icmif
International Cooperative and Mutual Insurance Federation
'A Global Reach for Local Strength'

A practical guide to understanding mutual insurance

Edition 1

Guide

This guide was written for use by supervisors and regulators of insurance undertakings to help them understand the specifics of mutual insurance.

Throughout the document, we use 'mutual insurance' as a generic term for insurance undertakings that are characterized by being jointly owned (and overseen) by their members and by not being listed on the stock exchange.

This guide does not set out a methodology for regulation, but aims to provide a clear and comprehensive description of the structure, governance and purpose of mutual insurance undertakings.

The aim is to deliver a better understanding of mutual insurers by regulators, to help ensure that rule-making does not create barriers to effective competition, and to stimulate constructive dialogue between supervisors and mutual insurers.

Ultimately, it is hoped that this will create a stronger alignment between the goals of regulation, supervision and mutual insurance, including the proportionate application of rules and standards.

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Foreword

In search of proportionality

I welcome the publication of this guide. Insurance regulation is undergoing important changes in many parts of the world. Following the example of the banking sector, more attention is being paid to linking capital requirements with the risks undertaken by insurers. As insurance is complex, the new regulatory requirements tend to be also very complex.

This guide should help regulators not to forget the principle of proportionality: not all insurers are equally structured and organized. Good regulation implies that account is being taken of the difference between mutual insurers and insurers organized as (limited liability) companies. Not to do so would be inappropriate and could be harmful to mutual insurers that have contributed immensely to the development of insurance, very often as small or medium-sized operators in local markets.

This guide should also remind supervisors, who are supervising the application of insurance regulation in practice, that they must consider the particular nature of mutual insurers in their actions. Supervisory actions must be proportionate, not only with the size but also with the nature of the insurer. The question is not whether a mutual insurer should be required to apply a particular rule, but how the rule should be applied in a manner that respects the particularities of a mutual insurer.

This guide gives an overview of what mutual insurance is and its relevance in today's insurance world. It is in the interest of all stakeholders that mutual insurers can continue to provide their services. This will only be possible if regulators and supervisors respect the principle of proportionality, not only in form, but also in substance.

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1. Introduction

The pooling, sharing or mutualization of risk is the principle behind the function of any insurance company; it involves spreading individual risks between a group of people or organizations. Insurance thereby began as a mutual concept, with the insureds also being the owners of the insurance undertaking.

Mutual organizations gained importance in the 19th and 20th century throughout Europe. Nowadays, mutual insurers exist in most regions of the world in a more-or-less institutionalized form and are commonly known as self-help groups, friendly societies, mutual insurance companies, industrial and provident societies, mutual (or social) benefit societies, fraternal societies, insurance cooperatives, etc.

In most cases, mutual insurers were set up by socio-economic groups (such as farmers, fishermen, craftsmen, teachers) in the absence of, or as an alternative to, mainstream insurance, with the main purpose of providing cover to their member-owners in exchange for affordable premiums.

In some parts of the world therefore, mutual insurers, as well as associations, cooperatives and foundations, form a part of the wider social enterprise sector[1]. This sector holds significant market share[2] in financial services (banking and insurance), agriculture, health and pensions, sport and culture, and has certain common features in each:

- primacy of the individual and the social objective over capital
- democratic control by the membership
- combining the interests of members, users and the general good (society)
- defence and application of the principle of solidarity and responsibility
- reinvestment of surplus to carry out sustainable development objectives and the provision of services to members or for the general good.

With regards to insurance, according to our analysis[3], there are at least 5,000 companies conducting business on a mutual basis worldwide, equal to 27% of the total insurance market.

1 http://ec.europa.eu/internal_market/social_business/docs/COM2011_682_en.pdf
2 In Europe, the social enterprise sector has a workforce of 14.5 million, equating to 6.5% of the European jobs market. See *The Social Economy in the European Union, European Social and Economic Committee*, 2012. http://www.eesc.europa.eu/resources/docs/qe-30-12-790-en-c.pdf
3 ICMIF *Global Mutual Market Share 2013*. See chapter 5 for more information.

2. Making markets work more effectively: regulation and mutuals

- Regulators in each continent have different priorities according to local circumstances.

- However all regulators are focused on ensuring markets work more effectively and efficiently.

- Most also have a focus on ensuring consumers are treated fairly and are protected adequately.

- A strong mutual presence in a market can support these regulatory priorities. For example, in the UK, the Financial Conduct Authority examined the role of mutuals in facilitating access to financial services and in promoting competition in the interests of consumers[4] and found that mutuals provide additional consumer choice and help tackle financial exclusion.

- The mutual business model supports fairness.

- Mutual business can be constrained if regulation unduly promotes the shareholder-owned business model or creates barriers to entry or unequal competition for mutual.

- Legislators in some countries recognize the value of mutuals:

    - For example, in the UK, the national regulators are required to provide a cost-benefit analysis for any new rules, and within this are required to analyze whether there are any different consequences for mutual.

    - In France, the legislator has taken into consideration the characteristics of mutuals by asking the regulator to consider SGAMs as a Group when applying Solvency II.

- Many regulators talk about being 'business model neutral', however, one-size-fits-all rules may penalize mutuals and limit their ability to compete effectively.

[4] In the following Policy Statement: http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-05

3. History of mutuality and insurance

In Roman times, some societies practised an equivalent to mutual insurance[5]. The governance of each society was conducted in the interests of its members, who either met in general assembly or elected a committee of management. Records show that burial clubs offered a mixed membership of slaves and freemen, with the only qualifications for membership being the payment of a joining fee, appointment by the president, payment of a periodic subscription and obedience to the rules of the general assembly.

Until the middle Ages in Flanders[6] it became customary to mutually insure against a combination of fire, shipwreck, loss of livestock, imprisonment, etc.

Modern insurance can be traced **back to the fourteenth century** when, at the request of merchants of Genoa, Florence and Flanders, the first insurance policies appeared. Under these policies, the "insurer" promised, in return for the receipt of a premium, to indemnify the "assured" for damage to goods caused by the occurrence of a marine risk. In the second half of the fourteenth century, King Ferdinand I of Portugal issued an ordinance establishing an **obligatory system of mutual insurance for ship-owners** in respect of vessels of 500 tons and over[7].

In the UK, the **first fire mutual insurer**, named 'The Fire Office', was created to insure brick and frame homes in the aftermath of the Great Fire of London, **1666**, which destroyed thousands of dwellings. At about the same time (1663), in the Netherlands, an insurance mutual for mills was created.

In the United States, the first company to underwrite fire insurance was formed in Charles Town, South Carolina, in **1732**. This encouraged Benjamin Franklin to widen the practice of insurance, particularly against fire, in the form of perpetual insurance[8].

In Africa, around 1845, The Mutual Life Assurance Society of the Cape of Good Hope was founded without any initial capital other than the premiums of its first 166 policyholders, followed, some 75 years later, by the South African National Life Assurance Company Limited.

In Central and Eastern Europe, the most significant development occurred in the 19th century, specifically in Lithuania, Russia and in the Kingdom of Poland. In 1803, the compulsory insurance of buildings against fire was introduced by the Prussian government. When Poland gained independence[9] from Prussia in 1918, there were far-reaching socio-economic changes which also affected the insurance sector. In 1921, an important Act on Mandatory Insurance of Buildings against Fire was passed and the Polish Directorate of Mutual Insurance was set up. It was a self-governing institution based upon the principles of mutuality, with the main goal being to serve the public interest rather than generate a profit. After WWII, mutual insurance companies

[5] Charles Farley Trenerry Agnes S. Paul, *The Origin and Early History of Insurance: Including the Contract of Bottomry*'.; P. S. King & son, Limited, 1926

[6] [...]were practically groups or societies formed for the purpose of mutual insurance of the members. The guilds' chief object was the mutual welfare and insurance of their members. The mutual insurance of the guilds' transactions was generally known and approved by authorities (clearly shown by the legislation of the Carolingian emperors)'. Charles Farley Trenerry Agnes S Paul, op.cit.

[7] The oldest known marine insurance contract, dated April 22 1329, is conserved among the diplomatic archives housed in Florence. '*A page from the History books, the Origins of Marine Insurance*', FFSA, 2006.

[8] He also established the Philadelphia Contributionship for providing fire insurance on houses.

[9] In contrast, mutual insurance societies located on the territories of the former Prussian partition were subjected only to minor changes. In 1932, under the regulation by the President of Poland, National Fire Insurance from Poznan and Pomeranian Fire Insurance Society from Torun merged, thus forming Mutual Insurance Company (Zakład Ubezpieczen Wzajemnych) based in Poznan, with its system built on the principles of mutuality.

operated until 1952 when they were nationalized and were not reintroduced again until the Act of 28 July 1990.

At the beginning of the 20th century, mutual societies began to play an important role in agriculture; across Europe, many mutual insurers were established by Farmers' Unions[10] to protect agricultural workers from risks such as fire, hail or cattle death. In France, over a 40-year period, it is estimated that 40,000 mutuals were created, the equivalent of three a day[11].

The mutual movement was then adopted by other socio-professional groups, such as retailers, teachers and doctors, not only to protect themselves against professional risks, but also against risks affecting all aspects of their private lives.

The development of health insurance would probably merit a chapter on its own. The concept of establishing a mutual society for health cover was spawned during the industrial revolution in the 19th century. This social transformation gave birth to new forms of solidarity and various provident society initiatives emerged. Workers grouped together to create welfare funds to finance the payment of daily allowances to sick or disabled workers, to pay for the care necessary for their recovery, to buy a house or to refund funeral expenses. These funds were merged with strike funds[12].

Takaful insurance

Takaful is an Arabic word meaning "guaranteeing each other" or "joint guarantee"[13].

The origin of Takaful can be traced back to ancient Arab tribal customs and the companions of the Prophet.[2] The practice of having a fund that pools contributions from a group of people to assist others in need was further encouraged during the early Islamic period. The first modern Islamic insurance was introduced in Sudan, and was based on a cooperative model not dissimilar to a conventional mutual insurer. More commercial models of Takaful were later implemented in countries such as Malaysia and Saudi Arabia. Takaful has evolved into a viable alternative to conventional insurance and is able to attract a wide range of customers, Muslim and non-Muslim alike.

Takaful insurance is now offered by over 60 companies in 23 countries and has evolved into a rapidly growing industry. Overall, global gross Takaful contributions are estimated to have reached US$14 billion in 2014. Year-on-year growth has levelled off from a 22% CAGR high during 2007-11 to a still-healthy growth rate of 14% during 2012-14[14].

Takaful insurance is available for both life ("family") and general insurance lines. Although it is based on concepts of mutual solidarity, a typical Takaful undertaking is a

[10] To name a few: Local Insurance (Finland), Groupama (France), Mapfre (Spain).

[11] These great numbers were mainly due to favourable social laws (such as workers compensation), as well as State grants.

[12] Mutual Societies in an Enlarged Europe, Consultation document, European Commission, 2003

[13] '*Islamic Insurance Revisited*', Swiss Re, 2011

[14] Global Takaful Insights. Market updates. EY 2014, http://www.ey.com/Publication/vwLUAssets/EY_Global_Takaful_Insights_2014/$FILE/EY-global-takaful-insights-2014.pdf

[2] For example, under the custom of "al-aqilah", it is mutually agreed among the tribes that if a person is killed unintentionally by a person of a different tribe, the accuser's paternal relatives will take the responsibility to make a mutual contribution for the purpose of paying the blood money to the victim's relatives. IFSB & IAIS – *Issues in Regulation and Supervision of Takaful (Islamic Insurance)*

two-tier hybrid of a mutual and a commercial company. This in itself poses significant issues for regulation and supervision. In addition, all the functions of a Takaful undertaking should conform fully to Islamic law (Shari'a), and this has implications in other areas of regulation and supervision.[3]

In a Takaful arrangement, the participants contribute a sum of money as a whole or partial tabarru' (donation) into a common fund, which will be used to assist the members against a defined loss or damage. There are several forms of contract that govern the relationship between the participants (policyholders) and the Takaful operator. The most widely used contracts are the mudaraba (profit-sharing) contract and wakala (agency) contract. In all models, the Takaful operator will usually provide an interest-free loan to cover any deficiency in the Takaful fund. The loan has to be repaid from any future surpluses of the Takaful fund.[4]

[3] Islamic Financial Service Board and IAIS, *Issues and Supervision of Takaful*, 2006
[4] Ibidem

4. Characteristics and values

There is a large diversity of legal forms associated with mutuality around the world, however the commonality between all mutual-type insurers is the absence of externally held share capital. This means that mutuals cannot be purchased on the open market by other financial institutions.

General principles

There is no clear all-encompassing legal concept that defines a mutual-type organization, as there are differences concerning traditions, history, (political) choices, markets, businesses, governance models and rules. **Legally speaking, most mutual-type organizations are a special kind of association, cooperative or company, as few countries have a dedicated regime for them. But all mutual-type insurers are private entities; are societies of persons versus capital[15]; are subject to democratic governance; and use profits for the benefit of members[16].**

In addition to these distinguishing features, mutuals and co-operatives share the following commonalities:

- **they are owned by a defined group of members (such as farmers, teachers, bus drivers, etc.), but may also serve a wider group of consumers;**
- **they have a governance structure which gives members a say in how the organization is run;**
- **they are run for the benefit of their members or in their members' interests, with profits retained within the business, or distributed to members and/or their interests.**

Cooperatives are formed and operate under an internationally agreed set of principles as defined by the International Cooperative Alliance (ICA)[17].

Mutual societies were the subject of a study[18] published by the European Commission which proposes a definition[19] for European mutuals, and which at the same time identifies around 40 types of mutual-like organizations.[20] Such wide diversity as seen in Europe is also seen across the rest of the world, leading us to believe it is wiser to avoid an overly prescriptive definition of mutual, and therefore to avoid a 'one-size-fits-all' approach.

[15] Societies of persons, i.e. members, rather than capital, i.e. shares

[16] A mutual entity is defined as an entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members or participants. IASB definition

[17] An autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise. A cooperative is expected to have subscribed to the statement of identity agreed by the ICA.

[18] Study on the current situation and prospects of *Mutuals in Europe*, 2012; http://ec.europa.eu/enterprise/policies/sme/files/mutuals/prospects_mutuals_fin_en.pdf

[19] A mutual is a legal entity whose purpose is primarily to meet the needs of its members (legal or natural persons) according to the principles of solidarity and mutuality amongst them. The profits and surpluses of a mutual are not used to pay a return on investment, but to improve the services offered to members, and to finance and develop their activities for the benefit of members

[20] This diversity is attributed to the cultural and historical settings of the European countries (DNA).

Mutuals have no share capital, but build up their own funds from retained profits over the years to build financial solidity. This particular feature of retaining profits constitutes a great strength of mutuals. Some of them do however access external capital for their growth, either in the shape of guarantees or subordinated debt. In France, a Bill allows mutuals to issue certificates with variable remuneration, whilst in the UK a new class of 'mutual deferred share' will permit the creation of new capital. This point is addressed in more detail in chapter 9.

Another important foundation for the solidity of mutuals is their governance structure, which in practical terms means member-policyholders in many instances elect the directors at the general meeting (though there are some exceptions). This has implications on the interactions between the board of directors and the management of a mutual, which will be explained in further detail in chapter 6.

The above-mentioned **features, i.e. limited sources of new capital and elections of directors, sometimes contribute to a perception by regulators that mutual undertakings are riskier then shareholder-owned** companies. These issues are also addressed in this document.

It should be noted that the mutual business structure is not inconsistent with t**he principle of profit-oriented management**. All mutuals need to achieve positive financial results and to generate annual surpluses in order to maintain the financial strength of the company and/or support growth. **The distinction between a mutual and a shareholder-driven firm is the primary business objective: for a mutual**, profitability is not the exclusive or primary objective. In practice, this means a mutual insurer will not seek to maximize profits to a same extent as a shareholder-owned insurer.

As a consequence, mutuals have an ability to manage for the long-term, and often have a social purpose which supports the interests of their owners, as well as wider groups of stakeholders, such as their staff and the communities in which they are present.

This social purpose has also been identified as a key characteristic of mutuals in the *ICMIF Global Reputation Report*[21] which is the result of a year-long investigation into all global digital and online conversations and content relating to the cooperative and mutual insurance sector.

The global search found that the values most commonly associated with the mutual insurance sector are:

- Share of profits – 42.5%
- Long-term – 24.9%
- Sustainable – 23.5%
- Not-for-profit – 5.1%

These mutual values provide the sector with the point of 'difference' which can support a good reputation and a unique position in the minds of stakeholders. They also reflect two vital aspects needed for reputational strength: strong stewardship and responsible citizenship.

[21] The 2013 ICMIF study of the cooperative and mutual insurance sector is an enquiry undertaken in 16 languages over a 12-month period (2011-2012) and encompassing 99% of ICMIF members. The research has listened to and analysed global digital and online conversation and content relating to the cooperative and mutual sector. It has compared it to that of the stock companies, drawn comparisons between developed and developing countries and examined sentiment, trust and emotion.

Essentially the sector is most associated with sharing its profits. This is the most visible and talked-about aspect or "value" associated with the mutual model. Also of significance is the value of being an organization that thinks about the long-term and sustainability. Less visible, certainly at a global level, is the value of being a member-owner of one of these organizations ('without shareholders', 'owned by you', 'member engagement' and 'controlled by members').

As shown in the following chart, there are regional variations in the perception of mutual insurers according to the values which are perceived as most important to these local audiences[22].

Regional variations in association with cooperative and mutual values

[22] For example, in the Latin American market, the reputational benefit of sharing profit is by far the most dominant characteristic associated with cooperative and mutual insurers.

5. Statistics

According to research by ICMIF, based on 2013 data, premium income, assets, investment and social data of over 5,000 insurance organizations in 77 countries, the global mutual and cooperative insurance sector had:

- USD 1.26 trillion in premium income
- 27.3% share of the global insurance market
- USD 7.8 trillion in total assets
- 1.1 million people employed
- 915 million policyholders/members

Notably, 86% of total global mutual insurance business was accounted for by mutual insurers in the ten largest insurance markets, with mutuals in the USA and Japan alone accounting for over half (54%). In five of the ten largest insurance markets, the mutual sector held a market share of more than a third, including four of the six largest markets, which reported record mutual market share levels as follows: USA (36.3%), Japan (45.3%), France(10) (46.3%) and Germany (43.3%).

Mutual market share in the 10 largest insurance markets

Global rank*		Mutual market share 2013	2012	2011	% growth 2012-2013	% share of global market*	% share of mutual market
1	USA	36.3%	34.5%	34.3%	+5.3%	27.4%	36.5%
2	Japan	45.3%	43.5%	42.6%	+4.1%	10.7%	17.8%
3	UK	7.6%	7.8%	7.9%	-2.2%	7.1%	2.0%
4	France[10]	46.3%	45.0%	44.3%	+2.8%	6.5%	10.9%
5	China	0.3%	0.3%	0.2%	+18.2%	6.1%	0.1%
6	Germany	43.3%	43.1%	42.1%	+0.7%	5.4%	8.5%
7	Italy	22.9%	20.3%	17.2%	+12.7%	3.7%	3.1%
8	Republic of Korea[11]	10.2%	9.4%	8.9%	+8.3%	3.2%	1.2%
9	Canada	19.3%	19.3%	18.9%	0.0%	2.8%	2.0%
10	Netherlands	49.3%	49.2%	45.8%	+0.2%	2.2%	3.9%
					Total	75.0%	86.0%

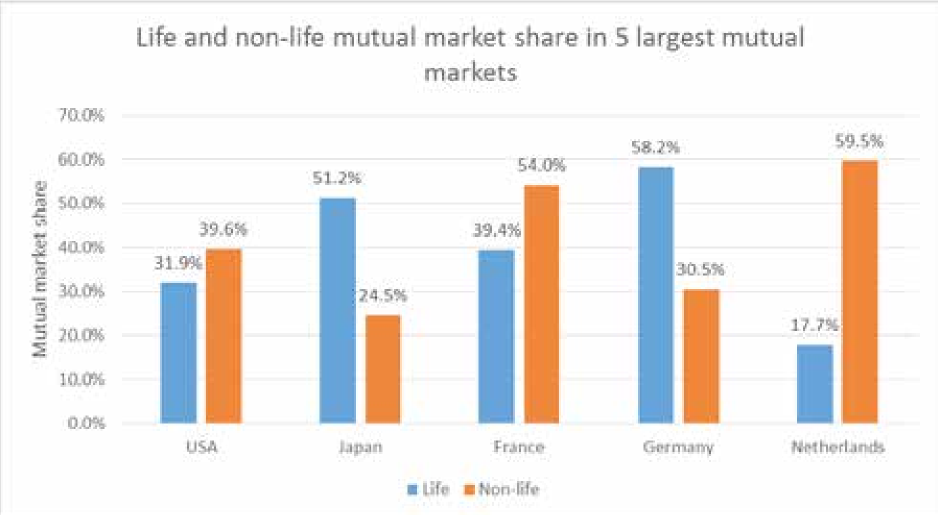
Source: ICMIF

*Global rank and % share of global market as per Swiss Re World Insurance in 2013

Life versus non-life[23] including health

Different markets exhibit different characteristics, based on the evolution of insurance in the country. In Japan for instance, life mutuals have a substantial market share but non-life mutuals have little presence. In France, by contrast, mutuals are more concentrated in non-life and health. In the US and Germany mutuals play a significant role in both life and non-life markets.

Mutual premiums account for more than half of total life business in seven markets, including Japan (51.2%) and Germany (58.2%), the second and seventh largest life markets in the world respectively. In France (the second largest global non-life insurance market) and the Netherlands (seventh largest), the mutual sector held more than half of the total non-life market.



Asset values of the mutual sector

The global mutual insurance sector held record asset values of USD 7.83 trillion.

Mutual insurers' total assets by region

	Total assets (USD millions)			% growth
	2013	2012	2011	2012-2013
Europe	3,207,928	2,977,137	2,975,066	+7.8%
North America	2,617,565	2,425,275	2,279,592	+7.9%
Asia & Oceania	1,967,232	2,178,213	2,202,797	-9.7%
Latin America	31,243	31,031	27,485	+0.7%
Africa	7,216	6,911	6,686	+4.4%
Total	7,831,184	7,618,568	7,491,625	+2.8%

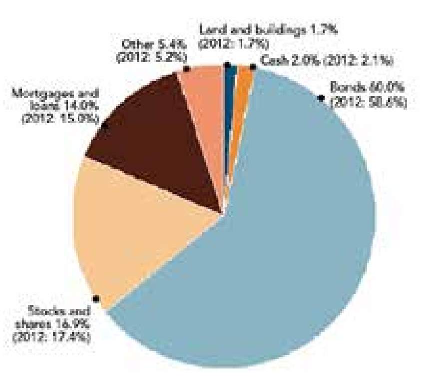
Source: ICMIF

[23] In marine business, over 90% of the world's commercial tonnage is insured by international group P&I (protection and indemnity) clubs, which are mutuals.

Investment assets of the mutual sector

Investments of the global mutual insurance sector are currently valued at over USD 6.6 trillion. Mutual insurers' investment values have proved resilient to the volatility of global financial markets since the crisis[24]. At a global level, 60% of mutual insurers' total investments were invested in bonds. A further 17% was invested in stock and shares (equities), and 14% of invested assets were in mortgages and other loans. The remaining 9% of mutuals' investments were held in cash (and other short-term) investments (2.0%), property and real estate (1.7%) and other investments (5.4%), which included investments in undisclosed financial instruments and derivatives.

Investment breakdown of mutual insurers (2013)



Collectively, the five largest markets accounted for over 80% of the mutual sector's total investments. US and Japanese mutuals continued to hold a higher proportion of bond investments (over 70%) than the global average, and a lower share of stocks and shares in their investment portfolios (9% and 11% respectively).

Number of employees in the mutual sector

At a global level, a total of 1.09 million people were collectively employed by mutual insurers in 2013, representing an increase of more than 10,000 employees (or 1.2%) from the previous year.

The European mutual sector employed 42% of the global total. Just over a third of mutual employees work for North American mutual insurers.

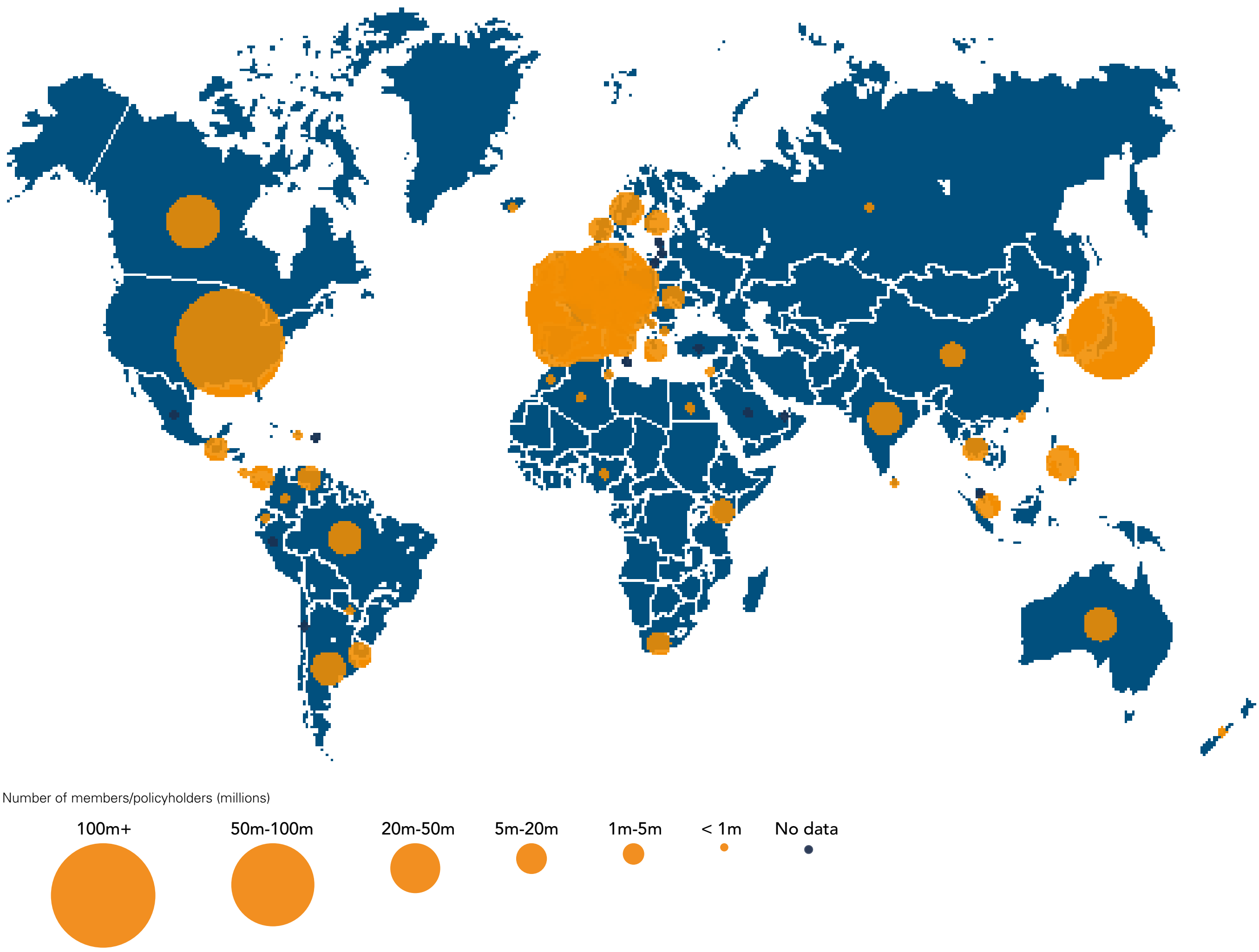
[24] They also were a third greater in 2013 compared to pre-crisis (2007) levels (USD 5.0 trillion).

Number of members/policyholders of mutual insurers

ICMIF's definition of "members/policyholders" in this instance encompasses the number of customers and the number of persons/people insured by mutual insurers, as there is no consistency between markets regarding which figure (if any) is reported. Our current analysis indicates that approximately 915 million members/policyholders are served by mutual insurance companies.

Just over 80% of member-policyholders of the mutual insurance industry were located in Europe (389 million) and North America (350 million). The Asia & Oceania region had 144 million policyholders, and there were 25 million people served by mutuals in Latin America and 7.5 million in Africa.

Global map of members/policyholders of mutual insurers (2013)



As updated data was found in 2013 for both new and existing markets, previous year's figures were revised where available.

6. Governance

The International Association of Insurance Supervisors' (IAIS) Insurance Core Principle 7 sets standards, gives guidance and proposes a methodology to supervisors in the area of corporate governance. As far as mutual and cooperative insurers are concerned, ICP 7 recognises that the governance of mutual insurers differs from that of stock companies[25], adding however that the standards are sufficiently flexible to be adapted to them.

Some flexibility is to be expected within any principles-based standards, and so too is proportionality: as the 2011 OECD Guidelines on Insurer Governance[26] recommends:

> (…) the guidelines may need to be tailored or applied in such a manner as to reflect the nature, scale and complexity of the business and the risks to which they are exposed [27].

Agency theory[28]

In most cases, mutual insurers have had to adapt their governance practices to meet the expectations of codes set primarily for stock companies. Mutuals, of course, share the same fundamental governance challenge as stock companies: namely how best to delegate the day-to-day management of the entity to a group of managers to ensure efficient operations, while maintaining overall strategic control and overall management of the entity, with all the agency problems[29] that separating management from control can entail. Accordingly, many of the instruments, procedures, principles and rights developed or established in the context of the stock company model apply equally to mutual insurers[30].

The potential misalignment of interests between an insurer's owners and its policyholders is an issue that is addressed in the aforementioned OECD Guidelines.

> 'As in the case of ordinary corporations, there may be a potential misalignment of interests between owners and managers at insurers given the difficulty in achieving perfect monitoring of management – symptomatic of the classic principal-agent problem. **The nature and extent of the misalignment may vary depending on whether an entity is structured as a stock company or as a mutual insurer**. In both cases, there is the potential divergece of interests arising from the separation of ownership from control, as managers of the insurer may pursue their own interests contrary to the interests of shareholders (in the case of stock companies) and member-policyholders (in the case of mutuals) [31].

[25] 'Governance of insurers formed as mutuals or co-operatives is different from that of insurers formed as joint stock companies (i.e., bodies corporate)…. These standards are nevertheless sufficiently flexible to be adapted to mutuals and co-operatives to promote the alignment of actions and interests of the Board and Senior Management with the broader interests of policyholders'. ICP 7, para 7.07

[26] Due for revision in 2016

[27] *OECD Guidelines on Insurer Governance*, 2011, Introduction, p.8

[28] Mayers, D. and C. Smith, *Ownership Structure across Lines of Property-Casualty Insurance*, in: Journal of Law and Economics, 31, 351-78, 1988

[29] The agency theory aims to explain the manner in which businesses are organised and how managers behave. This theory has been used by scholars in accounting, economics, finance, marketing, political science, organizational behaviour and sociology. Kathleen M. Eisenhardt *Agency theory: Assessment and Review* in The Academy of Management Review,1989, Stanford University http://www.jstor.org/stable/258191?seq=1#page_scan_tab_contents

[30] *OECD Guidelines, IV Stakeholder protection, Mutuals.*

[31] *OECD Guidelines, Some specificities of the insurance sector, Alignment of interests*

In other words, different forms of ownership may be better suited to particular situations. The stock and mutual forms of ownership each provide mechanisms for controlling agency conflicts by limiting the ability of various parties to behave opportunistically.

So if we consider the three key stakeholders of an insurance company – manager, owner and customer – and their respective roles:

- owners provide capital in return for a share of the residual income stream of the company;
- managers decide how the company is organized, financed and run in return for a salary;
- customers pay policy premiums in exchange for stipulated payments in the event of a specified event.

We note that stock companies and mutuals differ fundamentally with regard to the way they combine the three functions. Stock insurers have a standard corporate form in which the three key stakeholders are separate parties; in mutuals, the customers tend to own the company. The strength of mutuals lies in the alignment of customer and owner interests. Among other things, it allows mutual insurers to pursue longer-term strategies, as policyholders tend to be far more concerned by the company's financial strength, excess capital, and stability, with as low a level of risk assumed as reasonably possible. This alignment according to Moody's[32] is the one differentiating factor from shareholder companies which can make a very substantial difference in the way the two forms of companies are managed and the risks they are willing to assume.

Conversely, mutuals are not subject to corporate control through market forces in the same way as shareholder-owned companies, which means that they need to have other processes in place.

> 'However, as ownership interests (be it through a share or a policy insurance contract) in mutual insurers are non-transferable and non-negotiable (cooperatives) and tend to be dispersed, market control mechanisms such as the threat of takeover, strengthened management oversight by a block of shareholders, or the use of stock options as incentive measures are limited, if not completely lacking. Thus, the discretionary power of management in mutual insurers may be more extensive than in stock companies, unless counterbalanced by some other control mechanisms. These limitations should be taken into account when elaborating an appropriate corporate governance framework for mutual insurers.[33]

[32] Moody's insurance special comment: *Revenge of the Mutuals*, August 2009
[33] *OECD Guidelines on Insurer Governance, Alignment of interests*

General principles of governance

Still referring to the OECD Guidelines, we note that the governance concepts, issues and challenges relevant to stock companies are broadly applicable to mutual insurers. Certain essential features of mutual governance should however be outlined as they relate to the direct role played by policyholders in the governance which constitutes a distinguishing factor from shareholder owned companies[34].

This unique feature relates to three core elements[35]:

a) voting and participation;

b) distribution of surplus;

c) information and disclosure.

a) Voting and member participation in governance

The election of the board of directors of mutual insurers is generally organized in one of two ways: a direct model or an indirect approach. In the former, member-policyholders of the mutual insurer directly elect the board of directors and can participate in the general meetings of the mutual. In the latter model, the member-policyholders elect member representatives who then, in turn, elect the board of directors and participate in general meetings as delegates of member policyholders; in this case, the views of members are indirectly represented through these representatives.

Whilst the general ‘one-person, one-vote principle’ is widely applied, there are different models allowed by the law in a number of jurisdictions. In northern Europe for example, where the Nordic mutual model prevails, representation and voting rights have their background in the advanced way in which mutual-type organizations can make use of external capital, in the form of guarantee funds.[36]

Regardless of the model in place, member-policyholders generally have the opportunity to participate actively in the governance of the mutual and, either directly or indirectly through a representative, participate and vote in its general meetings, the highest decision-making body of a mutual.

The boards of mutual insurers are in many cases drawn directly from among the membership – a feature that is intended to guarantee good and effective control for ensuring that management prioritizes the interests of member-policyholders. It should be noted that many mutuals have a nomination committee (as one of a number of board sub-committees) which carefully screens candidates.

Many mutual insurers’ boards rely on the support of independent experts. To comply with Solvency II’s requirements, most European mutual insurers have enrolled their board members in specific training or education activities to increase their technical insurance knowledge.

[34] This is thus also of particular interest to the OECD, which takes a keen interest in how large institutions ensure effective member participation in the governance of the organization when the “ownership” base is widely dispersed and potentially disinterested in governance matters, and when there is limited external scrutiny and market discipline.

[35] *2011 OECD Guidelines on Insurer Governance*

[36] ‘*Study on the current situation and prospects of mutuals in Europe*’, op.cit.

The member policyholder: status, rights and obligations

Generally, membership in a mutual insurer is acquired at the signature of the insurance contract without any extra membership fee. In most cases, there is a binding relationship between being a policyholder and becoming a member; however non-member business is also permitted by law and in such cases is foreseen in the bylaws of the undertaking. Membership cannot be sold or transferred and ends when the insurance policy lapses, matures or is cancelled.

Members of a mutual have rights which derive from the insurance contract:

1. Payment of claims

2. Attending the annual general meeting

3. Electing the Board of Directors

4. Receiving funds from a distribution of surplus, if agreed by the Board of Directors

5. Voting on fundamental corporate transactions such as mergers, demutualization, and transfers of business.

Supplementary members' calls

Mutual and mutual-type associations with variable contributions may call for supplementary contributions[37] from their members (supplementary members' calls) in order to increase the amount of reserves that they hold to absorb losses.

Exceptionally, members can be liable for the obligations of the mutual to the extent stipulated in the mutual's articles of association[38]. Generally, members' liability is explicitly excluded.

Administration of assets

Provided the mutual meets its solvency requirements, reserves are primarily used for the benefit of the members, either current or future. The distribution of surplus to members is hence optional. The possibility of such distribution is provided for in the articles of association and the issued policy. Any distribution is decided by the Board of Directors and does not have to be approved at the General Meeting.

b) Distribution of assets in the case of liquidation, winding up or transformation

The question of asset protection is an essential one as it addresses the notion of ownership of the undertaking and its accumulated assets.

In general, and despite different ownership features between jurisdictions[39], the members of a mutual do not have any divisible property interests in the net value of the company.

[37] http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32009L0138, Article 52 DIRECTIVE 2009/138/EC
[38] In Denmark, members are liable for the obligations of the organization. For ordinary mutual insurance companies (Gensidige selskaber) and those falling under de minimis rules, The Financial Business Act, Section 112 states that the articles of association of mutual insurance companies shall […], contain provisions regarding: the liability of members and guarantors to the obligations of the company, and regarding the mutual liability of members and guarantors, cf. section 284 I.. For more detailed information we refer to the Study mentioned under note 15.
[39] Countries specify this by mentioning that the policyholders are the current members. In addition, in some countries it is mentioned that the general law is applicable only when the Statutes do not state otherwise

In the event of a winding-up, and after all the mutual's liabilities have been settled, the members of a mutual considered as its owners are entitled to a share of the remaining liquidation surplus. In some jurisdictions however, there are specific regulations concerning what should be done with the annual surplus and this is mainly left open to the mutual's articles of association.

c) Information and disclosure

In Europe, the application of Solvency II will set new standards on reporting from January 2016 and will undoubtedly represent a paradigm shift in terms of communications with the outside world.[42]

For mutuals, the pillar III reporting element of Solvency II imposes entirely new reporting processes. The feeling among the European mutual sector is that the demands for public disclosure are generally excessively detailed and far too extensive for the target group of the information. Many of the information requirements have no practical uses, even for highly-informed readers, unless they are professionals within the industry itself.

Some proportionality will, however, be applied as the Directive states that some exemptions to regular supervisory reporting shall be granted to those undertakings that represent less than 20% of a Member State´s life or non-life market respectively. It should be noted that in some jurisdictions, exemptions can be quite limited.

In the United States, rating agency Moody's observes[43] that mutual undertakings tend not to report with the same level of frequency and detail as their PLC counterparts; although some large US mutual life companies publicly report on an annual GAAP basis, many do not, and none reports GAAP results in detail on a quarterly basis. The rating agency adds that mutual insurers' financial performance never generates the same kind of interest as stock companies' performance, particularly in the short term. This can be an advantage for mutual insurers, as they are less likely to be the target of adverse publicity or an unhealthy focus on the quarterly reporting cycle.

[40] *EC Study on Mutuals*, op.cit..
[41] Upon winding up, in total, 6 out of 38 legal forms in the European countries have a legal system, which assures that the remaining assets are distributed to similar (not-for-profit) types of organizations. *EC Study on Mutuals*, op.cit.
[42] EIOPA note of 29 June 2015 on quality public disclosure https://eiopa.europa.eu/Publications/Other%20Documents/EIOPA_high%20quality%20public%20disclosure_Solvency%20II.pdf
[43] Moody's insurance special comment: op.cit.

7. SWOT analysis

Strengths, weaknesses, opportunities and threats for mutual insurers

Strengths	Weaknesses
• ownership structure allows mutuals to 'play a long game' • No return on investment objective • highly trusted brands • superior customer satisfaction • flexibility of not paying dividends	• rate of change of insurance markets and consumer expectations • limited access to new capital • weaknesses in governance • difficulty of engagement with members who don't understand their role

Opportunities	Threats
• meeting new needs (e.g. one-stop shop) • further product innovation • leveraging customer loyalty • invest in emerging markets	• Digitalization of personal lines which may undermine the relationship with members • Adverse selection resulting from price wars • Regulation more leaning towards stock companies causing additional cost

8. Business lines, investment strategies and conduct of business

Mutual insurers operate in all lines of insurance: property & casualty (or non-life) including health, life and pensions and, to a lesser extent, reinsurance.

Property and casualty

According to ICMIF research[44], mutual non-life premiums globally were dominated by motor (33.4%), health (26.0%) and property and fire insurance (23.8%). The remaining lines of non-life business contributed just 17% of mutual business, the majority of which was accident and liability policies (8.1%). In three of the five global regions, motor insurance was the largest product line and this accounted for more than half of the market in Latin America (60%) and Africa (52%). Motor products contributed 38 % of North American mutuals' total non-life premiums, and just over a quarter (26.9%) of European business.

Cost and effectiveness (cover): mutual versus shareholder-owned insurers

We found very little literature on the difference between mutuals and stocks on this issue. However a US academic study of the property liability insurance industry found that on a total firm basis, stock companies have higher total risk[45] than mutuals as the latter tend to underwrite less risky business[46].

This finding is confirmed by an analysis of commercial and personal lines by rating agency AM Best, which shows that stock companies are more likely to concentrate on commercial lines (with a greater focus on liability) while mutuals tend to focus on personal lines, which often fits better with their initial purpose. Personal lines business tends to be more stable and is more highly regulated, while prices in commercial lines tend to be more cyclical[47].

In the Netherlands, a DBB working paper[48] concluded that mutuals offer the greatest cost advantage to policyholders in accident and health insurance.

In the United States, the large mutual groups that conduct multi-state or national operations[49] have few structural differences from their stock counterparts[50]. This is consistent with insurance consumer buying patterns, which in most cases are dependent not on the legal form of the company, but on affordability and service [51].

44 *Global Mutual Market Share*, ICMIF, 2015, based on 2013 figures.
45 measured by the variance of the loss ratio
46 The analysis undertaken by the academics suggests stock insurers have more risks than mutuals where the risk inherent in future cash flows is proxied by the variance of the loss ratio. By Joan Lamm-Tennant and Laura T Starks, *Stock versus mutual ownership structures: the risk implications*
'Empirical tests of the risk differences between mutual and stock are powerful (95% assets of the P&C of US insurance industry over an 8-year period) using aggregate risk measure and additional risk measures decomposed by lines of business and geographical areas.' http://faculty.mccombs.utexas.edu/laura.starks/lammtennant%20starks%20jb.pdf
47 Best's special report, *Addressing Structural Differences In the Rating Process, US/Property Casualty*, August 2012.
48 Bikker, Jacob A., Janko Gorter, *Restructuring of the Dutch nonlife insurance industry: consolidation, organizational form, and focus*, in: The Journal of Risk and Insurance, 2011, Vol. 78, No. 1, 163-184.
49 In contrast to Europe where those are almost non-existent.
50 Best's special report, op.cit
51 AM.Best, Special Report, *Addressing Structural Differences In the Rating Process*, August 2012t.

Geographic diversification

Generally, mutuals are known to apply less geographic diversification and in the US, stock companies are shown to have greater concentration in those geographic areas that have the greatest risk; this is consistent with the degree of risk in insurers' portfolios[52].

Financial performance

How do mutual insurers perform compared to their stock counterparts? Not surprisingly, mutuals have a good track record with regards to "customer-orientated" performance measures[53].

That said, it is difficult to make comparisons, given the different scope and activities of mutual and stock insurers, although some studies show that mutual and stock insurers are equally efficient in managing unit costs and generating high returns[54].

Mutual insurers tend to have significantly lower costs, possibly resulting from their less complex structures, as per the analyses by the French and Dutch Supervisory Authorities, ACPR and DNB[55]. Quite surprisingly, the Dutch working paper also found that economies of scale are larger for smaller firms and become diseconomies for the largest firms[56]. Additionally, specialization was found to significantly lower operating costs and acquisition costs. This confirms that focusing on one or a few lines of business can have financial benefits, as evidenced by the excellent efficiency scores of mono-line insurers[57].

In rating terms[58], the performance of mutual and stock companies is similar. As expected, shareholder-owned company performance, as measured by combined ratio, is generally slightly better than that of mutuals. However, the variances in surplus growth, particularly among those rated above B+, are not drastically different. When the investment and underwriting performance are combined, surplus growth at each rating level above B+ is consistent across both shareholder-owned and mutual companies.

In the US, AM Best statistics on loss ratios, calculated as claims and associated expenses divided by earned premiums, show that on an aggregate basis, stock insurers have maintained a consistently lower loss ratio than mutuals. This may be attributed to mutuals seeking to minimize premiums and maximize claims payments, in line with their business strategy and member ownership, rather than seeking to maximize profits.

52 Joan Lamm-Tennant and Laura T Starks, *Stock versus mutual ownership structures: the risk implications*
53 '*Mutual life offices: a contribution to the governance debate*' Stephen Diacon*, Chris O'Brien*, Leigh Drake*, Noël O'Sullivan† * Centre for Risk and Insurance Studies, Nottingham University Business School
54 Shinozawa, Yoshikatsu, *Mutual versus proprietary ownership: an empirical study from the UK unit trust industry with a company-product measure*, Annals of Public and Cooperative Economics Volume 81, Issue 2, p. 247–280, June 2010.
55 See: Autorité de Contrôle des Assurances et des Mutuelles, *Rapport d'activité, 2009.*and *Performance of the Dutch non-life industry, competition, efficiency and focus*, Working Paper n°164 2008
56 Competition was measured indirectly by looking at scale of economies and X-inefficiency.
57 Hence making, on average, more economies of scale than in multi-line business.
58 AM Best's rating approach assesses capital strength, operating performance and business profile.

A higher loss ratio is thus acceptable for mutuals. Indeed, mutuals often have an attractive cost structure and, not being listed companies, tend to be less exposed to margin pressure and shareholders' expectations. AM Best analysis suggests that mutuals consistently run at a slightly lower expense ratio than stock companies.

This superior performance of mutuals may be partially attributable to their focus on serving a clearly defined customer (eg, socio-professional) group and their ability to assess and manage the risks presented by that group compared to broader or more distant insurers. In many instances, mutuals have developed risk-awareness and prevention campaigns, or safety and inspection standards to mitigate risk and reduce losses. Proximity between the firm and its customers also reduces moral hazard, i.e. policyholders may be less inclined to defraud a mutual to which it feels an affinity or closeness, than a remote, unconnected insurance company.

Health insurance

Health insurance dominates mutual non-life business in Europe, totalling 41% of total regional premiums in 2013, with prevalence in the Netherlands and France. But it is also quite significant in other regions of the world, such as North America (18%) and Asia & Oceania (18%), with over 80% of Australian non-life premiums generated by the mutual health sector.

As far as Europe is concerned, a recent estimate shows that mutuals provide healthcare and social services to 230 million European citizens. In France[59] alone, mutuals provide health insurance to 38 million people, totalling more than 50% per of the French population. Besides providing insurance services, the French mutual-type organizations manage their own healthcare facilities, such as hospitals, pharmacies, laboratories, dentists, and homes for the elderly[60].

Life insurance

Just under a half (46.4%) of global mutual life premiums were derived from traditional life insurance products, and a third (32.4%) from pension and annuity contributions. Investment and retirement savings products accounted for 11% of mutual premiums, the majority (over 95%) of which came from European insurers. The remaining 10% of the mutual life market was made up of long-term accident/health and disability insurance, and other miscellaneous lines of life business, such as creditor and income protection policies.

Traditional life insurance was the largest contributor to mutual life business in the majority of regions with the exception of European and North America, where mutuals held a lower proportion of traditional life insurance than other regions, accounting for 30% and 40% of their respective regional markets.

Pension and annuities were the largest line of life business for mutual insurers in North America, accounting for almost half (48%) of total mutual business. In Europe and Asia & Oceania, pension business contributed around a quarter of mutual life premiums.

Investment and retirement savings policies experienced a renewed growth in Europe where they made up 28% of the mutual market.

59 In France, mutual insurance started as a social movement as shown by the records which note the existence a fraternal benefit society in the year 1319. Mutuality contributed to the development of social protection in health and gradually, retirement schemes based on democratic practices which were an alternative to the mainstream insurance models which were based on lump sum contributions, proportional to the income. The author's translation of Michel Dreyfus' article , in Alternatives Economiques Poche n° 022 – January 2006

60 European Commission study: *Study on the current situation and prospects of mutual in Europe*, in http://ec.europa.eu/enterprise/policies/sme/files/mutuals/prospects_mutuals_fin_en.pdf

Performance

The absence of shareholders reduces the incentive for managers to behave opportunistically by, for example, setting reserve levels too low or investing so aggressively as to exceed the firm's risk appetite. The absence of shareholders also favours the setting of premiums at a sufficiently high levels to ensure adequate reserving. This constitutes a clear advantage to life insurance under mutual ownership.

Mutuals may also offer other benefits to customers, such as lower charges for withdrawals[61].

According to a study by Nottingham University, the impact of mutuality on risk-taking appears to be mixed: mutuals tend to use less reinsurance and invest a greater proportion in equities. They have less concentrated investment portfolios and more niche or specialized business lines.

The rating agency perspective suggests that mutuals operating in life insurance have the following intrinsic strengths[62].

- o stronger capitalization;
- o less risky business focus;
- o simpler product offerings;
- o less headline risk (i.e. reputational risk deriving from less financial/public disclosure);
- o affinity, 'affectio societatis' identification;
- o strong distribution (salespeople are often part of the target group hence in close contact with the customers);
- o strong underwriting skills;
- o robust and resilient balance sheet;
- o lower earning profile: higher claims pay-outs, i.e. a better claim-to-premium ratio;
- o diminished access to capital markets, and therefore less dependence on it;
- o greater alignment of owners and policyholders with longer-term orientation.

61 *Mutual life offices: a contribution to the governance debate,* Stephen Diacon*, Chris O'Brien*, Leigh Drake*, Noël O'Sullivan† * Centre for Risk and Insurance Studies, Nottingham University Business School

62 Moody's special comment "*Revenge of the Mutuals – Policyholder-owned US life insurers benefit in harsh environment*"

Conduct of business

Mutual insurers across the world strive to be leaders in customer satisfaction and service. Many have set up customer service review panels and regularly score very well in customer satisfaction index rankings.

Evidence tends to show that mutuals are more likely to provide better service; interestingly, even where customer/members of mutual insurers are not aware that the company is mutually owned, they have a more positive attitude towards the business in general[63].

The client-centric model is one possible explanation for this. Alternatively, the long-term thinking that is typical within mutuals suggests that they invest more in employee development. Some refer to the' service profit chain' to describe the relationships between profitability, customer loyalty, and employee satisfaction, loyalty and productivity[64].

Changing customer behaviours and new technologies have encouraged and enabled mutuals to become more competitive. Mutuals will often refer to "trust" as one of their unique selling points (USP). Other USPs include:

- a decentralized organization
- proximity to the customer
- personalized service
- general tied agents
- centralized marketing
- profits returned to the customer (eg premium discounts on policy renewals).

[63] The score for the industry as a whole fell from 52% in 2008 to 51% in 2009. For mutual insurers however the score was 58%. Association of British Insurers (ABI), Industry report 2007/08 *Customer impact survey, 2008*. Calculation on the difference between mutuals and stock holding companies: Association of Financial Mutuals: http://www.financialmutuals.org/index.php?option=com_content&view=article&id=93

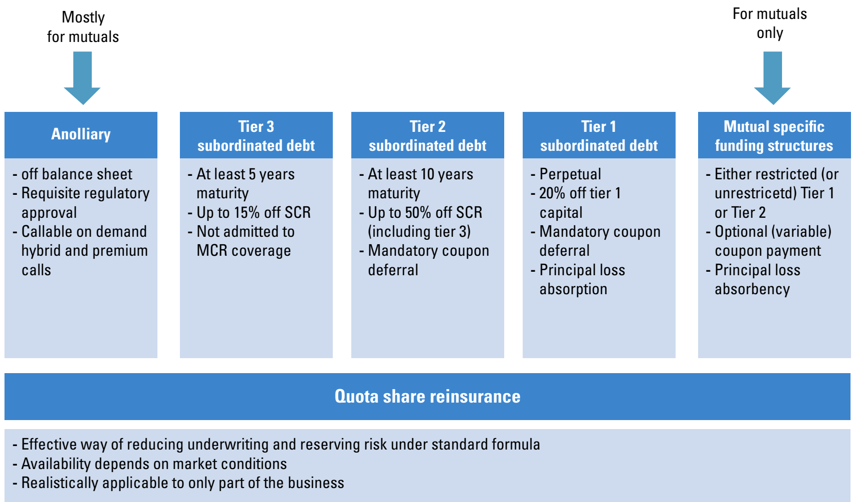
[64] The links in the chain are as follows: Profit and growth are stimulated primarily by customer loyalty. Loyalty is a direct result of customer satisfaction. Satisfaction is largely influenced by the value of services provided to customers. Value is created by satisfied, loyal, and productive employees. Employee satisfaction, in turn, results primarily from high-quality support services and policies that enable employees to deliver results to customers. '*Putting the profit chain to work*', Harvard Business Review, March 1994

9. Capital, structure, demutualization and mutualization

Capital

Due to their legal structure, mutual insurers are not under pressure to return excess capital to shareholders. The downside, in particular for small players, is that access to capital markets is generally restricted and this can have some bearing on their financial flexibility. As shown in the chart below, which applies to European mutuals, there are options to raise capital in a Solvency II environment.

Different forms of regulatory capital for insurers
Mutuals: How to raise capital?



Source: Twelve Capital

In many instances, historical barriers to market entry are the reason for mutuals to adopt a more conservative approach to financial management and a more prudent approach to capital. Mutuals' stronger capital position goes hand in hand with have a lower exposure to a short-term liquidity squeeze, as they are less focused on short-term performance and are less reliant on maturing debt[65].

Since 2015 in France and in the UK, separate Acts of Parliament have been passed to allow mutual insurers to raise Tier 1 capital. In France, *certificats mutualistes* can be sold to the members of the company, to companies of the same group and more widely. The remuneration of the certificates is fixed every year by the General Meeting and they are refundable only upon winding-up of the company.

In the UK, mutual deferred shares confer membership and provide each member one vote (regardless of the number of shares held). On liquidation, each shareholder's claim may be capped at the nominal value of the share. The restriction on voting rights is intended to protect the "one member, one vote" principle and so help prevent investors from forcing the demutualization of the issuing company in order to receive free shares.[66]

[65] Moody's special comment "*Revenge of the Mutuals – Policyholder-owned US life insurers benefit in harsh environment.*"
[66] See http://services.parliament.uk/bills/2014-15/mutualsdeferredshares.html.

Mutual deferred shares, *certificats mutualistes*[67] and *mitgliederanleihe* are alternative ways for mutuals to raise either restricted/unrestricted Tier 1[68] or Tier 2 capital. These types of instruments are typically issued specifically for mutual members, while insurance debt is placed with institutional investors. Ancillary own funds are softer forms of off-balance sheet capital which can contribute to meeting solvency requirements if approved by the regulators. These are often a typical feature of property & casualty mutuals.

Apart from these new instruments, a number of structural arrangements and provisioning techniques are available in Europe[69].

<u>Operational profits through retained earnings</u>

- o the best way for mutuals to ensure capital maintenance on an ongoing-concern basis
- o do not, however, provide the right solution when fresh capital is urgently required for meeting regulatory requirements or making acquisitions.

<u>Guarantee capital</u> (investment vehicle offered by certain institutions, which is held by a mutual company against any losses)

- o usually available for mutuals in limited amounts
- o available only from operators who are close to the mutual sector.

<u>Subordinated loans</u>

- o Public issuance
- o Non-public (targeted) issuance
- o Significant amounts have been issued to investors

<u>Supplementary calls</u>

- o Probably only valid for small mutuals with limited geographical operations or a limited or customer base.

<u>Membership accounts</u>

- o In the case of winding-up or bankruptcy, these funds can only be paid back after all other debts have been settled
- o In other cases, funds can only be paid back as long as solvency requirements can be met
- o In the case of paying back the funds, the supervisor must be notified one month before and the supervisor can disallow such paying back

67 Loc.cit.
68 Certificats Mutualistes will count as unrestricted Tier 1, a form of capital as strong as shareholders' equity.
69 AMICE working group on capital maintenance, 2011. www.amice-eu.org.

- o Changes to company statutes on these funds must be approved by the supervisor

<u>Principal Loss Absorbing Deferred Shares (PLADS)</u>

- o Designed to provide a fair and stable return for risk-takers.
- o Have a limit on distributions: the shares are only repayable upon the firm winding up.
- o Distribution is discretionary (not a contractual coupon), which ensures flexibility. Moreover, distribution is capped at a stated percentage to prevent alienation of surplus from members.
- o Can be held by institutions, high yield funds or retail investors. Need listing and secondary markets.
- o Could be suited for smaller undertakings.

<u>Social shares:</u>[70]

- o Nominative,
- o Held by members/clients, one member one vote.
- o Remuneration: interest rate which is close to the average yield of private bonds.
- o Upon winding-up of the company, members have no rights on the liquidating dividend.
- o These shares are negotiable but upon the decision of the General Meeting or Board. No quotation is possible.

<u>Perpetual Securities (CCI) without voting rights</u>[71]

- o Limit of 50% of the total capital,
- o Open to members and the wider public,
- o No voting rights at the General Meeting but will at Special Assemblies.
- o Remuneration is set by the General Meeting and is at least equal to the social shares.
- o Upon winding-up of the company, holders of the CCI have a right to the net assets.
- o These securities are freely negotiable and can be quoted.

<u>Perpetual Securities issued for the duration of the company (CCA).</u>

- o These have only been used by Crédit Agricole (France) so far.

[70] In cooperative insurers only.
[71] These have been introduced by the French Crédit Agricole in recent years.

- o The only possible holders are members of credit institutions or cooperatives.
- o No voting rights are granted at the General Meeting but are at the Special Assemblies.
- o Remuneration is set by the General Meeting and is at least equal to the social shares.
- o Holders of CCA have a right to some of the net assets (in proportion to the held capital).
- o These titles are freely negotiable but are not quoted on a stock exchange (prerequisite admission conditions).
- o The novelty of the CCA is that they are only held by members.

Structure

In some European countries with mature insurance markets, such as France and the UK, a strong consolidation movement is taking place, driven by increased competition from other providers (such as bancassurers) and by the transfer of the "single-production, single-distribution, single-handling" model to a 'multi-producer, multi-distributor' model that is more reliant upon partnerships.

Against this background, mutual insurers have fewer available strategies than their shareholder-owned competitors.

Groups of companies are commonly established as a result of consolidation, leading to control either by majority ownership or by duplicated management structures. Group formation among mutuals through ownership is not possible, as they have no shares and therefore no "owners" that can acquire a controlling stake.[72]

Some mutuals have resorted to establishing plc-type subsidiaries but this dilutes the mutual character of the undertaking, because policyholders of the subsidiary do not gain membership rights.

In France, the creation in 2001 of the 'Société de Groupe d'Assurance mutuelle" commonly known as SGAM, provides the potential to establish a group, whose holding structure reflects the mutualistic principles of governance and a non-exclusive focus on profit-making[73].

[72] In the course of deliberations within the IASB and FASB with regards to IFRS 3 'Business combinations- Combinations by contract alone or involving mutual entities', the IASB observed that differences between the ownership structures of mutual entities and those of investor-owned entities give rise to complications in applying the purchase method to business combinations involving two or more mutual entities. Complications also arise in applying the purchase method to combinations involving the formation of a reporting entity by contract alone without the obtaining of an ownership interest.

[73] Health mutuals have their own group structure called UMG and UGM, Union mutualiste de groupe et Union de groupe mutualiste, respectively.

The SGAM[74] was created by French Law with the Ordinance of 29 August 2001 based on the SGA (sociétés de groupe d'assurance), the existing model for public limited companies, with the aim of enabling the partners of the group to manage significant and sustainable financial links. The mutual group structure is open to all legal types of European insurance undertakings (PLCs, P&C or health mutuals, cooperatives, paritarian[75] organizations, pension providers or reinsurers), provided at least one of the organizations is headquartered in France and thus compliant with the French insurance code. The SGAM itself cannot sell insurance: its purpose is to manage investments and to delineate the strategy of the group.

The main distinction with a SGA is financial; while the SGA provides for financial participation of a company in the group, the SGAM defines the affiliation agreement, which allows several levels of integration of companies within the group, from a mere partnership agreement to a concentrative agreement with strong and industrialised integration.

SGAMs provide mutual insurers with the opportunity to form groups, to exploit economies of scale, to diversify their risk structure and to optimally face regulatory expectations, whilst retaining their specific mutual structure and governance, based on a democratic form of decision-making by their policyholder-members or their delegates[76].

With the transposition of Solvency II, the French grouping structure has evolved into a tighter, more binding SGAM[77], with responsibilities incumbent upon the head of the group, each new SGAM requiring the approval of the prudential and anti-trust authorities.

In parallel, the Solvency II transposition allowed the creation of a new, looser grouping of mutual insurers (GAM), not recognised as a group under Solvency II.[78]

The situation is different, however, in other European Member States.

In Germany, for example, mutual insurers have formed horizontal groups ("Gleichordnungskonzerne"), united by identical management. These groups are, for a limited range of specific purposes, such as competition law, recognised as groups. In the absence of rules for the consolidation of their accounts however, they feel barred from exploiting the benefits that the new prudential framework would offer them, were they a group – as most of their large plc-type competitors are[79].

Overall, the treatment of groups of mutual insurers in the fields of mergers, accounting, competition, taxation law and more is highly inconsistent across Europe.

Existing solutions such as European Economic Interest Groupings (EEIG) or partnerships merely enable the exchange of know-how or focused collaborations on operational issues. Other existing EU concepts, such as the freedom to provide services, and commercial agreements such as distribution partnerships, are perceived

[74] The SGAM is included in the Insurance Code (Code des assurances), articles L 322-1-2 and L 322 1-3 (Decree D 2002-943 of 26 June 2002 to transpose the Directive 98/78/CE of the European Parliament and the Council of October 27 1998 on the supplementary supervision of insurance undertakings in an insurance group).

[75] Jointly administered by the social partners, i.e. employers' and employees' organisations.

[76] Examples of SGAMs existing in France are: Covéa (MAAF, GMF, MMA, 2003); SMABTP (SMABTP, SMAvie BTP, 2006);AG2R Prévoyance, La Mondiale (2007); Sferen (MACIF, MATMUT, 2010); and MACSF (MACSF, le Sou Médical, 2009).

[77] The undertaking and the group must have 'strong and lasting financial' relationship; the group is to effectively exert a dominant influence by way of a centralised coordination on its decisions, including financial, of its entities. Art. L. 322-1-3. Ordonnance n° 2015-378 du 2 avril 2015 transposant la directive 2009/138/CE du Parlement européen et du Conseil du 25 novembre 2009 sur l'accès aux activités de l'assurance et de la réassurance et leur exercice (Solvabilité II)

[78] The GAM aims to facilitate and develop, by means of coordination, the activities of its members that remain directly responsible for their commitment guarantees. The grouping cannot exert a dominant influence on its members or establish strong and lasting financial relationships among its members Article L-322-5, op.cit.

[79] http://www.bpb.de/nachschlagen/lexika/lexikon-der-wirtschaft/19530/gleichordnungskonzern

by many players as insufficient to build a real and lasting presence in a foreign market, the only way out being to establish a plc-type subsidiary[80].

In the US the mutual holding company is derived from the phase of demutualizations affecting the mutual life insurance sector in the 1990s and has provided life mutuals an instrument enabling them to remain competitive, to increase its financial flexibility, as well as the capital needed to support long term growth[81].

Demutualization

A considerable number of demutualizations occurred in Anglo-Saxon countries: between 1992 and 2001 in the United Kingdom alone, a total of 29% of the life insurance market and 75% of the "Building Societies" market were demutualized[82].

Demutualization is a regulated process in which a mutual insurance company converts to a stock company with share capital and voting shareholders. As part of that process, eligible members receive the proceeds of the conversion in the form of cash, shares or a combination of cash and shares.

The reasons for demutualization are wide-ranging: they may include gaining access to capital markets, helping a mutual in difficulties, or allowing members access to a share of the intrinsic value of the organization. But empirical evidence in the 1990s in the US points to competition and industry consolidation as key factors[83].

Within the EU, all Member States have legislation on the legal conversion of mutuals. The rules on quorum and majorities are in general quite onerous and some Member States require conversion to be approved by the competent ministry. As mentioned in the chapter on distribution of assets, the legislation of some Member States follows the principle of solidarity across generations of members, according to which, since the assets of the society were built up over time, they do not belong to the present generation of members. Recently, legal solutions and regulations have been adopted to limit demutualization. In the United Kingdom, there is a proposed bill in development, providing for the introduction of the principle of disinterested distribution in the case of the conversion of an Industrial and Provident Society. This states that net assets can no longer be paid to members, but must be transferred to a society of the same nature or to a charity. Solutions are sometimes found at the contractual level. For example, building societies oblige new members to sign a declaration called a charitable assignment agreement, under which they undertake to pay to a charity any gain that they could make from the conversion of the building society into a plc[84].

In the US the most common way to demutualise is via the conversion to a mutual holding company: the mutual company's net worth (its surplus) is usually distributed to policyholders as stock, cash and policy enhancements. Each policyholder's share of the total distribution is determined according to some accepted method of allocation. The policyholder's membership rights are extinguished but their contractual rights remain unchanged. The company may concurrently issue additional stock in an initial

80 For an example of partnership among large mutual insurers, see Eurapco (European Alliance Partners Company). Objectives are exchange of experience, joint projects, synergies and market impact.

81 The mutual holding company: a new structural option, Association of Life Insurance Counsel, 1997

82 To name a few: Swiss Life (Switzerland), Norwich Union (UK), AMP (Australia); Scottish Widow (Scotland),

83 As shown by Swiss Re's analysis into the life/health demutualizations, Sigma, Swiss re, 4/1999, *The role of mutual ownership*

84 *Mutual societies in an enlarged Europe*, European Commission consultation document, 2003

public offering (IPO), in order to replenish its capital, raise more capital, and establish a market value and liquidity for the stock.

In Canada demutualization regulations for life insurance companies have been in place since 1999 (Mutual Company (Life Insurance) Conversion Regulations). For federally regulated property and casualty mutual insurance companies the following regulations came into force on July 1, 2015[85].

- Mutual Property and Casualty Insurance Company Having Only Mutual Policyholders Conversion Regulations

- Mutual Property and Casualty Insurance Company with Non-mutual Policyholders Conversion Regulations

The new demutualization regulations for Canada's P&C industry requires eligible non-mutual policyholders to participate in a demutualization by having their policies converted as well. In the process of converting, the demutualizing company distributes to eligible policyholders the proceeds of the conversion in the form of cash, transferable shares or a combination of cash and shares.

The financial benefits of demutualization are realized through a transaction accompanying the demutualization process, for instance through which some or all of the newly issued shares would be sold by way of an initial public offering and stock exchange listing.

There is not much evidence that demutualization has brought in new capital to the benefit of existing policyholders.

An AMI/ICMIF study[86] into the annual Money Management data on 25-year, with-profits returns shows that the resulting reduction in investment returns far exceeded the windfall pay-outs. In some cases, the demutualized company clawed back the windfall payment with one year. The reasons behind the decreases in pay-outs of demutualized companies are many and vary in importance between each organization. They include:

1. Cost of servicing the shareholder capital
2. Increased costs of managing the with-profits funds (mostly salary costs)
3. Increased costs of dealing with capital market regulation
4. Increased costs of dealing with investment analysts
5. Increased charges to the with-profits fund
6. Increase in short-term perspective leading to higher fixed income portion of with-profits portfolio which generally results in lower investment returns
7. Higher expense ratios of running a plc life company
8. May have ceased writing with-profits business therefore marketing effect of maintaining good returns is negated so investment returns reduce
9. Costs of, and prevalence of, mis-selling probably higher than in existing mutuals (this is not substantiated by any data)
10. Not as willing to use free assets towards with-profits smoothing effect as they were when a mutual as free assets may be used in other areas.

[85] See Office of the Superintendent of Financial Institutions (OFSI) http://www.osfi-bsif.gc.ca/eng/fi-if/app/aag-gad/Pages/demut.aspx.

[86] Considered the following organisations; Clerical Medical, Scottish Amicable, Norwich Union, Scottish Widows, Scottish Provident, Friends Provident.in a given period (1992 to 2006) and aimed to see the effect of demutualization on the annual pay-outs to policyholders of demutualized organisations.

A UK-inquiry into the effects of demutualizations in the 1990s[87] found there had been substantial increases in remuneration enjoyed by directors of those institutions, but no corresponding improvement in performance.

Some mutuals have established long-standing committees, to continuously assess the advantages and disadvantages of remaining in mutual ownership[88].

Mutualization

Skandia[89] in Sweden and Pohjola[90] in Finland are in the process of mutualization.

Skandia was formed in Stockholm in 1855 and was listed on the Stockholm exchange from 1863. During the 1960´s, Skandia acquired Thule Life Insurance Company, which was renamed to Skandia Liv. Skandia Liv was a non-profit distributing company limited by shares and run on a mutual basis. In 2012, Skandia Liv acquired the Skandia group from the former owner Old Mutual for SEK 22.5 bn (USD 2.6 bn). A new mutual life insurance company was established, Skandia Öms, which acquired the business from Skandia Liv, whereupon Skandia Liv was merged into Skandia Öms. The process was completed by January 2014. Skandia Öms is owned by its 1.4 million customers and they are entitled to vote for the mutual members' Representative Council and to attend AGMs.

The Pohjola financial group in Finland was being delisted from the Helsinki stock exchange, following a decision by the cooperative banking group OP-Pohjola to bid for those shares in Pohjola held by external investors. At the time of the bid, first announced in February 2104, OP-Pohjola owned 37% of the listed shares, though these gave it 61% of the voting rights. According to OP, the group wanted to abandon the hybrid model of a publicly listed financial institution which was only partly cooperatively owned and return the business to entirely cooperative ownership. The move, which involved an offer price around 18% higher than the closing price at the time of the bid, was warmly received by the financial markets and the purchase was completed by the end of 2014. Pohjola, originally an insurer which had been a quoted company since 1912, provides banking services to large and medium sized corporate customers as well as to individuals, has a significant asset management arm and also offers non-life insurance. It also provides central banking services for the 180 or so local cooperative banks which together make up the OP central cooperative. The decision to delist Pohjola has been followed by a decision to rebrand the whole group under the name OP. A separate delisting is currently underway for the large cooperative bank in the Helsinki area, which through a historical quirk had been separately listed since the 1990s. In 2016 this bank, Helsinki OP, will be integrated within the OP cooperative family[91].

[87] All-Party Parliamentary Group for Building Societies & Financial Mutuals (2006), *Windfalls or Shortfalls? The true cost of Demutualization*.

[88] One UK mutual has set up a special Board subcommittee called the Mutuality Defence Committee. Its main task is to approve and sign off all defence preparations. Each year the subcommittee issues a report to the Board entitled Earning our Mutuality'. This informs the process whereby the company is deemed fit to continue being a mutual.

[89] http://www.oldmutual.com/download/17841/2012%2002%2003%20-%20General%20Meeting%20Shareholder%20Circular%20(PDF).pdf

[90] https://www.pohjola.fi/pohjola/media/releases?id=341000&srcpl=1&kielikoodi=en

[91] Voice 83, ICMIF, 2015

10. Solvency II

Solvency II is undoubtedly the most important legislative project for Europe's insurance industry[92]. For mutual insurers Solvency II is associated with:

- o pooling resources or greater reliance on outsourcing
- o increased costs,
- o less flexible use of capital,
- o enhancing the knowledge of risks: improving risk mitigation, strengthening risk management,
- o increasing diversification.

For small and medium sized mutual insurers and niche players in Europe, It is of utmost importance that the principles of proportionality be properly applied, as per the recitals of the directive[93]:

(19) This Directive should not be too burdensome for small and medium-sized insurance undertakings. One of the tools by which to achieve that objective is the proper application of the proportionality principle. That principle should apply both to the requirements imposed on the insurance and reinsurance undertakings and to the exercise of supervisory powers.

(20) In particular, this Directive should not be too burdensome for insurance undertakings that specialise in providing specific types of insurance or services to specific customer segments, and it should recognise that specialising in this way can be a valuable tool for efficiently and effectively managing risk. In order to achieve that objective, as well as the proper application of the proportionality principle, provision should also be made specifically to allow undertakings to use their own data to calibrate the parameters in the underwriting risk modules of the standard formula of the Solvency Capital Requirement.

Proportionality should be evident in the three pillars: (i) valuation of technical provisions and calculation of the solvency capital requirement; (ii) governance requirements and ORSA; (iii) reporting and disclosure.

92 In the European Union, the insurance industry is to apply the new prudential framework by January 2016.
93 DIRECTIVE 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

11. Conclusion

Some of the largest insurance organizations in several developed markets are mutuals, demonstrating the significance of the mutual ownership model within the insurance industry.

In many countries, however, the majority of mutual insurers, which are small to medium-sized, are not well understood due to their legal form. They now also face the challenges resulting from new regulatory requirements which will cause them an additional strain due to their size[94].

These challenges will mainly derive from the high fixed costs of adaptation to and ongoing compliance with the new solvency framework regulation. The emphasis on risk diversification will also challenge the mutual model, which tends to be less diversified and has more geographically confined lines of business. Finally, regulations such as Solvency 2 provide for specific treatment of insurance groups which is likely to harm mutuals, which are predominantly solo undertakings.

One possible solution may lie in the creation of horizontal group structures which will allow for international branding and recognition, but with few exceptions, this is generally not yet possible on a global level[95].

The new regulatory requirements are mainly intended to help curb systemic risk. Maintaining a variety of business models and legal forms could help address this concern, as it provides a greater balance of interests and wider choice to consumers.

Mutual insurance provides an alternative form of enterprise and an integrative and stakeholder-oriented business model. In parts of the world where mainstream insurance companies are the subsidiaries of large international groups, mutual insurers allow the business to remain in national hands and provide a wider choice to consumers.

Last but not least, the very principle of mutuality has wide appeal among consumers and, based on anecdotal evidence as well as structured market research, inspires their trust: to consumers, mutuals stand for stability in the wake of the turmoil on the financial markets[96].

94 In Europe, more than 5000 licensed insurers are reported. SMEs approximately represent 95% of the number of European insurance companies and contribute to some 15% of the market share by premiums. Among this large number of SMEs, most have the mutual or cooperative legal form. See Insurance Europe, Briefing note entitled 'Solvency II The Small and Medium-Sized Undertakings and Solvency II' .

95 In Europe, France, Germany, Finland and Austria allow some kind of horizontal groups. In the US, the mutual holding company. It is interesting to note that more complex legal structures on corporate governance and corporate management exist in countries where the large mutual-type organizations are active in insurance. These complex legal structures include more possibilities for non-member investors; more indirect (representative) structures to guarantee democratic governance.

96 Swiss Re, *Mutuals and Solvency II: opportunities and risks*; *ICMIF Global Reputation Report*, op.cit.

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