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MANAGEMENT OF A SMALL LIFE INSURANCE COMPANY

Moderator: KEN GOLL. Panelists: BRUCE D. BARTON, JAMES R. MILLER. Recorder: RICHARD P. MAY*

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

- Tracking current developments
- Role of the actuary
- Distribution systems
- Other actuarial problems

MR. GOLL: The panelists this morning represent three different corporate backgrounds. On your near right is Mr. Jim Miller. Jim is a Principal with Towers Perrin Forster & Crosby and will be discussing the role of a consultant. On your far left is Mr. Bruce Barton. Bruce is Vice President and Director of Reinsurance Products of the Lincoln National Life Insurance Company and will review reinsurance involvement and facilities.

Unfortunately your program contains two errors as to the moderator and panel members. Due to other commitments Mr. Jack Birkenshaw and Mr. Nicholas Bauer are not present today. It is a unique occasion where I can substitute for two presidents of small life insurance companies. My name is Ken Goll and I am the Corporate and Valuation Actuary for the MONY Life Insurance Company of Canada. I will talk about the topic at hand from the perspective of working for a small company.

Our recorder this morning is Mr. Richard May from The Mercantile and General Reinsurance Company plc.

The three presentations this morning are relatively brief. After the presentations are over we would like to turn the microphone over to you for your observations, comments and questions.

My company, MONY Life of Canada, is a wholly-owned Canadian subsidiary of the Mutual of New York. Although our parent is characteristically described as a large Eastern Mutual, its Canadian subsidiary operates independently.

* Mr. Barton, not a member of the Society, is Vice President and Director of Reinsurance Products of the Lincoln National Life Insurance Company

Quarterly board meetings are held with significant representation of our parent on the Board. Considerable time and effort is expended at senior management level in the development of a corporate plan, and in mid-autumn the plan is presented to our shareholders for approval. My comments are anecdotal in nature and will dwell upon some of the particular elements of our recent corporate plans. I might also mention my comments have an underlying financial theme, perhaps more specifically related to a stock company environment as opposed to a mutual company.

First, some indication as to the relative size of MONY Life of Canada. In 1983 total assets topped the $100 million figure on sales of individual life and annuity products only. Capital and unappropriated surplus amounted to $14 million. There are some 26,000 policies inforce with average annual new business over the past three years of 6,100. Head Office staff is approximately 90 people. Distribution of products is primarily through general agencies.

What items are there in my company's planning process that are particularly appropriate to management of a small life company?

Initially, I had difficulty in identifying those aspects which were different from the opportunities and problems of medium and larger size companies. However, the aspects to me that have been relevant are distribution system, product development, surplus and expenses.

Prior to 1981, MONY Life had a career agency system. In spite of the many attempts to grow through that system, sales had remained level for a period of 4 to 5 years in a company which only started in 1973. In 1980 the decision was made to expand by brokerage offices with no new expansion through career agencies. Ultimately, career agencies were phased out as brokerage offices and general agencies became the mode of distribution. A new marketing and sales vice president, with substantial relevant background, was recruited to implement this strategy.

Success in terms of sales was more immediate than imagined. Sales, as measured by first year commissions paid, trebled in 1981 to $2.7 million. 1982 levels remained the same and 1983 dropped from these levels.

One major aspect of the transition has been a reduction in acquisition costs. First year compensation is defined by formula for our brokerage and general agency offices. At first blush, these costs seemed exorbitant. When we actually sat down and measured our career costs, for example commissions, bonuses, salaries, rent, etc., the cost of our career operation was significantly higher. What has happened to the 11 career agencies that existed in 1980? A number of career agency managers have made the transition to Managing General Agents and a few offices were closed. In fact, the transition was more rapid than anticipated and there are no longer any career agencies left.

In spite of wanting to switch from a career agency system and hiring capable marketing personnel, obviously more was required. The new agencies were attracted by competitively priced products and particularly innovation in profit design. In 1980 we were one of the first Canadian companies to

offer significant non-smoker discounts. A new money permanent product without cash values but with paid-up values was also developed at that time. But what is our current philosophy?

As a small company one of the more difficult challenges is to develop and market competitive products and at the same time to increase rapidly the company value. This needs to be done against the background of increasing competition at the distribution level. The strategies for achieving this are three-fold, namely:

(i) lower going-in costs,
(ii) innovation and product design, and
(iii) added value to agencies.

Our plan is to offer the consumer lower going-in costs than are available on traditionally designed and priced products. These products should offer a reasonable expectation of lower long-run costs, depending on actual experience. This can be achieved without sacrificing profitability by taking away the traditional guarantees and allowing the consumer to take the investment risks inherent in the product. The market segment calling for short run price and value performance rather than long term guarantees is the target of these products. From a more cynical perspective these products might be seen on the life side as a response to the new generation's desire to buy now, pay later. Both Universal Life and Indeterminate Premium Life are products which key into this market. On the annuity side, low load deferred annuities address this need.

Established carriers have been slow to respond to this market need. There are signs that this is beginning to change. Their slow response is a function of the severe conflict of interest created between a highly profitable inforce block of business based on long term guarantees and a growing market calling for short run price and value performance. This slow response on their part has provided and should continue to provide for some time an opportunity for my company to fill a specific market need, gain market share and earn a higher margin than might otherwise be possible.

Innovation in product design and merchandising play an important role in my company. In addition to enhancing our image at the distribution level, this strategy allows us to differentiate ourselves from our competitors, to create market opportunities and generally provide an opportunity to earn a higher margin. The development of products to meet a specific market need has provided my company and numerous other carriers with the greatest opportunity for innovation that the industry has seen for many years.

With an increasing number of carriers entering the brokerage-general agency market, there is increasing competition at the distribution level for the pool of so-called independent agents and casual brokers. The majority of carriers in this struggle appear to be operating increasingly on the low profit high agent compensation strategies. Continued waging of the campaign on this basis will cause margins to bleed. To decrease the emphasis from the low price high compensation approach, our strategy is to offer other important values and services at the distribution level. The values and services chosen are those that most of our competitors do not

provide or provide poorly. Examples of these values and services that are provided are:

1. A special quote function wherein we routinely respond to requests for a comparative rate or plan design not normally available.

2. Agency terminals which provide policyholder information, as well as illustration packages and investment rates.

3. Product Seminars which not only describe our products but also product usage for taxation and estate planning purposes.

Two of the greater challenges mentioned earlier that face a small company such as ours are those of surplus and expenses. I will dwell only briefly on these.

Prior to our rapid sales expansion in 1981, surplus was not a concern. Regeneration of surplus investment on our inforce block in a stagnant growth scenario was fulfilling our needs. What were then considered aggressive sales growth scenarios could be handled more than adequately by unappropriated surplus then available. 1981 and 1982 changed that dramatically. The initial sales success from new distribution outlets and innovative product design, together with weaknesses in our management information systems, meant a relative unawareness of the levels of surplus usage. At the same time surplus relief via reinsurance was an unexplored avenue. Today's scenario is considerably healthier because of management information systems being in place, reinsurance playing a more prominent role and thirdly and most importantly, the maturing of officer and managerial personnel in our company. I do not wish to pre-empt further any comments my friendly reinsurer from the Lincoln National may have in this vein.

Expenses are an ongoing challenge in my organization. My remarks here will detail the factors that have created the situation but not the solution. Hopefully my final comments on the role of the Actuary will put the issue of expenses in perspective.

Why are expenses a challenge? Our organizational structure is similar to any larger insurance company in most respects. Divisions or departments include the usual from accounting, agency remuneration and actuarial to underwriting and word processing. The only function not handled by salaried personnel is a legal function. The transition to a distribution system of general agencies and brokerage and away from a career agency system brought a different level of awareness of the wants and needs of agents. Service levels were required to change in order to attract and retain business. Our philosophy is that the agent is the customer.

The emphasis placed on innovation in product design affects the cost of a number of areas, such as marketing seminars and descriptive material, product development time, head office understanding and, perhaps most difficult, EDP system design, modification, testing and implementation. The sales growth that started in 1981 resulted in considerable additional staff being hired as then current levels were unable to provide the quantity and quality of support required.

Last year my company participated in the LOMA expense study. The purpose was two-fold. Internally it provided an awareness of where the actual dollars were being spent. Externally the competitive position could be compared. The results of the expense study confirmed that over the long term there is a problem to solve. Thus far, the simplistic answer of termination of staff has not been utilized. It is also not a real solution. The fact is, however, that the products currently being sold are being priced at as yet unattained expense levels.

Having discussed distribution systems, product development, surplus and expenses, what has my role as Actuary been? One of my earlier comments was the challenge of small companies selling competitive products while at the same time increasing company value.

For a number of years now our planning process included a number of financial models. The models were rather flexible in terms of actuarial parameters. Variations in assumptions with respect to interest, mortality, persistency, expenses and reinsurance costs were possible. Closed and open blocks of business could be analyzed, as well as varying growth rates by product types introduced. From these models, projected bottom lines and surplus levels under the varying parameters were produced. The annual presentation to our shareholder of our corporate plan would include one of the financial models as a target.

As the projection process has evolved, two areas required enhancement. One of these was the value of the business sold and on the books. At any point, while projected surplus was predicted, accountability to our shareholders of the value of his investment, measured as surplus plus present value of future profits, was lacking. These two components are now calculated and represent company value.

However, knowing company value, while informative, is incomplete. What should the company value be? The answer to that question ultimately is for the shareholder to determine. We began a process of evaluating a number of target values and what it would take to get there.

With apologies to Bradley Smith, who last year submitted a paper to be included in the Transactions of the Society of Actuaries, presenting his idea of "hurdle rate" that some of you might be familiar with, I developed for my company a "hurdle rate" concept to be used for product pricing. The concept is as follows: In order that a targeted company value be obtained, what must the required yield on invested surplus in new products be? This required yield is the "hurdle rate". Note that the "hurdle rate" becomes a function of two variables, namely the targeted company value desired and the amount of surplus invested in products. The lower the target company value is, the lower the "hurdle rate" is. Similarly, assuming the yield on products is greater than the yield on risk free investments, such as government bonds, the more surplus that can be invested in products, the lower the "hurdle rate" is.

Certain obvious restrictions come to mind in practical application of the "hurdle rate". As an example, one of our products is very profitable. Surplus investment per unit, however, is minimal. In order to attain some reasonable target value, the amount of annual sales required of this

product in terms of face amount would exceed the annual sales of the largest life insurance company operating in Canada. Another restriction is that while the most effective utilization of surplus would be to invest it entirely in products from a yield viewpoint, it would be greatly imprudent to do so.

From the research done on current values, targeted values and hurdle rates to meet the planning gap, a pricing policy was formulated: The pricing policy is a statement of the yield required on surplus invested in products. It has as one of its components targeted expense levels. Currently, my company's individual life sales can be categorized into five types; traditional products, renewable term products, adjustable products, segregated fund products and flexible premium deferred annuities, each of which have different yields. The pricing policy provides that whatever the mix of business, a minimum overall yield must be met.

Over the past few minutes, I've reviewed briefly the planning process and some of the particular issues that management of one small life company has considered. The focus of that company is now on company value. Operational targets have been set affecting all divisions within the company, each of which is intended to enhance company value.

Sometimes, however, the world does not evolve as it should. In those situations, there are professionals available for your assistance. I would like to turn the microphone over to Bruce Barton who will speak on the role of reinsurers.

MR. BARTON: Competition within the Life Insurance industry has increased tremendously during the last few years and this has placed increasing demands on the management of the smaller life insurance companies. Many people within the industry have predicted a rapid decline in the number of small life companies because of the increased financial resources and management talent needed to compete effectively in today's marketplace. I myself particularly disagree with this prediction because I believe that there is help available to the small life insurance company if they are willing to try to seek it out.

A smaller company though cannot "go it alone" in today's environment. You must obtain expert advice and develop sources of financial support. The theme of my presentation this morning, if you can give it a theme, is "make your reinsurer a member of your consulting team" or "how to get more out of your reinsurance dollar". Everyone is aware of the traditional uses of a reinsurer but few companies take advantage of the full line of services that a reinsurer can provide.

I will briefly touch on a few of the additional services. My comments are based on my own company, Lincoln National reinsurance, which is in a somewhat unique position to provide these services because it is part of a large direct-writing organization, but for the most part, most larger reinsurers could provide similar services.

A. "WINDOW ON THE MARKET"

First of all, your reinsurer can provide you with a "window on the market". This can be very valuable for a smaller company who probably has a more regional operation because it provides the company with a broader perspective of the market.

1. *Competitor Analysis*

Since a reinsurer will have as clients a large number of direct-writing companies, it is able to develop a broad base of knowledge of company activities. This knowledge would include new product development, underwriting practices or philosophy, marketing techniques, management style, etc. Thus, a direct-writing company should use its reinsurer as a valuable source of information on other company activities. No reinsurer will share information which has been given to it in confidence, or which is not available in the open market, but still a reinsurer can provide its clients with up to date information that otherwise might cause the direct-writing company considerable effort and expense to obtain.

2. *Market Developments*

Not only is a reinsurer familiar with individual company activities but it also is interested in ascertaining from these various activities broader trends or patterns. Since a reinsurer will have a broad exposure to new products being introduced into the market, it can provide its clients with information on these new products including new product innovations, sales successes, and emerging experience. Some larger reinsurers have sophisticated actuarial research and study systems which allow them to develop lapse and mortality statistics. This information can be very useful to their clients because often it is several years before published data is available on new product designs. Of course, any experience data so developed should be reviewed by each individual company with its actuary or actuarial consultant before it is used in pricing. However, it does provide an indication of general industry trends.

One of the most important factors in the success of a smaller company is the development and maintenance of an effective distribution system. Yet this is a very difficult task as other companies attempt to attract your agents with creative marketing materials, new products and promises of higher commissions. Your reinsurer can provide you with information about what new marketing approaches and distribution techniques other companies are using and which ones are successful. It can provide you with information on new approaches to agents compensation or new techniques for selling insurance such as direct response, and it can help you evaluate the viability of these new developments for your own company.

B. PRODUCT EXPERTISE

Another area where your reinsurer can provide you with valuable consulting advice or service is in the area of product expertise. Not only is a reinsurer familiar with what is happening in the marketplace with regard to new products, but he also has in-depth knowledge concerning these products.

1. Product Design

Your reinsurer can assist your company in designing new products by helping you evaluate the impact that certain designs will have on the saleability of the product and on possible anticipated experience.

2. Regulatory Requirements

Your reinsurer can assist you in the preparation of the necessary policy forms, either by providing sample forms or by assisting in the interpretation of policy form requirements. It can provide you with information on state filing requirements and new developments at the state level. Your reinsurer will also be familiar with, and up to date on, new regulatory developments at the federal level and what impact these have on product design.

I have been very careful in this section on product expertise to emphasize product design related-services and not product pricing. I believe this is the domain of the company actuary or consultant and the reinsurer will generally not be in a position to know the specific company situation well enough to be involved in actual product pricing.

3. Ancillary Products

It is often necessary for a smaller company to offer a broad range of products to maintain control of its agents. But most smaller companies cannot afford to effectively staff these ancillary product lines with the management expertise necessary to assure favourable financial results. In such instances a reinsurer can provide valuable assistance. It can offer advice or training in underwriting, claims, administration, contracts or any other area. It can provide assistance in handling complex risks by underwriting these risks for you on a facultative basis. In certain instances a reinsurer may be willing to accept a large percentage of the risk for a new product line to allow the direct-writing company time to gain expertise and comfort with that product.

C. UNDERWRITING SERVICES

Perhaps one of the most well known areas where a reinsurer can provide services or consulting advice is in the area of underwriting. In recent years, many smaller companies have been forced to offer very liberal underwriting requirements. This was necessary to enable them to attract and maintain agents. Unless these liberalized requirements are developed in a knowledgeable and professional manner, significant adverse financial results can be the outcome. Your reinsurer can provide assistance in a number of ways.

1. Risk Classification

The direct-writing company can benefit from the reinsurer's experience in impairment areas where the smaller company cannot collect a sufficient volume of data for follow-up purposes. One of the most basic underwriting services that a reinsurer is expected to provide is coverage for the infrequently encountered or experimental risk.

Of particular importance to companies with less experienced underwriting staffs, many reinsurers publish their underwriting guidance in the form of an underwriting manual. This helps the direct-writing company classify most risks independently and provides a basis for classifying risks that the reinsurer is willing to accept automatically.

Your company may also benefit from information about your reinsurer's underwriting procedures and requirements, particularly in judging the cost-effectiveness of changes in the age and/or amount limits for ordering certain requirements.

2. Risk Management

The reinsurer's expertise in financial underwriting may help minimize the risk of speculation and/or anti-selection, particularly on jumbo amounts.

The reinsurer may assist the direct-writing company in evaluating its underwriting practice/philosophy, in modifying that practice and perhaps in establishing new practices. Most reinsurers are willing to help the direct-writing company to develop various types of experimental or preferred risk underwriting programs.

Experience with evaluating the proficiency of underwriters' performance and auditing their work may be helpful to your company in improving its management of the underwriting function, and the reinsurer may provide technical assistance in helping your company develop automated systems for periodically evaluating your own underwriting and mortality results, particularly in the key-result areas.

3. Training Services

Most reinsurers provide both underwriters and medical directors with training in underwriting. Such training focuses on how to use an underwriting manual, the risk evaluation process, financial underwriting, the philosophy of risk classification, the cost-effective development of information needed to appraise risks, the practice and management of inter-relationships among the medical, underwriting, actuarial, and marketing departments, and exposure to recent developments within the industry from an underwriting perspective. Also, a telephone conversation with the reinsurer on an unusual or difficult underwriting problem can provide further training and, in many cases, the benefit of more extensive experience on such cases.

4. Information Services

Results from underwriting research and development activities that arise from the accumulation of mortality experience on large blocks of impaired lives including opinions on the underwriting impact anticipated from such developments, can be provided by your reinsurer. Your reinsurer may also assist you in locating information on medical developments and research besides interpreting and offering suggestions on how that information may be applied to underwriting.

Information may also be provided on how to respond to legislative developments and requirements, how to interpret their influence on underwriting procedures and methods, and on the classification of certain risks.

5. Other

Your reinsurer can assist your company in establishing a position and suggesting how to proceed with the investigation of claims that occur during the contestable period. He can assist your company in retention limit analysis, and he can provide guidance on the coordination of the underwriting and pricing functions.

D. FINANCIAL MANAGEMENT SERVICES

Another area which is becoming much more important and where your reinsurer can provide valuable advice or service is in the area of financial management services. Many smaller companies are growing very rapidly today and are in need of assistance in this area.

1. Surplus Relief

How does it work? The arrangement that Lincoln National uses in providing surplus relief is designed so that cash flow is minimized. We use a combination of coinsurance and modified coinsurance as you can see from the top two categories of the Surplus Relief Illustration.

SURPLUS RELIEF ILLUSTRATION
(000's)

	1984	1985
Reserve, EOY	2,312	3,069
Mod-Co Reserve, EOY		
%	40	58
$	925	1,780
Coins. Reserve, EOY		
%	60	42
$	1,387	1,289
Premium #	3,012	1,404
Death Claims	182	198
Surrenders	59	118
Res. Adjustment* ###	879	781
Expense Allow.--5% ##	944	70
Reinsurer's Charge**	49	45
Experience Refund	899	192

*Reserve Adjustment Interest Rate = 8%

**Greater of 3.5% of coinsurance reserves at the end of the year and .35% of total reserves for the year.

#1984 number includes initial premium of $1.443

##1984 number includes 60% allowance on initial premium

###1984 BOY Reserve = 1,443

SUMMARY OF MONETARY TRANSACTIONS
(000's)

FIRST YEAR

1.	Due Reinsurer	
	Premiums	$3,012
	Less Experience Refund	899
		$2,113
2.	Due Reinsured	
	Expense Allowances	$ 944
	Surrender Payments	59
	Death Claims	182
	Reserve Adjustment	879
		$2,064
	Due Reinsurer 1 less 2	$ 49

SECOND YEAR

1.	Due Reinsurer	
	Premiums	$1,404
	Less Experience Refund	192
		$1,212
2.	Due Reinsured	
	Expense Allowances	$ 70
	Surrender Benefits	118
	Death Claims	198
	Reserve Adjustments	781
		$1,167
	Due Reinsurer 1 less 2	$ 45

An initial premium is paid to the reinsurer equal to the reserve on the block of business on the effective date of the treaty ($1,443). I am assuming in this instance that surplus relief is provided on an existing block of business. At the same time, an initial reserve adjustment is paid to the reinsured equal to the modified coinsurance reserve ($925). An initial expense allowance is also paid at this time equal to (in this example) 60% of the initial premium ($1,387). The net effect of these transactions is to cancel each other out, and therefore no cash initially flows between the two companies. The surplus relief results from the fact that the reinsured takes credit for the coinsurance reserve being held by the reinsurer. The ceding company now has nearly the same amount of assets as it had before, but it also has less reserves than previously, and therefore more surplus.

The reinsured is thus getting relief from surplus strain up front and the reinsurer intends to recover the strain as the profits on the block accrue. It must be remembered, however, that the reinsurer will be reimbursed for this relief out of the future profits on the block of business. The reimbursement period is generally 4-7 years.

The illustration includes an expense and profit charge ($49). If experience is favourable, this charge represents the actual cost to the ceding company of the reinsurance, and, therefore, also represents the reinsurer's profit. Due to the fact that all monetary transactions involved are on a net basis at the end of the year, the only cash flow involved is the payment of this charge from the reinsured to the reinsurer, unless of course experience is unfavourable.

This next illustration summarizes the monetary transactions a little bit better. Due the reinsurer is the premium on the block of business which would include the premiums during the year that are payable as well as the initial reserve transfer that I referred to, less the experience refund. Due the reinsured are the various benefit items. The net monetary transaction then netting the two out, is the expense and profit charge due the reinsurer.

How do you pick a block of business? Since the surplus relief arrangement described here provides for relief through relieving the reinsured of a portion of its reserve liability on the block of business, the block of business chosen should be a block that develops substantial reserves, perhaps either a permanent block of business or endowments, or becoming more popular annuity business.

Administration of nonconventional surplus relief arrangements is generally handled on a bulk basis. One accounting statement is to be provided by the ceding company each quarter, which summarizes the necessary financial and accounting information. As mentioned earlier, all payments occur on a net basis at year-end.

The ceding company needs to realize that since it is entering into a reinsurance agreement, there will be substantial effects on its annual statement, particularly on its policy exhibit, and likewise premiums, claims, etc. will be reduced. Therefore, any tracking of these numbers on a year to year basis will be affected.

Many states also have regulations that require the Insurance Department to approve any bulk reinsurance transaction or any reinsurance transaction where more than a certain percentage of the business is reinsured. Hence, the ceding company should take care to check with the State Authorities before entering into this type of transaction.

2. Tax Planning

There are a number of ways in which reinsurance can be used to assist your company in its tax planning. The use of these various techniques may be somewhat limited in the future with the passage of a new tax law but I still think that a number of opportunities will exist.

For example, let's assume your company wants to increase or decrease its taxable gain from operations. This need could be met through your company accepting or providing surplus relief through an arrangement similar to that which I have just discussed.

Alternatively your company may want to affect its tax status as a life or non-life company.

There are and will remain significant advantages for a company to be taxed as a life insurance company. Yet a small company which has a rapidly expanding group or individual health line of business could lose this tax status. Assuming a block of life business, or ceding a block of non-life business, would be a solution to this problem.

3. Deficiency Reserves

Widespread rate reductions for term and permanent plans in recent years have created large amounts of deficiency reserve for a number of companies. The relief anticipated from the 1980 CSO table and related valuation law changes has been delayed due to slow adoption of these tables by a number of companies. The result is that many companies have substantial deficiency reserves which not only cause a statutory strain but also are non-deductible in calculating taxable gain. Under the new tax law excess interest on new money type products may cause a similar problem. A solution to this problem is for the ceding company to reinsure this business either through a conventional coinsurance approach or through a combination of coinsurance and modified coinsurance surplus relief as I have just discussed.

Under the latter approach the only reserves which are coinsured by the reinsurer would be the deficiency reserves. Otherwise, the arrangement is identical to a traditional surplus relief transaction.

4. Asset Management

Effective management of our company's assets is becoming an increasingly complex job in today's environment. The popularity of such new products as Universal Life and single premium deferred annuities has provided many companies with significant asset growth regardless of size. Your reinsurer can provide a number of types of services in the area of asset management.

For example let's assume a client needs to enhance its cash flow. This need can be met through a conventional coinsurance arrangement where the reinsurer provides allowances in excess of your company's commissions and expenses. Or, the solution could involve surplus relief again, but on a basis which would flow cash to your company. Of course, the charge for this type of surplus relief is much higher than for non-cash surplus relief.

Or let's assume your company needs investment assistance for "new money" type products. Managing the assets at an acceptable level of withdrawal risk and offering a competitive interest rate, while achieving profit objectives, is a difficult challenge for many companies offering Universal Life or annuity type products. The amount of accumulated assets may not justify the company's use of a segregated asset account and the company may not have the necessary sophisticated new-money techniques for internal tracking and allocating of investment earnings. A solution to this problem is to coinsure these assets with a reinsurer who has the needed investment expertise. The coinsurance arrangement would be refunding and provide for the return of all profits after deducting an expense and profit charge for asset management and a risk charge for reinsured mortality risks in excess of the ceding company's retention.

Alternatively, if the client company has the necessary asset management systems it might simply desire investment advice or counselling which the reinsurer of course could also provide.

Or let's take another example. Assume your company wants to convert a non-admitted asset into an admitted asset. A client company might hold a note from its parent which would be a non-admitted asset. The note could be passed to a reinsurer as part of a reinsurance transaction and the note would be an admitted asset for them. Or your company may be committed to investing in some form of an asset in excess of the statutory limit for that particular class of assets. Again, a portion or all of that asset could be passed to a reinsurer through a reinsurance transaction and very probably could be an admitted asset for the reinsurer.

> Or let's assume your company wants to convert an asset into cash without incurring a capital loss. Under a funds withheld agreement, as part of a reinsurance arrangement, your assets could be held in trust for the duration of the arrangement and then returned to you. In the meantime, an amount of cash equal to the market value of the asset could have been made available without your ever having to liquidate the asset.

There are, of course, other areas of service which time does not permit me to cover this morning. But, I would encourage you to discuss with your reinsurer the types of services that are available. In some instances, the types of services available will vary depending on the reinsurance relationship but, for the most part, these services are available to a reinsurer's automatic clients and usually at little or no cost. And in today's environment free advice is not something to pass up.

MR. MILLER: Today's session is entitled "Management of a Small Life Company" and I have been asked to provide some remarks from a consultant's viewpoint.

In preparing my remarks, I discovered that I had a problem -- that is, I'm not really sure how a small life company should be defined. Alternatively, I'm not really sure at what point a small company becomes a medium sized company, or for that matter a medium-sized company becomes a large company.

One approach I tried was to look at some traditional measures such as:

- assets;
- income;
- premium volume;
- number of employees, and so forth.

For example, the Stark - Moore federal tax proposal allows a small company deduction for companies with less than $500 million in assets and $3 million in taxable income. However, I'm sure many of you agree that this definition is somewhat arbitrary. I know of several $400 million companies that act like medium or large companies, and at the same time there may be some $600-700 million companies, particularly some of the newer annuity companies which act and operate more like small companies.

As you can tell, defining a small company seemed to be developing into a rather large task.

Fortunately, however, I believe many of my remarks will apply to both medium and large companies as well as small ones. That's because so many of the problems for opportunities facing the management of small companies are also shared to a greater or lesser degree by larger ones.

The role of a consultant in the management of companies is as diverse as the companies they consult with. It is important to note that companies will frequently hire multiple consultants. For example, companies may hire:

- strategy consultants
- marketing consultants
- investment advisors
- human resource consultants
- tax counsel
- systems consultants
- reinsurance advisors
- legal counsel
- financial consultants
- CPA's
- actuarial consultants

There are consultants who can tell you if you need a consultant, and if you already have a consultant, there are consultants who will tell you to change.

Our firm uses consultants too, in fact our company president recently had tickets to go to Schubert's Unfinished Symphony. He couldn't make it so he turned the tickets over to a consultant friend of his. When the performance was over the next day he asked the consultant, "How did you enjoy it? Do you have any comments to make?". Being a good consultant he prepared a written report which goes something like this:

(a) For considerable periods the four oboe players had nothing to do. The number could be reduced and their work spread over the whole orchestra, thus eliminating peaks of activity.

(b) All the twelve violins were playing identical notes. This seems to be unnecessary duplication and the staff of this orchestra could be drastically cut. If large volumes of sound are really required, this could be obtained through an electronic amplifier.

(c) Much effort was absorbed in the playing of quarter notes. This seems an excessive refinement and it is recommended that all notes be rounded to the nearest half note. If this were done, it would be possible to use trainees and lower grade operators.

(d) No useful purpose is served by repeating with horns the passage that has already been handled by the strings. If all such redundant passages were eliminated, the concert could be reduced from two hours to twenty minutes.

In summary, if Schubert had attended to these matters, he would have been able to finish the damn symphony instead of dying on the job.

Needless to say, there seems to be plenty of consultants available to assist management, but the question is when to use them.

Generally, we tell our clients that consultants should be used for three reasons:

1. Time Effectiveness.

   Consultants can often accomplish projects more quickly than internal staff. That is because they can usually devote their full energies to the project instead of being diverted with fire-fighting and other interruptions that often result if internal resources are assigned to the project. This is especially true if there are no internal resources available and the project timeframe does not allow for staffing-up.

2. Cost Effectiveness.

   Consultants are often accused of being high-priced on an hourly rate basis. They can often be more cost effective than using internal resources. This is particularly true if you compare the cost of a consultant with the full cost of an employee, their salary, their benefits, overhead, and so forth. Also, if the project is of limited duration again it may be more cost effective to hire a consultant than to staff up for a peakload situation.

3. Expertise.

   Consultants are experts in their chosen field. I am sure if you ask one, he or she will tell you. But the truth is that most successful consultants do have expertise acquired through experience which can be valuable. That's not to say that you cannot develop or acquire that same expertise level internally, just that it will cost time and money and that is often something you don't have a lot of.

Now, I'd like to discuss a few of the problems that we frequently encounter in small and sometimes larger companies.

1. Lack of Strategic Direction - This problem is prevalent in many companies. Although more and more companies are making attempts at strategic planning, many of these efforts seem to fail and one of the principal reasons for this is that most strategic planning activities are dominated by process. There is too much emphasis on the annual four-day retreat and too little emphasis on preparing for what happens after the retreat.

   Too often the discussion moves from "tree to tree," missing the "forest" entirely. The process is over-engineered and under-directed. Specific symptoms of this kind of problem include:

   (a) A Poor Business Definition: This occurs when a business is defined in historic terms rather than a view to the future. The question for the 1980's is "What business are you really in?" and too many companies look to the past to try to decide what business they are in. If the business environment changes, a company or organization needs to reconceptualize itself and its purpose in light of the changing world.

(b) A Lack of Market Focus: Planning exercises frequently fail to recognize what your customer really wants and needs. In fact, some companies don't even do a very good job of defining their customer. For example, if you are distributing your product through brokers or PPGA's, your real customer is the distributor, not the end-use policyholder.

(c) An Unrealistic Self-assessment: This occurs when specific company strengths and limitations are not clearly identified. You need to be able to look in the mirror and make an honest self-assessment.

(d) An Improper Definition of Success: Success is often defined in terms of improvements over past-performance, or in comparison to historic peer groups, instead of looking at the goals inherent in the company mission.

Now, for those of you that are suffering from a lack of strategic direction problem, I suggest you try answering the following three questions:

- Where are we today?
- Where do we want to be in the future -- and when?
- How are we going to get there?

2. The Search for a Market Niche - In order to survive, small companies must search out and find their market niche. Too often, our clients think they can be all things to all people. Some companies suffer from the "hot product" syndrome. They seem intent on being "street ready" with new products as soon as possible without analyzing:

(a) Whether they are right for their defined target market.

(b) Whether they will generate sufficient premium to justify the development costs.

(c) Whether the products satisfy their defined profit objectives and fit with their overall strategy; or

(d) Whether they have the necessary systems and investment capabilities and other expertise to even process the business once they do write it.

Although there may be occasional success stories with this kind of approach, we believe it is far better to identify your company's strengths and its distinctive competencies, and then use them as a base for building your marketing program rather than just copying what seems to be the hot product in the industry.

Another problem area that we encounter, and this is particularly true in small companies is:

3. Achieving Economies of Scale - Recently, I have had to deal with the problem of developing competitive premium rates in a small company which currently has high unit costs. This company is a subsidiary of a much larger parent which uses a branch office distribution approach. Sales are low because the company does not have competitive premium rates. At least that's what the agents say. Premiums are uncompetitive because the company has relatively high unit costs, unit costs are high because the company has a large base of fixed expenses, computer systems, executive salaries, branch manager salaries, and general overhead and so forth, and they have a relatively small volume of business to spread these fixed expenses over, so you have a real circular situation.

   In order to improve sales and reduce premium rates, we decided it would be necessary to do some planning. First, the marketing department was asked to identify the premium rate levels that would be required for them to effectively sell the products. Next, we asked them to make a five year projection of anticipated volume at these competitive levels. (By the way, this marketing projection or plan needs to be fairly detailed with quarter by quarter action plans to be credible. Simply writing down volume numbers without having a plan for achieving them is not enough.)

   Next, armed with the targeted rate levels and anticipated volumes, the actuaries and accountants developed expected unit costs at the end of the five year period and used those to price the products, which fortunately turned out then to be competitive.

   Finally, a complete five year financial projection was performed which illustrated the year by year gains and losses as well as the excess expenses which were not covered by the pricing unit costs.

   Now some people might argue that this approach would be unacceptable since if the full unit costs were used in pricing the products they would not be profitable, or at least not as profitable. I think it can be demonstrated that if sales goals are met, the value of the company five years down the road will be significantly higher than if the status quo approach was used.

Which brings me to my last point,

4. Rewarding the Key People - Everyone likes to be rewarded for a job well done. But it is especially vital that a proper reward system be established in a small company. This is true for all areas of the company but is especially true for the executive leadership and the marketing function.

   The key to successfully developing an executive compensation plan is to not develop it until the company's missions, goals and strategies are clearly defined. If a strategic plan is not yet in place, at least a strategic premise should be established. This premise should

be a best guess of what the ultimate strategic plan will be with respect to the environment, long and short-term corporate objectives, long and short-term strategies and related action plans.

In establishing an executive compensation plan for a life company, and evaluating its potential effectiveness, one should ask the following questions:

1. How clear is the overriding strategy of the company? How practical is it? How committed is top management to its implementation, particularly the long-term elements?

2. What management concepts and decision processes drive the company?

3. What financial measures are used by the company? Are they reasonable? Is there consistency among the corporate strategy, the executive compensation program and the product pricing activity?

4. What does the Chief Executive Officer really want in terms of compensation? What is his attitude toward current compensation levels?

5. Do people clearly understand their long-term goals and know when short-term compromises are to be made for the long-term good?

6. Do people really understand how their jobs are measured? Do they think the measurement standards are fair? What criteria are used?

7. Can the people who are responsible for certain activities realistically be held accountable for those activities?

8. Does the organizational structure facilitate implementation of the company strategies?

Perhaps the hardest issue to resolve is that of measuring performance. Neither statutory nor GAAP performance measures is generally effective, at least not as they currently exist. Neither reflects the long-term nature of most life insurance company contracts and neither provides any credit for the development of future business capacity. Both involve some level of judgment. Unless a company develops its financial measures by line and by function within lines, it is difficult to relate the measurement criteria to individuals.

We believe that the appropriate performance measure for long-term strategy fulfillment is the increase in the real value of the enterprise. Real value is the proper foundation for long-term incentives. Short-term incentives can then be built around milestones that signify progress toward satisfying the long-term strategies.

MR. GOLL: I have a question I would like to direct to Bruce Barton and it refers to Surplus Relief. My analysis of product yields indicates that the breakeven point is anywhere from five to seven years and the targeted yields on the product really only start to be obtained after that point. Bruce indicated that the reimbursement period is four to seven years. Presumably the reinsurer realizes his profit objective in that time span. Does this not place the direct writer with the concern for surplus in a worse position after seven years than he otherwise would have been had a surplus relief arrangement not been entered into? Alternatively, should the time horizons of the relief arrangement not be more closely linked to the product in question?

MR. BARTON: The Surplus Relief Illustration that I put up was one that normally smaller companies would enter into, and dealt with an existing block of business. Maybe I can explain that a little bit. Typical I think, for a company that is having a surplus problem is they are marketing new products, having more success than expected, and this is having a larger impact on the surplus than was originally anticipated. They come to their reinsurer asking about surplus relief (Is it available? How does it work?). The more common approach is to provide the relief not on the new business since the new block of business probably does not have significant enough margins, particularly if the company is in a growth situation. The effect is that to obtain surplus relief the company would have to pick an existing block of business. This block of business, probably four to seven years old already is more mature, and is making profit contributions as a more mature block hopefully would.

The time period can really be whatever the company desires, but I think if the company is in a growth period it doesn't want to, let's say, mortgage the existing block of business for a very long period of time, and it would normally seek relief with a four to seven year period runoff so that it could have "its business back" within that timeframe. If sales continue at a high level or if there continues to be a surplus problem, surplus relief could be renewed again or the percentage changed any time during that period but typically a new block of business, at least for small growing companies, would not be a likely choice for surplus relief.

MR. DAVID B. ATKINSON: Jim, I have a question on your consulting. If you walk into a company and they ask you to do a review of all their practices, what are the odds that they are going to take on your recommendations and implement them?

MR. MILLER: It depends on who hired you from the company.

It really depends on where the authority for hiring in the first place came from and how intent they would be on following through with your recommendations. There is really no pat answer to that.

While chances are if the Board of Directors hired you they probably felt there was a problem and assuming that they had the clout to go ahead and follow through with changes then, the recommendations are likely to be implemented. If someone at a more junior level hired you but changes required the consult of senior management they may not feel it is as big a problem as the people down in the ranks do and so would you be less likely to get some of your recommendations implemented.

MR. JULE L. GEHRIG: Being a small medium size mutual company we of course don't want surplus relief, we want to get rid of the surplus. What can you do for us on that kind of a basis? Would you work the same thing the other way around?

MR. BARTON: Certainly, as a matter of fact most reinsurers - my own company for example, do not necessarily provide surplus relief themselves. In other words what we would do is act somewhat as a broker to put our clients together, those who want to provide relief and those who want to get relief.

MR. GEHRIG: Are you going to have enough demand for surplus? I would assume that everyone is going to want to get rid of surplus now. I am speaking about mutual companies of course.

MR. BARTON: Because of certain tax developments, and so on and so forth, there are available in the marketplace now more companies wanting to provide surplus relief as opposed to being on the receiving end, but I think there has not been a lot of difficulty balancing that. For example, a lot of companies are writing annuities who were not writing annuities before and that type of product, depending upon how it is designed, can generate surplus strain. In the past we have had pretty good luck in balancing our requests, both in and out and we usually make up the difference for what doesn't balance.

MR. GEHRIG: I suppose that with the new tax law the companies trying to get rid of surplus are in larger supply and hence terms would not be as favourable probably as in the past.

MR. BARTON: Yes to a provider that is probably right. There are more companies wanting to provide surplus relief now. It is good news if you want to buy it but not such good news if you want to sell it.

MR. MELVIN B. DUNN: I think both Ken and Jim referred to value of the company in different context; Ken in the target value and Jim in the increase in real value. I was wondering if you could share with us what you take into account in measuring this value and how you define it in your companies and practices.

MR. MILLER: I would define real value using a value added type of concept where basically you look at what the value of the company would be if you were going to sell it at any given point in time, and typically that is the sum of three items:

(i) the statutory adjusted book value which is the capital and surplus adjustment for MSVR and non-admitted assets and certain other things.

(ii) the value of future profits on the business that is currently on the books discounted to the present at some risk rate of return, and

(iii) the future business capacity of the company, namely the value of the ability of the company to produce profitable business in the future and there are various ways of getting at that. One way is to make

some estimates of future production and then look at the profit stream that develops from that future production and discount that back to the present.

MR. GOLL: I agree with Jim on that. Certainly it is an evolutionary process in our company and last year when we did this for the first time, it was strictly the first two items that Jim mentioned, the capital and unappropriated surplus, plus the value of the policies then on the books. What values are the intangibles? We did not quantify that. I think, certainly from my background, so far strictly a financial background, that was valued at zero but there is a strong case to be made that it is worth quite a few dollars.

MR. BARTON: I have a question for the group. Of the people represented here how many of your companies use consultants at one time or another for some type of advice? (Virtually unanimous).

MR. GOLL: Would you all consider yourself small companies, those that raised your hands?

MR. GRANT GIFFORD: I have a question for Jim Miller; not a question more like a comment, Jim. Your approach to looking at the brief that you need projecting out 5 years, I see it has some pretty serious shortcomings. Our company is owned by ITT. The profit objective that we are measured by isn't a targeted, it's ....we have you on our books, say, for $10 million. We can go and buy a bond and get 10% on that so let's use 10% - you are worth $10 million we want $1 million profit this year. Your approach, by the way we have used this approach too and not five years, it goes to the field force and I don't know about a lot of you people here, but every time you go to the field force and say if I gave you this what would you sell. They are going to sell everybody in Canada. The projections become illusory and the algebra of putting it all together works but it doesn't stay static for five years; you come back one year later and you say "Well I have got to lower them again" and now you have another five year period. Meanwhile you are not getting the $1 million profit that you are supposed to, you might get $500,000. That becomes a loss in a profit sense and the ball is rolling. I don't see how you ever get the return on an investment that your shareholder wants. I agree that if you put this altogether with the idea of selling the company that it does have some merit. I am just looking for some comments from you on this.

MR. MILLER: I think your comment about looking at it from a standpoint of selling the company might be a valid one. If the company is an investment of a larger company for example, perhaps they acquired it with the idea that they were only going to have a 6, 8 and 10 year holding period on the thing and then sell the company and clearly, the more profitable business that you get on the books at whatever the sale point is, the higher the value you are going to get for the company and the better return you are going to get on the initial investment. I don't think my solution is the panacea of solutions, but if you look at what the alternatives are of staying status quo I am not sure that you are that much better off either. So I think you have to weigh your options and say, well what happens if I do nothing and am I better off making some short term compromises and hopefully building that into the long term good of the company.

I think another thing that kind of relates there is the idea of the agents wanting to compete in the same markets where the big boys are and running up against this type of price competition - that was one point I made in my address where I said - you've got to try to seek out a specialty niche and try to compete in areas where the price competition isn't so great. If you try to sell term with everybody else who have lots of advantages over you from a standpoint of distribution system or low unit costs, I don't think you are going to win if you are a small company. There are just too many other people out there who have tried it and haven't succeeded. So I really think the key is to try to find some specialty product lines and some specialty market niches that you can try to penetrate if you are going to get bigger.

MR. MICHAEL B. HUTCHINSON: I guess I would really like any of the panelists to comment on the problem in a small company of knowing how well you are really doing. Bruce has talked about a dizzying array of methods of cosmetizing the bottom line by various surplus relief methods and one of the dangers I think is you can produce a dandy looking statement, but you begin to believe it, perhaps rather than knowing what the real value of the organization is. Would anyone care to comment on the pitfalls of believing the statements you produce and how to overcome these problems?

MR. BARTON: I think if you begin to talk to the reinsurer about one of the financial management type services, for example, surplus relief for tax planning, I think that that is not the solution to your problem. It is what I would say is a patch. If you are buying conventional reinsurance your reinsurer is not going to solve your underwriting problem if you are not underwriting the business effectively. He will help you on the larger risks and the more substandard risks but the basic problem needs to be solved somewhere along the line. If a company is having surplus problems because of a spurt in growth, your reinsurer can help you get through that problem time, but long term you have got to solve that problem somewhere. New business has got to contribute to surplus and you have got to start developing a large enough book of inforce business that you can support your new operation. Maybe there has been a tendency in the past for people to be a little blase about these types of reinsurance transactions. Your company has got a serious problem and this is the patch to help you get over that bump. That's how it should be used and that is why, for example, we recommend that the surplus runoff quickly. Then you need to find out where you are and re-evaluate again.

MR. STUART L. SORENSEN: Two questions - First to Bruce. You mentioned many free services that a full line reinsurer can provide. Isn't it true though that those free services have to be priced in the various products and services that you do provide on a cost basis and therefore makes it more difficult perhaps for a full line reinsurer to compete with some of the specialty reinsurers?

And secondly a question to Jim concerning the third element in your value of a company being the ability to produce future business. Using Ken's example of his field force completely changing in a four year period, doesn't that third element, the ability to produce future business by your agency force, tend to be diminished in today's world?

MR. BARTON: That is a good question. In some ways the answer to that is yes, but I think generally I would say the answer is no. Most of the services that I indicated are services that a reinsurer would have to have available to its clients, for example the underwriting services. Any reinsurer of any size will have quality underwriters on staff and it could make those services available. I think it would be easier for me to answer from my own company's point of view. Many of the services that I indicated - training services, information services, and so forth, can be provided because we are connected with a direct writing organization and there is really no cost. The cost of using those services is you pay for your flight into Fort Wayne to sit down and visit our people. The real cost to us is some of our senior management time. For the most part I would say a full line reinsurer really has no more expenses to make those services available to a client than does a smaller reinsurer. I think that a smaller reinsurer has to be more price-competitive because he probably cannot offer that full array of services. That's probably what develops the price differential if there is one, more so than the cost of providing the service.

MR. MILLER: If the agency force is turned over in four years, is it likely that the value of the capacity to produce profitable future business decreased and I think that the answer to that in many cases is yes. In some situations the value of the third component - the future business capacity might be limited to the charter and licenses of a company, so I think you have to really look at each company in particular and determine what their situation is. Now the reason why we put that in there though is that sometimes companies may invest considerable dollars in developing some new marketing relationships, outside of what they are doing this year they may develop some new ones and that may significantly add to the ability to produce future business next year and the years to come. It is a changing thing, but clearly in the future business capacity isn't a continually increasing item. It can go down, it can be zero. In some situations it can be negative if the future business capacity is there but the business produced is not profitable based on their risk rate of return you discount it at.

MR. PAUL A. CAMBELL: I hope that what I can say can be taken in the good spirit of passing on helpful information and not as a commercial. I don't believe LIMRA has been mentioned this morning and certainly in connection with this last question. If your company is a member of LIMRA don't assume that the kinds of activities that go on and the kinds of information is strictly sales related. There are an awful lot of benefits that your company has coming from that organization, in terms of forms and research data and educational material and publications that can be helpful to you in your management role and certainly many of the typical actuarial roles. If your company is a non-member, work with your marketing people to explore the ways in which LIMRA and its member companies, its committees, and its forums can be very helpful to you in the kinds of problems that you have because you will find they are not unique for the kind of company that you are working with.

MR. GOLL: I would like to thank you all for coming this morning. I hope we have been able to shed some light on what goes on at a small company.

Certainly, I as a corporate and valuation actuary have indicated what I am particularly concerned about. It doesn't appear there is a lot of questions left, so I think we should go out and get the coffee while it is fresh, and thank you all for coming.