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GROUP PORTFOLIO MANAGEMENT AND PROFITABILITY

Moderator: ROBERT L. LINDSAY. Panelists: TED L. DUNN, EDWIN A. RODE.

1. Information needed to manage a portfolio.

2. How results are reported to top management and the Board of Directors - the frequency of reports, their contents and reliability.

3. Level of profitability considered acceptable for each product line or coverage.

4. Expense controls utilized as part of the line's profit plan.

5. The extent to which results are reflected in the compensation of Group Insurance officers.

MR. TED L. DUNN: Provident's group insurance premium income will be approximately $600 million this year. Since this represents about three-fourths of the Company's total premium income, top management is extremely interested in the results for this line of business.

Of our approximately 2,800 group insurance policyholders, 2,100 are non-retention groups and 700 are retention groups on which we prepare formal experience-rating statements. The 700 retention groups produce about 90% of our total group premium income.

In recent years, our profit objective at the Provident has been to earn at least 2% of group insurance premium income. This figure includes net investment income after federal income taxes. What has actually happened is that we have earned about 6% on our group term life line of business and about 1% on our A&H business which in the aggregate, for our mix of premium, has produced earnings of approximately 2% of total group premium income.

In managing a portfolio of group insurance cases for profit, it is necessary to develop the proper financial figures for the following distinct categories of business:

1. The first category is one on which losses on some groups may be offset by gains on other groups.

2. The second category includes those groups on which a financial settlement is made with the group insurance policyholder based on the experience with respect to that group policyholder alone. For this category losses on one group may not be offset by gains on other groups.

Examples of group insurance fitting the first category include:

1. Small group cases which are not subject to financial accounting with the policyholder; i.e., groups of, say, 25 to 100 employees.

2. Completely pooled group life and AD&D plans.

3. Excess group life pools on both small and large groups.

4. Long term disability coverage which is either completely pooled or partially pooled.

5. Excess major medical pools.

6. Other coverages on which no financial accounting is rendered to a group policyholder.

In running a profitable group insurance operation, one should strive to make each separate segment of this first category produce sufficient premium income to meet claim and expense charges and leave an underwriting gain which, together with net investment income after federal income taxes, will be sufficient to produce the desired profit objective.

For the second category of business, a financial reporting arrangement is needed which adequately monitors the experience on each individual group. In order to properly monitor these cases, Provident has developed a computer system which produces the profit or loss on a monthly basis for each retention case. This system develops the following information each month for each group:

1. The actual earned premium for each premium reporting unit. This is based on the premiums processed during the month and the premiums in course of collection at the beginning and end of the month. Premiums in course of collection are determined on the basis of normal premiums due excluding the effect of any premium adjustments shown on the last premium statement.

2. The paid claims recorded for the month.

3. The change in claim reserve for the month based on the last 12 months experience.

4. The estimated amount of expense recovered during the month. This is based on the earned premium and estimated retention percentage for the group. For example, a 10% retention on a $100,000 monthly premium would provide for an expense charge of $10,000 for the month.

5. The change for the month in the liability item known as the reserve for retroactive rate credits. Separate figures are accumulated for the group life and group A&H retroactive rate credit reserves, taking into account the fact that favorable experience on one coverage is used to offset unfavorable experience on the other coverage.

Thus, each month, for each retroactive rate credit reserve group, the earned premiums for that month less the estimated percentage of expenses which will be charged to the group are credited to the retroactive rate credit reserve for the group. Similarly, the claims paid that month and the change in the claim reserve liability at the end of the month are charged against the "retro reserve" for the group.

Since the group insurance business operates on a very thin profit margin, the experience of each large group policyholder may be of great significance since the loss of several hundred thousand dollars can easily develop on a large policyholder. The advantage of having each large group case under retroactive rate credit reserve control is that the bad actors are immediately known since a listing of the retroactive rate credit reserve balances and any unsecured deficits on such groups is made at the end of each calendar month. In addition, by reviewing this information at the end of each month, one can ascertain the groups whose credit balances are being depleted to the extent that it is likely that the group may be in a deficit position within a few months.

Another important group insurance management tool is the profit and loss statement. This is prepared monthly on an incurred basis. The advantage of having a monthly statement is that one knows at all times the level of operating results and if, for example, the experience is adverse, you will hopefully be able to institute proper remedial action at an earlier date.

Accompanying the monthly profit and loss statements at the Provident is an analysis prepared by the Group Actuarial staff which explains the operating results for the month and the calendar year to date. In this analysis, comments are generally made with respect to the status of each group case which has for that month contributed a profit or loss of a significant amount, such as $25,000. This enables management to pinpoint problem areas to particular group insurance cases and serves as a check to see that action is instituted to correct any adverse trend. In addition, the monthly analysis is useful in projecting the calendar year results some months in advance of the actual end of the calendar year.

Management must also direct its attention to the Group Department's expenses incurred. Even if all the accounts are in the black as far as experience is concerned, the only source of underwriting profit - excluding net investment income to the Company and gains on pooled coverages - is the margin by which the Company's quoted retention exceeds its actual expenses incurred.

In order to control expenses, Provident maintains a very detailed budget system. The principal divisions of the Group Department and sub-divisions of each of these divisions have their own budget report. In addition, each sub-division has a detailed budget report by type of expense. Finally, we also have a manpower budget which relates the growth in personnel to projected personnel needs. The desired objective of this budget is to have improving productivity from existing personnel.

At the Provident, there is a management performance incentive plan which has the purpose of motivating key management executives to produce a satisfactory growth in the rate of earnings per share of common stock. Participants in the plan receive deferred compensation based on the number and value of "management units" they receive. These are awarded annually by the Executive Committee of the Board of Directors based on an evaluation of the participant's work performance during the preceding year.

MR. ERWIN A. RODE: Prudential's Group Insurance Department is responsible for approximately $1.75 billion of annual premium income, which is about one-third of the Company's total premium income. This amount includes some $75 million of credit life and health premium, but excludes roughly $250 million of premium income from small group cases.

Our $1.75 billion of premium income is distributed over approximately 7,000 cases which include nearly every type of group, benefit plan, and administrative arrangement that is found in our business. However, there is no separate assignment of sales, administrative, or financial responsibility by major line of business. On the other hand, there is a definite allocation of responsibility on a regional basis.

All case work-sales, underwriting, administration, and claims - is handled in our eight U.S. Regional Home Offices and in the Canadian Head Office. Thus, the Regional Home Office has the responsibility for determining the basis on which a risk is accepted and for setting premium rates for both first and renewal policy years. The senior officer in charge of each of these offices is responsible to the Executive Office of the Company for the group insurance functions performed in his office, just as he is for the non-group lines of business. Reporting to the senior officer in each Regional Home Office is a single individual who is responsible for all group insurance operations in that office.

The Corporate Group Insurance Department is responsible for underwriting policy and rules, manual rates, rerating procedures, and the dividend formula, as well as for policy, general procedures, and systems in the areas of sales, administration, and claims. Thus there is some sharing of responsibility for group insurance operations between the senior officers in charge of the Regional Home Offices and the senior officer in charge of the Group Insurance Department. However, the primary responsibility for producing satisfactory financial results rests with the senior officer in charge of the Group Insurance Department since it is within his Department that all factors affecting financial results are brought together and dealt with on an overall Company basis. An additional responsibility of the Group Insurance Department is to monitor and evaluate each Regional Home Office's performance of its group insurance responsibilities.

Our present goal is to produce earnings averaging 1% of premium. However, since this goal is small in size when compared to the major transactions involved, the large outstanding items that have to be estimated, and the lead time needed for changes in premium rates to become fully effective, year by year results may vary on either side of this goal by as much as the amount of the goal itself.

Group insurance earning results split by the four annual statement branches are produced for top management each February in conjunction with the preparation of the annual statement. Also, each November a formal, detailed estimate of the calendar year's financial results is prepared. This estimate is used when presenting recommendations to the Board of Directors for dividends to be credited on policy anniversaries in the next calendar year. In addition, from time to time during the year, informal appraisals of expected earnings results, related to objectives, are given to the Executive Office.

Because aggregate financial results are formally reported to top management on a yearly basis, and dividend action is taken only once each year, there was a tendency in the past for us to follow a similar annual schedule for premium rate changes. This is no longer the situation. Although there still remains some emphasis on all types of financial decisions in November, when the dividend recommendations are made, monitoring earnings and making any indicated changes in the more financially significant areas of premium rates and underwriting practices is now a year-round operation.

To provide a better perspective on the trend in the aforementioned overall calendar year results and to aid in estimating them for a yet uncompleted year we determine modifications to the published figures by replacing the necessarily large estimated assets and liabilities with the corresponding actual figures that emerge after the results for the year are finalized - for example, the estimated due and unpaid premiums, claim liabilities, and accrued portion of dividends to be credited in the following year. We do not make use of overall financial results or loss ratios for shorter periods, such as a calendar quarter, to predict results because of the difficulties in producing timely numbers sufficiently free from distortion. These distortions arise from changes in claim payment lags and the problems of determining the actual earned premiums when payments are either delayed or irregular or affected by retrospective premium arrangements.

While these actual or estimated calendar year results tell top management aggregate results compared to our goals, their usefulness in the actual financial management of our business is limited. For this purpose we rely more on policy year information, which is obtained as a by-product of the dividend calculation process.

Of course, earnings figures produced from completed policy years have the disadvantage of being less up-to-date than calendar year results. Also, since they are based on dividend formula expense charges and interest credits, they reflect true earnings only to the extent that, in the aggregate, expense charges are in balance with actual expenses and interest credits are in balance with actual interest earnings. Offsetting these disadvantages is the facility they give us to readily isolate financial results for any desired segment of our business and to more quickly determine the reasons for and remedies for unsatisfactory results.

One important additional use we make of policy year's earnings is in evaluating the earnings performance of each of our Regional Home Offices. The substantial underwriting responsibility residing in these offices, mentioned earlier, makes this evaluation process a particularly important element in maintaining satisfactory earnings.

Each fall, for each office, we determine the policy year earnings for all cases with policy anniversaries in the twelve months ending July 1. These earnings are related to the required level of earnings, which we call "par". In other words, if every Regional Home Office achieves par, our overall Company earnings objectives will be met. The ratio of a Regional Home Office's earnings to par is reported to top management - along with other measures reflecting sales, conservation, expense, and service - in order to produce an overall evaluation of the office's group insurance performance.

In order to manage a successful operation, it is also important to determine certain results at times other than when policy year information routinely becomes available. Therefore, at key times during the year we require tentative calculations on all outstanding cases whose policy anniversaries are two or more months past due. Also, estimates of policy year results are required quarterly for uncompleted policy years on larger cases.

As mentioned earlier, because policy year earnings reflect dividend formula expense charges rather than actual expenses, it is important to have a measure of Regional Home Office group insurance expense performance. This is especially true since the Regional Home Offices generate the bulk of our expenses. As part of the Company Expense Management Information System, an expense index on a rolling twelve months basis is produced each quarter for each Regional Home Office. This index is the ratio of the office's actual expenses to the portion of our dividend formula expense charges that is designed to recapture these expenses. An index of 100 means that expenses are exactly balanced by dividend formula expense charges.

Each year the Regional Home Offices project their future expenses, formula charge credits, and resulting indexes as part of their objective setting. These results are used by the Group Insurance Department in deciding on the required levels of dividend formula expense charges for the ensuing year.

Finally, it is important to distinguish the management of new or growing coverages from older, more established coverages. For the former, stricter control over case underwriting and more timely or detailed financial information may be appropriate. For example, when poor experience on LTD began to emerge about ten years ago, we arranged for additional monitoring of that coverage by producing manual and payable premium loss ratios on a calendar quarter basis by sub-classes and individual cases.

More recently, we have begun gathering supplementary data on our rapidly growing dental coverage. This supplementary information includes experience variations by type of group and type of plan, and the trend in claim costs over the first few policy years.

MR. ROBERT L. LINDSAY: When compared with the group insurance lines of the Provident Life and Accident and the Prudential, M@NY's operation is both relatively small and new. This year's premium income will be a shade over $100 million, while the income from all of M@NY's lines combined will be about $800 million. We entered the group insurance business in 1953.

Our group insurance line has two major goals. The first and most important goal is to achieve an operating gain after dividends. The operating gain equals the Annual Statement gain adjusted by certain items that should not be reflected in the underwriting result of the accounting period. For example, one adjustment is to remove net investment income on surplus at the end of the previous year. We have achieved gains in three out of the last four years, for an overall net gain of $9 million after dividends, or about $2\frac{1}{2}\%$ of premiums. At present we are satisfied to break even each year. This means that we aim for about $1 million gain (about 1% of premiums) each year in order to have a reasonable chance of achieving our goal.

The second goal is to grow as fast as companies which started in the business about the same time M@NY did. The growth goal is a long term one which recognizes the fact that insufficient growth can lead to the problem of not

having sufficient resources to take advantage of future opportunities. Looking back over the thirteen decades of M©NY's existence, we can readily see the ill effects of inadequate growth on operating results and on the Company's competitive position. The lesson to be learned is simple: grow in order to survive. We have not met our group insurance growth goal in recent years since we did not want to risk a loss in order to obtain a better sales result. We came closer to achieving this goal last year.

Many factors are involved in a company's premium growth. The most obvious ones are sales and terminations. In addition, growth of existing cases, especially in the professional association market, can dramatically increase premium income.

Introduction of new products or repricing of existing ones will also affect new business and retention in-force. The level of expertise of your group field force and their ability to romance field underwriters and brokers into doing business with them is often critical in obtaining new cases. Finally, claims and other services need to meet the needs of policyholders to remove reasons for shifting carriers.

Our portfolio includes three broad categories of business - association plans for 30%, experience-rated employer/employee group benefit plans for 50%, and pooled employer/employee group benefit plans for 20%. The association plans and experience-rated employer/employee categories have generally been profitable, while the pooled category has sustained losses.

We experience-rate cases with seventy-five or more employees. Since rate adequacy is the key to a profitable operation, especially for medical care coverages where rates can become inadequate very quickly, we track our experience very closely. Cash claim data is accumulated by case and each month a tabulation is made of the medical care results for all experience-rated cases. Cash claim ratios for each of the last thirteen months, and comparable ratios for policy year to date through those months, are also calculated for each experience-rated case. Using this data, our renewal underwriters complete a rate increase calculation for each case which has $50,000 or more of annual health insurance premium. We move in quickly on cases exhibiting poor trends, especially on those which have no stabilization reserves to absorb potential losses.

The experience of the various pools for non-experience-rated medical care coverage is examined every other month. If the loss ratio of a pool is higher than desired and the trend is unfavorable a rate increase is processed for the entire portfolio.

Across-the-board rate increases have been effected at least once each year. The frequency of these increases indicates that we have either underestimated the inflation/change in utilization factors or have not previously requested the rate increase needed to break even. In this era of steadily rising medical care costs, it is easy to become trapped by not implementing pooled rate increases at an early date. Also, if you decide to limit the maximum increase to, say, 35% or 40% in order to conserve business, you are never going to catch up to the appropriate rate level.

Compensation paid to our group field force consists of a base salary plus incentive compensation. A special renewal credit is included for rate increase sales. Whenever the group specialist sells a rate increase, his

office is credited with 15% of the total annualized renewal commission. If a case terminates during the twelve months following a rate increase, the special renewal commission credit is pro-rated. We believe that this additional incentive gives our group field man more courage to sell a rate increase. Ideally, we might introduce a compensation plan with rewards based upon margins generated by each type of new and renewal business in force.

One of management's most important responsibilities is to determine the strategies to be followed in achieving goals and objectives. I won't tell you what our strategies are, but I will relate a recent step we took to implement our strategy. On September 7, we introduced a new portfolio of package plans for groups of ten to seventy-four lives. Coincident with this we stopped offering group insurance plans for cases with fewer than ten employees.

We discontinued giving rate manuals for the ten to seventy-four life class of business to our group field force and also to our branch offices. On these cases, a computerized proposal service is available which provides 24-hour turnaround time, without charge to the field. Moreover, the field was not left completely in the dark on rates, since our Sales and Field Underwriting Manual contains three tables which show plan cost relationships. Thus the field man can approximate the cost of different plans from the one originally prepared.

All of these changes in our package plan program were made in order to improve both profitability and efficiency, with an emphasis on the latter. They should lead to more effective use of our group field force as well as of our Home Office staff. The field man's expertise is in selling and servicing policyholders - not in calculating rates for proposals. His efforts should be concentrated on what we're paying him for. In addition, by merchandising only package plans in the under seventy-five life market, Home Office proposal, underwriting, and installation personnel can devote more of their time to "true group" cases. We realize that we may lose an occasional case because we will not provide the exact benefits requested, but these situations should hopefully be few and far between.

We report results to the Chief Executive Officer and to the Trustees on a regular basis. Calendar year results are reported in February when the dividend scale is ratified and confirmed. A tentative estimate is made early in the year for the May meetings and a more detailed estimate is made in October, based upon nine month's actual results. Also, each month year-to-date results are provided top management.

The estimates are not as refined as I would like. I would be more comfortable if the Provident's system were in use at M@NY. We intend to develop our information system in this direction as resources become available.