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FINANCIAL RESOURCE MANAGEMENT, MUTUAL COMPANIES

*Moderator: MARTIN L. ZEFFERT. Panelists: PHILIP BRIGGS, LUTHER O. FORDE, COLIN C. HAMPTON**

1. Dividend philosophy.

2. Maintaining equity among generations and classes of policyholders.

3. Enterprise risk exposure and management.

4. Portfolio versus new money interest rates, including related investment risks.

5. Who owns mutual company surplus?

MR. MARTIN L. ZEFFERT: I would like to suggest that our panel is not only well qualified, but very diversified. They all have in common a mutual form of operation. I do not know if that is accurate for a fraternal, but Luther Forde will tell you more about that. We will begin with Colin Hampton.

MR. COLIN C. HAMPTON: Union Mutual was the first company, in 1969, to create a so-called downstream holding company. We did this, not for any reason, other than the principal reason we are in business as we see it, and that is that it was a means of providing our individual participating life insurance holders with the lowest net cost. That was our objective then, and it is our objective now.

We, at the time of the creation of the downstream holding company, said that we are in the business of meeting this obligation that we have toward our individual policyholders. We were then selling group insurance, non-cancellable insurance, and equity products, which was a whole array of financial services even then. We thought of these as really stock type products. If we could take these stock type products and put them downstream, the profit from those products that we were selling would then be able to be flowed up in the form of dividends or other forms to the mutual company, Union Mutual Life Insurance Company. Our objective was to have Union Mutual a pure mutual company in the sense that it served individual participating life policyowners. That was the reason for that move in 1969 and we still think that the move we made then was valid.

The basic principle we had then was that we could earn more on stock subsidiaries downstream than we could earn in the traditional way of investing. At that time, we were trying to get a 15% return on the investment we had downstream. In 1969 and 1970, the traditional kind of return on investment was something on the order of 6% to 8%, so we felt we could double what we would do normally. Today we are talking about allocation of resources and I would like to show you the kind of organization we have, just as a little background so you will understand what Union Mutual is all about.

* Mr. Hampton, not a member of the Society, is President, Union Mutual Life Insurance Company, Portland, Maine.

Union Mutual Life Insurance Company is the parent company. Downstream is a holding company, Unionmutual Corporation, which holds our five various subsidiaries. One of our subsidiaries is Unionmutual Stock Life Insurance Co. of America which markets all our services and all our products throughout the United States with the exception of New York. The second subsidiary, Unionmutual Equity Corporation, is a company where we sell mutual funds and investment advisory service. However, as of last year, we sold the mutual fund business so we are no longer in that. The third one is Unionmutual Stock Life Insurance Company of New York. It sells non-can, group, and all other services in New York only. I think there are obvious reasons why we have separate companies. The fourth subsidiary is Unionmutual Development Corporation which is involved in a very minor way in the real estate business. The fifth and last subsidiary is Claims Service International, Inc. which we use as a means to servicing our reinsurance business. This gives you an outline of our organization. Again, all of the business other than mutual life insurance is sold downstream, the profits of which will flow back to the individual policyowner.

Another tool we have developed is affectionately known around Union Mutual as the "bucket theory". We will be going over the bucket theory and what we are trying to do with the resources that we have available to us. Finally, I would like to show you some of the results that we have attained from the kind of organization we have and the kind of goals that we have set.

We are trying to create profits. We make no bones about it. In fact, in our opinion, this is the only source from which we can do anything from a financial resource standpoint. What we have decided to do is to define for everyone at Union Mutual what the profit priorities are. We call these the guidelines for decision making. As we move along, I hope you will be able to see how this bucket theory provides us with an opportunity to make the tough decisions when it comes to resource allocation.

First of all, we define profit as gain from operations from all activities except the individual participating life, and there everything we gain we hope to give back to the individual policyowner directly. We are talking about this after dividends, so we are not looking at profit as coming from the individual participating life itself. We look at profit not as an end, but rather as a means to an end. This means that we are trying to accomplish two goals: one, we are trying to serve our clients' needs first; and second, provide the lowest net cost possible.

We have five priorities for the utilization of our profit dollars. We start with profit and as I indicated earlier, everything flows from profit. Without it, there is no opportunity for expansion; there is no opportunity for reducing net cost.

The first bucket is called survival. That is the first goal we think any company should have. We talk about survival in terms of adequate reserves and so-called required surplus. Charles L. Trowbridge, in 1967, wrote an article on the meaning of surplus in a mutual company.* We took that article very much to heart and determined what we consider to be the amount of surplus necessary for the kind of risks we are taking, whether they be group risks

*"Theory of Surplus in a Mutual Insurance Organization", by C. L. Trowbridge: TSA, XIX, 216

in life, long term disability or whether it be individual risks in non-cancellable health insurance. On the basis of that, we have determined a required surplus for every line of business. The presentation being made here is on a consolidated basis as to reserves, surplus and profits. "Required surplus" is the amount we are going to maintain. Everything over and above that will be returned to those whom we have designated as owners, i.e., the individual participating life insurance policyowners.

Trowbridge said surplus had two functions: one was to take care of the fluctuations in mortality and morbidity and the second, the uncertainty as far as investments were concerned. He was talking about surplus as a contingency need and that is what we are talking about here.

The acceptable level of performance as far as Union Mutual is concerned is to maintain a competitive dividend scale. We start with survival as our first objective; our second objective is to provide our owners with lowest net costs needs; and the third one is growth. Growth on average in our industry is some place around 7% or 8% a year. That is acceptable as far as we are concerned, but it is not necessarily our goal. The fourth bucket we have is employee sharing. We say we are going to pay competitive wages and benefits. The last objective we have, and which we can quantify, is what we call "external affairs". Here we are talking about external affairs as it pertains to the government in our legislative matters and our community and social responsibilities. Keep in mind a mental picture of this as we move on to some results of this kind of thinking. Think first in terms of profit at the top, profit flowing into our reserves and required surplus.

Let us look at some of the results that we have had over the past ten years with this bucket approach. When we talk about profit, we are talking about gain from operation. Starting in 1966, our profit was roughly 1.5 million dollars. Last year it was about 6.9 million dollars, a 66% increase over the year before. It also represented the third best year in our history. This is the upward trend. It is a jagged line. I think you can understand that because of the nature of some of the lines of business we are in. Now we talk about surplus.

We had about 15 million dollars of surplus up through 1971, and since that time, we have increased our surplus threefold where at the end of last year, it amounted to $47 million. That is the actual surplus we have on the consolidated basis. We figure that our required surplus is some place in the area of $45 million. As I indicated, the first time we went through this, we were talking about the acceptable level.

At Union Mutual, our annual report is called a performance report. We talk about performance. One of the things we intend to do and the way we are going to be the lowest net cost company is to pay a performance dividend. We have paid this now for the past two years. A performance dividend, in the terms of an industrial company, is the same thing as an extra dividend. We are paying this in addition to the very competitive dividend scale we have. We have developed our own measure of net cost - an index number - against which we judge our performance against our goal of being the lowest net cost company by 1980. Right now, on our measure, we are close to attaining our goal.

We have specific plans, but we do not think of them in terms of five year plans, as some companies do. Some of our plans are designed to meet specific goals or objectives in three years, other plans call for meeting goals in four years or five years. In this case, we are shooting for being the lowest net cost company by 1980.

We have a sales piece which we call "sharing our performance success". Last year we paid the regular dividend plus 13%. The year before we paid 10% extra. In other words, if you had a cash dividend, whatever you would normally get, it was enhanced by an additional 13% cash last year. No matter what dividend option the policyowner elected, the dividend was an additional 13% over and above what we had promised we would pay. Keep in mind that lowest net cost is the key financial objective as far as we are concerned.

Our growth objective happens to be a rolling five year objective. We want to double our premium income every five years. We have been doing that for some time now. It is a very specific goal. It is part of the whole planning process and allocation of resources we are describing. We have been involved in this kind of planning for five or six years. We started modeling the company in the early 1970's. At that time, we said there were certain things that had to be done. One of the first things was that we should define the business we are in. That has not changed at all over the past five or six years. We are in the financial protection business. We then defined our key financial objectives. Our first key financial objective was lowest net cost. We also talk in terms of a 15% return on equity on our stock products. Based on the required surplus theory, we are shooting for a 30% return on so-called "required surplus". That is a goal that we have established for the year 1980.

Let us see what has happened as far as growth is concerned in new sales. In 1966, we had roughly ten million dollars of new sales. Last year we had $77 million. That, of course, translates itself into premium income. Our premium income has grown from $70 million in 1966 to $354 million, a fivefold increase over the past ten years. Last year, our sales increased 40%. We are now America's fastest growing life insurance company as far as our premium income is concerned. In the past ten years, we have been growing at a compound annual rate of 15.6%. This is according to Best's for those companies with $50 million or more of premium income. That, as I indicated, was the key growth goal that we had in mind, doubling our premium income every five years.

Asset growth has been similarly quite dramatic. We had assets of $188 million in 1966 and have increased four times, with assets of $820 million last year. We had a 33 1/3% increase in assets from 1975 to 1976, and here again, we are also the fastest growing company as far as asset growth is concerned, where we increased from 1974 to 1975 at 18.6%. If in 1975, we were the leading company (with $550 million more assets) at 18.6%, having grown 33% in 1976, we should be able to maintain that posture of being the first last year as well. With the growth in assets which we have had, obviously we have had investment income which has trended upward very rapidly also, from 8 million dollars in 1966 to 49 million dollars, a sixfold improvement. That result came about as interest rates trended upward. We went from a 4.75% net investment return in 1966 to 7.56% at the end of last year. The most dramatic gain of all is our cash flow. Last year we had over two hundred million dollars compared with $25 million in 1966, and only $100 million in 1975. That is a direct reflection on the kind of pension business that we have been writing.

The next bucket, as you recall, is our employee sharing. We are talking here about additional rewards. For a while we paid a bonus. Based on our standard of 30% return on required surplus, however, we have been unable to pay a bonus for the past two years.

Therefore, we thought we would try something new as far as the compensation plan is concerned. What we have determined is that if you want to have the best results, you better have the best people. It is people that create the results. In order to have the best people, it is certainly necessary to have a highly competitive, if not an outstanding compensation plan. We are shooting for paying, on average, 110% of the industry average for any given job. We are attempting to get to this 110% in a three year process. Please be assured we do not look at this as a giveaway. We are expecting better results because of it - or increased productivity per person.

Last, we have our external affairs bucket. Here we are talking in terms of meeting extraordinary community needs. We believe in the social responsibilities area that a company such as ours - in fact, almost any company - can only be effective in its own backyard. If everybody kept his own yard clean, you would have a clean neighborhood. A clean neighborhood in all places would lead to a clean city, and if everyone had that, we would have a clean nation. So this is our approach. We concentrate our contribution in the City of Portland primarily, although to some extent to the State of Maine. We encourage all people to involve themselves in the key things that are going on in Portland with the idea that again, from self-interest if you will, Portland will be the best place - the ideal place - to live and work. Consequently, we, as a company, will benefit.

That is a quick description of our so-called bucket theory. We also have what we call the overflow or the holding tank. If you look at this from the standpoint of what we are trying to do, we would think in terms of filling all of the buckets. If we filled all buckets every year, then we would be a truly excellent corporation. There is also the possibility that there will be some years, because of the nature of the business we are in, where we cannot think in terms of a steady, smooth, or consistent rise in sales and earnings. So we are setting up what we call an overflow, or a holding tank. That holding tank will be equal to the amount of one year's increase in required surplus plus one year's performance dividend so that we will be able to pay that dividend through thick and thin.

Now let us look at the decision making process. Let us go backwards. Let us suppose that we do not have a good year. The first thing we are going to cut out is the community's extra amount - the extraordinary amounts that we would normally turn into the community. If, in fact, that top of the bucket is removed, then we would cut back on the additional rewards as far as employees are concerned.

The next thing we would be talking in terms of cutting back on is our growth. Of course, as you know, to grow 15% requires quite an amount of dollars for expansion. Then we would cut out the growth bucket. The last to be cut would be the performance dividend. We are putting things in the perspective that we think they should be. Our owners are the first people that we are trying to serve, and this is the basis upon which we try to make decisions. If push comes to shove on a decision, we say okay, what effect is this going to have? Is it going to benefit the policyowner? Is it going to benefit me? I would like to think, as idealistic as it may sound, that the decision is

going to be made to do it for the policyowner. It is the same way as far as growth is concerned, and the employees, and all the way down the line. This is the basis for, and the philosophy upon which we are making decisions.

What does all this mean as far as you are concerned? I think I really have two messages. First of all, I think it is absolutely necessary, whatever company you are with and whatever goals have been established, to set the priorities. If you do not have priorities of what you are trying to do in the planning process, you are never going to live by a discipline. It seems to me it is necessary to live by discipline if a company is to accomplish its stated goals.

The second thing that I think is absolutely necessary is to communicate what the company is trying to do to everyone in the operation. This bucket theory is a part of our corporate communications process. There are certain things that are designated as being necessary to be shown to everyone in the organization. All of our 1300 people at this point in time have had the opportunity to see this bucket theory.

The planning process, when you get down to it, is really nothing other than resource allocation. In every company there is a constant fight for resources, whether by function or line of business. Once goals have been set with their order of priority, the allocation is made easier. All the problems are not eliminated, but at least there is rational justification for what is done with the money.

MR. LUTHER O. FORDE: I would first point out that the vantage point from which I speak is as the actuary for a fraternal benefit society. Just by way of background, most fraternals are organizations in which ethnic, religious, or other cohesive groups have banded together for the mutual benefit of their members. In a more legal sense, a fraternal benefit society is an incorporated organization without capital stock, organized and carried on for the benefit of its members and their beneficiaries. The government of a fraternal is very democratic, with ultimate control in the hands of the members organized in local lodges or branches.

The Articles of Incorporation for Lutheran Brotherhood set forth the basic philosophy of our organization and stipulate that we seek to provide "protection...in case of death, or disability by sickness, accident, or old age". A set of basic policies which has been developed provide, among other things, that:

...We will offer financial services to those who qualify for membership.
...We will strive to increase, at all levels of management, knowledge of and dedication to the principles and practices of professional management for the purpose of continuing to build a great and enduring organization for the benefit of our members.
...We will develop and update annually a five year corporate plan.

Our organization has many similarities to a mutual life insurance company. We have about one million individual insurance policies--mostly permanent and term life insurance with a modest amount of health insurance and annuities. Our assets are about one billion dollars. In sharing our experiences then, it would be well to view them from the perspective of how a moderate in size insurance organization offering participating insurance, struggles

to come to grips with the management of its resources. For this discussion, management of financial resources is considered to be that collection of decisions and plans which have major long term financial impact on the company.

We have spent a considerable amount of time over the past several years developing our corporate plan. Our first effort in this regard was the development of a plan through the assistance of the American Management Association. I will not go into details regarding the process, but certain objectives or goals were established as a result. The major financial objectives were:

1. To secure sufficient premium income to achieve a stated share of our insurance market.

2. To earn a favorable net rate of return on invested assets as compared with the industry.

3. To retain a specific percentage of total dividends paid under options to purchase additional insurance or to accumulate at interest.

4. To retain a specific percentage of insurance proceeds as considerations received for supplementary contracts.

5. To preserve equity and our relative competitive position by allocating sufficient resources to insured members.

6. To reduce operating expenses as a percentage of total income.

7. To increase surplus funds so that the ratio of assets to liabilities is increased to a predetermined level.

In the process of developing the corporate plan, it was recognized that various external factors could have a significant impact on our operation and should be considered in any program to better manage our resources. These factors were broadly classified as (1) Economic, (2) Social, (3) Political, (4) Technological, and (5) Competitive. Dramatic changes in the economy evidenced by the crises over energy, high interest rates, declining common stock prices, and high inflation suggested that the Economic factor should be given special attention. A project which was labeled the "Inflation Study" was undertaken. Its purpose was to identify problem areas which might be encountered over a period of years because of inflation and its various ramifications.

Our corporate model proved to be a very valuable tool and was used to make financial projections over a ten year period. Projections were made under several assumed levels of inflation. Numerous "What if" type questions were probed in order to get a feel for the likely financial impact of the various inflation levels. Relatively few problems were identified under low inflation conditions (low inflation being around 2% per year). The projections tended to be an extension of the rather favorable experience of the last two decades. Even with moderate inflation (5% to 6% per year) the problems did not loom large. With two digit inflation, however, serious problems appeared likely. Among the more serious were:

1. Cash flow problems resulting from high demand for policy loans and cash surrenders. Although at Lutheran Brotherhood we have been fortunate in that even with the critical money market conditions of 1974, cash flow has not been a serious problem. It seems doubtful that cash flow would be favorable after several years of two digit inflation.

2. Unsatisfactory return for the insured on his savings. It is obvious that a 5% dividend interest rate is providing no return on savings when inflation is 5% per year.

3. Shift in sales from permanent to term--this follows from an unsatisfactory return for the insured on his savings.

4. Unsatisfactory level of income for the field. This will be a serious problem whenever there is a shift from permanent to term. Our term sales are about 45% of total life sales by amount. However, term produces only about 10% of the income to the field representative. Any further shift to term will seriously affect the field unless offset by other changes.

5. Rising expense levels which cannot be absorbed by increased volume of business or improved efficiency. While unit expenses would not have to increase if the number of units increases in proportion to inflation, it is doubtful that the number of units will keep pace after several years of high inflation.

In order to minimize the adverse effects that might result from continuing inflation, certain action plans were proposed:

1. Steps should be taken to deal with the policy loan problem.

2. An investment strategy should be formulated to optimize the level of investment in equities versus fixed dollar investments; levels of short term investments versus long term; and the quality of investments versus level of yield.

3. New products (including those not normally offered by life companies) and a revised product emphasis should be considered.

4. A tight control on expenses should be worked out on a continuing basis. All areas of operation should be examined to make sure that expenses are reduced to a minimum.

5. Dividend scale philosophy should be reevaluated to determine what can be done to obtain a more satisfactory return for the buyer.

It would be nice to be able to say that all of these action plans have been worked out with a satisfactory resolution of the problem. Needless to say, this is not the case. Our success in developing the action plans has been spotty at best. On policy loans, for instance, efforts have been primarily "jawboning" to get the insured to repay his loan.

Greater effort has been made in response to the action plan on dividend philosophy. Our basic objective in pricing insurance and in determining dividends is to provide protection as equitably as possible, where the net cost is the minimum consistent with the security of existing and future

policyholders. Each product must be self-supporting and, in addition, contribute to surplus. Furthermore, rates and dividends should be consistent with those for other products so as to maintain equity among the various classes of policyholders.

Our approach to dividends has been quite conventional. Mortality and expense elements have been straightforward, and the interest factor has been based on the total portfolio rate. Our concerns regarding our dividend approach were brought on by the need to obtain the best possible return to the insured and by competitive considerations. We had a special concern about pension funds for home office and field personnel. While we do not market group annuities, we carry the pension reserves for our own staff. The Employee Retirement Income Security Act of 1974 (ERISA) imposes a high standard on fiduciaries, and it was felt that a portfolio approach was not satisfactory; i.e., we desired a more precise method of allocating investment income to pensions than had been used in the past.

The resulting solution was to use an investment year method to allocate investment income to each major line of business--the lines being life insurance, annuities, supplementary contracts, health insurance, and retirement plan funds--each representing an annual statement line or a distinctive category of business. The change to the investment year basis was only in respect to new cash flow after the date of change. The dividend interest rate for the various products within a line is, then, based on the "portfolio rate" for the particular line of business. Adjustment for other factors such as the absence of a policy loan provision for a product within the line of business (as in the case on tax-sheltered annuities) was then made.

Our revised approach makes it possible to have dividends for a particular line of business which are responsive to the experience for that line. The pooling of the investment experience within the line of business avoids sharp fluctuations in the experience. We recognize that there are some shortcomings to the new approach. If the dividend rate is dramatically different for two lines of business, there will be a tendency for funds to flow to the line having the higher dividend rate. This would be most dramatic if a new product line were to be started in a period of high interest rates.

Consideration was given to developing a new money approach which would somehow recognize the different investment results applicable to the various year of issue blocks. The complexity of the system and the problems involved in dividend illustrations persuaded us to abandon this approach. It did not seem to us that equity is seriously impaired by using the portfolio rate for all years of issue, since most of the business will be in force for long periods. Admittedly, competitive considerations can force a change in this decision. Our new approach to dividends helped us competitively in some areas. Also, our ERISA concern was resolved.

Little progress has been made to respond to the action plan for new products. The need for providing better designed products in response to inflation continues to be of concern. Several possibilities for individual life insurance which we have discussed, include: (1) variable life insurance, (2) the life cycle concept, (3) life insurance based on the Consumer Price Index (CPI), and (4) guaranteed insurability tied to the CPI. Difficulties at the regulatory level and field acceptance are serious problems. A basic design

change in our pension coverage, which was made in response to the inflation concern, was to index the benefits to the investment return. Retirement plan obligations are based on reserves at 3½%. The excess interest instead of reducing costs, is automatically used to provide larger benefits. If today's interest rate of 7% continues indefinitely, each retired participant will receive a benefit increasing by about 3½% each year. Although the benefit increases do not necessarily correlate closely with inflation, the resulting benefits have been very well received by the participants and the cost to the employer is predictable.

The Inflation Study called attention to the solvency problem which can arise during a financial crisis. This suggested an evaluation of the proper level of surplus. The need for surplus in a fraternal benefit society is essentially the same as for a mutual company. While it might be argued that the open contract feature of fraternal insurance reduces the need for surplus, this feature more properly should be considered as defining the process to follow in the event of insolvency.

A precise handle on the proper surplus level is impossible to obtain since surplus exists to meet unpredictable contingencies. Nevertheless, we felt it worthwhile to probe our operation in order to get a feel for those risks which could be identified. We recognized that the surplus needed to cover adverse investment experience will depend on the distribution of assets and the risks associated with each investment category. We relied on previous research on the risk of default on investments. We also attempted to evaluate the likelihood of adverse claim experience due to random fluctuations in claims, and of the likelihood of occurrences of a 1917 type epidemic. Other needs for surplus were recognized--among them that premiums would become inadequate (a low risk because of the ability to adjust dividends), and the need for surplus to finance a new line of business.

Our conclusion was that, by far, the greatest need for surplus in our organization was for the risk of investment losses. This risk is due not only to the risk of default of the various investments, but also the potential losses resulting from the forced liquidation of quality assets because of negative cash flows when market values are depressed. While sufficient liquidity is the way to guard against this latter problem, it is because of the difficulty of establishing the needed liquidity level and the desire to maximize investment returns through long term investments that it is a problem.

We then quantified each of the needs, the amount for each being substantially greater than the likely strain under very adverse conditions. Our total surplus objective was established at a level less than the sum of all of the individually established needs for surplus, in recognition of the low probability of all needs being required at the same time. This was done somewhat arbitrarily, but in view of the dominant need being for investment losses, the result probably was reasonable.

I might note that we carry our insurance reserves on a modified reserve method. We had long felt that this suggested a significantly larger surplus than had reserves been on the net level basis. On the basis of our analysis and the dominance of the investment risk, we concluded that the margin in net level reserves is not a substitute for free surplus.

MR. PHILIP BRIGGS: I would like to discuss financial resource management mainly from the viewpoint of the five largest mutual companies. I believe these companies have enough common characteristics to be set apart, as a group, from the rest of the industry. I also believe that they are faced with some unique problems in managing their resources.

Each of the five companies - Prudential, Metropolitan, Equitable, New York Life, and John Hancock - has well in excess of $10 billion in assets. They are all national companies, they all have their own field force and they are all headquartered in a major urban center along the east coast. Each of the five companies is a major writer in more than one of the major lines of business with each one generating more than $2 billion of premium and annuity consideration income annually. Finally, they all have subsidiaries.

What are the financial resources of these companies? Obviously admitted assets form a solid, tangible base of their financial resources. As a group, we are talking about more than $125 billion as of the end of 1976. Another fundamental resource is their respective field forces representing over 70,000 individuals trained at a significant cost by each company.

Another major resource for these companies, and for that matter any other company (mutual or stock), is the home and head office employee force. We all know, what and how much it takes to train our underwriters, our claims personnel and our administrators. Investment personnel, accountants, lawyers, doctors, and actuaries all need specialized training and this, in turn, requires significant investments in time and money.

I am sure there are other financial resources - such as software systems and specialized services - but I think the three major financial resources - i.e., the ones which require our maximum management efforts are the resources I just mentioned - assets, sales force and home and head office employee force.

Now, let us turn to the objectives of our resource management. Obviously, for a mutual company - regardless of size - the basic objective is to provide insurance benefits and services at a minimum cost to its policyholders. In addition to this basic objective, the major mutuals also try to retain their current status as one of the five largest mutuals. This preservation of status objective is based on the assumption that many or most of these companies' policyholders elected them in the first place mainly because of such status - this seems to be particularly true in the case of group policyholders.

Let us examine these objectives more closely.

Providing coverage and services at cost has different meanings for different lines of business. For short term insurance coverages, such as health and group life insurance, and for non-participating or immediate participation guaranteed annuities all of the cost elements are reflected currently with the only contribution to surplus being small contingency charges. For long-term coverages, such as permanent life insurance and long term disability, and for participating deferred annuities, the only way to provide for coverage at cost is by accumulating sufficient surplus over the course of coverage to make sure that no class of policies will have to rely on any other classes at any point in the future. This can be done in several ways but at Metropolitan this is accomplished by making significant <u>temporary</u> contributions to surplus for these lines. Such amounts are set aside to assure coverage at cost.

When the policy terminates and if no need arose to use such amounts during the course of coverage, they are returned to the policyholders. These temporary additions to surplus form the bulk of Metropolitan's increase in surplus. If one examines the contributions of large mutual companies' surplus from the various lines of business over the past 10 years, just about all of the gains from operations for these companies have been generated by the ordinary line. If we assume that 75% to 80% of this amount arises from such temporary additions, we see that most of such gains are set aside temporarily only.

This brings us to the question of ownership of surplus of mutual companies. All of our surplus can be characterized as a contingency reserve held for the benefit of our policyholders. From what has been just said, the bulk of these mutuals' surplus arose from contributions of specific classes of policyholders and it is intended that these amounts be returned, when no longer needed, to such classes. But this does not mean that these classes own that portion of surplus - no class has proprietary interest in surplus.

Once the task of providing coverage at cost is accomplished through the workings of the dividend formula, the task of providing coverage at minimum cost has to be achieved by careful and intensive management of the company's resources. This requires maximizing your investment yields while keeping your investment risk within acceptable bounds - obviously a subjective area with each company following its own philosophy. It also means managing your sales and home and head office employee forces in a way that would maximize productivity.

For the group of major mutuals that I am discussing, the objective of providing coverage at minimum cost comes into interplay with the objective of remaining a member of the group. Two distinct, but interrelated competitive forces come into play here - on one hand we are trying to get the most of our resources in order to improve costs and services and on the other hand we are trying to provide the right kind of environment for our sales and home and head office employee forces to enable us to compete against the other major mutuals for the right caliber of personnel.

Let us concentrate on the latter a bit.

We are all aware of the serious problems insurance companies have with retention of sales personnel. Attracting and retaining the right kind of sales person is a difficult task which becomes almost impossible unless we can offer a complete portfolio of products at competitive costs. You cannot compete for the services of a top flight sales person against a company of similar stature unless you offer a similar product line. Once, one of the companies in this group offers a new product line - be it casualty insurance or a specialized separate account - the rest of the members of the group have to seriously consider introduction of a similar product, lest they lose out in the battle of providing the right kind of environment for attracting, and retaining, the needed personnel.

Let us now review the effects of trying to meet these objectives over the past few years.

The first obvious effect has been substantial growth. For the group of the top mutuals, assets have grown from $74 billion in 1965 to $121 billion in 1975. Annual premium income has doubled from $9 billion to $18 billion.

Insurance inforce has increased by $384 billion from $362 billion in 1965 to $746 billion in 1975. Can we expect a similar pattern of growth for the next 10 years? Obviously, there is always a possibility that some of our current markets will narrow either because of increased governmental incursions or as a result of increases in the corresponding share of companies that specialize in certain markets. Incidentally, this latter phenomenon has been apparent in the past few years.

Even in the fact of the narrowing markets, pursuit of the objective of retaining one's status of one of the major mutuals should continue to lead to a pattern of growth not dissimilar to the recent pattern. Note that growth will occur only through proper management of our resources. It will be very difficult to enter a new market or to render new services required by our current markets, unless we have the right mix of managerial flexibility and technical expertise in our manpower resources. At the same time, this type of mix will enable us to react quickly and fill the gaps arising from the shrinking of some of our current markets.

Growth and competition have also brought about a gradual change in the investment portfolio mix of these companies.

As cash flow increases, the investment department of each company has to look for new investment outlets and the ever present competitive pressures provide an additional push in the direction of novel ways of maximizing the yield of our investment portfolio.

Inflation has been a way of life in the past 15-20 years. In an attempt to protect policyholders against the erosion of the value of the dollar, many companies have been pursuing an investment policy of obtaining, whenever possible, equity features as part of the price for long term fixed income investments. Such equity features would include convertibility into common stock or warrants to purchase common stock.

This endeavor to protect policyholders against inflation, in combination with the belief, based upon historical evidence, that the long term return from common stocks tended to reflect inflation, led these companies toward a long term common stock investment program starting in the early to mid 1960's.

The same concern about inflation led in the late 1960's to programs of real estate investments through joint ventures with developers. Under this type of investment, the insurer offers a mortgage and also offers to buy a share of the equity, at a fair price, if interested in the property. In some instances, an additional inflationary hedge is provided through what is commonly called "contingent interest" which is basically a percentage of the increase in the gross rentals above an agreed upon rent roll.

In the public's mind, inflation was the underlying reason for the need for equity related products. Variable annuities and, possibly in the future, variable life have created the need for new specialized skills and services and this, in turn, has led to an increased need for proper management of our resources.

As these major companies developed the expertise to handle equity type investments, and as the popularity of common stocks increased, major group policyholders sought this type of investment vehicle for their pension funds.

This led to separate accounts, which, in turn, has added significantly to the growth in assets of these major insurers.

Another form of investment that developed in the early 1970's arose directly from the management of our resources. As casualty insurers started making significant inroads into the life field through life subsidiaries, and as the government and group coverages started cutting into the individual health sales, companies with their own sales force had to come up with additional markets. The objective here was not so much to increase the agents' earnings but, rather, to keep the agents' earnings at a level that would keep them reasonably satisfied with their employment and, therefore, willing to continue to sell and service their existing markets. This led to the entry into the casualty insurance business.

Obviously, there were other, as significant, reasons for entering these new markets. There was, and still is, talk about a capacity crunch in the casualty area. There appeared to be a desire on the part of the public for one step insurance coverages. And, finally, there was the belief that the entry of the major life mutuals, with their resources and reputation, into the casualty field, would tend to improve the attitude of the general public toward the casualty business. I am sure some of our casualty friends would be willing to debate some of these points, but I would like to note that substantial blocks of casualty policies orphaned by the recent withdrawal of casualty companies from certain areas were - and still are - taken over by subsidiaries of life companies.

Mainly because of legal restrictions, the entry into the casualty field was accomplished through the formation of subsidiaries. But casualty insurance companies have not been the only type of subsidiaries formed in the past few years. In an attempt to provide for long term capital growth and in conjunction with developed expertise in related fields, the major mutuals have been increasingly active in forming insurance and non-insurance subsidiaries in areas ranging from reinsurance to investment real estate to software systems and biochemical laboratory services.

Since 1965, common stocks of non-affiliates in the general account went from $2 billion to $4 billion, separate accounts from $141 million to $8 billion. Real estate partnerships have risen from zero to $382 million, while investments in subsidiaries stood at $926 million at the end of 1975, having also risen from zero in 1965. Note that the total increase in these categories accounts for 23% of the total asset increase over this period.

This kind of diversification has a signifcant impact on a mutual company. Traditionally, the experience factors of the dividend formula have reflected current experience with due recognition of long term trends. But in the case of common stocks, real estate partnerships, and all investments in subsidiaries, the current return is substantially below the return on the remainder of a company's investment portfolio. For the group of five mutuals that I am discussing the gross rate of return on these three classes of assets in 1975 was 1.66%, while the gross rate of return on the remainder of their assets came to 7.30%. It should be emphasized that this gap between the yield rate on these low return-high potential assets and the balance of our portfolio is expected to prevail in the near future. At the same time, it is anticipated that over the long run these assets will yield returns which - especially taking into account some of the side benefits - will be as high or higher than the return from our traditional forms of investments, such as bonds and mortgages.

For a mutual company this situation poses a serious equity problem. If the percentage of our portfolio invested in such low return-high potential assets is relatively high and if we merely reflect current investment returns without recognizing, to some extent, the probable long term returns from such assets, we run the risk of paying lower dividends to current generations of policyholders and correspondingly higher dividends to future generations. In other words, if the amounts involved are significant, the basic principle of providing coverage at cost could be violated since investments of current generations would not begin to show any returns until much later.

This is an area where the actuary has to become increasingly active in the management of our resources.

The first item of priority is to strike the proper balance. Continuous increases in cash flow, competition, and the need to properly utilize our manpower resources all point in the direction of increased diversification. On the other hand, the need to preserve our basic principles of equity would tend to pull in the other direction. Note that the picture is not really that simple. One could argue, for example, that entry into the casualty business is of maximum benefit to current generations of policyholders, since such entry helps us preserve (or more likely, improve) the quality of our sales force and, hence, the quality of our service to our current policyholders. Also, diversification could continue unabated if we felt that we could draw on surplus and assume that these new types of investments are currently earning what we would expect them to earn over the long run.

In all likelihood, most companies would try to achieve the proper mix of diversification into this type of investment and some sort of imputing of a rate from such investments to existing policyholders. It is easy to see how the actuary has an essential role in this since the financial soundness of the company, equity to policyholders and projections of the financial results of these new enterprises are involved.

The first fundamental decision in this process is whether to get involved in a new enterprise. In connection with this, the actuary has to weigh the likely return - and the pattern of such return - from the enterprise plus any side or intangible benefits derived from it against the effects - financial and non-financial - to policyholders and any immediate and near future effects on the company's surplus. Consider a straightforward example: With the recent emphasis on fixed-income returns, many major group policyholders have been pressing for private placement separate accounts. From a marketing viewpoint it would be certainly desirable to satisfy this need and go ahead and establish such an account. But the investment people and the actuaries have to try to measure the effects of such a separate account on the current body of general account policyholders. Would such separate account lead to fewer private placements going to the general account? Would the overall yield of the general account suffer? Is the current and future cash flow and liquidity position of the general account such that it would allow the establishment of such a separate account without any undue hardship to the investment efforts for the general account?

Once the decision is made to proceed with a new enterprise there is need to closely monitor the performance of such an enterprise, to measure actual versus targeted performance and to make the necessary adjustments to surplus and assumed rates of return as we go along.

Allocation of assets by line of business is another actuarial task that would seem to also fall under this general category of resource management. One basic idea that has to be pursued in this connection is making sure that one is clear as to what the primary purpose of making an investment was in the first place. The traditional forms of investments are naturally made for the express purpose of maximizing the investment return but some other enterprises - for example, an insurance subsidiary started only for the purpose of aiding the competitive position of a particular line of business - could lead to significant side benefits to particular segments of our business and this should be recognized in some manner in the allocation process.

This allocation problem is really intertwined with the management of our resources since the effects of various actions on particular lines of business would also have to be measured and monitored carefully.

Related to all these considerations as to how to allocate special-purpose assets and how to reflect the expected long term gains in dividends to current generations of policyholders is the question of how to recognize investment returns in our pricing. Through investment income allocation, we do recognize the timing, and pattern, of the various lines' contributions to the total company investment income. Theoretically, this investment allocation process could be refined and be broken down to recognize the timing of contribution by smaller cells of business within each line. In some cases, the only logical and practical way of pricing our business would be to reflect a particular block's contribution to our investable funds and to price such block accordingly - i.e., recognizing new money rates. This is primarily the case where the timing of premiums or annuity considerations is at the option of the policyholder - as would be the case for group pensions and for flexible purchase payment individual annuities.

In the case of level premium long term contracts, use of new money rather than portfolio interest rates presents some serious problems. One point that should be made first is that for such contracts, use of a new money rate would not produce significantly different results, over the term of the policy, than would be produced by use of a portfolio rate. This is especially true when the progressive nature of Federal income taxes is taken into account. If a different interest rate is to be used for each issue year - in a manner similar to what is done for group pensions - the administrative problems and attendant costs would be enormous. But even if we eased these problems a bit by varying the interest rate by block of business only, the costs would still remain rather high. Considering such higher expenses and attempting to achieve an optimum balance between equity and practicality, it would appear that it would be preferable to use portfolio rates than reflect different interest rates by issue year or block of business.

Another, very fundamental, argument against use of a new money rate approach for level premium individual policies is the effect it has on illustrative costs. In illustrating dividends on the basis of the existing scale we automatically make the assumption that this year's new money rate will prevail into the future. At times of high interest rates, such as this, there is an inherent assumption that levels of inflation pretty close to the current level will also prevail - and, yet, usually no adjustment is made to the current expense levels used in the dividend formula. Note that this problem is not present when the portfolio method is used - any future increases in expenses because of inflation are likely to be at least partially offset by increases in the portfolio rate.

The use of new money rates for individual level premium policies also tends to cause an increase in rewriting problems. It also causes major equity problems with regard to previously written policies since a large portion of current new money may be attributable to cash flow from older policies.

In summarizing, I would say that over the past few years, management of our resources for purposes of meeting our objectives has brought about a high rate of growth and diversification. The immediate future outlook is for more of the same. The growth and diversification have led to some serious equity problems and this, in turn, has led to an increasing involvement by the actuary in financial resource management, particularly of mutual companies. I would say that the way we handle this task will be a very crucial factor in determining the future course and success of our business.

MR. JOHN A. FIBIGER: So far a great deal of the concern about the use of new money rates in individual dividends has been because we have been in the period of rising interest rates. Mr. Briggs, would you comment on the accuracy or the adequacy or the fairness of dividend illustrations for a company on a portfolio basis in a period of declining interest rates?

MR. BRIGGS: It would depend on how far down the interest rates go. The interest rates and new money rates could decline substantially before they get down to our present portfolio rates. While I am not the expert at making up individual insurance dividend scales, I would guess that the assumptions we are now using would stand up on all but the most extreme types of situations that one could imagine.

MR. FIBIGER: Are not portfolio rates going to catch up with new money rates, eventually? It seems to me you have the same sort of theoretical problem in portfolio rates in a declining market which will have to happen eventually.

MR. BRIGGS: Probably we have not quite faced up to that because we have not had a situation for several years where the new money rate was not at least equal to the portfolio rate. Interest rates have been rising for such a long time from the pits of 1948 or thereabouts to the present high level. When the problem presents itself, we are just going to have to come up with innovative solutions to the problem. It has been a long time since we had to face it, but I do not think we are quite there yet. We are not in the situation where it would be realistic to anticipate a lower portfolio rate in the near future.

MR. FIBIGER: My point is that it is not proper to talk about the inadequacy of dividend illustrations on a new money rate basis in rising times because it is something you may not be able to sustain without admitting that the same thing applies under admittedly future, theoretical circumstances when you have interest rates going the other way.

MR. BRIGGS: If we get to the point where we are in effect deceiving the public by putting out illustrations which in fact we can not live up to, then we have to do something. I do not see how we can put out those illustrations which is why we are opposed to the concept of using the new money rates, because we do not think that in fact, we can live up to those in the long run.

MR. DAVID THOMAS: I would like to address this question to Mr. Briggs. If you assume that a certain part of your investment portfolio is invested in

equities earning a 2% return, plus a potential 6% or 7% appreciation return, and that they will continue to do so in the future and you are earning a 7% or 8% return on your fixed investments and that they will continue to do so in the future, are you going to reflect this potential future paper appreciation directly or indirectly in current real dollar dividend payout?

MR. BRIGGS: Yes, we are. I am not thinking so much of normal common stock investments where we rely primarily on the dividend yield, although we do impute an additional return for possible long term capital gains. I am thinking particularly of those investments in our subsidiaries that are not producing investment return at the current time. To maintain proper equity between existing policyholders and future generations of policyholders, we impute a rate of return on that investment and credit our present generation of policyholders at that rate. It comes out of company surplus and is credited to that class of policyholders now.

MR. ZEFFERT: This question of allowing in the dividend scale projection the possibility of unrealized capital gains is something I sit on every day. I do not quite know what to do with it. I find capital gains to be welcome things when they occur but impossible things to predict as to occurrence. When you have a substantial chunk of real estate in the portfolio and some of it is certainly appreciating and is up for sale, you wonder whether if you cannot in good conscience, if not in duty to your company, take some allowance for that. Has anybody else faced up to this?

MR. FIBIGER: You could assume there is a required contribution to surplus out of what could be called normal operating earnings. One possible way to take account of unrealized capital gains is to expect a smaller contribution to surplus, taken out of the current stream of earnings, assuming that at some time in the future some of the assets attributable to this non-current earning investment will produce the required surplus that you need. You need to develop some sort of surplus targets and some sort of surplus policy to make sure that you do not use this money twice.