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Ownership and Governance in the Insurance Industry:
A Review of the Theory and Evidence

NOEL O'SULLIVAN

The objective of this paper is to review the coexistence of mutual and proprietary insurance companies from a corporate governance perspective. The paper begins by reviewing the theoretical justification for the existence of mutual and proprietary companies in the insurance industry. The paper then examines the empirical evidence on insurance company performance and seeks to identify whether organisational structure influences managerial behaviour. Finally, the paper analyses the impact of insurance conversions (i.e. mutualisation and demutualisation) on the welfare of policyholders, shareholders and managers in order to identify whether the conversion process is motivated by efficiency or expropriation objectives.

The governance practices of large companies has become the subject of intense debate in recent years. A central concern for shareholders is the possibility that company managers may pursue objectives which seek to enhance their own well-being at shareholders’ expense. The potential for such discretionary behaviour on the part of managers is increased due to the degree of shareholder diffusion in public companies. Recent academic interest has focused on analysing mechanisms which seek to restore shareholders’ ability to control management. The presence of large shareholders [Schleifer and Vishny, 1986], non-executive directors [Baysinger and Butler, 1985; Cadbury, 1992] executive share ownership [Jensen and Meckling, 1976], and executive compensation contracts [Baker et al., 1990] are governance mechanisms which may be capable of ensuring shareholder influence in the decision-making process. Additionally, the
market for corporate control is frequently suggested as a governance mechanism of last resort whereby ineffective or underperforming managers may be displaced through a change of ownership [Manne, 1965; Oviatt, 1988].

While much public and academic interest has been directed at corporate governance in shareholder-owned (proprietary) companies little interest has been shown in the governance experiences of alternative forms of business organisation. This lack of interest is surprising since many important organisations in society are not shareholder-owned. An interesting example of how alternative types of organisational structure are able to compete successfully is found in the insurance industry where mutual companies, friendly societies, Lloyds syndicates and proprietary companies have coexisted for many years. From a governance perspective, the coexistence of mutual and proprietary insurance companies is of particular interest. An important characteristic of mutual companies is the fusion of the role of customer (policyholder) and owner which serves to alleviate potential conflict between shareholders and policyholders regarding the distribution of company surpluses. However, the merging of the customer and owner functions appears to undermine the model of shareholder control upon which much of the recent governance literature is based. By merging the functions of customer and owner, mutual companies exhibit a greater degree of ownership diffusion which makes effective control of senior management extremely difficult. In addition, the absence of shareholders in mutual companies eliminates the possibility of a hostile takeover – an important mechanism of control in proprietary companies [Rappaport, 1990].

The continued success of insurance mutuals suggests that these companies are capable of utilising alternative mechanisms of control to safeguard policyholders’ interests from managerial opportunism. The objective of this paper is to review the coexistence of mutual and proprietary insurance companies from a corporate governance perspective. The paper begins by reviewing the reasons for the coexistence of mutual and proprietary companies in the insurance industry. The theoretical rationale for this coexistence relates to the potential for conflict between policyholders and shareholders. Three areas of potential conflict are explored: the long-term nature of life insurance policies and the desire on the part of policyholders to avoid the adverse consequences of incomplete contracting; the unwillingness of low-risk insureds to subsidise the risks of higher-risk groups; and mutual policyholders’ attitude towards risk.

Section three analyses the potential for conflict between owners and managers in both mutual and proprietary companies. The separation of the functions of ownership and management in both mutual and proprietary companies suggests a need for appropriate governance mechanisms to
ensure that managers administer the company in the interest of owners. However, in view of the increased level of ownership dispersion in mutual companies and the absence of hostile takeovers, mutual managers are expected to enjoy a greater degree of managerial discretion than their proprietary counterparts. Two issues are addressed in this section: whether mutual companies seek to overcome weaknesses in external governance by emphasising different mechanisms of internal governance compared to their proprietary counterparts; and whether the existing empirical literature identifies any behavioural differences between the two organisational forms. Section four considers the effects of a change in organisational status - i.e. proprietary companies changing to mutual (i.e. mutualisation) or mutuals becoming proprietary companies (i.e. demutualisation). An important empirical question in this respect is whether policyholders, shareholders and managers experience wealth changes as a result of a change in organisational status. Some conclusions and suggestions for future research are presented in section five.

**THE POLICYHOLDER-SHAREHOLDER CONFLICT**

Fama and Jensen [1983a, 1983b and 1985] seek to justify the co-existence of mutual and proprietary companies with reference to agency theory. They argue that different forms of organisational structure can survive and control agency problems depending on the nature of the residual claimants. Proprietary companies are expected to be successful in circumstances where there is a greater need to diffuse risk, to separate risk bearing from decision making, to finance the purchase of organisation-specific assets, and to have a specialised professional management team. The potential for managerial opportunism is countered by the mechanism of the capital markets, principally the possibility of a takeover. Managers are expected to minimise agency costs in order to encourage a favourable performance evaluation of themselves and their organisations in the capital markets and thereby reduce the likelihood of a takeover and subsequent displacement.

Fama and Jensen [1983a, 1983b and 1985] justify the existence of financial mutuals on the basis that their residual claims are redeemable on demand. They argue that the survival of these mutuals depends on their ongoing liquidity which in turn discourages mutuals from engaging in the acquisition of organisation-specific assets. This aspect of redeemability helps minimise agency costs since residual claimants can sell their claims at any time and at a predetermined price. However, while such a rationale is undoubtedly a factor in the continued survival of certain types of financial mutuals, it does not fully explain the existence of insurance mutuals since not all insurance policies possess the redeemability characteristics
envisaged by Fama and Jensen. Indeed, early redemption of many types of insurance policy is penalised by the insurance company — thereby imposing a withdrawal cost on the policyholder.

Hansmann [1985] suggests a number of reasons for the evolution of mutual insurance companies. In respect of life insurance, Hansmann [1985] identifies three reasons why contracting may be incomplete and thereby facilitate the adoption of the mutual rather than the proprietary form. First, since life insurance contracts are typically long-term, it is difficult and expensive to design a contract which can effectively deal with all possible contingencies which may arise during the life of the contract. A central problem for the policyholder is to ensure that his insurer maintains sufficient financial reserves to pay out on the policy when a claim is made. Second, life insurance contracting takes place in an environment of asymmetric information — life insurance customers being relatively uninformed as to the merits and de-merits of competing contracts. In such an environment, Hansmann [1985] argues that life insurance customers are likely to be disadvantaged vis-à-vis the insurance company. Finally, the structure of premium payments in life insurance is designed to make it difficult for consumers to switch between insurers because insurers utilise front-end loading of premiums to tie the insured financially to that particular company. Such a system of lock-in makes it expensive for the insured to voice his dissatisfaction by withdrawing from the insurance contract.

Hansmann [1985] suggests that the problem of incomplete contracting in the life insurance industry may be countered in two ways. First, insurance regulators may intervene to monitor contracting between insurers and their customers. This has been pursued in most countries — typically requiring insurance companies to maintain adequate reserves to provide against foreseeable claims. In the UK for example, all registered insurance companies are required to make detailed annual returns to the Department of Trade and Industry in addition to publishing annual reports and financial statements to shareholders/policyholders. The formation of a mutual is another way of seeking to counter the problem of incomplete contracting. In mutuals there are no shareholders with an interest adverse to that of the policyholders. Consequently, the incentive for the company to behave opportunistically in setting the level of reserves is substantially reduced. The difficulty of market contracting between companies and policyholders is thereby eliminated by eliminating the market and merging the customer and ownership functions.

The uncertainty of long-term contracting which Hansmann [1985] attributes for the existence of mutuals in life insurance, does not adequately explain the existence of mutuals in property-liability insurance. Unlike life insurance, property-liability insurance contracts are usually short-term —
typically of one year’s duration. However, an important characteristic of many property-liability mutu-
sals is the relative homogeneity of the membership. Carter [1993] suggests that the estab-
ishment of many property-liability mutuals is attributable to a particular sector in society
coming together to insure themselves because existing insurance companies
are perceived to charge excessive premiums or impose unacceptable policy
conditions. For example, many mutual companies involved in underwriting
property-liability insurance today incorporate a particular interest group in
the company’s name—clearly signifying their allegiance to the insurance
needs of the named group. Common examples are the Mutual Accountants
Professional Indemnity Company (MAPIC), the Medical Defence Union
(MDU), and the National Farmers Union (NFU).

It appears therefore, that while life insurance mutuals have their origins
in the asymmetric information between stock companies and policyholders,
property-liability mutuals appear to have evolved from the reverse scenario
i.e. proprietary companies being unable to differentiate between insureds in
respect of the risks proposed. This lack of differentiation appears to
encourage those insureds who perceive themselves as being low risk to opt
out of traditional insurance in the belief that the interest-specific knowledge
which they possess would enable them to provide insurance to their
members at a cheaper rate than would be possible if insured by an all-
embracing proprietary insurer. Of course, the diversity of risks which
encourages certain groups to leave proprietary insurance companies is an
important attraction for shareholders in these companies who
may be reluctant to invest in a proprietary company in the absence of such a diverse
portfolio of insureds.

A number of researchers have suggested that the continued coexistence
of mutual and proprietary insurers may be explained in terms of risk.
Indeed, risk is a fundamental aspect of the Fama and Jensen [1983b]
justification for the existence of alternative organisational forms. Fama and
Jensen [1983b] argue that because of differences in the efficiencies of
controlling agency costs mutual companies should be more prevalent in
activities in which the costs of expanding and contracting assets is lower
and in which the costs of valuing those assets are lower. Lamm-Tennant and
Starks [1993] suggest that mutual insurance companies are expected to be
involved in less risky insurance business (risk being defined in terms of
variability in cash flows) than their proprietary counterparts. Lamm-
Tennant and Starks [1993] examine this hypothesis in the US insurance
market and find evidence that proprietary companies have more business in
those lines associated with greater risk. Furthermore, Lamm-Tennant and
Starks [1993] find that US proprietary companies have greater
concentration in lines of greater risk than their mutual counterparts.
Smith and Stutzer [1990] seek to explain the co-existence of mutual and proprietary insurers by focusing on the risk implications of participating and non-participating insurance policies. With participating policies the price of the insurance is determined \textit{ex post}. Consequently, the insured shares in the overall operating risk of the insurance company. In non-participating policies the price of the insurance is determined \textit{ex ante} and the insured does not share in the overall operating risk. Smith and Stutzer [1990] demonstrate that participating policies will be purchased by low-risk insurance consumers while non-participating policies will be purchased by high-risk consumers. In this respect a mutual insurance company is a participating policy since the policyholders have the residual claims. Smith and Stutzer [1990] test their theory on a data-set of medical malpractice claims which enables comparisons to be made between a mutual and a proprietary insurer. The authors measure diversified policyholder risk by the expected loss per policy (i.e. the probability that a policyholder will file a claim multiplied by the loss payment per claim filed). This is estimated using the product of the percentage of policyholders filing claims and the average claim payment made. They report that the proprietary company experienced larger claim payments, but a lower percentage of their policyholders filed claims. Smith and Stutzer [1990] conclude that in this specific instance the proprietary company appeared to serve a riskier clientele than its mutual counterpart.

It appears therefore, that the continued co-existence of mutual and proprietary insurance companies arises because of difficulties with insurance contracting. In respect of life insurance, the long-term nature and uncertainty associated with such contracts encourages policyholders to organise themselves into mutuals to isolate their wealth from possible shareholder exploitation. In the case of property-liability insurance, mutuals appear to have evolved from the desire of specific trades or professions to protect themselves from the adverse claims exposure of a diversified insurance portfolio – favoured by proprietary companies. The co-existence of mutual and stock insurers may also be due to mutual policyholders’ perceptions of risk. Lamm-Tennant and Starks [1993] illustrate that mutual insurers are engaged in less risky lines than their proprietary counterparts, while Smith and Stutzer [1990] show, in one specific instance at least, that mutual companies provide insurance for a less risky clientele than their proprietary counterparts.

THE OWNER-MANAGER CONFLICT

The previous section argued that the existence of mutual companies in the insurance industry is due to the possibility of conflict between policyholders
and shareholders in proprietary companies. The merging of the functions of customer and owner in mutuals seeks to avoid such conflicts. By eliminating shareholders however, mutual companies appear to exacerbate the potential for owner-management conflict. Not only are external owners (and hence the possibility of external monitoring) highly atomised in the mutual form, each mutual policyholder is unlikely to have a significant number of policies which might motivate active monitoring of company management. The result appears to give managers in mutual insurance companies greater opportunity for exercising discretion than their proprietary counterparts.

Despite the apparent weakness of owner control in mutual insurance companies, mutuals continue to compete successfully with their proprietary counterparts. This suggests that mutuals may utilise alternative systems of managerial monitoring to substitute for the absence of capital market controls. A number of researchers have examined control strategies which mutual insurance companies may employ in an attempt to minimise the loss of monitoring by the capital market. Mayers and Smith [1988] suggest that mutual insurance companies should be more geographically concentrated than proprietary insurers, since greater geographical coverage is expected to involve increased managerial discretion in setting rates and consequently would be more expensive for mutual policyholders to monitor. Mayers and Smith [1988] also suggest that mutuals should be more specialised, operating in fewer lines of insurance, again restricting the degree of managerial discretion and lowering monitoring costs for policyholders. Finally, Mayers and Smith [1988] hypothesise that mutual companies should be more prevalent in lines of insurance where management exercises little discretion in setting premium rates. Mayers and Smith [1988] test each of these hypotheses using US data. Their evidence supports the hypothesis that mutual companies are more concentrated geographically than proprietary companies. In respect of insurance concentration, Mayers and Smith [1988] report no significant difference between proprietary and mutual companies. However, the authors report some evidence of proprietary and mutual companies specialising in different insurance lines.

More recently O'Sullivan and Diacon [1996] examine the internal governance characteristics of mutual and proprietary insurers in the UK. The authors hypothesise that mutuals are expected to compensate for weak external control by exhibiting a higher quality of internal governance - for example, a greater proportion of outside directors and greater utilisation of board sub-committees. O'Sullivan and Diacon [1996] find that while the proportion of outside directors does not differ significantly between mutuals and proprietary companies, outside directors in mutual companies are less likely to have business links with their company than their counterparts in
proprietary companies. O'Sullivan and Diacon [1996] explain this finding by suggesting that mutual insurers are more likely to require the objective qualities provided by genuine outside directors while proprietary companies are anxious to retain the expertise of former executives on their boards. O'Sullivan and Diacon [1996] also report that mutual companies are more likely to have a remuneration committee than their proprietary counterparts, and remuneration committees in mutual companies possess a greater proportion of outside members. Overall, this evidence suggests that mutual insurers attempt to minimise owner-manager conflicts by strengthening mechanisms of internal control.

An important implication of the existence of different control structures in mutual and proprietary insurance companies is the possibility that managers in mutual and proprietary companies may behave differently. The lack of external governance suggests that managers in mutual insurance companies are expected to utilise their positions to improve their own well-being at policyholders' expense. Conversely, the presence of capital markets and the threat of a takeover and possible displacement is expected to encourage managers in proprietary companies to adhere to shareholders' expectations. Over the past decade a number of empirical studies have compared the behaviour of mutual and proprietary insurers. A dominant objective of this research is trying to identify whether performance and efficiency differences exist between the two organisational forms.

Fields [1988] tests for differences in expense preference behaviour between proprietary and mutual life insurance companies. In order for the expense preference hypothesis to hold, Fields maintains that three conditions need to exist: less than perfectly competitive markets, ownership diffusion, and the existence of managerial preferences. The requirement of less than perfectly competitive markets is necessary because a purely competitive market requires production to occur at minimum average costs. Spending on emoluments, by definition, increases average costs above the competitive level. In a competitive environment, the firm that spends on emoluments would record no sales as the market would clear at the competitive price. Ownership diffusion is necessary in that it relates to the monitoring costs associated with ensuring adequate performance by managers - the amount of monitoring by owners is expected to be related to the extent of ownership concentration [Demsetz and Lehn, 1985]. Finally, managerial tastes are important since they are expected to be closely related to expense preference behaviour. For example, the type of managerial compensation system in force may serve to limit excessive expense behaviour by managers - executive stock options being a typical example. Fields [1988] finds no significant evidence to support his hypothesis. Mutual firms are not more expensive producers. In addition, Fields finds no
significant difference in the types of life products provided by the respective company types. Fields [1988] concludes that management behaviour in the insurance industry must be influenced by factors other than the limits imposed by product and equity markets.

In an analogous study, Kroll et al. [1993] test for differences in the objectives pursued by the managers of proprietary and mutual life insurers. The authors examine three issues: the ability of mutuals to reward their owners (policyholders), a comparison of CEO compensation, and a further test of expense preference behaviour. Kroll et al. [1993] suggest that the average rates (net of dividends) for term life insurance policies issued by mutuals are expected to be lower than the rates for comparable policies issued by proprietary firms. Secondly, they hypothesise that CEOs in mutual companies are likely to receive greater compensation. Finally, the authors argue that average expenditures on general and administrative expenses will be greater in the case of mutuals. The empirical results reported by Kroll et al. [1993] indicate no difference in the pricing of proprietary and mutual policies. However, the authors find that CEO compensation (measured as a percentage of insurance in force) is greater in the case of mutuals and that proprietary insurers are significantly more efficient in controlling general and administrative expenses than their mutual counterparts, a finding which Fields' [1988] earlier study does not identify.

Mayers and Smith [1992] undertake a comprehensive study of executive compensation in the life insurance industry. In establishing their hypothesis, the authors address a number of considerations which are not addressed in previous research. Traditional arguments have suggested that because of less active ownership monitoring, executives of mutual companies should have greater scope to award themselves larger salaries – consistent with the expense preference arguments proposed in earlier research. However, Mayers and Smith [1992] suggest that because of the existence of mutual insurers in sectors where less managerial discretion is required [Mayers and Smith, 1986], CEOs in mutual companies are unlikely to have the same decision-making responsibilities of their proprietary counterparts and on these grounds it could be argued that CEOs in proprietary companies should receive greater rewards. This is also consistent with the arguments suggesting that good managers (in this case managers capable of exercising discretion in owners' interests) are expected to charge a premium when hired from the market for management services [Fama, 1980].

Mayers and Smith's [1993] empirical results suggest that executives in proprietary companies receive greater compensation than their mutual counterparts. This is consistent with the hypothesis that the additional discretion (decision-making) required from proprietary CEOs is rewarded with greater compensation. The authors also report higher levels of
compensation for executives of proprietary subsidiaries. Again this result
suggests differences in the amount of managerial discretion enjoyed by
subsidiary CEOs. The authors also find that executives who also hold
executive positions in affiliated companies receive lower compensation
than similar unaffiliated executives. Mayers and Smith [1992] propose three
justifications for this result – economies in decision-making, the provision
of lower quantities of service by affiliated CEOs (i.e. the CEO job title is
not comparable), and the possibility that remuneration of affiliated CEOs
may be under-reported compared to their unaffiliated counterparts. Finally,
the time-series analysis undertaken by the authors indicates that
compensation of CEOs in proprietary insurers is more responsive to
company performance than the compensation of CEOs in mutual
companies. This link between performance and compensation appears to
provide some support for the view that managers in proprietary companies
are subject to greater ownership monitoring and control.

In a recent UK study, Armitage and Kirk [1994] compare mutual and
proprietary life companies in respect of payouts on endowment policies,
 costs, and growth rates. The authors report consistently higher average pay-
outs for mutuals, with a significant advantage in many years of the study.
They also find that mutuals had a lower average cost ratio than proprietary
companies, again the difference being significant on many occasions. The
authors also find that medium and large mutuals experience greater growth
rates than proprietary insurers – with the possible exception of small
proprietary companies. These results appear at variance with the managerial
discretion hypothesis as well as previous research emanating from the US.
However, the authors emphasise the need for caution in the interpreting
their results. Traditionally, mutual life offices have written predominantly
with-profits (i.e. endowment) policies, which in itself provides scope for
managerial discretion [see Knights and Willmott, 1993]. Therefore,
concentrating on such a potentially organisation-specific type of insurance
may not present an accurate picture of companies’ overall behaviour. In
addition, growth comparisons may be contaminated by the fact that mutuals
are typically long-established in the market while the period of the Armitage
and Kirk [1994] study coincided with the establishment of a number of new
proprietary life companies. It is interesting to note that a similar longitudinal
study of UK insurers undertaken by Carter [1993] fails to identify behaviour
differences in mutual and proprietary companies.

Diacon and O’Sullivan [1993] examine the behaviour of mutual and
proprietary life insurance companies in the UK between 1984–91. The
authors specifically focus on two aspects of company behaviour: the degree
to which company management pursue goals other than profitability and the
effectiveness of internal governance structures in restricting managerial
discretion and promoting profitability. Diacon and O'Sullivan [1993] find that mutuals exhibit lower levels of profitability (measured both in terms of % increase in life investments and % increase in life fund), a higher growth rate (% increase in premiums) and are less likely to be involved in unit-linked business – where the scope for managerial discretion is reduced, than their proprietary counterparts. In respect of internal governance, Diacon and O'Sullivan [1993] find that a high proportion of non-executive directors serves to restrict excessive growth and improves profitability in mutual insurance companies only. These results suggest that mutual companies may compensate for the absence of capital market monitoring by strengthening their internal governance characteristics.

The absence of shareholders in mutual companies is expected to undermine the ability of policyholders to monitor the behaviour of management. A number of researchers have sought to examine whether mutual insurers utilise alternative mechanisms of governance in order to compensate for the absence of capital market controls. Mayers and Smith [1988] find that mutuals minimise the opportunity for managerial discretion by operating in fewer geographic locations and by specialising in lines of insurance which provide managers with fewer opportunities for exercising discretion. O'Sullivan and Diacon [1996] find that mutual insurers exhibit stronger internal governance characteristics than their proprietary counterparts. The consistent absence of performance differences between mutual and proprietary insurers suggests that mutuals successfully substitute for the lack of capital market monitoring.

MUTUALISATION AND DEMUTUALISATION

The study of insurance companies who choose to change organisational form is capable of providing some further insights into our understanding of the continued survival of both mutual and proprietary companies. Conversions from proprietary to mutual (mutualisation) and from mutual to proprietary (demutualisation) involves a re-arrangement of the relationships between the various stakeholders in the company. An important aspect of any analysis of insurance company conversions is to identify which parties, if any, benefit or lose from such a restructuring.

A number of reasons have been offered to explain why insurers choose to convert from mutual to proprietary status. An important motivation is access to capital markets. An insurance company may wish to raise additional funds for expansion or diversification from the capital markets but is constrained by its inability to raise funds under the mutual form of organisation. The proprietary form of organisation allows insurers to issue additional shares when an infusion of capital is necessary or to exchange
shares with another company to facilitate an acquisition. An early insight into the importance of access to capital markets is found in a survey of insurance officers by Greene and Johnson [1980]. Officers in proprietary companies cited the ability to diversify and to acquire other companies as an important advantage of the proprietary form. An additional motivation for demutualisation may be the potential incentive effects obtained by adopting the proprietary form. Jensen and Meckling [1976] note the benefits of aligning the interests of owners (principals) and managers (agents) by making managers part owners of the firm. Incentive devices such as share options and share bonuses are available under the proprietary form but not under the mutual form.

The demutualisation process may improve managerial monitoring through capital market controls but it introduces an additional conflict of interest between policyholders and shareholders. For mutuals, the apparent lack of managerial monitoring is offset by the union of the shareholder and policyholder functions. An important aspect of the conversion process therefore, is the potential for a rearrangement of stakeholder wealth within the company. A crucial objective is to identify whether a conversion involves efficiency gains or provides an opportunity for a transfer of wealth between the stakeholders involved. Mayers and Smith [1986] suggest that wealth expropriation provides a possible explanation for insurance company conversions. In particular, the demutualised company may alter its dividend policy — reducing dividend payments to policyholders. The conversion could also reduce the insurer’s ability to fulfil contractual obligations outstanding at the time of conversion. The possibility also exists that existing policyholders may not receive adequate compensation for surrendering their membership rights. Finally, Hetherington [1969] suggests that demutualisation may be motivated by the self-interest of managers. Through demutualisation, managers may be able to convert their de facto ownership (arising from mutual policyholders’ ineffectiveness as owners) into stock representing a substantial fraction of the demutualised company’s net worth.

Two US studies have examined the pre- and post-conversion behaviour of life insurance companies. Mayers and Smith [1986] examine thirty companies which mutualised between 1902 and 1986. McNamara and Rhee [1992] undertake a similar study in respect of thirty three companies which demutualised in the same period. The principal hypotheses examined in both studies is whether the conversions are motivated by efficiency or expropriation. A central objective therefore, is to examine how policyholders, shareholders, and managers were affected by the conversions.

Mayers and Smith [1986] utilise data on insurance income to assess the
impact of mutualisation on policyholders. Their results suggest little
difference in pre and post-conversion income. In addition, mindful of the
possibility that mutualisation may encourage a different product mix, the
authors also analyse the composition of the premiums written in terms of
participating and non-participating policies. Again, Mayers and Smith
[1986] fail to identify any significant differences in the data. This evidence
suggests that policyholders are not adversely effected by the mutualisation
process. As an additional measure of existing policyholder satisfaction, the
authors analyse lapse ratios around the time and for five years after
mutualisation but again fail to find evidence of an increased lapse rate.

Mayers and Smith [1986] examine stock purchase premiums in order to
analyse any possible wealth transfers from shareholders. Their evidence
suggests that shareholders receive, on average, a 75 per cent return
compared with 18 per cent for the S&P Stock Price Index. As an additional
check, the authors compare their results with existing corporate control
evidence and conclude that the shareholders of mutualised companies
continue to do well out of such conversions. Indeed, since shareholders need
to approve the conversion, it is unlikely that a conversion would be
approved if it was known to be detrimental to their wealth. Finally, Mayers
and Smith examine management turnover rates as a measure of
management welfare. They report that non-health-related turnover reduces
after the conversion – suggesting that managers actually benefit from the
mutualisation process. This evidence is consistent with the view that
mutualisation is likely to hinder the operation of the capital market as a
mechanism for disciplining managers.

An additional aspect of the Mayers and Smith [1986] study is a separate
comparison of firms where, prior to mutualisation, the shares are diffusely
held versus firms where ownership of the majority of shares is concentrated
in the hands the firms’ existing managers. In the case of firms with
relatively diffused ownership, there is a greater reduction in the potential
disciplining effects of the market for corporate control than in the
management-controlled firms. Hence, if mutualisation is motivated by
efficiency, favourable affects on policyholders should be more pronounced
in the management-controlled firms compared to the diffusely-held firms.
Thus, the evidence that there is a favourable change in premium income for
management-controlled firms seems to confirm the existence of an
efficiency motivation. The evidence of reduced industry-adjusted premium
income changes for the diffusely held firms is consistent with either an
efficiency motivation where the costs of a less effective market for
corporate control outweigh the efficiency benefits (i.e. a miscalculation) or
an expropriation motivation for these firms.

McNamara and Rhee's [1992] study focuses on demutualisation and
seeks to identify whether the demutualisation process is motivated by efficiency or expropriation. They specifically hypothesise expected relationships before and after the conversion process: the efficiency motivation would predict little change in premium income, admitted assets, or policy lapses, a decrease in the proportion of participating insurance policies and operating expenses and an increase in surplus and capital and management turnover. The expropriation hypotheses predicts decreases in premium income, surpluses and capital, admitted assets, and management turnover. The proportion of participating policies, lapse rates, and operating expenses are expected to increase under an expropriation-motivated conversion. The overall results appear to support the efficiency hypothesis. Premium income was unchanged and lapse rates remained constant after demutualisation. A significant reduction in the amount of participating coverage in force was detected. There was also a significant increase in capital and surplus immediately following conversion. Admitted assets and expense ratios were not significantly different. Management turnover increased around the time of the demutualisation approval, suggesting that managerial welfare was not a primary motivation for demutualisation.

The Mayers and Smith [1986] study presents strong evidence of gains for shareholders, some evidence of gains for managers, and no evidence of policyholder losses. They conclude that mutualisation is more consistent with the efficiency hypothesis rather than the expropriation hypothesis. These conclusions are also consistent with rational voting since the mutualisation plan is initiated by managers, and voted on by both shareholders and policyholders. In the case of demutualisations, McNamara and Rhee [1992] fail to find any significant wealth transfers between managers, shareholders and policyholders.

CONCLUSIONS

The objective of this article was to present a review of the theoretical and empirical literature on the coexistence of mutual and proprietary companies in the insurance industry. Three aspects of this coexistence are specifically addressed: the theoretical justification for the existence of insurance mutuals, the monitoring implications of mutual and proprietary organisations, and the impact of mutualisation and demutualisation on company stakeholders. The evolution of mutuals in the insurance industry seems to arise because of the problems associated with insurance contracting. In respect of life insurance, the possibility of conflict between shareholders and policyholders over the distribution of company surpluses appears to be an important influence for adopting the mutual form. By adopting the mutual form, policyholders eliminate policyholder-shareholder
conflicts since mutuality fuses the functions of customer and owner. The origins of mutuals in the non-life insurance sector appears to be due to the coming together of specific professions or industries who perceive themselves as being low risk and who view mutuality as a method of avoiding the diversity of risk types which proprietary companies attract. Finally, mutuals provide an appropriate structure for insureds who purchase participating insurance policies. By utilising the mutual form these policyholders shield themselves from the uncertainty associated with the operating risk of the company.

While the absence of shareholders has undoubtedly contributed to the popularity of insurance mutuals, the absence of capital market governance raises concerns about the ability of mutual policyholders to monitor effectively the behaviour of managers. However, the continued ability of insurance mutuals to compete with their proprietary counterparts suggests that mutuals have identified alternative control strategies. Indeed, the empirical studies reviewed in this paper fail to identify consistent performance advantages for either organisational form. However, research does suggest that mutuals may seek to avoid the potential for managerial opportunism by operating in fewer geographic locations and underwriting fewer lines of insurance than their proprietary counterparts [Mayers and Smith, 1988]. In addition, Diacon and O’Sullivan [1996] report that mutual insurers emphasise stronger internal governance practices than their proprietary counterparts – thereby seeking to substitute for weak external controls. Finally, an important feature of organisational structure is the ability of insurers to alter their organisational status from mutual to proprietary or from proprietary to mutual. A central empirical question is whether such conversions are motivated by efficiency or expropriation purposes. In order to answer this question we need to analyse such conversions to examine whether managers, shareholders or policyholders have benefitted from the restructuring. However, both Mayers and Smith [1986] in the case of mutualisation and McNamara and Rhee [1992] in the case of demutualisations fail to find any evidence of expropriation in the conversions studied.

From a governance perspective, the research reviewed here fails to provide a clear efficiency advantage for either the mutual or proprietary organisation. It is likely that future research needs to focus more closely on the factors which influence this performance. In their case study of one mutual life company Knights and Willmott [1993] draw attention to the growing pressure on company management to move away from with-profits business to unit-linked business. Since unit-linked administration charges are fixed at the beginning of the contract, the amount of resources which managers can manipulate is constrained. Thus a lower proportion of unit-
linked business in an insurer’s portfolio may provide an indication of managerial opportunism, enabling managers to exercise (disguised) discretionary expenditure and accumulate organisational slack. Valuable insights may be obtained by examining the product mix of proprietary and mutual insurers in order to improve our understanding of the impact of product governance on insurance company performance. An important characteristic of the UK insurance market is the large number of subsidiary companies which transact insurance business. While the vast majority are subsidiaries of proprietary companies, a small number are owned by mutals. In addition, a significant proportion of insurance subsidiaries operating in the UK market are not UK-owned. With the exception of Mayers and Smith [1992] and Diacon and O’Sullivan [1995] few existing studies have attempted to control for this important distinction. A related research issue is the degree of independence which the management of UK-owned subsidiary insurers enjoy compared to their foreign-owned counterparts and whether such control differences have implications for company performance.

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