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NEW LINES OF BUSINESS IN AN ESTABLISHED COMPANY

Moderator: LARRY R. ROBINSON. Panelists: DONALD R. SONDERGELD, MICHAEL J. COWELL, JAMES H. CHARLES. Recorder: NANCY J. STOCKMEYER*

1. What is a line of business? Allocation along annual statement lines, profit center, insurance versus non-insurance functions.

2. Why should new lines be added? Company's capabilities and potential, customer needs, competitive aspects.

3. Resources needed--funding (start-up and continuing), delivery systems, support requirements.

4. Performance measures--earnings, return on equity, other.

This session will include discussion of the paper "Profitability as a Return on Total Capital" by Donald R. Sondergeld, which is to be published in Volume XXXIV of the Transactions.

MR. LARRY R. ROBINSON: Each of us is vitally concerned that our companies, or our client companies, are going to be survivors of the tumultuous 1980's. One of the keys to survival, for many of our companies, may well be the addition of new lines of business. The panel will consider some of the strategic implications of such a corporate decision. Our panelists will present views from a stock company, mutual company and consultant perspectives.

MR. DONALD R. SONDERGELD: Let me first provide some background information on my company. I'm the chief actuary of our three life companies, Hartford Life, Hartford Life and Accident and Hartford Variable Annuity Life Insurance Company.

These stock life insurance companies are owned by the Hartford Insurance Group, often called The Hartford. The largest company in this group is the Hartford Fire Insurance Company. The senior officer of The Hartford manages all worldwide life insurance operations. This includes companies in the United Kingdom, Germany, Holland, Canada and the three life companies that I work with in the United States plus another U.S.-domiciled company. Each of the operations is a separate profit center.

With that background in mind, let me now discuss new lines of business as they relate to the companies with which I work directly. Although these three combined companies represent a single major profit center, the profitability of our business is further managed on a line of business

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basis. Each management line of business is a minor profit center. The names of our nine management lines of business are: Individual Life and Annuities, Individual Health, Group Life, Group Health, Group Annuities, Special Risk Health, Variable Annuities, Claim Annuities and the Corporate Line. The first five should sound familiar to you as they follow statutory line of business definitions. The last four are separate management reporting lines of business that get combined in various ways with the other lines of business for statutory reporting. We therefore have more management reporting lines of business than statutory lines.

The reasons we have the various lines of business profit centers for management reporting are related primarily to marketing considerations and secondarily to administration. In most cases we have separate sales organizations associated with each line of business and we usually have separate administrative personnel who handle the administration of the lines. If a new market emerges that is related to markets served by an existing line of business profit center, there is usually internal pressure from the existing line of business to serve that market rather than any outside pressure at the corporate level to form a new line of business.

I should also mention that we are predominately market-oriented for our lines of business, but occassionally we are product-oriented. For example, if we develop a product to serve a target market, this means we are market-oriented. That is, the market is identified first. In the case of product-orientation, the product is developed first and we then find a market for the product. Sometimes we develop a product to use in a specified market and later see if there are other markets in which the product could also be used.

It might be helpful to tell you the background associated with the creation of our two newest lines of business. These two are the Corporate Line of business and the Claim Annuity line of business. The creation of the Corporate Line of business was related to our major performance measure Return on Total Capital, or ROTC. ROTC is the ratio of GAAP net income to GAAP capital and surplus for the total profit center. Since ROTC is the major performance measure for our total operation, we felt that it should also be the major performance measure for each management-reporting line of business. It was therefore logical to build this concept into our pricing, our profit-testing, and our monthly reporting of earnings on a GAAP basis. These techniques were described in my paper "Profitability as a Return on Total Capital." There I mentioned that it has been said that the primary job of management is to manage capital and that all other management functions should be related to that goal. The ROTC is an index used in measuring what the job management is doing. It is also a measuring-rod that can be used to compare the profitability of insurance and non-insurance operations.

As far as the monthly reporting of GAAP earnings for lines of business is concerned, the technique is quite simple. First, we know how much statutory capital and surplus there is in the total profit center each month. We have formulas that we use to determine how much statutory surplus is needed in addition to reserves to support the risks associated with each line of business. These formulas produce something we call "Benchmark Surplus" for each line of business. The excess of total

statutory surplus over the sum of these Benchmarks Surplus items is allocated to the Corporate line. The difference can be positive or negative.

I know some companies prorate this balancing item over all operating lines of business. We prefer to allocate the difference to the Corporate line so that each line of business manager will not have his or her results affected by the surplus position of the total company. This was the major reason for creating the Corporate line of business.

GAAP capital and surplus equals Statutory capital and surplus plus various "GAAP adjustments." The major GAAP adjustments are the prepaid acquisition expense asset, the difference between GAAP benefit reserves and statutory benefit reserves, and deferred taxes. These GAAP adjustments can usually be directly allocated to each operating line of business. Those that can't, and there are a few, can be allocated to the corporate line.

From an operational standpoint, the Corporate line of business is a stockholder. Each month, positive or negative earnings are transferred from the various management-reporting lines of business to the Corporate line. No line of business except the Corporate line retains earnings. Also, surplus is transferred each month between the Corporate line and the other management-reporting lines of business in order to cover the changes in Benchmark Surplus. The result is that, at the end of the month, each line of business has GAAP surplus equal to his Benchmark Surplus plus his GAAP adjustments. As you can see, gains or loses do not get accumulated from year to year in the line of business as surplus is adjusted each month.

If we were to form a new line of business, that line of business would probably have a low or even negative ROTC in its early years due to expense overruns and non-deferrable acquisition expenses. It would probably take a few years for the business to mature and produce normal ROTC's.

Our newest management reporting line of business is called Claim Annuities. Our parent is one of the largest property and casualty companies in North America and it settles a lot of claims. One method of settling certain liability claims is to provide an annuity benefit as part of the settlement in lieu of a total lump sum benefit. This often has tax advantages to the beneficiary of the settlement. The Claim Annuity line of business represents single-premium annuities that are sold by Hartford Life to its parent. The major reason this is treated as a separate line of business is that none of our existing sales organizations are involved with this product. It does not fit into their market definition. It is part of our Corporate line of business and represents an internal marketing effort within the total corporation.

Segmentation of assets is another reason for treating Claim Annuities as a separate line of business. You are all familiar with the reasons associated with having an investment policy of matching assets with liabilities. In order to more easily implement and monitor this matching, we have segmented the assets of the Claim Annuity line of business. I should also mention that we have segmented the assets of our Group Pension

line of business and have done some additional segmentation within the Group Pension line by placing Guaranteed Investment Contracts (GIC's) in a separate account. That separate account really operates as a segmented general account.

Again, the major reason for our having separate lines of business is related to managing our marketing efforts, but segmentation of assets can be a related reason. The ROTC is used to measure the profitability of our lines of business and, in effect, the performance of those managing the capital invested in each line of business.

Let me now expand on performance measures. I did indicate that the GAAP Return on Total Capital is our major measure of performance. However, we price our products using a predetermined Internal Rate of Return (IRR). This pricing is done on a statutory basis using the initial statutory drain plus benchmark surplus as our investment. The IRR is the return on that investment. In fact, the present value of the statutory transfers made each month between the operating line of business and the Corporate line for any product equals zero when discounted at the IRR applicable to that product. The monthly transfers of statutory surplus are made on an after-tax basis. My paper shows the relationship between the statutory IRR and the unlevel GAAP ROTC yield rates. In fact, the present value of these surplus transfers, when discounted at the unlevel GAAP ROTC yield rates, also equal zero.

There are many other performance measures we use. Let me spend a few minutes running down a list I have. First, a very important item is GAAP net income, for which we have a monthly budget. We break net income down by source and analyze variances to budget by source. Names given to these source variances are: normal profit, interest on GAAP surplus, excess interest, acquisition expenses, maintenances expenses, favorable mortality and favorable morbidity.

We also look at the income statement by line of business and examime variances in the various items producing net income: premiums, investment income, policyholder benefits, expenses, increase in reserves, federal income taxes and realized capital gains. We also report on net income for certain products within a line of business.

On some of our products where the profit is largely related to the excess of the net investment income that we earned over what is credited to policyholders, we express this amount as a percent of assets and compare such amount with a profit standard. We refer to this as lift-off.

We also have a first-year lapse index that is developed monthly and varies by sales organization. The actual results are tracked against a standard. We also have a renewal lapse index that we report on each month.

On new business, we take a hard look at the statutory Internal Rate of Return together with the incidence of expected Return on Total Capital. We also look at the present value of profits in relation to the initial premium and also as a percentage of each premium.

On health insurance, claim activity is carefully monitored. We look at the loss ratio of incurred claims to premium and compare this with both expected and with permissible loss ratios.

Another measure of performance is a monthly report on disintermediation which shows the ratio of policy loans and surrenders to cash values for various categories of our business.

Measures of sales performance vary by line of business. They are often related to new annualized premium, but for individual insurance the New York scale of first-year commissions is our basic measurement of sales. We also have a sales productivity index which relates sales expenses to production by maturity of the sales force. In addition, we look at sales expense by sales office as a percentage of new production and compare this against a standard of performance.

We measure our administrative effectiveness by monitoring the amount of time it takes to underwrite and issue a new individual life policy. We also have various measures for tracking and analyzing manpower and expenses.

We refer to the types of performance measures that I have been discussing as key indicators. If we add a new line of business to our operations, one of the first things we would do would be to develop a business plan that would include a projection of new sales, total expenses and net income. We would also develop appropriate key indicators for that new line of business and compare actual performance against budgeted performance.

In summary, marketing considerations determine whether we should add a new management-reporting line of business as a profit center. Although we use a number of key indicators in measuring the performance of each line of business, they are all aimed at our understanding reasons for variances in our major performance measure which is Return on Total Capital.

MR. ROBINSON: In case you haven't had a chance to read Mr. Sondergeld's paper, I really would recommend it to you. There's quite a bit of mathematics, but I think it is comprehensible and very practical. We will return just a little bit later to Mr. Sondergeld's contention that management's chief function is managing capital. I'm not sure there is unanimity of opinion on that.

MR. MICHAEL J. COWELL: I will address the following issues in the program from the perspective of a mutual life company:

1. What is a line of business?

2. Why would a mutual company enter new lines of business?

3. How is the profitability of lines, both new business and existing business, best measured?

The study of lines of business in an established company, existing lines or the addition of new lines, leads inevitably to the basic strategic questions that Peter Drucker says are fundamental to all economic enterprises, "What is our business, and what should it be?" and "Who are our customers, and who do we want them to be?" In this context, strategic planning for new lines requires us to rethink how we perceive our basic business purpose.

Over the past year or so, State Mutual has been addressing these questions as they pertain to the company and the role of each line of business in its group of affiliated and subsidiary companies. We have found that an understanding of where we came from and how we got to where we are today, while it may be only of limited value in projecting where we ought to go, can be most helpful in addressing these underlying issues of strategy. I'll come back to this point later.

Addressing the first question, "What is a line of business?", I will use as an example the company that I represent. State Mutual was, by most measures, a traditional mutual life company. Founded in 1844, it is the fifth oldest life company in the U.S. For the first hundred years we had only one line of business, individual life, and that line of business was almost exclusively permanent whole life and endowment. Somewhat like Henry Ford, we made our product available to our customers in any color they wanted so long as it was black.

Without attempting to come up with a dictionary definition, I would suggest that a line of business is a convenient grouping of products and services that a business enterprise makes available to an identifiable segment of the market in which it operates. This is not intended to be anything hard or rigid; rather, it's a basis or focus for the strategic decision-making about your business, about your customers, what business you are in, what business you want to be in, who your customers are and who you want those customers to be in the future.

In this sense, State Mutual had a simply defined business objective for the first one hundred years of operation. It was to sell as much of this one line of business through a traditional agency system as considerations of financial prudence would allow.

In those days of almost no inflation, 3% interest, negligible lapse rates and policy loans, new business sales were among the most significant determinants of inforce and growth. Our customers were predominantly small business people, professionals, executives, and the traditional head of the family unit that for the first half of this century at least, looked to the life insurance industry to provide a means of protection against premature death along with an incidental, but important, element of savings. Indeed, State Mutual operated at that time much like many of the established mutuals, and some idea of the concerns of our companies can be obtained by looking at the meeting agendas of our own profession at the time.

At the risk of focusing too heavily on history, I'll just cite a few of the examples of the kind of issues that our predecessors of thirty or forty years ago were contending with. One was whether the Commissioners Reserve Valuation Method should be adopted by a mutual company which had

traditionally used the Net Level Premium method. That was a very serious issue thirty-five or forty years ago. Another was the extent to which mortality decreases under life annuities were offset by interest margins. I cite these issues not to make light of those problems; they were significant in their day and I am not trying to elicit a sense of nostalgia for the simplicity of the good old days. Rather, I want to lend some historic perspective to the issues before us today.

At that time, just after the Second World War, State Mutual, with just over a quarter of a billion dollars in assets had about three quarters of a billion of life insurance in force which was generating about thirty million in premium income and deposits. Our average individual life premium was $33 per $1,000 of insurance. So it is no wonder that some people still in the business today have had to resist the temptation to look back with nostalgia. In addition to that thirty million in premium and deposit income, we had net investment income of nine million, for a total income of forty million dollars from which we derived a statutory net gain of just over three million.

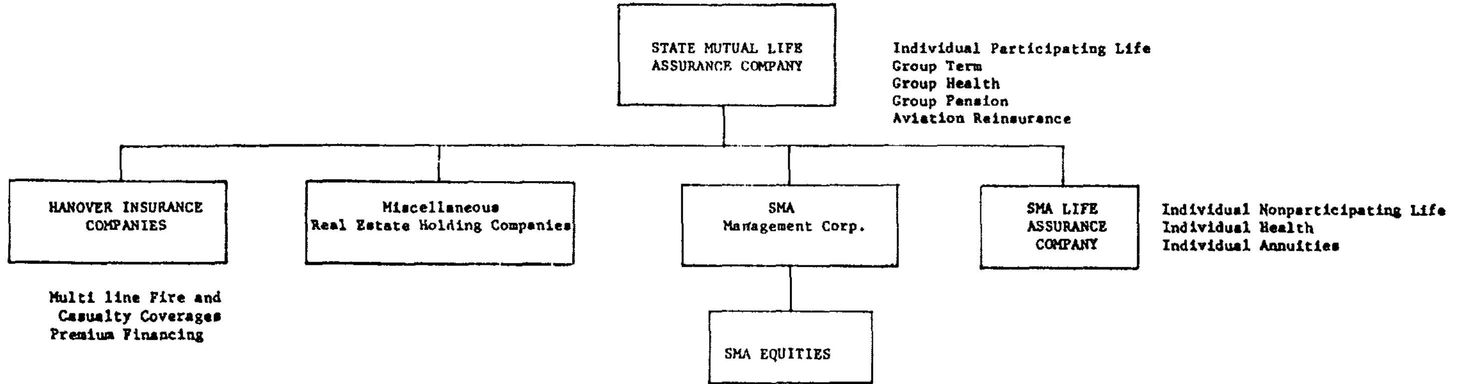
The constraints of time prevent me from giving a detailed description of the events of the past thirty-eight years. However, I believe you will see from even this condensed summary, that State Mutual was in the forefront of mutual companies to identify the need for change in the diversified financial services industry that has emerged. Suffice it to say that in 1945 State Mutual identified a substantial growth potential in the market for group life and health insurance and group annuities. We established a group department to enter these markets, and thereby quadrupled the number of our lines of business.

As a result of affiliation, acquisition, creation of subsidiaries and diversification within the mutual company structure itself, we have grown to almost three billion in assets, nineteen billion of life in force, five hundred and seventy-five million of premium income and deposits, and over two hundred million dollars of investment income from which we derived a statutory net gain last year of some thirteen million dollars, including subsidiary earnings. In this process, we have added more lines of business than I believe many members of our own management could readily identify without doing some research.

Rather than listing each line, let me just give you a simplified overview of our current corporate structure showing the major lines of business in the life insurance element of our structure (Exhibit I). This is a highly summarized overview, even simpler than described in Schedule Y. Basically we have what you might think of as a mutual company holding arrangement. State Mutual, the parent, is still the company in which we issue traditional cash value individual life insurance, all group products including group life, group health and group annuities. Our wholly owned stock subsidiary, SMA Life Assurance Company, is the new name for the corporate vehicle that we created in 1967 to write variable annuities. SMA Life has grown to become the corporate entity for our nonparticipating individual lines, principally yearly renewable term insurance, health insurance-mostly disability income-and also single premium deferred annuities. The Hanover Insurance Company, a large multi-line property/casualty insurance company that we began to acquire in the mid 1960's and of which we now own in excess of 50%, makes us unique among all

EXHIBIT I

STATE MUTUAL LIFE ASSURANCE COMPANY - 1982



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but the giant-size mutuals in terms of our entry into the property and casualty market. While we have not integrated the property/casualty lines of business with those in the life entities at point of sale, the Hanover Insurance Companies are substantially integrated into State Mutual's structure from the standpoint of management and services provided. I'm not going to pursue this point now, but perhaps during the question period we can discuss this aspect of new lines of business that a company generates, not by direct entry, but by acquiring another entity in that business and the reasons for taking that approach.

We still have a number of miscellaneous real estate subsidiaries; I won't focus on those in detail. We have another downstream holding company, which besides some residual investment management functions, more importantly holds SMA Equities, a registered broker dealer through which mutual funds are distributed to our field force.

Had we been discussing the topic of diversification a few years earlier, my description would also have included a television broadcasting station, a real estate investment management facility and an investment management fund complex, entities that we have since concluded do not fit directly in our overall corporate strategy. We also have disengaged from the sale of individual hospital and major medical coverages on an individual basis, although we do distribute the products of another carrier as an accommodation line to our individual field force. So, as you can see, State Mutual has over the last forty years gone a long way from being a single line company to becoming a multi-line diversified financial services complex. We tend to avoid the designation conglomerate, but in a sense I suppose if we were a stock organization we probably would be viewed by the investment community as a diversified financial service conglomerate.

So much for "What is a line of business?" In addressing the two other questions, "Why would we go into new lines of business?" and "How do we measure profit?", I'm going to focus principally on the lines within the life, health and annuity section of our complex and how these serve our corporate purpose.

The following two charts give some idea of the relative size of each of these lines as measured by 1982 premiums and deposits and also by assets under management. I won't dwell on the absolute numbers here, but in a discussion about allocation of resources and the significance of surplus by line of business, I think some of these numbers will help put the picture into perspective (Exhibit II). Our 1982 operating income, as I mentioned, is five hundred and seventy five million of premium; traditional cash value life insurance represents about a hundred and forty million dollars; term insurance, still quite small-just a few million dollars; individual health, fifteen million dollars. We changed the designation from individual annuity to individual wealth accumulation devices. "Wealth accumulation" seems to be another convenient "buzz word" in the financial services environment of the 1980's; it perhaps better fits the overall generic category of individual annuities, mutual funds and other devices that are in the nature of investment or accumulative, rather than insurance or protective devices.

EXHIBIT II

1982 PREMIUM INCOME - $576 MILLION

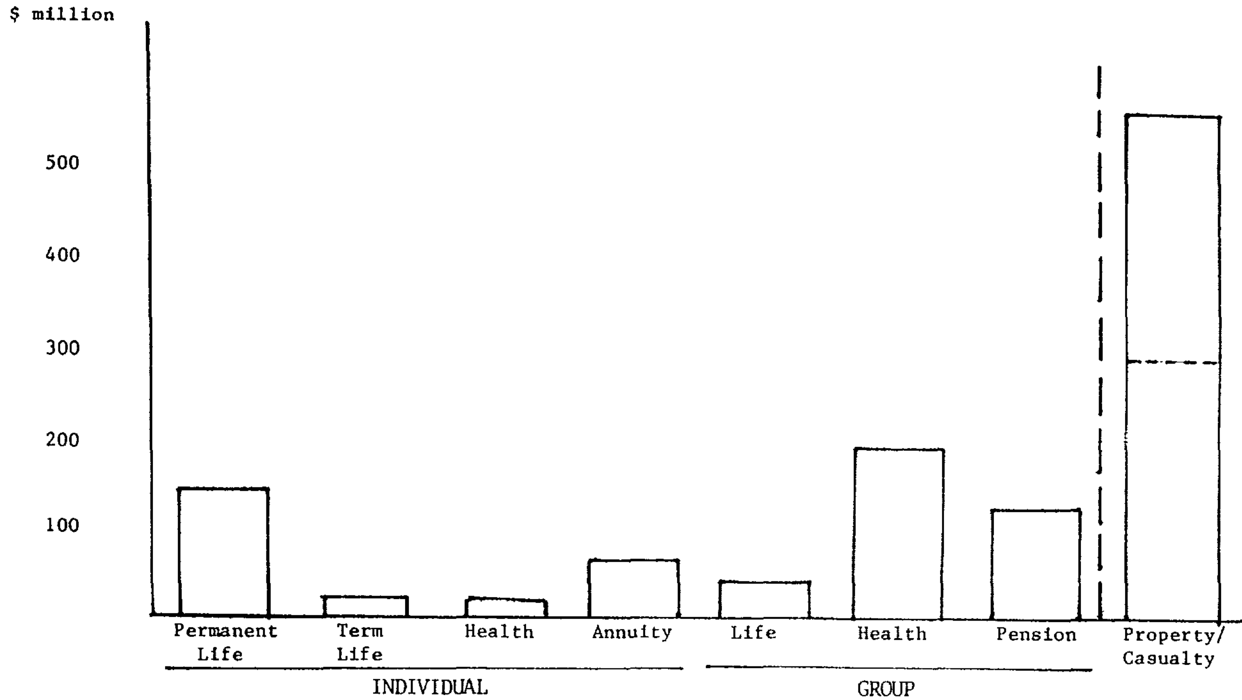
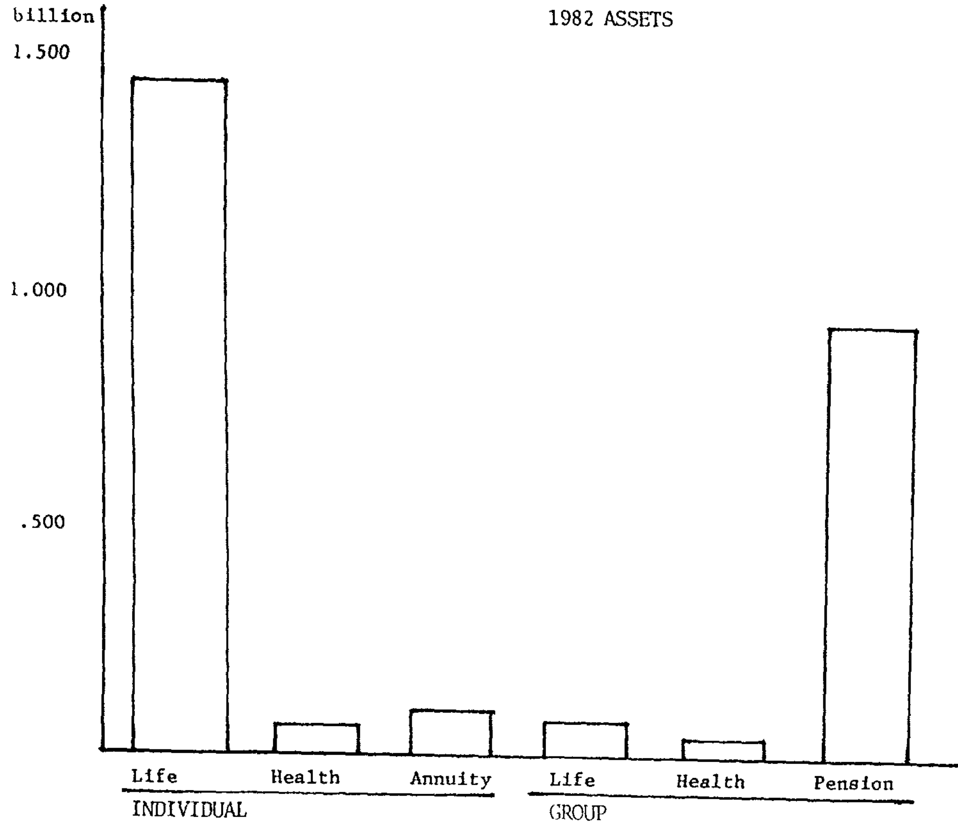


EXHIBIT III



On the group side, in terms of premium, our group life insurance generated some forty million dollars in 1982, while group health was approaching two hundred million; group annuity in terms of premiums and deposits was just over a hundred million dollars. I've sectioned off the side of the chart to show our property/casualty entity and have given a representation of what State Mutual's equivalent half-share would be if we were to have consolidated this premium in our totals. These premium figures here are not consolidated; they are on a statutory basis; as you know, under statutory accounting, the results of subsidiaries are reported separately. This illustration is simply to give you an idea of the relative magnitude of our property/casualty entity. You can see that our one-half interest in Hanover now represents our largest single line of business.

Turning briefly to the question of how much we have accumulated in terms of assets over the years (Exhibit III). Quite a different picture here. Out of our $2.7 billion of assets, almost a billion-and-a-half are represented by the individual life line; the individual health, individual annuity and the group life and health lines, while they may represent fairly substantial premium flows, generate precious little asset accumulation. The other substantial asset accumulation line is the group annuity business, and here we have almost one billion dollars of assets.

As distinct from the situation that Don described in the stock company setting in which other corporate activities have their own line of business, each of these amounts includes that line's proportionate share of activities in subsidiaries. For example, you don't see a representation here for Hanover Insurance because each of State Mutual's life, health and annuity line's ownership of that property/casualty entity is included in these numbers. I think that perhaps this is the first obvious major distinction between the accounting treatment of stock companies and mutuals that have entered into other lines of business outside the mutual parent company structure.

At the outset I suggested that an analyis of lines of business is related to the issues of how a company views its corporate purpose. This is the perspective from which we as a mutual company have addressed this question of why should new lines of business be added.

About ten years ago in an attempt to redefine what State Mutual was and who we were serving, our company undertook a review of this question that involved all levels of management. As a result we concluded that we were fundamentally a marketing organization, and that our primary purpose was to <u>satisfy</u> the <u>needs</u> of <u>individuals</u> and <u>businesses</u> with <u>products</u> and <u>services</u> to <u>create</u>, <u>protect</u> and <u>enhance</u> <u>their</u> <u>financial</u> <u>well-being</u>. I would admit that to some extent we created an "apple pie, motherhood and the flag" definition. With not much more than that, however, we set about reevaluating each line of business to see if it met this criterion. To a large extent it was this kind of analysis that lead us to abandon our stake in television broadcasting, a field of activity we concluded simply did not fit our redefined corporate purpose. That is an example of where we established a strategy that led us to get <u>out</u> of a line of business.

It was also instrumental in our restructuring the variable annuity company that we had created in order to make it the principal vehicle for the disability income portion of our individual health line which we have retained, and for the nonparticipating life insurance business-almost exclusively yearly renewable term-and nonparticipating fixed dollar single premium deferred annuities. In other words, we created this variable annuity company in the mid 1960's and then, in the course of identifying the needs of new lines, transformed it into a nonparticipating life and health insurance subsidiary which, as I indicated earlier, we have now renamed SMA Life Assurance Company for closer identification to the mutual company parent. This nonparticipating life subsidiary is also the corporate vehicle from which we expect to launch our first venture into the universal life market later this year. Again, I may seem to have begged the question and discussed our entry into these new lines of business without first giving the reason why.

Earlier I described how our corporate objective had evolved from maximum sales consistent with financial prudence--that is, emphasis on the growth of the company-to one of of satisfying the needs of our customers to create, protect and enhance their financial well-being. In the current reevaluation of our corporate purpose we are attempting to develop a strategy that recognizes both the expectations of our customers and the dependence of the company on profitable growth. This is not an easy task. This suggests that marketing considerations--that is, identification of market needs and the potential for serving more customers--are the primary determinants of whether we add a new line of business. Profit, however measured is an important but, for us, a secondary consideration. I mentioned earlier that the stocks and the mutuals seem to have different perspectives on this issue. Mr. Sondergeld may differ with me on this point, but I do believe that there is a distinction here that needs to be sorted out; we have to sort it out because while we are a mutual company, we do have a stock subsidiary, so we are coming from both perspectives.

Turning to the question of profitability and how to measure it, I would readily concede that mutual companies traditionally encounter more ambivalence over this issue than do the stocks. For one thing we have no stockholders breathing down management's backs demanding to know next week's rate of investment return and why it isn't higher. So this gives us control not only over the time period over which we will patiently await the emergence of profit from a new product or new line of business, but it leaves almost entirely to management the decision as to how much profit is acceptable; that is, at what rate and level today's policyholders should be repaid for lending capital to finance new business--be it existing lines or new lines. Of course a mutual management's powers are not absolute in this regard. As our policyholders become increasingly sophisticated and demand to know more about the rate of return on "their money" we will have to pay more attention to these questions if we expect to continue to manage their funds. This will probably lead to a blurring of the traditional distinctions between stocks and mutuals on the issue of profitability.

Mr. Sondergeld's outstanding paper sets out a methodology for analyzing profit as a return on total capital. In his definition, Mr. Sondergeld includes in capital the total amount of surplus needed to support inforce business. We do keep careful track of assets by line of business, and

also of the surplus earned by each line. Of State Mutual's two hundred million of surplus and mandatory securities valuation reserves, close to 70% is owned by the individual life line. In our planning and financial reporting we use what we call "benchmark surplus," but so far we have not developed measures of profit to nearly the degree of sophistication that the stock companies have as reflected, for example, in Mr. Sondergeld's analysis. Traditionally, most of our profit figures in the mutual industry have been developed from an annual statement accounting perspective. As a result we probably take more time explaining to our various publics why statutory gains are not a good indicator of profitability than if we went ahead and developed measures that are good indicators of profitability--if indeed we knew what those indicators were.

As actuaries we are well versed in what I call microanalysis. We tend to focus on the emergence of profit as measured by asset shares on a product-by-product basis. This type of analysis is important in the pricing and the marketing of new products. However, it may keep our attention focused on the leaves rather than on the trees or on the larger forest. Only in recent years has our education tended to emphasize the importance of financial forecasting for a line of business, or for an entire company, and the attendant financial responsibilities of someone in the organization to keep an eye on the relationship between the management of assets and the management of liabilities.

In this regard, I sense that in our formal education--and I am <u>not</u> speaking today as a representative of the Education and Examination system--over recent years we have done a much better job for our actuarial students in getting them to focus on the asset side of the balance sheet. I still think there is plenty of opportunity for enterprising students of mutual life company financial reporting to write a follow-up on Mr. Sondergeld's paper outlining the methodology for a mutual to develop appropriate, probably better, more precise measures of profit by line than those we have traditionally used.

I'm pleased to note that the Society is sponsoring a series of seminars this summer, the title of which is "Measuring the True Profitability of Life Insurance Companies." (I suppose by implication one can assume all along that we have been measuring the "false profitability.") I expect that when we next examine this question, our response on the issue will be somewhat more refined.

I have attemped in summary form, using my company as an example, to describe my perception of a line of business as a convenient group of products and services that a business makes available to an identifiable market in which it operates. Why would mutual companies, in particular, enter a new line of business? The primary motivation is the identification of market need--the opportunity to provide more customers with insurance and related financial services. And finally I have discussed some of the challenges and responsibilities in determining what the profitability of each of those lines is and how it should be measured. Mutual company quantification of profitability has traditionally been in terms of statutory net operating results, although the trend seems to be more in the direction of some measure of return on policyholder surplus.

MR. ROBINSON: I was especially struck with Mr. Cowell's statement that the growth of companies per se is no longer an acceptable corporate mission, but that we need to focus on the needs of the market place. That is something our organization has been wrestling with, as I'm sure many of you have.

MR. JAMES H. CHARLES: I would like to deal with the two subheadings why new lines should be added and the resources needed for them.

The Center in Hamilton handles the strategic planning process of many types of insurance companies, as well as other types of business. We've done it from the complete spectrum of stock companies, mutual companies, large ones to small ones, and life to property and casualty.

One of the most difficult strategic considerations that comes up in these planning processes is the entrance into new lines of business or new businesses. One of the principal problems is that it has an impact on the total organization in a way that nothing else does. It's very demanding on all the resources of the organization. Usually these resources are fully taxed and to add something onto them is just raising havoc with people's capabilities of handling them. It's something that requires a bit of forethought of the ongoing maintenance and considerations that are involved in such a step. What I would like to do briefly is to provide the rationale for considering such a difficult situation.

There are many obvious reasons for adding new lines. Most of these can be grouped under two major subheadings. First and foremost, all businesses have a basic corporate purpose of fulfilling the needs of the market place. If they don't do that in a reasonable fashion, they're not going to be around for very long. Secondly, it's absolutely essential that they have some form of profitability. Even a mutual company needs a certain amount of profitability. Most companies, in addition to being profitable, have a desire for growth. These are the basic reasons for taking on such a risky venture as adding new lines.

No business can expect to continue as a viable identity for a realistic period of time unless it reasonably fulfills the need of the market place. These days we're living in a world of very, very rapid change. Change is not only coming very quickly in terms of time frames, it's also extremely volatile in terms of the degree and the amount of the change. The customer's needs are a mirror or reflection of these problems. As we all know, he's become very much more knowledgeable and demanding in the expectation of fulfillment of these needs. From the insurance industry he not only wants protection, but he wants to preserve the value of his investment and, ideally, he would even like a return on that investment. In addition to this, the consumer has been conditioned by a series of factors toward so-called "one stop shopping." He will tend to go where most of his needs can be fulfilled on an easy, convenient basis. This is just another one of the many reasons that new lines are going to have to be considered. If the other fellow is offering fulfillment of most of these needs and you're only offering the consumer one of them, he's going to choose the other fellow over you in most cases.

Also, the need for new lines exists for companies that want to grow and be more profitable in their various market niches. Unfortunately, in most cases, existing lines of business are not adequate to do this. As you're finding out, profitability of the old individual life policy is rapidly becoming a thing of the past. The surrenders and the policy loans on these are horrendous and most companies are going to have to seek other means to achieve a profitable base that they can count on for a reasonable period of time.

This rapidly changing environment and the market needs have only made the basic quests of growth and profit that much more imperative and that much more difficult and hazardous to do.

Also, the compressed time frame of the product life cycle has implications of the increased risk of not recapturing the front end costs or a reduction of the profits in the margins in both the old and the new lines of business. This is going to foster a need for new lines to offset the above factors in the form of adaptable products that can survive change and competition with modifications that require a minimum of additional investment in a timely fashion. This means that when you bring in these new lines, if front-end costs are very heavy and you have relatively shorter product life cycles, you're going to have extreme difficulty in recapturing these costs and making some sort of profit.

In summary, the rationale for a new line is a response to the changing environment, the market need, and one of the principal ways of insuring the future of the industry.

In terms of the resources required, your business breaks into about four basic component parts: the market needs and considerations, a product that is going to fulfill these market needs, a delivery system to get it out effectively, and the support systems that can bring it all about in an orderly fashion.

In terms of the market, when looking for what new lines you need or want to go into, there is a host of considerations. Basically, you should be looking for the segments you want to get into, where the opportunities most appropriate for your organization and your company are, the needs and expectations of these segments and how to fulfill them, and the potentials of the volume, profitability and cost. What are the competitive considerations? Very importantly, what is going to be the impact of these things on existing business and existing lines? All these things must be considered in light of each other. Planning is somewhat of an integral process. You can't do it in a vacuum.

When you have the market set-up pretty well in hand you look at the product in terms of that. The considerations there are basically its design to fulfill the market needs and expectations of the consumer, determination of the volumes you can reasonably expect, the kind of costs you can put into the product, the kind of profit you can expect from it and the expected life cycle. For years we didn't have to worry about a life cycle on a product. It was just there and stayed the same. Now it is becoming a very important consideration. You, like the automobile manufacturers, are going to go through model changes, new products, etc. You're going to have to consider time frames that are much shorter than in

the past. As a result, it's going to be much more difficult to recapture costs and to have a reasonable profitability over a reasonable period of time. So the life cycle is going to be a very important consideration and a very difficult one to get a meaningful handle on.

What's the competitive response and the future flexibility of product change and enhancement? When designing these products, how is the competition going to respond to them? Are you going to have enough of a product need, in terms of your competitor's ability to copy, adapt, and so forth, to achieve a market advantage? Can you design the product to do that in a reasonable fashion? When he does start responding to you, do you have a built-in flexibility in that product in a way that you may enhance it so he can't catch up to you quite so fast; and if he does catch up to you, you have the next step in place? You're going to be constantly faced with that.

Also, what are the resources needed for product development, particularly actuarial resources? These days there are tremendous demands upon the actuarial departments in the insurance companies. I've yet to have one of them tell me that they have adequate actuarial resources. They're always pressed, they want new products, they want new lines and it's a tremendous strain on the capabilities of that department.

The other factor that we want to consider, in terms of the resources needed for these new lines, is the delivery system, the determination of an appropriate, i.e. effective and efficient, delivery system. By effective I mean that one can get the product to the market place and obtain a closing sale on it. By efficient I mean do it with reasonable costs. That's the major problem today. The costs of the delivery system in many cases are almost prohibitive considering what you have to sell the product for. You have to consider what kind of market penetration you want and whether this delivery system give it to you. What volumes do you need? What are the costs of this delivery system? What are the skills and the training required, how do you get them and how do you implement them to achieve a meaningful result?

What can you do in terms of adapting existing delivery systems? This is a big problems these days. What do you do with the high-cost career force agency that many of you have? How can you adapt in a way that allows you to bring in new products that don't have the margins you've experienced in the past? You're going to find this to be an increasing trend rather than a decreasing trend. Margins are going to be under constant pressure so you're going to have to find ways to perform more efficiently.

In considering the support systems, what are going to be the computer and the workflow system requirements for all these new products and lines? What's the fit going to be? What are the costs going to be? How do you set up management information and reporting systems that really let you know what's happening? Unfortunately, the bulk of the companies, I would hazard to guess, really have extreme difficulty knowing what's really going on in the various lines of their businesses. They sort of lump them all together and if they show a reasonable bottom line, they figure everything is all right. Management systems unfortunately are basically designed, or have been designed, with two elements in particular--an annual report and/or statutory or tax requirements. They are really not

designed to allow the businessman to run his business, to give him information that he really needs to run his business. Then, also you have to consider the impact of these new lines on your existing systems: computers, workflows, etc. Is there any kind of a fit, if not, how much is the cost of the adjustment going to be; how can you adapt and change what you do have?

Finally, and perhaps most important of all, is the human resource skills that are going to be required. Most of us have been doing things one way and we're going to have to change and adapt, train, etc. These things are very difficult. The importance of management values cannot be overstated because often organizations go into businesses that are really the antithesis of their management style. For a highly conservative company to get into a high risk business is an absurdity because it's doomed to failure from the start. The company will not take the necessary risk to even give it a chance of succeeding.

As I said earlier, this has to be accomplished on an integrated basis, making sure that the market, the product, the delivery and the support systems fit with each other and that there's a certain amount of integration and balance. All this is done within the framework of the corporate objectives and the strategic thrust of the organization, meanwhile considering the market's opportunities and threats, the company's capabilities and potential, the stockholders' needs or the company's needs and expectations and finally, the management value and style of the organization. If all these factors aren't considered in an integral process you may do very well in terms of market needs, but you may not come up with the delivery system that is appropriate, or your product may be lacking in competitive stature and it will be doomed to failure. You have to consider the total equation of new lines.

I think that a subject matter like this is very difficult to really address with any meaning to a group for the simple reason that it needs specifics. What works with GE doesn't necessarily work for Westinghouse. I hope we can be of a little bit better service in answering specific questions.

MR. ROBINSON: I'd like to ask the panel one question. How important are contingency plans when you're considering new lines? Must we always set up plans as to what to do if it fails? Do we have to have a fallback position and, if so, how do we know when to trigger that fallback position? Do we give up too early or do we wait until it's obvious to everyone?

MR. COWELL: I guess all I could add is that in a classical textbook strategic planning environment, you might have contingency plans for every eventuality you could conceive. But, if you could conceive all those eventualities you'd probably plan to avoid them. I think in practice it is difficult to get management to concede that its plans aren't going to work, because if they thought they weren't going to work, they wouldn't have made those plans in the first place. I think it's a textbook ideal. I would confess that we have only one set of strategic plans. We are developing and revising them continually. We only talk about what will happen if they don't work. We don't as yet have specifically defined alternative plans.

MR. CHARLES: If you went by the textbook, you should have contingency plans. The trouble is, in the real world, it's usually such an overwhelming effort just to obtain the original plan or any plan whatsoever, that in no way can you realistically expect contingency plans. I think the realistic approach is to have a guideline to at least let you know if the current plan is working or not working and the guideposts of the milestones in that. You would at least have an awareness of whether it is working or not.

The big danger is not so much that, but that the changes that go on in the world can call for dramatic changes within the existing plan. What we really lack is some type of a monitoring or an awareness system of these changes. You can't monitor everything--that's an impossibility--but you should at least have a guideline of the important factors. Normally, a plan has a certain amount of assumptions that go into it, i.e. inflation rates, interest rates, etc. Whatever the critical elements are that went into that plan, you should have an awareness of them, and you should have some monitoring capability in regard to them. If they change, they have implications of plan change.

MS. ANITA L. JONES: I've been a little bit surprised this morning that the panel seems to be using the phrase "line of business" as being synonymous with what I would conceive as being "business segment". I wonder if there is any feeling or any information that you could share about appropriate financial reporting lines of business within a business segment. I address specifically industrial life for those of us who have it, universal life as a line of business and so on.

MR. SONDERGELD: I guess a line of business means what we want it to mean. Our English is composed of English words and we all think we know what "line" is and "of" and "business", but we grow up in different companies and different companies probably use those words to mean different things. I think, in the annual statement you refer to lines of business that are those annual statement lines of business which I referred to in my remarks today. But a line of business can be anything you want to define it to be. We break our total profit center management down to the management of something we call lines of business. But even within those lines of business, we do some further analysis. For example I mentioned group health was a line of business, but the people managing the group health line of business have a further breakdown that they also look at such as long term disability, medical care, etc. I think no matter how you define a line of businss, there is always somebody involved in that line of business who has a further breakdown.

MR. ROBINSON: I think that is a good question. For example, in the individual line of business, a company might have an entire division that was selling financed insurance to college students. They might have another division of the company or separate reporting segment that had wholesale type insurance to employers. They might have another segment that had individual life insurance sales. If you took one organization, that would be three separate divisions, three separate profit centers. Another organization might say that's all under the same heading; it appears in the annual statement as individual life and we have one vice president in charge of individual life. I think it is an individualistic thing. Mr. Sondergeld's companies use profit centers, but if the company

decides to break up their profit centers by market as opposed to product, then they're going to be grouping all of the products into one specific market area. Another company might take the product tack rather than the market tack. I don't think there is a right answer. I think the point each of the panelists were trying to make was that each company has to come to its own decision to identify either the market or the product and to figure out how to measure appropriately the rates of return, how to measure whether or not a line of business should be maintained or added or, as Mr. Cowell pointed out, abandoned.

MR. CLEMENT B. PENROSE: I have a question for Mr. Cowell. You mentioned that most of your hard financial figures are based on statutory net gain or surplus, but in your planning and internal financial reporting you do determine a benchmark surplus by major line of business. Have you made any effort, in your regular ongoing internal reports, to relate statutory net gain or increase in surplus by line of business or segment to that benchmark surplus as part of your measurements?

MR. COWELL: Definitely, that is the basic purpose of establishing the benchmark. Let me back up a little. We started looking at this question in the mid 70's when we were faced with the first wave of accelerating inflation and interest rates, and were becoming concerned by policy loans, lapses, withdrawals and the depressed market value of some of our asset holdings from the standpoint of equity. We undertook a study on a "worst case" basis. What would be the "worst hit" we could take in individual life, group health, group annuity line, and so forth? We broke that down further into the mortality risk, using a fairly classical measurement of standard deviation of expected mortality, and the likelihood of capital loss on the asset side.

We based the second phase of our analysis on the blocks of business, breaking them down in more detail than the annual statement lines. The statutory profitability objectives, which were based on the operating characteristics of the line and what the market place would seem to bear, were established both on a 'micro' and 'macro' basis. We analyzed the components of the asset share contribution to the major lines, and also looked at profit from a long range financial standpoint. What we generally found was that our oldest, slower growing lines, particularly the individual permanent life line, started out with much more surplus than they needed. Our more rapidly growing lines, the group lines, particularly group health, started out with very little surplus and needed much more because of their rapid growth and their greater likelihood of taking "hits", both the catastrophic type and also the erosion on the group annuity side from the volatile value of the assets in an unsettled monetary environment. Since then we have built these profitability objectives into our long range planning and we're at the point now of defining more precise measures than we have had.

In a long way of answering your question, yes, we do tie these together but we're still less than satisfied with the definition of profitability. As I mentioned earlier, we hope to get a better handle on this "true profitability" as opposed to the "false profitability" that, presumably, we've been studying so far.

MR. SONDERGELD: I've had one person discuss my paper, Henry Ramsey, Vice President & Actuary of Penn Mutual. Mr. Ramsey indicated that he found my paper amazingly consistent with the manner of profit analysis used in his company. He used the term "required surplus" for what I use as benchmark surplus. Penn Mutual is in the early stage of using a form of financial statement, which they refer to as their management basis statement, which is based on GAAP principles, although in discussing what they do versus what we do they aren't constrained by something that we would refer to as nondeferrable acquisition expenses. We see Penn Mutual as a company that seems to be doing something very similar to what we do.

MR. TERRY D. KELLOGG: Mr. Cowell, you had said that there were some advantages to developing new lines through subsidiaries rather than folding those into the operations of the parent. Would you elaborate on and numerate those for us?

MR. COWELL: I think I'd have to hypothesize this with two environments, the contractual legal environment and the tax environment. There are certain products that, legally, mutual companies are not permitted to write. Several states require that mutual companies write participating business; because of the nature of the market, it makes more sense to write things like yearly renewable term and, probably, universal life, in a nonparticipating company. The same is true for single premium deferred annuities. I guess a combination of legal and marketing needs dictate the form.

Second, and extremely important, is the tax consideration. There are certain products, typically the asset accumulation type products, that, prior to the current "stop-gap" legislation didn't really make much sense for a mutual company in a nonparticipating environment. They were ideally designed--I'm talking now about traditional cash value whole life insurance, and qualified pension business--that at least under the 1959 Tax Act made no sense in a mutual company structure. For other products with a heavy mortality or morbidity risk component, where there was a high likelihood of loss, it made more sense to be in Phase II where a company could take advantage of any losses. Now under "stop-gap" many of those distinctions have been blurred. We are on hold right now, waiting to see what the outcome of the post-"stop-gap" tax environment will be before we redefine the entities in which each of these products should be written. Essentially, marketing, legal contractual requirements and tax considerations are the principal determinants of which entity to issue the line in.

MR. CHARLES: There might be one other that you could consider which I alluded to earlier in terms of management value and styles. You could have a product or line that you know isn't going to be implemented properly or accepted by the existing organization, company structure, etc. So it might be better to consider a separate subsidiary of sorts, making it relatively brand new, putting in the people that have the mentality that could bring it about in a successful manner. You'd probably have a much better chance of doing something like this if the product line was a threat to the existing mold and organization.

MR. COWELL: That is particularly true in an established company where an agency field force thinks it has a proprietary interest in the product line. To some extent it does in the mutual company. If your company wants to get into some experimental products and markets, it is easier to segregate or separate, or somehow to cushion the impact to insulate the impact from your traditional marketing distribution system (to upset them as little as possible) by writing this business in a subsidiary. An example would be a company that had not been in the brokerage business wanting to offer new products to a brokerage market; it might find it a lot easier to do so through a subsidiary.