

In The Midst Of The Downturn, Many U.S. Mutual Life Insurers Aren't As Down As Their Publicly Held Peers

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Publication Date

Oct. 16, 2009

In the late 1990s, as a number of prominent U.S. mutual life insurers demutualized, some believed that the concept of mutual insurance companies was destined to go the way of the telegraph and the eight-track tape. But a decade later, it's clear that not all mutuals would choose to go down the path of demutualization. What's more, some of the factors that many traditionally considered weaknesses for mutuals—such as their inability to access the capital markets—wound up being strengths of sorts during the recent economic downturn. As a result, many mutual insurers have fared the downturn far better than their publicly held counterparts.

Mutual companies are nonpublic companies that their policyholders own, and as a result, the strategic focus is policyholders' long-term benefit. The ratings on such insurers have benefited from their ownership structure, which does not have to balance the sometimes-conflicting pressures of building adequate capital to protect the policyholders with returning capital to the owners. On the other hand, shareholders own public companies, and their interests are best served by returning profits to the shareholders, which generally results in reduced levels of capital in the insurance company.

Companies within the mutual sector in Standard & Poor's Ratings Services' rated universe are divided into large mutual companies and midsized mutual companies. Large mutual companies have a national presence, a productive captive distribution system and an exceptionally strong capital position. Mid-sized mutual companies share many of the same positive attributes as their larger peers but often have a more niche competitive position and as a result have very strong ratings, albeit at slightly lower levels than their larger brethren. It is important to note that outside Standard & Poor's rated universe of mutual insurance

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companies, there are many small mutual insurance companies that could have significantly different competitive and financial profiles than large and mid-sized mutual companies.

Several mutual life insurance companies have consistently earned Standard & Poor's highest ratings as a result of very strong competitive positions, conservative asset management, favorable liability profiles, focusing on participating life insurance, and exceptionally strong capitalization. There are a couple of lenses through which to compare mutual insurance companies: large companies versus mid-sized mutual companies and public companies versus mutual companies.

Mutual companies have a distinct competitive advantage relative to public companies because they can profitably issue participating life insurance products. Participating products pass excess investment earnings back to the policyholder through dividends. In times of financial stress, the mutual insurer can lower or even suspend the dividends, which can go a long way toward stabilizing capital. Mutual companies, especially larger ones, have captive distribution systems, which consistently sell high-quality life insurance with very high persistency, even in challenging economic cycles.

Midsized mutual companies often have many of the same attributes as their larger peers, but they can lack the national presence or economies of scale. As a result, they often have a strong position in a regional market or a niche product focus. Consolidation among mutual insurers has been glacially slow, as larger companies would rather build capabilities than acquire them. In addition, midsized companies rarely have pressures to combine, as they generally are well capitalized and have minimal activism from their owners/policyholders.

Large mutual companies have earned Standard & Poor's highest ratings. Large mutuals have a powerful combination of consistent distribution strength through captive and affiliated distribution, exceptionally strong capital, and a heavy focus on participating life insurance, which we view to be one of the lowest-risk liabilities. Such companies are a driving force in the life insurance industry, have a national presence, and are household names. They own the relationship with the consumer—either through a career agency system or a relationship via an affiliation group. The customer typically views these companies as a one-stop shop for protection and asset-accumulation products, owning multiple products with the company and having a financial planning relationship with the company's agents. They have larger-scale operations that are similar to those of large public companies, and as a result, their product pricing is often on a par with their public brethren. Large mutuals have historically had strong capital positions, which were significantly redundant at the 'AAA' level, thereby mitigating the need for external sources of financial flexibility.

Large mutual companies with a captive agency include MassMutual, New York Life Insurance Co., and Northwestern Mutual Life Insurance Co. (Though not of the same scale, Guardian Life Insurance Co. of America has a similar profile.) These are the dominant companies in the mutual sector, and all three have significant individual life insurance market shares. They also have a strong focus on selling participating whole life policies, which Standard & Poor's views as being a particularly low-risk product given their ability to compensate for adverse experience through adjustments to the future dividends paid to policyholders over many years. All three companies are also committed to their career agency distribution forces and benefit from the enhanced policyholder persistency that can accompany a sale made through what the policyholder perceives as a value-added relationship with the career agent.

Another category of large mutual companies is focused on selling to affiliated groups. Examples include TIAA, United Services Automobile Assoc. (USAA), and—on a smaller scale—Knights of

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Columbus. These companies benefit from extremely strong levels of policyholder persistency because of their strong ties to the groups they serve. For example, Knights of Columbus's policyholders' affinity with the Catholic Church enhances persistency, USAA's policyholders have ties to the U.S. military, and TIAA has strong ties to the academic and health care markets. Although TIAA is not a traditional life insurance company, instead focusing on retirement planning, the rating on TIAA reflects its very high level of client retention, which stems from the investment yields that allow it to provide enhanced crediting rates to its policyholders.

Midsized Mutuals Often Serve A Particular Niche

Midsized mutual companies benefit from many of the same positive credit dynamics as their larger brethren. However, they often lack the dominant competitive position of large mutual companies. Midsized mutual companies generally do not have a dominant national positions and instead pursue regional strategies or niche products. As a result, these companies tend to rely more heavily on commoditized products (products sold primarily on the basis of price that tend not to require value-added advice from a sales agent, such as individual annuities and term life insurance) for their competitive positions or a higher level of distribution through independent agents/brokers (with the two usually going hand-in-hand) than their larger counterparts. These companies are generally fast followers to their larger competition—whether mutual or public companies.

The Distribution Channels And Product Mixes Of Mutuals Are Competitive Strengths

Mutual companies with a captive distribution system have a significant competitive strength, as these systems have successfully focused on high-quality, participating whole life sales and persistency of both life insurance and annuity products during challenging economic cycles. In some cases, mutual companies employ career agency systems and are closely affiliated with the mutual company—a relationship that could include being housed in sales offices branded with the mutual company, having salary and overhead paid by the company, agents trained by the company, and having long-term incentives for consistent production. In other cases, the mutual company has a distribution arrangement targeting affiliation groups. In both career and affiliation distribution, the channel produces consistent sales with very high persistency. These captive distribution systems are a huge barrier to entry for other insurance companies because building a distribution systems from scratch would at best be prohibitively expensive and at worst an exercise in futility.

Another benefit of a career agent force is that companies have more say in what products and product features they offer rather than being subject to the demands of independent distributors who are seeking to sell commodity products that optimize the latest product features at the most competitive price with the most attractive commission. In today's market, a commodity product strategy sold through independent agents usually translates into the company assuming a higher level of risk, for which there is a cost incurred if the company wants to reduce or offset that risk.

We believe that large mutual companies have benefited in the last decade from a realignment of the public-company distribution systems. As public companies gravitated toward independent distribution, we believe that agents who were more experienced and skilled gravitated toward the mutual companies' career agency systems. As a result of a career agent's focus on long-term customer relationships, this attracts a higher-quality agent who has achieved a higher level of training and

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expertise to maintain a higher-value-added relationship. In contrast, many independent agents tend to be more transactional, selling a customer a product when the need arises but lacking the long-term financial planning relationship with the customer. As a result, some tend to have a lower level of skill and training.

One of the major concerns accompanying a career agency force is a company's ability to attract younger agents to replace older, retiring agents. Historically, career agency systems were training grounds for the life insurance industry. Because career companies traditionally had lifetime relationships with their agents, they could rationalize investing the hundreds of thousands of dollars required to train an agent who is new to selling insurance. Training new agents costs so much because considerable subsidies are required in the first four years of an agent's career. In addition, no more than 25% of agent recruits have a successful selling career after four years. With the number of career agency forces shrinking, the number of companies that are producing life insurance agents is decreasing, and as a result, fewer life insurance agents are entering the business each year. Although certainly indicative of an aging field force, Standard & Poor's believes that the mutual sector as a whole is having success in its efforts to recruit younger talent into the industry, with the larger companies' career agency systems having the highest level of success. Career agency systems have benefited from the recent economic turmoil, as depressed employment opportunities have increased both the quality and quantity of applicants. We believe that in several years, the career agency system will benefit from this period of increased hiring opportunities.

Mutual Consolidation: Beneficial In Theory But Glacially Slow In Practice

In theory, consolidation of mutual companies has potential advantages because they could benefit from increases in both scale (lower unit costs) and scope (offering more products through complementary distribution systems). However, mutual company merger and acquisition activity has been glacially slow, and we expect it to remain so. The reason is that most mutual companies have little outside pressure from their owners to consolidate and great internal pressures to remain independent companies. These pressures come from senior management and employees who derive their livelihoods from the company, state regulators who are responsible for monitoring companies' financial security on behalf of the policyholders, and mutual company insured, who often believe that they could lose a measure of financial security if their company lost its independence. In addition, most mutual companies Standard & Poor's rates are well capitalized and have no immediate financial pressure to combine with another company.

Again, we view opportunities for consolidation along large versus mid-sized company lines. We believe that the large mutuals have limited appetite for acquisition. These companies typically have a strong distribution system combined with a full product portfolio that is operating at or near optimal scale. For these companies, acquiring a mid-sized or small company would be more of a distraction than a potential competitive advantage. If large mutual companies have a weakness in their product portfolio, they are much more likely to build the capacity organically, leveraging their distribution system and training their own talent rather than finding it by merger.

A mid-size mutual company could benefit from combining forces with a similarly sized company. There are a number of mid-sized mutuals that have followed such a strategy, including Western & Southern, National Life Group, Ameritas, and One America. The advantage of such mergers is that companies can gain a competitive advantage through expanding distribution, adding new products, or

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reducing costs on the existing product portfolio by increasing economies of scale. However, we do not believe that these combinations will ultimately transform a mid-sized company into a large company, principally because there are few opportunities to combine mid-sized companies that will result in a company that can challenge the large companies' distribution capacity.

Mutual Ownership Aligns Interests Of Owners And Policyholders

Standard & Poor's views a mutual organization as being lower risk to a company's credit profile, as they primarily have single stakeholders (their policyholders) rather than both policyholders and shareholders, as public companies do. In either form of ownership, execution of the business model is essential for strong ratings. As a result, public companies bifurcate profits to two stakeholders, while mutual companies return capital to policyholders or accrete it for their long-term protection. This is in contrast to public companies, which have to balance the requirements of maintaining capital to support their policyholders and returning capital to their equity owners through shareholder dividends or share-repurchase programs.

Although several companies chose to demutualize in the late 1990s, ostensibly to improve financial flexibility by obtaining direct access to the equity markets, the management teams of most mutuals today believe that the benefits of a single stakeholder outweigh the lack of access to equity capital that being publicly held would provide. Most mutuals maintain significant capital positions, partly because of the lack of demands imposed by equity capital to return gains through share-repurchase programs and dividends and the belief that accreting capital provides stability for the benefit of policyholders. Although many mutuals have established mutual holding companies, an organizational structure that would facilitate a mutual's conversion into a stockholder-owned company, Standard & Poor's does not anticipate many demutualizations in the near future.

By not having equity shareholders, and thereby not having quarterly public GAAP earnings pressure, mutual management teams are less concerned with accounting anomalies that can affect their quarterly financial results. As a result, they can manage their companies with more of an eye toward longer-term financial performance. In addition, there are no shareholders demanding high returns on their equity investment, which helps mutuals price their products competitively.

An area of potential concern with mutuals is the level of activism by the board of directors in the absence of public scrutiny and with less-active policyholders. Although policyholders own a mutual company, the level of influence they exercise with management is usually quite limited. As such, governance practices involving compensation, risk oversight, and succession planning can receive less stakeholder or public scrutiny. Although Standard & Poor's believes there is an adequate level of board engagement at most mutuals, it has the potential to be lower than that of publicly traded companies.

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Key Differences Between Mutual And Public Companies

	<i>Mutual</i>	<i>Public</i>
Capital	Accumulate for policyholder benefit	Need to return to owners through share repurchases and dividends
Pricing	Lower profit targets because of no shareholder demands	Higher internal rate of return to return gains to shareholders
Access to external capital	Limited to reinsurance and surplus notes, unless they have a mutual holding company structure	Debt and equity hybrid available
Management focus	Longer-term focus	Judged on quarterly results
Product focus	Participating whole life	Innovative higher return on equity products
Governance	Few outside pressures	Scrutiny from investors
Financial reporting	Statutory required, GAAP, and management accounting for internal purposes	Both statutory and GAAP required by regulators

Mutuals' Enterprise Risk Management Is Generally Adequate For Their Risks

Enterprise risk management (ERM) for mutual companies often is less comprehensive than that of similarly rated public peers, though there are some notable exceptions. Relative to public peers, mutual companies often have less-complex liabilities, larger excess capital positions, and—as a result of captive distribution—less-volatile liability profiles. These three factors reduce the need for that complex ERM practices the more complex profiles require, such as those with variable annuity living benefit hedging programs or dynamic capital-management programs.

Standard & Poor's ERM assessments for insurance companies ranges from 'excellent' to 'weak', with the bulk of mutuals assessed as being 'adequate'. USAA Life is the only mutual we consider to have 'excellent' ERM. Although the vast majority of these companies are deemed to have 'adequate' ERM, Standard & Poor's believes this is an appropriate level for these companies, given their relatively low-risk product offerings, ability to pass through adverse experience to policyholders through the dividend payout, and excess levels of capital. New York Life had an 'adequate' ERM assessment, albeit with several attributes of a 'strong' program, that did not prevent us from raising our rating on the company to 'AAA' in August 2007. (We've since revised our assessment of New York Life's ERM to 'strong'.)

We also consider Northwestern Mutual's ERM to be 'strong', reflecting effective risk controls, emerging risk management, and strategic risk management. Senior management regularly studies emerging risks and has retained a medical science expert to monitor emerging mortality and morbidity threats. The company uses an economic capital model, based on stochastic modeling of individual risks and aggregated using estimated correlation factors, which it updates regularly. The board and management uses this model when setting risk tolerances and monitoring adherence.

Standard & Poor's considers Beneficial Life and Security Benefit to have 'weak' ERM, driven primarily by their investment risk management. Both companies had concentrations of residential mortgage-backed securities (RMBS) or RMBS-related securities in their investment portfolios, with the expected losses from these holdings significant relative to the companies' capitalization. Beneficial received capital infusions in late 2007 and mid-2008 from its parent company to offset the expected losses from its RMBS holdings. (We withdrew our ratings on Beneficial Life on July 20, 2009, at the request of the company.)

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For mutual companies, the areas of ERM that have caused the most problems for companies are monitoring risk aggregation and holding to established risk limits. In some cases, companies had risks that they believed to be discrete independent risks, but in a stressed economic environment, they were in fact highly correlated risks. As a result, they had risk concentrations in excess of their intended risk limits. An example is a company that purchased CDO and other structured investments that it believed to be uncorrelated, and in fact they all had exposure to RMBS securities. Another example of weakly performing ERM is when a company purchased equities that increased in value rapidly and did not sell the securities off in a disciplined fashion. The result of this is that capital has higher volatility than was contemplated in the company's risk tolerance as the outsized investment decreases in value with market declines.

Operating Performance Tends To Be Less Volatile Than Public Peers'

It is difficult to make meaningful comparisons of mutuals' financial performance with that of publicly traded companies. The presence of excess capital at many mutuals, along with their payment of policyholder dividends, complicates any direct comparisons with public companies on an ROE or ROA basis. For mutual companies focusing on participating life insurance, an unquantifiable question that arises when analyzing a mutual's financial performance is to what extent the potential to reduce policyholder dividends can be considered as a financial cushion that can be used in times of stress to preserve capital, and to what extent is it a necessary cost of doing business that is used to retain existing policyholders and to attract new business.

Thus, we employ a higher level of analytical judgment when analyzing a mutual's financial performance. In Standard & Poor's analysis, a key consideration in determining the strength of a mutual's operating performance is whether it's consistently generating a sufficient level of earnings to maintain the level of capitalization. One benefit of the mutuals' excess capitalization is the additional investment income that it generates, which the company can use to enhance the policyholder dividend or retain.

Although the volatility in the equity markets during the past year has affected the mutual sector's financial performance, the impact has not been as severe as that felt by their publicly traded competitors because the mutual sector, as a whole, is not as dependent on the variable annuity marketplace. Therefore, it is not as dependent on the fee income generated by the separate account values, and it is not incurring the benefit and hedging costs associated with the death and living benefits on many of the variable annuity products sold today. In addition, because of the mutual sector's relatively low subprime mortgage exposure, the level of other-than-temporarily-impaired write-downs directly related to subprime investments has also been relatively low compared with that of publicly held competitors.

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