

Participating Policyholder Rights: The Next Challenge

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Policyholder participation rights will likely be the next major issue for life insurers, presenting challenges comparable to the industry's struggles with sales practices, financial solvency and illustrations. Considering the impact managerial decisions can have on policyholder costs and cash values, the lack of reliable information about what rights participating policyholders have regarding current earnings distributions and how such distributions are made among the policyholders is dangerous indeed. Permanent life insurance policies and annuities are long-term contracts with significant up-front loading costs, and as competition gets fiercer, customers will want a better understanding of their policyholder rights and of the insurer's obligations.

Insurers traditionally disclose little if anything substantive about policy operations and performance, perhaps because they don't want their management decisions and corresponding impact on policies questioned. Mutual companies, in particular, have "procedural barricades" that limit policyholder influence on management and effectively prevent any involvement of those who may have overcome

the information hurdle. But demand for managerial accountability and clarity on policyholder rights is inevitable, and the life industry will be forced to disclose more reliable information about life insurance policy performance.

There is a fundamental conflict between participating policyholders and stockholders over allocation of stock insurer company earning. In 1963, as stock life insurer policies began to represent a significant part of the total life insurance marketplace, Professor Joseph Belth advocated that the industry adopt rules specifying the procedure for making such allocations. Would any reasonable person knowingly purchase a mutual fund where the allocation of earnings between fund holder and fund management is unspecified? In fact, Securities and Exchange Commission mutual fund regulations explicitly prohibit such vagueness.

The life insurance industry appears to sanction such vagueness by not stating clear procedural guidelines for policyholder participation. New regulations might seem an answer. But appropriate disclosure would solve the problem by highlighting the

often detrimental aspects of poorly structured products.

Before stock insurers introduced their own participating policies following World War II, "mutuality" and "participation" were virtually synonymous. Mutuals, which were created to exclusively serve their members, were seen as a solution to the inherent conflict between stockholders and policyholders. During a 1905 investigation into mishandling of company assets by The Equitable (then a family-controlled stock company), one authority advocated the mutualization of not only the company but also the entire industry. But mutualization is neither a necessary nor sufficient solution to participation problems.

In fact, the problem of allocating annual earnings is not limited to stock insurers. Mutual insurers confront the issue when allocating earnings between policyholder dividends and surplus increases. Here the potential conflict is between policyholders who prefer to maximize today's payout vs. those who prefer to maximize tomorrow's or to further strengthen the insurer. An informal survey of a dozen mutual insurers indicated that only one has formally specified the allocation of

annual earning between dividends and surplus.

Mutuals do mitigate a vital aspect of the participation issue by eliminating stockholders' claims on earnings. But they also aggravate other aspects. Mutual policyholders are not merely customers but are in fact company members with specific rights. The problems associated with participating policyholders extend beyond earnings allocations. In 1905 the Armstrong Committee was established by the New York State Senate to look into allegation of mismanagement and improper fiduciary treatment of policyholder surplus. The committee recommended nonforfeiture statutes, prohibitions against deferred dividends and other proposals for clarifying and strengthening policyholder rights. Nevertheless, the mutual life industry still has a history of instances where the actions of a company's management have intentionally and unreasonably benefited itself, its agents or a third party at the expense of policyholders.

In 1910, Congress established the Pujo Committee to review if business organizations were properly serving the public and if interlocking corporate boards of directors posed problems. Although not dealing exclusively with the insurance industry, the committee found that the rules empowering mutual policyholders and constraining management were seriously flawed and that policyholders' interest and involvement in corporate governance were apathetic. The report concluded that control of mutuals by their policyholders was more fiction than fact.

One of the most compelling indicators of the need for clarification of mutual policyholder rights occurred in 1978, during a Senate Judiciary subcommittee investigation into the "Rights and Remedies of Insurance Policyholders." The then president of Metropolitan Life, Richard Shinn, attempting to justify his company's efforts to discourage an ordinary policyholder from running for election to MetLife's board of directors, told the subcommittee that MetLife policyholders do not own the company. Several other mutual chief executive officers and insurance law experts challenged Shinn's assertion. One insurance law attorney, Gary Krieder, stated that it is "well recognized that the mutual policyholder or customer is the owner. All state laws recognize this." That the head of the nation's second largest mutual could make such an assertion on such a fundamental matter documents the need for clarification of policyholder rights.

Interestingly - and in marked contrast - when MetLife was embroiled in sales abuse cases in Florida in 1993, MetLife executives argued against the imposition of large fines because they would only hurt the innocent policyholders, who were the sole owners of the insurer. Given the prominent status of mutuals in the life insurance industry, the vagueness about and restrictions on the rights of mutual policyholders to participate in managing the insurer's myriad operations is unsatisfactory.

DISTRIBUTING EARNINGS

There is also little clarity about participation rights in how the distribution of earnings is to be

made among policyholders. In 1975 the Equitable, at that time a mutual insurer, changed its method of allocating investment earnings from a portfolio approach to an investment-year approach. Initially, New York State Department of Insurance objected to Equitable's proposed change, as did Belth, whose point was not that one investment allocation was better than the other, but that the change violated existing expectations of the policyholders. But in a process shrouded in much secrecy, the regulators did an about-face.

Equitable's action reduced dividends to long-time policyholders in order to credit newer policyholders with larger dividends based upon higher current interest rates. The change essentially allowed the insurer to reallocate the dividend pie, distributing higher dividends to new policyholders, then illustrating those higher dividends to prospects. Unfortunately, when the courts reviewed the matter many important documents were protected by the regulators who agreed with Equitable that such materials were proprietary. In a divided opinion, New York's highest court held for Equitable.

Admittedly, questions involving the determination and allocation of investment earnings involve numerous judgments and are matters about which reasonable people can differ. Controversy exists, for example, about whether or not direct recognition is a legitimate, perhaps even necessary, means of reconstituting the investment pools in which policyholders participate. Public disclosure about such issues would not only highlight the difficult decisions managements must

sometimes make but also be prudent in an era when even the appearance of misconduct is likely to provoke harsh judgment.

DISCLOSURE IS NEAR

While any management decision may be questioned, management's objective is to choose the alternative that is fairest or can best be defended. Guardian Life Insurance Co. of America, for example, after deciding to realize an extraordinarily large capital gain in the early 1980s chose to distribute it over several years. Because the decision to recognize a capital gain in any particular year can be somewhat arbitrary and the original purpose of the investments was to provide long-term earnings for the insurer and its policyholders, Guardian Life decided the distribution over several years was more appropriate than a single, lump-sum dividend.

In 1975, if Equitable had recognized a capital loss on its low-yielding investments, it might have been able to provide the then-current, higher interest/dividend rate to all of its policyholders. Admittedly, this approach would have required a write-down of surplus, but absorbing investment losses is one of the primary purposes of surplus.

Some observers believe that there is no need for concern about policyholder participation rights because the life insurance market is a properly functioning, competitive place where customers will move their business if they are mistreated. The life insurance marketplace cannot qualify as a properly functioning competitive market until information sufficient for meaningful policyholder decision-making is provided.

Furthermore, the current restrictions on buyer/policyholder bargaining and mobility are inconsistent with a properly functioning competitive marketplace.

As the public begins to require disclosure of policyholder participation rights, focus will surely expand to include the determination and allocation of mortality charges and other costs. While initial, ultimate and other mortality charging approaches are sensible and legitimate, haphazard allocations and/or capricious and undisclosed changes in such approaches can lead to serious problems. Lapse-supported pricing, with its imposition of early excessive cost recovery and its subsequent distribution of such compounded sums to the persisting policyholders, raise participation issues: Do the implicit mechanisms represented in sales illustrations constitute a de facto participation agreement? If not does management's discretion have to be disclosed or explained? Should significant deference be given to managerial judgment, or are there circumstances where this discretion can be challenged legally? Certainly, the new NAIC model regulations on illustrations indicate that the National Association of Insurance Commissioners believes there ought to be close adherence between illustrations and actual practices.

Policyholder participation is an issue not only for insurance company executives but also agents, advisers, and any others involved in marketing and distributing policies. Those who haven't carefully reviewed the participation practices of insurers they recommend or sell are being lax. Bank executives who market

annuity and insurance products need to understand how the providers of those products determine the renewal interest crediting rates.

Life insurers eventually will have to face demands for clarification of policyholder rights. In light of current market conduct concerns, and with commission disclosure on the horizon, it might be prudent for the industry to address the issue of policyholder participation before it becomes a public issue.