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DIGEST OF SMALLER COMPANY FORUM— NEW ORLEANS REGIONAL MEETING

PENSIONS

A. Are smaller companies able to compete effectively in the pension market? How much expense is involved in tooling up to enter the pension field? What products are needed? What size and type of home-office staff are needed initially and eventually?

B. What degree of service is furnished to the employer in the following areas?
   1. Preparation of proposal and sales effort.
   2. Installation of plan and filing with Internal Revenue Service.
   3. Annual preparation of IRS Form 2950 and Department of Labor Form D2.
   4. Periodic actuarial valuations.
   How much of these services is furnished by the home office rather than by the agent?
   Do any companies make a specific charge for any of the above services when they are furnished by the home office?

C. In developing the pension policies, what differences are reflected as compared with ordinary policies?
   1. Agency compensation.
   2. Home-office expenses.
   3. Mortality.
   4. Federal income taxes.
   5. Policy language.
   6. Level of cash values.

D. What marketing techniques have smaller companies used in the following markets?
   1. Small employers.
   2. Large employers.
   3. H.R. 10.
   4. Section 501(c)(3) and Section 403(b) organizations.

MR. CHARLES H. CONNOLLY: I would like to direct my remarks to the matter of tooling up, particularly to the size and type of home-office staff that are eventually required.

We entered the pension field about twenty-five years ago, using ordinary products with adjusted commissions. However, we found, soon after we sold our first pension plan, that we were not in a limited pension market by any means; pressures immediately started to get us into not

the individual policy but the group permanent contracts, group annuities, deposit administration business, and, more recently, separate accounts. In the future, I am sure that this will involve variable annuities.

I think that it takes a lot of soul-searching, particularly in the agency area, before you decide to go into the pension market. The most important thing is to know that you have a sales force that will sell your product. If you have people who have been selling pensions for other companies, then perhaps you have good reason to get into the market. If you have a sales force that has never sold pensions and which you are going to have to educate from scratch, I think that it is a mistake.

Since you are in competition with consulting actuarial firms that are ready to provide every service, I believe that you must be able to do the same.

Further, you cannot rely on agents to do a competent job even if they are competent currently because, even under these circumstances, they will be subject to the same mortality as the rest of us and, further, if mortality does not catch up with them, then the inclination to retire will.

The H.R. 10 market is one that I think can certainly be tapped now by the smaller company because prototype plans are in effect and can be used through the years until the law is changed or something else comes up. Perhaps this is an area that a smaller company could go into quite profitably and with small expense with relation to staff.

The small pension plan, though funded through individual policies, differs only in minor respects from a large pension plan that is funded from or through more conventional mediums, and the headaches are pretty much the same unless you have a man qualified to do the whole job and feel that he is adequately compensated from a commission and perhaps override point of view.

CHAIRMAN JOHN K. ROBERTS: I would like to say that at Pan-American we find that the service required from the home office depends directly on the type of agent that is involved on the case and that you will frequently find yourself having to design the plan, making the cost calculations, and explaining them to the agent.

Further, if the plan is sold, you have the problem of getting the plan qualified and providing services. The purchaser would like to have your attorney give it some hints on how to get this plan approved by IRS, and merely having the plan on the books is not the end of the story either. Your evaluations on the subsequent anniversary will again have to be performed by the home office.

Therefore, you end up getting into a specialized legal, actuarial, and

agency service with regard to administration, where the key is, of course, flexibility and variety rather than consistency.

At Pan-American, we are now willing to do the side fund evaluations in the home office free of charge on cases as small as five lives or $1,000 of annual pension life premiums.

MR. CARLTON HARKER: In the Southeast, the C.P.A.'s and the attorneys, in many of the communities, tend to like profit-sharing and to downgrade fixed benefits. There is, therefore, a great deal of interest in profit-sharing. The agent, then, rather than running up against a brick wall, urges profit-sharing and then likes to have a little life insurance added to provide the level of protection that we all feel is needed. Therein lies the use of the individual policy. The burden of the profit-sharing end still remains with the employer and the trustee, as well as with the consultant to the insurance company. As a result, the insurance company is free of all this and merely furnishes the life insurance policies to the trustee. This is a very active area in which a small company can be interested and one in which it can instruct its agents fairly easily.

We have concluded, for a number of reasons, that there should be a separate set of policies for this sort of market. After all, the underwriting is different, the handling of additional policies is involved, and very often smaller policies are desired. Further, the commission structure and the net cost structure are different. In fact, almost anything one can imagine about this is different.

MR. HENRY C. UNRUH: At Provident we have a separate pension ratebook. We started out like a number of others, offering our regular ratebook service and cutting first-year commissions, but we found that in the long run this did not work out. We also felt that what we required was a completely different set of cash values.

We are not much interested in the group annuity business as such without life insurance, and we try to sell life insurance with every case that we get.

We also handle the side funds on what we consider a no-profit basis. We charge the expense attributable to handling side funds against the interest credit, and we keep track of each side fund with the net interest credits.

In connection with our regular ordinary business, we use a policy fee system whereas, in the pension division, we use a band system of premiums. We have a discount at $10,000 and another at $25,000.

Our commissions are lower than they are on our regular ratebook series, and, if the case gets large enough, we have a second, lower, first-year commission scale.

As for mortality, we made up our own mortality table. We checked through our business and, at the younger ages, approximately two-thirds of the business was issued without any evidence of insurability and about one-third with evidence of insurability. At the older ages it is the reverse. We made a composite table which is partially select and partially group, and we use that.

AGENCY

A. What are smaller companies doing to cope with the shortage of qualified agency manpower?

Are changes being made in the financing of new agents?

Have higher financing and larger subsidies been successful in attracting men to a career with eventual income based largely on commissions? Do extensive training and direct supervision reduce the need or period for large amounts of financing?

B. What are the advantages and disadvantages of building an agency organization via personal producing general agents v. "career shop" managerships or general agencies which recruit, train, and develop a staff of agents?

C. What incentives are useful to general agents or managers in meeting company objectives of new-agent manpower, production, and persistency?

D. What types of studies have companies made of the cost of agency development? What have been the results of such studies? Have these studies been helpful in establishing programs of controlling agency-development costs or changing agency-development philosophy?

MR. ROBERT S. FILLINGHAM: As one incentive to improved persistency, we have been using a persistency bonus. This is paid quarterly and is determined by applying a bonus rate ranging from 10 to 50 cents per $1,000 exposed to lapse in the agents' two-year persistency rate prepared each quarter.

The two-year persistency bonus rate per $1,000 for each agent depends upon into which of five approximately equal divisions of the interval from 80 per cent (or the company average plus 1 per cent, if greater) to 100 per cent his persistency rate falls.

To receive a bonus, the paid-for exposed to lapse in the period under consideration must be at least $250,000.

In the case of general agents, on personal production the bonus rates are 75 per cent of those paid to writing agents. If the entire agency has a two-year persistency of at least 80 per cent (or the company average, if greater), the general agent also receives 25 per cent of the bonuses paid to his agents.

MR. BRUCE G. LINDSAY: My comments are directed at Question D, although some of the other areas will be touched upon indirectly in the discussion. Three days ago the answers to the questions as they pertain to Lamar Life would have been that we had made no studies and therefore had no results to be helpful in establishing programs of controlling agency costs.

John Roberts asked for some questions to be used for this forum, and I gladly provided them. Then, about a month ago, he wanted the answers. Actually, if I had known the answers, I would not have had the questions. Anyhow, in an attempt to have something useful to say, I made a quick study of our financing plan. I must thank John for spurring me to do this, as the results are enlightening and somewhat frightening and I am sure that the results will influence any revision that we might make.

Our plan is a two-year program. It is strictly a subsidy type, wherein we pay x dollars per month for two years. We withhold commissions to the validation level during the two-year period. Commissions earned in excess of validation are paid to the agent, half when the excess occurs and the other half in the agent's third contract year if he is still with us. The validation requirements are based on earned commissions and lives. The general agent gets a bonus at the end of the third month and sixth month and is paid an extra 25 per cent of commissions in the seventh through the twenty-fourth months if the agent is validating.

With regard to the study, it was done in haste, so I hope that you will excuse any liberties that I had to take where exact facts could not be gotten easily.

Experience was separated into two categories—terminated agents v. active agents completing the plan and still with us. Two asset shares were calculated, one for each group. The asset share for terminated agents reflected their respective persistency, but commissions were left out because the company retains them. In each case a weighting was made to reflect the percentage of term v. permanent being written. The attrition of agents surviving three years was assumed to be 5 per cent each year thereafter. On the small group used, only six agents survived the third year; therefore, the 5 per cent is strictly arbitrary, as it is impossible for 5 per cent of six agents to leave.

The results of the study can be summarized in outline form as follows:

I. Agent termination rates

Year	Per Cent
1	73
2	34
3 and over	42

II. Lapse rates of business

A. Terminated agents

Year	Per Cent	Months in Force
1	43.6	5.5
2	9.4	18.5
3	5.5	29.5
Thereafter	4	....

B. Active agents

Year	Per Cent
1	24.5
2	7.3
3	3.8
Thereafter	2

III. Average production

A. Terminated agents

Terminating in Year	Production in Year Terminating	Surviving Year Indicated	Production in Year Survived
1	$ 84,000	1	$168,000
2	78,000	2	156,000
3	132,000	....	....

B. Active agents

Year	Production
1	$180,000
2	382,500
3 and over	540,000

IV. Months of financing for terminated agents

A. Year terminating

Year	No. Months
1	5
2	18
Thereafter	24

B. Average monthly financing: $450

The above statistics were used in computing the two asset shares mentioned above. In addition, assumptions were made as to average age at issue, proportion of term v. permanent insurance written, and kinds of plans being written in each group.

A model office was set up for the hiring of fifty new men in each year. The asset shares were then applied to the business written by the two groups of agents, active and terminated. On this basis, it takes the company seventeen years to turn the corner from the inception of the financing plan. At one point the company has as much as $1.5 million invested in the program. Once the plan gets into the black, substantial profits emerge. On a single group of fifty new agents, it takes eleven years before the business produced returns the company's investment.

Obviously, the most important factor in a program for manpower development is the retention rate. The model office would be affected

substantially with marked improvement or deterioration in the rates used. Assuming that the retention rates cannot be improved, I find the trend to higher financing for longer periods very disturbing, especially in the light of the current competition pertaining to premiums.

One thing that we have found to be true (as has much of the industry, I believe) is that it just does not pay to finance an experienced man; 100 per cent of our attempts have failed, and we will no longer do any such financing.

FINANCIAL RESULTS AND PLANNING

A. How do smaller companies report financial and operating results to management? How frequently are such reports prepared? What responsibility does the actuary have in preparing and analyzing the reports?

B. What efforts are being made by smaller companies to forecast financial results over periods longer than a year? What problems can the smaller company encounter in such long-range planning?
How have computers been utilized in these efforts?

C. How are smaller companies analyzing expenses by functions and lines of business? What cost-control and work-measurement programs have been used? Have they been effective?

MR. HENRY K. KNOWLTON: At Protective Life we make a gain-and-loss type of breakdown by line of business within operating departments. The four operating departments are group, ordinary agency, creditor, and corporate. There are fifteen or sixteen lines of business.

We were making quarterly reports but are now making them monthly, usually by the fourteenth of the following month. We plan to break this down further annually so that we will get the ordinary separated into participating and nonparticipating business.

We have some fifteen ratebooks, and we would like to find out annually how much profit is being contributed by business from each of these.

MR. CARLTON HARKER: I find that we are better off if we study all the adjustments carefully before publishing monthly figures. It is important to accrue common stock dividends, bond interest, premium taxes, and municipal taxes. Also it is necessary to have due premiums calculated correctly.

MR. HENRY C. UNRUH: We operate as if we had four separate companies. We have prepared monthly earnings statements for many years. We are now actually computing the ordinary life reserve each month. We take the 1966 valuation and calculate the 1967 mean reserve by due date of the premium. This gives twelve blocks; for changes we adjust the reserves. We also have due and deferred premiums each month, so that in effect we have a Convention Blank Statement each month. The calculation of reserve takes about one hour each month. Only minor reserves are estimated, for example, deficiency reserves and active life disability reserves.

MR. BENJAMIN R. WHITELEY: At Standard Insurance Company an operating statement is prepared monthly. It contains a balance sheet, income statement, and breakdowns of income, expenses, capital gains and losses, and insurance in force. The actuarial department is responsible for interest required on reserve, gain from mortality, gain from terminations, available loading, and gains from annuities, supplementary contracts, and supplemental benefits.

Once a year we make a special analysis of the previous year's results by line of business. We attempt to remove the effect of such factors as abnormal claims, federal income taxes on surplus funds, and any one-shot abnormal occurrences. The resulting "normalized" gains are compared with similar gains by line for five years.

About five years ago we developed expense-provision factors in terms of insurance in force, policies sold, per cent of premium, and so forth. Each year we compare actual expenses with those so provided. We also compare actual lapses with expected and actual claims with normal claims.

CHAIRMAN JOHN K. ROBERTS: The Pan-American reports financial and operating results to management through (1) monthly memos to the Board of Directors; (2) a quarterly budget report to the Board of Directors; and (3) the annual statement convention blank.

The monthly memos indicate results on a cash basis only. They contain detailed premium-collection information, summaries of investment income and claims, and schedules of new business paid for, gain in insurance in force, and insurance in force.

A full company budget is prepared in October and approved around January 1. At the end of each quarter, incurred financial results are compared with the budget.

The actuarial department receives data from other departments, reviews them for reasonableness, and assembles the final report. We also develop basic data for reserves, reinsurance, and health claim liabilities. We analyze results by discussing methods of developing data, compare segments of the report with previous periods, and develop operating gains by line of business.

MR. KNOWLTON: We keep track of agency-development costs so that we do not have to pour more money into development than we had anticipated. The computer is not much help.

MR. THOMAS K. PENNINGTON: As a consultant, I work for much smaller companies. Long projections (five or ten years) have often been essential because of surplus problems.

Projections are done as a combination of fairly accurate asset-share-based evaluations of existing business and broad-brush projections of future writings, due to the many uncertainties in this area.

CHAIRMAN ROBERTS: We have found that the LOMA annual cost study has been a good source to start from.

As part of our annual statement work, we split expenses into investment, ordinary life, pensions, individual health, and group life and health. We shortly thereafter allocate them between United States and Latin-American segments. We put the results of some twenty-four companies together to see how we rank. This gives us some idea of how well we handle expenses.

MISCELLANEOUS

A. How are traditional life insurance and annuity products being modified in the light of a persistent "creeping" inflation? What have been the considerations among smaller companies concerning variable annuities?

B. How will the role of the smaller company actuary of tomorrow differ from that of today in
   1. Product development?
   2. Market research?
   3. Financial forecasting?
   4. Other areas?

MR. ROGER K. BROOKS: In the individual area, adjustments have been minimal and mostly involuntary, such as the shift to term insurance and the introduction of the guaranteed purchase option.

In regard to variable annuities the three major areas of concern are market potential, agency problems, and legal problems.

Market potential for most smaller companies would be small. Many members of the higher-income groups would be more interested in direct stock market investments.

One of the main problems in the agency area is that the opinions of the agents on equities range from very favorable to most unfavorable. The lower commission rates would also be a problem.

In the legal area there are three subareas: Blue Sky laws, state insurance laws, and the SEC. Blue Sky problems are minor. The state-insurance-law problem mainly concerns the establishment of subsidiaries. The major problem is whether the sale of individual variable annuities will bring us under the SEC. This involves such things as voting rights, redeeming shares in seven days, and periodic filing of a prospectus.

MR. CHARLES W. McMAHON: In the insurance industry, it seems to us that the ideal solution to inflation is yearly renewable term with the amounts and premiums increasing at the rate of inflation. The problem is that we would also like to build up our assets.

We developed an increasing annuity providing for an increase of 1 per cent a year for the first twenty years. The cost is rather high, and at age 65 it takes about nine years to reach the level annuity that the same purchase price would buy, and it takes about eighteen years for the annuitant to get as much total income as that on a level annuity.

We have been studying the wholesale market, primarily the profession-

al associations. I received the impression that, if you get a statement of health, you can get a controlled level of mortality. It seems to me this may be the way of the future, to reach more people than the individual agent can today. I would like to hear the comments of anyone else on this.

CHAIRMAN JOHN K. ROBERTS: We had one experience with a professional association with limited underwriting. We found that the mortality we got was about 20 per cent substandard, whereas we needed 10 per cent or less to meet mortality assumptions.

MR. JAMES L. CLARE: Variable annuities (i.e., equity unit annuities) were made famous by the College Retirement Equities Fund (CREF), and vice versa. Nearly all TIAA-CREF pension plans, although grouped for investment management, have the "ownership" of the assets strictly allocated on an individual or "money-purchase" basis. It was therefore not considered sound to switch from stock investment before retirement to fixed dollar after, since to do so would force a liquidation of stocks at the point of retirement, to the possible detriment of the annuitant. Then, almost by accident, common stocks were incidentally realized to have been more profitable investments after retirement in the past, on average, over long periods of time than other readily available investment alternatives. Over shorter periods of time, the correlation of a variable annuity with the ups and downs of the cost of living is uncertain. In spite of this, variable annuities may be very attractive to individuals, as witnessed by the success of CREF, not because of directly offsetting the cost of living, but because of their common stock investments.

Group pensions are different. Group pensions already have common stock investments. In my paper (*TSA*, XIV, 340), I noted that variable annuities are not needed in ***group*** pension plans. For a given contribution, pensions are determined by (1) investment profitability, (2) low expenses, and (3) good benefit design. Variable annuities tend to put a straitjacket on investments, reducing retirement incomes below amounts otherwise obtainable. Also the additional expenses of variable annuities reduce retirement incomes. The benefit design of variable annuities is much inferior to that of a unit benefit plan, with purchasing-power protection in retirement *directly* offsetting increases in the cost of living.

If the larger companies promote variable annuities excessively while the smaller capitalize on the advantages of group pensions, the smaller companies will be conceded a competitive advantage.

MR. RICHARD M. FRIDLEY: The typical actuary of the past and his responsibilities are well known to us. Many traditional duties are still being performed by the actuaries, but the approach to assignments is now radically different.

We still develop the new policies and determine the proper premium rates, but now we must consider market potential and competitive aspects. A nice new product is useless if it has no potential or is priced so high that it is unsalable.

I expect that the actuary always had the responsibility for determining what policies should be put in the ratebook and that he was ill-equipped for this responsibility. We have felt that this should be an agency function, because agencies are better equipped to know what is salable and where the markets are. I think that a close relationship between the marketing efforts of the company and the actuary is now essential and will be more essential in the future.

Today the actuary is involved in areas of underwriting, accounting, taxes, and general administration. Formerly his chief job could be viewed as "seeing that the company did not go broke." Today the actuary must have a working knowledge of computer capabilities and applications.

Our marketing techniques will be altered in future years, but the agents of the future will require more home-office support than ever before. Much of the technical work will come from the actuary, who must become more oriented to agency problems and needs; for example, market research, sophisticated statistical sampling techniques, product research, and perhaps studies in consumer psychology.

Also, planning in the sense of forecasting statistically to determine in advance the results to be expected under different sets of circumstances and assumptions will be needed. By varying these assumptions and viewing the expected results, management will be able to set realistic and meaningful goals and objectives. This type of planning is now possible with computers, and the actuary of the future will be deeply involved in it.