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MANAGEMENT OF A SMALL LIFE INSURANCE COMPANY

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A discussion of the special problems and opportunities of a small company.

a. Tracking current developments

b. Role of the actuary

c. Distribution systems

d. Other actuarial problems

MR. ALBERT E. EASTON: Before I begin commenting on specific points, I probably should give you some background on me and on my company so you will understand the perspective from which I approach the questions of small company management. Although I've been working with a small company for the past 15 years, most of that time as chief actuary, like most small company actuaries, I also spent quite a few years with a large company. Berkshire Life is a small mutual company concentrating in ordinary business with about 70 million of premium in force and three billion of ordinary life insurance. Assets just topped $500 million in 1983, so the IRS no longer admits that we are a small company.

Marketing is a very important thrust of the company, as it is for almost all small companies. We compete in a market (upscale individual sales) that is dominated by much larger companies. We are probably one of the very few small companies competing in this market. However, I suspect that almost all small companies are competing in some market that is dominated by larger companies.

Our management structure is largely based around committees. While we do have a hierarchy, we also have a very active committee structure with the committees empowered to make important strategic decisions, and in fact, actually making them. This is possible partly because the chief executive officer is an active member of several of the most important committees.

For example, our Product Development Committee has made all product decisions for approximately the last 15 years. The committee includes members at various levels within the organization, including the chief executive officer, our chief underwriter, heads of our Data Processing and Policyowner Services Department, our chief investment officer and several others. I chair it as chief actuary. An agenda is set out before each meeting describing the problems that will be discussed at that meeting, and the committee members try to come prepared to talk about those problems. We try to stick to the agenda at the meeting, but after we have completed it, we will frequently spend some time discussing other problems not on the agenda. Minutes are published throughout the company shortly after the meeting indicating what was decided. This has proven to be a very effective way for us to make and communicate decisions on products.

I realize that some of you may have had some bad experiences with committees, and I have had some myself. I think the key to successful committee operation, in our case, includes first of all, a total avoidance of game playing. No one is trying to make a point merely to hear himself talk or to impress others at the meeting. Once we have discussed all aspects of a topic, we make a decision and move on. Decision-making, believe it or not, is by consensus about 90% of the time. There is enough agreement on the basic principles under which we are operating, so that we can all agree on most issues. When it becomes clear that no consensus is developing, the CEO is quick to step in and make a decision after he has heard all viewpoints. Secondly, the committee meets frequently with always the same members. We all know each other well enough to feel free to speak up when we have a point to make.

Tracking Current Developments

Tracking current developments is a very important communications function and one in which the actuary has a key role to play. (I will comment on this further under the role of the actuary.)

Barely keeping up with current developments is not enough for a small company or for any company. It is necessary, in the communications sense, to keep ahead of current developments. This does not require any mystical "sixth sense" or anything more than good intelligence and reasoning ability. It is the same ability that a chess player uses to think a few moves ahead in response to his opponent's move.

The particular developments that you want to keep up with vary considerably by company, but they probably include all of the following:

a. Changes in your markets - Certainly this is important to every company, especially small companies. You need to know what new products are being offered in your market, what new competition may be developing, and whether your market itself is changing.

b. Changes in legal environment - Under this category I include changes in tax laws, NAIC developments, changes in state laws in any of the jurisdictions in which you operate, etc. There is a huge amount of data constantly being generated in this area, and you need to develop a sense of what is important and deserves detailed study, what needs to be held for possible later study, and what can probably be ignored altogether.

   The ACLI does a fairly good job of keeping you up-to-date with bulletins, but the bulletins only give the bare facts. It is up to you to think beyond them to the effect that the changes can bring about in your company.

c. Developments in the actuarial field - As lengthy (and sometimes turgid) as they are, I try to read the Transactions as soon as they arrive, as well as the Record and the Actuary. It is also necessary to keep up with new opinions and guidelines being promulgated by the Academy of Actuaries. Obviously, there is not time to dig very deeply into some of the research topics that are covered, especially in the Transactions and in Arch, but I do try to be aware of what is going on, so that if I run into a situation where a technique could be applied, I am at least aware of it. In recent years, the seminars sponsored by the Society of Actuaries have been extremely important and useful. Many

times they cover developments in various fields before they are fully researched and described in publications.

d. Data processing developments - In some small companies, the actuary has to be the data processing officer as well. Fortunately, I do not have that problem and do not have to keep up with the latest developments in hardware and software. However, I suspect that every actuary should be somewhat aware of the developments now taking place in microcomputers, because they may have actuarial applications.

e. Reinsurance developments - As a small company actuary, you will almost certainly receive a number of visits from reinsurance representatives who will do their best to keep you up-to-date on recent developments in the reinsurance field. The Society of Actuaries new Reinsurance Committee is also working in this area.

f. Other environmental changes - As a bare minimum, the actuary will want to keep up on the changes in mortality rates and in the interest rate and investment environment. Probably, there is a great deal I left out.

While you are doing all this tracking of current developments outside your company, it is altogether too easy to lose track of developments inside. Keeping track of what is going on in the areas that report to you is just good management. But how do you keep track of other areas?

For example, in most companies the marketing function falls outside the actuaries' province. How do you keep track of what is being sold by whom? Or, even more important, what is not being sold by whom and why? Again, communications is a key. Successful companies have well developed channels of communication to handle such things. If you do not, you should have.

Before I leave the field of tracking current developments, I should comment somewhat on the use of consultants in this area. When we consider all of the areas in which a small company actuary should try to keep up-to-date, doing so in any real depth is impossible. Fortunately, there are consultants available who try to keep themselves well informed on particular topics of interest to small companies. We have successfully used consultants in entering a new line of business or developing a product or technique which has never been used in the company before.

Role of the Actuary

I said before that the actuary has a very special role to play in communications. Actuaries are hooked into what I believe is one of the best communications networks in the industry. Spearheaded by the Society of Actuaries, but helped along by the Academy and by actuarial clubs, actuarial information flows from company to company better than almost any other information. I firmly believe that a good actuary is a good communicator, first and last. Most of the actuaries that I respect excel especially in their communications skills. Some actuaries are good mathematicians too, but I have never considered mathematics to be the most important skill for an actuary.

An actuary's job within a small company is to communicate all these technical changes to people who may not have the same technical background. Actually, this situation is not much different in a large company, except

that in a large company, a poor communicator can survive (at some level below the top) by communicating only with other actuaries.

In fulfilling this communication role, it is important to remember that communication is a two-way street. You have to give information and listen. There are two people involved in every communication, and an actuary communicating to a non-actuary has to be very careful to be understood. You can do this best by knowing your listener and giving him just the right combination of:

a. What he wants to hear;

b. What (you think) he needs to hear.

Consider, for example, the following statement:

> "This term product is absolutely no go. If we adopt it, we'll lose money because of deficiency reserves."

To an agency vice president, that does not say much. He does not know what deficiency reserves are, and he is puzzled as to why your competitor has adopted such an awful money-loser. Why not rephrase the statement to:

> "Probably, this term product is not right for us. Because of the low premiums, we'll be legally required to hold extra reserves in the early years, which won't be paid back until the later years. Holding those extra reserves will use up some of the surplus we had been planning to spend on agency expansion in the next few years."

He may respond in various ways, but at least the latter statement sets the stage for a dialogue.

The Distribution System

In my own company, management of the distribution system is very similar to the other company management. Heavy use is made of committees, which include both field and home office representatives. Communications, once again, is the key. When the field and home office begin to respect each other's problems, they become willing to work together on solving them.

This is not to suggest that no attention at all is paid to the hierarchy. The chief executive is a member of these field/home office committees, just as he is on solely home office committees; but the key ingredient is respect for one another.

MR. JOHN R. McCLELLAND: My introduction to the actuarial profession and to the life insurance industry took place in the early 1960s at a mid-size eastern mutual life company. I learned quickly of the "eternal value and magic" of whole life insurance. That value was considered to extend to the agents, customers, employees, company, and country. As we now recognize, that decade marked a golden period for this business. It was easy to manage a life insurance company and it was hard to fail.

About 15 years ago, I joined my present employer. Continental American now has assets of $330,000,000 and revenues of $80,000,000. At the time I was hired, it sold participating whole life insurance to upscale customers through general agencies and personal producing general agents. It is

stockholder owned but, since it is admitted to New York, it is subject to the restrictions of New York as to the profits from the participating business that can be transferred to the stockholders. Accordingly, the culture of the company was typical of mutual companies.

In the early 1970s, management identified several of the problems that I will be discussing; particularly, the economic problems of the agency distribution system. The response was to develop an alternate direct response distribution system. Today, more than 90% of new business, and about 50% of premium income, is attributable to the direct response system and the company's culture has become dramatically more entrepreneural.

It is from the perspective of this change that I wish to address the topic of management of a small life insurance company. Although each of the panelists has a somewhat definition of small, so that we all can have a common reference point, I consider "small" any company with less than $100,000,000 of revenue. You may personally have a different cutoff, but I suspect you will agree that the cutoff is rising at a faster pace than inflation.

Turbulent Times

All of our companies have been buffeted by turbulent times. The list of problems that must be faced contains the familiar ones: Expense pressures, intense price competition, rapidity of change, technological change, volatility in financial markets, deregulation, new competitors, shrinking real incomes for our agents, thinner profit margins, and changing consumer preferences.

These changing consumer preferences are driven by inflation, by changing lifestyles, and by changing consumption patterns. Involved here are family demographics, changes in age distributions, the increase in the number of households, the decrease in the number of dependent children per household, etc. It also involves changing work and employment patterns and changing attitudes toward work, retirement, job mobility, and working spouses. The changed consumer preferences are seen in the shortened time horizons for savings, the increased expectation for, and knowledge about, the real return on those savings, and the desire for living benefits —— to benefit "me".

Inflation's Impact

I believe that most of these forces are closely related to the decade of inflation that we recently experienced. Since inflation is usually viewed in economic terms, the cost pressures faced by agents, customers, and companies alike are clearly associated with it. However, inflation is also a social and political matter. As the entitlement ethic replaces the work ethic, and as politicians in all kinds of economic and social systems promise more than the people are willing to work for, inflation is the inevitable result, as the economic equivalent of "musical chairs" takes place.

This experience with inflation has substantially reduced the attractiveness of the main product of the individual life insurance business —— the whole life policy.

The dramatic reduction in price inflation of the past two years is most welcome. I doubt, however, that it has changed the fundamental outlook of most consumers. The members of my parents' generation had their economic

outlook and spending habits permanently shaped by the depression years. In a like way, but with dramatically different results, my generation's habits have been altered by the decade of inflation. Even if rapid inflation does not resume, these spending and saving habits will be slow to change. We, and our colleagues in our companies, must take these changes into account as we attempt to deal with the future. For while these changes and problems constitute a threat to many in our industry, they present great opportunities for those who respond appropriately.

How to Respond

This brings us to why we are here today — What is the appropriate way to respond? I believe that a small company can and will both survive and thrive if it develops and carries out a comprehensive strategy. This message has been repeated in articles and speeches by consultants and others for several years. Before we dismiss the thought as the buzz words of this period, let us recognize that all of the changes mentioned have resulted in much narrower profit margins. In the "good old days", if we goofed, the result was smaller profits and reductions in surplus. Today, the results are, and will continue to be, more dramatic — failed companies and customers left in the lurch.

This strategy that I suggest need not involve reams of paper, vast staff bureaucracies, and all the parade of horribles that small companies do not have the resources to even consider. The strategy need be nothing more than the chief executive's intuitive assessment of where he or she wishes to take the company.

Know the Market

To develop that strategy, each company must know its market and its characteristics. You must know your competitors and their strategies. You must know your own strengths and weaknesses. You must assess the potential for growth of your market. Lastly, you must understand the key factors for success in your market and be able to assess realistically what changes or actions will be needed to satisfy those key factors. As you go through this process, it is absolutely essential that you see the world as it is, not as you might wish it to be.

Three Approaches

Once you have identified the market in which you will be operating, the next step is to devise a specific plan for competing in that market. In his book, "Competitive Strategy", Professor Michael E. Porter of the Harvard Business School has pointed out that the numerous strategies for competing in business are largely variants of three "generic strategies". These three approaches to outperforming other firms in an industry are: (1) Become a low-cost producer; (2) Differentiate your product; or (3) Focus on a special market niche. Let us look at each of these strategies.

Low Cost Strategy

The low cost strategy involves achieving a position where your costs of doing business are lower than those of your competitors. You then can either undercut competitors' prices and increase market share, or maintain competitive prices and achieve superior profitability. Since claims costs are the largest part of the costs of most products, superior underwriting results would appear to be the obvious way. However, it is not clear whether a company can develop a unique way to reduce claims cost that is not

easily copied. Because of the economies of scale for other costs, it is rarely possible for a small company to achieve a true position of low cost. The desire for a low cost position is an important factor behind the merger and acquisition activity in the life insurance industry.

Product Differentiation Strategy

The product differentiation strategy involves enhancing one's product so that the market perceives it as better than competing products. In general, this could take many forms: Design or brand image, technology, features, customer service, distribution network, etc. However, most of these approaches take the form of some unique feature in the product itself. As we have all found, there is nothing to protect a new insurance product once it is offered in the market. New policies are easily and very quickly copied by competitors. While product differentiation is a better approach than no strategy at all, it is difficult, since it involves continually developing new and better products.

Focus Strategy

The third type of strategy is to focus on a particular buyer group, on a segment of the product line, or on a regional geographic market. It is the classic strategy for the smaller firm in any industry which wants to avoid direct competition with the larger companies. The entire strategy is built around serving a particular target market very well. I suggest that those of us concerned with the management of small life insurance companies carefully consider this type of strategy.

Stuck in the Middle

The three generic strategies are all viable approaches to dealing with competitive forces. However, they do require both a decision and a commitment. Given the nature of people, some companies will fail to develop a strategy or will not want to risk putting all their eggs in one basket by embracing a single strategy. What happens then?

The company that does not develop a strategy (what Professor Porter calls "stuck in the middle") is in an extremely poor strategic position. It is almost guaranteed low profitability. It either loses the high volume customers who demand low prices, or it must sacrifice profits to get this business away from the low-cost firms. At the same time, it also loses the high-margin business to those firms who have focused on high-margin target markets or who have achieved differentiation.

Multiple Strategies

The firms that think that risks will be lower by pursuing multiple strategies may well actually increase their risks. A company that concludes that it must pursue multiple strategies should carefully consider how it will do so.

Each strategy involves different resources, strengths, and organizational arrangements. As a result, each has different crucial requirements for success. Because of these differences, a firm pursuing multiple strategies ought to divide itself into semi-autonomous "mini-companies", each of which is organized and staffed to focus on a single strategy.

Development of a Focus Strategy

In order to develop a so-called "focus strategy", a company should first look at what it is now doing. Quite often, a focus strategy is being pursued in whole or in part without a clear articulation of that fact. In any case, the particular market that will be served must be identified and its needs understood. Then each of the company's functional policies must be developed so that the target market will be served very well. The focused firm is able to serve its narrow market more effectively or efficiently than competitors who are not specializing. As a result, the firm can achieve differentiation or lower costs for that particular market.

The market may be defined in terms of the ultimate customer, such as doctors, farmers, women, etc. It may be defined in terms of a particular geographic area. Once the market has been defined, then the products and services desired by that market must be analyzed to find which ones you can deliver on a competitive and profitable basis.

With the market and your approach to it identified, the next step is to recognize that investment will be required. You must be able to do a superior job of serving this market. This will involve both people and money. I believe that you must be perceived as being the best at what you have selected to do. If you have made the right choices, your company will grow rapidly, be very profitable, or both. Such results will attract copy cats. Your continued success will depend on continuing to know more about the market than those who copy you.

Need for Information

If a company is to know very much about a specific market niche, then there will be a tremendous need for accurate, timely information about the market, its needs, and the company's experience. The key questions, as always, are: What results are we getting? How does that compare with what we anticipated? And what changes in approach are suggested by those results?

By knowing more about the market and its experience, one can anticipate changing needs, design new products to meet those needs, and segment the market to capture the better portions. This requires an up-to-date information system that is designed to capture data about the market.

We need people with perception and skill to analyze that data and to reach conclusions and insights that will permit our company to stay ahead of the other companies that serve the same market. The analysis of that data will require an intellectual honesty willing to accept results different from preconceived notions. After the results have been discovered, they must be communicated to the rest of the organization in an understandable manner.

Role of Actuaries

Considering my background and this audience, it should be no surprise that I consider actuaries very well qualified to fill this role. But a word of warning is also appropriate. This function will be performed, since it will be crucial to the success of our companies. If actuaries do not do it, someone else will.

I mentioned that insight will be important. Since we are talking about small companies operating in a rapidly changing environment, we often will not have "sufficent" data to demonstrate "conclusive" results. We also will have less intercompany experience on which to rely. As the markets are segmented in narrower slices, and as our data increasingly are viewed as proprietary knowledge, we will have to use incomplete data to help us and our management colleagues make fundamental choices on which success or failure will depend.

Those of us involved in the management of small life insurance companies are well aware of the problems that these turbulent times have brought. While we attempt to meet those problems, we should realize that these same problems present great opportunities. Change is, after all, the ally of those who are prepared for it.

Stock Company Perspective

Our moderator has asked me, as the stock company employee on the panel, to comment on the relationship of the company actuary with the stockholders. He asked whether the stock company organization places any special financial constraints on the actuary and his work, and whether profit maximization is the actuary's goal.

Of course, I can offer comments only from my experience with a single stock company and my observations of other companies. I ask you to keep that limitation in mind.

Actuary's Role

As you all will recognize, the insurance enterprise requires the skills, techniques, and background that the actuary normally has. These tend to be "financial" in nature. Hence, we are normally involved in matters and analysis of a financial nature. In one form or another, we help answer questions like:

What are the likely financial results from a particular course of action?

What results is the company now getting?

How do those results compare with what was expected?

These questions and the actuary's role will be similar in both stock and mutual organizations. The way that role is performed has more to do with the reporting structure and the particular personalties of each company based on each company's unique history.

Organization Goals

I believe that any organization goes through similar stages as it decides what goals to pursue and how to accomplish those goals. In dealing with such questions, those individuals responsible for the enterprise will attempt to satisfy the various groups with a stake in the outcome. In the typical mutual company, these stakeholders include customers, employees, agents, and management itself.

The only difference for a stock company is the presence of an additional and very important group — the stockholders. They have unique perspectives and expectations. More importantly, they have the ability to impose a discipline on what the hired management does.

Small stock companies are particularly apt to experience that discipline, since being small probably also means having a limited number of stockholders. If a major stockholder is also active in management, that discipline is even more apparent.

Potential Goals

Observation of the market behavior of various stock and mutual companies has convinced me that different organizations do pursue different goals in different ways. It also has convinced me that the type of organization, stock or mutual, does not necessarily tell you what behavior to expect.

A project in which I am currently engaged may help me elaborate. My employer is now wholly owned by an industrial company. With that owner, we are in the process of mutual education. The subject is what the insurance industry is really like, what alternative strategies and goals exist, and what results are likely.

Thus far, we have concluded that currently, the insurance industry is really a collection of distinct businesses. Each has distinct characteristics, including the markets served, distribution systems employed, and products sold. Accordingly, each has different financial and other requirements and will likely produce different financial and other results.

Among the objectives that are available are emphasis on long term stable growth, emphasis on a particular product, emphasis on asset growth, use of investments to control other firms, building customer relationships, and development of a particular distribution system. These possible objectives are common to both stock and mutual organizations. Other objectives of concern to stock companies involve the relative emphasis to place on distributable (statutory) earnings compared to GAAP reported earnings.

We have reached the key conclusion that the goals, objectives, businesses, markets, distribution systems, and products all interact. A decision about one will narrow the possible choices for the others.

Stock Company Decision Making

In the case of a small stock company, it is fairly clear that the viewpoints of the stockholders will somehow prevail: But because stockholder groups are different, the choices made by different companies will differ.

Thus, to answer the moderator's questions, constraints are placed on the actuary, but they will differ, depending on the objectives of the stockholder group. Likewise, the emphasis to be placed on short term profits, compared to longer term objectives, will reflect those same stockholder objectives.

MR. DOUGLAS MENKES: I would like to begin by briefly describing my professional background so that you will have some idea as to the areas from which I draw my comments. Since entering the insurance field in 1970, I have been associated with three very different organizations for nearly equal periods of time. I began with a large eastern mutual company as an actuarial trainee and served in various capacities which were the result of exam progress and the rotation program. There were many opportunities for actuaries, including positions as department managers and division heads. Actuaries could be found in Underwriting and Data Processing Departments as well as in product development and financial reporting areas. Most of

the actuaries had well defined, highly specialized functions. I never really appreciated the role which these actuaries played in the management and growth of the company until I left.

My next employment was with a much smaller organization—a small to medium size stock company—located in Florida. The company had been in existence for about 25 years and was run by the son of its founder. Much more so than in a large insurance company, the direction and style of this company reflected the views and approaches of one or two individuals. Although management kept the actuaries in a little corner, the work was less specialized than in a larger company and we often wore many hats. One of the good things to come of this was the company's ability to make relatively quick organizational changes to cope with changes in the insurance industry. One such major change was a system called matrix management, which I will describe later.

Having worked for both a large mutual and a smaller stock insurance company, I decided to try consulting. In this capacity, I have worked with insurance companies of all sizes and been exposed to various types of management. A couple of months ago, I was visiting with the president of a small life insurance company, whose views I greatly respect. I asked him, "Jack, I am going to be speaking on a panel regarding the management of a small life insurance company. What would you say if you were speaking for about 20 minutes?" After making sure that the meter was off, Jack replied, "Basically, I would stick to what I do best and not make large commitments in areas in which the company has no expertise. It is as simple as that, and I don't know how you take up 20 minutes saying it."

There are a number of people who feel that no one company can be all things to all people and that the small companies which do best in the long run will be those which concentrate on what they do best. We see examples every day of what might be called specialty companies. They concentrate on such areas as substandard insurance, term insurance, structured settlement annuities, credit insurance, health insurance or single premium deferred annuities. Of course, many of these companies become so successful that they grow to the point where they are no longer small. The trademark of their success, and the reason for it, however, is concentration in an area of expertise—not expansion through multi-line marketing. The area of expertise need not be a well defined product. There are companies which could end up concentrating on certain groups of products as a result of unique marketing specialties. One example which comes to mind are the companies which write group life and disability insurance to complete the insurance package for groups insured by Blue Cross and Blue Shield organizations. Although I would not expect to see these companies in the group medical insurance field, it would not surprise me to see an increasing interest in products used to fund qualified savings programs such as individual retirement accounts, simplified employee pensions, defined contribution plans, 401k plans, and tax sheltered annuities.

On the other side of the coin, I have heard arguments advanced to justify expanding into a number of markets. Many of them are based on attaining lower unit costs by spreading certain fixed expenses which are common to all lines of business. Other arguments relate to the stability of corporate earnings - that is, it is unlikely that experience in all lines of business will be poor at the same time. I do not have any problem with this line of reasoning as it pertains to mortality or morbidity experience. What

happens in practice, however, particularly in very small companies, is that the expenses of selling and administering insurance, combined with the low market shares attainable by these small companies, make profitability a challenge even during a good year. This has become an acute problem in recent years as sophisticated insurance products, extensive disclosure requirements, and continued lack of regulatory uniformity, and inflation have contributed to high operating expenses.

As an actuary in a small insurance company, what types of unique problems or opportunities do you face? Certainly, keeping abreast of current developments is part of your job, regardless of the size of your company, but it is especially challenging in a small company. To remind yourself of just how dynamic the insurance industry has become in recent years, just look over the topics covered at this meeting. Some of the more important issues and developments of the 1980s are federal income taxes, demutualization, unisex, interest sensitive life products, asset and liability matching, investing in options and futures contracts, the C3 risk, new nonforfeiture and valuation laws, the entrance of the financial service industry into life insurance, runaway health care costs and the use of personal computers. Furthermore, the financial reporting associated with many of the new insurance products is not clearly defined. Financial reporting is of concern not only to publicly traded stock companies, but also to many mutual companies or closely held stock companies which have adopted modified earnings bases in an attempt to match earnings with revenues.

Now let's look at the discussion topics from the annual meeting 10 years ago in 1974. Some of them dealt with pension legislation, some with certain desirable professional qualities such as high standards of work, independence, and professionalism. There were two discussions which covered expanding the actuary's role in general and specifically into investment areas. Finally, there were discussions on equity products, price disclosure and life insurance dividends. While most of the developments of 10 years ago are relevant today, many of the most significant issues are different.

An actuary working in a large insurance company is likely to have an easier time following current developments than one working in a small company. In a large company, almost all actuaries are involved in specific lines of business, so that for an individual the impact of certain developments will be less significant than others. For example, a group actuary does not need to know the intricacies of the 1980 amendments to the standard nonforfeiture and valuation laws. He might be aware of the salient features of the laws, but would not have to devote much time to them. Also, a large company can afford to have actuaries working on specialty committees within the industry, or even on special research projects involving current issues. The actuaries share their experiences, so that a general level of awareness emerges which is most difficult for one or two actuaries working in a small company to attain.

One day last year, I received a call from a former co-worker in Florida. He had moved to a computer software company which specializes in actuarial systems. Basically, he wanted to know how I went about keeping current and if I had any ideas which might help him. At the time he was the only actuary with the company and found that he could not get his hands on copies of proposed tax legislation and other such items on a timely basis.

I suggested subscribing to some of the news bulletin services, attending actuarial meetings and seminars, and trying to develop a contact in a large insurer who could channel hot information to him from time to time. I do not think that I told him anything that he had not thought of himself, but I did confirm his belief that it "wasn't just him". There is no doubt in my mind that keeping current in a small insurance company is much more difficult and time consuming than in a large company.

What is the role of the actuary in a small life insurance company? One role, which should be obvious from the preceding discussion, is being the source for most of the technical information which pertains to design and pricing of the company's products and the environment in which it operates. Hopefully, the role involves much more. It is the actuary's job to analyze the risks which are taken in an insurance company. This should encompass projections of financial results as well as subsequent analyses of actual results versus expected results, broken down by significant components of profitability. These analyses are important, even if done on a crude basis at first. Consider the plight of a small insurance company which cannot base its premium rates on its own expenses because to do so would result in premiums which are too high to be competitive. Chances are, the premiums were set based on competitive considerations. The target profitability is a goal to be attained at some future time when the company has grown to the point where its expenses are in line with those of medium size established companies. Although this future point may not be well defined, the company—as a minimum—should compare its actual expenses with those generated by its pricing assumptions each year to see if the difference between the actual and target expenses—on a per unit basis—is narrowing. These types of analyses are useful for other purposes, such as making gross premium valuations for recoverability studies.

Too often, in small companies, financial analysis is either ignored or attempted by accounting departments based upon empirical relationships. The extreme and unfortunate case occurs when the senior management of a company views its actuaries as necessary evils which exist for purposes of signing annual statements. Sometimes this view is conveyed mistakenly when actuaries are unable to communicate and deal effectively with non-actuaries—especially marketing people.

Thus, the role of an actuary can vary widely from company to company. The extent to which an actuary gets involved in other than the essential functions tends to depend on the actuary's ability to communicate and sell himself, as well as on top management's views on the role of the actuary. There will be times when your views on what your role should be differ from the views of the people running the company. The company in which I last worked had a large sign in large block letters in full view of everyone entering the building. The sign read, "The most important person in the company is the one who 'makes the sale'. I think that a better sign might read, "The most important person in the company is the one who makes a profitable sale".

Earlier, I referred to a corporate organizational structure called matrix management. For those of you who may not be familiar with it, I will describe briefly how it works. Under matrix management, the company is organized along the lines of its major markets as opposed to traditional lines such as ordinary, group and pensions. Examples of possible markets are insurance sold by agents on a one-to-one basis, insurance marketed

through financial service intermediaries, banks, consumer finance companies or mortgage loan companies, insurance marketed by direct response, or group insurance and employee benefits. Each marketing line of business consists of a business board comprised of members representing each function necessary to run the line of business. For example, there could be members representing marketing, administration, legal, data processing, actuarial, investments, and accounting. One of the members would be selected by top management to be the business board chairman. This person would be responsible for the financial well being of that line of business. His compensation would reflect the performance of this line. One variation, which I have seen, is to exclude the investment function from the business boards and for purposes of measuring the performance of each board, allocate investment income consistent with pricing assumptions, with any differences being allocated to a corporate account. I do not recommend this variation when interest sensitive products are involved, since in the design of these products every effort should be made to involve the investment people.

The corporate organization looks like a matrix with the columns consisting of the lines of business and the rows consisting of the various functions. This may not seem very different in practice than many insurance companies, which have not taken the trouble to draw a matrix and fill in the boxes. While there may be some truth to this, the strength of matrix management is that financial accountability is clearly defined. My co-panelist has asked me, if in a small company, does matrix management lead to the same few key people doing the same job but wearing different hats. If the company is small enough, or if it concentrated only in one line of business, this could happen. Even in a very small company, which markets only one or two lines of business, someone should have financial accountability, although a true matrix organization may not be feasible.

Like most organizational systems, matrix management has its advantages and disadvantages. The three biggest advantages which I see are:

1. Financial responsibility is clearly defined for each line of business.

2. When more than one competent employee exists in a service department, the opportunity to participate in the management of the company is facilitated by having different department members serve on different business boards.

3. The administrative and financial needs of each line of business are clearly defined.

The drawbacks are those of any management structure which designates clearly which of the employees are on the guest list. While opportunity for advancement within a department may exist, the opportunity to be a business board chairman may seem elusive or nonexistent to many people. This can be an acute problem if the company's top management selects business board chairmen from one discipline—such as marketing—instead of from the group of business board members based on personal qualifications.

While small companies generally are able to react quickly to changes in the industry, there are some special problems which are more common to small companies than to large companies. Small companies may not be in a position to assume the types of risks which are necessary to compete in particular markets, such as guaranteed investment contracts or single premium deferred annuities. Companies which invest primarily in triple A rated corporate bonds will not be able to compete in these markets. Although the higher yielding riskier investments default infrequently, the impact of a default is much more severe for a small company. Some of the risk taking problems can be overcome through reinsurance; particulary, the mortality risk. Another area in which opportunities are limited for small companies is research. The February, 1984 issue of the Reinsurance Reporter describes an experimental underwriting program, which Lincoln National had conducted, in order to study how mortality had changed and to assess its competitive position. It underwrote a small number of risks—in relation to its total inforce--and observed the experience which emerged. In a small company it would have been most difficult to generate a statistically credible exposure without taking great risks. Still another problem encountered by small companies is the lack of a Best's rating due to size or immaturity. In some markets, such as structured settlement annuities, an A rating is required to obtain business.

In spite of these obstacles, there are many small insurance companies succeeding—especially on a G.A.A.P. basis. The ones which are ultimately successful will be those which concentrate on a few areas in which they have expertise.

MR. LARRY SILKES: There is always a problem in defining what is a small life insurance company. For me, if the management even thinks of listening to me - the company is small. The more important question is how does size prevent the company from competing in its markets. In addition, management must ask how can the company overcome the limitation of size? And how, because of its size, can it outperform its competition?

A small life insurance company has several problems competing against a large company. The traditional problems are:

1. High unit cost
2. Small Surplus - cannot take unnecessary risk or issue policies with heavy surplus strain
3. Small Exposure - a few extra claims can lead to severe adverse earning experience
4. The quality of people it can attract is limited. The small company cannot pay the competitive salaries; in addition, there is generally little or no opportunity for advancement for people below the top management level.

The list can go on. However, there are many interesting solutions to these problems that allow the company to overcome its limitations. First, there has to be a change in perception of what an insurance company is. One view of a life insurance company is that it is a single unit that creates a product, takes in premium income, administers policies, invests the remaining funds and pays claims. Or we can unbundle the company and decide where each function can be accomplished most economically, whether internally or externally.

Below I will give an example of a company that I have been affiliated with. I am sure that you are aware of other examples. I know of one company that wanted to sell an interest sensitive investment oriented product. To accomplish this, it made arrangements with a distributor to market its product. Then it contracted with an investment consultant to devise and implement the investment strategy necessary for the product. With respect to administration, the company felt the volume was not going to be excessive, so it decided to handle it internally. However, we all know that if it wanted to, the administration could have easily been farmed out. Finally, the company had a consulting actuary handle the certification of its liabilities.

Reinsurance becomes a necessary element in the implementation of most strategies because it is with this mechanism that surplus relief can be obtained and risk minimization can be accomplished. Surplus problems can be solved if it is realized that surplus is a purchasable commodity. In addition, it must realize that surplus is not cash and has a different value. A sound risk policy needs to be established based on the company size and expected growth. The company can layer its risk by adjusting retention as it grows. It then can provide an overall umbrella with a stop loss treaty.

Another key reason the younger and smaller companies have been so successful is that they do not have to worry about their old policyholders. The company can become a "cannibal life" without having to worry about the consequences to its own portfolio.

There are other examples of small companies aggressively attacking areas and outperforming the larger companies. Some people refer to this strategy as finding a niche and exploiting it. Management must decide what strategies it is comfortable with and how it can implement them — it must decide what strengths it needs to implement the strategies.

One of management's essential tasks is to fully understand how new business affects the operation of the company. In addition, the management must always be aware of what is happening with the existing blocks. I have been able to set up in a crude way some "early warning" signals in one of the companies for which I have worked. A substantial increase in the due premium should be analyzed to see if there will be an increase in future lapse.

Because the company was small, the number of deaths was usually less than 200. This is a manageable number to work with for analysis. One useful test is to divide the number of deaths by the select "q" to approximate the exposure. A comparison of the expected exposure with the actual exposure can be done on an agency or a company basis.

After each quarter, I would analyze the financial results similar to the old gain and loss exhibit and break down the current GAAP earnings by source. (The gain from interest, mortality, lapse, etc.). Also, I would compare the valuation runs from one period to the next to check on persistency.

The principles of management for a small life insurance company are the same - independent of size. The goal is to allow the company to compete in its market. It is up to management to search for ways to overcome the limitation of size.

MR. EASTON: I see a few of my reinsurance friends. Can any of you comment on what a reinsurer looks for in granting surplus relief, and how a decision is made.

MR. WILLIAM TYLER: The last two or three years have been atypical since much of the surplus relief and financial reinsurance has been conditioned upon the tax situation and other aspects of those years. In general, surplus relief programs that my company has offered during the past 15 years to smaller companies depend on recognizing whether the cause of surplus need was based on good growth or poor management. In particular, the profitability of the block of business being reinsured should support the surplus relief granted. In general, the amount of surplus relief should be substantially lower than estimated future profitability. The purpose is not for the reinsurer to take on an undue risk in earning its charge for surplus relief, but to provide financial support on a temporary basis. Generally, we have worked very closely with the insurance departments of the reinsureds' state of domicile, and sometimes with the Indiana Department. (We are domiciled in Indiana.) In dealing with surplus relief programs of significant size to small companies, we have to be concerned about how these would be viewed by the State Insurance Departments. We have usually either requested or required that these programs be sent to the State Insurance Department for review. Reasonable programs have almost always been approved, but we feel that it is important to keep the regulatory authorities informed.

MR. JAMES PILGRIM: Having just moved from a large stock to a small company, I have become more concerned with the importance of surplus as we may be a net buyer of surplus rather than a provider. However, in my prior affiliation, we viewed surplus relief positions similar to underwriting a mortgage. We expected to realize our investment out of the present value of future profitability of the business. In 1965, John Burley wrote a paper for the Conference of Actuaries in Public Practice called Raising Surplus Through Portfolio Reinsurance, whose basic principles still apply. In recent years, reinsurers have tried to eliminate some of the elements of risk to protect their investment. Several states, particularly Illinois and Colorado, require filing of these agreements.

MR. EASTON: In many cases, a small company may not have the luxury of committing scarce management time to extensive decision making concerning allocation of scarce surplus. Often, a small company is forced to commit its surplus to maintaining itself in key markets, while being unable to develop or market in other lines of business.

MR. MELVILLE YOUNG: I had the pleasure of working for many small companies. I believe that many should not have been encouraged to grow. Most companies requiring surplus relief need it for very legitimate reasons. However, in many cases, we felt that encouraging the company to grow would not be a service to the insurance industry or to the policyholders. We feel it is very important to analyze the management as well as the block of business reinsured and the company's financial situation in reviewing a surplus relief program. We want to know what purpose the surplus is to be used for - whether to finance growth, maintain dividends to a holding company, or for some other purpose. We often come upon a request because of a need for a cash dividend. We find that surplus relief reinsurance is usually not appropriate in this situation. During the past few years, tax mechanisms have been available in these situations which are no longer available under the new tax laws.

The blocks that reinsurers will accept vary in risk. We try to structure this to be manageable. The level of risk and the tax position of the reinsurer will determine the price of the reinsurance. The tax deductability of the reinsurer's reserve would have an impact on price.

MR. SILKES: Small companies are mostly entrepreneural. They try to get business with as many tools as they have. As they grow, the company must become more administrative. Eventually, the company may become more of an investment company. An administrative company, due to conservative reserving, may be worth more dead than alive.

MR. PILGRIM: A question for Mr. Menkes. My experience is that matrix management is an efficient form of management. Is this your impression?

MR. MENKES: I think that it can be. I would say that the particular company that I discussed was efficient before matrix management was adopted. Committee meetings were replaced by business committee meetings. I don't think that this is necessarily more efficient. I think that its strength is that it forces accountability for each line of business.