

RECORD OF SOCIETY OF ACTUARIES 1976 VOL. 2 NO. 4

AGENCY PROFITABILITY MEASUREMENT

*Moderator: ROBERT D. SHAPIRO. Panelists: JOHN R. GARDNER,
ROBERT D. HOGUE, MICHAEL B. HUTCHISON, DAVID A. WEBSTER.*

Each company has its own measures for evaluating agency performance, such measures reflecting the strategies and objectives of the company's underlying marketing plans. The discussion will focus on how agency performance is measured in different types of agency organizations, concentrating on issues such as:

1. The differences in approach by type of company and agency organization,
2. The rationalization of the company and the agency perspectives in the performance measurement system,
3. The rationalization of short term and long term performance goals (e.g., balancing current year's sales and future sales potential created by developing new agency manpower),
4. The focus of the system (Is it designed to be a technically accurate accounting system or is it designed primarily to be used by agency management personnel?),
5. The way in which the renewal block of business is considered in evaluating agency profitability, and
6. The treatment of cost incurred in developing new production sources.

MR. ROBERT D. SHAPIRO: Each company has its own marketing objectives and strategies, and they in turn determine the way in which marketing performance is planned and measured.

Marketing performance measurement is merely part of an overall marketing planning and control system. Such a system involves clearly quantifying marketing goals, defining marketing strategies and tactics, measuring and evaluating marketing results and taking corrective action where indicated.

A life insurance company might be simplistically portrayed as being composed of four basic modules: a marketing module, an administration module, an investment module, and a risk-taking module. Theoretically, each of the functions represented by these modules could be subcontracted to an external corporation. For example, if we had a separate marketing corporation that received the commission and other sales overhead allowances in our pricing structure (no more and no less), our marketing risk would be minimal with the burden falling completely on the marketing organization to live within these allowances. Typically, however, the marketing organization is an integral part of our company and we must evaluate how the marketing organization is doing with respect to the allowances in our premium rates.

Measurement of marketing performance has proved an elusive quantity to define and measure due to time lags in identifying and controlling results. We also have a complex conceptual environment and need to work with a substantial degree of uncertainty and assumption volatility when evaluating such items as agency survival, agency productivity, financing plans, and the value of business to be written in future years. Probably the main reason for our difficulty is our failure to define exactly what we are trying to measure, who is going to use the information, and how they are going to use it. Since the marketing plan is the core of the corporate plan, we must develop a clear marketing performance management system that is meaningful to and fully involves both the actuaries and the marketers in our companies.

One general approach to establishing performance standards and measuring progress toward them is often called the Value-Added Approach. At the corporate level, value-added is the change in the company's adjusted book value plus the present value of future profits expected from business written by the company. This value figure consists of three components:

- (a) Realized value (i.e., capital, surplus, and similar funds).
- (b) Unrealized produced value (i.e., the present value of expected profits under existing business).
- (c) Unrealized unproduced values (i.e., the present value of expected profits under expected future business to be written). This is the value of future marketing capacity.

Generally, we segregate the third item from the first two items because it is of much greater uncertainty. We should attach a lower credibility to the third item, but it remains important to management. We should assign more credibility to what "has been done" compared to "what might be done"!

At the marketing operation level, the current year's realized value (i.e., statutory earnings) is considered along with changes in the unrealized values (both produced and unproduced). The unrealized unproduced value is difficult to evaluate and is normally considered as a distinct item from the other components of value in our management process.

The advantages for a technique that utilizes the value-added concept are many. First, the value of the company's claim on future earnings is recognized when the policy is issued. If a year-by-year profit projection forms the basis of the value calculation, proper reflection on both short term and long term results is possible. The impact of a variation in assumptions can be evaluated as a one-number change in the value of the business or as a related index number.

Comparisons of actual-to-expected production, marketing costs, profits, etc., are needed to supplement the performance valuation. Statutory and GAAP profit figures, while providing helpful insights, generally function primarily as indicators of general business performance and reflect the accounting assumptions implicit in their development.

An example might serve to illustrate the problem of answering the question, "What do we want to measure?" Suppose that we have an agent who sells a \$25,000 Four Year Term Life plan with a \$200 annual premium. The agent receives a \$150 commission and the agency incurs non-commission marketing costs of \$60. The company anticipates a \$100 first year statutory loss with \$50 statutory gains in years 2, 3 and 4. The GAAP profit averages 6% of premium (e.g., \$12 in year 1). The product rate structure includes an allowance for non-commission marketing costs of 50% of the first commission.

How do we measure the performance represented by the sale of this policy by one individual agent? Six possible ways in which we might measure performance are:

1. The Company loses \$100 -- this is the component of the Company's statutory statement which is represented by the sale of the single term policy.
2. The Company earns \$12 -- this is a component of the GAAP financial statement represented by the sale of the single term policy.
3. The Company earns \$15, the difference between the \$75 allowance for "other marketing costs" and \$60, the amount spent.
4. The Company loses \$10 -- this is the net result of the cash flow: \$200 premium, less \$150 commission, less \$60 other marketing costs.
5. The Company earns \$35 -- this represents the value of future expected profits under the Four Year Term plan that was sold discounted to time of issue taking into account assumed expenses, mortality, interest and persistency.
6. The Company earns \$50 -- the sum of the \$35 (in #5) and \$15 (in #3).

Which measure of profit is appropriate? Vastly different management results are created depending upon which one is chosen. From a stockholder's perspective, statutory produces the worst results, GAAP produces middle of the road results, and "value-added" produces the best results. We believe that "value-added" is the most appropriate measure from the standpoint of properly reflecting all of the underlying variables that make up Company management performance. The "value-added" approach is best described in #5 and #6 above.

MR. ROBERT D. HOGUE: At the Lutheran Mutual, we have been measuring agency profitability since 1972. Since the time of our early research into this field, we have encountered several ways of analyzing and measuring it. (The different methods which we have seen in use vary from very simple but useful handwritten comparisons of budget, ledger, and production items to some highly sophisticated systems which seem to be the result of a great deal of background research and development from actuarial, accounting, and/or marketing viewpoints.) Seemingly, each company develops its own way to measure, even to define, agency profitability.

The evolution of agency profitability measures is in a primitive stage. Because of the diversity in marketing systems in the industry, the diversity in concepts of agency profitability, and the diversity of professional viewpoints in developing these studies, the industry is far from agreeing on a single theoretically sound and practical standard approach, and it may never have one.

However, based upon what we have observed to date, I will offer four broad categories:

1. Performance Index Measurements

This approach consists of monitoring the performance of agents and/or agencies by comparing various ratios of agent and/or agency specific operational items with corresponding company averages. The rationale behind these studies assumes that relative profitability can be determined by establishing ratios of agency-specific experience factors to company averages. In other words: "If the company as a whole operates at a given level of profitability, and if its level of profitability is related to a given set of experience factors, then the relative profitability of sub-units of the company (field office units) can be determined by comparing such unit-specific experience factors to company averages."

2. Income and Disbursement Statements Method

A second type of profitability measurement is the generation, for each field unit and/or line of business, an income and disbursement statement. These statements are basically ledger statements of the cash flow through a field unit. The basic assumption behind this approach is that cash flow is the principal source of profitability and should be the central variable of a profitability study.

3. Profit and Loss Statements Method

An obvious extension of the Income and Disbursements Statement Method is that of allocating company annual statement Net Gains from Operations by field office unit. A refinement of this method is an adjustment of the statutory earnings to GAAP earnings. These studies are difficult to develop fully, but the acceptability of this definition of agency profitability poses no problems, and the results are acceptable to company management.

4. Agency In-Force and Manpower Valuation Method

With the publication of the Life Office Management Association (LOMA) Financial Planning and Control Council Report No. 19 entitled, "An Approach to Measuring Profitability of Field Office Operations of a Life Insurance Company", many companies have attempted to include year-to-year elements of increased agency manpower values in their agency profitability measurements. This is the value-added approach which Mr. Shapiro described in detail.

Once our survey had been made of these various approaches, a choice had to be made which would fit our managerial and operational characteristics. It seems that each company looks at the various approaches being used from a pragmatic point of view, based upon its particular marketing system, influenced by the type of professional who develops the study within the company. I have found that marketing people tend to favor the Performance Index Measurements Method, accountants tend to favor the Income and Disbursement Statements Method, and actuaries tend to favor either the Profit and Loss Statements Method or the Agency In-Force and Manpower Valuation Method. At the present time, company choices of approach and methodology are almost entirely practical in nature, and almost never theoretical. I have not seen the theory evolve to the point where these four basic methods can be compared on a theoretical basis. Our choice was primarily practical and only secondarily theoretical.

The Lutheran Mutual is basically a single line whole life mutual company operating through a career agent field operation. Our field force is composed of career agents operating under a salaried manager structure. Our sales growth planning is agent and agency oriented, concentrating first on planned manpower growth, then on budgeting, and lastly, on projected sales totals. We judged the Agency In-Force and Manpower Valuation Method to be best suited to our needs. We highly value the control and management of our agencies.

In developing our Agency Profitability Study, we closely followed the general approach described in LOMA Report No. 19. Our Agency Profitability Study relates all profitability to the activities of our agents (production profitability) and our managers (agent recruiting, agent retention, and production level increase experience).

Our basic profitability measurement formula is composed of four parts:

1. The Present Value of Future Profits on each agent's production during the year.
2. The changes in the expected Present Value of Future Profits during the year on the agent's production during previous years.
3. The Present Value of Future Profits on the expected future years' production of the new agents recruited by the managers during the year.
4. The changes in expected Present Value of Future Profits on the expected future years' production of the agents recruited by the managers during previous years.

Profitability, then consists of value added from production and recruiting plus changes in value of in-force and manpower.

I might add that we have not yet developed and integrated the second element into our study. This element will be the most difficult to develop and should be the least informative when available.

In the application of this formula we strove to develop as much supportive information as possible. Incidentally, a company which develops a theoretically sophisticated study with a central profitability index but without sufficient supporting detail will probably make fewer significant changes in their field operations than a company which produces and analyzes a mass of detailed information. We have learned more at our company from analyzing agency activity than we have from looking at bottom line results.

In the choice of the policy and agent related present value factor development, the treatment of expected and actual field unit expenses, the choices of assumed experience factors (especially the discount rate chosen and the assumed future production and survival levels of new recruits), and in the construction and application of the profitability measurement formulas, attempts were made to achieve these basic objectives:

- (a) Our study is designed to analyze in descending order of priority:
(1) the activities of our agency managers, (2) the annual production activities of our agents, and (3) the profitability of the policies themselves.
- (b) As far as practical, our agency profitability system forms a closed measurement system whereby all profitability would be discounted to the year in which the activity causing such profits occurred. Differences between actual experience and the expected experience basis of the present value factors used would be reflected as profits or losses on a year-to-year basis in a manner such that these changes would generate profitability changes as soon as such changes could be reasonably justified.
- (c) We wanted an extremely sensitive study whereby as many conclusions as possible could be formed as early as possible. We wanted a study which would allow field management to make intelligent decisions when the performance measures indicated future problems, rather than after the fact.
- (d) The study itself was to be designed to be understandable to, usable by, and someday taken over by the company's home office marketing management personnel. We built common sense into the report formats. We found out early that we would waste our efforts if we used too much actuarial jargon in explaining the results of the study. Our study concentrated on clearly displaying and explaining results in terms of five basic experience factors: average profitability per \$1000 issued, agent survival, recruiting levels, average productivity per agent, and policyholder persistency.

As a final step, we developed an Agency Model which could be used in conjunction with the Agency Profitability Study to project expected future differences between the results of the current behavioral patterns of each agency manager and the results of his adopting specific changes in one or more of these five basic experience factors.

Bob asked me to give a Lutheran Mutual case study presentation. First of all, let me list a few of the things that we have done with our results so far:

1. We revised our agency managers' income and expense allowance formulas to achieve better correlation between agency profitability and the managers' income and expense allowances. We do not include profitability measures, per se, in the managers' income formula.
2. We have counseled each agency manager to review the results of two model runs on his agency. The first projects results based upon past trends; the second projects results based upon improvements in one or two of the five principal experience factors mentioned.
3. Agency growth standards have been developed for the company as a whole. These standards address recruiting, retention, and production levels primarily and were based upon the size and growth characteristics of our profitable agencies. This step alone is going to repay the cost of our study in a very short time.

We have learned enough from our study to place the five primary experience factors in perspective. For our company, a priority ranking of the effects on agency profitability of these five experience factors, in descending order of impact, would be: (1) policyholder persistency, (2) agent survival, (3) average production per agent, (4) recruiting levels, and (5) average profitability per \$1000 issued.

MR. MICHAEL B. HUTCHISON: The process of assessing the performance of an agency in terms of its profitability (somehow measured), rather than strictly in terms of sales volume, as has traditionally been the practice, is a relatively new phenomenon in the life insurance industry. I suspect it is a reflection of the increasing involvement of actuaries, accountants, and assorted other misfits in the marketing side of the business.

Before commenting on my own and my company's views on this matter, I should probably identify my biases. I am employed by an aggressive, mature, but rapidly growing Canadian stock company, which sells most of the products and product lines offered by the life insurance industry, using most of the marketing methods available to the industry, which has active marketing operations in nine different countries. We use a pure brokerage general agency approach in the United States, a pure career agent system in the Caribbean, both systems independently in the United Kingdom, and a hybrid combination of the two in Canada, all supported by a separate group marketing organization. (We obviously have not decided on the right way to do it.) With this particular patchwork quilt as a backdrop, it is rather difficult to find simple answers to some of the questions.

As a company, we had been stumbling along for years without really knowing (or caring?) much about the profitability of an individual agency. As long as interest rates kept rising, the overall company profit was in fine shape, and nobody worried much about detailed profitability measures.

In recent years, however, several things have happened to change that. Inflation and the resulting pressures on cost put the squeeze on profits, and created a need to know more about the profitability of segments of our operations. The term "profit centre" became a hot new buzz word. Computers made it possible, at least theoretically, to subdivide profit

by "profit centre". Finally, actuarial-type minds began to be applied to the problem of agency profitability.

Thus, many of us set out in search of the "holy grail" to subdivide the profit down into as many little profit centres as possible (secure in the knowledge that the whole equals the sum of the parts). Many of us did so mainly because the answer was there, and it behooved us to find it.

That led us up against the question of how to define the "profitability" of an agency. We all recognized the limitations of our statutory statements. GAAP was an improvement, but it took LOMA's Report 19 to offer us an intriguingly logical answer - the three-tiered value added system.

In our company, we set out to push back the frontier. We even got to the point of developing some of the parts of the massive computer system needed to accomplish the miracle. It was not until we were that far along that we finally stopped and asked ourselves the key question. Why were we doing this? Why measure the profitability of an agency?

Several possible answers suggested themselves:

- (i) because we want to know
- (ii) because the agency managers want to know
- (iii) to better assess the performance of the agency manager
- (iv) to motivate the agency manager to perform better

The first two answers were obviously too frivolous to justify the necessary expense. Therefore, the right answer had to be either or both of the last two. We therefore examined the notion of agency profitability measures in the context of these last two objectives and, somewhat to our surprise, came to the following conclusions:

- (i) The profit of an individual agency is a poor measure of managerial performance, for a number of reasons:
 - A number of components of profit - notably mortality and interest - are really beyond the control of the manager. Unfortunately, these are also the more volatile elements of profits, especially with a sample as small as an agency. Thus, while it might be interesting to know that the Phoenix Downtown agency lost \$1,000,000, we could not really nag the general agent much if the cause was a couple of massive death claims on twenty-year old policies.
 - Several components of profit are not easily attributable to an agency and thus must be allocated artificially - such as investment income or Home Office overhead. The political problems involved in making such allocations on a basis acceptable to all parties are most difficult. (As long as a "profit centre" can blame the loss on flaws in the allocation formula, he will be reluctant to admit the unprofitability of his operation.)

The (b) and (c) components of Report 19 profits depend on assumptions some actuary makes as to future profits, making them difficult to sell to managers or general agents, especially when the news they convey is bad. Valuing an agent is particularly difficult when your agents are not homogeneous. With our particular heterogeneous array of career agents, brokers, general insurance agencies, employee benefit consultants, etc. the task is virtually impossible.

- (ii) Admittedly, many of the problems above can be minimized by neutralizing the "agency profit measure" against the effect of elements beyond the manager's control. However, we concluded that even so, the single agency profit figure was not a very motivating factor in improving managerial performance.

In that respect, it is somewhat like the interest adjusted net cost index; it might tell you that one agency was more profitable than another, but it would not really tell you or the manager why, unless you unbundled the various components. Moreover, the profitability of one agency might differ from that of another for reasons quite beyond managerial control (just as the cost index for an industrial company's products might well differ from that of a company specializing in estate planning for executives).

As a result of this thinking, we stepped back from the theory a bit, and asked ourselves what we were trying to accomplish, and how best to do it. We concluded that our real objective was to motivate the managers to perform better, and to do that, we had to provide them with better information on the extent to which they were achieving corporate objectives within their control, in a form that was meaningful and credible to them.

In this respect, we differentiated between objectives and constraints. Objectives are things which managers or general agents can logically be motivated to achieve; in this regard, the perspective of the company and the manager are identical. We defined two such broad objectives:

- (i) the writing and conservation of quality business
- (ii) the recruiting and development and retention of quality agents or brokers

The extent of attainment of these objectives can be easily measured by traditional yardsticks, and the motivation of managers to attain these goals can be easily accomplished by traditional methods - financial rewards, and the combination of ego recognition for good performance, and "wrist slapping" about bad. Since our field leaders had long been attaining remarkable results in this area, we anticipated no real problem.

Constraints, on the other hand, are unpleasant things imposed by the company that tend to get in the way of attainment of objectives, but are a necessary condition to the achievement of profitability. In this area, we defined two constraints:

- (i) the need to operate within cost standards defined by premium loadings, and
- (ii) the need to operate within surplus strain limits defined by the company's overall financial position. (Limits the amount of renewal profits we can reinvest in new business or manpower.)

These constraints were something about which we really had not asked our managers to bother their heads. In the past, we had kept things under control, simply by saying no more frequently than we said yes.

However, with the growing interest of our managers in their own "profitability" to the company, in assessing their total performance, we decided that we could best live within these constraints by enlisting the support and assistance of our field managers (rather than the traditional approach of fighting them), albeit with a little nervousness about how willingly they would accept these constraints.

To achieve this co-operative approach required that substantially better information about their costs be provided to managers than we were then able to provide, and that they become part of an integrated corporate objective-setting process. Both of these required substantial mobilization of systems and computer resources. We therefore put Report 19 back on the shelf, and gave priority to development of such a budgeting and cost feedback system.

We have not completed the task, but our early results are most encouraging.

We have certainly had some problems - some traditionalists do have difficulty changing gears - but generally the field attitude and response has been excellent. Many of them, operating in the real world as they do, have much more realistic and businesslike attitudes toward cost and profit, than do many of us Home Office "bureaucrats". Generally, they are delighted to have information as to whether they are cost-effective, and fully understand the need to keep costs within premium loadings (the alternative being less competitive premium rates).

The surplus strain limit constraints on expansion are more difficult to sell, but generally the agents are buying, with some excellent results. Many are spending less time adding new manpower, and more time developing existing manpower and improving persistency, with positive effects.

In summary then, we have tabled consideration of sophisticated agency profitability measures in favour of what we consider the more urgent need to develop complete information systems on the separate elements of profitability within field control. We may not know as much about the profitability of our agencies, but we hope we will achieve greater profitability whether we can measure it or not.

MR. JOHN R. GARDNER: Sun Life is a mutual company distributing life insurance and equity products exclusively through its career agents. These agents are located in fifty sales offices operated under a branch managerial rather than general agency system. The sales manager is paid principally on production, secondarily on performance with respect to cost and persistency. Rules governing conference qualification and trophy competition are aimed at reinforcing the concept of production with profit.

The company has had in effect for many years both a production planning and expense budgeting cycle. While at the corporate level the linkage between the two has been obvious, coordination at the branch level has not been tight. In particular, the sales manager was not assisted to any extent in relating the two.

Three years ago the company adopted as its marketing strategy for the United States career agency development at a pace quicker than both it and the industry until then had been experiencing. As a consequence of this strategy, the company is committed to investing heavily in future growth.

I will comment on three objectives that our performance measurement system supports:

First, Sun Life recognized the need for a tighter relationship between its planning for production and manpower, and its budgeting for expense. An improved yield on annual distribution expense was especially desirable during a growth period. Growth was to be achieved, but as economically as possible.

Second, within the branch office system, field sales management should be encouraged to function as businessmen. Only with current information that presents and interrelates both results and costs can the sales manager be expected to operate as an entrepreneur.

Third, improved decision-making in the allocation of distribution resources by home office marketing personnel requires comparative agency performance measurement. Because it is company money, the home office ultimately approves the shape and operation of a branch. We wanted decision-making aimed at optimizing the yield on staff, space and management resources.

We did not have as an objective an absolute profit target. The question asked should be, "how can one become more profitable?" not, "how much profit is there?"

We made three assumptions.

First, Progress is better than perfection, to borrow a phrase from one of my associates. Rather than an absolute measure of profitability, the company is looking for comparative yardsticks that will assist in raising the cost effectiveness and yield on each branch operation.

Second, the sales manager is a Competitive Animal. Apart from directing his actions to maximize earnings under his contract he will, if given the opportunity, strive to run his office so as to gain recognition for its efficiency and its contribution to corporate goals. Peer recognition through trophy standings, enhancement of his opportunity to contribute to corporate decision-making, and greater leverage in his efforts to secure favorable attention for the members of his branch all combine to motivate the manager.

Third, the value of any measurement system lies in its ability to Influence Action. An abstract measure that does not relate easily to the branch or line agency management task will not influence results. If a contribution to improved profit performance is desired from the field manager, he must be given information and tools that are expressed in terms familiar to him.

We function under a four-part performance measurement system. Profitability measurement is the final step of our analysis. To understand how the profitability component functions, one must have background built up in the first three stages.

- (i) PRODUCTION PERFORMANCE is planned for and monitored by product line.
- (ii) MANPOWER analysis makes up the second stage. Not only is the manpower count and retention measured, but also productivity per agent and performance of new agents.
- (iii) FISCAL RESPONSIBILITY is surveyed by relating current expenditure in the branch to its historical pattern and current budget.
- (iv) BRANCH PROFITABILITY ties the three together and is the topic of the remainder of these remarks.

This final component of the system looks both at the overall branch picture through an agency performance index relating total production to total expense, and at the utilization by the branch of company resources such as staff, space, communications support, management resources and financing of new agents. This second aspect of performance measurement is expressed in terms of resource ratios.

The agency performance index assists us to determine the overall yield on distribution resources in that agency. It is the ratio of total annualized new commission flowing through the branch to total expense embodied in the branch budgets. This index is embarrassingly simple but has proven extremely useful to field management and home office.

Considerable debate arose as to whether the ratio should be production to expense, or inverted as expense to production. It suited Sun Life's situation to look at optimizing production per unit expense. Field managers should be thinking of how much production they can generate for every dollar spent. Such an approach is more conducive to growth and appeals to the sales mentality.

The concept of the agency performance index caught on quickly, more rapidly than one would have expected. Managers talk of their ratios, which are found in divisional bulletins. Managers recognize that as they make decisions, the cost and production components must be weighed, one against the other, through the ratio.

Comparison of one agency with another is difficult and, on a total performance basis, is not at this time important to Sun Life's approach. The agency performance index so far described does not allow for the impact on a branch operation of different degrees of new organization building. A branch could show an attractive index, which might be more the result of no building than of solid performance.

The company has used for years in its manager's contract a Building Ratio to normalize production to expense to eliminate the impact of varying degrees of development of new organization.

The agency manager is in the short term locked into his branch operating pattern to a high degree. Part of this pattern may have been inherited and part may be of his own devising. Variations commonly found are selective hiring combined with the use of luxurious physical facilities in an established agency; heavy hiring (hopefully accompanied by prompt postselection), direct mail and inexpensive space; and high agent productivity sponsored in part by extensive staff support. The agency performance index, measuring overall results, informs the manager as to his progress and his relative profitability; it does not tell him much about how he might change the mix of distribution resources employed and what might be achieved by such a shift.

In Sun Life's system, resources have been grouped into five major categories:

Staff: salaried office personnel and secretarial allowances

Space: rent, office alterations, equipment purchases and office allowance

Communications: postage, telephone, telex, printing and supplies

Management: both branch manager and middle manager compensation

Financing: net developmental subsidy to new agents

Each of these categories is examined through a resource ratio, which expresses branch production relative to the total cost of each resource. In addition, resource utilization is compared through other indicators:

Staff: number of agents per staff member and per dollar of staff salary

Space: area per branch member

Communications: communication costs per agent

Management: number of agents per middle manager

Financing: subsidy per agent under financing, and production from new agents relative to financing costs

The pattern of these ratios over time is informative in that the manager can detect changes occurring in his operation. They also enable him to contrast his shop with the structure of those of other managers. In this way, he can develop a feel for the directions in which he might manoeuvre in his search for greater profitability, while minimizing possible disruption to his operation.

What about renewal business?

While short term persistency does enter into both the manager's compensation formula and his trophy standings, renewal business has not to date been built into the company's agency performance evaluation system.

Renewal premium income flowing from current production will most likely be built into the system by shifting from new business as the indicator of production, to expected new and renewal premium income as the measure of branch output. This should be an improvement to the system and it is hoped that it will be understood and appreciated by the manager.

These measures, built into the company's annual planning and budgeting cycle, are proving to be critical in the decision-making process. Budgets are established annually in advance on the strength of production and manpower plans submitted by agency; authority to spend the budget hinges upon steady progress during the year toward realization of planned objectives. The measures described play a key role in creating the budgets and in making subsequent adjustments during the cycle.

With six months results in hand, a new projection on production for the year is taken, and through the agency performance index, a revised budget established. At this stage additional budget will be allocated to some branches, while the budget of others is reduced. Aggregate results will determine whether the director is recovering money to put into a reserve for the benefit of the company should production appear to be falling short of plan, or whether he goes to the company seeking more money to pay for new business in excess of that originally expected.

Two major contributions to the management process created by these measures have been the tying together of an extraordinary volume of statistical information, previously available but infrequently utilized, and the providing of a performance standard against which decisions can be made. As a performance standard it has made decisions not only better in quality, but also more acceptable, in that no longer is the home office appearing arbitrary in its intervention in a manager's branch. Business logic now provides third party support.

MR. DAVID A. WEBSTER: At USLIFE we have three basic thrusts to help us measure agency profitability. The first is a simple qualitative assessment of all new appointments through the underwriting department. In some of our subsidiaries this takes the form of assigning one underwriter to underwrite all of the business of new appointments. He will form

certain quality judgements based upon his experience in dealing with various types of producers over a period of years. Every two weeks he will review his impression of the new appointments with the agency officer and the president of the company. Depending upon the caliber of the underwriter, this can be a very valuable session to alert the agency officer of the particulars of the producers his mean are appointing. It helps to highlight sales methods, typical cases sold, types of products, producers' attention to detail and his integrity in difficult underwriting situations.

The second, and somewhat more quantifiable, is the development and tracking of "allowable sales expenses". Our product development assumptions (and GAAP assumptions) have an allowance built in for sales expenses. We have purposefully expressed this expense as a percentage of premiums written to allow us a simple tracking device. Each of our companies is asked to break their budgets down in such a way that their actual anticipated sales expenses can be compared with the assumed sales expenses used in the GAAP factors. This allows management a measure of the integrity of their assumptions and, as a result, the adjustment required to anticipated profits from sales. As the year progresses a quarterly comparison of actual premium volume produced with actual sales expenditures provides a good monitoring device.

The third approach we use in tracking agency profitability is tied in with our new agency monitoring system, which we call COBRA. The balance of my discussion focuses on our COBRA system.

USLIFE in process of installing a new agency reporting system in each of its subsidiary life companies (currently installed and running in our Texas Company and our California Company). Basically the System is designed to capture data at the lowest level, accumulate it and produce a series of summary reports to be used by various levels of agency management. In most of our companies this starts at the producer level, with the first report on an agency basis, the next on a field vice president basis (summarized agency information), the next on a company officer basis (summarizing field vice president) and the last on a total company basis.

The reports capture such information as number, volume and premium of new production, categorized by a few selected major plans with summaries by par and non-par. There are comparisons with the prior year and with the profit plan. The reports are produced monthly.

On the field vice president level and higher we have two additional pieces of information, a persistency figure by agency and a GAAP profit margin.

The persistency numbers are 13 and 25 month persistencies based on number, premium and face amount separately for the average of each agency's most recent 12 months of exposure. The formula is P divided by $P + L$ where P is all those policies during the most recent twelve months which have paid their 13th months (or 25th months) premium and L is all those policies during the same period that had an opportunity to pay the premium and did not. (Conversion, reversals and deaths have been eliminated from both P and L .)

The reporting system is driven by the issue system so that all numbers will tie with the other company reports and the financials.

The GAAP profit margin is an entry in a table which shows the difference between the gross premium and the GAAP net premium by plan and age at issue. Although we haven't decided exactly how to utilize this number yet, we think it will give us the capability of discussing each agency/field vice president contribution to that years GAAP profits through the new sales. Agency contests measured by this element have been talked about but to date have not gone past the brainstorming phase. As I mentioned earlier we have identified the "allowable sales expense" for each field vice president at profit planning time, based upon his planned new sales and the GAAP assumptions. It would be a very simple step for us to adjust his GAAP "profit margin" by his share of any excess of sales expenditures over "allowable sales expenses" and develop a compensation arrangement for him based on his contribution to GAAP profit margin. Again, these thoughts are only in the idea stage at USLIFE.

One very trying flaw in measuring agency persistency is the time lag in identifying bad persistency. In order to develop a 13-month persistency ratio, the agency must have been with the company at least 13 months. In fact, when we allow for lag time on actually removing a policy from the master file as a voluntary termination, we are somewhere between 30 and 90 days past its premium due date. That means the first measure we have on a new agent is about 15 months after appointment. By the time a real pattern can be established we are 24 to 30 months past his appointment date. When a large segment of the new appointments are Personal Producing General Agents (PPGA's), this is very undesirable. Additionally new appointments by existing agencies tend to be buried in this system since the lowest level for persistency calculation is the agency (not the producer) level. So although the new reporting system produces sound actuarial statistics, it cannot be viewed as the weapon with which to attack problems. Stated another way, the new agency reporting system at USLIFE is a very valid tool to measure where we have been vis-a-vis persistency and GAAP profit margins but too late to give us the reaction type tools we require to correct problem situations particularly in persistency performance.

MR. ERNEST J. MOORHEAD: The particular point that I bring up has to do with the profitability of participating life insurance.

The solution for a profitability measure must take in an element that has been left out of all of the literature that I have seen, and that is the necessity for the company to have a competitive product. That necessity will be much greater in the future than in the past, largely because of the interest adjusted method. And there is going to be a necessity, not because the customer is going to insist on it, but because the agent is going to insist on being given products that are competitive, and insist on it to a measure that has not been faced by actuaries in the past. The profitability of participating business, all of the business of a mutual company, should be measured in terms of what would emerge from a competitive dividend scale. The effect of using this approach would be that, no longer would we be in the anomalous situation of having profit disappear simply because the actuary changed the dividend scale, nor would we have the situation of profit getting greater and greater simply because the

company was not keeping up with competition.

MR. HAROLD G. INGRAHAM: It is curious that in the discussion of agent's profitability, no mention was made of two other areas of measurement - What particular tests and measures you would apply in evaluating the success of new agents financing plans, and second, what about the impact of policy loans? What sort of policy loan control measures are you applying in your respective companies in measuring the profitability in controlling loans?

MR. HOGUE: We have a financing plan, we have become more strict in dropping agents - new agents that appear to be failing. The profitability effectiveness of our financing plan is a concept I have not really considered. As far as policy loans go, in our company they are only about 10½% of our assets and have not become a large problem yet. We do not include them as an adjustment to agency profitability, although some companies include them as an element.

MR. INGRAHAM: Special surveillance is necessary to evaluate the appropriateness of a general agent's pattern of recruiting under a new agent's financing plan. Obviously you want him to bring in recruits, but you have to be careful that he does not get himself into a personal cash squeeze because of losses that will follow large failure rates, and heavy loss sharing burdens that he has to bear as a result of losses incurred.

MR. GARDNER: Our situation is not the same as yours because being on a branch managerial system, the manager has only a minor share of any financing losses. We determine exactly how many people the agency should be planning to hire during the coming year and then we can predict and budget for the financing cost. We attempt to monitor performance by looking at the performance of the new manpower relative to productivity achieved by them relative to the money we are spending, validation percentages, and so on. It is not taken directly into account in the so called profit measures we use.

MR. DANIEL F. CASE: I would like to take advantage of an opening provided by Jack Moorhead when he mentioned competitive dividend scales. Any profitability measurement for a mutual company must be in terms of the job the company is doing for its policyholders. The fact that one company has a higher actual net cost than another does not necessarily mean that it is doing a worse job. It may be serving a different market, one which has inherently higher mortality or lapse rates.

The way to handle this might be to base sales illustrations on estimated future dividends instead of on current scales. The company would be making offers based on these estimates. The company's profitability would then be measured in terms of a comparison between the actual net costs it achieved and the ones it had estimated. An agency's profitability would consist of its contribution to the company's profitability.

MR. MOORHEAD: When I spoke of competitive dividend scale I meant a dividend scale that is competitive for the market in which the company is operating. I am not suggesting that necessary differences in mortality, lapse, and operating expenses of all kinds are not relevant to this. I think they are exceedingly relevant and if I were running a company, I would indeed try to measure my dividend scale in relation to what was appropriate in the market in which I am operating. That far we certainly do agree. I think the rest is not practical. I do not believe that it is possible to move to an estimate that is of any value over a long period. The actuary is no better than anybody else and worse than some people in estimating the future. I do not know of any actuaries that would be capable of producing a forecast of the dividends that should be paid in the rapidly changing world in which we live that could be used in the future with any feeling of success as to being able to say we did better than we thought we were going to do or we did worse. The conditions that will emerge are too complex nowadays. So if Mr. Case had advanced his idea - if I understood it correctly, in the easier days in which I was operating, we might have been able to do it. I do not believe it could be done in the 1970's.

MR. THOMAS G. KABELLE: I wonder if any of you take the select nature of persistency into account? Younger agencies, which will sell to the younger market, could automatically appear less profitable.

MR. HOGUE: We used a seriatim record of all of our issued policies each year, and in the present value of future profits factors applicable to the policies issued by each agent, we have factors broken down by a number of items and one of these is issue age. We vary the persistency tables by policy mix. We key in on the agent's previous experience according to the 13 month persistency index. That particular variable is, as I mentioned, the one that has the most impact on the agency profitability measurements for our company.