**The Merger of Mutual Life Insurance Companies: A Possible Answer to the Demands of the 1990s**
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# The Merger of Mutual Life Insurance Companies: A Possible Answer to the Demands of the 1990s

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Over the years, there have been few mergers of substantial mutual life insurance companies. In the 1960s and 1970s, two mergers were proposed: Fidelity Mutual with Pacific Mutual, and Mutual Benefit with Union Central. Both were eventually called off.

There were a handful of small mutual consolidations in the 1970s and 1980s. Also, Central Life merged with Wisconsin Life, and Century Life established a "permanent affiliation" with Cuna Mutual. In the first two years of the 1990s, Phoenix Mutual and Home Mutual announced plans to merge, as did Pan-American Life and Charlotte Liberty Mutual.

Other financial services industries have a history of mergers of mutual organizations. Mutual life insurance company mergers, however, have not been common. A key reason is that entrenched traditional management often has a strong desire to maintain control. A merged company cannot have two equal CEO's!

Also, poorly managed mutual life companies historically have been able to survive. The competitive and interest environments were kind to companies in the 1960s and 1970s. In addition, statutory accounting methods failed to adjust for economic reality. The lack of a viable sales operation reduces sales and long-term value, but increases current statutory profits.

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Until recently, few in the industry appreciated the potential benefits of merger. Natural fear of change played a part. State insurance departments did not encourage merger either, as they do not like seeing local companies disappear.

The life insurance industry in general, and mutual companies in particular, are undergoing fundamental changes in an attempt to survive and prosper in the 1990s. Many companies are defining or overhauling their missions, strategic plans, performance standards and corporate structures. As long-term objectives and plans change, so do required resources and possible strategic approaches. Merger is one option that is increasingly being considered by mutual life insurance companies.

Other factors are increasing the interest in mutual merger. Stock life insurance company mergers and acquisitions have been numerous and visible over the past decade. Generally, the same reasons for merger apply to mutuals. A number of mutual companies will not be able to succeed independently within the competitive environment of the 1990s, and merger may be their only reasonable hope.

The potential for merger depends on a company's current financial position, its future plans, its age and size, its type(s) of business and the age and depth of its management. Where a mutual's business plans cannot be supported by existing structure and financial strength, an alternative such as merger should be explored.

## Reasons to Consider Merger

There are four broad strategic reasons for a mutual life company to consider merger, namely:

- To facilitate implementation of refined corporate strategies.
- To preserve current values in weak or failing mutuals.
- To support an expected shift in the fundamental nature of the business.
- To attain critical mass.

Through improved business fundamentals, a mutual merger can create a strategic whole much larger than the sum of its parts. For example, administrative effectiveness almost always is improved due to larger scale, reduction of corporate overhead and reduction of reinsurance costs. The larger size and larger surplus of the new company is viewed more favorably by the rating agencies and customers. The appearance of creativity plus the ability to pick the most desirable sales opportunities from both mutuals often make profitable sales easier. These



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improvements ultimately accrue to the benefit of the policyowners through improved net costs.

A mutual company considering merger should evaluate its strategies and goals against these potential benefits. This evaluation is a first step in resolving the issues presented below.

## Critical Merger Issues

Critical issues relating to mutual mergers may be categorized as follows:

Merger rationale
Post-merger management
Equity principles
Surplus principles
Human resource issues

In addressing these issues, the management of each mutual company must focus on increased values that should occur as a result of merger, before detailing precise methods of allocating financial values post-merger. Improving fundamentals from the merger are critical to improving financial results for current and future policyholders. Current policyholders will improve their position by being a part of a larger, safer, more efficient, more vibrant company.

The viewpoint of the potential merger partner must be considered carefully. Merger success requires that neither side feel disadvantaged by the transaction. Differences between or deficiencies within the two operations must be addressed, but always in a way that satisfies both sides.

Finally, long-term expectations and goals are more important than short-term business considerations. The key to success is that the new company formed by the merger deliver expected benefits.

Decision makers should analyze the financial impact of a proposed merger on the policyholders of the two merging companies. Such an analysis would use both merger and non-merger assumptions. The analysis should quantify the amounts expected to be available for dividends and retained surplus under both merger and non-merger scenarios. The results will provide important information for (1) managements of the companies (both in confirming the financial value of the merger, and in providing a foundation for developing the fund accounting plan and post-merger management procedures), (2) state insurance departments, (3) boards of directors acting for the policyholders, and (4) federal or other regulators with an interest in the transaction.

### Merger Rationale

The merger must be a good fit, both in appearance and in reality. Critical questions to address include:

(1) How does the merger enhance the basic purpose of each company? What is the basic purpose of the combined new company?

(2) What are the anticipated benefits and costs of merger to the policyholders in each company?

(3) What is the projected impact of the merger on the companies' future financial statements?

(4) What is the expected impact of the merger on future dividends for existing policyholders in each company?

(5) How should each group of policyholders share in the financial results of the new company?

(6) How will the rating agencies view the new company in terms of business fundamentals, surplus ratios and asset quality?

(7) How do the operating philosophies and future outlooks of the potential partners compare? What conflicts exist and how will they be resolved? Consider items such as:

- Business missions
- Equity principles
- Financial objectives
- Marketing and distribution strategies
- Dividend and surplus philosophies

(8) What is the best way to view the merger from the standpoint of the policyholders?

(9) Are there better ways to structure the merger? Alternatives to merger would include acquisition, co-mingling, liquidation, bulk reinsurance and joint venture.

(10) What is the assumed contribution of the existing policyholder groups to permanent surplus? What about future policyholders, both on a non-merger and a merger basis?

(11) Is anyone disadvantaged by the merger?

(12) How will the merger affect the business activity and number employed in each of the states of domicile?

(13) How will the employees and agents of each company be affected by the merger?

(14) What mechanical/procedural problems exist and how will they be handled? Consider:

- Who will be the surviving company?
- What will be the surviving product portfolio and ratebook(s)?
- How will staffs and systems be consolidated? What transition programs will be required for adversely affected employees?
- Which states must be contacted?

The basic purpose of a merger is to enhance or otherwise build from the individual plans of the two (or more) companies. Financial analysis should quantify the reasonableness of the combination, as well as provide a basis from which to monitor future progress of the new company. Generally, the merger will be defined in the merger plan and the post-merger financial management principles set forth in some type of fund accounting plan.

In examining the relative financial



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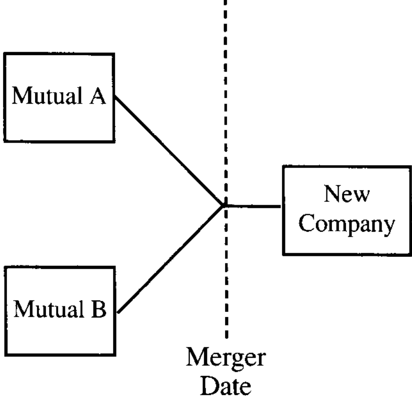
position of mutual merger candidates, key financial factors to analyze include (1) the earnings potential reflecting recent mortality, morbidity, persistency, expense, investment and sales performance; (2) surplus levels, including both statutory and intrinsic surplus computed on a comparable basis; (3) current and past net cost position, as well as dividend histories; and (4) nonfinancial factors such as franchises or successful niches, technology, field force and management. Also, in today's environment, asset characteristics and problems need to be examined carefully as a part of the investment performance review.

### Post-Merger Management

Often there is a conceptual framework to a proposed mutual company merger that looks like this:




It is important that new company management have proper and reasonable authority and direction in evolving long-term new company plans and strategies and in establishing future new company dividend scales.

The substantive aspects of post-merger financial management should be documented in a fund accounting plan. This plan will include a clear definition of post-merger organizational structure, post-merger equity and general management philosophies, post-merger guidelines for sharing experience results and surplus management principles. In addition, the plan will define relationships among the various lines of business, the relationship of growth to the financial mechanism and termination of fund provisions.

The fund accounting plan must be agreed to before the actual merger. Issues unresolved at the point of merger can hinder the management effectiveness in the new company.

### Equity Principles

Equity is a cornerstone of the mutual life insurance concept; it demands that each policyholder group ultimately pay a price for its insurance that bears a reasonable relationship to its actual experience costs. Obviously, there is no such thing as perfect equity! Equity, of necessity, is broadly defined and must be considered over the longer term.

A mutual company merger introduces the complexity of combining two groups of existing policyholders, each with perhaps substantially different characteristics (e.g., difference in coverages, investment experience, expense levels, underwriting/mortality/morbidity experience, surplus levels, and dividend histories). Three principles for maintaining equity in a merger might be:

(1) At the point of merger there will be no change assumed in the future performance of each class of business compared to prior experience. Thus, there would theoretically be no immediate change in existing dividend scales if these scales are current.

(2) Experience that unfolds after merger will be reflected in the normal year-to-year review of dividend scales. Significant changes in experience (e.g., expense improvements) resulting from the merger and future operational modifications will be reflected appropriately in the future dividend scales of old and new policyholders alike.

(3) There will be consistency in recognizing and accounting for prior dividend treatment and distribution approaches in order to treat the old policyholders equitably.

The fund accounting plan will define the financial framework for the post-merger equity and dividend philosophy.

In evaluating the equity issue in a mutual merger situation, managements must address equity among existing policyholders within each company and future policyholders in the new company, equity between different lines of business, equity between different ratebooks and different generations of policyholders, and equity between persisting and terminating/borrowing policyholders.

### Surplus Principles

Statutory surplus is needed in a mutual life insurance company for many reasons, including providing for statutory solvency, buffering fluctuations in operating factors, covering surplus strain created by new business, providing a foundation for growth and development, allowing the desired level of investment freedom, permitting the desired degree of risk-taking, and providing a comfort level for customers, agents and rating agencies.

Statutory surplus levels can be affected by many controllable factors such as the reserve basis and reinsurance. In addition, statutory surplus levels are influenced by statutory limitations, competitive situations, line of business characteristics and other factors. Every mutual company must manage surplus to preserve intergenerational equity according to its particular philosophy.

Key questions relating to surplus in mutual company mergers include:

(1) *What is surplus?* Traditionally, mutual company surplus has been defined as statutory net worth; i.e., the difference between statutory assets



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> *A merger often means a loss of jobs in order to achieve the anticipated merger expense savings.*

and statutory liabilities. Statutory liabilities involve a level of management discretion (e.g., establishing life insurance reserves on a net level or preliminary term basis).

Surplus can also be defined as the amount of net worth that would emerge if liabilities and assets were evaluated on a realistic basis. Such intrinsic surplus could, for example, be compared to the realistic present value of current dividends assuming continuation of the current scale to determine the company's potential for continuing or increasing the scale or the possible need to reduce it some time in the future.

In recent years, capital requirements and required surplus have become critical management issues. The flight to quality that has occurred places heavy pressure on all companies, mutual and stock, to conservatively manage risk and capital. This emphasis on security and strength is changing the way most companies manage their businesses, with mutuals facing the difficult task of balancing the often-conflicting demands of safety, equity and growth.

(2) *Who owns the surplus?* Generally, current policyholders did not contribute all of the current surplus. Normally, a mutual company expects each generation of policyholders to leave a permanent contribution to surplus. In addition, surplus is generally viewed as being unallocated, for the protection of the company as a whole.

(3) *What does the policyholder own?* The policyholder can be considered to own a right to earnings; his or her reasonable share of the earnings related to his or her contributions to such earnings, after reasonable consideration of the corporate requirements with respect to surplus.

### Human Resource Issues

A merger often means a loss of jobs in order to achieve the anticipated merger expense savings. This is more of a problem for management where attrition rates are low and the merger clearly establishes one CEO on top. This issue is more severe if the merging companies are separated from each other by a long distance.

Often a mutual merger unfolds more like an acquisition. The surviving company maintains its home office, most of the key management positions and the bulk of its current work force. The disappearing company's employees must move to another location, if comparable jobs are available. The organizational and cost impacts of merger are positive from the surviving company viewpoint. The disappearing company may view the transaction as positive for its current and future policyowners, but it is very difficult for its management to pursue, since it requires giving up jobs for themselves and their coworkers.

Since in many respects the managers of a mutual company control the company, they should have some motivation to merge if it is clearly in the best interest of policyowners. Otherwise, they may not consider merger and will continue on for many years, often dissipating the value of the company. There should be room in a mutual merger to provide compensation to those employees who recognize they have substantial control over the company and are doing something which may not be in their personal best interest.

While these benefits should not constitute a windfall, they should go beyond normal severance and outplacement. Otherwise, many desirable mergers will not happen. Even after paying generous severance, merger transactions generally will be attractive to policyowners. Thus, while the primary regulatory concern is protecting policyowners and insuring that management is not unreasonably enriched, the judgment of what is reasonable should not be unduly narrow.

## Implementing a Mutual Merger

Successful implementation of a merger of mutual life companies requires careful planning and management. There is usually a substantial pre-planning period, followed by a merger implementation period of at least six months between announcement and completion.

The implementation period will be a new experience to most mutual companies. It will involve numerous, intense meetings with potential partner(s), as well as working with states and specialist advisers including investment bankers, attorneys, accountants and actuarial/financial consultants. There will be considerable strain on available top management time.

Critical reports such as an independent financial analysis and equity study, responses to anticipated regulatory questions and the merged company management plan must be completed as quickly as possible.

A number of actions, additional reports, documents, and basic decisions must be addressed. The boards of both companies must approve the proposed merger, as must key state insurance departments and policyholders of both companies.

The fund accounting plan, which is the basis of post-merger financial management, must be carefully drafted. Other required documents include the merger agreement, joint proxy statements, notices and proxies related to special policyholder meetings, and other general merger communications.

Major questions where clear answers are required include:

- What is the precise organization chart for the new company?



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• Who will be the CEO?
• Where will the new company be domiciled?
• What will be the name (and logo) of the new company?
• How will the new company board be structured?
• How will the field forces be integrated?
• How should non-par and non-life lines be treated?
• How will the administrative approaches (e.g., underwriting, policy forms, commissions, etc.) of the companies be coordinated?
• How will retirement and other employee benefit plans be integrated?

## Conclusion

This article focuses primarily on the merger of two mutual companies where neither is in danger of insolvency. Hence, it intends to explore strategic mergers.

A merger where one company is near insolvency creates different issues than those envisioned here. For example, solvency mergers are really acquisitions of a weaker company by a stronger one. The major concern of the acquiring company is that it attains a long run increase in surplus commensurate with the risk it undertakes. The distressed company is concerned with obtaining the best possible benefits for its policyowners given its precarious position.

The next decade will shrink today's 110 or so mutual life insurance companies. Although merger is not a simple path, it often will be the preferred alternative to the many mutuals who cannot win in the quality, price and customer driven marketplace of the 1990s. It behooves management of every mutual life insurance company to consider merger as an option for enabling its long-term objectives for policyholders, agents and management.**J**

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