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SCHIFF'S

INSURANCE OBSERVER

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The Revolution Was Not Televised

Staring at the Sun

The limos are lined up in front of Goldman Sachs until late at night. Investment bankers, money managers, and corporate lawyers are buying lofts in Soho and Tribeca, not far from CBGB's, the birthplace of that nihilistic form of noise and self-destruction known as punk rock, epitomized by a T-shirt worn by a member of Richard Hell's group, Television, that said simply: "Please kill me."

Insurance companies are wearing that same T-shirt today, as they compete beyond reason for business, acquisitions, and investments. Insurance has become, in the words of analyst V. J. Dowling, "a capital trap," and we're in the "cheating phase" of the cycle where companies are fudging their results. They are praying for an upturn that, alas, will only come when capital is depleted and fear abounds.

On the other hand, we haven't seen so many insurance-stock bargains since 1994. Good companies such as W.R. Berkley, EMC, NYMagic, and Risk Capital (all of which we've bought) are selling below book value, as are many others. Although we've been bearish on the industry for quite a while (and continue to be so), we are bullish on cheap stocks of good companies; they usually provide decent returns to those who are patient.

No one, however, should get rich off a mutual insurance company. A mutual is a non-stock corporation that's supposed to be run for the benefit of its policyholders. When managed properly, a mutual can be a wonderful institution. If a mutual falls into the wrong hands—and many have—it becomes an institution that serves "special interests"—those of its officers, directors, and managers.

We began examining the mutual insurance industry closely in 1996 and were distressed by what we found. While we knew from our years in the insurance business that many mutuals didn't really "walk the walk," we were surprised to discover that many no longer even "talked the talk." Across the country a movement was spreading, and its message was an ugly one: it's okay to screw mutual policyholders because they aren't really "owners." And, because they didn't understand what they had, they wouldn't notice when it was taken away.

By mid-1997, horrified by the events at Allied Mutual and by the mutual-insurance-holding-company movement, we decided we couldn't be an "observer" any

The soft market: Underwriters rush to insure a burning building.

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longer. It was time to step into the ring. We felt that we had an opportunity to make a difference in one of the insurance industry's greatest financial issues: what would happen to the $300 billion of value in America's mutuals that belonged to the mutuals' policyholder-owners?

We didn't know that our "opportunity" would become a costly round-the-clock job that would leave us exhausted, disgusted, and exhilarated. Even if we had known that, we probably wouldn't have done anything differently.

In our first article on Allied Mutual (September 1997), we wrote the following:

> We sense a turning of the tide, a move towards reform. Not so long ago, shareholders of public companies were disenfranchised, too, but activists... demanded accountability. This simple truth is often forgotten: mutual insurance companies are not the property of their directors or employees—they belong to their policyholders.
>
> Policyholders' long period of quiescence may be coming to an end...

David Schiff announced his candidacy for Allied Mutual's board in these pages and in a $7,500 ad in *The Des Moines Register*. He wrote that by exposing Allied's unsavory dealings "to the light of day, the policyholders, the regulators, the press, and the public will demand change. The time is right, and I hope my action will serve as an inspiration for mutual policyholders, as a wake-up call for regulators and legislators..."

Words are powerful, but so is money. For every *word* published here, the big mutuals—MetLife, Principal, MassMutual, New York Life, John Hancock, Northwestern, Prudential, and others—spent thousands of dollars to forward their agenda. They advertised, sent out mailings, dispatched lawyers and teams of executives across the country, bombarded state legislatures with money and lobbyists, and lavished money on investment bankers.

In January 1998, several months after Jason Adkins (a public-interest lawyer who had a profound influence on Schiff) and Schiff had been crisscrossing the country, speaking before NAIC meetings, state legislators, industry conventions, agents and brokers, and anyone else who would listen—*Schiff's Insurance Observer* published "The Revolution Will Be Televised," an in-depth analysis of mutual-insurance history, corporate governance, and recent hearings that had been held by Assemblyman Pete Grannis of New York.

The atmosphere was becoming charged, and we envisioned a revolution culminating in reforms along the lines of those enacted after the 1905 Armstrong hearings. We wrote the following:

> A pundit once said, "nothing is illegal if 100 businessmen do it." America's mutual insurers can join together in a conspiracy; they can hire the fanciest lawyers and place lobbyists in every state capitol; but in the end, their audacious mutual-insurance-holding-company maneuvers will backfire. Before too long their affronts to decency, fairness, and mutuality itself will unleash a wave of rage and a sense of betrayal that will explode in front-page headlines, exposés, and—yes—national hearings...
>
> We envision mutual directors being grilled in Washington by a latter-day Charles Evans Hughes, the steady gaze of network cameras capturing each embarrassing moment.
>
> But before it's too late—we want to say something that Clint Eastwood's Dirty Harry might have said to Harry Kamen [MetLife's chairman]: "The Magnum .45 of fairness and public opinion is cocked and pointed at your head. The only unknown is whether there's a bullet left in the chamber. So think about it long and hard, and ponder this question: 'Do you feel lucky, Harry? Do you feel lucky?'"

As it turned out, Kamen and many other mutual CEOs *did* feel lucky; they didn't give a damn about any Magnum .45 of fairness. After all, they were packing heavy artillery: money, governors, legislators, lawyers, and investment bankers. What they didn't have, however, was The Truth.

In one respect, Kamen and his co-conspirators were right, and Schiff was wrong: the revolution would *not* be televised. What happened, instead, was a quiet revolution, one in which the well-armed giant mutuals one-by-one laid down their arms, caving in as their disgraceful behavior was attacked by guerrilla activists.

They were beaten in a brawl of words by a motley crew: Adkins, a lawyer, reformer, and man driven by fairness; Joseph Belth, a retired professor from Indiana and writer of *The Insurance Forum*; Pete Grannis, chairman of the New York State Assembly Insurance Committee and a man so out of touch with big-money politics that he refuses to take donations from the industry he oversees; and Schiff, a pissed-off insurance observer.

There were many others who played a role in the battle: 24-year-old Brendan Bridgeland, policy director of the Center for Insurance Research and a tireless worker; Theresa Amato of the Citizen Advocacy Center (in Elmhurst, Illinois), who stayed up all night with Adkins and Schiff, preparing an assault on the Illinois legislature; Annamaria Lloyd, a outspoken Principal Mutual agent from Seattle who traveled to Des Moines to join Adkins and Schiff and testify at Principal's mutual-holding-company hearing in January 1998; David Winters, a big-time money manager who flew in from New Jersey to speak out at the same hearing; James Hunt, an actuary and former insurance commissioner who is now with the Consumer Federation of America; Ralph Nader who spoke with power and eloquence at the New York State Assembly hearing; David Morrison at the Coalition for Consumer Rights; Citizen Action; New York Public Interest Research Group; a number of stock insurance companies (including Conseco, which played a key role in Indiana); the American Association of Retired Persons; and various policyholders, agents, and individuals who wrote letters or spoke out someplace.

The media were important, as well. If you're right, know what you're talking about, and spend your day speaking to reporters about events that have major financial ramifications, chances are they'll want to write about it. Adkins' and Schiff's travails were covered extensively by newspapers, insurance publications, magazines, newsletters, some radio, and a bit of television. Schiff ran for Allied Mutual's board and made bids to acquire FCCI Mutual, Provident Mutual, and Allied Mutual on behalf of policyholders. Adkins, and the

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organization he founded, The Center for Insurance Research, filed motions, brought lawsuits on behalf of policyholders, and weighed in just about everywhere. Joseph Belth went to Provident Mutual's public hearing, asked pointed questions, then sunk his teeth into the matter like a pit bull—and still hasn't let go.

The facts speak for themselves: a bunch of knowledgeable activists can bring about change—especially when they're right. The subject of mutual-insurance-holding companies and demutualizations went from being arcane to being the biggest issue in the insurance industry—particularly the life insurance industry.

The mighty Prudential, which had been plagued by scandal, was the first to throw in the towel, announcing plans for a demutualization in February. John Hancock succumbed a few months later. Then New Jersey prohibited mutual-insurance-holding-company conversions, and the New York bill, supported by Governor Pataki, Senator D'Amato, Insurance Commissioner Levin, and the Life Insurance Council of New York, disappeared in June. (In the fall, D'Amato removed a provision from H.R. 10—that he'd previously inserted—that would have allowed mutuals to redomesticate if the state in which they were domiciled didn't permit mutual-insurance-holding-company conversions.)

Then MetLife, which had miscalculated so badly, announced that it, too, would demutualize. In 1999, General American, the second mutual-insurance-holding company, gave up on the now-discredited structure and announced that it would demutualize. Last month AmerUs, the first mutual-insurance-holding company (and the only one to have issued stock publicly) announced that it was considering a full demutualization. (By this time, investors weren't particularly eager to buy stock in mutual-insurance-holding-company subsidiaries.)

Along the way, some mutuals managed to slip through the cracks. As a rule, the farther a mutual was from a media center, the greater its ability to pull the wool over its policyholders' eyes. Among those that converted to mutual-insurance-holding companies are Ameritas in Nebraska, FCCI in Sarasota, Ohio National, Principal in Iowa, and Security Benefit in Kansas.

What has now evolved is a two-tiered structure. Smaller mutuals in states far from the glare of publicity, *may* be able to convert to mutual-insurance-holding companies (even though the concept is brain-dead and waiting for someone to pull the life-support plug). In all likelihood, however, they will find themselves encumbered with lawsuits, particularly if they try to issue stock.

As for the biggest mutuals—that's a different matter. Although MassMutual could, in theory, convert (since Massachusetts has a law permitting mutuals to do so), it would have trouble explaining why it was shafting its policyholders by giving them nothing when John Hancock, Prudential, MetLife, and General American are giving out stock.

MassMutual, Northwestern, State Farm, Nationwide, or any other giant mutual would probably not want to be in that position. For these companies, the ramifications of embarking upon a mutual-insurance-holding company could be disastrous; their size guarantees that there would be plenty of media coverage, most of it unfavorable. Their size also guarantees that there would be lawsuits.

The most recent body blow to the mutual-insurance-holding company structure took place on February 11, when Judge Levin in Pennsylvania enjoined Provident Mutual from implementing its abusive conversion plan (which had been approved by the Pennsylvania Insurance Department after a farce of a hearing presided over by deputy insurance commissioner Gregory Martino.)

Judge Levin ruled that Provident's information statement to policyholders contained material omissions, including the following: 1) The plan didn't disclose that Morgan Stanley and/or PriceWaterhouseCoopers had concluded that full demutualization was better for policyholders than the mutual-insurance-holding company conversion contemplated. Such a disclosure would have provided the proper context for policyholders to evaluate whether the plan was really in their "best interests." 2) Policyholders weren't informed why Morgan Stanley wasn't asked to compare Provident's plan with other alternatives in order to determine which plan was better from a financial point of view. 3) The plan didn't adequately explain what policyholders would have received under alternatives—such as a full demutualization. Policyholders could then have evaluated the Board's conclusion that the conversion was in their best interests. 4) The plan didn't discuss the material factors that Morgan Stanley relied on in reaching its opinion.

In short, Provident got its policyholders to vote for something (a plan of conversion), without properly informing them of the ramification of their vote. Without informed consent, a vote is tainted.

Last April, at the Provident public hearing, Schiff urged the Pennsylvania Insurance Department to make Provident provide such disclosure to policyholders. [See *Schiff's Insurance Observer*, May 1998]:

> I think Provident policyholders should be told approximately how much the company could be sold for—a rough estimate. If it were twice book—and there are approximately 300,000 policies—that could be $5,000 per policyholder.
>
> Policyholders can't possibly make an informed decision unless you provide them with the proper information, which you have not done.
>
> In this brochure you sent [to policyholders], you said the plan "maximizes the value of our subsidiaries." Who does it maximize value for?

If policyholders of a mutual were given a simple choice: $5,000 (or $2,000 or $10,000) in cash or stock from a full demutualization, versus a "membership interest" that carries no expectation of profit in a mutual-insurance-holding company, virtually all would choose the money or shares. Mutual executives have known this all along, but they never explained it to policyholders this way.

As a result, many giant mutuals that wanted to raise capital (foolishly, we think) have, perhaps, missed the market. At best, their timetables have been set back by a couple of years. And their policyholders have been ill served by the executives' money grab. But for now, the worst is over.

There is a place for mutual insurance. (A mutual-insurance-holding company *does not* preserve mutual insurance, but rather destroys it, because the mutual insurer is converted into a stock insurer.) One cannot compare mutuals and stock insurers by looking at returns-on-equity or earnings growth—the goals for each organization are different. Mutuality is a good structure when used properly. Companies like Guardian, New York Life, Northwestern, and State Farm would do well to keep that in mind. (New York Life, however, should keep it in mind *after* booting out chairman and CEO, Sy Sternberg.) ■