Kajian Ekonomi & Keuangan
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The Governance and Demutualization of Mutual Insurance in Indonesia

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Riwayatartikel:

- Diterima 31 Agustus 2017
- Direvisi 11 Januari 2018
- Disetujui 15 Januari 2018
- Tersedia online 20 Februari 2018

Key words: insurance; governance; demutualization; mutual insurance; AJB Bumiputera 1912

JEL Classification : G22, G23, G28, G34, G38, H32

Abstract

This paper outlines international best practice in terms of the governance of mutual insurance companies, the key drivers of demutualization and its implications. It examines demutualization as a possible option for Indonesia's AJB Bumiputera 1912, following its poor performance in recent years. It also provides relevant insight on governance issues and the demutualization process within the context of the regulatory and supervisory framework for Indonesia Insurance Act No. 40/2014.This paper use descriptive qualitative approach to explain the recent problems of AJB Bumiputera 1912 as the only mutual insurance company in Indonesia. To conduct the analysis, this paper is using the data of AJB Bumiputera 1912 Financial Statements for the past 5 years as the main source of information as well as other sources available, especially on the company website. Its findings shows that governance in AJB Bumiputera 1912 should take into account increasing the involvement of policyholders as well as good database management of policyholders, using latest technology to reach them to reach sufficient number of Representative of Policyholder. It can be one of the options to decrease moral hazard as well as distribution of huge power of the Representative of Policyholder. This paper also offers possible options of demutualization and its implication of the policy to the stakeholders to overcome the problems.

Abstrak

Tulisan ini menguraikan praktik terbaik di dunia international dalam hal tata kelola perusahaan asuransi usaha bersama, faktor-faktor apa saja yang dapat menjadi pendorong utama kebijakan demutualisasi dan implikasi yang dapat ditimbulkan dari kebijakan tersebut. Tulisan ini mengkaji demutualisasi sebagai alternatif pilihan yang mungkin untuk AJB Bumiputera 1912 di Indonesia menyusul kinerjanya yang kurang baik dalam beberapa tahun terakhir. Tulisan ini juga memberikan wawasan yang relevan mengenai isu-isu tata kelola dan proses demutualisasi di Indonesia dalam kerangka pengaturan dan pengawasan Undang-Undang No. 40 Tahun 2014 tentang Asuransi. Tulisan ini menggunakan pendekatan metode deskriptif kualitatif untuk menjelaskan permasalahan yang terjadi saat ini di AJB Bumiputera 1912 sebagai perusahaan asuransi usaha bersama di Indonesia. Untuk melakukan analisis, tulisan ini menggunakan data Laporan Keuangan AJB Bumiputera 1912 selama 5 tahun terakhir sebagai sumber informasi yang utama dan juga sumber-sumber lainnya yang relevan, seperti informasi dalam website perusahaan. Temuan kajian ini antara lain perlunya tata kelola yang baik di AJB Bumiputera 1912 dengan meningkatkan keterlibatan lebih luas dari para pemegang polis dalam perusahaan dan perlunya memiliki manajemen database para pemegang polis yang baik, terutama dengan menggunakan pemanfaatan teknologi terbaru untuk mencapai jumlah anggota Badan Perwakilan Anggota (BPA) yang cukup. Ini dapat menjadi salah satu alternative dalam rangka mengurangi moral hazard dan pembagian kekuasaan yang terlalu besar apabila hanya terdapat sedikit anggota BPA. Kajian ini juga menawarkan alternatif yang mungkin dilakukan untuk menyelesaikan masalah yang terjadi di antaranya demutualisasi serta kemungkinan implikasi kebijakan tersebut terhadap para pemegang polis perusahaan

1. BACKGROUND

Insurance companies play an important role in society by helping individuals manage risks arising from premature death, sickness and accidents. Individuals can transfer these risks to insurance companies, which then manage these risks by pooling them across a large customer base and through reinsurance. Insurance companies can take different forms such as mutual and stock companies. This paper focuses on mutual insurance companies only.

There are several types of insurance company in Indonesia that are recognized by Indonesia's Insurance Act No. 40/2014, such as limited liability, cooperatives and one mutual company, which was established long before the Insurance Law was ratified. A mutual insurer is an insurance company which is collectively owned by its members and which acts in the best interest of its members (Association Internationale des Societies d'Assurance Mutuelle, 2008). Asuransi Jiwa Bersama Bumiputera 1912 (Bumiputera 1912 Mutual Life Insurance Company) is the only mutual insurance company in Indonesia. Table 1 provides recent information on AJB Bumiputera 1912's market share and performance.

TABLE -1: Financial Data on AJB Bumiputera 1912

	2011	2012	2013	2014	2015
Total Assets of AJB Bumiputera 1912/GDP current market	0.289%	0.283%	0.278%	0.260%	0.244%
Total Assets of AJB Bumiputera 1912/Total Assets of Insurance Industry	3.94%	4.07%	3.83%	3.49%	3.44%
Total Assets of AJB Bumiputera 1912/Total Assets of Life Insurance	7.32%	8.65%	8.60%	7.43%	7.46%
Total Assets of AJB Bumiputera 1912/Total Assets of General Insurance Industry	38.39%	35.04%	23.50%	21.59%	22.74%
Liabilities (including policy liabilities) to equity ratio of AJB Bumiputera 1912	11,610%	4,204%	-8,435%	-764%	-1,113%
Return on equity ratio of AJB Bumiputera 1912	44%	17%	-45%	-24%	-15%
Equity of AJB Bumiputera 1912 (in million rupiahs)	183.38	552.69	-296.03	-4,020.76	-2,710.68

Note. From Financial Services Authority, 2015 and AJB Bumiputera 1912 Financial Report, 2011-2015

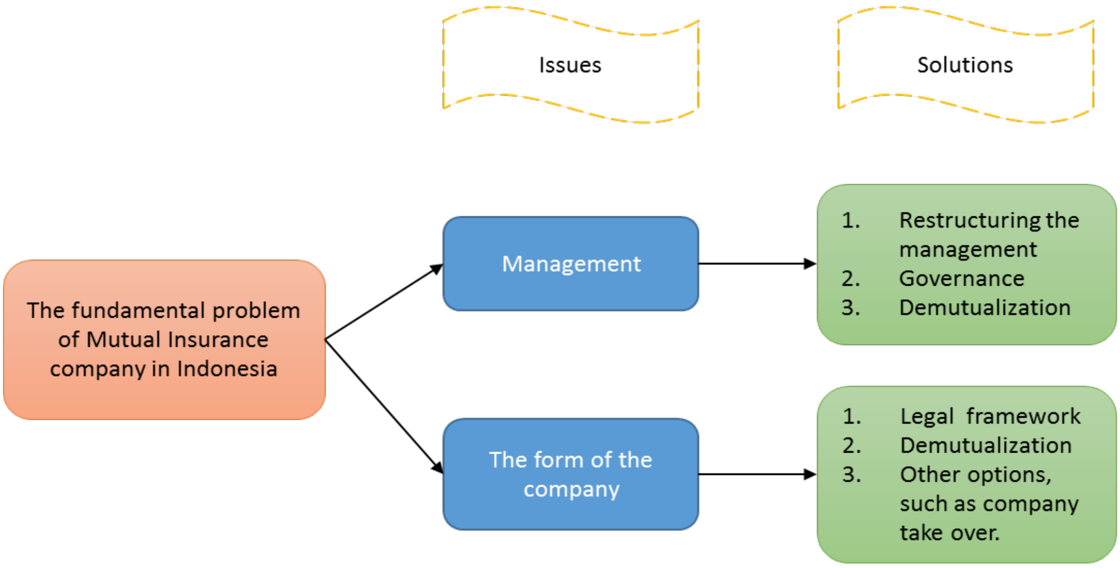
We can see from Table 1 that AJB Bumiputera 1912 has a market share of only around 3.44 percent of the whole insurance industry and its share of both the life insurance and general insurance industries has declined in recent years. AJB Bumiputera 1912's performance over the past three years has been relatively weak, recorded negative equity, and increased liabilities. With more than 6 million policyholders (Nirmala, 2017), this insurance company has a lot of stakes if government does not involve in its settlement.

According to the Insurance Act No. 40/2014, the Indonesian Government does not encourage the establishment of new mutual insurance companies in Indonesia. The performance of the only mutual insurance company in Indonesia in recent years would appear to justify this approach, but there are some questions left unanswered. This paper addresses the following research questions:

1) Does the mutual form of an insurance company, in general, perform less efficiently than the stock company?
2) What are the key governance issues for mutual insurance companies and how could they be changed to improve performance and competitiveness in the market?
3) What are the key considerations involved in demutualization of a mutual insurance company to increase its performance?

This paper focuses on the key issues shown in Figure 1.

FIGURE -1: Mutual Insurance Issues in Indonesia



As indicated above, the current practices of AJB Bumiputera 1912 have led to losses for the past three years and its capital has been consistently eroded. This paper seeks to determine the fundamental issues associated with mutual insurance in Indonesia. Possible problems are possibly management issues, the inability of the management to maximize the policyholders' wealth, and the form of the company structure, which that a mutual insurance company is unable to raise capital other than that arising from profits on existing and issuance of new insurance policies. Potential solutions include:

1) changing the management structure
2) ensuring good corporate governance through the legal and financial framework
3) demutualization of the mutual insurance company through issuing tradeable shares to policyholders (and perhaps outsiders)
4) other options, such as takeover by another company (which also involves demutualization).

2. LITERATURE REVIEW

There are several research in the area of mutual companies and mutual insurance companies in particular regarding to the issue of agency conflicts, governance and possible options to overcome general problems faced by mutual insurance companies.

Brockett, et all. (2004) examine the efficiency of insurance companies via data envelopment analysis using solvency, claims paying ability, and return on investment as outputs and using a financial intermediary model for the insurance company. Their findings can be summarized as follows: (1) stock companies are more efficient than mutual companies, (2) agency is more efficient than direct. Stock and agency › stock and direct › mutual and direct › mutual and agency where " › " means "more efficient than." Not only regulators but also the managers, investors and policyholders all devoted much attention to solvency (as well they might) so that very small (if any) inefficiencies were present in this variable. In fact, solvency was accorded the highest priority to ensure an absence of any shortfall. This is why, insurance companies are accounted for their ability to solve solvency problems, claims paying ability, and return on investment.

MacMinn and Ren (2011) conducted a research on comparison of mutual and stock insurance companies. They found that the current empirical literature supports the managerial discretion hypothesis, but cannot preclude alternative explanations. One such explanation is the adverse selection of insurance customers and owners. This issue and its implication for risk taking deserve more research attention. In addition, the evidence on the efficiency of mutual versus stock insurers is mixed and has resulted from different evaluation approaches or different samples. More testing is required but should be based on a theory that incorporates the incentives and behavior of all stakeholders in the insurance firms and markets. Spiller (1971) also conducted a research on comparison between 19 stock insurance companies and 27 mutual insurance companies which operated under New York regulations between 1952 and 1966. He found that stock and mutual life insurance companies exhibit different performance characteristics using proxies of percentage increase in assets over 15 year period and percentage change in net premium income.

Jemison and Oakley (1983) conducting a research on good corporate governance on mutual insurance companies. Their findings can be summarized as follows:

1. There is, in general, very limited opportunity for individual policyholders to participate in the nomination and election of board members, particularly in the large mutual companies.
2. Most of the firms surveyed had a majority of outside directors on the board. However, 19% (almost one-fifth of the total) do not have a majority of outside directors, although these companies tend to be concentrated in the smaller size categories.
3. One-third of the respondents had board members who were serving concurrently as directors on one or more unaffiliated insurance companies.
4. A majority of the companies surveyed do not have an audit committee of the board, although there is a positive correlation between company size and the presence of an audit committee.
5. There is a limited flow of information from the companies to the policyholders regarding the financial position of the company, particularly in the larger insurers.

Given the inherent limitations of policyholder disinterest, statutory restrictions, and the current cost-benefit calculus, there is little reason to believe that existing practices of policyholder involvement in the selection of mutual company board members will be changed quickly.

Boulton (1980) in Jemison mentioned that in general, boards can be thought of as having three roles: legitimizing management's decisions, auditing management's performance, and directing the firm to ensure corporate survival.

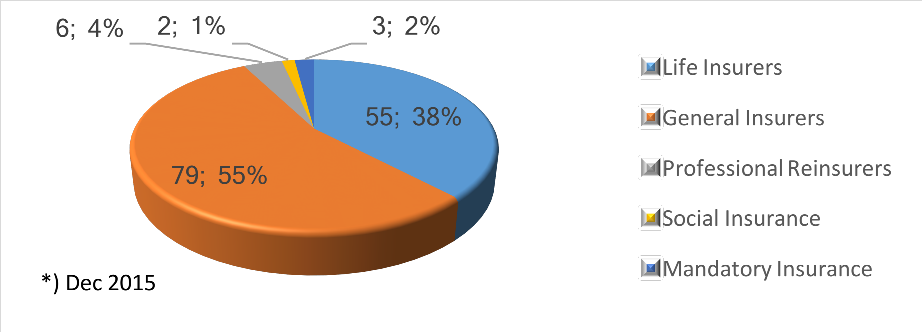
Consultation Paper from Department of Finance (1998) provides the definition of demutualization and its purpose. According to the article, demutualization is a process by which a mutual company converts to a stock company. The resulting more flexible corporate structure should serve to improve the company's competitiveness and efficiency and provide greater opportunities to expand its lines of business, invest in new technologies, increase market penetration, and fund new acquisitions.

Chugh and Meador (2006) investigate the effectiveness of demutualization as a strategic response to the challenges posed by the dramatic changes in the regulatory and competitive environment in the life insurance industry. The study finds that the demutualized firms generally have implemented a successful strategy based on higher growth, greater profitability, cost effectiveness and shifts in product mix. Also, they find that management takes greater risk in the investment portfolio. In addition, demutualization unlocks value lying dormant in the mutuals' surplus. The paper concludes that the demutualized firms have generated substantial excess returns over the several market indexes, creating significant economic value.

Indonesia Insurance Industry

The Indonesian insurance industry has a low penetration rate (i.e. ratio of insurance premiums underwritten to GDP) of around 2.5 percent but it is one of the fastest growing sectors within the country's financial system (Indonesia Insurance Industry Report, 2016). Life insurance coverage is also low with only around 20 percent of the population holding life insurance policies. According to the Financial Services Authority of Indonesia, there were 145 registered insurers in December 2015. Among the 55 life insurers, there is only one mutual insurance company, AJB Bumiputera 1912. Total assets of Life Insurance to GDP of Indonesia is only 3.28% while total assets of Life Insurance to total insurance assets ratio is about 46.11%. In regards of insurance services, Insurance Act No. 40/2014 clearly identifies requirements for the separation of life insurance and general insurance businesses. Figure 2 shows the number of registered insurers in Indonesia. Table 3 indicates the growth in the number of registered insurers in Indonesia over the past five years as well as the recent trends in asset growth in each industry sector.

FIGURE-2: Number of Registered Insurers in Indonesia, December 2015



Note. From Financial Services Authority, 2015

TABLE-2. Number of Insurers

	2011	2012	2013	2014	2015
Number of Registered Insurers:	139	140	141	141	145
Life Insurers	45	47	47	50	55
General Insurers	85	84	85	81	79
Professional Reinsurers	4	4	4	5	6
Social Insurance†	2	2	2	2	2
Mandatory Insurance‡	3	3	3	3	3

Note. From Financial Services Authority, 2015

Table-3. Total Assets of Insurers, trillion Rupiah

	2011	2012	2013	2014	2015
Total Assets Insurance	349.71	427.87	659.72	784.28	819.85
Life Insurance	293.74	269.25	293.74	368.06	378.03
General Insurance	55.97	66.50	107.44	126.75	124.01
Professional Reinsurers	N/A	N/A	N/A	22.11	208.16
Social Insurance	73.14	92.12	93.38	N/A	N/A
Mandatory Insurance	N/A	N/A	N/A	103.46	109.65

Note. From Financial Services Authority, 2015

AJB Bumiputera 1912 plays an important role in Indonesia's insurance industry as a competitor in the insurance market. Established in 1912, the company has more than 6.5 million policyholders (Pengelola Statuter, n.d.). With such a large customer base, the company should benefit from economies of scale, operate efficiently, and maintain a strong capital structure and revenue stream, thereby ensuring that future obligations arising from policyholders' claims are met. Unfortunately, the company has not performed at all well recently. After negative equity recorded for the past three years (as indicated in Table 1), the company's capital has been depleted and its assets are not sufficient to meet future claims from existing life insurance policyholders. AJB Bumiputera 1912 cannot offset this capital deficiency by acquiring capital from the sales of shares as mutual insurance companies are not allowed to do this. (Even if it were possible, investors would be wary of contributing equity to company in such a loss-making position).

† Social Insurance is a government mechanism for collecting mandatory funds that provide protection against of socioeconomic risks affecting insured parties and/or their family members. Before 2014, Social Insurance was managed by PT Jamsostek (now called BPJS Ketenagakerjaan) and PT Jasa Raharja but since then it has been managed by BPJS Kesehatan dan BPJS Ketenagakerjaan.

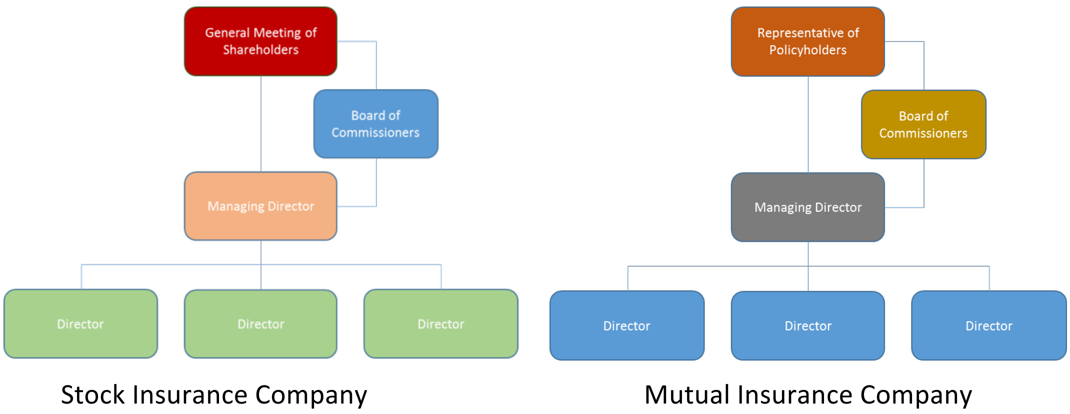
‡ Mandatory insurances are insurance services that has been mandated by the Government of Indonesia. Before 2014, mandatory insurance was managed by PT Askes (now called BPJS Kesehatan), PT Taspen, and PT Asabri. Since then, Mandatory Insurance has been managed by PT Asabri, PT Taspen, and PT Jasa Raharja.

The Insurance Act does not encourage the establishment of new mutual insurance companies in Indonesia and the regulation of mutual companies and mutual insurance companies has not yet been ratified. According to Insurance Act No. 40/2014 Article 6 Verse 1 point C and Verse 2, the only mutual insurance company that recognized by law is the one that has been established when the law is enacted. This article implied that there will be no mutual insurance company allowed to be established after this Insurance Law passed. To some extent, this makes AJB Bumiputera 1912 vulnerable, but it also provides flexibility in terms of its corporate management structure and governance.

The governance structure of AJB Bumiputera 1912 is set out in its 2011-2015 financial report. There are 11 people appointed as members of the Representatives Board of Policyholders, which has oversight of and responsibility for the ownership, rights and obligation of the policyholders in the company. The Representatives Board of Policyholders is the only entity within the mutual insurance company that is eligible to convene General Meetings and Extraordinary Meetings. A General Meeting is a meeting of the general membership of an organization which usually held once or twice a year. An Extraordinary Meeting is a general meeting at an irregular time. One of the agenda items in these meetings is the election of the board of commissioners and the board of directors of the company.[§]

With only 11 members representing 6.5 million of policyholders, there is a significant concentration of power, and there is only a small number of people eligible for election to the board of commissioners and the board of directors. From the financial statements of AJB Bumiputera 1912 from 2011 to 2015, it appears that there are Representatives of Policyholders who also hold positions in the board of commissioners.[**] It is not considered to be good corporate governance practice for a company to have people holding multiple positions at the same time with different targets. This can create possible conflicts of interest and thereby also inhibit directors' ability to achieve corporate goals. To overcome this issue, some research has suggested reforming the governance of mutual insurance companies through legislation that would mandate more policyholder participation in the director selection process (Long 1979). In the absence of specific mutual insurance regulations, the structure of mutual insurance companies in Indonesia tends to be similar to that of a limited liability company (as required by the Limited Liability Act No. 40/2007), see Figure 3.

FIGURE-3. Organizational Structure of Stock Insurance Company and Mutual Insurance Company based on Limited Liability Company Act No. 40/2007



With a large number of policyholders of a mutual insurance company who also act as the owners of the company without a majority owner, there is no incentive for each policyholder to supervise the management, as long as their insurance claims are expected to be paid. There has been very little change in the Representatives of Policyholders, or the Board of Directors, or the Board of

[§]See Indonesia Law no. 40 year 2007 concerning Limited Liability Company for the company structure

[**]Precise details of governance arrangements in the company's articles of association is not publicly available.

Commissioners of AJB Bumiputera 1912 over the past five years, with a huge concentration of power occurring as part of the management structure and on the supervisory boards of the company. In addition, since there is no incentive and pressure to maximize the wealth of shareholders and expand the business of a mutual insurance company, board of directors are likely to be risk averse and have a desire to maintain security and tenure. Moreover, because there is no market price for shares in a mutual insurance company (unlike stock insurance company) there is no external stock market pressure for good performance. This can mean that the mutual insurance company tends to be managed in a conservative way, and does not pursue profit growth, operational efficiency or improved competitiveness.

3. RESEARCH METHODOLOGY

This paper is using descriptive qualitative approach in order to explain the recent problems of AJB Bumiputera 1912 as the only mutual insurance company in Indonesia as well as its possible options of demutualization and its implication of the policy to the stakeholders. Descriptive qualitative has been chosen to be used in this paper in order to get the full disclosure of AJB Bumiputera 1912's problems.

The data that has been used in this paper mainly comes from AJB Bumiputera 1912's website, including but not limited to its financial statements for the past 5 years and any information in it, Financial Services Authority, Indonesia Insurance Industry Report, and Insurance Law.

4. ANALYSIS AND DISCUSSION

A. Mutual and Non-mutual Insurance Company

To qualify as a mutual insurance company in the United States (US), the following characteristics must be present: (1) the right of policyholders to be members to the exclusion of others and the right of such members to choose the management; (2) the sole business purpose is to supply insurance substantially at cost; (3) members have rights to the premium income in excess of those amounts needed to cover losses and expenses; and (4) common equitable ownership of the assets by the members (Rev. Rul. 74-196, 1974). In addition, all of the policyholders in a mutual company are automatically the owners of the company and entitled to vote for management. Moreover, some companies use active participation (direct democracy) amongst all policyholders in the voting process and others using representatives of policyholders (indirect democracy) in the voting process (Association Internationale des Societies d'Assurance Mutuelle 2006). In the event of liquidation of a mutual insurance company, each policyholder can expect a pro-rata share of the net assets left in the company. (This may not be received for some time, since assets will need to be reserved to meet future claims while the company is in run-off mode).

According to Hansen (2010) and Banham (n.d.), there are several differences between mutual insurance companies and stock insurance companies, see Table 4.

TABLE-4. Differences between Mutual Insurance and Stock Insurance Companies

	mutual	Stock
owners	policy holders	stock holders
focus	make money for policy owners	make money for stock holders
status	non-transferable	Transferable
capital acquirement	issuing policy, inability to raise capital through public investment, less financial flexibility	issuing stocks, ability to raise capital through public investment, more financial flexibility
capital market requirements	is not beholden to capital markets	is beholden to capital markets
voting rights	may have a voice in voting on management personnel and policy decisions	have the option to exercise discipline on management to operate as efficiently and profitable as possible
dividends[c]	uninterrupted tax-free	Taxable

provide	continuity of affordable insurance, payment of claims, as well as long-term profits for policyholders	short-term quarterly profits for shareholders
risk	long-term safety is paramount	there is an incentive to take risks

[c] This is the case in the US

In addition, according to Hansmann (1985), mutual form company has no class of shareholders with an interest adverse to that of the policyholders, so the incentive for the company to behave opportunistically in setting the level or riskiness of reserves is substantially attenuated. This is one positive side of the form. However, there are several negative sides as well, such as:

a. The number and geographic dispersion of policyholders in most mutuals has led to substantial shareholder apathy, so the effective control of the mutuals is entirely in the hands of their directors and managers.
b. Lack of control from outside party makes directors and managers are having low incentives to minimizing costs.
c. Lack of diversifying business line by law.

Davis (2001) found that while cooperative or mutual organizations have some competitive advantages over joint-stock companies, this may have been eroded by various developments in recent decades. MacMinn and Ren (2011) suggested that the main explanation for the coexistence of mutual and stock insurers is agency theory. Jensen and Meckling (1976) found that different forms of organizations create different incentives for the contracting parties and thus different costs of controlling the incentive problems. In a stock company, there is always an issue around conflicts of interest between the owner/shareholders and the managers. Although the main purpose of the stock company is to maximize shareholders' value, managers can always ensure decisions taken by the company are in their own interests, which can be very different from the company's primary goal. Incentives, such as remuneration and bonuses, can alter managers' behavior. However, shareholders are able to monitor management performance through the stock price of the company as well as incentives-based performance, to minimize unwanted behavior and moral hazard (i.e. when management is protected from consequences of poor decision making), (Shapiro 2005). There are also potential conflicts between the owners and the other stakeholders (policyholders in insurance, depositors in banks) which may lead to the company taking excessive risks. (Owners of the company may get the upside benefits if risk taking pays-off, but their downside risk is limited by limited liability).

Mutual insurance companies face different agency problems. Conflicts of interest between policyholders and owners do not exist (since they are the same) but since mutual insurance companies are not listed, there is no way to link management performance with company value other than through the company's ability to meet its obligations to pay insurance claims. In addition, mutual insurance companies tend to have high monitoring costs to overcome asymmetric information for policyholders, especially in a direct democracy approach. Management can become entrenched, even if their performance is inferior. In addition, there is no opportunity for retraction of board members' benefits, both financial and non-financial, for poor performance.

Current practices regarding voting rights of mutual insurance companies in Indonesia, as mentioned above, use and indirect democracy approach. This means that policyholders elect their representatives according to geographical area. For AJB Bumiputera 1912, there are 11 people representing 11 different regions who become Representatives of Policyholders for 6.5 million of policyholders. Also, as mentioned earlier, it is possible to hold concurrent positions as a Representative of Policyholders and member of the board of commissioners, for multiple periods in the same positions for terms of more than three years.

B. Governance of Mutual Insurance Companies

The Cadbury Committee (1992) noted that corporate governance is the system by which companies are directed and controlled. Corporate governance guides a number of key components of effective board practice based on underlying principles such as accountability, transparency, profitability and focus on the sustainable success of an entity over the longer term. It also mentions the key roles for the boards including culture development, and the establishment and maintenance of the values and ethics of the company. According to the Association of Financial Mutuals (2014), the code of conduct of mutual insurance outlines requirements for high standards of governance in the best interests of members. The purpose of corporate government is to facilitate efficient, entrepreneurial and prudent management that can deliver the long-term success of the company. Mutual insurance companies are expected to maintain high standards of governance in the best interests of their members.

Corporate governance is primarily about the management of a company. Jemison and Oakley (2007) suggested that corporate governance involves questions of who controls and who should control modern corporations. They indicate that the election process for who will control a company should take into account the purpose of the company, and the company should be led by people who are completely trusted by policyholders. Policyholders in mutual insurance companies have entirely different aims from those of the shareholders of a company.

In a mutual insurance company, many policyholders are often unaware of their rights of ownership of the company and they mostly care about whether their insurance claims will be met in the future. This lack of awareness of their ownership rights means policyholders may fail to exercise their rights and obligations to the company, despite participating (indirectly) in the election of management and the board of directors and board of commissioners via elections of members to the Representatives Board of Policyholders. Since the Representatives Board of Policyholders is the highest authority in mutual insurance companies, representing the interests of all of the policyholders, individual policyholders should select these representative members carefully.

The Representative Board of Policyholders needs to create a participation process that enables policyholders to be involved easily. In addition, communication technologies should be used to disseminate information on the company widely and responsibly to each policyholder regardless of their interest.

In the previous section, we discussed the multiple roles held by some of board directors, members of the board of commissioners and Representatives of Policyholders within AJB Bumiputera 1912 and the relatively few changes which have occurred in recent years in the board structure. Dual roles lead to a concentration of power in the hands of a small number of people, which can also create moral hazards and self-interested behavior rather than acting on behalf of the policyholders. If a mutual structure is to be maintained, we recommend restructuring the governance surrounding the election of board directors, Representatives of Policyholders and members of the board of commissioners, to ensure policyholders' interests are protected. A clear separation of people who sit on these boards can also reduce moral hazards and unwanted behavior. Introducing additional members of the Representative Board of Policyholders could also enhance the diversity and representativeness of the huge number of policyholders of AJB Bumiputera 1912.

Mutual and stock insurance companies face different options for raising capital. The only source of capital for mutual insurance companies is from surpluses arising from existing policies or from issuing new insurance policies. In addition, whereas a board of directors in a stock insurance company aims to maximize the wealth of shareholders, the board of directors in a mutual insurance aims to meet the future obligations of policyholders.

Camboly (2006) used a questionnaire to examine governance based on regulations applicable in the European Union member countries.[††] She suggested that strict regulations regarding conflicts of interests between parties are needed in order to guarantee the independence of the board members. In addition, there is an obligation for board members to disclose any conflicts of interest to the board of directors as well as to auditors. This regulatory framework encourages the reduction of moral hazard, unwanted behavior and the concentration of power among board members.

[††] European Union member countries and eleven companies or associations provided information in the following countries, such as Belgium, Denmark, Finland, France, Germany, Hungary, Italy, the Netherlands, Spain, Sweden and the United Kingdom.

One concern with mutual companies is the role of members in ensuring effective governance. Jemison and Oakley (1983) found that in general there are very limited opportunities for individual policyholders to participate in the nomination and election of board members, especially in large mutual companies.

Board directors and commissioners are responsible for managing the mutual insurance company's operations in accordance with the applicable provisions. Members of the Representative of Policyholders in a mutual insurance company should report to the audit committee and account for the duties and powers given to them. In addition, the audited report of the Representative Board of Policyholders should be accessible to all policyholders. The report should make appropriate disclosures about their accountability in terms of their duties and powers.

Legislative changes may be necessary to allow for a different governance structure for mutual insurance companies that would ensure good corporate governance, for example, changing the number of Representatives of Policyholders and prohibiting dual roles of board members. If the decision is made to maintain a mutual insurance company structure in Indonesia, the legislation will need to be changed as the Insurance Act does not allow for the establishment of more mutual insurance companies.

The relatively poor performance of Indonesia's only mutual insurance company highlights the fact that no one within the organization is directly responsible for the management of its assets. This leads to the suggestion that demutualization may be appropriate path to achieving a more efficient organizational structure (Davis, 2016b). However mutuals tend to be well-capitalized before demutualization (Lombardi 2000).

There are several reasons for a mutual company to demutualize. Mayers and Smith (2002) and Davis (2001) suggest a number of motives for demutualization of mutual company including to: remove growth constraints caused by the lack of access of capital; enter a business line that requires strong control mechanisms as well as risk taking; transfer the communal wealth of the mutual into private wealth in the form of tradeable shares; and facilitate the introduction of wealth services for both current and future members.

In most international cases mutual companies are demutualized when they are performing well, however, as AJB Bumiputera 1912's performance has deteriorated over the past three years, demutualization is just one of a number of possible options for improving its financial performance.

C. Demutualization

Demutualization is the process of converting a mutual life insurance company which is owned by its policyholders into a publicly traded stock company owned by shareholders, as part of a conversion plan approved by policyholders and state regulators (Chugh and Meador, 2006). There are several reasons why a mutual insurance company might choose to take this path. Lombardi (2000) highlighted several factors influencing the timing of demutualization of mutual insurance in Canada (and the decision to take this step), These include significant new opportunities emerging from the globalization and integration of capital markets, increased access to capital and the need to deal with multiple national regulations during the demutualization process.

Chugh and Meador (2006) also suggested that the main reasons for demutualization by US life insurance companies were the marked changes in the regulatory and competitive environment in the life insurance industry in the recent past which have made the mutual structure less competitive. As discussed earlier, because of the constraints on their capital acquisition, growth in a mutual insurance company is dependent upon accumulating capital from profitable operations. Another incentive for demutualization can be the desire to convert the accumulated, communally owned, capital of the mutual give into private wealth. Demutualization is one way to overcome a company's financial problems, which cannot be resolved within the mutual structure. Provided that the company is solvent, it will have positive market value, facilitating demutualization. But if it has negative equity, then the feasibility of demutualization depends upon its future growth and profitability prospects.

C.1. Key Consideration of Demutualization Process

Because demutualization requires the allocation of shares (either for no cost or via subscription) in the new company to members and others, there are several factors that need to be considered as part of the demutualization process. These include:

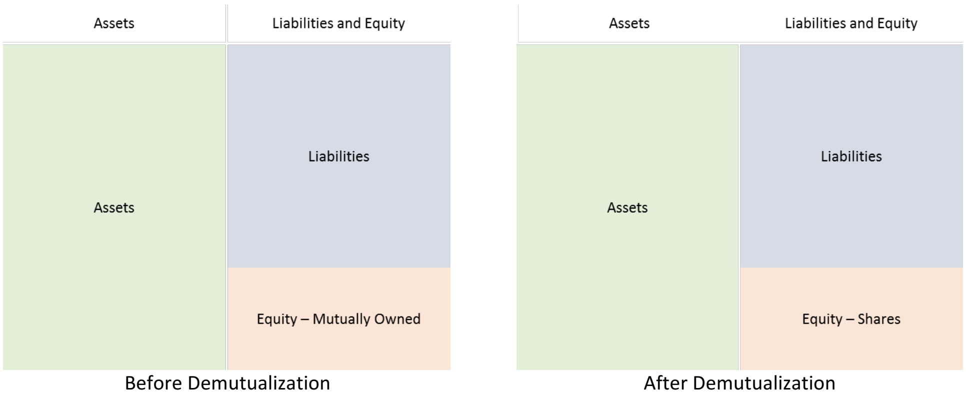
1. Cut-off date for membership
   This can be determined by the date of the general meeting held to approve the demutualization. Whereas a stock company usually has majority shareholders to guide the strategic direction of the company, in order to get approval for demutualization from the mutual's policyholders, it is strongly recommended that a general meeting be held and attended by the majority of representatives of policyholders. Since there are no majority of shareholders in the mutual company and each policyholder has one vote, and the representatives of the policyholders must vote in the interests of each policyholder at the general meeting. It is important to make sure that calculations are made of insurance claims for the next fiscal year to ensure these obligations are met.
   Obtaining approval for demutualization from a majority of policyholders through an extraordinary meeting is not straightforward. It can be difficult to ensure that the members of the Representative Board of Policyholders represent the majority of the policyholders. In addition, one-policyholder-one-vote rule makes it harder to achieve a majority vote. To do so, governments can intervene and give full support to the management to ensure that demutualization occurs. Governments can also issue regulations to impose demutualization, especially in cases where the weak financial position of the mutual insurance company could affect the stability of the financial system if it is not addressed.
2. The amount and value of shares created by converting policyholder ownership into shares
   This can be determined in aggregate by the embedded value of the company at the cut-off date. Embedded value is the present value of future profits yet to be realized from existing policies plus the adjusted net asset value of the insurance company. In the event of demutualization, the embedded value is determined by calculating the potential profits that shareholders will receive in the future after demutualization and also including the funds belonging to policyholders that have been accumulated prior to demutualization. To make sure that the embedded value at the cut-off date reflects strict risk management practices, it needs to exclude the goodwill aspects of a company's value. Goodwill is an intangible asset that goes beyond the assets, liabilities and equity of the company, such as the company's brand name, good management, good customer relations, patents etc. Thus, where the company has an opportunity to become more profitable in the future, its market value could exceed the embedded value and any investors should be willing to pay a price per share in excess of the embedded value.

C.2. Methods of Demutualization

Figure 4 shows the balance sheet of a company before and after a 'pure' demutualization process where no new investments and shares are given to the policyholders. As we can see here, there is no change in the assets and liabilities of a company after the demutualization (although the demutualization process will generally involve significant costs, reducing the value of equity). The only difference is that the equity, which was formerly mutually owned, is converted into shares. The key primary considerations in this type of conversion are the cut-off date at which majority policyholders agree to pursue demutualization and how to calculate the number of equity shares for each policyholder after the conversion process is completed.

Following demutualization, the governance of the new stock company is such that shareholders (former mutual owner of the company) have voting rights determined by the number of shares they own and they then have an opportunity to set the policy direction of the new stock company. However, structural changes need to occur to ensure the boards and representatives meet the legal requirements and regulations of private companies in each country. Moreover, agency problems can arise in the new stock company where there are conflicts of interest between shareholders and management. In addition, adjustments in compliance are also needed in order to meet the capital market and reporting requirements of a stock company.

FIGURE -4. Balance Sheet of Company Before and After Demutualization



As well as a 'pure' demutualization in which members receive shares in exchange for membership rights, a demutualization can also involve issuing new shares at a price to investors (including the old policyholders) which injects capital into the company. It can also occur via a takeover by an existing company with members receiving shares in the acquiring company for giving up their membership rights (discussed later). Figure 5 illustrates the case of acquisition of a mutual insurance company by another stock insurance company and shows what will happen to the balance sheet. When the stock insurance company (Company A) buys the mutual insurance company (Company B) and converts the equity which the formerly mutually owned to become shares, the balance sheet of the unified company reflects the integrated assets, liabilities and equities of the two companies.

FIGURE -5. Balance Sheet of Company Before and After Acquisition and Demutualization

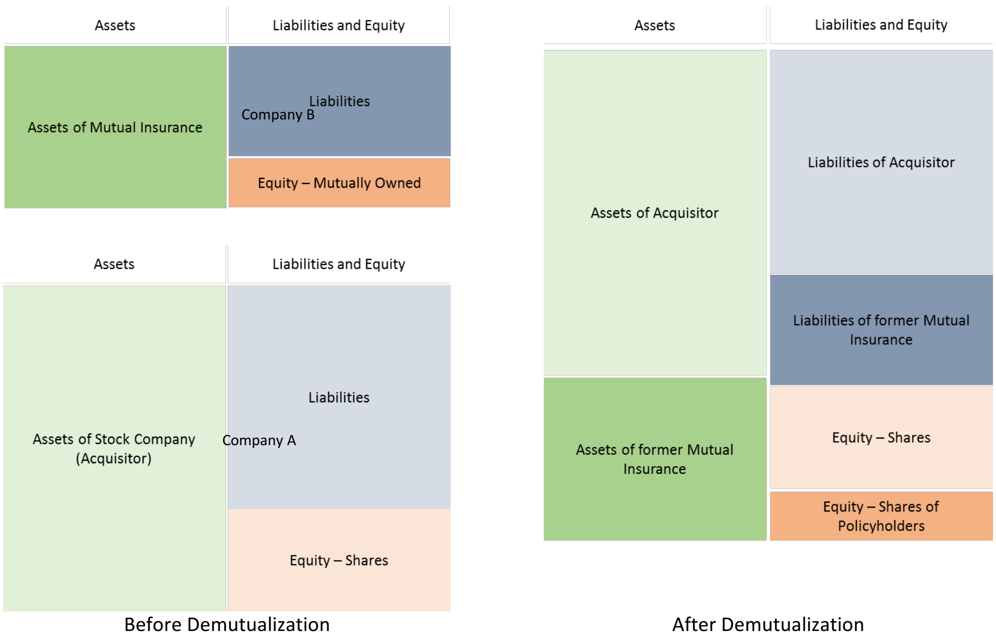
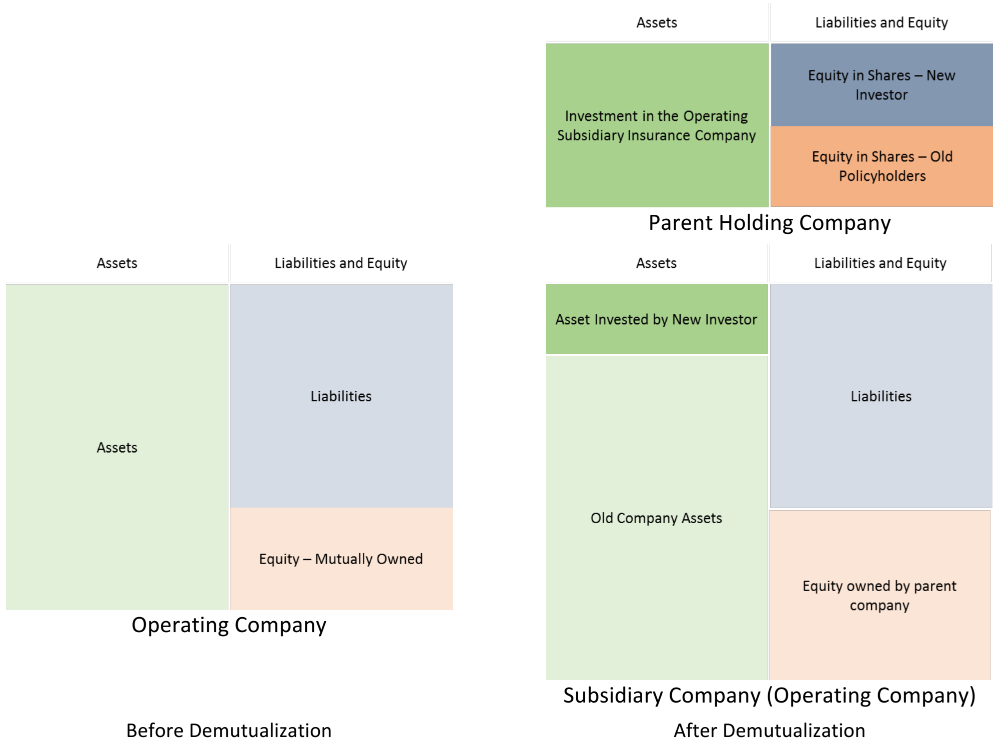


Figure 6 shows the balance sheet effects of demutualization involving the allocation of shares to members and the issue of new shares to investors for a price (providing a capital injection into the insurance company). In this case, the shares are held by the new holding company and the insurance activities are conducted by this new subsidiary company.

After demutualization, the stock insurance company becomes the parent holding company and the demutualized mutual insurance company becomes the new subsidiary company of the stock insurance company. Shares in the holding company are held by previous policyholders who received shares and by new investors who subscribed for new shares. The parent holding company holds as an asset its equity in the operating insurance company (the former mutual). The key consideration as part of this process (as well as determining the relative amount of shares each policyholder receives) is the need to calculate the embedded value of the ownership of former policyholders which is converted to new shares and the size of the corresponding capital injection, which becomes the new equity of the stock insurance company. This must include the present value of future profits expected from the new stock insurance company plus the adjusted net asset value of the mutual insurance company.

FIGURE -6. Balance Sheet of Company Before and After Acquisition and Demutualization Process to become the new Subsidiary Company

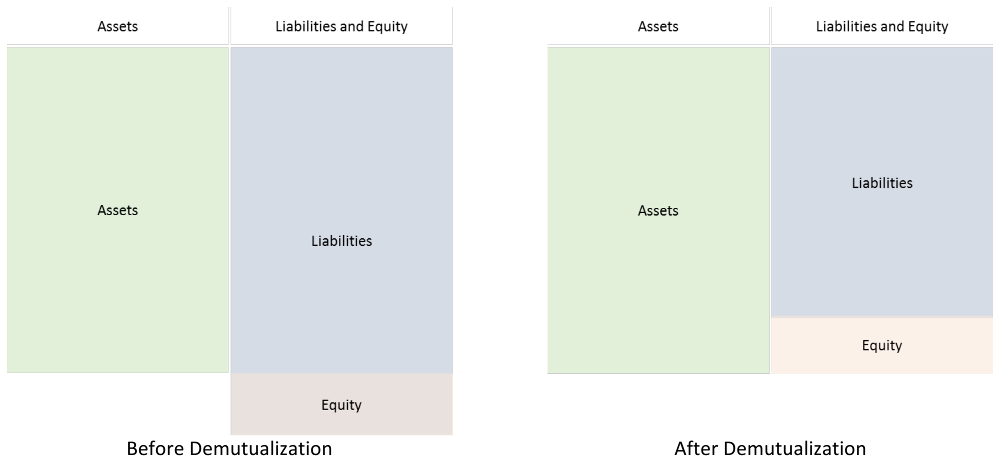


Finding the appropriate solution for AJB Bumiputera 1912 is complicated because of its negative equity position. Unless the (unaccounted for) goodwill/franchise value of a potentially profitable future business exceeds the negative equity, no one will want to buy shares in it – since they have zero value. Figure 7 demonstrates the effects of demutualization of a mutual insurance company from an initial position of negative equity. It requires policyholders to take a haircut (write-down) on the value of their policy interests in order to restore a position of positive equity.

In a situation of negative equity, there may be either full participation by all policyholders or partial participation by policyholders. With full participation, all policyholders agree to release all/part of their future benefits in the conversion into shares. This will require major organizational change due to the shift in ownership from policyholders to shareholders of the company. However, with partial participation of policyholders, not all policyholders agree to release their future benefits in the conversion into shares. In this case, the policyholders who agree to release all of their benefits will become the new shareholders and the others will keep their benefits and hold the position of policyholders in the new stock company without any ownership rights.

Achieving such an outcome is problematic, since it requires agreement of a substantial proportion of policyholders to convert some part of their policyholders' benefits (although this might not be paid in full by the company) into equity in a (currently) loss-making company. Unless there is some expectation of good performance in the future (such as involving a wholesale replacement of the board and management), there may be little point in agreeing to such a proposal. Instead, it may necessary to have some process involving acquisition by another existing company, such that their management takes control and a partial write-down of policyholder benefits in exchange for shares in the acquiring company.

FIGURE- 7. Balance Sheet of Company Before and After Demutualization with an InitialNegative Equity Position



C.3. Important Elements of the Demutualization Process

Prior to demutualization, to ensure the process is smooth, there are a number of steps that need to be taken by management in order to boost the performance and value of the company, such as:

- redesigning the insurance products to be more attractive to policyholders, including reducing the costs and premiums for specified benefits in the future
- reducing costs and product prices to increase the competitiveness of the company (involving improved operating and/or investment efficiency)
- terminating offerings on products that are costly and unprofitable to the company
- preparing the employees as well as other stakeholders, such as policyholders, management, and board of directors to for necessary changes in the culture of the new business
- rebranding the company for its new structure and prospects
- calculating the initial demutualization costs
- determining the profitability of the business lines of the company, and the costs and benefits structure in each business line and its products. Determining which business lines should be retained (those that will generate capital accumulation to cover costs over the long term) and which should be terminated (especially those where the costs exceeds the benefits).

In addition, the mutual insurance company needs to appoint an independent advisory board to support the demutualization process. There are several independent advisors available to assist with the demutualization process, including.

- accounting/actuarial firms that assess the value of the company and examine accountability through the demutualization process (including the process of allocating shares to policyholders)
- private business consultants that analyze the capital needs and financial structure and stability of the company from a corporate finance perspective
- law firms that deal with issues concerning the prevailing regulatory framework in relation to demutualization
- tax consultant firms that deal with taxation issues, especially regarding the need to avoid double taxation for the new stock company, new policyholders and new shareholders.

Other considerations in terms of demutualization (Bomben 2015) are:

- the motives for demutualization and the alternatives available

- the share of the returns and loss capitalized over previous years to should be distributed equally amongst policyholders
- the need to avoid foul play through misleading statements being issued to policyholders, which could cause them to transfer their business to another provider
- policyholders will receive/pay the capital gain/loss after demutualization process and it will be subject to tax
- what will happen to the unclaimed benefit/loss after demutualization
- the options which policyholders will have in regards to their shares after demutualization

Ever after the demutualization process is finalized, there are several other factors to consider including the post demutualization performance of the new company. Keneley (2007) found that organizational change is often ongoing after demutualization due to growing levels of competition within the insurance industry, especially with the entry of banks into the industry. Also, more competition is expected in the future which means that only efficient insurers will survive. Keneley (2002) also studied demutualization within the life insurance industry in Australia and found that those companies that demutualized continued to hold a substantial proportion of the market in terms of industry assets and premium income.

5. CONCLUSION

This paper outlines international best practice in the governance of mutual insurance companies, the key drivers of demutualization, and the implications of the demutualization process. It also addresses the possible demutualization of Indonesia's only mutual insurance company, AJB Bumiputera 1912, as a potential solution to its recent weak performance.

Governance

Good corporate governance is critical for all companies and it should be taken more seriously by mutual insurance companies in order to increase their competitiveness within the market. However, this requires more effort on the part of individual stakeholders because the performance of a mutual insurance company cannot be measured independently through capital market indicators. The governance of AJB Bumiputera 1912 is not in line with international best practice, with multiple roles of its board members creating agency problems as well as moral hazard. In addition, the one-policyholder-one-vote rule in mutual insurance companies means policyholders cannot easily supervise the boards due to high monitoring costs. Moreover, the mutual structure makes it more difficult to acquire capital from outside investors, and issuing new insurance policies is not an easy option due to the level of competition within the insurance industry.

Demutualization may be the best option for restructuring at mutual company in order to increase its performance and competitiveness. However, this raises several issues including the cut-off date of membership of the policyholders and the valuation of the new shares to policyholders and investors in the new stock insurance company.

Recommendations

Mutual insurance company governance needs to recognize the growing interest and involvement of policyholders in governance issues. Advances in technology have improved opportunities for distributing information to policyholders who are widely dispersed geographically. Good database management can also enable better communication with policyholders about important company information. Encouraging policyholders to join mailing lists, receive text messages, and occasionally check the information board on the company's website can also help to promote more active participation by policyholders. However, it is important to ensure that there are sufficient numbers of Representatives of Policyholders to decrease the concentration of power in the company, and the moral hazard of this body. In the absence of laws regarding mutual insurance companies in Indonesia at this stage, the government should provide assistance to ensure the legislative process runs smoothly and examine all of the governance issues which could improve the performance of AJB Bumiputera 1912.

If improving the governance of AJB Bumiputera 1912 does not solve the performance problems of the company, demutualization may be the best option for the company. The legal framework for demutualization is an important consideration for the government. The company's management would also need to take several steps to ensure an efficient demutualization process. This includes getting approval of the majority of the policyholder; restructuring the company to focus on profitable lines of business; hiring several independent advisors regarding the legal framework, business process, taxation issues and accounting and actuarial mechanisms of converting mutual equity into shares. However, as there is no guarantee that demutualization is the best option for AJB Bumiputera 1912, the demutualization process would need to be closely monitored and scrutinized by all of the company's stakeholders, including government

6. ACKNOWLEDGEMENT

This work would not have been possible without the support of the Chief of Fiscal Policy Agency Ministry of Finance, Head of Center for Financial Sector Policy, Director Australian Centre for Financial Studies (ACFS), and last but not least Australia Indonesia Partnership for Economic Growth (AIPEG). I am especially indebted to Prof. Edward Buckingham, Interim Director of ACFS, Prof. Rodney Maddock, and Gavin Forte, Lead Finance Sector Adviser of AIPEG, who have been supportive of my writing process of this paper and who have worked actively to provide me with the protected academic time to pursue those goals.

I am grateful to all of those with whom I have had the pleasure to work during this projects. Each of the members of ACFS has provided me extensive personal and professional guidance and taught me a great deal about both scientific research and life in Melbourne during the writing process. I would especially like to thank Prof. Kevin Davis, as my teacher and mentor, who has taught me more than I could ever give him credit for here. He has shown me, by his example, what a good scientist (and a person) should be.

Nobody has been more important to me in the pursuit of this project than the members of my family. I would like to thank my parents, whose love and guidance are with me in whatever I pursue. They are the ultimate role models. Most importantly, I wish to thank my loving and supportive wife, Qory Dewi, and my wonderful child, Emilio, who provide unending inspiration.

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Attachment 1

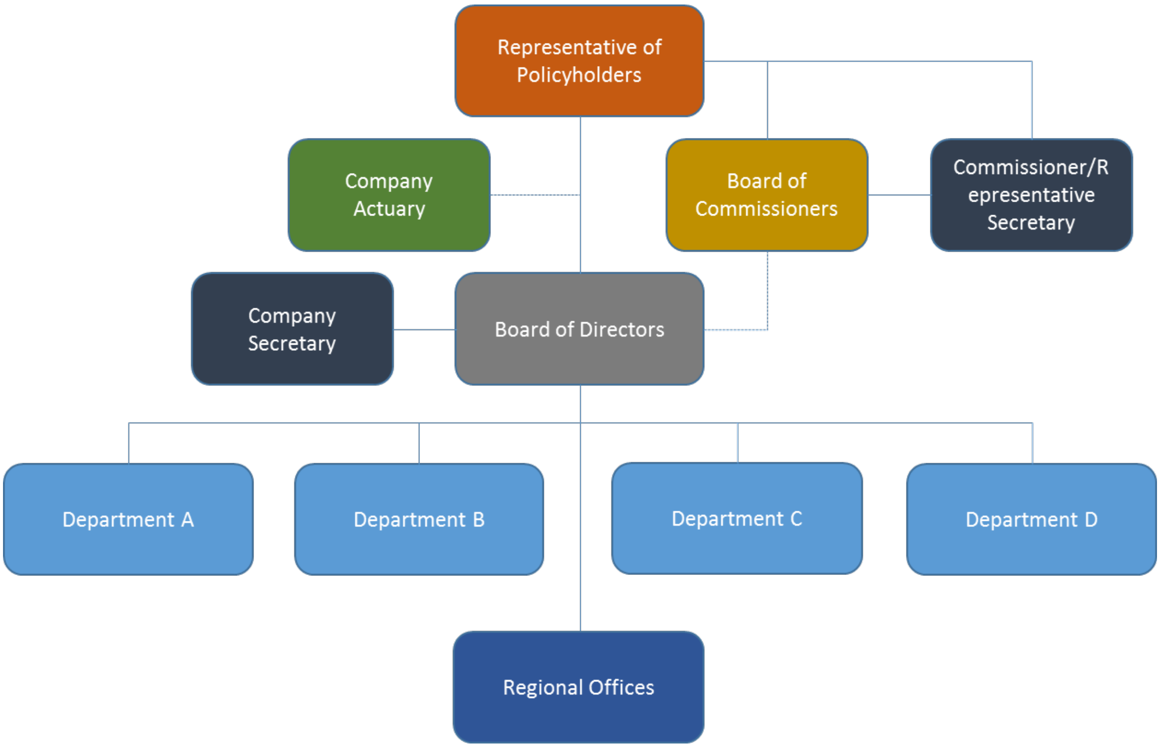
Key Indicators of Indonesian Insurance Industry

	2011	2012	2013	2014	2015
Market Structure					
Number of Registered Insurers :	*139*	*140*	*141*	*141*	*145*
Life Insurers	45	47	47	50	55
General Insurers	85	84	85	81	79
Professional Reinsurers	4	4	4	5	6
Social Insurance	2	2	2	2	2
Mandatory Insurance	3	3	3	3	3
Insurance and Reinsurance Brokers	165	179	182	157	203
Loss Adjusters	27	26	25	26	28
Insurance Development:					
Total Industry Asset (IDR Trillion)	*544.78*	*572.83*	*659.72*	*807.68*	*1046.77*
Life Insurance	293.74	269.25	293.74	368.06	378.03
Non-Life Insurance	55.97	66.5	107.44	126.75	124.01
Social & Mandatory Insurance	195.07	237.08	258.54	312.87	544.73
Premium Reserves (IDR Trillion)	*276.65*	*266.29*	*298.48*	*301.2*	*349.31*
Life Insurance	210.69	188.35	210.69	222.07	248.7
Non-Life Insurance	65.96	77.94	87.79	79.13	100.61
Annual Premiums (IDR Trillion)	*85.38*	*98.34*	*99.02*	*168.81*	*200.41*
Life Insurance	46.64	53.23	49.42	58.95	65.41
Non-Life Insurance	18.48	26.03	28.58	30.13	34.82
Social & Mandatory Insurance	20.26	19.08	21.02	79.73	100.18
Net Profit (IDR Trillion)	*24.50*	*30.09*	*27.35*	*86.87*	*32.02*
Life Insurance	6.59	8.57	2.78	15.85	8.84
Non-Life Insurance	4.37	4.94	5.06	6.81	6.99
Social & Mandatory Insurance	13.54	16.58	19.51	64.21	16.19

Note. From Financial Services Authority

Attachment 2

Corporate Structure of AJB Bumiputera 1912



Note. From http://www.bumiputera.com/pages/default/our_company/organization_structure/0

Attachment 3

Financial Statement of AJB Bumiputera 1912, December 31 2011-2015 (in millions)

	2011	2012	2013	2014	2015
Assets	21,488,348.63	24,299,560.38	25,251,042.02	27,359,604.94	28,196,999.46
Liabilities	21,304,973.81	23,746,875.29	25,547,067.65	31,380,369.82	30,907,681.66
Equity	183,374.82	552,685.09	(296,025.63)	(4,020,764.90)	(2,710,682.20)
Revenue	5,841,676.84	6,178,708.22	6,917,778.52	7,653,176.70	6,746,281.40
Expenses	5,759,332.61	6,088,083.14	6,785,913.15	7,528,611.59	6,348,464.65
Net Income (Loss)	82,344.23	90,625.08	131,865.37	124,565.11	397,816.75

Note. From: http://ajb.bumiputera.com/listdocument/document/information_center/download_center/0/4/0/1