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FINANCIAL PERFORMANCE "YARDSTICKS"

Moderator: HENRY W. SIEGEL
Panelists: STEVEN W. FICKES
JOHN T. GLASS
RAYMOND A. MATISON*
Recorder: FRANK TODISCO

o What measures should be used in setting objectives and evaluating performance for companies and product lines?

- Return on investment
- Economic value
- Premium or revenue growth
- Cash flow
- Statutory accounting earnings
- Generally accepted accounting principles earnings
- Dividends paid
- *Performance compared to competitors*

o What variations are appropriate for stock and mutual companies and for United States and Canadian companies?

MR. HENRY W. SIEGEL: Mr. Raymond A. Matison is an investment banker with Kidder, Peabody and Company.

MR. RAYMOND A. MATISON: What measures should be used in setting objectives and evaluating performance for companies and product lines? That is, for what purpose are we making the objectives or measurements? Is it for:

1. an investment decision comparing alternative investments;
2. the feasibility of a financing, i.e., an equity or debt offering;
3. a strategic alternatives study;
4. a mutual company conversion; or
5. entering a new product line?

Public reports or information cannot help us in making product-related decisions, so we will focus on other means. Generally accepted accounting principle (GAAP) financials by line are generally not

*Mr. Matison, not a member of the Society, is a Vice President of Kidder, Peabody and Company.

available, and statutory reports by line are inadequate. We can at best look at lines, not products. The evaluation measures used depend on the purpose of our study.

Investment decisions to purchase stocks may be weighted by 50 percent to whether the market appears favorable to make any equity investment. Perhaps 30 percent of this weight relates to whether the particular industry appears attractive for investment, and only the balance of the investment decision relates to the particular company or security. Therefore, we first focus not on company characteristics, but on market characteristics.

In selecting a company as an investment the most important considerations are whether the company will continue to earn profits; whether those earnings will grow at a reasonably predictable rate, without great volatility; what the company earns on shareholder equity (particularly relevant with regard to alternative investment returns); and whether the company will share those earnings via dividends with shareholders. Please note that shareholders generally receive cash as dividends; therefore, the mix or nature of business may not be significant to investors, because what they receive in dividends as cash is not distinguishable from the nature of the business.

To avoid embarrassment, financial analysts are likely to choose companies first where predictability of earnings is high, and there is growth and value. Investors want good investment performance and to buy their stock cheap. Market performance or relative market performance is a valid financial measure.

In analyzing a specific company, it is important to sense excellence and clearly defined goals in a management. This is difficult to measure statistically. A well managed group health company is better than a poorly managed individual life company. A well managed credit life company is better than a poorly managed annuity company. A well managed debit company is better than a poorly managed multiline company. Shareholders don't care about the nature of business that generates their dividends and capital gains.

Tremendous growth in a market of limited size will be of limited attraction. A new product line, while exciting to insurance agents, may not have a great impact on a company's near-term results. Consider, for example, a new life insurance product that is introduced by the Mammoth Life Insurance Company. This exciting new product is expected to account for 50 percent of next year's individual life sales. If such sales results are achieved, the new product's first-year premium represents perhaps 1/10 of individual first year and renewal life premiums. Applying broad industry averages, that may represent 1/50 of total individual life assets. Of course, Mammoth Life also writes group life, accident and health (A&H), and pensions. What is the effect of this product on the total company earnings in the near future and on total revenue growth? Not very much!

What affects long-term growth and earnings characteristics are different structures or concepts in different companies. You could take the

distribution methods of State Farm, or Allstate, or Farmers' Group and their relative cost advantage, or take distribution through stock brokers or thrift institutions. Better concepts, applied consistently over a long period of time, bring above average results.

For investment recommendations, the most important financial measures are prospective earnings, revenue, dividend growth, and relative price paid. Since the quality of earnings is so important, the analyst will look at component revenues and earnings by line on a statutory basis. Also A&H claim reserves may be reviewed for consistency over the years. Examination of reinsurance transactions can shed light on reported profitability. Changes in allocation by line of investment income or expenses change reported profitability. But given the market, industry, and company weights, financial performance measurements for an investment decision are not complex or detailed.

In soliciting a company for an equity financing, the company's overall performance is important. The investment banker makes a "common stock comparison," choosing from four to ten companies that are approximately in the same size and category of business. Indeed, the lack of available publicly owned, comparable companies may require the inclusion of companies which stretch the definition of "comparable."

The statistics gathered for such companies will normally cover a five year period. A comparison of the target company's financial measures are made to mean, median, and a range of results of the comparable companies. These financial measures include:

1. earnings and earnings growth rate
2. revenues and revenue growth rate
3. dividend, dividend growth, yield rate, payout ratio
4. pretax and after-tax margin
5. return on equity
6. debt to total capitalization
7. stock price performance statistics: price-earnings ratios, price-to-book-value ratios

These categories are shown to a board of directors or an executive committee -- as opposed to a detailed statistical compendium. Nonetheless, other items that include premium growth, net investment income growth, combined ratios, statutory surplus, premiums to surplus ratios, or surplus to assets ratios are reviewed where applicable. The numbers in these elements included in a limited period presentation expose a company on an absolute or relative basis.

Such a comparison is one basis for determining how a private company might be priced if it were to become publicly owned and also for determining the value of a mutual company conversion. Finally, it would show why a public company trades in a specific way relative to its peers in the marketplace. This analysis would show whether a particular security appears underpriced based on its financial performance and if it makes sense to go to the market for additional capital at the current price. Then one can proceed with a specific size and pricing recommendation to our investment banking prospect.

A strategic alternatives study would take much more data into account. We would look at growth by major line of business and at market penetration by major state. We would identify major individual competitors in these states or compare performance to national agency, regional, or direct marketing companies. We could compare loss and expense ratios and categories of expenses over given periods of time.

For example, Kidder, Peabody and Company was retained in January 1984 to do a study for the MacArthur Foundation's Bankers Life and Casualty Companies. We analyzed each line of business and looked at detailed, state-level performance of group life and A&H collectively, and of guaranteed renewable and other lines of business. We were able to enhance that company's perceived market value and sell it for 382 million dollars on a zero-surplus basis.

In mid-1984 we were retained to do a strategic study for the Western Casualty & Surety Companies. We looked in depth at some ten major lines, and all other lines combined, of property-casualty coverage in their major and other states. We analyzed growth, market penetration, competition, loss experience, expense levels, investment performance, reserves, and trends in all of these. This fine company was purchased by the Lincoln National earlier this year for 270 million dollars.

Some additional measures can be applied when valuing a business enterprise such as a mutual company or a nonpublic entity. One can use a discounted dividend model or a valuation based on discounted cash flows calculated by computers. But this computation determines a range of value rather than financial performance. The financial performance is, of course, a determinant of its value.

A private or mutual company most likely can set whatever objectives it chooses. A public stock company always has to keep in mind objectives that will not reduce its return on equity because the investor can always liquidate his investment for a better one. Therefore, anticipated future increases or decrease in shareholder equity will affect in parallel its corporate market value as reflected by its stock price.

MR. SIEGEL: Mr. Steven W. Fickes from Tillinghast, Nelson and Warren has been a consultant to many national and international insurance conglomerates, holding companies, and other insurance companies.

MR. STEVEN W. FICKES: Throughout the world, companies are more concerned now with how they are doing. They no longer are just concerned about earnings measures. They want to know whether or not they're doing well compared to other companies in similar situations.

The first and probably oldest measure of how a company is doing is statutory earnings because they are the amount of money you can dividend out to shareholders or to an upstream holding company. The disadvantage of statutory accounting is that earnings are stated too conservatively. Statutory earnings measure solvency and not how a company is doing on an ongoing basis. If a slowdown in sales occurs, it usually will cause an increase in statutory earnings, so statutory

earnings are not a good means for measuring the performance of a company.

Some mutuals are going to GAAP accounting in order to get a realistic view of what their earnings are on a year-by-year basis. The advantage of GAAP accounting is that it produces more of a going concern number. An increase in sales will not depress GAAP earnings to the same degree as statutory earnings. However, because you don't defer 100 percent of costs, there will be some decrease. One disadvantage of GAAP accounting is that it also contains some margin for conservatism. Also, you can suffer from the lock-in principle. Finally, there is a great deal of judgment involved with GAAP accounting.

Cash flow can be used as a measurement tool with the real advantage that it's the only one that looks at real money. But an increase in sales again can cause a decrease in early year cash flow for most life products, so it still doesn't show how well you're doing.

Under the appraised value approach, each company treats itself as an investment. At the beginning and end of the year, you determine the appraised value of the company. Even though statutory earnings may be zero, the measure of how well the company did during the year is viewed in light of the increase in the worth of the company. This approach can be used for both mutual and stock life insurance companies. In the U.K., this approach is common and most management incentive schemes are based on the appraised value approach during a given time horizon. The disadvantage to this approach is that you can lose sight of profits. Recently a U.K. company had an appraised value performed and the value of the company was up. But when they were paying management bonuses, they realized they had forgotten about statutory earnings and didn't have the money to pay the bonuses.

There are other financial performance yardsticks, such as growth numbers: in premiums, assets, and in-force business. During the term insurance wars, many companies measured how well they were doing by growth and in-force. This had its obvious disadvantages. Also, a smaller company could record phenomenal growth, while a much larger company may have less growth, yet be doing better on an absolute basis.

Another financial yardstick is return on investment (ROI), which can be used for both a product line or the entire company. For a product line, it offers the advantage of a comparative measure between alternative investments. You can invest surplus in a product that has a 15 percent ROI, or you can invest the same funds in stocks or bonds which probably have a lower return - and you can compare both investments. However, the allocation of surplus and expenses to determine an ROI can be difficult. You can calculate the ROI either marginally or effectively. When you calculate marginally, you assume that one additional product line is not going to create the need for a new home office building. You don't have to hire a new president, and you don't have to hire new marketing people. On this basis, the product line probably will have a high ROI. However, on an average

sharing of all costs basis, the product may not be doing as well. You also have ROI with a company or an acquisition. The problem for the acquired company is what to base it on. Do you base the ROI on what you were bought for, or do you base it upon what you consider to be the true worth of the company?

Another important financial yardstick is the comparison of competition. This is the question consultants get asked the most: How are we doing compared to everybody else out there? The advantage to using a comparison of competition approach is that, for example, in one year you may have a 15 percent return. Comparing with the life insurance industry, the rate of return on the average may be only 5 percent. But your competitors may have had a 25 percent rate of return. That may show that you did not take advantage of all the opportunities that were presented.

I use the "basket approach" to evaluate other companies for acquisitions. I look at our stock price and determine what investors are getting for each dollar invested in our stock, that is, the number of dollars of assets a dollar bought; the number of cents of statutory capital and surplus a dollar bought; and the number of cents of premium income that a dollar bought. Then, in looking for companies to acquire, I determine where we could get more for each dollar we spend in that acquisition than our investors would get for each dollar spent on our stock. However, this is limited to publicly traded companies.

You're required to produce a statutory earnings number; therefore, you're going to use that as a financial yardstick. Companies are required to produce GAAP earnings; therefore, we use GAAP earnings. As a result, we end up with a mixture of financial yardsticks. So, what would be the ideal system that would produce necessary financial performance yardsticks that are consistent with each other?

The definition of a perfect financial reporting system is one that would yield the necessary yardsticks and can be had fairly simply. One of the criteria should be that the ideal financial reporting system would measure both the quality of earnings as well as the quantity. You also need to be able to reflect growth. Income alone does not do this. You should not be inhibited by statutory boundaries. You should have some type of financial reporting system that allows you to report on a responsibility basis, not on a statutory or tax basis.

The system should allow you to project and reconcile what you have projected. It should reflect internal change and self-adjust. You need a system that reflects environmental changes without distorting what management did. If something happens outside the company that management had no control over, you should reflect this in your reporting method. If you have to deal with the chairman of the board or the marketing people, the system must be simple, at least in principle.

Finally, the ideal system would be both a summary and a complete explanation. That is, the chairman of the board could look at one

number and see how well the company was doing while you could examine that number more closely and determine the statutory and GAAP earnings and every other pertinent piece of financial information. There is no such system but more companies are working toward developing an ideal system.

Companies are coming up with the same idea from different directions. They are trying a semiappraised value approach, with an interim income statement whereby the appraised value at the beginning of the year plus the income from the income statement will produce the appraised value at the end of the year. This differs from currently used appraised value approaches which just take snapshots at the beginning and at end of the year. The emphasis of such a system would be on management reporting lines as opposed to individual statutory characteristics.

This appraised value approach produces the appraised value (or value from an investment viewpoint) and the income. The appraisal value of the company would be broken into free cash, free surplus, statutory surplus, GAAP surplus, and then total value of the company. In this ideal system, you could introduce above and below the line adjustments. That is, you may have an appraised value at the beginning of the year of 100 million dollars. You would hold your assumptions consistent for an entire year and do an appraised value at the end of the year and maybe come up with 110 million dollars. When you introduce improvement in lapse rates, and so on, the new appraised value with new assumptions may be 115 million dollars. This change would be reflected in a 5 million dollar below-the-line adjustment, meaning management wasn't directly responsible for it.

By the appraised value approach with modifications, we can measure both quantity and quality of earnings, reflect growth, and allow for projections and reconciliations. The system, if you tied it to profit test assumptions, could be self-adjusting, and by using below-the-line adjustments, you could reflect environmental changes.

MR. SIEGEL: Mr. John T. Glass is vice president for Individual Life Insurance at Lincoln National, responsible for direct individual life valuation (statutory, tax, and GAAP), asset-liability matching, and financial models and projections.

MR. JOHN T. GLASS: The January 1985 issue of Forbes magazine contains the thirty-seventh annual report on American industry. Forbes uses the phrase "Yardsticks of Management Performance" in describing the statistics it gathers for the different publicly traded companies. However, competitively, these yardsticks of management performance would be useful for any business - both stocks and mutuals, in the insurance arena.

Under the heading of "Profitability," the main yardstick for performance is return on equity (ROE), and the company's debt to equity ratio and its net profit margin is also displayed. Under the general heading of "Growth," the primary yardsticks are sales and earnings per share. There is also an earnings predictability rating which has been assigned

to each company. These performance measures are important ones for any publicly traded company. At Lincoln National, we are very conscious of them as a "report card."

Lincoln National Corporation (LNC) is a multiline insurance operation which is currently engaged in the life and health insurance business, employee benefits, and property-casualty insurance as its major business segments.

Officially, LNC has adopted a corporate ROE target of 15 percent. This is a goal to stand on, not a ceiling to try to touch with our fingertips. It is the primary financial goal for all of us, but might vary depending upon the degree of risk in our various businesses. It works well as a so-called hurdle rate. It may not be the ideal financial indicator to maximize, particularly from a competitive point of view. The original 15 percent was set as a target, keeping in mind what the capital markets expected of us, what the real ongoing cost of capital is for a business enterprise such as ours, and so on.

The second key yardstick at Lincoln is growth in net operating income. This would be perceived as a measure of growth rather than as a measure of profitability because using net earnings per share as the single measure of profitability can be extremely misleading. In tandem with return on equity, however, growth in net operating income is a meaningful financial tool.

We use productivity measures internally at Lincoln National Corporation. They are broad-based, including the ratio of revenue to operating and administrative expenses, the ratio of revenue to salaries and labor, the ratio of revenue to nonsalary related expenses, and the ratio of revenue to one hundred employees in millions of dollars. In our effort to become a low-cost producer, we monitor ourselves against key competitors using ratios derived from statutory statements.

Investment performance is particularly important for interest-sensitive products such as universal life, where a proactive stance should be taken regarding the after-market management of the product.

Innovation is a more subjective area of performance. This involves, but is not limited to, acquisitions and divestitures.

Each of the strategic business units (SBUs) within LNC sets its own goals on ROE, net operating income, profit margin, sales, and productivity. These are all incorporated into the financial plan which each SBU produces annually in the fall. These financial plans, which represent the translation of the strategic business plans into numbers, are approved at the corporate level. Particular emphasis is placed upon the goals for the succeeding calendar year because the management incentive plan bonuses are based upon those numbers.

Lincoln has adopted a definition of GAAP required equity, the average of which for the year becomes the denominator for the SBU-ROE calculations. GAAP required equity is defined as statutory minimum surplus plus GAAP adjustments to the balance sheet -- a common and

useful definition for stock life insurance companies. The statutory minimum surplus formula was developed internally and encompasses the traditional C-1,C-2, and C-3 risks plus a general contingency margin. The GAAP adjustments to the balance sheet mainly consist of the adjustments for deferred policy acquisition costs, benefit reserves, and deferred taxes.

As you might imagine, the establishment of five-year financial goals is a result of the modeling process. For those of us in our Individual Products Division, this represents a combination of the modeling efforts for the older conventional block of business and our newer universal life and disability income blocks of business. Earnings projections may be a science, but the setting of earnings objectives is an art!

We periodically review the statutory minimum surplus formula to make sure that it reflects the latest thinking on the C-1, C-2, and C-3 risks. Along with most other companies, we are getting more sophisticated in matching assets and liabilities. As our sophistication increases, we will become more adept at managing the surplus requirements attendant to our various businesses.

All of this indicates a consciousness on our part, and on the part of most stock life insurance companies, that the return on stockholder equity and like measures used by the financial community in measuring performance are also key measures for the internal management of the company. Consequently, the pricing and valuation people have now done more communicating than ever before, and the pricing programs, which were originally set up on a return on investment (ROI) basis using a hurdle rate, now have been expanded to reflect the emergence of GAAP earnings. We are now to the point where there is little difference between the ROI inherent in the pricing process and the ROE which emerges when the GAAP accounting is done.

In doing competitive analysis work, each LNC strategic business unit decides on a list of competitors then develops a matrix, placing itself on the chart in comparison with its competitors. On one axis, it measures growth by utilizing revenues. On the other axis it uses ROE as the primary financial measure of performance. Thus, it is measuring the profit performance of a given company against the growth of that company.

For a stock life insurance company, ascertaining the ROE is not difficult. The interesting aspect comes when the peer group of competitive companies includes mutuals. We have decided to GAAP these mutual companies by using the information in their statutory annual statements. We do an adjustment for acquisition cost, benefit reserve, policyholder dividends (which we deem to be stockholder dividends), and deferred tax. This is done with respect to their direct individual life insurance business only. Although, one could question the validity of the results, by working with data for the company for several years, one acquires a broad feel for the basic earning power of the company. Problems arise with respect to the handling of earnings on surplus and so forth. We then create a GAAP required equity for the mutual company consistent with the internal definitions used within

LNC. Thus, we assess the C-1, C-2, C-3, and general contingency risks and establish a base statutory minimum surplus amount for these peer companies, along with the GAAP adjustments to the balance sheet.

In summary, LNC has become more conscious of the need to make wise use of its capital. Total LNC stockholder equity is broken down into its strategic business unit components. Each SBU manages its required equity to the best of its ability. In general, the corporation decides how to allocate capital to the SBUs based upon the experienced or anticipated ROE. This is not the only basis for allocation of capital, but it is primary.

As time goes on, the insurance industry will see itself more as a business employing capital and earning a return on that capital for its stockholders. Analyses of return on stockholder equity or return on invested capital will be done in a manner similar to the manufacturing industry meaning that returns may be broken down into profit margins times a turnover rate, and so forth. This will make the length of time necessary to tie up one's capital in the insurance business versus other business a more important consideration.

At any given point in time, a company's ROE or net operating income may be askew from its normal pattern. This means that these measures must be used in light of past and anticipated performance, accounting for the various businesses in which the total corporation is engaged.

MR. SIEGEL: The appraised value system, while having advantages, is perhaps more subject to management manipulation than any other. If you change your interest rate by .25 percent, you can throw several hundreds of millions of dollars around. Furthermore, it's difficult to distinguish what economic factors you couldn't have controlled from those you could have controlled. Interest rates go up and down all the time.

MR. FICKES: The first important thing is to freeze assumptions, so that you can see what would have happened if all things remained equal. You may need a system where you could introduce changes to an assumption without having an effect on what management did or did not do for the year. The reason companies are beginning to go to this is that it allows you more of a "where-are-we, how-are-we-doing" approach to management reporting. Outside of mutuals, many companies can't be validated again when a company actually is sold. If you're hundreds of millions of dollars off, somebody will know that your assumptions are off.

MR. GEORGE HALL*: When calculating statutory required equity, how do you reconcile that to your existing statutory equity? What do you do with the difference when you add up all your business units? I could see this as a conflict with the business heads.

*Mr. Hall, not a member of the Society, is Senior Vice President and Chief Financial Officer of Transamerica Occidental.

MR. GLASS: The business heads are primarily concerned with what happens within their own units, of course, and there is a balancing item which is characterized as existing at the corporate level.

MR. THOMAS F. EASON: You listed a number of measures of revenue to labor cost and other items. Could you describe more what you mean by revenue? How do those measures fit into financial planning and management decision making? When you talk about revenue, with the tremendous dislocations involved with universal life and the exchange business, how do you adjust your thinking for different quality of revenue?

MR. GLASS: The ratios used are calculated on a GAAP basis for LNC in total. Each strategic business unit produces productivity measures, which are components of that total. We use those measures on an on-going basis to ascertain whether we are, in fact, improving our productivity over time. The dislocations that you refer to have had to be accounted for, unless they were present in the accounting periods to relatively the same degree. Revenues would consist of all of the revenues, including the premium income, the net investment income, and any miscellaneous revenues. Distortions between first year and renewal are avoided by using total premium income. As to quality of revenue, one would have to make an allowance for the effect of lump sums in interpreting the result. So far, this has been done subjectively.

MR. EASON: I'm interested in some of those interpretations. If you're familiar with how you have looked at things like lump sum and exchange activity, some comments on that would be useful, if you are able to and feel it's appropriate.

MR. GLASS: Ongoing roll-overs are not healthy. We established definite rollover rules to govern the level of the agent's commission. We also monitor the new-money/old-money ratio agency by agency and strongly encourage an up-trend in it. We discourage roll-over activity by limiting production credit for "club" qualification purposes.

MR. F. ALLEN SPOONER: It's possible under the value added or appraisal approach, to have a company's value continue to go up every year even though they lose money every year, because they always assume that things are going to get a little bit better. The fact that they've added a lot of new business and grown means that the value of the company has gone up even though they were a little off the track that year. How much credibility do you give to that bad year in deciding what the value of the company is? How much effect has that had on the value? It seems to me that you get into a terrible judgment problem with swings in the value added or lost in one year based on a relatively small change in experience.

MR. FICKES: You want to be consistent from year to year. This approach started in the U.K., and it's just now trickling over into North America. The U.K. does not have the problems of the vast swings in value. On a value added approach, no one should report one

single number as the worth of the company. You should be looking at a floating range of values, and it could be a high and a low number.

The company should be worth something in between. Over the long run, you should see a trend, and management should understand what's going on. You could have a bad year from an income and a tax standpoint. The optimum tax strategy would be to have the value-added value of the company go up as much as possible while having income of the company be zero. You pay no taxes because you've reinvested everything into the business, and you always get an after-tax rate of return on it.

MR. DENIS W. LORING: Internal rate of return is a single measure that spans a length of time. Return on equity has to be done externally rather than internally, in the sense that one calculates the return for, presumably, one year. One calculates equity either at the base for the year or mean over the year and then divides. In your calculation and analysis of return on equity, hurdle rate, and so on, do you look at more than a one year time span by looking at returns over a number of years versus projected equities for those years?

MR. GLASS: Yes, we look at both the internal rate of return and the leveled GAAP ROE over a thirty-year period.

MR. STEPHEN W. FORBES*: In casualty operations, how comfortable do you feel about your systems in terms of the accuracy and credibility of your loss reserves?

MR. GLASS: Mr. Richard S. Robertson in the audience could better answer that question.

MR. RICHARD S. ROBERTSON: Our system works well with our property-casualty operations, with the current exception of one small company. By and large, one of the keys to running a property-casualty company is getting a good handle on what your loss reserves ought to be.

MR. SIEGEL: When looking at the generated returns in the insurance industry as a whole, is there any characteristic that makes you immediately more favorably inclined toward a company?

MR. MATISON: We rarely look at new companies with which we're not familiar already. Essentially, you're looking for the opportune time to buy into a particular industry, or to buy the stock market. We look for high quality management and consistency in the concepts that I mentioned. Concepts tend to last longer than one year of sales increases.

MR. EASON: I'm with a mutual company, and it struck me that there's an interesting challenge for the investment community if there are some

*Mr. Forbes, not a member of the Society, is Senior Vice President, Financial Planning and Control Division, Life Office Management Association.

other mutual companies that follow Union Mutual towards demutualization. In that event, how will the investment community go about putting a value on the stock of a large mutual that may decide to become a stock enterprise, and how would you approach that if a client asked what the Prudential stock would be worth if the company went to market?

MR. MATISON: I don't believe that the large mutual companies will demutualize. There's no need because they're doing that through stock subsidiaries downstream, and they have the ability to raise capital. I do think that medium-sized life and property-casualty companies, which are not in New York, will go forth with demutualization. Our approaches are consistent with the ones that I mentioned in terms of viewing a mutual company, with its lines of business and size comparable to some stock companies, to see how it would trade if it were a public entity. You can use also the discounted dividend models to provide different ranges based on different assumptions. What you have is a range of results. At that point, you use judgment in selling the securities to the marketplace, which becomes the ultimate determinant.

MR. HOWARD L. ROSEN: Do the companies which are using the value added concept, look at current year's issues separately from past years' issues, or do they look at the progress of each individual year's issues? If, for example, a company changes its pricing philosophy and locks-in more conservative assumptions than in prior years, the company could have horrendous performance overall even though the actual sales of the given year may be of high quality.

MR. FICKES: In general they do, but it's different from GAAP. When you throw a new year's issues on at the end of that year, you also take a fresh look at past issues. You look at one year's issues, like 1984, separately, and then before 1984 as a group, also.

MR. JOHN C. WINTER III: Do you price on a GAAP basis at Lincoln National?

MR. GLASS: Yes.

MR. WINTER: What do you do about your equity not remaining level relative to earnings during the course of a product's lifetime? Deferred acquisition costs start high and wind up at zero, whereas the earmarked surplus of your assigned equity is probably relatively level. That would make it difficult for a product to earn an acceptable return early in its lifetime and easy later. Do you have some sort of weighted average equity over the lifetime?

MR. GLASS: The GAAP adjustments are forced to be those which produce a level ROE over thirty years, utilizing the pricing assumptions.

MR. WINTER: Some lines earlier in their lifetime won't be earning an acceptable return. Do you ask a business unit to weigh that against

more profitable lines, or do you subsidize higher and lower than your overall return goal between business segments?

MR. GLASS: We effectively subsidize between business segments. Every business segment is in the position of pricing on a prospective basis for the products that are coming into the market and building into the pricing process the GAAP rate of return, which it has as its goal. As actual earnings are reported, of course, old business is going off the books and new business is coming on. Actual results are a combination of both of those things.

MR. WINTER: Have you been hitting the 15 percent?

MR. GLASS: Not in ROE for the corporation as a whole.

MR. WINTER: How close have you been coming?

MR. GLASS: As a corporation, Lincoln National Corporation in total is below 15 percent and striving for it. Prospectively speaking, the pricing incorporates a given SBU's target ROE level.

MR. JOSEPH H. TAN: In your pricing using GAAP, would the provision for adverse deviation affect the trend of your ROE?

MR. GLASS: Yes.

MR. TAN: Do you have any principle on how much provision is set such that the trend of ROE is level or steadily increasing? How much is any increase over time of the ROE?

MR. GLASS: The pricing programs are set up to produce a level GAAP rate of return over a thirty-year period. For this purpose, the GAAP adjustments are forced and inherently reflect the choice of margins for adverse deviation in the aggregate.

The level GAAP rate of return reflects a return on the entire required GAAP surplus. In the ROE denominator, we include the GAAP adjustments to the balance sheet as well as the statutory minimum surplus. Following the pricing, the GAAP valuation area takes the pricing assumptions and calculates the GAAP earnings without any margins for adverse deviation in the GAAP factors. This is done to verify that, in fact, the pricing people have put some air in the basketball. If this is not true, then the GAAP people can't make it bounce. We do not experience much slippage at all between pricing and GAAP; it's less than 1 percent. If the pricing people give us something with 15 percent in it, it will come out 14 percent-plus in GAAP. I'm sure there are some technical differences between ROI and ROE, which contribute to that difference. Additionally, the pricing people will assume that we capitalize and amortize all of the acquisition costs, whereas when we get to the GAAP side we may not quite do that. So there exist some minor differences.

If we could choose margins for adverse deviation in GAAP accounting such that the return on equity could be level, thereby avoiding any big

variations from year to year, it would be advantageous. When we first set up GAAP in the 1970s, a ratio of the GAAP premium to the gross premium of 90 percent, without any margin for adverse deviation involved, raised the question how to pick margins for adverse deviation. Often the answer was to go halfway. So the ratio may have jumped from 90-95 percent -- a pragmatic solution. Wouldn't it be good if the GAAP adjustments could be structured not only from an accounting point of view but also from an ROE point of view?