KBRA KROLL BOND RATING AGENCY

U.S. Fraternal Benefit Societies Have Come A Long Way: 2019 Update

Fraternal benefit societies (*fraternals*) came about in the late 1800s to assist the large number of immigrants coming to America. One of their more significant needs was to provide for families' financial well-being in the event of untimely death of the breadwinner. Although a conventional life insurer could also provide these services, fraternals were unique in that they united people through a common bond such as religion, ethnicity, or occupation. Moreover, the mission of these organizations has been to support their communities. Fraternals provide fertile ground for relevant, important, and meaningful community service activities that make a difference in the lives of individuals and enhance their quality of life.[1]

These not-for-profit, policyholder-owned companies are comparable to mutual life insurers in certain respects, in particular their focus on selling permanent life insurance through captive agents and conservatively managed long-term operations. Kroll Bond Rating Agency (KBRA) views participating life insurance as the industry's most creditworthy product. Additionally, the mutual and fraternal business models are based heavily on relationships. However, the fraternal bonds are stronger as the connections with agents and regulators—albeit meaningful—take a backseat to relationships with members, lodge leaders, and other community service organizations. Fraternals' dedication to helping others sets them apart from commercial insurers, demonstrating their value to society and validating the wisdom of the federal tax exemption.[2]

Membership in a fraternal involves more than just purchasing a life insurance policy or annuity. Firstly, the policyholder is part of an organization that is dedicated to providing members the tools to safeguard his/her family's financial security. More importantly, the society helps members invest the profits from the sales of financial services products back into their own community through an array of service programs and activities. Studies have shown that consumers are more likely to choose a cause-related product over a similar stand-alone product. This explains the increasing trend of socially conscious companies including Allbirds, AUrate, Bombas, CAUSEBOX, Cotopaxi, Ethique, Everlane, Leesa, Parachute, STATE Bags, ThirdLove, TOMS Shoes, United By Blue, Warby Parker, and Yoobi. If these companies could achieve a level of success in their particular lines of business, fraternals should as well.

Early Success Not Sustainable

In the early 20th century, fraternals wrote half of all life insurance policies in the United States. These organizations were not regulated at nearly the same level as their stock and mutual counterparts; meaning, they were not required to hold assets sufficient to meet outstanding liabilities or make deposits with the state. But almost every blue-collar worker belonged to at least one fraternal and some had multiple memberships. These societies not only provided financial security and a social environment but were mainstays in communities throughout the nation. Fraternal organizations did not limit their services to life insurance; many provided protection against loss of income from sickness or accident. Some even provided medical care through "society doctors" on a fixed-fee basis, much like today's HMOs. In addition, many fraternals extended aid to their members even when there was no claim under the benefit rules, thus combining charity with mutual aid.[3] Lastly, along with helping other members, fraternalists reached outside their own societies to assist others in need.

---

[1] Annotti, J. (2009, Jan. 20). *Making a Difference, One Knight at a Time…* [Web blog post]. Retrieved from https://fraternalsblog.org/2009/01/20/making-a-difference-one-knight-at-a-time/
[2] Ibid. All fraternal councils and assemblies in the U.S. are exempt from federal income tax under Section 501(c)(8) of the Internal Revenue Code as "fraternal lodges."
[3] Siddeley, Leslie. The Rise and Fall of Fraternal Insurance Organizations, George Mason University Humane Studies Review, Volume 7, Number 2, Spring 1992.

Figure 1: U.S. Fraternal Benefit Societies					
NAIC Code	**Society Name**	**State of Domicile**	**Commenced Business**	**Net Admitted Assets 6/30/19**	**Capital & Surplus 6/30/19**
56197	Alliance Of Transylvanian Saxons	OH	1902	$ 93,907,961	$ 12,430,954
56286	American Mutual Life Association [1]	OH	1910	42,523,165	12,216,909
56766	Artisans Order of Mutual Protection	PA	1873	15,464,396	4,630,671
56499	Assured Life Association	CO	1890	58,596,176	13,830,078
57223	Baptist Life Association	NY	1883	28,531,545	1,522,868
58130	Catholic Association of Foresters	MA	1879	10,554,875	3,786,590
56030	Catholic Financial Life	WI	1885	1,668,175,720	106,153,674
57770	Catholic Holy Family Society	IL	1915	154,234,274	6,686,944
56316	Catholic Ladies of Columbia	OH	1897	126,891,176	4,083,515
57347	Catholic Life Insurance	TX	1902	1,203,637,387	100,003,348
57487	Catholic Order of Foresters	IL	1883	1,201,690,224	78,185,858
57363	Catholic Union of Texas, The KJT	TX	1889	87,840,123	5,327,856
57053	Catholic United Financial	MN	1878	998,003,882	40,613,526
56634	Croatian Fraternal Union Of America	PA	1894	492,454,506	51,918,621
56138	CSA Fraternal Life	IL	1911	136,155,573	3,746,196
56324	Czech Catholic Union	OH	1899	18,505,611	3,075,874
56049	Employes' Mutual Benefit Association	WI	1914	867,536	663,111
57991	Everence Association Inc.	IN	1966	429,312,148	110,256,080
57754	Firemen's Mutual Aid & Benefit Association	IL	1897	22,760,036	14,647,322
56332	First Catholic Slovak Ladies Association Of The U.S.A.	OH	1892	1,010,593,458	104,813,479
56340	First Catholic Slovak Union of the United States of America and Canada	OH	1890	392,330,151	33,643,777
56642	First Windish Fraternal Benefit Society of America [1]	PA	1912	6,500,101	4,991,344
56685	GBU Financial Life	PA	1892	2,937,408,495	213,646,651
56693	GCU	PA	1892	1,975,139,865	166,341,160
56154	Gleaner Life Insurance Society	MI	1894	1,230,964,958	93,910,802
56677	Grand Lodge of PA, Sons & Daughters of Italy, Benefit Insurance Fund	PA	1965	3,683,056	324,805
57444	Hermann Sons Life	TX	1890	261,417,378	18,834,012
57509	Independent Order of Vikings	IL	1896	1,811,715	1,146,021
56707	ISDA Fraternal Association	PA	1960	131,640,845	8,672,279
57355	KJZT Family Life	TX	1894	153,271,419	16,692,520
58033	Knights of Columbus	CT	1882	26,267,892,427	2,269,122,743
57835	Knights of Peter Claver, Inc.	AL	1909	3,314,702	2,508,218
56227	KSKJ Life American Slovenian Catholic Union	IL	1894	518,352,484	19,048,165
56715	Ladies Pennsylvania Slovak Catholic Union	PA	1900	15,931,646	3,835,198
56758	Loyal Christian Benefit Association	PA	1890	195,585,637	3,607,384
57967	Luso-American Life Insurance Society	CA	1957	121,592,442	6,849,699
57541	Modern Woodmen of America	IL	1883	17,103,274,630	1,979,676,470
56251	Mutual Beneficial Association Inc.	DE	1914	114,685,186	2,094,935
57568	National Catholic Society of Foresters	IL	1891	164,745,732	17,984,645
56774	National Council Junior Order United American Mechanics of the US of NA	PA	1893	1,521,960	202,639
56073	National Mutual Benefit	WI	1916	344,563,587	35,818,730
56782	National Slovak Society of the United States of America	PA	1890	1,254,761,347	60,310,106
56375	North American Swiss Alliance	OH	1889	3,485,815	826,862
58009	Police and Firemen's Insurance Association	IN	1913	203,055,387	61,627,348
56812	Polish Beneficial Association	PA	1990	18,040,685	284,658
56820	Polish Falcons of America	PA	1926	67,669,649	826,516
57622	Polish National Alliance of the United States of North America	IL	1880	431,788,999	21,778,894
56839	Polish National Union Of America	PA	1908	26,217,877	933,941
57630	Polish Roman Catholic Union of America	IL	1887	201,968,783	12,015,201
57940	Portuguese Fraternal Society of America	CA	1880	133,084,563	11,452,265
56863	Providence Association of Ukrainian Catholics in America	PA	1914	46,182,659	2,427,140
57657	Royal Neighbors of America	IL	1895	1,100,102,736	195,502,510
56871	Russian Brotherhood Organization Of The USA	PA	1900	15,580,145	3,287,646
56936	Serb National Federation	PA	1929	46,940,542	3,187,528
57193	Slovak Catholic Sokol	NJ	1905	87,025,311	8,068,655
57673	Slovene National Benefit Society	PA	1904	211,458,281	7,358,067
57142	Sons of Norway	MN	1895	351,822,741	18,325,980
57436	SPJST	TX	1897	244,580,529	16,721,070
58181	Supreme Council of the Royal Arcanum	MA	1877	109,204,630	12,121,543
56383	The Order Of United Commercial Travelers Of America	OH	1888	14,559,163	7,995,997
56006	The Travelers Protective Association of America	MO	1890	14,272,689	12,499,952
56014	Thrivent Financial for Lutherans	WI	1902	96,134,829,301	9,812,373,279
57215	Ukrainian National Association, Inc.	NJ	1894	176,073,834	11,412,154
58068	United States Branch of The Independent Order of Foresters	NY	1881	3,441,542,483	145,874,548
56456	United States Letter Carriers Mutual Benefit Association	TN	1891	253,662,670	34,314,159
56413	United Transportation Union Insurance Association	OH	1971	228,439,242	56,261,737
56480	W.S.A. Fraternal Life	CO	1908	50,951,082	8,950,522
57711	Western Catholic Union	IL	1877	201,156,042	7,845,956
58017	Western Fraternal Life Association	IA	1897	302,652,122	23,270,340
57010	William Penn Association	PA	1886	474,458,173	34,319,678
56170	Woman's Life Insurance Society	MI	1892	203,744,108	19,098,670
57320	Woodmen Of The World Life Insurance Society	NE	1890	11,076,385,531	1,520,691,347
57290	Workmen's Benefit Fund Of The USA	NY	1884	32,910,133	1,381,365

[1] Admitted assets and capital & surplus are as of 12/31/2018

Source: Regulatory Filings

During 1910-1920, fraternals were required to follow solvency regulations, which caused a significant decline in society formation rates. Other factors that impacted fraternals were the rise of group insurance and the enactment of workers' compensation laws. These conditions led to a decline in fraternal market share to below 10% by the 1920s—and it would never recover from historical levels.[4]

The commercial life insurance industry exploded after World War II and fraternal members became a target market. Consumers had more choices and an improved financial position. As such, people more often chose to buy policies from commercial carriers. Additionally, state and federal government programs reduced the need for fraternal providers. However, the most relevant trend was the dilution of religion and ethnicity observed across the country. Clearly, the ties to religion and ethnicity are not as strong as they once were. Current market share for fraternals is estimated at between 1% and 2%, with the four largest societies accounting for the majority of premium and about 85% of "fraternal industry" assets.

To Evolve or Not to Evolve?

The growth of television, video games, computers, the internet, and other technological tools have helped minimize the role of fraternals in society by giving people alternatives to attending lodge meetings. Fraternal groups such as the Freemasons, Elks, and Rotarians have experienced substantial membership decline over several decades, consistent with fraternal insurers. It appears substantially more difficult to recruit Millennials, or even Gen-Xers, given the reduced need for face-to-face social interaction as well as societal changes that have eroded the importance of common bonds. In many cases, the current membership is an older demographic who is not as concerned with bringing in new members.

In addition to these demographic and environmental trends impacting fraternals, the societies themselves have resisted change and were not effectively communicating the fraternal story to grow membership. This was even true coming out of the financial crisis, when policyholder-owned companies were viewed much more favorably than their publicly traded peers. A Chicago Tribune Magazine article in 2009 stated that "fraternal benefit societies seem increasingly out of touch, relics of an earlier generation." Fraternals' corporate governance structures required modernization with implementation of substantive enterprise risk management programs to ensure financial stability. Regulators were encouraging some societies to change their business practices to enhance their financial condition, even suggesting consolidation in certain situations. At the same time, commercial life insurers were conducting aggressive marketing campaigns, ranging from sponsoring specific sports events to acquiring naming rights of stadiums. The issues were coming to a head and the industry needed to take decisive action.

Making Progress

With help from industry trade association American Fraternal Alliance (AFA)—guided astutely by President and CEO Joe Annotti—fraternals identified their major challenges and took steps to address them. The overriding issue is the societies' seeming inability to effectively communicate their great community story. Fraternals need to essentially reinvent themselves, positioning the organizations as key providers of financial services products and, most importantly, demonstrate their commitment to community service reinforced by a common bond.

Consistent with commercial life companies, consolidation has played a key role in the fraternal space. Many of these consolidations were accomplished for strategic reasons, although there were some cases in which a small fraternal was rescued by a larger peer. Generally, these mergers occurred due to lack of competitive products, absence of a competent and motivated sales force, increasing overhead not keeping up with revenue, or fraternal programs that did not resonate with the community. In addition, the financial services industry had become more complex and

[4] Zanjani, George. The Rise and Fall of the Fraternal Life Insurer: Law and Finance in U.S. Life Insurance, 1870-1920, Federal Reserve Bank of New York, October 2003.

highly regulated, and organizations below a certain size threshold did not have the breadth of resources to maintain operations. Finally, there were situations where financial security came into question, driven by asset impairments or high cost structures, both of which eroded surplus.

As the number of U.S. fraternals continued to shrink due to consolidation, the industry and AFA came up with alternatives to mergers, whereby companies could share services, identify cross-selling opportunities, or enter into alliances or affinity relationships. This cooperative initiative has been a win for all parties involved as fraternals have capitalized on opportunities to share services in such areas as underwriting, compliance, licensing, information technology, and product development, as well as to use the industry's collective purchasing power to garner group discounts.

Further success of this initiative has been demonstrated via the August 2019 launch of the Conventus Now, LLC joint venture, which partners Milwaukee-based Catholic Financial Life and Minnesota-based Catholic United Financial. Conventus will serve as the vehicle through which the two societies develop and operate state-of-the-art technology solutions to better serve current members and facilitate membership growth. The partnership should better position the insurers to achieve economies of scale as well as potentially create technology solutions for other fraternal benefit societies in the future.

Additionally, fraternals have developed some more sophisticated products to satisfy the needs of their members and prospective members. These products have been more competitively priced to compare reasonably to their commercial life company peers. Although fraternals are nonprofit organizations, they need to generate earnings from their financial services business to carry out each society's mission. Additionally, agents have been provided tools that enhance the attractiveness of the product portfolio while keeping the sales force well-informed and motivated. Above all, to succeed, these agents need to emphasize fraternalism: that the consumer is buying from an organization that funds social service projects in its community and that he or she is encouraged to participate in these volunteer efforts.

Lessons Learned

Clearly, there were some tough lessons learned from the financial crisis. Among the most challenging were those experienced by life insurers with less diversified investment portfolios and/or exposure to asset classes that were not fully understood. A real-life example of this occurred at a life company in Utah. Although not a fraternal, it was affiliated with the Church of Jesus Christ of Latter-day Saints (LDS). In 2007-08, the company experienced realized losses in its investment portfolio of approximately $540 million due to disproportionate weighting of its bond portfolio toward investments in residential mortgage-backed securities, asset-backed securities, and collateralized debt obligations with subprime and/or Alt-A collateral. The losses necessitated roughly $600 million in capital contributions from LDS as the life company's losses exceeded its capital. To avoid this potential outcome, fraternals have taken steps to strengthen their internal investment management processes and fixed income capabilities by hiring seasoned analysts. For societies that outsource their asset management, thorough review processes were undertaken to determine if the managers' risk tolerance and allocation objectives were consistent with the fraternals' liability structures. Additionally, comprehensive reviews of investment guidelines and investment risk management practices were completed industrywide. These reviews were essential given the 2011 implementation of the same risk-based capital standards to fraternals that apply to commercial insurers.

Rising to the Challenge

One of the most significant challenges for nonprofit organizations—particularly those in business since the turn of the 20th century—is to modernize their corporate governance structure. The AFA has been instrumental in facilitating this movement, with the endgame being advancement of the decision-making process and improving the relevance and longevity of the fraternal model. The National Association of Insurance Commissioners (NAIC) has adopted a model act requiring annual disclosures of corporate governance procedures so that the regulator can gain an understanding of the insurer's (or group's) corporate governance structure, policies, and practices. These changes will likely enhance the performance of the board and streamline operations, allowing for more resources to be allocated to fraternal activities.

Examples of positive steps taken by fraternals in this area include (1) separating chairman of the board and CEO roles; (2) mandating term limits for board members; (3) electing the board (by full membership) from a slate of diverse, experienced candidates; and (4) requiring the CEO to be hired by, and to report to, the board. Additionally, several fraternals have taken significant steps to better utilize resources through revamping, or even eliminating, conventions and replacing them with more modern member gatherings and/or regional meetings. These agenda meetings typically focus on community service engagement improvements, networking, and idea sharing. Overall, there is still room for improvement but KBRA believes these positive steps allow fraternals to better carry out their social missions as well as help members improve their ability to positively impact the communities in which they live and work.

Moreover, the AFA has taken several proactive views on state-level solvency reform—rather than the alternative, a potential of harsher state-mandated regulation following a future insolvency. The AFA's proposal includes:

- RBC minimums, with the possibility of early regulatory intervention
- Requiring fraternals to notify regulators prior to assessing their policyholders
- A more streamlined process for voluntary workouts prior to liquidation.

Improving the solvency regulatory system is key to strengthening protection for consumers given that contracts issued by fraternal benefit societies are generally exempt from participating in state guaranty funds. As such, KBRA views the AFA's efforts in this area as a credit positive for the sector. In May 2018, Minnesota was the first state to pass an AFA-sponsored fraternal solvency bill, followed by Texas in June 2019. The AFA, with strong support from its member societies, continues to work with other states to pass similar legislation. Additionally, delegations of AFA members are continuously meeting with state legislators to increase lawmakers' awareness of the positive social impact of fraternals—mainly to discourage any future legislation that inhibits fraternals' ability to fulfill their financial and community service missions.

Regulatory Update

During its 2019 Summer National Meeting in New York City, the most significant issue discussed that would impact fraternal operations and producers is the enhancement of existing suitability standards for the sale of annuities. The NAIC's Annuity Suitability Working Group is developing a definition of "best interest," taking into account the Securities and Exchange Commission's (SEC) June 2019 regulation, which details the regulator's "best interest" standard for sales of securities by broker-dealers. Revisions to the Model Regulation will be exposed in late 2019. KBRA notes that it is unlikely that all states will support this definition, with New York pushing for stricter standards.

In addition, the NAIC's Capital Adequacy Task Force adopted minor revisions to the Life Risk-Based Capital (RBC) formula and instructions to reflect the elimination of the separate Fraternal Annual Statement. As such, fraternals will file the Life RBC formula starting year-end 2019.

No discussion about the long-term viability of fraternals is complete without touching on the federal tax exemption. Given the government's economic challenges, it is not surprising that this issue has been constantly under the congressional microscope for some time. Aided by the efforts of the AFA and its members, fraternals were able to maintain their tax-exempt status in the recent tax code overhaul. In 2018, Oregon and South Dakota introduced legislation that would have amended or repealed the fraternal tax exemption. But the measures were defeated thanks to the actions of both large and small AFA member societies. KBRA believes this is a positive result for the sector. However, it still remains a key issue and could again be challenged in the future.

Although fraternals maintained their tax-exempt status, the effects of tax reform were felt on their 2018 year-end RBC ratios. Since RBC is on a post-tax basis, required capital increased following the drop in the corporate tax rate to 21% from 35%. As a result, RBC ratios across the entire life insurance industry declined notably at year-end 2018. KBRA believes the decline was a one-time occurrence; our credit evaluations and ratings were unaffected.

Potentially a more significant impact on fraternals' RBC ratios could come with the recent NAIC proposals to alter the calculation of asset risk (C-1), expected to be implemented in the near to medium term. Although outlining the full effects of the proposed changes is outside the scope of this research report, it is important to highlight the provision for portfolio diversification that could drastically increase the capital charge for bond portfolios with less than 200 different issuers. This portfolio adjustment factor could have an outsized effect on smaller fraternals or those societies with more concentrated investment portfolios.

Contacts

Andrew Edelsberg, Managing Director
(646) 731-2371
aedelsberg@kbra.com

Brian Spadaccino, CFA, Director
(646) 731-2437
bspadaccino@kbra.com

Donna Halverstadt, Managing Director
(646) 731-3352
dhalverstadt@kbra.com

Related Reports

Access for free at www.kbra.com

- **Are Two (IFSR) Ratings Better Than One? You Decide**