Approved: February 5, 1997
Date

MINUTES OF THE Senate Committee on Financial Institutions and Insurance.

The meeting was called to order by Chairperson Don Steffes at 9:00 a.m. on January 29, 1997 in Room 529-S of the Capitol.

All members were present except:

Committee staff present: Dr. William Wolff, Legislative Research Department
Fred Carman, Revisor of Statutes
Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee: Roger Viola, Security Benefit Group
Kathleen Sebelius, Kansas Insurance Commissioner

Others attending: See attached list

Hearing on SB 93 -- Conversion of mutual insurer to stock insurer

Roger Viola, Security Benefit Group, appeared before the Committee to request statutory authority to convert mutual insurance companies into a stock insurance company through a process called demutualization (Attachment 1). These provisions would allow for more flexibility in the conversion process bringing Kansas more in line with other states who have adopted such legislation. The determining decision lies with the Insurance Commissioner who must approve the plan prior to bringing it before the membership. Members of the insurance company are notified after the plan for demutualization is approved by the Board of Directors. The majority of those voting would constitute a plurality either by ballot or proxy. The time period between notification of the plan of conversion and time of ballot/proxy would be sent to each member. Sometimes proxies are signed at the time of joining the mutual company. In the past, SBG has solicited 20% of its membership regarding such a plan and only 10% of that number responded. Current statute regarding demutualization would require the distribution of all the company's statutory surplus with enrichment for only a few members and the company, if it could, would have to begin all over again.

Reasons given for demutualization were: access to capital, participation in financial services consolidation, and environmental consideration by strengthening position with rating companies.

Mr. Viola described in detail the three types of demutualization which this bill would allow:

1. Traditional - Members exchange membership interests in mutual insurer for cash, securities, policy credits, dividends, subscription rights or other consideration, or some combination thereof.

2. Subscription rights - Policyholders exchange membership interest in mutual insurer for subscription rights to purchase shares.

3. Mutual holding company conversion - Policyholders exchange membership interests in mutual insurer for membership interests in mutual holding company.

The response has been that most people are not concerned with the type of demutualization as long as they receive their dividends. Guaranteed values would not be affected, however there might be a difference in performance later. The proposed demutualization statute would not allow management to keep 30% of the stock. If policyholders do not want to purchase 100% of the stock, it would be offered to the public and at the same rate which policyholders paid. Management would also buy off the open market.

Once conversion to an intermediate mutual holding company has been completed, a member must own a life insurance policy with the company to vote. Basic stockholders do not have the right to vote. The purpose for this is that capital can be raised without taking a risk of rebel takeovers and demutualization can occur when

interest rates are right.

Kathleen Sebelius, Kansas Insurance Commissioner, gave an overview of the Department's involvement in the research and preparation of the proposed legislation which was submitted to them more than a year ago. The Department's main concerns are with notification to members, oversight of the entire plan, and evaluation of companies involved. Protection is built-in to this plan for the consumer. This plan will allow more market flexibility and without it, SBG and the other fourteen mutual companies based in Kansas may be forced to leave the state in order to grow. Before demutualization plans can be implemented, a mandatory public hearing is held. The plan is returned to the Insurance Department should any major changes occur. In dispute resolutions, the final authority would be that of the Insurance Department. There are specific provisions for mergers of mutual and stockholding insurance companies.

The Committee discussed the tremendous oversight authority which would be vested in the Insurance Commissioner even though a structural framework outlining such authority would be included in the bill.

The **hearing** on **SB 93** was continued until February 6, 1997.

The meeting was adjourned at 10:03 a.m. The next meeting is scheduled for January 30 in the Commerce Meeting at 8:00 a.m.

SENATE FINANCIAL INSTITUTIONS & INSURANCE COMMITTEE GUEST LIST

DATE: 1/29/97

NAME	REPRESENTING
Trish Copeland	Security Benefit Group
Brenda Kramer	Security Benefit Group
TAD KRAMAR	" "
Roger Fricke	BK IV
Teresa Lubenauer	Ameritas
Callie Hill Denton	Kathy Peterson & Assoc.
Meg Henson	Ks Medical Society
Susan Schmelzer	KCUA
TOM WILDEN	Kansas Insurance Dept
STEVE LOBELL	AMERICAN HOME LIFE
HOWARD FRICKE	SECURITY BENEFIT
David Hanson	Ks Insur Assocs
Ted Miller	State Treasurer's Office
Bill Mitchell	Alliance
[illegible]	Ks Insurance Dept
Matt Goddard	HCBA
[illegible]	Farmers Alliance
Roger Viola	Security Benefit Group

The Security Benefit
Group of Companies

Security Benefit Life Insurance Company
Security Benefit Group, Inc.
Security Distributors, Inc.
Security Management Company

700 SW Harrison St.
Topeka, Kansas 66636-0001
(913) 295-3000

Date: January 29, 1997

To: Members of the Kansas Senate Financial Institutions and Insurance Committee

From: Roger K. Viola
Security Benefit Life Insurance Company

Re: Bill to Amend K.S.A. 40-4001 et seq.

My name is Roger Viola. I am Senior Vice Ppresident and General Counsel of Security Benefit Life Insurance Company and I am here today to speak in favor of S.B. 93. This bill substantially revises the current demutualization law in Kansas and brings it up to date with the demutualization laws adopted in many other states.

Demutualization is the common name given to the statutory process of converting a mutual insurance company, whether a life or a property and casualty insurer, into a stock insurance company. Mutual insurance companies do not have stockholders. Instead they are governed by their respective policyholders in that the board of directors of a mutual company is elected by the company's policyholders. When a person buys a policy from a mutual company, he or she acquires certain rights. First and foremost are the contractual rights specified in the insurance policy. Second, the policyholder acquires the right to cast a single vote at the election of the directors of the company. These are called membership rights. Once a mutual policyholder surrenders his or her policy or allows it to lapse, these rights are forfeited.

Security Benefit is a mutual insurance company. It was formed in 1892 as a fraternal benefit society but converted to the mutual form in 1950. It currently manages over $6 billion in assets and this past year exceeded the $1 billion milestone in revenues for the first time in its history. The Company has experienced significant growth in the last few years and it is our desire to see that growth accelerate in the years ahead. Unfortunately, we are constrained by our mutual structure from growing at a rate comparable to our stock company competitors. This is why companies such as State Mutual, American Mutual, Maccabees, The Equitable, Guarantee Mutual, UNUM and others, have demutualized in the past few years. Many other mutuals are seriously considering demutualizing. Pacific Mutual, has recently initiated the process in California as has General American in Missouri. One of the similarities of all these companies, though, is that the demutualization did not occur until after their respective state legislatures passed laws that contained provisions comparable to those in S.B. 93. Most noteworthy is the fact that two new methods of demutualization have been crafted in recent years, neither of which were even conceived when Kansas passed its current law 10 years ago. S.B. 93

Senate F.I.+I.
Jan. 29, 1997
Attachment 1

District of Columbia, Illinois, Nebraska, Iowa, Missouri and California have all enacted one or more variations of these new laws.

Let me first of all describe the advantages which a stock company enjoys over a mutual.

1. Access to capital -- Stock companies enjoy a much more flexible capital structure in that they can issue common and preferred stock, debt and surplus notes. Stock companies can thus leverage the capital structure to optimize returns on equity. A stock form of ownership also allows for "unstacking" of regulated and non-regulated business.

2. Participation in financial services consolidation -- Stock creates an acquisition currency. Cash acquisitions are not only an expensive use of capital but frequently, the seller of stock does not want to receive cash because of the adverse tax consequences it creates. Yet a mutual insurer has no stock to offer in exchange for that of another company. Thus growth opportunities are severely limited.

3. Environmental considerations - Being a stock company strengthens considerably the company's position with rating agencies such as Standard & Poor's, Moody's and Duff & Phelps. They tend to disfavor a mutual company form of organization, again because of the constraints on its capital raising ability. Stock also increases a company's flexibility with respect to possible acquisitions.

Recently, I came across some data from Goldman Sachs, an investment banking firm, which showed that 33% of all life insurance industry assets were owned by mutual companies in 1995 compared to 37% in 1991. 18% of the industry's total net income was derived from mutuals in 1995 versus 26% in 1991. Likewise, since 1991, mutual companies have raised $8 billion of capital and only by way of surplus notes, while stock insurers have raised over $30 billion through a combination of common and preferred stock, convertible debt, convertible preferred stock and debt. These numbers make it clear that stock companies are growing faster than mutuals and that the capital raised by stock companies has dramatically surpassed that raised by mutuals.

The current Kansas demutualization statute is inherently deficient in one notable way. It requires the distribution of all of the company's statutory surplus. It effectively unjustly enriches a few policyholders, and requires the company to start again from scratch. I don't believe any company, certainly not one the size of ours, would ever demutualize under this statute. However, if a company did want to do this, it would not be foreclosed from doing so under S.B. 93. But it would have other alternatives, too.

Section 3, beginning on page 2 of the bill, is the heart and soul of the bill. It provides for three alternative methods of demutualization. To assist in understanding these models, I have prepared a four page handout which contains diagrams of the respective corporate structures. On page 1, you can see the structure of a typical mutual insurance company such as Security Benefit. Because it is owned by its policyholders, its affiliates, by definition, must be downstream subsidiaries and subject to the investment restrictions contained in Kansas law.

(1) The corporate structure resulting from the historical, or more traditional form of demutualization is shown on page 2 of the handout. Section 3, subsection (a) of S.B. 93 provides for this method of demutualization. The policyholders exchange their membership interests in the mutual insurer for cash, securities, policy credits, dividends, subscription rights or some combination thereof. Typically, an intermediate holding company would be formed that would own the stock of the downstream insurer. Any stock to be issued as consideration to the policyholder would be stock of the holding company. The subsidiaries of the insurer could be held at either the holding company or the insurance company level.

It should be noted here that whatever method of demutualization that might occur, certain procedures and safeguards apply to all. The plan must be approved by 2/3 of the company's directors, the insurance commissioner and most importantly, the company's policyholders. The commissioner must hold a hearing on the proposal and must determine that the plan is fair and equitable to all of the company's policyholders and does not unjustly enrich directors, management or employees. Additionally, the bill provides the commissioner with the authority to retain experts such as lawyers, accountants, actuaries and investment bankers to advise in the process, all of which are paid for by the demutualizing company. And finally, S.B. 93 contains a provision which dictates the minimum amount of consideration which must be distributed to the existing policyholders entitled to share in the distribution. requires opinion of actuary.

(2) The second demutualization model is authorized by subsection (b) of new section 3. This begins on line 17 of page 3. It authorizes a plan of conversion in which policyholders exchange their membership interests solely for the right to subscribe for stock in a newly formed holding company or, absent such an intermediate holding company, the insurer itself. As you can see on page 3 of the handout, a holding company, if created, would own 100% of the stock of the converted stock insurer. This model is based on a similar statute which was passed a few years ago in Illinois. It has also been adopted more recently in Pennsylvania and Michigan.

Policyholders have the right to subscribe for 100% of the stock of the converted insurer or of the stock holding company, if one is formed. A "fair and equitable" standard is used to determine the allocation of subscription rights among policyholders as well as to determine how the shares of stock would be allocated in the event of an oversubscription. This must

all be set forth in the plan to be approved by the commissioner. Any shares not subscribed to by policyholders may, at the option of the company, be sold to the public or through a private placement, but any such offering may not occur at a price lower than that which was offered to policyholders. This will assure that policyholders will receive as good an offering price as anyone else to whom the stock is offered.

A plan of conversion based upon the subscription rights model must set the total price of the stock at the estimated pro forma market value of the company. This must be an amount that is estimated to be necessary to attract full subscription for the shares. The establishment of this value is done by one or more qualified experts, not the company itself. This formula will protect against the company being overvalued for purposes of setting the option price. And yet, if history is a good indicator, the value of the shares should appreciate upon them being offered publicly, especially for a well run, progressive and growing company.

(3) The third and final model provided for in subsection (c) of section 3 is based on a new demutualization structure first passed two years ago by the Iowa legislature. Similar laws have been enacted in Missouri, California, Pennsylvania, Minnesota, Rhode Island, Vermont and the District of Columbia. The model is commonly referred to as a mutual holding company statute. Before we get to page 4 of the handout, which sets out the structure, you should understand that the mutual holding company structure is based on the two inherent mutual policyholder rights which I mentioned earlier. (1) First, the mutual policyowner has a membership interest which gives him or her the right to vote for directors of the company. (2) And second, he or she has policy or contract rights. A demutualization based upon the mutual holding company model, simply takes those rights and bifurcates them between two separate, but related entities. The insurance contract and related rights are retained in the converted stock insurer. The voting rights are transferred to a newly formed mutual holding company. The mutual holding company must at all times retain at least 51% of the stock of the converted insurer or in an intermediate holding company, if one is formed. The intermediate stock holding company must then own 100% of the stock of the converted insurer. The remaining 49% of the stock may be sold to the public at the discretion of the company.

Page 4 of my handout will hopefully clarify this. On the left hand side of the page, a mutual holding company structure is shown where stock is sold to the public subsequent to the demutualization. The voting rights are transferred to a new mutual holding company. The directors of the new mutual holding company will be elected by the policyholders, just as they are now. So long as a person owns a policy in the converted stock insurer, he or she retains a voting right in the mutual holding company. If their policy is surrendered, lapsed or otherwise terminated, they forfeit their membership rights in the mutual holding company. Persons acquiring insurance policies from the new stock insurer after demutualization, would likewise acquire membership rights in the mutual holding company.

A likely scenario would involve the formation of an intermediate stock holding company which would own 100% of the converted stock insurer. Subsidiaries could also be transferred from the converted stock insurer to the intermediate holding company and S.B. 93 provides that this may be done so long as the converted insurer received consideration in an amount not less than that at which the subsidiary is being carried on the company's annual statement filed with the insurance department.

The intermediate holding company would consequently be the entity in which stock would be sold. At no time can the mutual holding company own less than 51% of the stock holding company. But this does offer the stock holding company the opportunity to issue 49% of its stock to the public. This still allows the company to raise significant capital in the marketplace and to have a readily available currency for future acquisitions and growth. Both of these advantages are absent from the current mutual insurance company structure.

The right-hand side of page 4 of the handout shows what a mutual holding company structure would look like without a sale of stock to the public. As you can see, it looks the same as the left-hand side but with no outside shareholder involvement. This is important, though, because it allows a company to demutualize but not issue its stock to the public immediately. Instead it can await a favorable financial climate to go public or use the stock in a future acquisition. But the point is, it separates the demutualization process from the capital needs of the company. This flexibility is not afforded in any other type of demutualization.

There are many advantages to the mutual holding company structure. For instance, a company would pursue this form if:

- Limited new capital were required immediately
- Ability to access capital markets on a timely basis was viewed as advantageous
- Acquisition flexibility is viewed as important
- Structuring flexibility and ability to unstack businesses is viewed as important
- Ability to decouple restructuring and capital raising pending market conditions is viewed as advantageous
- Retaining flexibility to pursue statutory mergers with another mutual or mhc is considered important

Not only have policyholders not given up anything which they currently have under the mutual holding company structure but, in fact, they have gained the potential to be a part of a much stronger and better capitalized company. Because of their 51% ownership of the publicly traded holding company, policyholders still have the ability to protect their collective interest as a group.

Another substantial protection for the current policyholders of the mutual company is found in new section 4 of the bill which provides for what is known as a "closed block" consisting of all of the participating individual policies of the mutual life insurer. Under this section, the commissioner can require that the company set aside in this "closed block," assets sufficient that taken together with their cash flow and anticipated revenues will be sufficient to support the closed block including payment of claims and expenses, and to provide for the continuation of current dividend scales. I should emphasize the "closed block" provisions apply in all three methods of demutualization. This also protects the policyholders' contractual rights and assures that the company cannot arbitrarily reduce its dividend scale.

Changing course, there are two developments on the federal level which I believe are somewhat related to our bill, though not readily apparent, of which you should be aware. First, earlier this month, Congressman Jim Leach introduced a bill in Congress to purportedly enhance competition in the financial services industry. This bill allows the affiliation of banks and insurance companies. Section 303 of that bill provides that a mutual life insurer organized under the laws of any state may transfer its domicile to another state as a step in a plan of reorganization in which the mutual life insurer becomes a stock life insurer, whether as a direct or indirect subsidiary of a mutual holding company or otherwise. Such a redomestication would require approval of the state insurance regulator of the new state. In a nutshell, this says that a mutual insurer can redomesticate at its own election from a non mutual holding company state to a state which does have such a law.

Section 303 preempts state law that impedes such a redomestication.

I bring this up not to suggest that a Kansas domiciled company would redomesticate if Kansas did not have a mutual holding company law, but instead to suggest that this could be an economic development tool for our state to attract mutuals from the other states that do not have a mutual holding company law.

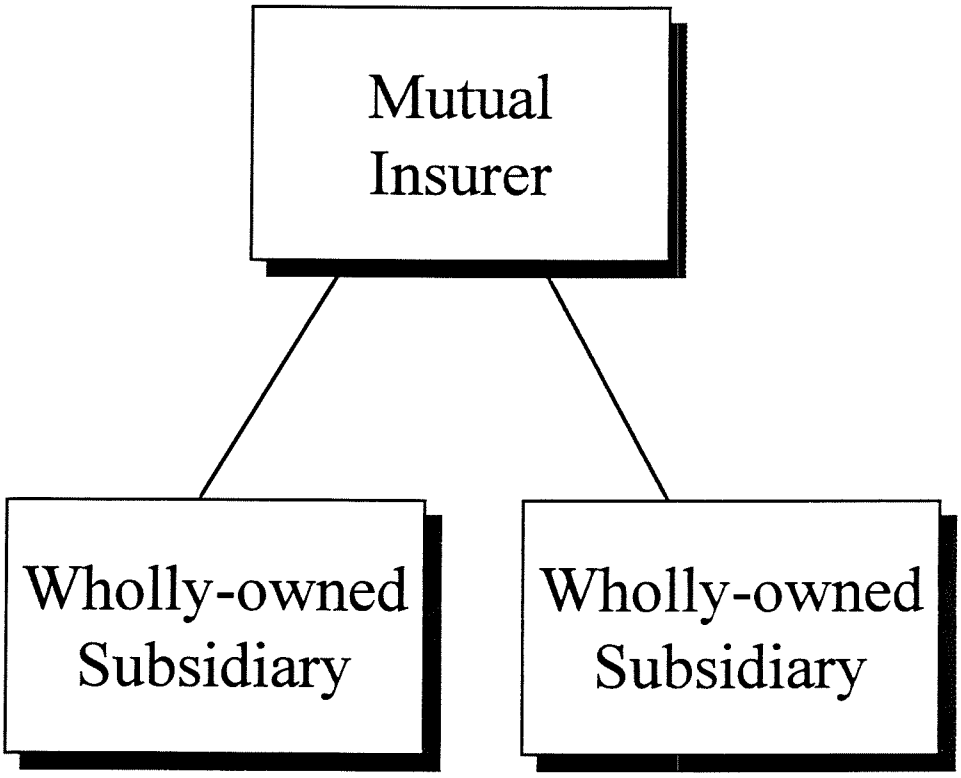
Secondly, last week, the Comptroller of the Currency approved Chase Manhattan Bank's application to establish an operating subsidiary to engage in certain insurance underwriting activities. We believe that this is the beginning of a movement toward bank and insurance company affiliation. If the Leach bill is also passed, the pace of bank and insurance company affiliation will accelerate rapidly. We also believe that this will increase further the competitive forces in our industry. Unfortunately, mutual insurers could not currently own or be owned by a bank simply because of their mutual structure. If insurers are to effectively compete in the future, they have to be positioned where they can affiliate with other financial institutions and gain access to the capital markets. I believe S.B. 93 allows mutual companies the ability to obtain these powers without diminishing the rights of policyholders.

I believe that any of the three models identified in S.B. 93 provide economic benefits to our Kansas mutual companies, their policyholders and our state. Kansas companies will benefit through the ability to grow as a result of the ability to raise additional capital and more readily affiliate with other companies; their policyholders will benefit by being made a part of a stronger company and at the same time being fairly compensated for their mutual company rights, or in the case of a mutual holding company, having those rights redistributed; and our state will benefit through the additional revenue which that growth would create.

In conclusion, I want to say that we have been working on this bill for the better part of a year. We have worked closely in drafting the bill with legal and accounting firms who have been involved in nearly every demutualization that has occurred. I feel we have crafted an excellent bill.

We have also worked closely during this period with the Kansas Insurance Department and have accommodated their concerns throughout the process. I especially want to thank Commissioner Sebelius and Tom Wilder for their cooperation, their insight and their positive attitude toward this bill. I encourage you to vote favorably on S.B. 93.

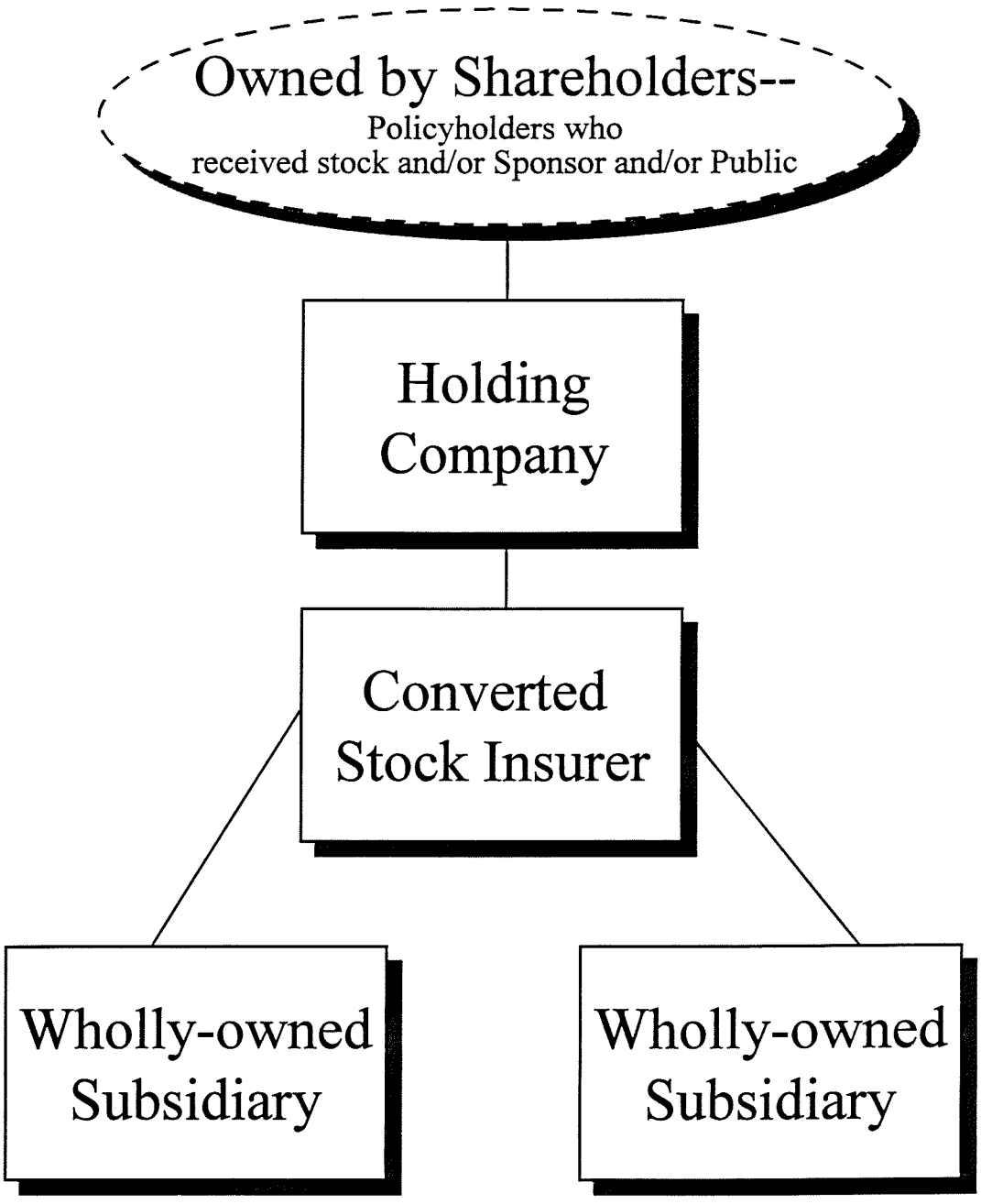
Before Demutualization



Traditional Demutualization

Pursuant to Proposed New Sec. 3(a) -- Page 2 of SB 93

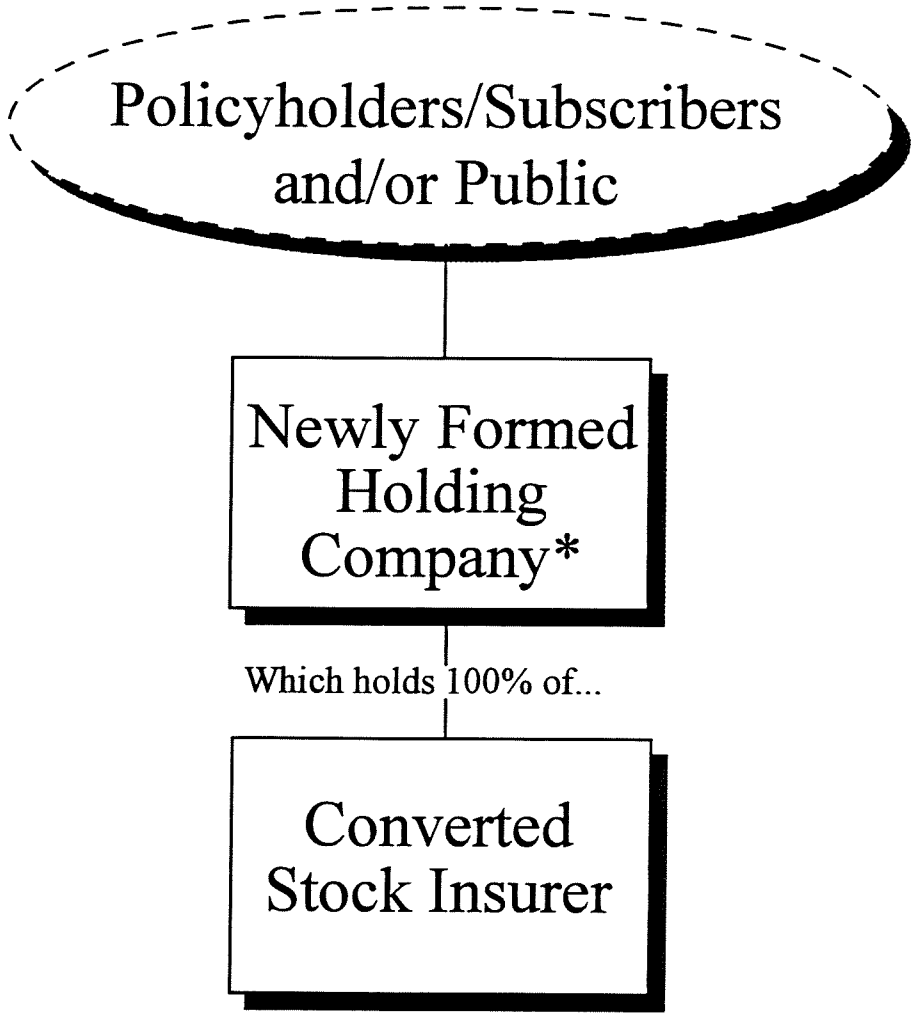
Policyholders exchange membership interests in mutual insurer for cash, securities, policy credits, dividends, subscription rights or other consideration, or some combination thereof.



Subscription Rights Conversion

Pursuant to Proposed New Sec. 3(b) -- Page 3 of SB 93

Policyholders exchange membership interests in mutual insurer for subscription rights to purchase shares of ...



* As alternatives, policyholders could receive subscription rights to purchase shares of:

- the converted stock insurer, or
- another insurer or other corporation ("sponsor") infusing capital into the company.

Mutual Holding Company Conversion

Pursuant to Proposed New Sec. 3(c) -- Page 4 of SB 93

Policyholders exchange membership interests in mutual insurer for membership interests in mutual holding company.