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DETERMINATION OF EARNINGS BY, AND WITHIN LINES OF BUSINESS

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1. A company's product lines for statutory reporting are defined by the form of the annual statement and by regulation. Many companies use a more detailed analysis by line and subline for internal reporting purposes. What criteria are in use to define such sublines?

    a. Do any companies use a different definition of product lines for shareholder reporting than for statutory reporting?

    b. Does anybody make use of a "corporate" line to include interest on surplus and possibly some expense items?

2. What procedures have companies adopted to allocate expenses by line?

3. What general philosophy is used to allocate sales overhead?

    a. Is there ever any justification in considering a product on a marginal basis when it does not appear capable of carrying its full share of overhead?

4. What approaches are used to allocate federal income taxes?

    a. What approaches are used to allocate GAAP deferred taxes?

MR. RICHARD S. ROBERTSON: In addressing this subject our concentration is primarily on life insurance companies and their determination of earnings by, and within lines of business. This is a very broad subject, one that we could not hope to cover in a comprehensive manner in the time we have allotted, or probably in any time that can be allotted to the subject. Instead of trying to do so, we have put together three experts on the subject and we are going to take two or three or four specific questions and get their points of view as to how these might be answered. Our primary hope is that we can stimulate some thinking on the part of all of you, perhaps introduce some new ideas, and perhaps argue about some old ones.

Jerry Stein is with the Prudential; he is the Assistant Controller there. As such, he is very much concerned with the problem of determining and allocating earnings by line of business. Joe Crowe is a Vice President in the Individual Division of Aetna. Jerry can speak for how a large mutual company allocates, and Joe can speak for how a large stock company does so. Dan McCarthy is from the New York office of Milliman and Robertson. Dan can speak for how small and medium sized companies tackle the problem.

As a starting point, the first question I am going to put out for the panel is "What is a line of business?" For statutory purposes, we are told what a line of business is. But for other purposes, for stockholder reporting or internal reporting, many companies have taken other approaches to the subject.

MR. DANIEL J. McCARTHY: My initial comments on this subject are not aimed so much at stockholder reporting as they are at internal reporting, and what a company looks at in terms of its own understanding of lines of business and how it evaluates its profits and losses. We have seen, in recent years, an increasing proliferation of definitions for a line of business. The reasons for this appear to be two-fold and connected. The first is that there is a much more widespread appearance of distinctly different products and markets within what the statutory blank defines as a single line of business. As a result, companies are amalgamating some things that are often very much unlike each other because they are required to do so for statutory reporting. The second factor is that they have these very unlike things put together for statutory purposes and would like to understand how they are working separately.

As examples of different products within a single line of business, we are seeing various kinds of group permanent products combined with other group products in the group life insurance line. Also, single and flexible premium deferred annuities, with widely different interest crediting or interest guarantee problems from individual, more conventional, annuity products, are appearing in the annuity line. And in the group annuity line, we are seeing what probably should be labeled as investment only contracts with long term investment guarantees.

There are also different markets. We have worked with one company which typically has been a general agency company as far as its ordinary production is concerned. Recently, they have started a separate brokerage organization, selling sometimes the same products. The company is very interested in tracking separately the experience of these two different marketing approaches to the same set of products. Some companies, particularly those which are very active in ordinary pension trust work, separate pension trust as a separate sub-line within ordinary. Interestingly enough, a number of other companies who may obtain a third or more of their ordinary production from pension trust do not make that separation. I have often surmised that the reason is probably that they fear what the real answer is and would just as soon not know.

I have also noticed, in this proliferation of sub-lines of business, that the stock companies seem to be much more active than the mutuals in making these sub-line differentiations, ignoring for the moment questions of differring company size. Initially I was inclined to assume that this meant that profit was a sharper delineator than equity. Rejecting this conclusion and looking at the dividend structures of some of the mutuals which do not make formal sub-line differentiations, I concluded that, at least in part, the mutuals, or many of them, achieve the same result informally through the dividend formula without establishing formal sub-lines. In other words, if you have different expense charges, lapse assumptions, means of advertising and acquisition expenses, in effect you have created a sub-line because you have created a different dividend class, even though it may not be labeled a sub-line in the company's internal reporting. A stock company, leaving aside for the moment questions of participating business sold by stock companies, is typically looking at its initial price or heavy excess interest credit, and seems to be more inclined to want to be able to track these through a formal sub-line.

Finally, when you are talking about sub-lines of business, fundamentally you are talking about investment income, expenses and Federal Income Taxes. The means that companies have adopted for budgeting their expenses, for expense control and for monitoring or putting together annual statement results have become increasingly flexible and susceptible to an extension to cover a definition of line of business which is as broad or detailed as you might want to make it. As a result, some of the very substantial clerical pencil-pushing that used to stand in the way of breaking down to finer and finer lines of business does not seem to be the factor today that it was 5 or 10 years ago. So, the interest in understanding what the results are can now be carried through to a conclusion without worrying quite as much about the clerical drawbacks. This is another factor which helps to explain the finer proliferation of lines of business that I have observed.

MR. JOSEPH F. CROWE: Until a couple years ago, I worked mainly in the Individual Life area, and there we really were not too concerned with the very fine breakdown. For the last two years, I have been in the Individual Health area, and we look at what is a smaller line with what seems like infinite detail. I am wondering if one of the criteria is that you have to break things down as finely as required until you obtain at least one line that has acceptable results.

Two other comments that I might make to supplement what Dan said relate to the coverage for the product you are selling and what need it fulfills. In the health area, disability income and medical expense are grouped together in the statutory statement. Obviously, the characteristics of these businesses are significantly different, and most companies separate them in their internal studies. Another consideration, that I feel needs to have some attention in the breakdown of earnings by line, is organization. One illustration might be the career agent-brokerage setup which Dan mentioned. If a company is organized so that there are separate career and brokerage operations, it is most likely going to be interested in seeing results along that line.

MR. JEROME M. STEIN: We have a few sub-lines that do not appear on the statement also, and we feel that it both helps our pricing and gives us a better feeling of the equity that we are achieving in our branch allocation. For example, for life and health, we have group branches, creditor branches, our small group and our smallest group. Each of these has its own life and health sub-branches for our own internal analysis.

We also keep records of the money we spend on our subsidiary activities in an effort to allocate to them a fair share of any expenses which we incur on their behalf. We have a number of subsidiaries, some of whom we provide services for and whom we treat like branches of business. Altogether, we can count close to 80 lines, sub-lines and sub-branches that we use in our analysis.

MR. ROBERTSON: One thing that some companies are doing for shareholder reporting purposes is to take out of each individual product line the surplus that has been earned in the past, and put it in a general corporate line. By doing this, you do not have to worry about which product lines pay the stockholder dividend and the trends of product line earnings do not get influenced by things such as stockholder dividends or surplus that happens to have been accumulated as a result of favorable past decisions. We have not done so yet and we may not do so, but the idea has a lot of merit.

MR. CROWE: I have to admit that I am not particularly close to this subject, but one observation I make, based on some discussions I have sat in on, is that it seems like a few years ago most of the discussions that I heard on this subject were in the area of getting the surplus out and treating it separately. Now the trend seems to be to allocate it by line and get it back to the line so that a determination can be made as to what the return on investment or surplus is for each of the lines.

MR. McCARTHY: We have done some work with one sizeable stock company that does what you suggest, Dick. They have maintained for some time a separate corporate account into which goes surplus earnings, and out of which comes such things as dividends to stockholders. Until fairly recently, that company, which has no participating business to speak of, allocated investment income among lines of business in proportion to mean liabilities for statutory purposes. They then had to reallocate this investment income in their GAAP statements in order to pull out investment income on capital and surplus. Their situation became considerably more complicated when they introduced the investment year method of allocation among lines of business for statutory purposes. This meant, in effect, that they had to create line of business fund accounts that would match the statutory definition of line of business and then allocate the surplus back to these accounts.

After dealing with this, they then had to confront another problem. Given that fund accounting on a statutory line of business basis means that you have to be able to attribute all of your income and outgo to statutory lines of business, they had to develop a philosophy for how they would allocate the stockholder dividend among lines of business. As a practical solution, they assumed that the stockholder dividend could be allocated among statutory lines of business in proportion to statutory earnings of the immediately prior year, treating negatives as zero. Fortunately, the company's history was such that the statutory earnings always exceeded the stockholder dividend. This will not always be true.

So when you have a substantially different definition for GAAP purposes than for statutory purposes, particularly if you create some kind of corporate account, you have to think through your allocation philosophy in two different ways and make sure that they are not completely inconsistent. And this will often pose some interesting questions.

MR. ROBERTSON: The next subject for discussion is systems and procedures that have been established for the allocation process. Jerry and I have talked some about this and I was very intrigued with some aspects of the Prudential system. Can you tell us a little about that?

MR. STEIN: There are two facts to keep in mind at all times when you are talking about allocating expenses. First, no matter how much or little time or money you spend, how simple or elaborate your procedures, the bottom line is the same. And second, the money has already been spent, the actual expenses have been expended. So the natural inclination is to spend as little as possible on the analysis that must be done. Anyone who has had the allocation responsibility has dreamed of the magic allocation formula which would accomplish the job by taking A times in-force plus B times new business plus C times number of policies plus D times mean monthly rainfall. If only we could find the right values for A, B, C and D, we could cut our staff by 90%.

Unfortunately, there are two good reasons why we cannot take this simple approach. First, regulations require methods which at least approach equity and which recognize the varied ways in which expenses are incurred. Second, the allocation process is crucial to the pricing of the products. Every dollar that is not charged to branch X must be charged to branch Y or branch Z. Remember, the bottom line will not change. I will describe two very different ways in which we have approached this problem in recent years.

In case there is some confusion, in the jargon of my company, the term branch is synonymous with line of business. So anytime I use the word branch please translate that as line of business.

The operations of my company are not only very large and diverse, they are also geographically dispersed among ten home offices in the United States and Canada. Our size and diversity may only differ in degree from those of other large companies. However, our decentralized operations present relatively unique expense allocation problems and opportunities.

The two biggest problems are gathering this information in an orderly fashion and maintaining a degree of consistency which is acceptable. Our home offices stretch from Los Angeles to Toronto and many of them have several separate satellite locations. The size of these home offices range from 800 to 8,000 employees, the median being somewhere around 2,000, and each has its own cost accounting staff.

On the opportunity side, because almost all sales and service transactions are in fairly homogenous organizations, each concentrating on a geographical region, a large portion of the company's total expenses are more easily allocable to specific branches or lines of business. Moreover, our size has permitted us, in a few cases, to dedicate an entire building or office to the operations of one branch of business, such as Group Pensions. Also, the corporate policy making is segregated in a distinct home office, the largest, minimizing the difficult problem of separating policy making overhead from line operations.

Over the last thirty years or so, since we decentralized our operations, we have tried two principal approaches to separating operational expenses for branch allocation. One approach was a transaction oriented allocation system. Identifying hundreds of types of transactions, we gave each a unit value which was intended to represent the relative cost of that particular job. The sum of the products of the transaction counts and unit values gave us the basis of distributing the actual cost of these transactions to branch of business. This system requires two types of maintenance. First, the relative values of the unit costs have to be frequently examined and adjusted if the results are to remain credible. Second, new lines of business or types of transactions have to be equitably added to the system as soon as they arise.

The other approach has been to derive the allocation of expenses to line of business as a by-product of our large budgeting, planning and expense accounting system. Before I describe how it produces allocations to line of business, let me summarize how its primary objectives, budgeting, planning and expense control, are achieved.

We have found that expense control is not satisfactorily achieved by either of the two ways in which a company is normally analyzed: organization or line of business. Line of business is an abstraction that is not easily budgeted for with units which service several branches. Also, we have found that organizational budgeting can lead to the undesirable emphasis or de-emphasis of certain functions in order to achieve budgetary objectives. Therefore, we divided the company's work into more than a dozen "businesses", which we call "activities". Some examples of these activities are individual insurance administration, group insurance, ordinary agencies and data processing.

Every organization plans and budgets for the work of each activity which it performs, and its expenses are charged to these activities. Management is responsible for its actual results as compared to its budgets for each activity. Each organization's activity plans and budgets must be approved by company wide activity heads who are senior officers.

The computer system which supports this expense control operation permits such accounting down to the detail of the section and even the individual employee level. After a division's, section's, or individual's expenses are allocated to activities, they are further allocated within each activity to line of business.

These allocations by organizational units from activities to branches are accomplished by whichever classical allocational methods are appropriate. Examples of such methods are transaction counts and time studies. The cost accounting unit of each home office assists the management of the operating divisions with their allocation procedures. These cost units, in turn, receive policy and procedure guidance from the corporate expense accounting organization.

I would like to conclude with the observation that the best way for a company to assure itself of equitable expense allocation is to have each line of business represented by a strong and knowledgeable executive. It is desirable that this executive be an actuary if the company's staff is large enough. Each branch executive should have the responsibility of analyzing the expenses allocated to his or her branch and objecting to the results that do not make sense. The balance of power created thereby will prevent grossly unfair allocations to any group of policy holders. It will not make the life of the branch allocator any easier, but it should make his results a lot more satisfying.

MR. ROBERTSON: Your procedure of allocating first to activity, and then allocating from activity to line, could help solve the problem that many companies face of managers being charged for expenses which they have no control over. Although, as you mentioned just prior to your close, there still is the problem of the line manager concerning himself with the way he is being charged expenses by the activities. Nevertheless, it sounds like an excellent system.

MR. CROWE: One of the things that we have found is that it is important to have a direct link between the planning and reporting functions as far as expense allocation and budgeting is concerned. If the budgets are allocated as reasonably as possible on a consistent basis with the way actual expenses are allocated, potential problems are highlighted early enough so that something can be done about them. You do not have to wait until after the fact to find out your expenses were higher than you expected.

I would like to make another point as far as the organization is concerned. In our life division operation, which encompasses the products sold by our life company to individuals, we have a profit center organization. There are three separate profit centers: health, annuity and life products, each encompassing basically all of the non-marketing functions. That cuts down the amount of allocation because instead of having one actuarial department, one underwriting department and one administration department, each of which has to have its expenses allocated among the three lines, each profit center has its own departments. Obviously this can only be done if size supports it. It also, along with Jerry's comment, means that there is someone interested in what the expense allocations are for that profit center and questions will be raised if unexpected results are developing.

MR. McCARTHY: If we step back for a moment from the giant mutual with $40 billion of assets and look to companies of not really small size, but somewhat more moderate size, some type of system which at some level is transaction based is about the only way to get consistent results. Now I agree with everything Jerry said about the fact that you have to have your eyes open and have the commitment to maintain that system when you put it in, or it will produce results which get increasingly crazy. It does take some maintenance time, but you really do get results that can have a degree of consistency that is hard to achieve by any other means. This is particularly true if your major administrative areas are handling transactions in a variety of these different sub-lines, for example, if you have par and non-par business, or you are accounting for pension trust or certain kinds of annuities separately. Inevitably, the transaction flows in these sub-lines are going to be growing at different rates, depending on what is being emphasized or what is selling better this year. It is very difficult to get consistency in this kind of a structure without some kind of a transaction basis.

The transaction basis has one more advantage, it enables you to do something which Joe just mentioned, to be able to test out next year's budget in terms of its likely allocation. You can take a look at the budget in terms of this year's transactions as a starting point, or better yet, projected transaction counts for next year. By testing using your transaction base system, you can see what kind of a line of business allocation you would obtain. If the results are reasonably consistent with where you thought you would be, you are probably all right. If not, at least you have an idea of where to look.

MR. ROBERTSON: Let us now talk about a couple of specific items and what procedures might exist for allocating those. The first one on my list is sales overhead. By sales overhead, I mean just about anything that might be considered a selling expense that is not directly allocable, such as commissions. It would include probably most of the staff of the marketing department, unless they work in a specific product area. It would also probably include agents' financing costs.

MR. CROWE: This is an area where we have spent a lot of time in recent years simply because sales or marketing expenses are such a big percentage of the total expense of most individual operations. Our basic conclusion is that, while equity needs to be maintained and be of primary concern, it is desirable to have a system that can be understoood by the chief marketing officer so that it is effective in planning and carrying out day-to-day operations as well as in allocating expenses that have occurred.

Several years ago we decided that it would be wise to at least take a first step in trying to tie in our pricing and planning functions, so that when we were preparing our budgets we could take the unit expenses that had been built into our prices into account. At this point, we had to have some sales numbers. We applied the unit expenses and came up with what we referred to as the budget guideline, the amount of money that the marketing department could spend if they were going to stay within unit costs and avoid having to face the possibility of a rate increase down the road. This worked very effectively for the first few years. It gave the marketing department a better understanding, when they were starting their budget process, as to how much they could spend, and I think was effective in controlling costs and reducing them from what they otherwise might have been.

One of the problems we ran into, though, was that through the year the objectives, in terms of sales mainly, never came out exactly as they were expected. So that we might have had a plan that called for us to meet unit expenses, but if we spent the dollar budget we probably did not meet unit expenses. We then started talking about a variable budget approach which would allow us to update the amount of money the marketing department could spend as we went through the year. We did this by reapplying our unit expenses and it led to nothing but confusion because of the fact that our unit expenses were fairly complicated. They were related to number of policies in force or submissions or premium volume, and it was very difficult for the chief marketing officer to go from his sales results to these revised expense objectives.

So we looked for another approach. I would like to briefly give you a simplified example of the type of approach we have been taking with some success. Assume that the ordinary operation of a company has three major product lines which it sells - life insurance, annuities and health insurance -and that the marketing operation is expected to spend \$20 million in the upcoming calendar year which is to be allocated \$15 million to the life insurance, \$2 million to annuities and \$3 million to health insurance. Let me further assume that the annualized new premiums expected from each line of business are $25 million in life insurance, $10 million from the annuity line and $12 million from health insurance.

As a starting point, to relate all marketing expenses to annualized new premium, we generate the following unit expenses for the three lines of business:

Life insurance: $15,000,000 ÷ $25,000,000 = $.60 per dollar of new premium.

Annuities: $2,000,000 ÷ $10,000,000 = $.20 per dollar of new premium.

Health insurance: $3,000,000 ÷ $12,000,000 = $.25 per dollar of new premium.

Obviously, this set of unit expenses is an over-simplication. It does, however, achieve two important things. It relates expected marketing expenses to expected sales and points out that the life line is expected to support more marketing expenses per dollar of sales than the health line, and health in turn supports more than annuities.

If the Marketing Department is expected to achieve unit expenses and not just meet a dollar budget, as a rough guide, these unit expense targets can be used on an ongoing basis. Assume that half way through the year the following sales results are being achieved:

Life insurance: 10% below objective.

Annuities: 10% over objective.

Health: right on objective.

If sales continue at this rate and unit expenses are to be met, the Marketing Department's adjusted budget becomes:

$25,000,000 (.9)(.60) + $10,000,000 (1.1)(.20) + $12,000,000 (.25) = $18,700,000.

That is, the Marketing Department must underspend its original budget by 6.5%. Underspending its budget is not the only choice. Sales results can be improved in the second six months. For example, assume the marketing department feels, that even with continued emphasis, the best result it can achieve in life insurance is 5% below its $25 million objective. This translates into an annualized premium shortfall of $1,250,000, and at a $.60 unit cost, $750,000 less of allowable expenses. The 10% sales overrun in annuities only covers $200,000 of the $750,000, so there is $550,000 left to be covered. How can this be done? Well, an additional $2,200,000 of health insurance premium would do it. Obviously, there are other options.

It seems to me that this is a much more effective way for the marketing department management to be able to control expenses. Assuming targets are updated from year-to-year and no tremendous variation from results to objectives is realized in sales, this system should be reasonably accurate compared to using a large number of units and a large number of lines of business mentioned earlier. Obviously, it can be refined and still be workable. For example, there may be different unit expenses for different products within the lines of business, e.g., pension and non-pension, term versus permanent. In addition, it may be appropriate to use a different unit than annualized premium or to use more than one unit. In all of this, however, it is important to realize that a balance needs to be struck between accuracy and simplicity, and it is important to resist the temptation to get too detailed a system to remain workable.

The important point here is that the Marketing Department management can use the relationship between its production results and its expenses. A sense of understanding and involvement can be generated easier than under a more complex approach. The system can be extended down to the level of general agencies and it can be used effectively to tie together planning, implementing, and reporting.

MR. McCARTHY: What happens if, when the year is over, despite all of the best efforts of the Marketing Department, there is an overspending of unit expenses or an underspending?

MR. CROWE: The expenses obviously still have to be allocated to the profit center. As I mentioned earlier, there is a profit center head responsible for each of the three product lines. If the Marketing Department underspends its unit cost objective, and it inures to the benefit of the profit center, that is identified separately as something that the Marketing Department contributed to profits. On the other hand, if year-end expenses are overspent it obviously impacts on profit, but it is something that is the responsibility of the Marketing Department and not the profit center head.

MR. McCARTHY: Consider for the moment two companies, each of which is primarily an ordinary insurance company with its own field force, be it general agency or branch, but which also has a group life and health operation of some size. Consider the questions that these companies face in allocating some field costs (agent financing, some other general agency costs, etc.). The point to stress is the fact that your answer can depend heavily on your objectives. I will give two illustrations of different approaches that could be taken.

Assume for purposes of the example that while virtually none of the ordinary business is brokerage produced, a great deal of the group business, but not all of it, is brokerage produced. Company A elects to allocate all of these costs to the agency organization. They should be related, therefore, to some index which reflects the sales results of that organization, for example, the first year commissions paid to that organization. And so they take first year commissions, ordinary and group, generated by the sales of the agency organization and they allocate these expenses to the ordinary and group lines of business in proportion to first year commissions, leaving out the brokerage business in group. Company B says sales are sales and commissions are commissions. Let us simply take all of our first year commissions, never mind the source, and then take this block of money that we had to allocate, which as it happens comes from only one of those sources, and allocate it across all of our first year commissions.

Both A and B are real live cases. It is obvious that Company B, which is allocating this expense across all of its first year commissions, is going to be contributing less of these expenses to ordinary and more to group than Company A. Both A and B regard their results as deliberate rather than accidental, and maintain that they are consistent with the objectives of the company. A's objective is to have a very competitive group product and to charge group with only the expenses that demonstratively flow from the sales of the group product. B says that its objective is to take the sales organization, which is related to the primary reason for the company's existence, and to say that brokerage sales are really kind of accidental, not withstanding the fact that they are 60% of group sales. Therefore, all lines ought to bear the cost of the sales organization which is related to the company's primary purpose.

My point is not to argue for A or B, but to say that there are a fair amount of examples that you can find of Company A or Company B, and not just in the particular case I have given you of ordinary and group. It does mean that you have to think through what your objectives are and what you are doing. We have also found a couple of companies which fell into the Company B category by what I would call historical accident, and probably if they had had Jerry's technique of having a reasonably strong person looking over what was happening, they would not have stayed Company B, or at least they would have had thought about it for awhile before simply moving ahead. This often comes about when a company first gets into a new line of business. For many companies twenty-five years ago, group was a new line of business and it did not matter much in year one and not very much more in year two. By the time you get up to year twenty it matters a great deal. If somebody has not had the responsibility for reviewing that question between year two and year twenty, probably nobody has ever looked at it.

MR. STEIN: On that last point, as we all note, the New York regulations do allow certain types of marginal treatment for new lines of business. The only problem is that "new" is not defined, and as you point out, a lot of new lines remain new for longer than they can be justified. The branch actuaries that I mentioned before are a major factor in controlling improper allocations in this field also. We try to charge these non-commission, non-override type of expenses to the lines that we feel benefit from the money being spent. So, for example, new agents training allowances most desirably should be charged against the branches of business that those agents will be selling and servicing in the future. Obviously, this is impossible to do since it is necessary to wrap up the allocation of each year's expenses soon after the year is over.

However, there are certain things that could be kept in mind in doing these allocations. For example, if you were, as some companies have been known to do, to restrict health insurance sales to agents with at least two or more years of service, and if you were using a new business basis for part of your training allowance, you might not charge your health lines proportionally as much as your other lines. This is because you know that for a couple of years these agents will not be producing any business in those lines. We again come back to this control that I mentioned, we feel that our responsibility is to explain to our branch actuaries why we are taking a certain path and we expect them to argue with us. And we expect to defend our allocations. If we find they are not defendable, we feel the system is working and the adjusted results are even better.

MR. ROBERTSON: Let us take another specific. Consider Federal Income Taxes. What approaches are being used to allocate Federal Income Taxes?

MR. McCARTHY: I will start with a specific example which was reinforced in my mind yesterday when I attended the discussion on dividend philosophy, and there was mentioned the problem of a stock company which has participating as well as non-participating business. Take a stock company with substantial par and non-par lines that has either separate fund accounting for these two lines, or at least has some limitation on the transfer of earnings from the policyholder lines to the stockholders. Federal Income Tax allocation can be very important because it has a direct effect on stockholder earnings, and, in the long run, it will have a significant impact on policyholder dividends. Most of the conventional means of allocation, including a separate company or a company wide marginal rate approach, will work quite well when these par and non-par branches are defined as separate lines of business and are in the same tax position as the company as a whole. However, the possibilities are far more varied when this is not the case.

Consider, for example, a company which when taken as a whole is taxed on Taxable Investment Income plus 50% of the Gain from Operations in excess of Taxable Investment Income, and that the non-par business of the company considered as a separate company would also be in the same tax position as the company as a whole. But, the par business considered as a separate company would be taxed on Taxable Investment Income less $250,000 and would have unusable policyholder dividend deductions below that point.

When this case arose in real life and we had to consider how to allocate Federal Income Tax between par and non-par, there were three possibilities considered which had widely differing effects on the relative equities of the policyholders and the stockholders. The conclusion of the company's accounting firm was to say that the life insurance company's Federal Income Tax was really a tax on Gain from Operations, so they simply proposed to allocate the tax in proportion to gain from operations after all deductions, including full recognition of dividends. This minimized the tax for the par line because they get full credit for the dividend deduction which would not have been allowable treating them as a separate company. The company's solution was to allocate tax to the par line, treating it as a separate company and giving it no credit for the unused dividend deductions, and to allocate the balance to non-par. This, of course, maximized the tax on the par line and therefore minimized the tax to the stockholders. My solution, which at least had the merit of falling between the other two, was to allocate the tax to the par line initially the same way the company did, but then to give the par line $.50 on the dollar for the unused dividend deductions. The argument was that the unused deductions were not of any benefit to the par line by itself and also were not of any benefit to the non-par line by itself, we go half and half, and at least wind up somewhere in the middle. It happened that the company and the accounting firm, because neither could sustain their own position in light of the other, ultimately opted for the compromise and we thought we had it all worked out. I might say by way of parenthesis, that in the following year the tax positions of both sublines in the company changed, so it turned out that we did not have a long range solution after all.

MR. ROBERTSON: At this time I invite questions from the audience, questions or comments on any subject in the area of expense or earnings allocation by line of business.

MR. JAMES W. HUTTON: Should a product line ever be considered on a marginal basis, or should it carry its own share of overhead? I would like some thoughts on this.

MR. CROWE: My feeling is that if this should ever be done it should only be done rarely. One of the main reasons this question would be raised is if the particular product line is not competitively priced to start with. If the result of using marginal pricing is to make it more competitive, there is a chance that it could grow substantially enough that it becomes a very large proportion of the total and it is very difficult for the remaining lines to absorb the overhead. I would also be concerned that maybe some of the fixed costs or overhead were not all that fixed. One final comment, it would be wise before seriously considering this approach to be sure that the expense allocation is reasonable so that the appropriate expenses are being allocated. And if they are, then address the basic question, are expenses too high to start with?

MR. McCARTHY: I think there are a couple of distinctions that need to be made in dealing with this subject. The first is between what I would call internal and external overhead, and the second is between allocating for pricing purposes and allocating for earnings' reporting purposes. I will use internal overhead to mean costs related to the operation of a line of business as opposed to the company as a whole, but which are not transaction related. That is, they are not directly related to the selling or servicing of the transaction level line of business. It could include overall direction of the line, supervisory functions, perhaps some actuarial research and a variety of other things. With a line of business which is relatively small, it will often be the case that the superstructure which operates that line would not necessarily increase very much in expense cost, setting aside inflation for the moment, if the line were to be increased significantly in size. For pricing purposes, if you do not recognize this and make some reasoned judgment, you will simply never have a competitive product and you will have a cyclical effect, the line will get smaller and the problem will get worse. If you really want to drop that line, you should probably face the issue and drop it and not let it orphan itself by this process.

Whether or not you follow through and use the same marginal allocation for earnings reporting is a more difficult question. It seems to me that for internal overhead of the type I have described, it is probably wrong to attribute it to anything other than the line of business if, in fact, the people work only on that line of business. It is very hard to construct an argument for doing anything else. That means that the company has to accept, for the short run, a negative earnings target for that line until it will turn itself around. It may even mean that, at the price of staying in the line, you need to be willing to write off some irrecoverable losses after a few years. But I think the key, at the outset, is to price the product judgmentally bearing in mind the possibility of reasonable growth, and see what that does to your earnings.

MR. STEIN: A little bit of marginal costing is like a small dose of heroin, it is still habit forming, and once you start it is almost impossible to break the habit. There is no place to go once marginal costing is agreed to for competitive purposes because every product line is the darling of some part of your marketing organization or some part of your executive organization. A good reason can be brought up for marginal costing just about anything in your portfolio, including your biggest line which might be ordinary life. And it is a lot easier to say no if you have always said no. Once you break that barrier you will have problems.

I referred earlier to the New York regulations which provide some specific opportunity for relief from certain types of overhead expenses. Here, management sense has to be applied largely to how long a new product remains new. If you do not price a product properly, you are going to lose money, and you may as well know that you are going to lose money. Once more, I refer back to the strong presence within your organization representing each of the lines of business so that marginal costing for one product will not slip through without powerful forces objecting. That huge lump sum of expenses that is not easily allocated still has to be paid for by some group of policyholders. Your first step down this road makes it very difficult to maintain the integrity of the rest of your system.

MR. ROBERTSON: Would anybody else in the room like to contribute to this question of whether marginal costing is ever appropriate?

MR. BERNARD RABINOWITZ: We own some small affiliated companies, and part of the problem we have had is that the smaller companies have a very high overhead. Quite often, when we price products for these affiliates, we are told "do not worry about the aggregate costing method, we know it is going to show negative earnings, but on the marginal basis we are going to show profits and at least we can justify some of that overhead." What do you do? You have a company with an underwriter working 75% of his time and really not doing too much. For the remaining 25% of his time, would you give him some business to underwrite? What happens is that the overall earnings for the company does tend to go up a bit, even if the business is a loser on the aggregate costing method. We have never been able to reconcile this problem, but it is the sort of problem that any growing company has.

MR. McCARTHY: In relation to what Jerry said before, I think it is important to differentiate between marginal costing of the type that Bernie has described for pricing purposes, where you can make real arguments for it, and for line of business allocation purposes where the argument is much harder. I also agree with Jerry, though, that once you put your foot in that path even for pricing purposes, you need to have some kind of a philosophy to stay with or it will become worse and worse. For small companies of the type Bernie described, we have tried to work on an actual to expected basis. We develop a set of unit expense rates that we believe would be respectable and competitive if the company reaches a certain size, and have urged the companies to measure the degree of their actual expenses from year to year, adjusting the unit expense rates for inflation. This way they can see both in absolute dollars, and as a percentage, whether they are gaining ground or losing ground toward the ultimate objective of being able to cover their expense rates by their business in force. If you do not develop some kind of a measuring rod like this, then all the cautions about one dose of heroin, or a little bit pregnant, or whatever, apply up and down the line.

MR. STEIN: Joe's point is also worth reiterating with respect to this example. Once you do the marginal pricing to get the benefit of that 25% to help with your overhead, you had better hope that it does not go much over 25%. If the marginal costing makes it a popular enough product, you will find that your margin has disappeared and that you are selling a losing product which is very popular with your marketing people. So if you can be sensitive enough to watch what is happening with this marginal costing you might have a chance of succeeding in your objectives, but it is awful tough to pull back on a product that is selling.

MR. WILLIAM O. BURNS: The word accommodation has to be thought about a little bit. You can design a line or product that you do not expect your agency force to use very often, but that needs to be there as an accommodation in case they run into a certain situation. As long as the overall profitability of the organization and the favorable attitude of the agency force increases because of that accommodation, this is desirable.

MR. McCARTHY: How would you measure the profitability to the company arising from the improvement in the attitude of the agency force from one accommodation product? I understand what you are saying in theory, but it could be a difficult thing to judge and practice.

MR. BURNS: Well, one way is increased earnings.

MR. McCARTHY: Yes, I was questioning not the result, but the source of the results.

MR. JOSHUA JACOBS: In connection with allocations, how important is it to allocate between group life and group health when, as a general rule, you cannot sell much group life without the group health in a combined sale? It seems that most companies show much greater earnings on group life than they do on group health in their reports. But, is this not based on some objective decisions as to how the expense is being allocated between these two very major lines when the sale is nearly always combined, and there is no choice of dropping one line and keeping the other line as a practical matter?

MR. STEIN: Recognizing the current marketing practices in the group business, there is not any one company that sells moduals in units of X times A and B. There are significant mixes in type of benefit, particularly on the health side of a group contract, that are selected and in the cost of those benefits. Equity demands that there be reasonably good pricing of the two pieces separately. There will be equity and marketing problems if an assumption of a mix is made and a good client wants a different mix, which would cause your total package to look unattractive given the mix assumptions you have chosen. That is the big danger I see in forgetting about the difference between the two lines.

MR. McCARTHY: I agree with what Jerry says, and I believe that they are typically sold in conjunction. I believe the way to deal with this is to recognize the differences in terms of the target earnings that are established for each line, rather than to try to fix it through the expense allocation. You deal well with the point Jerry makes about a whole differing mix of coverages if you allocate the expenses as best you can and then recognize the combination realities in terms of what you should expect at the bottom line for life and health, possibly even not having separate targets for the two of them, but merging the total expectations.