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The 'Enhanced Mutual' – A Potential Game Changer?

An enhanced mutual structure could mean big rewards for all those involved

By Richard Bland

Federated Rural Electric Insurance Exchange's Phil Irwin figured it out. "It" was a way for his company to substantially boost its surplus, strengthen its member ties, and save on taxes all in one fell swoop, simply by changing its legal structure.

Federated made the changes back when Irwin was the company's chief financial officer, and the financial advantages began immediately and have only grown over time. Irwin, who later became Federated's CEO, can proudly look back at the tens of millions of dollars added to his company's earnings and surplus capital as well as a healthy increase in policyholder numbers, all because of one strategic decision and its successful execution.

Imagine if year after year your mutual could improve its after-tax, bottom-line net income by up to 50 percent more than what it otherwise would have earned; internally grow its surplus capital by up to 50 percent more than what it otherwise would have increased; and forge and strengthen its long-term bonds with new and existing members in a way that differentiates it from and assists it in fending off the onslaught of publicly traded competition.

And what if a company could accomplish these gains without changing the way it does business – without implementing the latest fad in management techniques, without changing its personnel or headcount, and without changing its pricing rate structure or even the amount or type of business it writes?

This is exactly what Federated did. "When you put it all together – the increase in our surplus, the growth and loyalty of our membership, and the financial returns to our members – there is no comparison," said **Kelly Klug**, who helped with the transformation and took over as CFO when Irwin became CEO. "No way could we have accomplished what we did without changing our corporate structure. These are real, meaningful financial dollars-and-cents gains, not the exercise of special accounting or tax accounting rules that simply classify the numbers differently."

This might sound too good to be true, and perhaps for some mutuals it is; yet, the enhanced mutual insurance company model approach allows some mutual insurance companies to achieve significant financial and member gains … without changing the way they conduct their business.

What is an Enhanced Mutual?
"I would call it 'mutual plus,'" said Tom Kivell, national director of insurance tax for Des Moines, Iowa-based accounting and consulting firm McGladrey. "Most mutual insurance companies have operated in the same manner since their formations. From a financial perspective, every mutual insurance company should consider this option."

An enhanced mutual retains all of the traditional concepts of mutuality with a few added features. Chief among them is the ability to provide members with a financial stake in the company, which is a significant added benefit.

To be able to provide policyholders this financial stake, companies must alter their legal structures as Federated did. Under this altered structure, companies can take advantage of certain long-standing provisions in the Internal Revenue Code available exclusively to entities that are so structured.

"From a legal standpoint, the changes needed are not necessarily obvious, but they are available and worth the effort," said Federated's long-time general counsel **Susan Olander**. "Our board members recognized the advantages from the start, and they are proud of what this company has achieved for the membership. The financial strength and returns have really benefitted our members."

Enhanced Mutual Advantages
Two of the advantages Olander alluded to are member retention and the ability to increase the company's financial strength. Mutuals have long been recognized for the fundamental idea that the customer – or policyholder – comes first. Some would say this is what really differentiates mutuals from their stock competition, and because of it, mutuals enjoy an unrivaled loyalty from their policyholders. Still, suburbanization, urbanization, and mega-dollar advertising campaigns have put pressure on the traditional mutual insurer-policyholder relationship.

The enhanced mutual concept can cement that relationship in a way other corporate structures – even traditional mutuals – cannot. Mutual owners or members technically own their companies, but their rights are limited to voting for their boards of directors and sharing any remaining assets in the case of liquidation. In fact, many policyholders only reach out to their insurers when they have a claim, leaving them with little or no connection to their company other than remitting premium payments. But enhanced mutual policyholders can personally profit from being an insured. They can watch "their accounts" grow throughout their relationship with their enhanced mutual and be paid from them, keeping in contact with their insurer as they are allocated positive financial results each year.

As the enhanced mutual's policyholders' financial interests grow, they will demonstrate greater loyalty to their insurer and be less likely to change companies just to save a few dollars in premium elsewhere. Retired Navy Captain J.S. Mahoney Jr. has watched his insurance account grow by several thousands of dollars and has received several thousand more in payments from the account. This has led him to be a loyal customer who is heading into his fifth decade with the same insurance company.

Mahoney's 25-year-old daughter understands the financial benefits her father has obtained from his insurance company. She now insures with "Dad's company" and looks forward to sharing in similar financial rewards during her lifetime, showing that the enhanced mutual could even help bridge the insurance generation gap.

The loyalty that comes about from the enhanced mutual's financial-interest advantage cannot be matched by stock insurance companies, even with their multi-million dollar advertising budgets full of television ads and social media opportunities. But loyalty isn't an enhanced mutual's only advantage.

A company with this structure can build surplus capital faster than traditional mutual insurance companies. Some say mutual insurance companies are limited in their ability to generate capital by the nature of their organizational structure and policyholder-based ownership. But enhanced mutuals can grow their capital at an accelerated pace. It all ties back to what is provided in the tax laws. Based on these laws, enhanced mutuals may internally generate contributions to surplus capital by up to 50 percent more each year than their non-enhanced mutual brethren. Where a regular mutual is able to grow its surplus internally by $2 million in a given year, an enhanced mutual may be able to grow its surplus – based on the very same amount of pre-tax statutory income – by $3 million. And more surplus means more options to better improve capital growth prospects, employee hiring, compensation, and technology.

"The net bottom-line surplus building difference between this type of company and a traditional insurance company is jaw dropping when you examine them, especially over a period of several years," said Lew Salmon, founder and managing partner of the Atlanta, Georgia-based accounting firm of Salmon Barton & Associates.

So long as the enhanced mutual is profitable, this growth continues year after year. "The compounding aspects should not be overlooked," says McGladrey's Kivell. He also says those compounding aspects can be substantial. By adding to surplus capital faster, the enhanced mutual has more capital to use to write more business and generate more investment returns, which should allow the company to grow surplus capital and net income by ever greater amounts.

Healthcare Providers Insurance Company, a property/casualty company in Madison, Mississippi, has experienced great success. CEO Larry Bourne credits his company's enhanced mutual-like structure for the more than $35 million in surplus from earnings in only nine years of operation. “You still have to price your business right, manage your business right, underwrite your business right, handle claims correctly, and have some luck,” said Bourne, “but at the end of the day, once you do all of this, if we were not structured correctly we would have accumulated only half of the surplus that we have.”

The Best Enhanced Mutual Candidates

As a general rule, two criteria can be used to determine if a mutual can qualify as an enhanced mutual: the lines of insurance it writes and its historic or projected future profitability.

Personal lines coverage is the largest line of business that should satisfy most of the criteria to be an enhanced mutual.

A mutual that writes only, or almost only, commercial lines of insurance is usually not a good candidate. But there are a few exceptions. If a mutual writes a substantial amount of commercial insurance for nonprofits such as universities, colleges, churches or other religious entities, hospitals, credit unions, or governmental entities, then it could still qualify.

The enhanced mutual model works best if a mutual is profitable or expects to soon become profitable. In Federated’s example, it had experienced financial losses in the early 1990s, but could foresee profitability in future years and it changed its structure to take advantage of that expected profitability.

And it worked. When he was promoted from CFO to CEO, Irwin remembers telling Federated’s board chairman that “there was nothing I could ever do for Federated in the future that would be as valuable as the effect of changing our legal structure when I was CFO.

“What I said then is still true today,” Irwin concluded.

Richard Bland is a tax insurance, corporate insurance, and regulatory insurance attorney who practices out of Richmond, Virginia. He co-developed the enhanced mutual insurance company structure with his colleague, Scott J. Sorkin.