strategies to follow for global competition in the financial sector.

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1. Source: "Special Report: World Business," The Wall Street Journal, 09/28/06.
2. See Besanko et al., "Economics of Strategy," (3rd ed.), p. 391.
3. One of the competitive advantages of mutuals over stocks has been their more efficient distribution channels.
4. Fox-Pitt, Kelton, "Corporate Finance Outlook: Mutual Insurance Companies," October 1998, p. 3.
5. Other factors may trigger demutualizations: mutual company executives are richly rewarded when an insurers goes public. Furthermore, reorganizations benefits investment bankers, attorneys, accountants, and consulting actuaries whose professional services are required to implement the demutualization.
6. New York State Assembly Standing Committee on Insurance, "The Feeling's Not Mutual: An Analysis of Governor Pataki's Proposed Mutual Holding Company Legislation," March 1998.
7. See Stephen Paul Taylor-Gooby of Tillinghast-Towers Perrin, "Demutualization in an International Context," Society of Actuaries, Record 24:1 (June 1998).
8. Other costs (such provider reimbursement, which depend on negotiated discounts) are assumed to be independent of the company's ownership structure. The assumption is more or less reasonable, depending on the market under consideration. For purposes of the present discussion, a sweeping cost hypothesis is necessary.
9. Unique features may include services targeted to specific populations (e.g., acupuncture for Chinese customers), marketing material in a language other than English, contracting with certain group of providers (e.g., Spanish speaking doctors), etc.
10. For example, in the US not-for-profit Blue Cross Blue Shield plans sell their products through captive agents. Stocks typically rely on brokers and general agents, who tend to be more expensive.
11. Regardless of price changes, stocks would adopt a long-run *margin strategy* due to their earnings commitments to shareholders. *Shadow pricing* (see Besanko et al., op. cit., p. 391), popular with HMOs and very much a US phenomenon, is unlikely to play a role in the current insurance environment.
12. Market discipline forces stock companies to minimize production costs.
13. Agency Theory attempts to explain the manner in which businesses are organized and how managers behave. See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," Journal of Financial Economics 3:305-60 (October 1976), and J. Zimmerman, "Accounting for Decision Making and Control" (2006), pp. 156-163.
14. Arthur Fliegelman, Kevin W. Maloney, and Robert L. Riegel, "March of the MutualsA Rapidly Evolving World," Moody's Investors Service, May 1998.
15. The promise to fulfill contractual obligations is part of the insurance product. When this obligation is impaired, the value of the product diminishes.
16. Although mutual insurers can and do pay performance-linked bonuses, these have tended to be more modest than the stock and options packages that stock companies pay their executives.
17. Much of this discussion is based on Henry Hansmann, "The Ownership of Enterprise." See also Besanko et al., op. cit, Ch. 4 and 5.
18. Two important examples of these early mutuals were the German Wandsbeker Kranken-und Totenlade, established in 1677 and the British Amicable Society for Perpetual Assurance Office, founded in 1706.
19. Credibility was crucial in light of the risks associated with long-term insurance contracts.
20. As a matter of fact, claims reserves is one of the few places where not-for-profits and mutuals can "discretely" accumulate surplus.
21. Despite regulatory oversight, many early US stock companies were quite unstable. 60% of the stock companies operating in 1868 had failed by 1905.
22. The strategic importance of commitments cannot be overstated. Mutuals, by virtue of their ownership structure, were committed to serve their customers who were also owners. Stocks were committed to their stockholders first, then to their management teams, and finally to their customers. Regulation forced stocks to act with a minimum level of responsibility towards their customers, thereby extracting a "commitment" that, although different in nature from the early commitments of mutuals, had the effect of rendering claims on solvency credible.
23. This section is based on David Mayers and Clifford W. Smith, Jr., "Ownership Structure Across Lines of Property Casualty Insurance," Journal of Economics 31: 351-78 (1988).
24. Joan Lamm-Tennant and Laura T. Starks, "Stock versus Mutual Ownership Structures: the Risk Implication," Journal of Business 66:29-46 (1993).
25. Keeping other variables constant, the higher the loss ratios the larger the shares of premiums that flow back to policyholders in form of lower payments. Higher loss ratios, on the other hand, could reflect weaker underwriting standards. The lower the cost ratio, the greater the insurer's operating efficiency.
26. Mutuals are typically subject to higher solvency standards which would also depress ROE measures. Additionally, the risk profile and the corresponding expected returns of the businesses that mutuals and stocks underwrite are different. When a mutual plans to convert, however, management shifts its focus from servicing customers to maximizing profits.
27. Source: http://en.wikipedia.org/siki/Scottish_Widows, as accessed on December 11, 2006. See also www.scotishwidows.co.uk.
28. Source: http://en.wikipedia.org/wiki/Lloyds_TSB, as accessed on December 11, 2006. See also www.lloydstsb.com.
29. Lloyds TSB expected minimum layoffs.
30. Combining insurance and bank products requires training of salespeople which may be expensive and not without glitches.
31. Many actuarial studies confirm the commonly held belief that product bundling increases horizontal differentiation and makes rate comparison more difficult, all of which results in lower lapse rates.
32. The results of the branding campaign undertaken in 1986 exceeded expectations: brand recognition shot up from the historical average of 30% to 86% in six weeks and has remained high since then. No other insurance company in the UK has ever produced such a well received icon as the "Widow." Source: Scottish Widows website.
33. See Besanko et al., op. cit., pp. 377-378.