STRATEGIC STUDY SERIES

Insurance Research

Growing Pains at Property-Casualty Mutuals

Strategies for Action

2017

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1. Introduction

Property-casualty insurers organized as mutuals confront rising pressures to grow. Sources of the pressure include the need to keep up with insurance technology advances, high expense ratios, demographic changes, the war for talent, and the prospects for future shrinkage in the private passenger automobile insurance market. The combined impact of these forces is leading mutual insurer executives increasingly to focus on growth.

Mutual insurers face more obstacles to achieving growth than do stock insurers. Barriers to growth are rooted in the mutual form, which precludes mutuals from straightforward capital-raising in equity or debt markets. In recent years, many mutuals have embarked on a variety of nonstructural and structural initiatives to support growth. This study analyzes the pressures facing mutuals and describes current and past activity by mutuals to position themselves for future success through various nonstructural and structural change initiatives.

The core mission of serving policyholders has empowered property-casualty mutuals to adapt to the times, enabling them to stay relevant amid members' developing needs and thrive through close to three centuries of transformational change in the U.S. economy. This study sheds light on how mutuals may confront the current unfolding chapter of their existence and continue to fulfill their member-centric mission.

The study reveals that mutual insurers are no strangers to change. There have been close to 300 transactions involving mutual insurers since the 1980s. In addition to structural changes to the mutual form of organization, including demutualization, mergers and acquisitions, and mutual holding company formations, our study examines the record of insurers that have pursued less transformational nonstructural initiatives to boost capital or enhance growth. These include affiliations, surplus note issuance, product line diversification, geographic expansion, and various forms of operational improvement.

As a group, property-casualty mutuals are currently in strong operating positions, with low leverage, ample invested assets, favorable underwriting performance, and high financial strength ratings. The good results have been supported in part by lower-than-average natural catastrophe losses in recent years. Nevertheless, we have found that C-suite mutual insurance leadership is actively seeking to identify new sources of revenue and growth. Growth is perceived as a proactive response to the imperative to compete with other insurers that may be ahead in the never-ending technology arms race, with other forms of innovation, and with a scale advantage.

Years of “normal” and above-normal catastrophe losses will return, as evidenced by the flurry of third-quarter 2017 events, and other new challenges will emerge. How might mutual insurer executives position their companies to be equipped with the staff and services needed to face the risk profiles and client expectations five to ten years hence? This study explores this important question based on a review of current strategies pursued at leading mutual insurers, analysis of the history of transactions and initiatives undertaken by mutuals, and discussions with mutual C-suite executives, brokers, and bankers serving mutual insurer customers.

Note: In this study, there are some current and historical examples of mutual insurers illustrating themes and initiatives described in gray boxes. These are representative of many similar examples. Companies chosen for description were selected either because information is more readily available in insurer disclosures or because they are instructive demonstrations of the themes under discussion.

Conning has published the following Strategic Studies on property-casualty mutuals:

Date	*Title & Subtitle*
2014	*Property-Casualty Mutuals—Resilient and Staying Relevant*
2008	*Property-Casualty Mutuals—Managing Through the Softening Cycle*
2004	*Mutuals and Stocks in the Property-Casualty Industry—How Does Your Company Grow?*
1992	*The Mutual Insurance Industry—Challenges for the 90s*

For more information on these and other Strategic Studies, please visit our website at www.conningresearch.com.

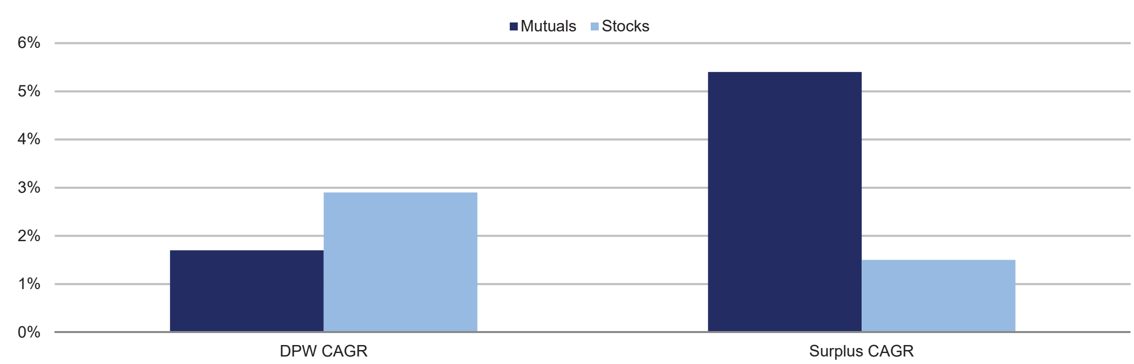
2. Executive Summary

Growth is commonly viewed as a response to many of the current pressures confronting property-casualty mutual insurers. These include keeping up with accelerating technology developments, managing high expense ratios, worsening risk profiles in rural areas, recruiting and retaining talent, and an uncertain future for personal auto insurance. The combined impact of these and other factors is leading executives at mutual insurers to look beyond current favorable results and consider the competitive positioning of mutuals five and ten years hence.

Although all insurers, whether structured as mutual or stock companies, may face similar pressures, mutuals may feel these pressures disproportionately for three reasons. First, their structure limits their ability to access growth capital via the capital markets. Second, mutuals are more commonly represented among the ranks of smaller insurers that are challenged for scale. Third, mutuals have a stronger presence in rural regions than do stock insurers. How will mutuals be able to sustain delivery of their value proposition in an environment of increasingly sophisticated competitors and new players delivering products and services more efficiently, meeting customer expectations more completely?

In the past decade, premium (direct basis) growth at stock insurers has outpaced growth at mutuals, though surplus growth at mutuals has far outpaced surplus growth at stock insurers.

Premium and Surplus Growth at Mutuals and Stocks, 2006-2016



Prepared by Conning, Inc. Data source: ©2017 A.M. Best Company—used by permission

In recent years, property-casualty mutuals have been pursuing structural as well as nonstructural change initiatives at an accelerating pace, possibly driven in part by the observed lower growth trajectory at mutuals. Growth is widely perceived as a solution to many of the pressures faced by mutual insurers. A variety of structural and nonstructural options is available to mutuals to increase financial strength. Mutual insurers should evaluate the range of options available to them in order to support development and maintenance of financial strength needed to face the market and external challenges they confront.

Nonstructural changes include affiliation or strategic alliance with a mutual insurer partner, surplus note issuance, reinsurance change, and various forms of operational improvement. Structural change, where there is a major change in corporate structure, may include merger with another insurer, demutualization, or mutual holding company formation. While the structural change process is usually time-consuming, may require policyholder and regulatory approvals, and can be costly, nonstructural change initiatives can be undertaken more straightforwardly. Affiliations can assume many different forms. Some are relatively simple “alliance” arrangements to share designated functions or achieve synergies in distribution or product mix for expense savings or diversification. Others are more far-reaching, involve change in control, require regulatory approval, and are precursors to acquisitions.

Whereas a decade ago there was typically only a handful of transactions in the mutual sector announced every year, in recent years, there have been ten or more occurring annually. In contrast to such transactions and agreements among mutuals in the past having been often defensively driven, involving small insurers seeking to shore up the weaker of two partners, some recent transactions are proactive moves by strong insurers positioning themselves to become yet stronger for the future. The list below identifies mutuals that have been involved in change transactions in the past two years. Discussions with executive leadership at mutual insurers reveal that there is widespread interest in finding partners to further mutuals’ goals for growth, diversification, and expansion.

- American Family Mutual
- Auto-Owners
- BrickStreet
- Concord Group

- Federated Mutual
- Illinois Casualty Co.
- Motorists Mutual Insurance Co.
- Mountain States Insurance Group
- Nodak Mutual Insurance Co.

Our analysis points to the collective weight of external and market changes bearing down on mutuals, causing them increasingly to evaluate available alternative courses of action to face the future. Although industry results have been good and capital is at high levels, business as usual appears not to be a viable strategy for mutual insurers seeking to prolong their already impressive longevity. The wide variety of transactions and strategies seen at mutuals in recent years demonstrates that there are many options available to mutuals seeking to effect change.

The notion of change is familiar to mutual insurers. Through more than two centuries, mutuals have demonstrated resilience and nimbleness by responding to changing needs of their policyholders, remaining faithful to their purpose of staying relevant to their members. Midwestern mutuals serving rural ethnic communities once issued policies in German or Finnish because their early policyholders were more comfortable with their native languages. Today's mutuals strive to cover whatever risks their members have through distribution channels in accordance with policyholder preferences.

Nonstructural Change

Mutual insurers can improve their financial strength through numerous types of initiatives that do not entail change in their structural form. These include operational improvement, surplus note issuance, product and geographic expansion, reinsurance change, and affiliation with another mutual insurer.

Affiliations vary widely in the degree of integration between the two partners. Historically, in most cases, a weaker partner has sought to shore up its financial strength rating via reinsurance pooling with a stronger partner. Some amount of independence and separate status is maintained, though the stronger of the two partners often assumes a degree of control. Such arrangements typically precede the weaker of the partners eventually merging into the stronger partner. However, there are also instances of two financially strong insurers affiliating in order to capitalize on complementary capabilities. Among the reasons why affiliations between two strong insurers are relatively rare is the friction that may arise when there are two separate management teams and two separate franchises.

Our analysis of mutuals that have entered into affiliation agreements reveals that most had favorable results in the period following the affiliation. In most cases of affiliation arrangements studied, both partners had better performance following the affiliation arrangement than in the five years prior. This suggests that affiliation arrangements may hold ample benefits for both strong companies as well as for weak companies, provided the partners are carefully chosen and the affiliation is well executed.

Structural Change

Among the structural change alternatives available to mutual insurers are merging with another mutual, demutualization, and mutual holding company formation. Mutuals pursue such structural change for two main reasons: (1) to have greater access to capital markets or (2) for increased structural flexibility to support diversification of their operations. There have been relatively few instances where property-casualty mutuals demutualized and went public. Almost all such cases were followed within a few years by the converted company being acquired. Structural change that entails formation of a mutual holding company or a downstream stock company is more common because it allows preservation of the mutual form.

Our analysis of mutuals that formed MHCs (mutual holding companies) did not identify insurers experiencing consistently better or worse results, measured by surplus growth and combined ratio, following formation of the mutual holding company. Whereas the declared motivation for mutual holding company formation often has been access to capital, most mutuals that formed MHCs were not found to be accessing the debt or equity markets for capital.

Our analysis of mutuals that engaged in mutual-to-mutual mergers found mixed results. In ten of 15 such transactions studied, the post-merger performance, measured by post-transaction combined ratio and surplus compound annual growth rate, was poorer than the pre-transaction performance of the stronger insurer among the merger partners. This poor track record may underscore the conventional wisdom that successful merger outcomes require careful due diligence and disciplined execution in the post-transaction integration process.

Nonstructural change initiatives preserve mutuality and typically are less disruptive, less time-consuming, and less costly than structural changes. Our finding that mutuals that entered into affiliations experienced more pronounced post-affiliation growth in premium and surplus than did insurers that undertook structural changes suggests that mutuals may look favorably on affiliation arrangements as attractive ways to form complementary, mutually beneficial partnerships. Our discussions with mutual executives found that many are open to exploring such tie-ups. A challenge is to find an affiliation partner with compatible or complementary corporate culture and business profile.

The combination of keen competition in the mature U.S. insurance market, prospects for anemic exposure growth, likely disruptive change coming to the insurance industry, and pressures bearing down on mutuals suggests that mutuals will be willing to entertain various types of change. The wide array of available alternatives, ranging from friendly, noninvasive tie-ups and alliances to major change in structural form, means that mutuals wishing to explore the options have many at their disposal. The pressures and challenges in the insurance industry, particularly those affecting distribution and technology, are likely to give more power to customers. Because policyholder needs and service are at the heart of the mutual insurance value proposition, it stands to reason that the mutual sector is poised to benefit from the coming transformations.

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