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LIFE (AND CASUALTY) COMPANY ORGANIZATION FOR THE 1980's

Moderator: C. DAVID SILLETTO. Panelists: FRANK W. BARSALOU, JACK V. MASTERMAN, C. NORMAN PEACOR*

1. The Emerging Managerial Environment - What will the life and life-casualty company management environment be in the 1980's, and how will it differ from the past in terms of:

    a. Available manpower, professional and managerial skills?
    b. Marketing?
    c. Distribution systems?
    d. Products?
    e. Lines of business and other diversification?

2. Emerging Strategies - What new strategies are called for, and how will goals change with respect to:

    a. Profit?
    b. Surplus levels?
    c. Growth?

3. Emerging Organization - How should companies organize for the future?

MR. C. DAVID SILLETTO: Welcome to Concurrent Session D on Life and Casualty Company structure and organization in the 1980's. On my left is Frank Barsalou who is pinch-hitting for Dave Carpenter this morning. Frank is the Vice President in Corporate Marketing with the Occidental Life Insurance Company of California. On my immediate right is Norm Peacor who is Executive Vice President and Chief Actuary of the Massachusetts Mutual Life Insurance Company. On his right is Jack Masterman, Executive Vice President of the Mutual Life of Canada, and I am Dave Silletto, President of Lincoln National Life Insurance Company. Our first speaker this morning, speaking on Question One is Frank Barsalou.

MR. FRANK W. BARSALOU: The amazing change that we have all experienced in recent years has been one thing in terms of how it has impacted our personal lives, but it is still another in terms of how it has impacted our companies and the industry at large. Whoever thought, for example, that our mighty oil and steel industries would be staggered by the foreign competition. Whoever thought that our savings and loan industry would be out of the first mortgage business. Whoever thought that the average house in California or Florida and in some other Sun Belt areas would be valued at about $100,000.00, that more than half of our married women would be in the work force, that IBM and Digital Equipment Corporation would be marketing computers through retail stores, that a $500.00 hand-held computer would have many of the capabilities of a 1960 model multi-million dollar super Univac which required thousands of

*Mr. Barsalou, not a member of the Society, is Vice President of Occidental Life Insurance Company of California square feet of refrigerated space to operate, that Prudential would be in the stock brokerage business, that the prime rate would reach 20% twice in a period of a year or two? On and and on it goes. It really is a brave new world. Most challenging of all, I think, is the fact that this change is accelerating as we go. How is this change going to impact our industry at large and our own companies within the industry?

As I see it, there are three powerful engines of change. The first of which would have to be inflation and the attendant volatility of interest rates. Today, the whole spectrum of financial industries is inflation driven. In our own industry, the shift to term business, the new trend toward universal-type products, and the increasing interest in mass marketing and multi-product marketing are obviously inflation-oriented responses. The second major engine of change is technology, primary information management and communication systems that offer us the potential of increasing productivity, not only in the home office, but in the field, as well.

The third major area of change would have to be changing lifestyles and consumption patterns. This involves family demographics, the changing age pyramid, the change in the number and composition of households, etc. It also involves changing work and employment patterns, changing attitudes about work, about retirement, about mid-career changes, and job mobility, etc. And, of course, it involves income spending and savings patterns as they have evolved, the way we are responding as individuals to the inflation, the growing number of households, and the role of working wifes as consumers, etc.

These prime movers that I have just mentioned obviously have a direct relationship to insurance marketing and distribution and to the financial structure of our life insurance and casualty business. For example, today, at least half of the population on this continent is not called on by a life insurance agent. Most of us in the business are seeking to sell the upscale market, which constitutes only about 5% of the households and only about 20% of the disposable income. The largest market segments, the middle and lower income groups, are not getting the attention that they deserve. Another area of challenge involves the fact that the cost of one-on-one life insurance marketing today is uneconomic for at least 75% of our typical agent field force. An agent simply cannot afford to go to the kitchen table to sell a $50,000.00 term policy. When IBM and Digital Equipment recently came out with their new lower priced, lower-margin line of computers, they found that their established reps. could not make a living selling at the commissions associated with those new products. So, in the period of the last year, these two companies have established a chain of retail stores as an approach to that problem. Agent turnover, the cost of financing, and the cost of training are getting more difficult to pass on to the consumer. Another area of challenge and opportunity involves changing consumer needs and preferences. People want more living insurance, later life coverages and service, more realistic cash values, tax shelters and tax features, more estate protection, etc. There is a growing interest in personal financial planning, a role which many of our agents have assumed in the past. But the quality of agent counseling needs to be improved; our customers are more sophisticated, and their needs for financial counselling more demanding. We need more efficient delivery systems. One-stop shopping for financial services is a subject of current interest. Time-saving sales and servicing via the electronic media and the mails lie just ahead. AT&T and cable systems will provide a two-way communication capability into the home; the marketing potential of these developments is enormous. The average consumer is looking for a more centralized source of commonly needed financial products and services. We are going to see more segmented product and marketing emphasis.

Another area of challenge involves the subject of agent income. Based on their total commissions today, the typical agent in the United States is not making a very good living. Agents have not kept up, in real terms, with the inflation. Even worse, they are not competing successfully with other industries in terms of average salesman income. The average agent in our industry needs a working wife, a real estate license, an inheritance, or some other form of good luck to make it. This further exacerbates recruiting, retention, and financing problems, about which we all know too well. If we did a return on investment analysis for each of our field representatives, we would find out how serious the problem is, not only from the agent point of view, but in terms of our invested capital.

A final area of challenge involves the impacts of inflation on the financial structure of our companies. Inflation is the basic cause of our policy loan situtation and has worked to erode bond portfolio values, etc. Its impact on overhead costs needs no comment.

Problems that have occurred as a result of this change about which I have been speaking constitute a threat to many in our industry. To others, however, they present great opportunities. Successful companies in the years just ahead will respond in an appropriate manner. The successful company of tomorrow will probably be more multi-product marketing oriented. While the typical company will not be "department stores of finance", they will likely offer a broader line of financial products and services. Life companies are going to have to respond to the changing posture of brokerage firms and the banking and savings and loan firms, as we move through this era of deregulation.

As I previously mentioned, personal financial planning will serve more and more as a lead-in to multi-product selling. Prudential, as you have recently read, is now marketing a $20.00 simple will package. It is likely that they have not done this to make money on the product alone; it is a way of getting information about the customer as a lead toward the sale of life products, casualty products, and other kinds of financial services and products. Multi-products marketing is going to be essential to increasing the income base of the typical agent in the field today and to increasing the company profit opportunities. Mass marketing is more and more a byword throughout the industry. We need programs to support the existing field force. There are mass marketing programs available today that are compatible with agency system-type operations. But in addition, we are going to see more mass marketing programs that consummate sales via mass media. How else can we reach those huge middle markets that are not really properly penetrated today? Finally, as previously mentioned, the advent of communications to the home owners is going to have a very significant impact in terms of changing our minds about the value of mass marketing as a means of reducing unit costs of distribution and overhead operations in the home office.

Electronic data management and communication present a significant area of opportunity for those who are capable of keeping pace with the state-of-the-art. We have to find ways to increase productivity, not only in the home office, but in the field. The average agent today spends only about 10% of his time in prospecting and selling; this figure must be improved. We must get more cases per agent. We must lower the cost of issuing and servicing the products that are sold. The time is not far off when individuals in the field will be issuing proposals at the point of sale; they will be underwriting at the point of sale and actually issuing policies at the point of sale.

Another great area of opportunity and challenge involves our ability as an industry and as companies within it to attract the kind of people which it is going to take to operate successfully in the more complex business environment which has evolved so rapidly. We have to find better ways to attract professional people; actuaries, systems analysts; good management trainees, etc. We are going to have to consider terminal contracts instead of life-time employee arrangement situations. We are going to have to think in terms of incentive pay programs and employment in the home which will become increasingly common with the use of terminals. We need fewer people, we need better people. The same is true insofar as the field is concerned. We need better training programs for these people. Thought should be given to programs to keep them on salaries instead of on a commission basis through the training period. We have to be able to show people that they can make a living before we can recruit them, and then we have to come through with this income potential if we are going to retain them.

Insofar as the companies themselves are concerned, there will likely be fewer of us in the industry. The economics of operation are going to become more rigorous and severe as time goes on. Current product and marketing trends, along with the need for more automated market support, are going to require capital resources that are more commonly available in the larger and more well-established companies. Even so, many of the established companies that want to do some of these new things are going to find themselves lacking in the required skills, facilities, and resources. As a result, a great deal more acquisition activity and more joint venturing will likely occur.

In conclusion, we must move with the current tempo of change or be buried by it. Our industry is an old and mature one. We really have not had to do much different over the last number of decades. Those of us who stand still are bound to suffer. Today, we are responding primarily to inflation and the impacts of inflation. Who knows what we will be responding to in 1985? Impossible as it sounds, perhaps it could be deflation! In any case, the future is for realists; it is for those of us who are willing and able to accept change and to respond accordingly.

MR. JACK V. MASTERMAN: I think Frank fairly well covered the waterfront. I agree with him that we are in an era where there has never been as much pressure on the industry, in fact probably all institutions, but we see it in the marketplace, on the products, and in the distribution system, etc., everything that Frank spoke of. I read an article in the Probe Magazine recently written by George Joseph, and he said, "Do not tell me of the changes yet to come, we are already living with them", and I think that is only too true. In that environment, it is extremely easy to be pessimistic, and I was glad that Frank ended on an upbeat note because I feel rather optimistic about it myself. Those companies who are prepared to meet these challenges are going to thrive. Although one of the obstacles that we will have to deal with is the regulation environment, and I deduce that you have a tougher time in the United States than we do in Canada with some of the inflexibility there, but I think that may be an obstacle to progress.

The only other thing that I would add to the managerial environment, and it perhaps is peculiar to Canada, is a fractionalization of the country. We see more and more evidence of our agents and our group reps. telling us that their customers are so much different in their particular province or region than the customers elsewhere, and I do believe that companies are going to have to address that by perhaps some form of decentralization. But overall I think Frank has covered the waterfront very well.

MR. SILLETTO: Having some insight in the regulation both in the U.S. and Canada, I would concur that your deduction is correct about having more flexibility here than we have down in the States. Norm, do you have anything to add on this question.

MR. C. NORMAN PEACOR: I would just like to strike one final blow for the dinosaur. The concept of one-stop selling and mass marketing and the likes of it has its appropriate place. We are of the belief, however, that a concomitant with that will be the highly specialized company specifically targeting markets and maybe your upper 5%, Frank, but the two types of organizations will breathe together, if not live together, and there will be room for both. I have to mention it in that fashion because we have looked at the one-stop, the entry into the property casualty business, and several of these other things and have rejected them inasmuch as our field force is of a different type. I think there will be more publicity about the one that Frank is talking about, but the other will coexist.

MR. SILLETTO: In my view, sub-topic "a" deserves comment apart from the others. We have all been operating for sometime now in an environment where the supply of manpower, especially professional and managerial skills, is assumed to be in abundant supply. This arises for two reasons. First, we all are aware of the basic demographic fact that the so-called "post-war baby boom" is now entering its productive years in our business establishment, and substantial numbers of people seem to be in the marketplace. Secondly, that abundant supply factor is even made more apparent by some constriction on the demand side. In general, we are all aware of the economic ills that the entire country is struggling with. More specifically, our industry seems to be responding to the need for improved productivity, and this is certainly true in my company where major efforts are under way along these lines. We have corporate objectives that include reasonably ambitious volume increases achieved with a total staff count that will be less five years from now than it is today. As a result, I feel that this leads to an overwhelming emphasis on quality rather than quantity. When hiring needs are minimal and the supply seems abundant, the successful companies will be the ones that take the time to be selective.

My only comment on the other four sub-topics would be quite similar to Frank's. The change and the absolute necessity not only to react to change but to even initiate it will be the all important consideration. Personally, I have a very unclear picture as to what the specific details of any of the four sub-topics will be even five years from now. On the other hand, I do have confidence that there will be with us for a long time some evolutionary version of what I will call conceptually an "insurance agent". I do believe that there will be a continuing need, at least in a significant segment of the marketplace, for a personalized sales effort involving our products, perhaps some related non-insurance products and a collection of financially-orientated services -- the specifics as to which products and services that person will sell or how that person will be compensated are very unclear. In the final analysis, the public will be served, and we must be sensitive to their needs and provide products and services that are responsive to those needs and delivered through a distribution system that is not only economically viable but, in fact, competitive with alternative systems.

MR. MASTERMAN: The forces of change which Frank identified as constituting the managerial environment are reshaping corporate strategies and, in turn, goals with respect to profits, surplus levels and growth. We are all aware of the mounting pressure inflation puts on the cost of operating an insurance company. In addition, it is causing tremendous and irreversible change in the attitudes of our customers. As a result of it, they have shortened their time horizons for savings, increased their expectations for interest rates and become very cynical about the real worth of dollars to be delivered in the future. Pressures on their pocketbooks have made them more sensitive to cost benefit relationships, and the constant attack by consumerists on the traditional high savings forms of life insurance are not falling on deaf ears.

The marketplace for our products is changing rapidly, and it is sometimes difficult to determine what is cause and what is effect. Nevertheless, life insurance companies have been proacting or reacting by examining and adjusting basic fundamental corporate strategies. The reference to emerging strategies in the second section of the topics for this concurrent session seems particularly appropriate. As the changing scene is perceived by the corporate officers, they will adjust their corporate strategies, but it will be done in an evolutionary fashion. Successful ninety degree turns are rare indeed! However, at this stage there do seem to be some patterns developing in how companies intend to respond to changing market forces. There are at least five market strategies being pursued to various degrees, with companies adhering to one or more of them.

The first course is probably the least visible because it involves the least amount of change. It might be described as a business as usual approach but with possibly a narrower definition of the target market. Perhaps because of the increase in group coverages, the existence of government programs, the rising cost of maintaining a one-on-one system of distribution and/or the rising financial pressures on potential customers, these companies are redefining their markets. They generally come to the conclusion that they must focus on the more affluent section of the market to increase average size and so reduce unit costs. Through training and provision of support services, they direct their field forces accordingly. Obviously, they have come to the conclusion that there will always be a place for traditional life insurance products, with perhaps some minor modifications, so they will address the forces of change by penetrating more deeply the upper income market.

This is a market which is already highly competitive, and logic would suggest that competition will make it even more intense in the future. It may be possible for a company to retain essentially the same overall profit goal, and achieve it with a lower profit margin per unit applied to larger units per sale and more sales. The degree of success achieved depends upon the rate of growth, which in turn depends upon a competitive pricing position.

A second emerging strategic course for a company is to become a broader based insurer, and Frank referred to this. Over the few years there have been several companies, including some of the giants, who have moved into automobile and home owners insurance. Seeing the recent roller coaster results for profit and loss at least in Canada, one might suspect that the main attraction is not related to bottom line. The primary impetus for such a change likely comes from concerns for the field force. "What can we do to help our agents survive as the market for life insurance transforms to term insurance with low commissions?" One obvious answer is to provide more products for the agent to sell.

The company must face the question of whether it is going to become the risk taker for the automobile and homeowners' coverage or simply to provide the means for the agent to address the customers on a one-stop shopping basis. In other words, it will have to resolve whether it is the manufacturing concern or a retailer.

Those who choose to become manufacturers will have to define part of their profit goals and surplus level requirements in relation to the property or casualty lines. They will have the added advantage of being able to spread fixed field costs over the new product lines as well, provided sales for the life products hold up. In recognition of the more volatile nature of profit and loss in these lines, no doubt a higher surplus ratio must be maintained.

A third emerging strategy for a company is to define itself as a financial institution rather than a life insurance company. There has been considerable discussion recently about the blurring of the distinction between life insurance companies, banks, trust companies and stock brokerage houses, etc. There is no shortage of examples of this occurring in both the United States and Canada.

Life companies moving in this direction have likely concluded that inflation and traditional cash value life insurance are not compatible. Generally, this strategy involves highly competitive term and whole life products to address the insurance market, and flexible payment accumulation annuities or money market funds with new money interest rates to address the savings market. Some companies have developed single plans which address both markets in a unique and seemingly highly successful fashion.

A successful pursuit along this avenue requires several changes. Generally, agents' productivity will have to improve if they are to survive with the cheaper highly competitive and thinly priced products. The company cannot take a traditional view of existing business and the replacement potential. Obviously it is an easier strategy for a newly formed company to pursue than one with a large block of existing business. Nevertheless, an existing company cannot allow the existing block of business to freeze it into inactivity if it is convinced that this alternative is the proper one for it to pursue.

This alternative also changes the nature of the liabilities quite dramatically and requires a comparable change in the character of the assets. New money products will have to be supported by investments with current yields and with appropriate maturity dates through immunization strategy in order to minimize the investment risks.

A fourth emerging corporate strategy is to offer insurance and annuity products through non-traditional distribution systems. The basic change in corporate strategy on this avenue pertains to distribution system as compared with the third alternative which involves a change in product philosophy. In fact, some companies have successfully combined alternatives three and four and developed new products to be offered through non-traditional distribution systems. A good example of this is the E. F. Hutton Company offering a non-traditional product through its stockbrokers. Because the longer established companies are more firmly committed to their own distribution systems, this course is usually pursued by fairly young aggressive companies. Logic would suggest that it would be far more difficult for an established company to change its distribution system radically than to alter its product portfolio.

Finally, the fifth strategy is one of growth through merger or acquisition. There may be several reasons for companies to pursue such a course including the desire to expand geographically, have access to a different distribution system or market strata, or to achieve economies of scale. Judging by the prices paid in recent years, there is considerable interest in this form of expansion. In fact, many knowledgeable people predict a high degree of rationalization of the life insurance industry during the 1980's with drastic reduction in the number of separate insurance company groups. The pursuit of such entrepreneurial activity requires a very clear understanding of the sources of profit and its emergence and the required surplus levels. Otherwise, it is impossible to judge the real worth of a prospective acquisition.

Generally, any proposed change of corporate strategy will force management to focus more fully on these aspects. I suspect that the current volatile environment by itself is sufficient to cause management to pay more attention to its sources of profit and surplus level. It has been suggested that because of the complexity of surplus emergence in our industry we have less of an understanding of our position than those in other industries have of theirs. Although we may have been able to manage our corporate affairs in a looser manner in the past, the bottom line pressures will not permit this management style in the future. Looking to the future, it does not take much perspicacity to see that profit margins are going to be much thinner. The squeeze will be the result of many factors. Included among them are increasing competition, the shift to cheaper forms of coverage, costly consumerist demands, rising expenses, more liberal underwriting, the risks of re-entry term, new low rates for life style or non-smokers' plans and the costs of dealing more on a regional basis to address particular customers concerns.

It is difficult to pick out any countervailing force at all; everything seems tilted toward a unit profit margin squeeze. Companies must address this through such things as increased productivity, both at the head office and in the field, leaner organizational structures and innovative use of new technologies of data processing and communications to reduce costs.

The problem of maintaining appropriate surplus levels will be exacerbated by worsening persistency. The existing policyholders will be attracted by the new forms of coverage available and by such things as the lower non-smokers rates. Further, the increase in term sales will put more policies on the books which can be easily replaced without significant loss to the policyholders. Companies will find it essential to reduce initial costs to cut their losses on early termination, and trends to level commission or persistency hold-backs will likely develop.

All of these forces will force companies to re-examine the fundamental questions of why they are in business and what profit margins and surplus strength they must have to remain in business. Bigness will be viewed as a necessary survival goal; any strategy which will give the company greater control of the client will be pursued, as will any strategy which will give the company the flexibility necessary to cope with the rapidly changing world.

Because of the nature of the corporation, it may have been more natural in the past for stock companies to have a clearer understanding of profit goals and surplus requirements than mutual companies. Changing times and changing strategies will force both types of companies to be more precise in their thinking hereafter. In short, the era of bottom line management is upon us and will likely be with us for some years to come.

MR. BARSALOU: Jack's mention of the surplus ratio situation is really interesting in terms of what likely impact declining ratios will have on the ability of companies to grow, and to increase volume to work against overhead cost, etc. Many companies are going to find it difficult to grow because of their present surplus situation. Also in that connection, product development will be undertaken in the future with more of an eye to when and how soon products come into break even cashflow. Another thing that Jack mentioned that was very interesting to me was this matter of acquisitions. We are going to see a lot of terrible mistakes such as we saw in the acquisition era of the 1960's. People, including our own organization, Transamerica, getting into businesses we did not know anything about, such as the movie business, and the airline business, etc. It takes many years for management to adapt to the differences that actually exist in other kinds of businesses. Acquisitions that are consummated in the present time are very likely to not look so good in terms of the fluidity of the whole inter-financial industry structure as we see it going today. What might be a good acquisition today may not be so good in terms of what actually occurs five years from now. And also along the lines of Jack's comments and Norm's earlier on one of my subjects, I really do not think that ninety degree turns are very good. I would certainly agree with Jack on that point. We all, whether it is in our personal lives or our business lives must rely on what we have already learned and the skills that we have developed. The great pressure will be on executive management to adapt and control new activities as they are brought into the business.

MR. PEACOR: Many of the emerging strategies that Jack is talking about are going to rely not entirely on just what is done in the actuarial profession but in particular what is happening in the investment area. I do not know how it is in your company, but there is certainly a mental block that says the world out there has really and truly changed. We are passing through a temporary phase of disintermediation and illiquidity, and as soon as this is gone, after another couple of months we will go back to making long-term fixed rate commitments in the mortgage field. A long period of stability would be necessary before all of the people that got burned in this current crunch could consider going back to a long-term fixed rate investment. Long term may be five years. What is currently hurting the companies is the illiquidity of current investments. We are in a cash crunch. Replacements, lapses, and persistency problems are creating the specter that said it is now possible to have a run on the bank. Many oldtime investments, and oldtime may be starting 1980 and earlier and, in fact, for us it is 1981 and earlier as we measure up to the commitments we made back in '78 and '79, are essentially illiquid, and even in a valuation process it says if you apply a market value to an illiquid mortgage loan, it is worth x number of dollars. You may have problems realizing that as you try to sell it. The companies are, in my view, going through a very difficult period. Exacerbated by the competitive cost pressures on new products which make the old policyholders products out of date and subject to replacement either within the same company, and that calls for a project update, or by transfer to another company. I do not think that we have seen the end of that problem, and in fact, the universal life type products are going to make it even worse in the future, so I look at the current asset structure of the company and wonder just how good it is in a real crunch.

MR. SILLETTO: My company, The Lincoln National, is comprised of a substantial number of operating insurance companies, involving almost all lines of insurance, functioning in a holding company environment. We have just completed an extensive survey of our entire operations with the objective of more clearly defining the businesses we are in and the appropriate strategies for those businesses.

As a result, we defined some 14 or 15 so-called strategic business segments and then tried to evaluate those in a variety of ways. For example, we looked at such things as our competitive position in that particular business, the present and future outlook for that business from the standpoint of growth potential and return on equity and finally what appear to be the key factors for success in that business. Following that, we developed specific strategies that we felt would maximize our future prospects. This ultimately leads to the setting of specific goals as to growth and profits that are consistent with the strategies. We are now in our second year of this process, and I can certainly attest that it has had a major (if not dramatic) impact on our operations and very much in a positive way.

Financially, this has had two important impacts on our operations. First, we have come to realize that our capital is not an unlimited resource, and we must try to find ways to utilize that finite resource as effectively as possible. This is a difficult change in thinking for what has traditionally been a capital-rich company in a capital-rich industry. In addition, we have come to view return on equity (or return on investment) as the most important measurement of the effectiveness of our various operations. It seems to me that this is the one financial concept that ties together the three components of this question, profit, surplus levels and growth. We are incorporating it very heavily in our planning and pricing processes now, and we will continue to do so until something better comes along.

MR. PEACOR: It is always difficult to generalize on a question as broad as this one -- emerging organization. To talk about how companies should organize for the future implies that the individual has more than a local knowledge of what is taking place and is about to translate that into some kind of farsighted suggestion. Moreover, what might emerge as a structure for a mutual company in the 1980's could easily bear comparison with the already existing structures of stock companies. Vice versa is even a possibility, but I am under the impression, and in fact the belief, that such is not the case.

In my own company, the Massachusetts Mutual, we are wrestling with this question at the present time. If you will bear with me, I will describe the process and where we stand. First of all, any consultants that we have employed have told us that we are a highly functionalized company. Currently, we have about 14 main functions, and they relate to such items as actuarial, agency, personnel, securities investment, computer operations, real estate and mortgage, etc. We have long been this way, and it has been generally accepted until recently that this is a good way to do business.

A new Chief Executive Officer took over a year ago, and he has challenged this appraisal. He is much more inclined to look at an organization that is highly product oriented with what he wants to term as a bottom line responsibility for that particular product as belonging to a single accountable individual. To this end, early this year he did the obvious. He split the Group Division into its two component parts -- Group Pensions and Group Life and Health. This was a simple division and, for all practical purposes, existed at the time of the announcement. The difference was that he now has an individual particularly and personally accountable for that particular line of business.

The other product lines are not so easily separable, nor is the profitability and accountability so easily determined. Let me say as background here that for us, the other product line is essentially regular Ordinary Life insurance with some subheadings that will be spoken of in a moment. We do not have other specific major lines of business, such as credit life insurance, industrial insurance, individual accident and health -- to name but a few.

It is, obviously, easy to determine that Group Life and Health can be a profit center. The products involved are one year term insurance products, and the results are not only forthcoming immediately but, in the case of 1980 dramatically. The impact of decisions, positive or negative, takes place quickly and is readily apparent. The react time that Jack spoke of earlier is very quick.

In the case of Group Pensions, although the results are longer term, the nature of the current business makes it possible to measure the results on a short-term basis quite accurately. In large part, this comes about because the results are strongly investment oriented, expense fluctuations are small and mortality risks are born by the contractholder in many instances. The new money rate concept of Group Pensions makes the results very current, and even sales results can be influenced by day to day decisions. As with Group Life and Health, this product line is easy to structure, and it is not difficult to define the limits of accountability and responsibility. By the way, in the case of the Massachusetts Mutual, there are separate marketing field forces which provide the necessary sales objectives, and these are under the control of the head of that operation. So he has the whole package, actuarial, administration, underwriting, sales and he leans on computer resources as a service.

It is a truism that such is not the case with the Ordinary Life product line. It can be considered in our case that all but the actuarial function in connection with the Ordinary products report to a single individual. Those functions are agency, underwriting, policy issue, policyholder service and Ordinary claims. Such functions as law, personnel, computer and actuarial are really in the corporate basket. But here, the bottom line becomes very difficult to assess. Marketing or underwriting changes and decisions have long term affects, so it is impossible to predict 1981 results as a direct reflection of 1981 decisions, and you have to reserve future years for future decisions. The bottom line is a diffusion of what is taking place currently and what happened 10, 20, or more years ago. In fact, the profit center concept here becomes much more highly sales oriented as that is the most obvious function for monitoring and control.

Nevertheless, it is possible within the line itself to have some subparts where individuals can be accountable for almost all the pieces and, in some cases, even the bottom line. For example, a single individual could have the responsibility for disability income protection. Individual annuities and pension trust policies are two other areas susceptible to this analysis although these product lines begin to move along the lines towards longer term and lack knee-jerk reaction to current decisions. Moreover, it can be argued that these lines in and of themselves are too small to warrant the kind of staff and attention that a true profit center would require.

Finally, we have products that cross, for one reason or another, major product lines. We have, for example, our 2-9 lives small group product which is marketed by the Ordinary line, but which is essentially a Group product. As an Ordinary product line, it needs to be carved out of the Statement results by means of internal accounting mechanisms. The pricing and underwriting decisions of an Ordinary profit center head will influence the bottom line results in the Annual Statement of the Group Life and Health profit center head. If the organization of the 1980's is going to be product oriented, then some clear lines of demarcation for accountability need to be drawn. In the same vein, there is nothing like participating in a discussion between product profit center heads to determine an equitable, objectively arrived at allocation of overhead expense.

The product line organization is fine to describe, but it also has to be recognized that each does not exist in a vacuum. As each product line develops its own strategies, there must be a corporate referee to be sure that the total structure does not suffer as each line gets what it wants. Nowhere is it more apparent for a mutual company than in the development of supportative investment strategies. For example, our Group Pension line is very interested in high interest-bearing non-equity oriented investments in the corporate general investment account. Group Pension policyholders who want an equity orientation in their investment can select from our common stock fund, real estate account, or some other venture if one becomes appropriate. On the other hand, the Ordinary account is very interested in equity participation or opportunities both as a means of doing better than pure interest and also to recognize that the capital gains tax rate is less than the marginal rate on investment income. These two strategies are mutually independent, and if both succeed, then in the extreme, the corporate tax is larger than if both were treated as separate companies. Other items, such as the allocation for computer resources, can only be resolved at a corporate level where corporate priorities can be determined.

Under this type of structure, each major product line of business can begin the process of developing its own goals and strategies for attaining them. Sales goals, profits, rate of growth, contribution to surplus, internal organizational structure, personnel development can be clearly defined and accountability assigned. Since profit or contribution to surplus remains, I believe the single most important consideration, ways and means can be found to measure even the most arcane bottom line.

I would like to spend a few minutes to chat about holding companies and subsidiaries. This is in that area where at least the Massachusetts Mutual is trying to catch up with what has taken place so often as a stock company operation. We are finally in the process of creating a holding company which will contain subsidiaries for which functions are at this time largely undetermined. One of the subsidiaries, however, has been well enough defined to have the potential to serve as a defined profit center. M. M. L. Pension Life Insurance Company has been established for the purpose of writing tax-qualified business and avoiding the injurious tax consequences that Massachusetts Mutual is suffering under. It is now licensed in 25 states, and we continue to chew away at the remainder. The important point here, however, is that should the Group Pension business be written in this subsidiary, then we would have the most complete profit center orientation that is possible to define. That not only includes the question of sales results but the important function of investment strategies applicable to that line. The bottom line is quite clear and easily measurable. I know this has been done by other companies, at least in part, and my apologies to this audience for acknowledging what has long been evident elsewhere. The possibility of entering into the reinsurance business, splitting the Life and Health operation, or entering into some other enterprise, becomes a possibility. The real point that I would make of this whole process is that subsidiaries and holding companies will become even more of a factor in the 1980's, and some of the experimental uses are going to be interesting to watch.

I would be remiss not to speak of the tax planning function. Five years ago, tax planning was, at best, of minor interest to many companies. The unpredicted and unprecedent rise in interest rates as a result of inflation is generating unconscionable tax costs to companies. Reinsurance and modified coinsurance arrangements are suspect, and the industry is awaiting the Internal Revenue Service's rulings on this subject. I know our own consideration of subsidiary uses gets an impetus from tax considerations, and tax planning is an increasingly important part of my company's operation. You know, a million here, a million there, it all adds up.

Addressing the last topic on the agenda briefly, I think we will see a different type of individual performance by actuaries and other professionals. If there is a heavy trend towards product line accountability and responsibility, such can only fall on individuals. Those individuals must be trained and capable of making quicker decisions with clear ideas as to what the results are likely to be. In results oriented companies, people will themselves be motivated and rewarded for their results and will want such recognition. The other side of the coin, obviously, is that the reward for failure is as negative and obvious as one would expect from a risk situation.

MR. BARSALOU: On Norm's comments about investment strategy, I would like to venture the idea that we are going to have to become a little less conservative. More of us are going to be in the real estate business or whatever it takes to balance the situation in a more reasonable way. Another area of Norm's comments which I found extremely interesting was his whole concept of profit centers. Having gotten into the insurance business only quite recently myself, out of the consulting business, I was very much interested in looking at my own company's way of accounting for things, as well as those of other companies in the industry. I came to the conclusion that insurance management was not as cost accounting oriented in terms of product lines as our manufacturers. You go into a toy manufacturing company, and let us say they have a line of 10 basic toys. You will find they have a discreet accounting system for each and every one of those products in that line. They can tell you where they are in terms of profit and loss, in terms of return on investment or on equity at any given point in time. In our business, we do not do that and we are essentially a manufacturing company. We are manufacturing products and services which are intangible, but they are still products and services. I certainly agree with Norm that we have to move toward a better understanding of the financial aspects of the various products, the various lines of business, and the various divisions of operation. The typical insurance company way of handling it has lead to a lack of proper management information with which to operate the business effectively.

MR. MASTERMAN: We went through quite a major company reorganization in 1975, and I was reminded of our thinking on that occasion with some remarks that Norm made with respect to their organization. Prior to 1975 we, I guess, would be classified as a functionally operating company. I was the Vice President of Operations which included the actuarial functions and the systems, etc. There was another individual who was Vice President of Marketing. I often thought that he had a pretty tough life compared to mine. He was constantly under the gun for sales and retention of business, etc., and if anyone turned to me, I could simply say you know it was priced 20 years ago and do not look at me. So we felt that largely for the Group reasons we should reorganize by line of business. We established at that time a division for the Group simply

Our structure does lead to each of these segments being a profit center because they are self contained, and they are held accountable for the achievement of profit objectives. They operate, as I said earlier with only a minimum amount of shared resources. The most important one I think being data processing.

Almost complete operating autonomy is granted to the strategic segments. The control at the top, on the other hand, is almost totally financial in nature. The coordination of investment strategies, the allocation and management of capital, and tax planning are the three primary functions being performed at the corporate level. While we are still learning to function in this new environment, the results so far have been very worthwhile.

MR. BARSALOU: At Occidental, we have developed what we call OPAS, Office Profitability Analysis System, and this system seeks to determine the profitability or a relative profitability measure between products, and we stop at our 15th product which accounts for about 95 percent of the total premium volume. By field office, whether it is a GA or a branch, the system uses a discounted cash flow of premium income which takes into account persistency, mortality and all the other factors, and against that we have a system of cost accounting inputs which involve Home Office, Field Office, Agent Financing and other segments of cost. We get to a bottom line profitability estimate by product, and by office operation. We just put the system into place last year. It took us three to four years to develop the concept. It is not a finite manufacturing type, highly specifically reliable output, but it does provide a basis for a comparative ranking of profitability using the same set of rules for all products and for all field operating units.

In addition to that, just very recently we developed a return on investment and a return on equity, a measure for each of our primary lines of businesses. It is very difficult to assign equity and borrowed capital as it has been invested in each line, but again it is an attempt to look at productivity. It is an attempt to get a step closer to what you might call capital budgeting, which is putting your money or your new investment money where the profits are, than we ever had before.

MR. ROBIN B. LECKIE: Manufacturers Life is a mutual company that is organized on a product and territorial basis much as has been talked about this morning. In addition, we have a final product, which is surplus, being managed separately. Surplus represents the history of your company. Surplus is supported on the one hand by its own interest earnings, and it is supported on the other hand by certain charges against the product lines in order to keep the surplus at the level that is considered appropriate for the company. Certain taxes would be charged to surplus. We also charge 15 percent of a very narrowly defined overhead against surplus. That is a device to get around certain allocation problems by product, and we will also charge certain approved developmental costs when we are opening up a new line altogether.

We do not use the statutory reserves. Naturally we have our statutory management, but in the lines we are using cash values including the negative cash values in the first few years. We use pricing assumptions for expenses, and we have a functional cost analysis that defines it accordingly. We also have within the company internal because we believed that the marketing thrust could not operate in Group without the actuarial expertise and responsibilities. The primary advantage that we got off it was in the Individual area. We were in the midst of some thinking of re-working our product portfolio, pricing and some major changes in distribution system, and I do not think that we could have done it in the old form of operations versus marketing. When you bring them together as a line of business, you develop a spirit of teamwork that we have seen work just tremendously for us, and we brought some new products to market in fairly short order that would have taken another couple of years to do on the old form.

I was also interested in remarks you made, Norm, with respect to equity support for the Individual product. You alluded to the tax advantage there, and also some remarks that Frank made with respect to increasing real estate investments. Our products have changed quite dramatically, probably largely as a result of this change in product portfolio that I referred to in 1978, so that I guess about 75% of our Individual business is on a term basis, and most of the savings dollars that we are attracting are coming to us by flexible annuities. Our annuity premium income in 1980 was probably about 30 times what it was about 8 years ago, and we do not believe that that form of product is amply supported by either real estate or equity investment, and therefore, we move more to the mortgages and bonds.

MR. SILLETTO: It so happens that the time of this meeting also finds our company undergoing significant organizational change. We have decided to organize ourselves in accordance with these 14 or 15 strategic business segments that I mentioned earlier. Some further comments are in order as to what we really mean by this. To begin with, it is the antithesis of the traditional functional structure because each strategic segment contains all of the functions or almost all of the functions necessary to accomplish its objectives. Furthermore, our new structure is almost completely independent of corporate structures. In our case, we happen to have a multiplicity of corporations for a variety of reasons, and the existence of those corporations was not a factor that we took into account in defining these strategic segments.

A segment may be one line of business but typically would involve several lines in the traditional sense. For example, I manage our Individual Products Division sold through our agency force, and this involves the traditional product lines of Ordinary Life insurance and disability income. The distribution system will frequently define a strategic business segment. There are four primary life insurance companies in our corporation involving five life insurance strategic business segments and the products are fundamentally the same. The key differential is the distribution system. Those five segments that involve Individual Life insurance would be two within Lincoln National Life itself, one through our direct marketing agency force and the second our life reinsurance operations. A third then is Security Connecticut Life, a brokerage company operating through that distribution system, a fourth is the life affiliate of our property casualty company which sells life insurance strictly through its independent general insurance property casualty agents, and then fifth a strategic segment on its own is our Canadian affiliate here, Dominion Life.

notional funds for all new money products that goes right back to original time. We have just taken all products that were priced on other than a portfolio basis, including all our annuities and most of our pension products, and for our company that is over half our assets. This way we are able to get profit by each individual Ordinary line, and, while there are certain problems in our process, it is an indicator after making the surplus charges as to whether or not that line is self-supporting or whether there is room to start to improve dividends, and this enables fairly effective product management while still maintaining a degree of actuarial control on top of the company.

MR. HARLOW B. STALEY: In this morning's session, there have been many interesting subjects touched upon. Everything from Universal Life to return on equity and surplus requirements, cost accounting manufacturing style, and expense allocation, etc. The one comment that I seem to find running through all of these topics which has not been touched upon directly is the importance of the efficiency in our information systems, both in their design and in their implementation. The enormous dependence that we all have now on these information systems is mind boggling to say the least, and particularly as we implement the kinds of things that all of us have been talking about up here this morning.

MR. PEACOR: I would like to go back to one comment of Robin's. I keep mulling it over on this question of surplus and surplus allocation. It reminds me of the discussion I had at the Equitable where they carved up the surplus, and in their process of dividing the company up into profit centers, they took the surplus and said you each get a piece of it and then that becomes their own developmental source of funds or their own process of measuring profit and loss. I do not want to say that they do not have a corporate surplus because there may be one after they have carved it up. But they have, at best, allocated the surplus rather than said that each line has a zero surplus and each will make a general contribution to a general surplus. I think arguments can be made on both sides of that.

MR. SILLETTO: We have taken somewhat a middle ground on this. We have a recorded surplus that is the result of our past operations. In addition, we have used an actuarial analysis to develop formulas by line of business that we feel is our minimum required surplus to conduct operations in that line of business, depending on the current size of the portfolio and growth potential and so forth. Now the imputed surplus through the actuarial techniques bears no relationship to who earned that surplus in the past. Your charge then is to operate on the basis of the surplus that has been imputed to you by these other techniques. It so happens that our actual surplus is still in excess of the aggregate actuarially calculated minimum surplus, not a whole lot in excess but somewhat in excess. In evaluating lines of business and returns on investment, we use the actuarially calculated minimum surplus formulas that we have developed.

MR. DICKSON J. CRAWFORD: Our only subs at the moment are in the investment property management area, not in the insurance business. I am reasonably familiar with the structure which keeps your participating policyholders up in the parent mutual company and your activities downstream are non-par, eventually for the benefit of the par policyholders. I thought I had heard that in at least one mutual company structure, there were going to be par policyholders downstream in the subs. Just as a point of information, does the panel know if that is correct? It seems odd to me from the nature of the different kinds of policyholders, and if that is true, what are the reasons that might be happening?

MR. PEACOR: I will take NML Pension as an example. Our tax-qualified business, which is participating, may or may not be in the holding company, but our motivation is strictly taxes. We have an excess tax problem created by the way the Federal Income Tax Law works, a five-year average versus the current earnings rate. If it were written in the subsidiary, the worst we would pay is the tax on surplus, and we also operated from the belief that mod-co was not going to last very long. We are in it like everybody else, but if that whistle gets blown, in spite of our belief that it is appropriate to use in the tax qualified market, we are simply looking at this as a transfer of the nature of our business. The par and non-par question does not apply.

MR. WALTER S. RUGLAND: In the 1980's, we are going to see a great diversity in corporate management structures. If we have to categorize them, probably half of the companies are going to structure themselves with the product as the prime divider, and the other half are going to go with market as the prime divider, or as Dave said, distribution system. Depending on the company, each is as viable as the other, but the result of that prime determinant is going to create very different structures within companies, and one of the dangers that must be guarded against is that you do not want to look at your neighbor and see what they did because that is not going to fit to what you wanted to do.

Another observation is that within any type of structure such as this, it is important to have an understood basis of measurement, a basis to measure management performance, and that measure does not necessarily need to be something that is already existing, such as statutory, GAAP or something else, but it needs to be something that is understood, and can be related from one manager to the other.

Another trap that I have already seen existing is that any restructuring tends to create an enhancement of a corporate staff, and in many instances that corporate staff gets in the way of successful restructuring. The dilemma for the senior manager is to make sure that the corporate staff is there working but is not in the way, and that is something that senior managers are paid to do, and those that do it well will be rewarded well.

I think that by ten years from now, many companies will no longer have actuarial departments. We will determine that the skill of the actuary is not one that you lock into an actuarial department, and in fact, actuaries do many things functionally within an actuarial department today that go on perhaps elsewhere in different structures. We may end up not having actuarial departments and not having actuarial titles, but the actuarial designation itself will be even more important.

MR. RICHARD M. WENNER: There was much talk this morning about actuaries relating assets and liabilities together, not ignoring the asset side. In the current environment, and probably in the near future and not distant future, investment performance will be a key role in all our product profitability. In our discussion of a product profit center, I was not sure how the investment function was handled. Maybe you could comment a little about that. It seems to me you are really quite a bit away from a true product profit center as long as you do not have the investment function under the control of the profit center manager.

MR. PEACOR: In that regard, we have separated the cash flow of the company into two component parts. One is Group Pensions and the other is all other. There is not enough cash flow in the life and health, and the net result is that although we have a functional investment operation, it is very clearly and virtually in daily contact with the requirements and needs of each of the two major product lines. So the control is not there, but the conversation is.

MR. MASTERMAN: We have a flexible premium annuity which attempts to compete with the products of banks and trust companies in Canada, and the thing which sells it is the interest rate. Unless you are there, you are just not going to make your sales, so it is not just a matter of the profit margin that you are developing in conjunction with the investment area. It is, in fact, whether you are going to make a sale, and as a result of this, we have set up an arrangement whereby our actuaries are meeting at least weekly with the investment people to establish the interest rates that we can pay on this. It is essential that these sort of bridges be developed.