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FINANCIAL PERFORMANCE MEASURES FOR MUTUAL COMPANIES

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- Is return on equity the best financial measure?
- How suitable are the various available accounting models?
- For the measurement of earnings, how should a company treat:
  - -- Dividends?
  - -- Tax?
  - -- "Corporate" items?
  - -- "Value added" of operating units?
  - -- Capital gains?
- How should earnings objectives be chosen?
- Should all lines of business have the same return on equity objectives?
- How might stock company perspectives on these issues differ from mutual company perspectives?
- What should be the role of financial measures in capital planning?

MR. FORREST ALLEN SPOONER: Bob Stein made a few comments in another session about why performance measures for mutual companies have changed in importance over the last few years, and I have some similar comments. There are a number of things that have happened in mutual companies over the last few years that reflect what is happening in the industry as a whole.

For a starter we have a number of products that are either nonparticipating or essentially nonparticipating including the nonindividual lines, but even within individual lines. We have a number of stock subsidiaries that are in different businesses or even in the same business but with different approaches to product design and marketing. The lines between participating and nonparticipating business have become much more blurred over the last few years. We can talk about excess interest products that reflect nearly directly investment performance of the company, the general diversification of companies into new types of business and the increases in competition both from within the industry and from outside competitors which are competing with us in one or more of the businesses in which we operate. All of these things have created strains on the kinds of financial reporting and the kind of performance measurement we do within mutual companies.

In addition, the growth and expansion into new activities and new businesses have created a greater awareness of the need for mutual companies to track how we are doing as far as having adequate capital for our businesses and having adequate resources for future capital. Consequently, many companies have developed new financial reporting structures to try to give them the information they need to manage their businesses and their use of capital. They need to measure their performance against other companies and against their competitors. They need to measure their performance against their own internal goals so that they can manage their operations properly, and achieve strategic direction of the company. Is the company headed in a good direction and will the financial results that come from moving in that direction be acceptable?

We are going to try to address some of the issues of financial reporting for mutual companies. At this point I'll introduce the panelists. Mr. David Ingram, is an Actuary from Provident Mutual. Mr. Howard Rosen is a partner from Coopers & Lybrand, and Mr. James Wertheimer is Executive Vice President for Massachusetts Mutual. Our recorder is Mr. Michael Slipowitz, who is Assistant Vice President at MONY Financial Services which is also my company. I'm Senior Vice President at MONY Financial Services.

The first issue that we would like to address is looking at return on equity as a concept. Is this the best financial measure that a mutual company should use for measuring its own performance?

MR. JAMES L. WERTHEIMER: I love reading the annual reports to policyholders from mutual companies. A typical reports reads as follows: The CEO says the past year was by far the most successful year of the company's 150 year history, record dividends were to paid to policyholders, and each of the product lines achieved record sales and earnings. What do we mean when we say these things? Have we ever had a year in our recent history that was not a success? Mutual companies need goals around which a consensus can be built by which they can measure their success, and this leads me to my topic. Is return on equity the best financial measure of mutual company performance?

I'd like to preface my remarks with three personal comments:

1. I've changed my own opinion about these issues several times over the last few years.

2. My comments are just that, opinions. In other words, this is an expression of my personal prejudices.

3. The conclusions that I express, while they may be true at the corporate level, are less precise at the Strategic Business Unit (SBU) or product level.

I'll discuss several topics. First, I want to say a few words about capital management in general, and the purposes of capital management, and then I want to talk about the relationship between capital management and performance measurement. As far as capital management is concerned, it is safe to say that this is a hot topic in actuarial circles today, including papers and seminars and much attention being paid to the topic by stock and mutual companies. But for a mutual company, capital is equivalent to surplus. Surplus is retained earnings which in general is the only source of capital for a mutual company. The investment bankers would like you to believe otherwise. They'd like you to believe that you can go and borrow some money and invest that in the business and think of that as capital as well. But to me that is truly leverage. That is not a source of capital. The only real exception I suppose for a mutual is raising capital through a stock subsidiary, but that has its own limitations which I'm not going to elaborate on.

In general, what are the purposes of capital management? Capital management defines the financial relationships between the corporation and its strategic business units. Capital management attempts to define the capital needs of the corporation and to relate those needs to the available capital resources. In other words, it helps to answer the question as to whether the corporation has sufficient capital resources and earnings power to achieve its strategic objectives. It provides a mechanism for the allocation of scarce capital resources among the various enterprises contending for it. For a mutual company, capital management helps provide answers to questions such as the following: How much surplus is available for a liquid acquisition and diversification? How much surplus is available for distribution to policyholders? Do certain lines of business require additional capital or are they generating excess capital that can be made available to other lines distributed as dividends to policyholder-owners? Capital requirements can be arrived at by conducting required surplus studies. Consider the four contingencies Cl, C2, C3 and C4 and then relate the resulting requirements to inforce parameters through required surplus formulas.

What is the relationship between capital management and performance measurement? I believe that the key to mutual company financial planning is the balance sheet. When a stock company does its strategic planning it asks questions such as: what is the earnings potential for the plan? What is the initial investment? What's the return on equity? I believe that a mutual company's focus is somewhat different. Mutual companies ask questions such as: Is there sufficient surplus to carry out the plan? What kind of profitability is needed in order to achieve the desired surplus position and achieve the plan? Note that earnings are not necessarily an end in themselves, but a requirement in achieving a surplus target.

For mutual companies there are four measures of performance that are interrelated and in some cases contradictory, but they are all important. These are equity, efficiency, growth and solvency. What then must a company do in order to deal with these four conflicting goals? To achieve these four goals requires the companies set strategic objectives, determine capital needs, determine earnings requirements, determine the implied return on equity, decide whether the implied return is achievable and, if so, set earnings targets and proceed.

In conclusion, return on equity is not an end in itself for a mutual, but is part of a comprehensive capital management program for a mutual company.

MR. SPOONER: Jim has pointed out the importance of capital management and the return on equity approach to reporting earnings. Yet a lot of companies do not use a return on equity method even though they acknowledge the importance of capital management. How do some of the other methods compare as far as the return on equity results that they produce?

First I might comment a little on why some companies are not using a return on equity method. It may be a little difficult perhaps for the internal company management to really get a grasp of and feel comfortable with it. It's not GAAP, both for stock companies that are following GAAP and for mutual companies that are using that as a reasonable model to look at because it has been the model for stock companies for fifteen years or so. There is a problem of interpretation both for the internal people and the outside people who are used to GAAP. Another is that the members of your board of trustees are used to some kind of GAAP reporting in their own businesses. Most trustees, at least in our company, are not from insurance companies and they are more comfortable with something that's close to what they've seen in the businesses that they are from. Return on equity as a method is something that would seem different. A last reason is that in setting dividend scales both at the time a product is issued and subsequently, most companies are not following an ROE (Return on Equity) model. It doesn't really lend itself to deciding the level of dividend year by year. They'd be more likely to use something like a fund method or a a direct contribution method. So for those reasons many companies do use something else. They may use GAAP, they may use some kind of a release from risk approach or they may use something that's modeled after their dividend development and calculation.

All of these methods have available a return on equity calculation. How well does that return on equity calculation comport with what appears if you were using return on equity method? The answer to that is going to vary from company to company depending on the ways you do your accounting, on the types of products you have, and so forth. But one model I can refer you to is the model that was used in the report of the Greeley Committee that was working under the Society's Committee on Conversion of Mutual Companies. Many of you may have received it in the financial reporting section. What that committee did was to look at a variety of other reporting methods. They looked at conventional GAAP, full release, a sort of full release from risk, a sort of composite method, a source of earnings method, and, of course, statutory and return on equity. The conclusions that emerged from the model used in that group are that the ROEs after the first couple of years, even for a single year's issue, are not too far off by these other methods from the ROE that would be produced by the return on equity method, except, of course, for statutory. When a series of years issues are pulled together so you have a going concern business type model, even a fairly large change in the growth in new business in a particular year is reflected only fairly slowly in the return on equity that's produced for the company as a whole.

I think the conclusion you can draw from that is, at least by this one model, the return on equity calculation that comes from other approaches is not too bad. A number of companies in spite of the interest in capital are still very much focusing on statutory earnings. After all, we use the statutory statement, we need to remain solid on a statutory basis, and the importance of statutory is still certainly there. Why isn't the statutory approach the only approach that we use?

MR. DAVID N. INGRAM: In trying to form my opinion on this and other financial management questions, I like to look at financial literature that relates to primarily noninsurance companies. When I compare insurance companies to noninsurance companies in looking at this, I want to start at the lowest level of financial measurement, or financial reporting, and that is the cash flow statement. But I really have a hard time comparing insurance companies to manufacturing firms. Insurance companies are just cash rich in that sense. There's no need for insurance companies to manage their cash flow in the same sense that cash flow management is practiced in a noninsurance company. Cash can be easily raised by sale of assets or the sale of a product. In the General Session, Mr. Fred Carr said you just have to be able to afford the price that you are going to get for the assets that you sell. The constraint there on what price you can afford comes from your statutory balance sheet or your statutory income statement in the case of raising money through product sales. That becomes a constraint on many of your operations in a mutual company. You can't run a negative statutory surplus and it's very difficult to run for quite a length of time with a negative statutory income.

So just as noninsurance companies have to manage their cash position and their cash flow statement, I think insurance companies have to manage their statutory statement. You can think of the statutory statement as taking the place in the capital budgeting systems of the cash flow statement in noninsurance companies. Jim has mentioned that this is a hot topic in the eighties in the insurance industry. In publications such as the *Harvard Business Review*, it was a hot topic in the late 1950s and early 1960s. So we've got a little catching up to do.

The statutory income statement does tell you how well you are balancing your current capital expenditures with the sources of capital in the period. But neither the cash flow statement of a noninsurance company nor the statutory statement directly reveals the efficiency of prior capital investments. Noninsurance companies found a need for an income statement that reflects adjustments for transactions that go beyond the one period in which you are reporting. Insurance companies have also had needs for this and that is why first the statutory statement was developed to correct excesses that went one direction when all reporting was done on a cash basis a hundred years or more ago. Then the GAAP statement tries to correct some of the problems from the statutory statement.

The statutory statement tells, as I've said, whether you have overspent yourself in a period or not, but it doesn't tell you whether you've spent your money wisely or not. The ROE approach makes an adjustment. It capitalizes some or all the capital investments that you're making, primarily your acquisition cost. That alters your income statement because it capitalizes and amortizes that investment, and it affects the equity measurements because that unamortized investment becomes part of your equity and the ROE is the ratio of those. It provides a measure of what rate of growth in new capital expenditures can be supported by the inforce business of company. It also can be used to perform an aggregate test on the dividend scale of a mutual company. If the ROE that is actually coming out of your statement is the aggregate growth rate that you are shooting to maintain, then your dividends are in line. When those two things come out of line it's either because your dividend scale is wrong or your experience is deteriorated. It allows measurement of performance without detailed analysis which separates strain from renewal profits which is needed in using the statutory statement.

PANEL DISCUSSION

MR. SPOONER: Dave, Jim and I all represent the mutual company perspective on these issues of capital management and return on equity and the importance of measuring the return, and so forth. Stock companies might look at this in another way.

MR. HOWARD L. ROSEN: Since I do spend some of my time in audit support for my audit partners, I sat and I listened to Dave say that one of the important things is to manage your income statement. I had to sit back and say, "Now what did he mean by that?" I hope it was something harmless and appropriate. I'm sure it was. In truth, as our industry and its products have changed, the views and the modus operandi of stock companies and mutual companies have really come together. In the opening, Al spoke about the products that the mutual companies are selling that are not quite in the vein of mutual company products as we all used to think of them. Let's look at the other side of the coin. What about the products that stock companies have come to sell that are not much in the vein of stock company nonpar products? Are interest sensitive life products participating, or are they nonpar products?

Certainly the IRS has some views. A couple of years ago they clearly said that excess interest was a dividend. So in their view interest sensitive products were very much like par products. Both stocks and mutuals, though, need to raise capital. They need to raise capital for the continuation of operations and for the diversification of operations. So in one or more ways both stocks and mutuals have to look at equity, and therefore, either directly or indirectly at the return on equity. Return on equity has been used by stock companies for many purposes, many of which are also used by mutuals, but so far financial reporting hasn't been one of them. Companies use ROE in pricing for return on equity and this is of particular use in situations where Return on Investment (ROI) makes no sense. This can occur in situations where on a product-by-product basis or even a policy-by-policy basis the investment or acquisition costs are de minimis or where the product costs are not clear cut in terms of how much it costs to issue a particular policy, as in the case of mass marketing.

In this particular situation, ROE can be set as a goal on an accumulated basis say after five, ten, or twenty years. But this as in any use of equity is going to require that someone in the company establish a basis for what required or allocated surplus is. ROE can be used for manager performance evaluation usually on a product line or product sub-line basis. If a manager has been allocated a given amount of funds with which to operate, what return is he realizing on those funds? Is he using the surplus to the company's best advantage? In these situations it is not unusual for bonus compensation or even total compensation to be based on some measure of ROE. The other side of this coin is allocation of surplus. What product lines have generated relatively more profit per dollar of surplus required or allocated than others? Products or product lines with higher ROE are bound to be allocated more surplus dollars when those surplus dollars make themselves available.

The last example I want to use is one that is almost exclusively for stock companies. In fact it is exclusively for those stock companies that follow GAAP purchase accounting. When blocks of business of companies are valued, the present value of profits is discounted at some rate X. That rate X is essentially a combination of the time value of money, the risks inherent in the business, and what a willing investor is willing to buy an asset for. That percentage also represents an ROE, a return on the equity in that product that he is buying. What has essentially been done is that the profits have been capitalized, and they represent the equity in that particular part of the company. So ROE would be a measure used in purchase accounting.

Currently mutuals are grappling with many of the questions that stock companies had to grapple with in the late sixties and early seventies, prior to the development of the Stock Life Audit Guide. In general: at the present time, stock companies don't have to grapple with a lot of those questions, the ones that the mutuals are fighting with right now, because they've already been answered. The basis of income right now is GAAP. We don't have to worry about that. Essentially GAAP says that you try to match revenue with expense. Profit is earned in proportion to the services rendered in the contract. Here, though, there has been an evolution of use by the accounting profession, the AICPA, and the Financial Accounting Standards Board (FASB). A shift from FASB Statement Number 60, which essentially says that you recognize profit using the premium approach, to Exposure Draft 36 for interest sensitive products which says, no, the profits should really be recognized in proportion to the sources of income. At any rate, both stocks and mutuals must determine required surplus or allocated surplus if they're going to use some function of surplus like a return on equity.

In my view at this point, the primary difference in the way that stocks and mutuals view equity and return on equity is essentially that for stock companies ROE results from GAAP accounting. A lot of the preliminary steps have been fixed in concrete. If stock companies want some other basis of measurement, such as an ROE concept, they're going to have to establish a fourth set of books to go along with statutory, GAAP and tax. ROE, however, is being considered as the aim of financial reporting for mutual companies, and I think that's the fundamental difference in the views.

MR. SPOONER: One of the outcomes of the measurement of financial performance in a company is an earnings figure and there are some issues on how you should measure earnings. The first issue we'll take a look at is whether earnings should be before or after dividends.

In my company we measure after dividends for several reasons. First, going back to the theme that's been carried through our presentation so far, if our emphasis is on capital management, then earnings should be a measure of the increase in our capital capacity, and the increase in the capital capacity of the company is measured by earnings after dividends. That's the amount that's leftover as available to increase the capital base, and to use for whatever activities the company needs to continue on an ongoing basis.

A second reason is that earnings before dividends are sensitive to product mix because of the changes in product design that also were referred to earlier. Some of the older products tended to be high premium, high dividend products. More recent products tend to be low premium, low dividend products. There are products that have no dividends at all, or there are products that have excess interest or something that's a little bit like a dividend, but not exactly a dividend. So the issue of what's before and what's after has gotten blurred, and the expectations of before and after vary depending on the type of product.

A last reason why we use earnings after dividends is there's some comparability between mutual company earnings after dividends, and stock company earnings after dividends to both policyholders and shareholders. Both of those figures are the amounts that are available to increase the equity of the company, and you can get something from seeing the extent to which stock companies are able to increase their equity, and the extent to which mutuals are able to increase theirs.

MR. INGRAM: I've got a number of diverse comments to add here. First there is the question of whether to measure earnings before or after dividends. I can think of one good use of before dividend earnings in a mutual company management basis statement and that's the aggregate test of a dividend scale. Many companies over the years have used a dividend scale test of a ratio statutory earnings before dividends to dividends. I think as anybody who has used that measure has found out, there's quite a number of problems with that in any year since you don't have the same sales you have always had. The GAAP earnings, though, don't have the same problem, and, in fact, the GAAP earnings include an amortization of the acquisition costs which is the same thing that is being done in most people's dividend scales. So the ratio of dividends to GAAP earnings for a participating line should be more stable then that ratio to statutory earnings. It's still going to cause a problem as you change product mixes, or have different levels of gross premium margins, but at least it does have an improvement over that prior measure used.

I think after-dividend earnings aren't the most commonly used and people are using adjusted earnings statements. This is useful since it does match the pricing basis and most people look at the shares, or book profits or something after dividends for their par business. But I think that the concept there causes a conflict with what I think of as almost a cultural imperative in our capitalistic society, and that's an imperative to maximize profits.

In a mutual company management we find ourselves in the position of trying to hit a particular ROE right on the nose. You're doing well if you hit the 8%, or 10%, or 12% or whatever your target is on the nose. You go above that, and you're underpaying dividends, and you go below that and your dividends are too high. This just causes a conflict. One of the ways that you solve that conflict is by managing your dividend scale in a way that's not really advantageous to your policyholders. We've looked at Provident Mutual and we've been developing a different solution of how to handle that. That is to try and split our dividends into two portions, one of which we think of as an experience refund portion and we try and define that portion much like a stock company selling participating business would. We've gotten a little bit of experience with us, having recently acquired a stock company with a block of par business. We find that our dividend mechanism isn't that much different from them, except in the situation when our surplus starts to grow too large, in which case the mutual company increases dividends, whereas, a stock company does not.

That extra dividend that arises in those situations we call our equity or ownership dividend. This comes when the company doesn't have any particular use for the extra surplus that it has for growth. It's the same kind of dividend payout that often happens in nonlife insurance companies. For instance, I believe it was General Motors in the last six months paid out a large dividend out of surplus of capital it did not have a particular immediate use for. In using this idea, we're trying to further develop it. If a one-shot thing arises, for instance the recent runup in the stock market causes large gains for you, you may pay an equity dividend because of that, but you would not want to bring that kind of dividend into your pricing illustrations because you don't see how you're going to repeat that time and again. But if management can make a commitment of developing these excess profits from things like equity investments in general, or investments in nonpar lines, or in stock subsidiary companies, you could include that in sales illustrations since you can sustain an amount for this ownership dividend.

The thing that happens in the income statement here is that we will then deduct our experience refund dividend from earnings, but the equity dividend portion will come out of the surplus account, so that we are dividing that up into an above-the-line portion and a below-the-line portion.

MR. SPOONER: Two other experience items that have to be dealt with in the measurement of earnings are tax and so called corporate items. Tax is particularly complicated for the mutual companies because of the equity tax which is on top of the normal income tax. Jim, do you have comments on how those might be looked at?

MR. WERTHEIMER: As I mentioned earlier, I believe that strategic planning at the corporate level should focus on the balance sheet and on the contribution to surplus due to overall company performance. From this prospective, earnings should be measured after all taxes, corporate items, and anything else. So how do we relate this to earnings requirements at the SBU level? In my company we've taken the approach that normal income tax is part of SBU accountability. The equity tax, on the other hand, is charged against earnings on surplus and is not part of SBU accountability.

It is difficult to generalize about corporate items. For example, some companies have taken the view that certain corporate overhead expenses should be charged against earnings on surplus, rather than charged against the SBU and provided for in product pricing. I take the opposite view. I feel the above approach simply leads to higher profitability requirements for the SBU. In other words, if the overhead is charged against surplus, earnings have to be that much higher in order to generate a given return on surplus. So I feel it is better to explicitly provide for such overhead expenses in the pricing discipline. On the other hand, the vagaries of this so-called add-on tax are such it is very difficult to accommodate it in a viable pricing strategy.

MR. SPOONER: Another issue that needs to be dealt with in the measurement of earnings is the value added concept. In my company we do not look at value added for subsidiaries or internal businesses in which we are directly operating. I found it helpful for forming my own ideas to look at the change of equities that you can own, and try to analyze where the change takes place.

Common stock which you buy as an investment is essentially carried on the valued added method. You pick up the newspaper, and you take a look and whatever the value added was, you carried in your statement in one way or the other. For a subsidiary, this doesn't happen, and I think there are several reasons. One is, of course, generally accepted accounting principles don't call for that. For a fully consolidated subsidiary you carry the earnings. You don't have anything to do with value added, and even for one valued by the equity method, you don't estimate the market value of the subsidiary, you carry it according to other accounting principles.

Another reason is that it's often not clear what the market value of the subsidiary is. In fact, most of the time it's not clear what a market value of the subsidiary is. Unless you happen to be a part owner of something that also has a market that you can use for a valuation, there's a lot of judgment involved.

Third, when you look at a subsidiary, one way or the other, you do get full credit for the increase in the equity of the subsidiary either because it's consolidated, or because you carried it by the equity method. For the common stock, you really have no direct share in what's going on in the company that issued the stock. What happens to their internal earnings or their internal equity is only of concern to the extent that it's reflected in market value of the stock itself.

Moving one step further up the ladder, there's the issue of whether you try to use value added for the mutual company that's the parent of all these subsidiaries. Obviously, there are problems. One is that you can't sell the company. It doesn't have a market value unless you are prepared to go through the demutualization process. The second is that value added does involve assumptions in forecast that can be complicated and difficult to deal with in the ways in which they change from year to year. In my company, I'd say the most interest is in some way taking account of the increase in value of the subsidiaries, but my contention is that you're not really presenting everything on a comparable basis if you take account of the increase in value of subsidiaries, and don't in some way take account of the increase in the value of the parent business. It's an inconsistency for those who are managing parent operations in that it puts them in a disadvantageous position when they're trying to compare their results with someone else's. So for those reasons we don't use a value added method anywhere in our subsidiary or parent operations.

Another item to be dealt with is capital gains, both realized or unrealized. How do you deal with those? Do you include those in earnings? How do you consider those in your measurement of financial performance?

MR. INGRAM: I'm just going to give a quick summary of what the three companies represented here are doing with it, and I ask the indulgences of the other members of the panel in case I get this a little bit wrong. One of the companies takes statutory realized and unrealized capital gains, and brings them into income on a spread basis using the 15% annual release method which is being used by Canadian companies. The unreleased capital gains there are set up as a liability. So this treatment affects both income and equity. Another company is following a similar procedure for statutory realized and unrealized gains, and also bringing in unrealized gains on real estate and joint ventures. It brings income in on a three-year spread basis, but includes the value in equity immediately. The third released to match the maturity period of the liabilities. In this company, if these gains are included in the dividend award payout, though, the reserve will be set using an interest rate which does not reflect the gains. So that results in a larger dividend liability in the adjusted statement. I think the net result of that procedure is the same as for the first company where it explicitly sets up a deferred capital gain liability. But in this case it only reflects the amount of those deferred capital gains which are promised to be paid out through the dividend scale.

MR. SPOONER: Howard, do you have anything to add to that?

MR. ROSEN: Before I go through a lead-in on whether or not there is any difference between the ways that stock companies and mutual companies view the concept of whether or not capital gains should be included either in earnings in the ROE fraction or in any kind of earnings, let me say that it is my opinion that the views have virtually come together as one for all insurance companies, and the answer is, yes, for all life insurance companies.

I think for property and casualty the answer may be different. But for life insurance companies, my feeling is everybody agrees that because of the state of the art now, capital gains, realized capital gains, at least should definitely be taken into account. In recognition of the fundamental changes that have happened in our industry in the last fifteen years with respect to stock companies, the FASB Exposure Draft Number 36 includes a provision wherein capital gains or losses will be treated as part of operating income. This is the so-called single step income statement. Investment earnings are growing as a source of profit. Consider the interest sensitive products, universal life, annuities, GICs, what have you. These are all products which have developed or changed as a result of outside pressure and competition, not only between insurance companies and insurance companies, but between insurance companies and outside financial institutions. The competition resulted essentially because of the increased emphasis on investment earnings. In the late seventies, investment rates went through the ceiling. Insurance companies effectively did not respond to that until several years later. Asset portfolios are now actively managed. Capital gains are frequently planned in the investment strategy; they don't just occur. There is some planning for that.

When you think of capital gains and losses, many people think immediately of Fred Carr. Also, they play a significant role in any asset/liability matching exercises the companies are going to make. However, as they occur, they can cause fluctuations in earnings patterns. These fluctuations are very hard for management to understand unless there is some mechanism to handle them. Management may feel if capital gains happened one year, why shouldn't they happen every year? It's the same management. They're managing the same portfolio the same way. Why shouldn't it happen every year? Unfortunately, if you have capital losses that are either planned or unplanned, the same logic may apply. Statutory and current GAAP accounting show capital gains separately from earnings from operations, and this too can be very misleading not only for those within the industry, but for those outside of the industry trying to analyze the earnings of insurance companies.

There is a growing use of the concept of what I would call an interest stabilization reserve. David mentioned several approaches in current use right now. In general, the procedure defers and amortizes capital gains and losses over periods which tend to vary from company to company, and they vary from company to company because there are no rules yet. The period of amortization may either be set to match the liabilities of the products that the assets support, or the types of assets that are generating the capital gains and losses.

MR. SPOONER: If a company was to use the return on equity measurement, how would they go about selecting a target objective for ROE? There are several considerations that might affect the process for a mutual company. In general, the return on equity objective should be related to the anticipated capital needs of the company (for example, see Robin Leckie's paper). At what rate must capital grow to meet these needs? Projections of required surplus should be used. These consider not only changes in the level of risks to which the company is exposed, but also statutory accounting phenomena such as new business strain and the MSVR which may use a company's surplus. Then we can look at what results might be at the end of the five years to see where we were, and we use that as a test of whether we were in reasonably good balance. I think that's the primary consideration in setting a return on equity objective for the company as a whole.

A second is that you have to give consideration to how you are actually measuring your performance. For example, as Dave mentioned, in my company we look at the appreciation on real estate and joint venture activities even though they don't show anywhere in the financial statements. That means we're measuring more of our real return than a company that doesn't recognize those. So we might look for a higher return on equity. Another company that doesn't give specific recognition of those might know that they have some margins hidden away that they have available to them that aren't being measured, and so they can accept a lower current return because they know they've got some future returns waiting for them that they haven't taken credit for.

Another issue is deferred tax. There has been a long-standing issue of whether that can be discounted or not. I think most companies don't discount. We don't, and yet, again, for something like real estate, the value of that discount may really represent some additional return that you haven't taken credit for in the measurement of your earnings. That's another small example, but an example of why you might accept a lower return than if you did take account of that credit.

A third consideration is the practical consideration which is, what can your company do? You look back at the history, and your results, and what you think you can achieve. You look at your pricing and assess your competitive position because obviously you have to remain competitive, and there are limits to the margins that you can build into your products and still stay in business. You look at the returns that are being achieved by your competitors as some measure of the returns that might be possible for you. Of course, again, you also look at the competitors and see why they're achieving returns that are different from yours, what kind of improvements you might have to make to match somebody, and whether you think it's realistic for you to do that. Then you go through the balancing process again. If it's not realistic for you to achieve the return that you need to supply your capital needs, then your only choice is to scale back your capital needs, or else find additional ways of raising capital other than earnings from your businesses.

Those are a few thoughts on what might be considered for the company as a whole. For individual lines, there might be some other considerations, in particular, should each business have the same return objective, or should there be variations from one business to another?

MR. INGRAM: After putting forward the idea earlier of the ownership dividends, one can construct a theoretical idea then that your objectives in all of your lines should be to maximize the return before payment of equity dividends. In practice, we haven't gone quite that far. We set objectives for par lines at a level which are close to long-term growth expectations for those lines. In general, nonpar lines have a somewhat higher ROE objective. That's because they're expected to contribute to the equity dividends at some future time.

In addition, we have a corporate line which we haven't as of yet come up with a systematic way of determining objectives for, because our corporate line is a balancing item in some regards in our statements between what we've decided to allocate to our product lines, and what the total company does. It includes the free surplus of the company. We've moved discontinued lines of business and the residual financial effects of those into the corporate line, and also include several different corporate activities which are not particularly related to product lines.

Another thing that's made it particularly difficult to set goals is that we have corporate in our company holding the bulk of our equity investments in common stocks, and we are allocating fixed income instruments to the product lines. This gives us a stabilized return for the product lines for the most part, but gives corporate what turns out to then be a very highly leveraged portfolio because it is issuing some of the fixed income investments that are being attributed to the product lines. That causes the corporate gains to fluctuate very widely from year to year and we are unable to set exact goals for that. But we do expect that corporate line to produce some surplus over time to go into the equity dividends.

Our goal setting process starts with our new business planning. Our new business planning follows a capital budgeting type approach where we make a plan for how much strain we are putting in to different types of products, and at what return on investment. You can think of this as a new money rate on capital investment in each line, and the expected return on investment is compared with the hurdle rate for par and nonpar lines. As I mentioned earlier, the hurdle rates relate to the growth rates and the additional equity dividends. Riskier, more uncertain products will sometimes be asked to hit higher hurdle rates.

To set the goal for ROE for a line of business, we look at what we call the expected ROE, and also a projected ROE, and I'll tell you what the difference between those is. The expected ROE is kind of a portfolio rate of all prior new money rates, all prior return on investment on new capital investments and new business. We don't usually expect a change in ROEs from the original pricing, and that complicated statement I just made is really just another way of stating something some of you will remember. I certainly didn't hit it when I went through the exams fairly recently, but Weeks's Axiom which was mentioned in Quinn and Marshall's book on dividends, was that dividends should not rise or fall according to the volume of new business. That's really what we're doing by saying we're not going to change the expected ROE on participating business once it's been put in force.

The projected ROE, though, is determined by taking your expectations from pricing, and taking into account what you really think is going to happen in the very near future for that particular year. Variations in lapses, for instance, might cause a slightly accelerated amortization of acquisition cost, which would depress or raise earnings. The goal ROE then is usually somewhere in between the projected ROE and expected ROE, depending how much of a stretch goal we want to set up for a year.

MR. SPOONER: Howard, do you think a stock company would look at this any differently?

MR. ROSEN: Yes, I think in answering that question, I'd like to handle it a little differently. What I'd like to address here is why might stock companies and mutual companies have different views on choosing the basis for financial reporting? If all of our companies were on an exact, even playing field, GAAP had not been discovered by whoever discovered it, and if everybody had to come up with an appropriate basis for financial measurement in the current scenario, stock companies and mutual companies might come up with different answers.

I think that we might get a little perspective on this question if we look at the remaining fundamental differences in the way that mutual companies and stock companies operate. First of all, with respect to stock companies, we're dealing with two distinct constituencies. We're dealing with policyholders and stockholders, and it is a battle between their interest that will ultimately determine the way that stock companies would choose their financial measurement. Non-par products bear more risk. Traditional nonpar products are priced using a fixed cost concept, and since we have investor owners who bear the risk of inadequate pricing through their investment of capital, they would seek a higher yield on their investment if there's fundamentally more risks in the products that they are supporting. That is, they would seek higher stock dividends, or higher stock appreciation.

Therefore, it would seem to me that a stock company basis of operation would emphasize profits. Earnings per share (EPS) would drive the financial statements. The higher and the more consistent are the EPS, the easier it is for a company to then attract and retain outside capital. With regard to stock companies then, surplus is necessary to promote earnings for stockholders, insure solvency, and protect against temporary adverse fluctuations in experience, as well as supply growth capital for new or expanded ventures.

Let's talk about the same ideas with respect to mutual companies. We have one constituency, but that one constituency has two conflicting interests. As Dave said, it may be possible to regard a dividend as really made up of two pieces. One, it is a return of redundant premium representing the policyholder interests. Second, the ownership element is very similar in nature to a stock dividend. There is a certain conflict of interest between the two. On the one hand, owners want to maximize profits. If you're going to maximize profits, it's not going to get you there if you minimize your costs to your policyholders. On the other hand, policyholders want insurance at cost. This is the fundamental basis with which the mutual organization was established. Surplus here is necessary to insure solvency again, to supply growth capital again, but in some cases, to also support the dividend scale. So it would seem to me then that mutual companies would seek controlled growth of surplus funds while stock companies would seek to maximize the growth of surplus funds through profits. I think that that's really the basis that those companies would diverge in their views.

FINANCIAL PERFORMANCE MEASURES FOR MUTUAL COMPANIES

MR. SPOONER: We've talked a lot about financial measures, and capital planning for mutual companies. Howard, do you have any final remarks on the importance, the need for that as you might look at them?

MR. ROSEN: Al asked me to give you an outsider's viewpoint on the need for financial measures and capital planning in a mutual company. It seems to me that the need for changes in the mutual company environment has evolved to a rousing crescendo over a period of years. Mutual companies began losing market share, and there were a lot of reasons for that. It seems to me that the insurance industry was changing faster than mutual companies were. New stock company products had par elements, indeterminate premiums, and excess interest. The dividend mechanism was not as responsive as the excess interest mechanism. Excess interest products today change every month. Stock company products then develop all the advantages of par products, but without the need to have higher premiums.

Under the three phase tax system that we had until the last few years, interest sensitive products created tax problems in the mutual company environment. If a mutual company wanted to compete with a stock company in the sale of a specific type of interest sensitive product, it was either forced to establish or acquire a downstream stock company. There was also competition from outside sources and not just insurance companies, but also outside investment institutions. Investment income was the name of the game, and there was enormous competition for the savings dollars that just naturally flowed into insurance companies. This suddenly stopped when interest rates went up, and either cash values didn't respond, or dividends didn't respond.

Older mutual companies developed a need to raise capital. The interest rate inversion of the late seventies created excessively high interest rates. That led to increased policy loan activity. Many of the policies had 5% interest rates. The loan rates and secular interest rates enabled people to arbitrize their money very successfully at the cost of mutual and stock insurance companies. Cash flow problems resulted. Rises in acquisition maintenance and overhead expenses didn't help matters either. Insurance companies for many, many years operated by what is characterized as a method of "benign neglect." Premiums came, profits came in, mortality went down, expenses were manageable, lapses were kind of steady. Managers and executives now need to better understand their own business.

Product profitability is an issue. What are the sources of gain and loss in our products? How is our experience matching the assumptions we used in pricing? What are we doing right? What are we doing wrong? How do we emphasize what we are doing right and cure what we are doing wrong?

Managing performance is an issue. Mutual companies found themselves at a competitive compensation disadvantage. They had no profit-sharing, no stock option, and no employee stock ownership plans (ESOPs). What were they going to do? There had to be a way to better manage and evaluate the performance of the people who were operating a product line.

How about the better uses for surplus? We have all kinds of different products out there. Do we know, or did the mutual companies know then how those products were using the surplus? Was the investment necessary to begin and maintain an operation being handled the best way? There had to be a better way of measuring the effectiveness of the companies than companies had at that particular point.

Statutory accounting has its limitations. It's conservative. It doesn't necessarily fairly represent the economic realities of the business, particularly when interest rates didn't change with respect to valuation, but they sure changed in the secular environment. Statutory accounting can be misleading. Results are bad in times of high production of profitable business. Does this seem reasonable? Results are good in times of high lapsation of cash value insurance. Does this seem reasonable? The need for alternative means of financial management in reporting became crystal clear. We're still in the evolutionary phases of development of what most people concerned feel is the best possible means for effective financial reporting for mutual companies. But it seems obvious, at least at this juncture, that equity and its maintenance and growth have become the focal point of consideration in the search for appropriate financial measures for mutual companies.

MR. SPOONER: That concludes our impromptu remarks. I'm sure people will have questions or comments on some of the things we've said.

MR. RONALD KLEIN: One comment that I thought I heard Mr. Ingram make was that your company pays dividends according to GAAP earnings, not statutory earnings. If that's true, is there a problem that you might be paying out money before you actually earn it?

MR. INGRAM: I would be willing to bet that everyone is paying out dividends according to GAAP earnings because everyone has been amortizing acquisition costs in the dividend formula.

MR. KLEIN: I remember reading something with one of the exams where you're supposed to be paying dividends according to statutory because of this problem, and I wonder if that was more widely done where you're paying it more on GAAP earnings than statutory.

MR. WERTHEIMER: I think statutory income tends to limit the amount of dividends that you can pay, but there are various philosophies of either a top-down or a bottom-up approach that you can use for establishing a dividend stream. Your comment about paying out earnings before you actually make them really depends upon what you view your earnings to be. I think statutory income, statutory balance sheets, and statutory considerations tend to limit the total amount of dividends that you do pay out. It does not prescribe how much you pay on a given product or product line.

MR. KLEIN: I would have been under the impression that if it was paid according to GAAP they would be more level and not increasing, and according to statutory they are increasing.

MR. WERTHEIMER: I think one of the interesting things that came out of Harry Garber's demutualization task force was the study as to two theories of mutual company ownership, which was the revolving fund and the permanent equity concept. I think that the point you could make is that there's probably no mutual company today that pays dividends out of current earnings, in the sense that earnings on the contracts are being turned back around into dividends. I think that you could very well demonstrate it, but if you tried to do that, the slope of the dividend scale would indeed be quite different than what you're seeing in current product offerings. I think that what it basically proves is that any company that claims that it's using this revolving fund approach, is probably fooling itself.

MR. DANIEL J. KUNESH: Mr. Ingram, how do you define GAAP when you say that most companies are paying dividends on the basis of GAAP? Are you defining it for external reporting purposes?

MR. INGRAM: No, I'm sorry I used that phrasing. I was using it very sloppily. I just meant that people are paying dividends according to an adjusted earnings measure. They look at their products, and they are not waiting the five to fifteen years it takes for a block of sales to actually have made a profit on an accumulated statutory basis. They are doing it according to an adjusted earnings basis which includes an amortization of acquisition cost.

MR. STEPHEN L. WHITE: Now that these companies have developed better or more appropriate financial performance measures, what are your plans to communicate these results to either policyholders or rating services like Standard and Poor's?

MR. SPOONER: I can answer that for us, and then the panelists may want to comment as well. We have not made any communications to policyholders on this for a number of reasons. There are tax issues, there are accounting issues, and there's no official way you can do it. I think The New England is the first company that I've seen that this year made a reference in their annual report to a management result to try to give an indication of how they're doing without presenting a detailed statement. As far as the rating agencies, we've talked to them about the concept, primarily because of this issue of hidden values, things that we think are not presented in the annual statement in a way that really shows what we've got going for us on the balance sheet. I've talked about that to people coming in from rating agencies to try to give them some sense of where we think we have these hidden values, but we don't have any plans to go any further than that.

MR. WERTHEIMER: We certainly have no plans to communicate our adjusted earnings results to our policyholders. We are certainly reviewing them with our board, but we are a far cry from actually publicizing these results. As far as the rating agencies are concerned, we have by sub-line of business by SBU, particularly in the group annuity area, used our internal adjusted earnings concepts to help demonstrate to the ratings agencies the inherent profitability of that business. But as for the corporate level, and certainly the ordinary life area, we have not made any attempts to communicate what those results might be.

MR. INGRAM: Just so far as the ratings agencies use of these statements goes, the impression I got when we did try and discuss these adjusted earnings with ratings agencies was, that until there was a standarized basis for mutual companies to present adjusted earnings, they really weren't going to put a lot of weight on the results of those adjusted earning statements because they felt they needed something that could be easily compared between companies.

MR. GARY CORBETT: I have three rather brief questions, but they're quite dissimilar. The first is this problem of deducting policyholder dividends, using before or after earnings. The problem as I see it is, if you are going to reward managers for only after-policyholder dividend earnings, particularly those in the experience refund portion, which as I understood the Provident would also keep in above the line and deduct out in order get the earnings, how do you motivate those managers to do a better job of managing experience to benefit the owners of the company, the policyholders in that case, if they are being measured essentially on the bottom line?

MR. SPOONER: Again I'll respond for us, and then see what comments other people have. I don't think we necessarily have a good solution to that problem. The solution we do have, I think, is that the dividend policy is not short term. We wind up thinking about dividends over several years, the standard types of things that appear in all the literature about long-term trends, and so forth, and, in fact, we don't find in practice that there's any incentive either to tinker with the dividend scale to beat the system, or to hold back increases.

It may be a function of the environment we're in where most companies are not looking at increases, but are looking at holding the line. I think, in fact, even though we do reward managers for maximizing gains after dividends, that it hasn't produced a conflict between maintaining a dividend scale that's both fair and, frankly, competitive even in the historical basis, and in having the people try to achieve the most efficient result which, of course, could be reflected in an improvement in dividends in future years. Does anyone else want to comment on that?

MR. INGRAM: I think it's a mistake to try to spend a lot of time trying to devise a financial reporting system that's going to be perfect, that's going to solve all your different problems. I think with regard to the dividend management and management of experience, you have a counterbalance force which Al referred to. The competitive position that you're in is going to keep that piece of your business managed in a way you'd like it to be. The real other control you need on that is just to make sure that your dividend process does not inordinately reward new sales versus in-force business for managing your experience.

MR. SPOONER: Jim, did you want to add something?

MR. WERTHEIMER: I would say to Gary that the comments I made earlier relating to the mutual company view is that I wouldn't use even the bottom line itself as really the ultimate measure, but the balance sheet. The concepts that we've been talking about here are in terms of measuring ROE, or at the individual product decision levels, rather than at the aggregate level of the company. Certainly you'd want to look at your after-dividend contribution to surplus when you're looking at the individual product level.

MR. CORBETT: The second question is for more for you, Al. I understand the problems with value added, and probably agree with the problems in calculating it. You can't sell the company without a value added method. Some type of value added calculations are necessary in order to give appropriate credit to sales and appropriately penalize lapses in excess of expected. This is true for stock companies as well as mutuals.

MR. SPOONER: I think the best answer I can give you is we probably get around it a little bit by also providing incentives on growth in the company as measured by the more conventional measures, assets and premiums. So we do give some recognition to growth that hasn't yet appeared in the bottom line. Aside from that, if somebody has a terrific new business year, it probably doesn't get directly reflected. Maybe the answer is a longer term incentive program, and we're considering something like that, but we don't have one in place right now. Anyone else?

MR. WERTHEIMER: I think another answer is that you don't simply judge management based on the bottom line, but you set other measures, one of which might be lapse rates in and of themselves, giving whatever way you want to in your recognition formula for the importance of that item.

MR. CORBETT: Although I do accept that measures which ignore the future profits on sales and lapses can be supplemented by other measures, such as growth, you need relatively simple bottom line measurements for SBU's. Even if "value added" is not a part of a company's primary internal financial measurements, I do suggest showing, perhaps as a footnote, the results on a value added basis.

The third item is more of a comment. Referring to capital gains and, in particular, the gain on fixed income securities caused by interest rate fluctuations, the only sound method of accounting for such gains is to spread the gains over the remaining term of the investment sold. If gains are taken into surplus, whether through the income statement or not, liabilities must be recalculated in order to provide for a level of investment earnings different than originally assumed. The method followed in Canada with respect to capital gains and losses on fixed income securities is ideal. When we turn our attention to capital gains and losses on equities, including real estate, there is no such unique solution. From a management point of view, I would support spreading such gains and losses but can also appreciate the accountant's desire, at least for external reporting, to report such gains and losses when realized.

MR. SPOONER: I'll give you the answer, again, for my company and it's a nonactuarial answer, but that's the way it is. When we first were thinking about capital gains, I'd done a little work, and I thought we really ought to divide capital gains into three piles. One pile is things like real estate and common stock where it's a pure equity gain, and you don't want to take it all in the year it happens, you want to average it someway, perhaps over something like the business cycle. What I came up with for no particularly good reason was let's spread it over three years.

For things like default problems, I was inclined as a conservative and as a watcher of GAAP, to just knock it all out in the year taken, in the year it happens. Then for the situation, which I think you're probably most concerned about where you sell a high-yielding bond and take the profit, and then you just eat it over the ten years, that kind of a gain should be spread over the remaining lifetime that the bond would have had if you didn't get rid of it. I was ready to do something simple like just assume it was going to be ten years and take all the bond gains and spread them over ten years.

I had this lovely theory worked out, and I marched into the trustees and I explained it all to them, and one of them said, "That sounds fishy to me," or words to that effect, and we wound up using three years for everything. I hope somebody else has a better answer than mine, but like I said, that's the way it is.

MR. INGRAM: I just have one comment on it. I guess I'm not real sure you can make a clear delineation between real capital gains and capital gains that are a result from an interest rate fluctuation. The stock market seems to react quite a bit to interest rates as well, so that those capital gains are a part of that whole question.

MR. CORBETT: I would have included only fixed income securities. I understand what you're saying.

MR. JAMES F. REISKYTL: I have comments on a number of things. One, I happen to agree, Al, with your approach to capital gains. It makes the most theoretical sense whether you explain it to the trustees or not. I'm surprised that Howard was suggesting that you should bring gains into income because I'd have thought he would have been arguing for reflecting income over a period, and surely, realized gains are not income for a period.

I think there is a basic problem there unless you have a gain for that period. You ought to reflect the increase in income for the period and not a realized gain which is obviously going to reflect the results for multiple years, and may not even be in that period at all, and to include that in income, in my opinion, is inaccurate.

MR. ROSEN: I did not necessarily mean that the entire capital gain should be taken into income immediately, but it should be taken into account in some way in the earnings stream. What I would agree with is that it should be taken over a series of periods. I am in agreement with the idea of an income stabilization reserve, or an income stabilization process of some sort. Whether or not that process matches the expected lifetime of the assets that generate the capital gains and/or losses, or whether or not I think that the amortization period should be based on the liabilities that those assets back, is a different issue. But when I said it should be taken into income, I meant it should be taken into consideration in establishing an income pattern, so as to foster continuity, rather than a discontinuity.

MR. REISKYTL: The second point goes back to the days when I taught dividend seminars. I can't resist when you say we are not paying dividends out of earnings. Surely, you wouldn't want it to be quoted that the Society of Actuaries concluded on whatever day today is, that we are not doing that. I would refer you to Bob Winter's paper which I suspect most of us have read, or at least are aware of, and that gets back to expectations and if expectations don't pay, don't change, you, in fact, are paying them out of earnings. Again earnings depend on what you define them to be, if you take a very strict interpretation of earnings for statutory meaning full recognition of acquisition costs, you'd come up with the answer you mentioned. But I think you'd agree, and in fact, I would say are amortizing in your scale and, therefore, paying out of earnings.

The best financial measure, I'd say, is in the dividends paid to your policyowners, or really the best financial measure for a mutual company is a net cost to its policyowners. If I had my druthers, the bottom line would be dividends and it would not be a contribution to surplus because I view that as simply a charge or a cost of conducting the business. That's very little to do with how you manage the company. Yes, you have to have enough earnings to continue to operate, but the management objective of the company is not to have the highest earnings. The objective of the company, I believe, is to pay the highest dividends. That comes to another fundamental question that Arnold Dicke got to in another session. I think you have to define what a mutual company is. Maybe that should perceive how we measure its earnings. Once you define that, you then have to decide what you do with these subsidiaries in all these other lines. Should the rate of earnings for those, the rate of return, or however you measure it, be the same for these lines of business as in your participating block? I suggest the possibility to be consistent with what Arnold Dicke suggested, that if you run a line of business as an investment then the ROE or your return on it ought to be commensurate with that investment, and if you're taking more risk, you ought to have a higher return. That has little or nothing to do with the growth rate or the ROE as used for the par block of business, which I think a number of you stated today has to do with the growth rate of your company. The growth rate of the company may be totally different than the economic return that you expect on an investment. That earnings rate is intended to reflect our growth, whereas a stock company presumably is looking for a rate of return so it can be an attractive investment in the investment community. That's a totally different perspective from my viewpoint.

MR. WERTHEIMER: I'd like to comment on that last point that Jim mentioned. I think that many mutual companies certainly take the view that you suggested with regard to either subsidiaries or particularly nonpar lines such as the group line. These lines require investment of surplus. They involve a certain amount or risk, perhaps in many cases more risk than the participating lines of business, and then ought to produce a regular return on their capital requirements commensurate with the risk, and commensurate with what might be available elsewhere in the marketplace for that investment of capital.

On the other hand, and this is not my point of view, but I think some mutual companies, from the way they operate, view the purpose of the mutual company as being to grow in all areas, not just simply to provide insurance at cost, the traditional mission of the mutual company. To grow whether it's in the group life and health area, or the group annuity area, or in these new interest sensitive products which are really not participating in the sense that traditional products are participating. The need for growth exceeds the need to earn a return. That's the impression that one can have, and that there really isn't any intention to produce a return back to the owners of the company. The entity itself is what needs to be preserved. Is growth being done for the good of the entity rather than for the good of the traditional owners? I don't think that there's a single view among the mutual segment of the industry as to what the mission of a mutual company is.

MR. SPOONER: Yes, my comment on growth is I've always had trouble subscribing to the "no new business is best for the policyholder" theory. The realities of expenses and changes, in the business that you have, require growth to maintain competitive results for the policyholders that you already have, in addition to those that you're picking up new. I certainly agree with what both you and Jim said, that the fundamental purpose of the mutual company in treating its policyholders isn't an issue, but that you can't really manage the balance between capital and growth of the company if you're not measuring one against the other. What you do with the result is maybe another story, but that as a way of measuring your "balance," it seems that you really have to watch that closely or you'll get out of balance and have problems you can't solve.

MR. INGRAM: I want to add one more comment on the idea of growth by really loosely paraphrasing, or completely restating some of the ideas of the economist Joseph Alois Schumpeter. He characterized that in a capitalistic society there are two possibilities for an enterprise, and that's growth and death. He said that it's impossible in a capitalistic society to manage an enterprise that is not growing, and is not taking on new ways of doing things at all times because otherwise other enterprises in a similar business will take their business away from them.

MR. CHARLES C. MCLEOD: I should like to comment on two points -- the use of an ROE measure and the treatment of capital gains.

I have some reservations about an ROE measure apparently being promoted as the best measure for mutual companies. One of the unique features of a mutual company is its ability to develop its own measurement system for management purposes -- unlike stock companies it does not have to be constrained by GAAP. The real test of a financial management measurement system is how well it shows the extent to which management's objectives are being achieved. Different mutual companies will have different objectives, and different measures and/or reporting systems will be necessary. For example, the mutual company operating in one state will have quite different objectives and measures than Prudential. The "true" mutual company, which tries to pay the highest policyholder dividends possible, will have different measures than the mutual company which acts as though it was a stock company and rarely increases dividends.

There are a variety of possible measurement systems for a mutual company, and there are advantages and disadvantages of each. Instead of promoting one system over the others, I think it is better to recognize that the choice of the system:

-- should recognize the objectives of the company,
-- should be consistent with pricing and planning,
-- should be implementable (recognizing the resources within the company), and
-- should be comprehendible and credible to the users.

On the subject of capital gains, I think that the treatment of these, if done poorly, can lead to more distortion of earnings than perhaps anything else. For example, if realized gains are reported in income but not unrealized gains, the result may be that management sells assets only if a capital gain will result and doesn't sell investments if a capital loss will result -- even though these actions could be wrong from an investment viewpoint. Being from Canada, I am biased towards the Canadian treatment of realized and unrealized gains but, even with the Canadian approach, distortions can arise if assets and liabilities are not valued consistently. Consider the case where a single premium deferred annuity is surrendered, the associated assets are sold at a capital loss, and a market value adjustment is collected from the policyholder. The capital loss will be amortized over the remaining life of the security; the book gain on surrender should not flow into income immediately, but instead should be amortized over a number of years also.

MR. SPOONER: I would agree with your second point on the need for a reserve. There's probably not much I could add to what I already said to Gary about treating the gains.

On the first point, I would say that in this Greeley report that I mentioned earlier, that was an issue that was discussed by that committee, and I think they essentially came to the same conclusion. No one method is right, but whatever method you do use should have that return on equity result as a yardstick to make sure that you're getting something meaningful in that area.