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NEW-COMPANY PROBLEMS

Marketing

A. What specialized marketing areas and techniques have been used by new companies? How successful have they been? What hazards are associated with them?
B. What success has been achieved in the sale of life insurance through casualty agents, through health insurance agents, or in combination with mutual funds?
C. What methods have been used for the development of a sales force? Has the personal producing general agent been a successful means of establishing new companies?

MR. C. DAVID SILLETTO: In considering this question of marketing with regard to new companies, it is important to differentiate between those having and those not having an existing sales force to utilize. For example, fire and casualty companies that form life affiliates or mutual funds that form a life insurance company to work through their existing sales organization have one set of problems, and companies that are formed without an existing sales force have another set of problems. I will restrict my comments here to those not having an existing sales force to utilize.

We have to begin by remembering that all companies, however large, have the problem of adding new agents or agencies to their sales forces. This means that they have the problems of recruiting manpower, training it, and financing it in the broadest sense. By that, I mean subsidizing sales manpower until it becomes financially self-sufficient.

There are two necessary ingredients in this self-sufficiency. One is that the new sales force must have understandable products to sell and must be handling a product that generates a sufficient flow of premium and commission dollars so that they can make a living.

We must recognize that new companies have *only* this problem. They have no underlying base of agents or agencies that are financially stable and self-sufficient, and therefore their whole marketing effort has to be directed toward this question of starting, building, and adding manpower.

It could be said that there are two basic ways to acquire a sales force—one is to build your own and the other is to buy trained manpower. Let me comment first on building your own sales force.

One way to do that might be thought of as a full-scale approach using conventional products, in other words, to start with nothing and build an agency force, knowledgeable in handling all the common lines of insurance, selling conventional products. There are big hazards in this, and one of our questions does specifically call for hazards. One hazard is that this is a very expensive process. A second hazard is that it puts a heavy burden on the management of the new company. The sales or agency-management business is essentially a "numbers" business. We all know about the survival rates of agents and the turnover rate of agency managers. If you have ten general agents and one of them fails, that is 10 per cent of your sales force. If you have one hundred and fifty or two hundred general agents, that is quite a different matter. You can play the averages better in an established company.

The other approach to building your own sales force, in contrast to this full-scale approach, would be the specialized approach. This could be specializing either by product line or by geographical area. By product line, we mean basically what we all have called "special policies." Here you can teach the newly recruited man a simple sales presentation that he can learn quickly and give him a product that he can master and go out and sell; hopefully it will be a product that generates enough commission dollars for him to make a living rather quickly. This is an area in which coupon policies were used in many instances in the past. We all know that there were abuses at times with these, but I think that we should also be aware that there are many companies now of substantial size which at one point in their growth used this approach.

One company that I know of has now become very successful in selling a package of mutual funds and permanent life insurance. It is a life paid-up-at-65 contract. They pay a 65 per cent commission on the first-year premium of the life insurance and 5 per cent, I think, to the salesmen on the mutual fund dollars. This means that, for the total package that he sells (and it is a savings plan idea), he gets an average 35 per cent commission on the dollars he generates.

Another way that a company can specialize is in a limited geographic area. In this manner a company can avoid meeting the large companies head-on competitively. I think that in many cases a new local company with local ownership can justify having agents, say, in rural areas, where a large company does not feel that the market potential justifies having them there.

The hazards in this are that it is difficult to maintain momentum and growth if you stay specialized. They wear thin after a time. And, of course, as time goes on there is a terrific temptation to generalize and become a full-scale company writing all lines of business. The main problem, then, is how to accomplish this transition from a specialty company to a general company without destroying what you have already built in the way of agency manpower.

The other approach that I mentioned, other than building your own manpower, is that of buying trained manpower; the most common form of this is personal producing general agents. A company goes to successful producers of established companies and buys them with a general agent's contract. This has several hazards. It can be expensive. It also places some burden on the company to offer a complete range of products, because these men typically have been producing for well-established companies that do have a full range of products and they are not willing to give that up. Third, I think that the greatest hazard of this approach is that it is very difficult to buy a man's loyalty. After all, one company bought this man away from another company, and, if somebody else comes along and offers him a higher price, he can be bought again.

As you probably know, many new companies consider themselves "brokerage companies." To my way of thinking, this is nothing more than another manifestation of this process of buying trained manpower. Instead of signing a man up as a general agent, you get some of his production as a broker.

In summary, I would say that all the methods about which we have talked here have been tried by some new company somewhere. Agency-building, special policies, personal producing general agents, mutual funds, and brokerage have all succeeded in some instances and have all failed in other instances. As far as I am concerned, the key to success is not the method itself but the quality of the management manpower trying the method.

MR. CHANDLER L. McKELVEY: It might be helpful to try to identify a little more exactly what Sentry Insurance is. It is an all-line group of fire and casualty and life insurance companies. We operate internationally. Actually, it is thirteen companies—when I left home about two days ago—and our premium income runs about $225,000,000. Basically we sell through a direct-writing-company employee sales force. We have a little over nine hundred men who write, who are full-time employees of Sentry Insurance. This is our sole source of production for our life insurance company.

Sentry Life of Wisconsin was started in 1959. It is now eight years old. Writing through these nine hundred men, the company now has about $20,000,000 of premium income, a substantial portion of which is not life insurance but group accident, health, and group annuities.

I will direct my comments to attempting to get production through fire and casualty agents. I think that the basic problem for companies attempting to market life insurance through this kind of sales force is the fundamental difference in the nature of the fire and casualty field and the life sale. And there is a fundamental difference. Life is essentially a creative sale. The man who sells a life insurance policy, and I am thinking primarily of individual life, has to create a need or a desire on the part of this prospect. He has to create a conviction on the part of his prospect that he needs more coverage. With fire and casualty, on the other hand, is is not necessary to create this need or desire. Virtually everyone knows that he has to have coverage on his automobile and fire insurance on his home. The creativity of the sale does not exist. For this reason the typical fire and casualty salesman, whether he be an independent agent or a direct-writing salesman, tends to think of himself primarily as a technical person rather than as a salesman.

And, generally speaking, I think that it is true that the man who feels comfortable in fire and casualty sales normally will not like the creative, emotional, if you will, sale that life insurance entails. This is the kind of problem that we have had and that everyone has had who has attempted to market with fire and casualty salesmen.

With mutual fund salesmen the story is a little different, because again the sale of mutual funds is essentially a creative sale and by and large they have been more successful along that line. To give a rule of thumb, companies have generally found it difficult to get more than about $100,000 per year production in individual life, on the average, from full-time fire and casualty agents.

At Sentry our production in 1967 will be about as follows per man. We will get about $75,000 per man of individual life, or an annual premium of about $1,300. Our average premium per thousand runs about $17, which is pretty much in line with the industry in general. In group life we will also get about $75,000 of production for an additional $750 of premium per man, on the average.

This is somewhat better than most companies that are trying to merchandise life insurance through fire and casualty salesmen. I believe that there are two or three reasons for this. First, our top management is convinced of and committed to the importance of life insurance. They are convinced that the over-all help of the all-lines organization is dependent upon a vigorous sale of life insurance. Second, we do have a direct-writing sales force, and we do have more control over their activities than companies operating through the American agencies system. A third factor that I think is important, particularly in group, is that our salesmen have sold group health insurance for many years and are therefore familiar with that type of coverage; so, group life was a natural extension.

We have learned some lessons about fire and casualty agents which I will pass on to you. We have tried to market both participating and non-participating individual life through our salesmen. We have found that we have been much more successful with nonpar. All fire and casualty salesmen are very aware of price, and nonpar has been better because it is a simpler product, the sales appeal has been easier for them to deal with, and they have liked it better.

Another thing that we have certainly learned—and I guess this is not news to anyone—is that constant attention and pressure are needed for life sales. We have found that the worst mistake we can make is to let up on the pressure for life insurance sales.

Another thing on which we have done a great deal of work is the so-called one-stop selling—the idea that one insurance man can handle all one's insurance needs. This has been a mixed blessing, to say the least. We have definite evidence in our book of business that the combined idea of fire, casualty, and life selling has had an adverse effect on our persistency in life insurance in the sense that a new element of risk, risk to the persistency of the life insurance, is introduced by having it combined with the fire and casualty coverages.

The idea of canceling insurance is much more prevalent in automobile or homeowner's areas than it is in life insurance. Someone becomes unhappy with our handling of claims or the attention that he is getting and reacts by canceling all his insurance, including his life insurance. Because of this, as well as the fact that fire and casualty salesmen are not (at least ours are not) generally what you might call the programing type of salesmen, the one-stop selling concept has not been a smashing success for us.

Fire and casualty salesmen are product-oriented rather than market-oriented, as I think most of our good life insurance salesmen are. So we have found that it is very desirable to have some specialty products in your portfolio and that certain segments of the force will take certain of these and run with them.

MR. JOHN S. FRY: A major trend to be aware of is that the new companies formed in the last eighteen to twenty-four months do plan to exploit a specialty. They plan to develop a specialty by and large in either or both of the areas of (1) who the potential insurance customer is to be and (2) what source of sales manpower is to be tapped. A major characteristic of this trend is that these new companies are not new in the sense of being formed by hardy, individual entrepreneurs. Instead, they are formed by well-established businesses that have a view to the more or less captive markets that they are close to and—and this is fundamental—figure to profit substantially by cultivating this captive source. The captive source in the market may be homeowners with mortgages, holders of credit cards, charge customers, or loan applicants, or it may be instead not the ultimate consumer but the salesman himself. He may be, for example, the fire and casualty agent of a fire and casualty insurer or the broker-dealer of a mutual fund.

In planning to develop the potential inherent in the casualty agent's clientele and his prestige with them, two situations ought to be distinguished. If the sales force is controlled to a considerable extent, quotas of life and casualty production can be set. The acceleration with which the fire and casualty man moves toward acquiring skill in life sales can be influenced by the management.

However, when generation of life business from general-lines men or independent agents is attempted, the experience has repeatedly been that the agent is not a self-starter in producing life and cannot be motivated to a significant extent to learn to sell life insurance.

Companies that have mined a worthwhile amount of this business use the fire-and-property man as a bird dog and pair him with an experienced life salesman.

The most successful method of pairing is for the fire-and-property man to both make the appointment with the prospect and accompany the life man to make a joint call. It works fairly well for the agent to set up the appointment but to leave the presentation and, hopefully, the close to the life expert. This, though, is not as good as the first method. The least-inspired results are obtained when the agents' contacts are used solely as a prospect list.

The relationship between the life company and the casualty company whose agents are being tapped has taken several forms: (1) there may be no direct relationship; (2) the relationship may be a formal, corporate one; or (3) the relationship may be an informal one with a casualty insurer that lacks a current interest in a life affiliate itself.

A word on commission patterns. A company or two have tried level commissions, arguing that this is acceptable by custom to the fire-and-property man and that the company's surplus strain is eased. Experience shows us, though, that this idea does not work and that a level pattern is not acceptable.

Life business collateral with mutual funds has been sought in several ways. Perhaps 25 per cent of the mutual funds distributed are through large security dealers. These sales are big, but they are also casual from the broker's view, and he cannot be interested in tying in life insurance.

The remaining 75 per cent of fund shares are sold by full-time, door-to-door fund salesmen. A couple of attempts on the basis of an attractive product consisting of a common payment facility have been made to obtain life sales through dually licensed broker-dealers. These attempts were by companies without a financial association with a fund, and they were not successful. It seemed that most of the broker-dealers already had a life connection. They generate a good volume of business, but most of it is in exchange for 80–100 per cent commission contracts, not in exchange for a unique product.

The situation with the most potential and the best success to date is that in which the fund and the life company are associated. A fund may have moved into life insurance or an insurer acquired a fund. One motivator for the fund is the SEC opposition to "front-end loads." With a no-load fund sold with insurance the salesman's commission would come only from life insurance. Life companies, on the other hand, have found that an affiliation with a fund is valuable in recruiting life insurance salesmen.

MR. ALAN RICHARDS: I am going to talk about Question B, regarding the sale of life insurance in combination with mutual funds. This discussion is from the standpoint of an organization consisting of a management company—Insurance and Securities Incorporated—that manages a large, established mutual fund—Insurance Securities Trust Fund—that in turn is invested almost entirely in the stocks of life insurance companies and fire and casualty insurance companies. This is one of the few organizations having its own full-time sales force and selling its own fund directly to the public.

Life Insurance Company of California was formed in 1963 as a wholly owned subsidiary of the management company and has achieved considerable success through the dual licensing of nearly all the men in the existing fund sales force to sell both funds and life insurance.

Our experience has been that a moderate proportion, perhaps 20 per cent, of these investment-oriented men will sell life insurance in significant quantities, another 20 per cent will have nothing whatsoever to do with it, and the remainder will sell life insurance only intermittently. Nevertheless, this sales force has shown great stability, with very low turnover rates, and the result has been life insurance sales each year on the order of $100,000,000.

As might be expected, the bulk of the business has been term insurance, particularly decreasing term. However, this was mitigated somewhat by our sales strategy, which was to feature a combination plan consisting of whole life and decreasing-term insurance to age 65. Without this product our proportion of term insurance would have been much higher than the 70 per cent actually experienced.

The investment business, in general, and the mutual fund business, in particular, is somewhat cyclical with regard to sales. Above all, sales of mutual funds seem to rise and fall with increases or decreases in the market value of the underlying investment unit. This could come as a surprise to those who are used to the relatively stable year-by-year sales of the life insurance business and who may be contemplating the sales of funds as an additional product.

In the last two or three years, sales of our own fund have been severely depressed as a result of the trend of market values for insurance stocks. This has provided an interesting test of sales results on the life insurance side when fund sales are low. Our experience has been that sales of life insurance do, indeed, decline under these conditions because of the contraction in size of the total sales force but that, after a period of adjustment, sales of life insurance *per man* tend to be nearly as high as they were when fund sales were high.

MR. BERNARD KAVANAGH: When a new company enters the substandard market competitively, one may expect to have many exaggerations spread about the company and about its activities.

A company doing a thorough job in substandard business could, we felt, be of service to the public, bring profit to the stockholders, contribute to surplus, and use impaired-risk underwriting as a means of introducing a broader portfolio. We felt both a moral obligation and the business necessity of planning the impaired-risk program so that it would be of long duration and of a permanent nature.

In order to go into the substandard market with a little more vigor than the average new company, we felt that we had to strive to consider all the factors involved and to study each in depth. Over forty of these were considered from the point of view of the company, including the agency force, and then again independently from the point of view of the reinsurer.

The following are ten items that are considered in order to maximize profits in the substandard business:

1. What are the persistency and not-taken rates of business before and after a substandard program?
2. What is the saving on recruiting the agency force?
3. What are the effects of the geographical area on mortality?
4. What is the possible saving in not financing agents?
5. What are the savings on high integrity and quality of general agents?

6. What is the amount of fraud by medical examiners?
7. What are the savings on mortality and other effects of very prompt issue?
8. What is the effect of the different types of reinsurance treaties?
9. What is the cost of declining or of highly rating a case that could have been accepted or rated lower?
10. What is the effect on sales of other business?

We tried to evaluate each one and found it quite difficult to do so; we did put a numerical value on each of them, combining logic with judgment values, and then went through a crude asset-share type of calculation to see what ratings we could offer. Then, as is quite often done, we found a simple or mechanical method of rating impaired risks that would produce the results dictated by our study. As an added safety factor, we also put into effect a stop-loss type of reinsurance treaty.

In addition, we gave some thought to the equity of an impaired-risk program from the point of view of the insurance department with the usual arguments that growth to the company is for the benefit of the existing policyholders as well as stockholders. Throughout we kept in mind the concept of the total package as profitable and producing average results.

After having a couple of years' experience, we went back and were able to check in bulk the mortality and expenses, which compare favorably with our anticipated results, by individual considerations for each element. We do not expect to be able to check each individual element because of the intangible nature of such items as the savings resulting from the integrity of our general agents or the elimination of some fraud.

The impaired-risk underwriting has stood on its own feet, and we plan to continue in this area. It has also served to introduce several other plans of the company and has resulted in large volumes of business which we might not have written otherwise. Current markets change, classes of risks frequently have their ratings changed, and so we must keep up-to-date on such a program.

MR. FREDERICK S. TOWNSEND: A number of life insurance companies have been able to create unique marketing schemes which virtually eliminate the agent's prospecting problems. When an agent does not have to prospect, the company can reduce commission rates and, in turn perhaps, reduce the premium rate as well. Although the commission rate is reduced the sales volume is extremely higher, and thus the agent's earned income is substantially higher. If the lower commission rate is reflected in a lower gross premium rate, a product becomes even more competitive and sales are further boosted.

MR. CHARLES F. B. RICHARDSON: I was tempted to get up here and underline a comment made by Dave Silletto about the enormous cost of building a full-time sales force, particularly today. I had occasion some years ago to attempt to project what the costs would be. Later I had a chance to check these projections with some people in other large companies that have done similar work.

Quite recently we had occasion to make some projections in regard to an agency-expansion program because of the restricting effects of Section 213 of the New York law. We found that, if we established one new agency a year for eight years, the expenses would exceed the margins generated by Section 213 by something close to $300,000 for one agency per year.

So I want to underline Dave's comment about the tremendous expense of building new full-time agencies. Mind you, it is a good investment in the long run, but it does take a long, long time to pay off.

This brings to mind another remark that I would like to make, which is that I think one of the greatest weaknesses in our state laws is the fact that the minimum-capital-surplus requirements for new companies are entirely too low.

MR. CLAUDE Y. PAQUIN: My remarks are not directed to new-company problems very specifically, but there is one remark that John Fry, the speaker from the Continental, made that led me to make this remark. He said that there was some attractiveness currently for mutual funds to ally with life insurance companies, especially in view of the fact that the front-end load has been attacked through the SEC investigation on mutual funds marketing. It seems to me that, if the mutual funds were to become no-load funds and were sold in conjunction with life insurance, the commission under life insurance might have to rise above its current level since more is sold than just life insurance.

Considering that the current commission rates, for the non–New York companies at least, to general agents or personal producing general agents are in the 90 per cent area, it is conceivable that, where a mutual fund sale is made along with a life insurance sale, the commission rate might go up to 100 per cent on the life insurance portion and maybe even higher, to 110 per cent. If this were to happen, I think that it is quite possible that the SEC might find that its restrictions on the front-end load are evaded thereby and that the whole scheme is a sham, as far as it is concerned; it might try to regulate, at least from that standpoint, the life insurance business.

Another thought that I had on the front-end load is that "what is good for the goose is good for the gander"; if the SEC successfully attacks the principle of front-end load in mutual funds, it might also destroy the marketing approach of the life insurance business, especially if federal controls of the life insurance business are forthcoming, since the federal insurance regulators might be expected to adopt a philosophy not too different from that of the securities regulators.

MR. RICHARDS: Maybe I can make a very brief comment here. There may be some misunderstanding as to the intent of the SEC-sponsored legislation on front-end loads. The front-end load in the strict sense relates only to a contractual plan. The plan is purchased for a fixed period, perhaps ten or fifteen years, and as much as 50 per cent of the first year's payment goes into load. This is the thing that the SEC is really seeking to outlaw.

They are also seeking to reduce the level load, which is the basis on which the bulk of mutual funds are sold. They are proposing to reduce the load from approximately an $8\frac{1}{2}$ per cent maximum to 5 per cent. They are not seeking to eliminate sales loads.

MR. ROBERT C. TOOKEY: I will comment on this subject as it pertains to our new-company clients, principally in the West, that have made a go of it. The "mustard cutters" have had great success in working with mutual fund sales organizations. The obvious reason, of course, is that these fellows already have a good meal ticket, so the placing of life insurance is simply a by-product sale. Among those that have fully worked the insurance market, the average salesman was able to place some form of life insurance in one out of three of his new mutual fund sales.

In the cases where the company offered all the usual forms of insurance with emphasis on permanent plans, the salesman would usually first offer the prospect the whole life policy; often this was like pulling teeth, because fund salesmen were trained for years on the concept of "Buy term and invest the difference." Usually, after the sale of the fund is made, the salesman offers his prospect, as a service, an additional product at very little extra cost. The point is made that we know what the family will receive if both parents survive, but, in the event that the breadwinner does not survive, his spouse will need the planned-savings goal more than ever. So the company offers this protection as a service, with whole life offered first. If the prospect finds this unattractive, something on the order of joint life term may be suggested as an alternative. If that does not fit into his budget, he is offered the "stripped down" version, the VW, so to speak; this plan is the well-known decreasing term, contract-completion insurance.

My other comment relates to the question "Has the personal producing general agent been a successful means of establishing new companies?" I think that he has been over the years, but, when we had too many new companies coming in at the same time—all competing for personal producing general agents—the cost of writing new business eventually became excessive. The original theory of the personal producing general agent approach was that the company could give these producers the full general agent commission but would not have to provide supervision. However, it is normally necessary to supervise personal producing general agents, though perhaps to a much less extent than the typical producing agent.

Personnel

A. How successful have new companies been in attracting experienced administrative, underwriting, and actuarial personnel?
B. What combinations of personnel, administrative procedures, and tables of organization have proved to be the most efficient in controlling costs in the new life company?

MR. WILLIAM A. BROWN: Our company was formed in late 1964 in Atlanta, Georgia, and most of our staffing took place in the early months of 1965. At this time there was still a lot of excitement in our area about new life insurance companies. Stock options, while not as enticing as before, were still thought to be quite valuable fringe benefits. Many of us still had on rose-colored glasses and underestimated drastically the difficulty of getting a new company started.

The amount of our initial capitalization was unusually large. The net received from the sale of stock in United Trust was $\$10\frac{1}{4}$ million. This placed the issue among the largest ever for life insurance companies. With this amount of money, the company was obviously no fly-by-night outfit. It had adequate funds for any reasonable operation. The investment income would help to meet the heavy expenses that we would incur in the early years.

The location of the company, I think, helped in our recruiting. Atlanta, Georgia, is considered, at least there, to be a very progressive city. It has excellent climate, very good school systems, several institutions of higher learning, and professional baseball, football, and soccer teams. With all these nice things, it was really not too difficult to attract people to our company.

As a matter of fact, when I joined the company in early 1965 as the third employee after the president and his secretary, we already had quite a large stack of résumés and other expressions of interest. From these, we could have chosen well-qualified applicants for all areas in the administrative end of our shop.

The initial discussions with the president and the agency man indicated that we were going to operate in a slightly higher-than-average policy market and with more than one type of sales force, including a brokerage operation. We wanted to provide good service to the field, from the beginning, and went about staffing our company with this in mind.

As administrative vice-president, I wanted people who were experienced and who had high qualifications. I knew that we would have a rough time in the early years of the company, and I wanted a core of good supervisory people who could be counted upon.

I had spent several years in consulting and company work in Atlanta and knew several people in the specialty areas that I needed to fill. Of the four supervisors that I hired, I had worked directly with three of them and we knew one another well. All four of these people are still with me after two and a half years.

Our five supervisors have a total of seven college degrees, one is a Fellow, one is a C.P.A., one is an Associate, and most have passed several LOMA examinations. These people were given considerable freedom of action from the very beginning and a lot of responsibility and authority. We were able to hire them by offering adequate salaries, stock options, and the usual fringe benefits.

I believe that this administrative division of this new company has performed quite well; at least we have had very few complaints from the president and the agency people.

As for validating the attractions that we claimed for the company and for our city, the record is not outstanding. The market for new-company shares collapsed almost immediately after our company was organized. Our stock is now quoted at $6\frac{3}{8}$ compared to present capital and surplus per share in excess of $8 and an original offering price of $10. So the stock options now appear worthless.

Our production of business has not been what we, and some others as well, would like for it to have been. We have found that it is very difficult to build an agency force and very expensive, also. With the investment income from our large capital funds, we have been able to hold down our operating losses and we still have most of our funds.

Atlanta has experienced a couple of minor riots. Part of last summer was rather dry and hot. Some of our school systems are currently being investigated for one reason or another. The football team of one of our better-known institutions is literally a wreck. Our Atlanta Braves finished seventh this year. The Atlanta Falcons have a one-five-one record. I think that the Atlanta Chiefs, our soccer team, finished last also.

With this kind of record, the fact that we have been able to retain our entire supervisory staff attests to their sense of loyalty, forgiveness, and perhaps their good sense of humor. I have, however, been charged with misrepresentation.

Part B of the question reads, "What combinations of personnel, administrative procedures, and tables of organization have proved to be the most efficient in controlling costs in the new life company?"

At United Trust we use manual systems almost entirely. We do have a couple of types of business on punched cards to facilitate valuation, and we do some of our accounting work on punched cards. We tried to set up our system of manual records in a way that would facilitate the transfer later to some automated system.

Our organization is as follows:

1. The assistant actuary is responsible for all the actuarial work, including drafting policy forms, premium rates, values and reserves, experience studies, dividends, and certain office services relating to benefit plans for employees.
2. The assistant treasurer is responsible for the cashier duties, security-custodian relations, custodian of mortgage records, and the preparation of certain tax reports. She also has some responsibility in the area of office services relating to personnel and benefit plans.
3. The comptroller is responsible for all accounting, field payroll, purchasing and supply, printing, and all financial reports, including tax returns and budget work.
4. The director of underwriting is responsible for all new-business processing, including underwriting, issue, and reinsurance. He is also responsible for what policyholder service work we have at this point, file maintenance, and claims.
5. Our part-time medical director is an internist and spends time in our office as necessary, perhaps a couple of hours a week.

We have a small subsidiary company with the home office in another state. This office is staffed with four female employees. Most of the new-business work is done in Atlanta. Each of our supervisors in the home office in Atlanta extends his functional area of responsibility to the subsidiary operation as well.

Each supervisor has clerical help as needed in his particular area. At present the assistant actuary has one clerk; the assistant treasurer, one; the comptroller, four; and the director of underwriting, three. In addition, we have one secretary in our department and one girl who is the company's receptionist and switchboard operator.

I believe that we have been able to control our administrative costs reasonably well through knowledgeable and responsible supervisory people. Each of us must do work at times that a good clerk could do, but we do not add another person until there is enough work to keep this person busy. Although our supervisory costs may be higher than our present production level requires, increases in our cost can be controlled by adding people at the lower levels only after we can justify these additions.

In addition to work related to our own production, the assistant actuary, the comptroller, and I have spent a considerable amount of time in the last two years examining merger candidates. We have acquired two small companies and have studied, to some degree, at least fifty. Our closing ratio does not seem to be any better than that of our agents.

MR. JOHN G. SELIG: Our companies are relatively small, but we have been successful in attracting personnel. The problem is not only attracting qualified prospects but retaining personnel after they are hired.

A prospect must have his interest aroused to at least respond and schedule an interview. The job opening must have romance and provide satisfaction to the prospect in the areas that the applicant feels are lacking in his present job. Basically, a selling job must be done during the initial contact and later during the interview.

If an organization is to attract personnel, it must have a good growth record with prospective job stability. An organization that has rapid turnover of its management group or is subject to merger or takeover presents a very unattractive picture regardless of the salary or job content.

The salary range must be competitive for the opening. The small company must be prepared to pay more than the average salary if above-average prospects are to be attracted. In return, the small company can usually demand more than a forty-hour week from its management employees.

Subsequent to hiring an applicant, it is incumbent upon management to reduce turnover of personnel who are performing above average. In order to hold personnel, the top-management team must gain the respect and confidence of all employees by demonstrating its ability and knowledge. The position for which the person was hired must live up to his expectations, which were detailed and amplified during the employment interview. If the company defined the job in superlatives and later was not able to deliver, then it will have a dissatisfied employee.

Personnel who are working for a small company must be compensated on a basis that is equal to or greater than the salary available with other companies for similar work and responsibilities. It is imperative that the company pay competitive salaries and grant competitive salary increases. An employee usually has a fair idea of the salary range that he can command in today's job market. Compensation is not the only reason for employee dissatisfaction, but it certainly is close to the top of the list. Once a person becomes slightly dissatisfied with his job and has the impression that his compensation is below average, you have lost an employee.

MR. JOSEPH D. AUSTIN: Our company has been successful in attracting experienced administrative, underwriting, and actuarial personnel, primarily because of the size of our capitalization. We felt that it was a definite advantage to have our own underwriter for our field force long before he was spending full time on the underwriting function. We also felt it desirable to hire an actuary, since we probably turn out more actuarial calculations and management reports than most small companies.

In order to afford people of this caliber, we sought men who were willing to perform a variety of jobs in addition to the jobs in which they had been trained. For example, our underwriter has undertaken a number of jobs, such as heading up our issue operation, in addition to underwriting policies.

We were fortunate enough to set up an integrated home-office system when we were organized. It would have been a far more difficult task to accomplish this after we were writing business. We feel that the system will afford us substantial savings in the years ahead.

The most effective tool for controlling costs in our company has been a budget. We set up a budget which will eventually be the basis for cost-control studies and also for a functional-cost study. It has been set up so that expenses can be determined by department as well as by function; there is also a breakdown between first year and renewal. While departmental expenses do not have very much meaning at the present stage of our development, we now break the budget down into four categories—investment, the inside operation, agency, and overhead. As the company grows and becomes departmentalized, we will break the study down by department.

Likewise, at the present time, the functional costs have been combined, so that we only develop the inside acquisition function, consisting primarily of issue and underwriting; the selling acquisition function, which is practically all our agency expense at the present time; and the inside maintenance function. Overhead is allocated over the other functions. As time goes by, we will break down the acquisition function into issue, underwriting, and selling and the maintenance function into premium billing, premium accounting, valuation, policy change, and so on. These functional expenses will then be divided by an appropriate unit, such as policies issued or in force and a unit cost obtained. We can then study our unit costs from year to year. These unit costs will also be the basis of asset shares and other actuarial calculations.

MRS. ANNA M. RAPPAPORT: We are just about ten years old now. We started in 1958. My company has been successful both in recruiting good people for the home office and in keeping them. I think that the reason is that a new company can be a very good place to work.

You can have a lot of freedom from organizational problems and the restraints that are always present in an older, established organization. You can give people the chance to work to the fullest of their capacity, and very often people will. You can also offer opportunity in a new company which you just cannot offer in an established company.

Funds

A. What techniques have proved most successful in preserving surplus funds during the early days of a new company? How has health insurance or group insurance influenced the rate of surplus development (or depletion)?
B. How are problems of undercapitalization being solved in the present market for life insurance company stocks?
C. How successful has state regulation of initial capitalization of new companies been in providing adequate funds to stand the strain of operations for an acceptable period of years?

MR. MELVIN L. GOLD: The best techniques for preserving funds in the early years of a new company are threefold: (1) hire a president who knows what he is doing; (2) start with enough money; and (3) invest your money, don't dissipate it.

I would like to emphasize that the problem of insufficient surplus is more often a lack of competent executive talent than insufficient funds.

It is extremely difficult in today's market to raise additional capital, and most financially weak companies are solving their problems by being gobbled up in one form or another.

State supervision was not particularly successful in assuring that new companies started operations with sufficient funds. All the states are now raising their requirements, but it is far too late.

MR. D. ALAN LITTLE: Among the many conflicting situations that one will encounter in seeking answers to this problem are the following:

1. Special situations, such as fire and casualty subsidiaries able to operate piggyback on the parent sales and systems organization to reduce cost.
2. Special plans of operations, such as one West Coast company where the sales organization is taking level commissions rather than a front-end rate with lower renewals.
3. Knowledgeable management attempting to operate at the lowest possible cost despite sizable capital and surplus at their disposal.

I could enumerate many other examples of situations where lower capitalization might be required.

Regulation as currently enacted is concerned primarily with the protection of the policyholder and, to a lesser degree, with the investing public. Such standards as are written into law or otherwise enforced are intended only as minimum levels at the time the laws are drafted or amended. Conditions change and situations arise that differ from the areas that the laws are intended to cover. While I will give some personal observations of the adequacy of existing regulation based on a study of new companies that I recently made, I seriously question that any minimum capital and surplus law can be drafted that covers all situations.

There are numerous ways to study the effectiveness of minimum capital laws. One could, for example, review the statements of companies formed over a given period of five to ten years and develop ratios of those requiring additional capital to the total studied. The study would be dependent on attitudes of the investment public during the period studied. If the public is enthusiastic about life stocks, many companies could and would raise additional money without being in financial difficulties.

Another method might be to compute a survival rate for new companies. While some companies fail to survive for other than financial reasons, a low survival rate could be interpreted by some to show inadequate regulation, while a high rate would indicate the reverse.

A third method would be to prepare model-company projections using a variety of assumptions and then compare these results to the requirements of the various states. Such a study should reflect, in addition to the purely actuarial factors, the wide variance in management competence.

In lieu of these methods, I selected a sample of twenty-two companies from the 1966 edition of *Best's Life Insurance Reports*. All were companies that commenced business during the years 1960–66. The sample did not include any subsidiaries of fire and casualty companies or any companies in which mergers, acquisitions, or bulk reinsurance influenced the results.

The average company in the study had the following characteristics. During 1966 it wrote $26 million of new business, had almost $50 million of insurance in force at year-end, and had a loss from operations of $184,000. Averages, however, do not tell much of a story. For example, the only two companies showing a gain in surplus since organization had capital of $300,000 and $1,000,000, respectively, among the lowest in the study. Both were above average in new writings and insurance in force. Previous speakers on this panel have discussed conservation of surplus, and apparently these two companies have adopted some of their techniques.

More to the point, however, is the surplus drain of the companies in the sample. The average loss of surplus was $800,000, and this figure may be understated because of poor reporting on stock-selling costs. Half of the companies have lost more than $500,000, and of this group not one had a gain from operations during 1966. Let us compare these results with the capital and surplus requirements of the various states. Currently most states require from $250,000 to $1,000,000. One state requires $25,000, while a few require in excess of $1,000,000. In most states, the average company in the sample would now be insolvent if it had been forced to live at the minimum level, particularly if you include the loss for investment earnings on capital above the minimum. Recognizing that there will always be exceptions to any rule, I must conclude that the current minimum levels are inadequate. In fact, one might easily conclude that the minimum should probably be as high as $2,000,000 or more. Any such increase, in my opinion, should give due recognition to the position of a parent which is also a qualified insurer.

There is one final observation that we can make from the study, and that is the tendency of expense levels to increase much faster than the level of capitalization. If larger requirements simply increase the rate at which management will spend, then very little has been gained. Several states are now requiring ten-year projections, and this procedure coupled with appropriate follow-up could show as promising results in the area of new-company regulation as a raise in the minimum capital requirement.

MR. CLAUDE Y. PAQUIN: I would like to make a very brief comment under Question B, "How are problems of undercapitalization being solved in the present market for life insurance company stocks?"

I am somewhat surprised that the remark was not made here that one can always use portfolio reinsurance. This is one possibility that has not been mentioned.

Our own company has a subsidiary which resorted to portfolio reinsurance twice, in 1959 and in 1962. Apparently over the long term it does not work too well, but over the short term, considering the current market, I think that it may work well enough to bail out a company for a few years.

MR. CHARLES G. BENTZIN: We have in Arizona a peculiarity in the law known as the limited capital stock life insurance company. A limited capital stock company can be formed for $25,000 of capital and $12,500 of expendable surplus. It is limited to writing a maximum risk of $5,000 on any one life, for both life and accident and health, regardless of reinsurance.

There are approximately 180 such companies in existence at this time. Practically all of these are reinsurance companies which are formed by finance companies for banks and auto-dealers elsewhere in the country. They do no direct business.

However, there has been some attention given to agents throughout the country who wish to have their own companies but who do not have the capital funds to form them in other states. In this case some sort of reinsurance for money arrangement has been formed. This, I think, is a significant development, in that in almost all cases it is considerably cheaper to buy the administrative services of an existing company than it is to form a company and to hire all the personnel to do it.

Consequently, there have been a couple of these companies set up to receive this reinsurance which have been very, very profitable. Those I am referring to are not for captive credit companies that have captive markets; these are cases in which an agent in fact is producing in another area and uses this arrangement for his means of acquiring capital gains.

I would like to suggest that people who are thinking of starting new companies consider seriously writing with another company, since one of the bigger problems in developing a company is developing the marketing organization; if you can find a compatible company with whom to write, who is willing to reinsure, this can postpone the rather substantial cost of developing a home-office administrative setup until such time as the sales force and the method of selling are clearly established. When an adequate volume of premium is coming in, only then do you need the services of an extensive home-office staff, and it can then be incurred.

MR. GOLD: Some years ago New York had a minimum capital surplus requirement of $750,000. Today it is around $3,000,000, and I have not noticed any particular correlation between the amount of money the company started with and how well it did.

I cannot quite see a limit much above $3,000,000. If you cannot have a successful company with $3,000,000, something is wrong. If you start with $10,000,000, you lose a tremendous amount of leverage. I find that, if you have more money around, somehow you spend more.

Financial Projections

A. To what extent have financial projections been used by new companies as a management tool? Who prepares such projections, and who analyzes actual experience as related to the projections?

B. To whom are the projections and the analyses communicated, and how often are they revised?

MR. ALLEN L. MAYERSON: Financial projections are more and more being recognized as a valuable management tool for small companies. State insurance departments, too, are beginning to realize the utility of projections, both to indicate the adequacy of a new company's proposed capitalization and to make the promoters of a new company realize the financial consequences of their plans.

When insurance departments require projections as a part of the preincorporation material to be submitted by the promoters of a new company, they generally request a five-year projection. Some insurance departments ask for ten years, although, in my view, a ten-year projection involves too many assumptions about distant events and is seldom of real value. Most states will accept any projection supplied by a qualified consulting actuary; others scrutinize the projections carefully and insist on assumptions which seem reasonable in relation to the actual experience of other new companies. Some departments permit a projection to be based upon a few, or even one, plan of insurance, with a single-issue age, rough-and-ready mortality assumptions consistent with the assumed issue age, and little or no reflection of reinsurance costs. Others require a complex model office which, since the company has yet to issue a policy, may be just as far from reality as a simpler one-plan, one-age model; it has, however, the merit of requiring much work, hence enabling the consulting actuary to charge a sizable fee.

The preincorporation projection, besides assuring the insurance department that the proposed initial capital and surplus is adequate for at least five years of operation, often compels the promoters to face up to the unpleasant fact that a new insurance company will almost surely lose money for the first five to ten years of operation. In some cases this has resulted in their starting operations with a higher initial capital than originally contemplated. In others it has discouraged the promoters, so the company was never started at all.

An initial projection, before incorporation, rarely corresponds to actual operations for very long. Seldom do the actual operations of a new company resemble, in any but very broad outlines, the operating plan that was contemplated before the company opened its doors. Actual results are more likely to be worse, not better, than those projected.

Once a company has begun operating—hopefully with adequate capital and surplus, experienced management, and a sure-fire plan for selling life insurance—financial projections become an indispensable management tool. An accurate one-year projection, which should come close to reproducing the annual statement results, is a must, and a three- to five-year projection, revised and brought up to date, is very helpful.

First-year and renewal operating results should be projected separately. Thus the effect of a change in new business written, the most variable of the assumptions required in the projection, will not invalidate the results of the projection but can quickly be reflected in the figures. It may also be helpful to do separate projections by department, especially if the company is engaged in several lines of business or is using various marketing methods with different acquisition costs or lapse rates.

The projection of renewal operating results can usually be done quite accurately. The average premium per $1,000, the average commission rate, and the cost of reinsurance are known. It is necessary to estimate the lapse rate, of course, and this is probably the hardest assumption to make; but a lapse rate higher than expected will result in a release of reserves to surplus and may actually improve the current year's financial results (at the cost, of course, of future profits). The increase in reserves can be estimated by doing two valuations at year-end—obtaining the reserve at 12/31/68 on the 12/31/67 in force. With an accurate reserve at two year-ends on the same in force, an average plan and age can be chosen, or perhaps an average age for each of several plans and years of issue, to extrapolate reserves for the longer-term projection.

I prefer to calculate a first-year margin (usually negative) and a renewal margin (hopefully positive) for each calendar year without deducting administrative expenses, including interest income only on the reserves. Interest on capital and surplus is kept separate. Expenses for the current year can be estimated from the company's budget (every company should have one), and the sum of the first-year margin, renewal margin, and interest earnings *less* administrative expenses is the net gain from operations.

One useful index that should be included in the projection is the relationship of formula to budgeted expense. Formula expenses will usually be expressed as k per cent of first-year premiums $+c$ per cent of renewal premiums, $+\$p$ per new policy $+\$r$ per renewal policy $+\$m$ per $1,000 of new business written. These should be chosen as realistic going-concern expense rates, goals that the company can hope to achieve once it has forsaken the ranks of brand-new companies and has enough insurance in force to cover its overhead expense. The ratio of budgeted expenses to formula expense (and the ratio of actual to formula expense) can provide an early indication of the company's progress toward (or away from) an eventually profitable operation.

The trend in the ratio of total operating expenses to total income may offer a useful indicator of eventual profitability, and this, too, can be included in the projection; but this ratio, unless it is calculated separately for first-year and renewal business, is subject to distortion because of the relationship of new to renewal business. However, calculating separate first-year and renewal ratios requires an allocation of administrative expenses, which is a particularly difficult thing for a new company to achieve.

Once the consulting actuary has prepared an accurate one-year projection, it is helpful to compare actual and projected results each month. This can be done by the company but should be reviewed by the actuary. It is necessary to be careful, however, since the distribution of premium income by month is not at all uniform, either for first-year or renewal business. It is, therefore, helpful to express the reserve increase for the year as a percentage of projected premium income (separately for first-year and renewal) and to estimate the month-by-month reserve increase by applying these percentages to actual collected premiums. This has the same effect on monthly financial statements as if a part of the premium collected were journalized to reserves.

In my view, it is not a good idea to capitalize acquisition costs, especially in a small company where (*a*) the definition of what is an acquisition cost is somewhat hazy and (*b*) acquisition expenses may or may not be recouped eventually. To capitalize acquisition costs in a published statement is a departure from standard insurance accounting procedures; is illegal in some states which require all published statements to be consistent with NAIC accounting rules; and may be misleading, even to management. The amount actually expended by a new company to acquire business has little or no relationship to the profitability of the business.

It is very helpful to management to know the increase in the actuarial value of the insurance in force during a year, since a comparison of this increase with the loss from operations is one measure of how successful the year has been. The figures are even more valuable if first-year losses can be compared with the actuarial value of new business written and total profits plus the increase in the actuarial value of total business with the return on invested capital which management hopes to obtain. These actuarial values must, of course, be based on asset-share or profit studies for a network of plans and ages, which entails assumptions as to future interest, lapse, mortality, and expense rates. If management decisions are to be based on such profit studies, it is worth devoting considerable care to the choice of these assumptions; when in doubt, it is better to err on the conservative side, when estimating the present value of future profits from a given block of business. Estimating an average profit factor per $1,000, separately for first-year and renewal business, can be made part of the projection work. Once the factor has been determined, it is not difficult to multiply it by the amount of insurance in force at the end of each month or each quarter, and, by subtracting from the corresponding figure for the previous month or quarter, determine the increase in the estimated actuarial value of the insurance in force for the current accounting period.

Since the present value of future profits requires so many assumptions which may or may not correspond to reality, I would not recommend that the present value of future profits on business in force be published, but, for internal use only, I find them a very useful addition to management's supply of knowledge about the company.

MR. THURSTON P. FARMER, JR.: Some insurance regulatory authorities require that all new life insurance companies prepare a financial projection covering a five- or ten-year period. Even in the absence of such a requirement, management of a new company needs a financial projection as a guide in measuring success of their operations and as a guide to cash flow, to surplus needs, to personnel and office needs, and in setting investment policy. Financial projections have been widely used by new companies, particularly by the more sophisticated managements. Because of the frequent need for financial projections, our office recently developed a rather sophisticated program for our IBM 1130 computer to make the extensive calculations required in a projection.

Financial projections require assumptions as to future lapse rates, mortality rates, rates of investment return, new-business production, product mix, and general expense. They also require use of actuarial calculation techniques to forecast future premiums, investment income, benefit payments, reserve increase, commissions, and tax. The actuary should be the one primarily responsible for making the projections, because he is the one best qualified to decide upon certain of the assumptions and because he is usually the only one capable of devising proper calculation techniques. However, he must draw on the talents and clairvoyance of other members of the management team to assist him in making the assumptions as to new-business production, product mix, and, particularly in the first few years of the projection, general expense. Furthermore, he must consult with other members of the management team to determine the kind of market it contemplates, which will help him decide on a lapse and mortality basis. Also he must learn from other members of the management team the initial investment philosophy to help him decide on an assumed investment rate.

Ideally two projections should be prepared, one based on a higher-production assumption and another based on a lower-production assumption. The actuary should analyze and interpret actual experience each year and should relate it to the forecasts made in the projections. The projections should be revised each year, unless experience indicates that the assumptions used in the last projections are still valid. While any of the assumptions can be wide of the mark, the assumptions as to new-business production and product mix are perhaps subject to greater deviation from original estimates and thus necessitate revised projections.

Projections should be communicated primarily to management, because it has primary responsibility in meeting personnel and office needs, in setting investment policy, in determining which products to emphasize, and in satisfying future surplus needs. The actuary, whether he is a company official or a consultant, is usually able to communicate directly with management. The projections should also be communicated to the board of directors. The actuary is often not able to communicate directly with the board, but he should make himself available to the board to explain the basis of the projections and their significance. Projections are sometimes used as a basis for raising additional capital, so they may be communicated to financial houses and to prospective stockholders. In this area particularly, the actuary has the responsibility of making sure that those who see the projections understand their basis and significance. Usually the actuary does not communicate directly with this last group, so the communication problem is more difficult.

MR. FREDERICK S. TOWNSEND: Financial projection is merely an elegant name for asset-share techniques and model-office projections. The main purpose of preparing financial projections is to benefit a company's long-term growth, and projections are usually prepared either for management, controlling stockholders, or potential investors. There are many purposes for which projections are prepared, many conclusions drawn from projections, and many uses of projections.

The preparation, interpretation, and use of financial projections are becoming more sophisticated. This seems to be true whether one is an investor, a company president, or an actuary.

For many years in the actuarial profession we have used asset shares to determine whether the introduction of a new policy would result in a contribution to surplus and, if so, at what point in time. Probably not until reading Anderson's paper on nonparticipating gross premiums did some actuaries begin to think in terms of return on invested capital or the broader concept of return on common equity.

Management has exhibited its stark recognition of return on common equity in 1967 by the number of major and medium-sized life insurance companies adopting the holding-company approach; but the most significant reason is a growing trend to increase a company's return on common equity. Obviously, this is done in either of two ways: (1) by increasing the company's earnings per dollar of invested capital or (2) by reducing the company's idle capital funds.

This simple concept, return on common equity, brings me back to the subject of financial projections. A prime purpose of a financial projection may be to determine whether a capital investment is more rewarding in the production of life insurance, as an investment in a manufacturing enterprise or service industry, as a real estate investment, or as any other form of investment.

A number of mutual funds and manufacturing companies have had financial projections prepared by consulting actuaries in anticipation of creating life insurance companies. Yet some of the same organizations decided not to create life insurance companies simply because the projected future profits, discounted at desirable rates of return, were less than prospective earnings in other fields of business activity. This is the type of approach expected from a businessman. In contrast, a general agent starting his own life insurance company would probably be thinking only of creating a life insurance giant and would not be concerned with the potential return on his invested capital vis-à-vis other investment possibilities.

Today, many knowledgeable investors own life insurance stocks, and management has felt the pressure to produce increased profits. Capital funds returning less than 5 per cent represent sterile capital. The holding-company concept permits the reduction of capital shares, the issuance of preferred shares, and the investment of capital funds in ventures other than life insurance. Striking examples of this are the affiliation of Occidental of California with companies in the finance, title insurance, and entertainment fields; the move by Greatamerica Corporation from the life insurance business into banking and Braniff Airways; the proposed acquisition of Paul Revere by AVCO; and the attempted acquisition of United Insurance of Chicago by Teledyne.

What I have taken a long time to say is simply this: A prime purpose of financial projections is to show to stockholders, prospective stockholders, or management the potential return on common equity in the life insurance business.

Most other financial projections are prepared for the benefit of management. Such projections may involve an analysis of in-force business, potential new business, or both, and may forecast certain operating statistics for a number of years into the future. The primary product is usually a projection of both company earnings and the development of company surplus.

The projection of earnings provides management with a guideline as to when it may first expect to achieve a statutory operating gain or determine future earnings to be generated from present in-force business which may be used for the further development of new business; or it may simply project the financial stability of the company to a specified time in the future. In the case of companies which either may run out of surplus or may wish to maintain minimum surplus levels, a projection may determine the additional capital funds necessary to be supplied either by a parent company or through the sale of additional stock. A refined financial projection, in the case of a young undercapitalized company, might accurately forecast the future life expectancy of the company's corporate existence.

The development of earnings and surplus derived from a financial projection, particularly for a new or small life insurance company, is affected in large measure by the level of new-business activity and the cost of acquiring such new business. Therefore, one of the prime purposes of a financial projection may be to determine a desirable level of sales activity. In the case of a company with very limited capital funds, projections prepared for two or three levels of sales activity may indicate that it is necessary for the company to develop new business at the slowest projected rate in order to prevent becoming insolvent. Or, if the company has substantial surplus to incur operating losses for an extended period of time, such as five to ten years, such financial projections might actually indicate that the most aggressive level of sales activity is the best course to pursue. Although this would produce larger operating losses in the immediate future, it may result in substantially lower unit expense costs and thus generate larger renewal profits per $1,000 of insurance in force on a substantially larger block of renewal in-force business. Thus, in spite of a larger initial operating loss, the more aggressive sales pattern might produce a statutory operating profit sooner than would be the case if the company were to record meager sales over an extended period of years.

In fact, this particular use of a financial projection suggests a strange fact—the sales forecast in a financial projection may be more important than the actuarial assumptions upon which the projection is based.

Assuming that such projections are prepared by an actuary, I offer remarks, based upon practical experience, with regard to why projections should be prepared with great caution. An actuary, for his own protection and reputation, should take care to see that (1) the assumptions in a financial projection are either reasonable or qualified, (2) actual experience is followed and related to such projections, and (3) such projections are not misused.

In stating that actuarial assumptions in a financial projection should be either reasonable or qualified, I refer to the case where questionable assumptions may be dictated by company management. An actuary preparing a financial projection based upon doubtful management assumptions should indicate possible pitfalls in management thinking or which assumptions will be difficult to experience.

For instance, in the case of one failing young company, a consulting actuary was called upon to project earnings over the next three calendar years. Under the projections, the current substantial operating loss would transform into rapidly increasing operating gains, based primarily on the assumptions of management that premium income would immediately double while general expenses would be reduced by approximately a third. In the next calendar year, premium income did increase but only moderately. As for general expenses, they registered a larger percentage increase than did the premium income account. The company folded. In this particular case, the above three principles were violated. The assumptions on which the projections were based were neither reasonable nor qualified. The company's experience was not followed during the course of the subsequent calendar year. And, with respect to misuse, the financial projections (probably unknown to the actuary who prepared them) were used by management to try to market stock to potential institutional investors.

Consider a second case, where a noninsurance corporation decided to enter the life insurance business after a consulting actuary had prepared an extensive, reasonable, and accurate financial projection. However, when the life insurance company was formed, the entire ratebook was prepared on a set of actuarial assumptions for gross premium rates entirely different from the assumptions and rates upon which the financial projection was based. This action violated two principles. The assumptions upon which the financial projection was based were not adhered to. Thus the financial projections turned out to be ultimately misused.

Another point which I have taken a long time to make is this. Actuaries are generally called upon to make financial projections. They can be intellectually honest and do an excellent job. However, they should not be misused and given a black eye by management. Projections must be reasonable or qualified, they must be followed to see how actual experience develops against expected experience, and care must be taken to see that the original purpose of any projection is understood and that it is not ultimately misused.

Assume an ideal situation in which the actuary performs his job well and management intends to make honest use of the projections. The figures derived in a financial projection may be interpreted as either satisfactory or disappointing. If satisfactory, the plan on which the projections were prepared is followed. But, if the projections indicate results other than what management is trying to achieve, then changes must be made. Two examples follow.

In one case, a company with an extraordinary growth rate in new business was faced with operating losses which would ultimately put it out of business. Projections were reprepared on a lower level of sales activity, but the ultimate result was not changed—only delayed a few years. Obviously, the only answer was that harder efforts would have to be made toward reducing the company's aggregate expenses. Thus, management attacked a problem which it had previously been content to live with and ignore.

In another case, two companies had agreed on approximate merger terms, using rules of thumb to value the in-force business. However, when the management of the acquiring company discounted projected future profits in an actuarial projection at what they considered to be an appropriate yield rate, they found their initial thinking to be much too generous. As a result, the offering price was reduced.

Actual experience as related to the projections should be analyzed by the person who prepared such projections, or by some other person who is equally qualified both to understand the original projections and to analyze actual experience as it develops.

As I have probably already indicated, projections may be communicated to parties considering entering the life insurance business, to persons in the process of forming a new life insurance company, to persons putting new capital into an existing life company, to parties interested in the merger or acquisition of another company, and to management for any number of decisions in long-range planning.

Financial projections are even made in the investment business (1) to project operating earnings created by the sale of a special policy which may constitute much of a company's new sales and (2) to project the total future earnings of a given company.

Communications

A. What are the special communications problems of the actuary or consulting actuary in working with the new life or health company?
B. To what extent is information provided to stockholders and policyholders regarding the creation of value during a company's early stages?
C. Is it proper from the actuary's point of view to capitalize acquisition costs? Should earnings be adjusted by considering the change in present value of future profits on business in force?

MR. FREDERICK S. TOWNSEND: There appears to be a growing interest in the subject of adjusted earnings. Most of this interest is generated by investment analysts, some interest is shown by various company managements, but very little interest is shown by the actuarial profession other than by a few individuals.

I have rather strong feelings on the subject of adjusted earnings; they are summarized on pages D244 and D574–75 of Volume XVIII of the *Transactions*. My views seem to be at odds with the vast majority of the investment profession but in harmony with several members of the actuarial profession who have investigated the subject of adjusted earnings.

To my way of thinking, the increase in the present value of future profits on insurance in force represents an increase in the adjusted book value of the company and should not be considered a part of a company's annual earnings. The company's annual earnings should not anticipate future profits but should represent the actual earnings of a single calendar year.

I believe that adjusted earnings for any given calendar year should represent the operating earnings on the renewal business *less* the cost o replacing any renewal business which terminated during that calendar year. This is equivalent to adding back to statutory operating earnings only the surplus depletion incurred by the increase in the company's in-force account.

Although this method gives no immediate credit for potential future earnings from the increase in the in-force account registered for a particular calendar year, in the succeeding calendar year the increased in-force account serves as a new and larger base of the renewal statutory operating earnings.

MR. MELVIN L. GOLD: I would like to discuss for a moment the communications problem that exists between actuaries and management and possibly to a greater degree between consulting actuaries and management.

Far too often our task is merely to prepare the annual statement and a new plan; often we do not really tell management how well they are doing and where they are going. We are often not asked. I think, however, that this is a responsibility, particularly with smaller companies that may be heading for disaster and do not know it or will not tell themselves the truth.

I think that as actuaries, and particularly as consulting actuaries, we have the responsibility of relating what is happening, in writing, to the president or—perhaps even better—to the board of directors. I have seen too many instances where the members of the board, at the moment of disaster, said, "The president has been giving us such wonderful talks and prognoses. We didn't realize how bad things were."

This is another case where ignorance is no excuse. I certainly think that the board should ask for reports from the consulting actuaries and that in many cases these consultants should report to the board, not just to the president.

MR. MILTON F. CHAUNER: I would like to second those comments. Communication is the key. The effectiveness of the actuary's work from the standpoint of the new company is determined by how well the actuary is understood by the top company officials that he contacts—usually including the president. The chief executive's knowledge of actuarial work and his attitude toward it largely determine the ease or difficulty of communication.

The president who knows the importance of the actuary's work, and is inclined to listen, is fine. Most actuaries not involved in consulting, I think, assume that this is the type of person with whom we usually deal. However, many new-company top executives merely suspect that the actuary's work may be useful. One president may want to determine that usefulness by himself; another needs to have someone other than the actuary tell him.

Some organizers of new companies are quite informed about the actuary's work—or misinformed about it but at least curious to find out what the actuary does. The really tough case is the executive who has decided that the actuary's work is not needed because it is unimportant; furthermore, he may be impatient or mildly belligerent about even hearing about it. This poses quite a communications problem.

It is up to the consulting actuary to effect good communications. Different combinations of the characteristics cited call for different types of presentation by the actuary. While he must use accurate terminology, it must be geared to the attitude of the chief executive. He must employ the proper degree of simplicity, describing results and reasons in a way that can be digested by the particular individual with whom he is talking.

It is very easy to have in our own minds clear and sensible answers to the actuarial aspects of a new-company operation; most of us have worked quite a bit with them and we think that we know the answers. In a way, though, we are often very inept at getting our story over.

Perhaps this is merely saying that we must realize that communication is a two-way street and that we are as much responsible for one side of that street as the person to whom we want to communicate. When an intricate or obscure problem arises, I feel that the actuary speaks up well. We will rise to the occasion when additional information is desired, and we communicate well when the discussion broadens our own knowledge of some part of the insurance field; but I feel that often we are not too articulate when the opportunity arises to interpret or explain the results of our work in nontechnical language. Better use might be made of what might be thought of as conversational chitchat as an avenue for communication when the consultant deals with the new company.

MR. JOHN J. BYRNE: It seems to me that Mel's comment is well taken; communications problems of the consulting actuary are different from the communications problem of the senior actuary in a young company. I think that the most important line of communication is directly to the board of directors and not to the management. This is where the consultant can operate more easily and more forcefully.

A typical board of directors has one or two people who understand life insurance economics and two or three more, maybe, from the investment-banking community who understand a little of what you are talking about—they have heard this story before. Then you have perhaps five or ten blue-chip people who really do not have much of an idea of what you are talking about. Nevertheless, you have a real responsibility to tell them regularly just how they stand.

Some companies try to do it monthly; I think that is too often. I do think, however, that we should have a position on a statutory basis before the board of directors at least quarterly. Some states are beginning to require this for young companies, which is an excellent idea. Without a requirement, it probably will not be done in many instances. It is not inexpensive.

At least once a year there must be some hard-core, business-like, nontechnical interpretation of how we did, and adjusted earnings is a difficult concept. It has to be simple. To make it simple, you may have to trade off precision, but simplicity is important. Put the emphasis on adjusted book value rather than adjusted earnings. It is much easier to get a reasonable, precise, simple handle on adjusted net worth than it is on the annual-earnings aspect.

If the young life insurance company owns subsidiaries or has a common stock portfolio, I think that you should introduce to them the MSVR requirements with respect to the subsidiaries. If this is not done, two or three years later there will be some surprises about where capital gains have been going and the doubling-up in the maintenance of security reserves in the early years.

MR. LAWRENCE MITCHELL: I have a question which will take not too long to expound. Generally most of us, in developing premium rates for our clients or companies, use a set of assumptions on expenses, mortality, lapse rates, and such things. Also generally, I think, it is recognized that earnings of a company are not easily divided into some rather limited period of time—a year or six months or three months. I am just curious about whether anybody has taken the approach—in lieu of using adjusted earnings—of comparing, over a period of time, the company's actual expenses, actual lapses, and actual mortality with what we in our little broom closets have all assumed in developing the premium rates?

MR. TOWNSEND: I have had an opportunity to see reports of the type that you have asked about in small companies. Incidentally, we found better reports of that sort among the smaller and medium-sized companies; there was a lack of such reports among the larger companies in the industry. The larger companies maintain that it is too difficult to prepare such reports.

MR. CHANDLER L. McKELVEY: The technique that I am going to describe is probably quite inappropriate for a company that has serious statutory problems in the sense of running out of surplus and that sort of thing, but I believe that it is very useful. At least we anticipate that it will be useful for breaking away from the accounting strait jacket, with your own management, of attempting to use accounting-type figures as the basis for analysis.

Any time that you try to use one set of figures for several purposes, the value gets blunted. One difficulty that we have had is the fact that accountants have a difficult time with life insurance in general. The statutory basis on which we have to keep our books gives figures that are difficult to adjust for analytical purposes.

What we are going to do next year is use a gross premium valuation instead of the statutory valuation required by the states to keep our basic company records and our profit and loss. Incidentally, we have twenty-seven branch offices that are primarily fire and casualty processing centers, marketing centers, but we do hold each of them responsible for profit. So all our company reports, which include rates broken down by these twenty-seven branches, will reflect only the profit and loss results using the gross premium valuation.

The adjustment that is needed to produce the statutory reserves, the statutory profit, is shown for what it really is—a mandatory adjustment figure for reporting purposes to change the accounting basis from a going-concern type to what you might call a drop-dead basis.

I think this decision will change the whole psychology of our accounting as far as the value of the business is concerned. We believe that this is going to create a different attitude and give not only some valuable psychological benefits but some analytical tools.

This is very similar to an increase in equity in the unlimited premium reserve in fire and casualty. One of the things that we have looked for is to quantify the results of the producing units, such as agencies. You can tell right from your accounting records whether a particular agency is doing well or not. Also it gives a much truer picture of what lapses really cost.

Gross premium valuation can be quite complex or it can be quite simple. You can get very involved in this kind of thing or keep it fairly simple. We intend to keep it simple. We intend to sweep some of the crudities under the rug but come up with something that will be more meaningful and at least a little closer to what is really happening.

MR. JOHN E. HEARST: Although the officers of some companies have ignored their asset-share projections as being inapplicable to their operations, others have applied this technique creatively to analyze their experiences and to chart their futures. One company, largely because the background of its officers' management is in law and accounting, has made extensive use of projections as a management tool. In its first year of operation the experience was compared month by month, and at times day by day, to the asset-share projection used to test the premiums. The comparison extended to the mortality, lapsation, and the budget for acquisition of new business and administrator expenses.

Although modifications have since been made to the initial projection and other projections have been used, their purpose is still to provide an estimate of what can be spent to acquire new business and what is needed to administer existing business.

The projections and the studies used in determining the assumptions have been made by the company's actuary. The monthly reports of earnings and the comparison of the actual to expected experiences have been made by the company's accountants. The analysis of the experience has been made by the senior management of the company.

New projections are made whenever new policies are developed or whenever experience differs materially from the assumptions. At the end of the first year's operation, for example, the actual mortality differed appreciably from that in the projections, so new projections were made. Mortality and lapse studies are made annually.

A separate projection is now used to estimate reserve increases and expected deaths because the modifications of the asset-share studies had become too complex. This projection is made from the valuation report where the in-force is projected on the basis of the company's expected lapsation and mortality to the end of the next calendar year. The projected business is then valued on the basis of average reserve factors.

By making extensive use of projections, this company has a reasonable estimate of its earnings from month to month. It also can act quickly on the basis of its experience to correct weaknesses in its operations.

MR. JAMES W. KEMBLE: I would like to address myself a minute to this subject of communications and to say that I have a strong feeling, having listened to many of our discussions in the past years, that as a profession we need to begin to assert ourselves considerably more than we have in the past. I think that you see even in the largest companies a trend toward developing what it is that can be sold. There is so much blue sky in some of the dividend illustrations that I have seen in the past few years that it appears to me that we have given up a good deal of what we have had in the past in the way of authority and in the way of leadership in the industry; it is time that we begin to recapture some of that.

MR. E. FORREST ESTES: I was with Bankers Life of Nebraska until 1963, when I retired. I have not found it easy to remain retired, so at present I am life actuary of the Arkansas Insurance Department.

There are three thoughts that I would like to leave with you. The first concerns communication of ideas. As one man put it, when figures are presented to a group, they will understand one figure, it takes mental effort for them to absorb two figures, and three figures confuse them.

The second point has to do with new companies—particularly in their first three years. A new company soon learns that its premiums have to be competitive, that is, it will have a limited income and the job has to be done within the income available, which means that management has the job of managing. Like the grocer—he prices sugar within the area of competition or he does not sell sugar.

The third point has to do with professional integrity. I am thinking of a company that started in Lincoln, Nebraska, some years ago. I was asked to help them out on an advisory basis. The time came when, due to favorable economic conditions and an energetic agency department, the company found itself writing more new business than it could afford. I warned the president of the company of the seriousness of his situation and gave him my recommendations, but it was evident that my advice would be ignored; so, I discontinued professional relationships with his company, making it clear that I took this action because I preferred to maintain my own professional reputation. The story has a pleasant ending. About a year later I learned that he had reconsidered and that his company had turned toward a more healthy growth. I have always felt that what I did caused a turning point in his company.