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PROFIT CENTERS -- MANAGEMENT REPORTING

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- o Reporting structure
  - -- Line of business
  - -- Distribution system
  - -- Profit Centers
  - -- Strategic Business Units
- o Profit and performance criteria
- o Definition of balance sheets and income by reportable unit
- o Allocation of surplus, investment income, expenses, federal income taxes
- o Use of financial management information
- o Practical considerations and other matters
  - -- Realized gain and losses
  - -- Subsidiaries

MR. ROBERT W. STEIN: During the last several years I have spent much of my time working with companies designing, implementing and teaching how to use enhanced financial management reporting systems. There has been a tremendous amount of interest in management reporting concepts during the last several years, and there have been many speeches, articles, and seminars in the actuarial field and in many other nonactuarial forums. I think the level of interest in

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this topic, financial management systems and reporting, goes way beyond the normal interest in keeping current with what is happening in a developing area.

I think that the level of interest (1) reflects a real concern over the nature of the financial reporting and analyses systems that the industry has typically had in place and has relied on over the past years, and (2) demonstrates a real need to make improvements in those financial management systems.

But why do we see all of this activity now? Some might say, and for today's purposes I will take an extreme position, that this activity and interest in developing such systems reflects a growing awareness of, and a desire to improve on, what can be described as the chronically mediocre financial performance of the life insurance industry.

We are all aware of the conditions of the last ten years and how we got to where we are. We can all describe the buffeting that the industry has been under. But whatever the description of the path taken to our current position, we can see that the current environment is characterized by extremely keen competition within the industry.

There is cutthroat price competition and severe competition for access to distribution systems. From outside the industry, we have a constant, and somewhat irrational, fear of what the banks and other financial institutions are going to do to us -- whether we like it or not.

I think there is intense cost pressure in both the home office and the field organizations, which is frequently accompanied by a general lack of information concerning the nature and source of the costs which are being incurred in such substantial levels. Somewhat unfortunately, there frequently is very little real understanding of what costs are being incurred and how they relate to the product's ability to recover those costs. One other symptom of the current situation is a real difficulty in managing the computer technology that the industry seems so enamored with. But these are just a few of the symptoms. I think the conditions are much broader than this and in the opinion of many, have led to unsatisfactory financial performance.

And what is the industry's response to this situation? Well, I think it is relatively clear. The reaction to this situation has been somewhat slow in coming and perhaps only has taken place after a realization that business as usual is just not going to turn around the performance of the industry. The first topic of our panel discussion addresses something that we see throughout the industry -- a general move to develop a real understanding of the financial performance of companies and of the organizations that you are all members of. There is a tendency these days to try to focus on what is driving results, to develop an understanding of the critical success factors of the businesses that you are in, and maybe for the first time, a growing effort to actually manage those success factors and the associated financial results.

We will see how three different organizations have dealt with the current environment and their organizations' need for better and more timely financial information, and how they use that information in the management of their operations. We will hear discussions of product and distribution system reporting structures, how companies are determining key financial performance standards at various levels in the organization and how that information is being used to hold management accountable for financial results. We also will hear a discussion of how companies measure risk in their own organizations and how they measure the capital which has been devoted to their businesses. The measurement of capital is an essential element and helps these organizations better manage and better evaluate the capital commitments they have made in their operations and the returns that this capital is providing.

Another noticeable response to the condition of the industry, and one which only can be successfully managed with the kinds of financial performance reporting systems that we are going to be talking about, is the explosion of innovative ways to try to improve financial results. When you look around the industry you see a lot of new arrangements with distribution systems, generally designed to increase productivity and better control costs. We see situations where equity interests and profits are being provided to the distributors of products. Joint ventures of all forms are designed to provide companies better access to markets and niches throughout the general marketplace.

In addition, we see substantial efforts to control costs, even to the point where profit centers are being made out of what historically were cost centers to obtain a better feel for what is driving costs, where costs are being incurred, and how they are being recovered. We see major restructurings, companies evaluating whole product lines or entire operations and dispensing of them after reaching decisions that financial performance can just not be turned around. This is something that rarely took place in the past. Even some very fundamental organizational changes have been made. Mergers and acquisitions have always played a large role in the insurance industry, and today they are playing an increasing role. And now, in the mutual sector, demutualizations continue to be important and are utilized in strategic restructurings to achieve growth and financial performance objectives.

But none of these kinds of activities, or any other steps to improve financial performance, can be done without the financial management systems which are needed to monitor and report on the activities which companies decide to undertake. The need to measure and analyze results is critical and the need to truly understand operating performance is essential in trying to improve the results of any organization. We will be hearing what steps are being taken to better understand the operating results of companies and how those results are being used to actually manage results.

MR. JAMES M. DURHAM: I think that, as Bob said, the management of insurance companies has been typically mediocre at best and that your profession and mine have contributed significantly. I think, unfortunately, I even have to put myself in that category, thinking that I didn't always do what I should have done, looked at what I should have looked at, and thought about the financial performance and management of our company. First of all, Monarch is a stock life insurance company. It is a new company that has been in existence for about 80 years and we have had virtually all new management in the last four years. Many members of that new management team are from outside of the insurance industry. We were a company that for a five to seven-year period really wasn't selling any new life insurance or disability insurance and essentially the books of business were running off. With our management change came an emphasis upon two primary products. Monarch had been in the business of individual disability income insurance and had been a leader in that business for a number of years. Then in 1980, we entered the variable life insurance business and today we are the number one producer of new premiums of variable life insurance. We sold $1 billion in new premiums last year and expect to sell $2 billion this year. In addition to those products, we have a line of annuities, primarily single premium annuities. We have some direct response life and health business and, of course, the traditional ordinary life insurance block of business and a closed block of major medical business, of about $8 million in annual premiums.

One problem that we encountered in assessing our financial performance and gearing up our management was that the accounting systems in all of our companies were manual and every company had a different system. Financial statements were prepared on a quarterly basis and there was not a great deal of concern as to the accuracy of those financial statements. The attitude was that it would be correct by the end of the year.

We had no formal, coordinated planning process. An actuary sat in his office once a year and generated a business plan which produced computer printouts not only for a one-year business plan but for a ten-year business plan as well. No one other than he had any input into that plan, and I am not sure anyone other than he ever saw that plan. When we compared that plan to actual results, many of the lines were off significantly, but the totals were very close to what we actually reported. So the response was that the model had to be okay. There was no explanation and no understanding of why results varied by line. There was a terrible inability to explain results not only against the planning model, but also against the prior year. The actuaries saw insurance on a long-term basis, rather than on a monthly, quarterly, or even annual basis. The accounting systems didn't provide sufficient detail to get down to a level to be able to analyze the various lines of business. When they could get any detail they were unable to tie it all together, to talk about what it meant, to find where they were going, what they were doing. Accountants were, of course, happy to point their fingers at the actuaries, saying that it was their fault.

Our organizational structure had some difficulties in that with our primary line, the variable life insurance responsibility for the profitability of that line of business was outside of the life insurance company that was the legal entity for the business. We had several lines of business that run through that legal entity the same way, so that we had problems between the CEO of the life insurance company and the CEO of the other operation in terms of who is being charged for what and whether the charges are fair. We had similar products in different companies with different pricing assumptions. Many of our servicing and processing operations were in separate companies, so that life insurance company A got a charge for data processing but no one really knew whether that was a reasonable charge for what was received. You know how intercompany allocations go. Our structure was further complicated by the fact that we use multiple distribution systems -- a career force, insurance brokers, stockbrokers and direct marketing. We also use the career forces of other insurance companies in our disability line and, of course, the career force sells all products for all companies.

Any analysis that was done on an annual basis was sketchy and generally done via actuarial techniques. Many of the analyses that were performed were kept to the actuaries themselves and not explained with the top management of the company. The questions we were plagued with and that we continually asked our accountants, our actuaries and the CEOs of our businesses were, "How much are we making and why?" Our belief was that if Monarch were our own business we would want to know every day how much we were making or losing and why. We wanted to know by product and product was defined very narrowly. It was not life insurance, it was not just single premium variable life insurance, it was each product within the single premium variable life insurance category. We also wanted to know by distribution system. We used many, some more significant than others. For example, stockbrokers are the biggest distribution system for single premium variable life. Merrill Lynch, up until recently was 90% of that production, so we wanted to isolate Merrill Lynch to see the profitability of that system. We wanted to see results by product and by distribution system on a statutory basis, GAAP basis, pricing basis, and tax basis. We wanted to know the actual and plan results and why they differed. We believe, as most companies do, that the more people who understand the profitability of the business, the more likely they will succeed in the business. To this point only the actuaries and some accountants understood that.

We wanted top management financial information on a monthly basis, and income statements by product and by distribution system. The outline of that simple income statement included first-year premiums, renewal premiums, gross investment income, investment expenses, net investment income, claims, surrenders, increase in reserves, first-year commissions, renewal commissions, other acquisition costs, deferred policy acquisition costs (DPAC), capitalized DPAC amortized, maintenance expenses, overhead broken out between direct and indirect, and pretax income. We felt that this was a simple format that CEOs and top management could easily focus on and understand. We also felt that it provided the ability for them to focus on the items that they can control, such as investment performance and expenses. In this analysis, the comparison of actual results to the plan was our primary concern. Comparison to prior year was secondary, particularly in a case like ours where we reallocate resources frequently to new products and new distribution systems. We also wanted cost center information, measures of efficiency, cost per claim process, and cost per policy issued.

This information is used for preparation of the annual business plan by product and by distribution system for the allocation of resources. We are not a large company and we don't have a lot of people or financial resources. We intend to grow and have been growing very rapidly and we want to do it in the most efficient manner possible. We want the information used in pricing regarding unit costs so that we can use it in tax planning. Essentially, we want to be able to prepare a tax return by line of business and determine the impact of each line on our tax position.

Our client/company arrangements, as mentioned earlier, function as follows. We enter into an agreement with a company that sponsors our product to their distribution system or career force. They pay us for all of the administration on those policies, and we reinsure portions of the business that they sell. With that, we need to know what it costs to perform each of the functions to negotiate an appropriate joint venture arrangement. It helps in providing the detail and in explaining the monthly variances against the plan.

We want to get to the basics of the business and arrive at future expectations. It is not relevant to be told that commissions are up because premiums are up. It is relevant to be told where we expect the level of those premiums to continue to grow because of our financing needs and our significant growth. An example would be single premium variable life. Last year, we sold $350,000,000 more in new premiums than the $650,000,000 that we had anticipated. With a 10% cash strain, that is significant.

Another reason for obtaining the management information is that the rating agencies, in particular Standard and Poor's, now used for claims paying ratings as well as debt and other securities ratings, look at the quality and type of management information and control systems the companies have. Our system is Set up in such a way that legal entities lose their significance in the planning process and evaluation process, and the holding company expenses are allocated back across product and distribution systems. It also is used for transfer pricing within our organization where we have different entities performing different services. We have just completed putting this system in place in our company. Next, we need to convince our actuaries to set up the same type of systems to monitor persistency, mortality, and morbidity on a frequent basis by product and by distribution system. This should be done so that it is understandable, usable, and easily communicated to top management.

One problem that arises in implementing a system such as this is top management support. In our case, top management insisted upon it. The next problem is getting the operating management to support this system. This becomes easier when top management supports it, but it is still not simple when the attitude is that it is a long-term business which we have never really managed in the past. In getting operating management to help design the system, there was a concern about the level of detail needed. We were concerned about a finer breakdown -- like the types of disability products sold. It was a massive computer programming job to get all of the individual insurance processing systems to break down the detail information to support the system on a timely basis. We wanted information in this format that would automatically feed the monthly closing. To get each of the companies to adopt a uniform chart of accounts was difficult, as every accountant believes his system is better than the others. We needed an automated, flexible system to be able to generate this information. This is also difficult when you are going from purely manual operations to an automated system. In order to better allocate expenses, we set up the chart of accounts, structure, and cost centers in such a way that most of the expenses could go directly to the particular lines of business and to the distribution systems. This is probably easier to do in a company our size than in a larger company. We needed a reliable allocation methodology. We did not want to rely on methodologies that were used, for example, in preparing the annual statement. Recognizing that we could not do that with the people we had in-house on a timely basis, we hired Ernst & Whinney to perform a study, develop the system, and actually implement it for us. This cut the time at least in half.

From the standpoint of allocation of capital to the lines of business, much of that had already been done for us by virtue of the legal organization. One of our companies is a pure annuity company, capital is intact in it. On the variable life insurance side of the business, since it was a brand new line of business, it was very easy to track the amount of capital we had invested in the operation. As far as the other lines of business, we have not yet decided on an appropriate methodology for allocating capital within the structure, particularly to the disability business. The problems of the insurance industry, and in many of the insurance companies, provide a significant opportunity for your profession and for mine. Actuaries have probably been the life of the industry and the lead in developing information for pricing. Management is much more active today in the pricing of products and in challenging the pricing of products, and in determining whether or not we bring a product to market. It is an opportunity for actuaries to look forward, pay less attention to the rearview mirror, be management oriented, think more about how to manage the business, control the various aspects of it, change quickly when you see experience change, and, finally, be able to communicate with top management of the organization in a method which they can understand. CEOs of insurance companies have for many years been very happy to delegate the responsibility for financial results and pricing to their actuaries. In our company, we see that has changed. We see top management and our board of directors challenging what we are doing in pricing and in our actual results. The attitudes of our people, at least our actuaries and accountants, are certainly changing, but not as rapidly as we would like them to change.

MR. STEIN: During that process, what kind of financial performance objectives were established and what key measures of performance do you rely on at this time? Also, what kind of elapsed time and manpower did this entire process take?

MR. DURHAM: I am afraid we are not as sophisticated in looking at the results as we would like to be at this point. We have a corporate goal of a minimum of 15% return on equity. We try to assess that as we go through each company's annual business plan and determine whether or not the capital that has been allocated will generate a 15% return. If not, why not? What is it going to take to get it up to that if it is possible to do so? We actually make the determination as well as we can make it, at the point the annual business plan is submitted. From that point on, it is a matter of comparison to the actual results.

MR. ARNOLD A. DICKE: Regarding the 15% rate of return, are your lines assigned any form of required surplus or is that return simply on the statutory type of strain? What is the basis of that return? What is the equity?

MR. DURHAM: The return is on the GAAP equity of the companies.

MR DICKE: Do you use GAAP in this?

MR. DURHAM: Yes.

MR. RICHARD S. ROBERTSON: I want you to comment on three areas. (1) You indicated that you allocate federal income taxes essentially by a separate return basis for each of the profit centers. Are you fortunate enough that when you add those up you get the total, and, if not, what kind of problems do you have in trying to decentralize your tax planning? (2) Do you allocate investment gains and losses and if so, how? (3) Are there any other areas where you find it necessary to use a different measure of earnings for a profit center than you use for reporting for the company as a whole?

MR. DURHAM: The implementation of the reporting system took about a year and a half. We felt that this was much longer than it should have taken in an organization the size of ours, with as few products as we have.

Regarding the taxes by profit center, somehow the tax people always make it come out equal. I am not sure what allocations they go through to do that.

Assigning income to those lines of business where we have not specifically allocated capital is a problem, as in the disability I talked about before. It is easy on the variable life line of business where we can simply identify capital, or on the annuity business which is in a separate company. That is because we have just implemented this level of information in the company as of January 1 of this year. The calculations that they have done to date have been approximations, so we have not specifically run into the problems that you question.

Regarding investment gains and losses, to the extent that we have allocated our investment portfolio to a product line, the major area is our annuity business. One company is a pure annuity company and in our other companies we have matched the assets and liabilities in those annuity lines so that it is easy to determine where the capital gains come from. They are allocated on that basis. For our variable life business, this is already done because it is all in separate accounts. This is also true for our variable annuity business. Again, the disability and the old life business kind of sit out there by themselves, and approximate methods are used for allocation.

Regarding measures other than the 15% return on equity, if I understand your question, we know that we have some lines of business that don't return 15%. In our old life line of business, for example, we have tried to obtain information to figure out if there is anything we can do to increase returns to the level that is acceptable. If not, can we get rid of that business?

MR. STEIN: Regarding the alternate performance standards, with respect to certain businesses are returns on assets or some other measure used as opposed to return on equity and what are the returns in each of the lines? Mostly, you mentioned that you look at statutory and pricing bases as well as GAAP. Do you have any goals in those areas on any of the other lines?

MR. DURHAM: The only area where we look at our return on assets is in the variable business. We really consider that to be much more of an investment management business than an insurance business. So really it is a matter of looking at it both ways.

MR. STEIN: Are your return-on-equity targets after realized gains and losses?

MR. DURHAM: No.

MR. FORREST ALLEN SPOONER: You mentioned that you did a lot of work on expense allocation to go beyond what is done in the annual statement. Was that just a matter of breaking things down to the next levels by subdividing lines of business, or is it something more general than that? Did you recategorize expenses or what were you trying to do there?

MR. DURHAM: We wanted to identify as specifically as we could which expenses went with each product and distribution system. Much to our accountants' and computer people's chagrin, we have a chart of accounts that number in the thousands for the reporting levels needed. We tried to take it down absolutely as far as we could take the detail and to break everything down as fine as possible. While top management gets the summary income statement, lower levels of management get different levels of detail, all the way to the cost center manager who might end up with 50 lines of expense on the information that he gets.

MR. J. PETER DURAN: What approach have you taken to the allocation of overhead and corporate-type expenses?

MR. DURHAM: That was the primary area of Ernst & Whinney's work for us. We tried to do it in terms of where management effort, corporate effort, and resources were being spent as opposed to allocating it by premium. Obviously, in our case, we could not allocate it by premium if we sold a billion dollars worth of single premium variable life insurance and had $90 million of a disability income premium. You get a wide distortion and the variable life insurance line gets hurt significantly relative to the disability line. We were able to break it down primarily because of our structure. For example, when I talked about the management of the variable life line actually being outside of Monarch so that their overhead did really run to the disability business, we allocated very little of that to the insignificant or dormant lines of business for the old life insurance line.

MR. PAUL F. KOLKMAN: I am going to be describing an approach or a system that is actually quite similar to the one Jim described. There are some differences, some of which I consider significant and some which I do not consider to be significant. My discussion is going to be from the point of view of a stock life insurance company that is owned by a significantly larger financial services organization. I am going to describe how the total organization of IDS Life Insurance Company has approached the profit center reporting issue. Some of the systems we have put in place briefly touch on some of the problems we encountered and point out some of the good and bad features of our approach.

PROFIT CENTERS -- MANAGEMENT REPORTING

My remarks are going to be from the point of view of IDS Life Insurance Company and its two life insurance company subsidiaries. These companies sell a full range of insurance and annuity products and at year-end 1985, IDS Life was the 18th largest life insurance company in the country in terms of assets. IDS Life Insurance Company is owned by IDS which is the significantly larger diversified financial service organization and IDS is in turn owned by American Express. In this type of a structure, you can look at profit center reporting on a number of different levels -- profit center reporting by American Express's subsidiaries to it, profit center reporting by IDS, profit center reporting to IDS, and profit center reporting within IDS Life itself. As far as American Express is concerned, there really is not much to talk about. The subsidiaries are all managed independently, and as long as an adequate financial return is generated, the company has a long tradition of allowing subsidiaries to operate freely. I am really not aware of anything going on at the American Express level to try and bring some sort of overall consistent profit center methodology into place.

Reporting to IDS is another matter entirely, and that is where I will spend most of my time. As I mentioned, IDS is a large diversified financial organization. The company currently owns or manages some $33 billion in assets and is divided into 19 profit centers. Some of these are quite small and report to the same individual, so that for summary reporting purposes, we only have ten reports that most people see. What a company chooses as its profit center, as Jim mentioned, is going to cut across a lot of lines. It will be driven by the company's goals, products, distribution system, and will largely ignore subsidiary lines. Examples of some of our major profit centers include our mutual fund operation with $17 billion in assets which is not organized as a separate subsidiary. Also, we have a certificate profit center. The certificate company is a separate subsidiary which sells a bank CD-like product that is not FDIC insured. We have a pension management subsidiary which manages about $4 billion in assets. Our insurance profit center includes the insurance lines with three life insurance companies within the group. We also have a separate annuity profit center which consists of the annuity lines of the three life insurance companies within the group. These two profit centers have about $9 billion in assets.

You can see that the profit center definition really ignores its subsidiary structure. Some say the subsidiaries are broken up, and some say subsidiaries are preserved in the profit center reporting. We have other profit centers in which there is really no subsidiary involved at all. Some of the newer profit centers we have include bank services. These are a nonbank bank, a tax preparation service, a small property and casualty (P&C) company and the securities brokerage operation. With that kind of a list of profit centers, developing a consistent management reporting methodology approach was not very easy. We did it over a number of years, and it took a significantly longer time than Jim described. I believe we put our expense allocation system into place in the late 1970s. The profit center reporting system we have today really evolved rather than being the result of a deliberate effort to do something. As expected, there were a number of problems encountered in putting such a system into place. I have to admit that a significant number of the problems were caused by the actuaries dragging their feet at times and saying that it could not be done.

The first big problem we encountered was the different natures of the businesses themselves. We have transaction driven businesses, the insurance businesses driven by premiums, and the annuity business driven by assets or margins. In addition to that, the various subsidiaries, although possibly involved in similar businesses, had accounting conventions that were all different. The mutual fund operation and the certificate operation, for example, do not hold liabilities for customer accounts. Thus, selecting a common set of standards and measures really took a long time and a lot of effort.

The second big problem was that there were a lot of functions centralized within IDS itself. Rather than a lean holding company at the top, we have a very large organization which performs a lot of services for us, such as data processing, investment management, sales and marketing, legal, and the list goes on. The life insurance company itself consists only of an actuarial, accounting, underwriting, issue, and claims areas and the type of things unique to the life insurance business. Even a lot of our new business activity is handled by our parent. This means that an extensive expense allocation system was going to have to be the base of any profit center reporting system. This final issue was the allocation of the usual types of expenses and the allocation of investment income and equity among the profit centers, especially within the life insurance companies.

A lot of what we did in addressing these problems was heavily influenced by the fact that we are owned by a large nonlife company. This is in contrast to the situation Jim described, in which a life insurance company diversified. Because of this history, a lot of what we do has an unusual and nonlife insurance company type flair about it. Our goal was to develop an accounting or reporting approach and format that would be understandable to our nonlife company management. In the expense allocation system, we chose a very large and complex system of charge-outs, based on time reporting and other factors. It is really a big black box. The system is probably now seven to eight years old, but it works very well. It allows us to allocate on a monthly basis, expenses by line and by company, with essentially the same precision with which we do it at year-end. We took the same approach with respect to the allocation of investment income and surplus. On a monthly basis we go through processes identical to those we go through at year-end.

All of our profit center reporting is done on a comparison to plan basis. We develop our plan in two steps. There is a strategic planning process which is not numbers-oriented at all, other than certain global requirements of return on equity (ROE) goals or growth goals. Our mature profit centers have return on equity objectives. For new start-up operations, these are waived in favor of growth, as long as it is demonstrated that the growth is profitable. The second step of the process is the development of a one-year operating plan and this is a very numbers-oriented operation. The operating plan is consistent with the strategic plan and it is done in exactly the same detail with which we are going to report results during the coming year. In other words, we plan by profit center by month.

In monitoring performance against this plan, we look at three different areas. The first one is a set of key indicators which is really nothing more than a list of mutually agreed-upon measures of performance. We might look at the return on assets for certain lines or at premium volume. They are anything that the profit center and the people being reported to can mutually agree upon as key measures of performance. The second area is GAAP net income. This is obviously the most important for us. And here we look at GAAP income by month, by line of business, splits among new business, existing business, and terminating business. We look on a monthly basis what it costs us (on a GAAP basis) to write the business we wrote. We look at how much we earned for the month from the business that was in force at the beginning of the month, and we look at whether or not there was any impact on GAAP income from surrender experience during the month that was other than expected. The third thing we look at is a set of supporting analyses which are really rate/volume type analyses such as mutual fund fees, annuity spreads, and premium margins. If we earned a little more or less money in a month, we are interested in whether that is the result of more or less business than assumed or whether the business was about the same but just more profitable. We split that up in what we call a rate/volume type analysis.

Of these three, the GAAP net income is the most important one. We report GAAP income by line of business, and then merge that into the profit center reports by the fifth work day of each month. This includes full allocations of expenses, both deferrable and nondeferrable, and it includes investment income allocations, equity allocations and tax allocations. The internal reports within the life company show a lot more detail than that. The three life insurance companies are ultimately split into two profit centers, insurance and annuities. But our major company, IDS Life, has thirteen profit centers, thirteen lines of business, within it. They are not all managed as profit centers. The detail that we have monthly is really quite extensive. In looking at planned/actual variances, it has allowed us to pick up things quite a bit earlier than we would if we were doing quarterly reporting. Our basic financial data is like that of all life insurance companies and comes out in standard GAAP format. It shows the usual premiums, benefits and reserve increases and investment income. In contrast to Jim's situation, which was a life insurance company that diversified, our management does not understand premiums. They especially do not understand reserve increases. So in our reporting we have converted everything to a source of earnings, or a contribution to earnings, basis. Rather than reporting premiums to our parent, we look at premium margins. Rather than looking at investment income and reserve increases, we report spreads. Rather than looking at death claims, for example, we look at variations from expected death claims. For surrenders, we do not bother to report upstream what surrender activity was. We look at whether or not there was a deviation in the month from what we expected. Only if there is a significant deviation do we start to talk about surrenders.

The goal in all of this has been to try and identify those key elements of profit center profitability and then monitor those, report those upstream, and rely on the management of our parent to understand what is going on. How does all of this work? In general, it really works quite well. We have gone through a multiyear process in getting there, but we are not yet done. We do not have a clear road map ahead of us of what we want to do. Such things as equity allocations within the life insurance companies are more advanced than the equity allocations within our parent and something will probably be done there in the next year or two. The system we have is not easy to put together and it is really not easy to keep together. We plan and report in tremendous detail and we report results very quickly. It is a type of reporting I guess most life insurance companies would consider impossible. We not only report in that much detail that quickly, but we get hung up on one to two hundred thousand dollar variances between plan and actual in a month in a company that has a pretax income in excess of a hundred million dollars. This takes a lot of time, but you would be surprised at what you find. Probably part of the biggest benefit has been that our parent has really developed what I believe to be an understanding of their life insurance and their annuity operations. They know what drives profitability and they are receiving information that they feel is actionable. They see variances, they see explanations of variances and they come back with very good questions. I believe that overall the system for us has worked very well.

MR. STEIN: It goes without saying that both of you, and everybody in your organizations, are convinced that the time and effort to prepare monthlies is worthwhile and would pass any kind of a cost/benefit test. What size of accounting and actuarial staff do you have performing financial reporting or analyses functions on a monthly basis?

MR. KOLKMAN: As far as cost/benefit analysis is concerned, as an actuary I still have the feeling deep inside that monthly results don't tell you all that much. But, ever since the beginning of time for us we have been owned by a nonlife insurance company. These companies very firmly believe that you look at results monthly, you plan very carefully, you report very carefully and if you see a variance you find out what it is. And, you do it before it gets big. We went through some difficult times with that because in a lot of cases the problems were with the plan. You have to spend a lot more effort in preparing a good operating plan. But I would have to say, it is worthwhile despite my professional bias that says it will all come out right at year-end. As far as staff is concerned, they prepare the information and then route other information on up to IDS.

MR. DURHAM: Paul's sentiment about determining what is happening in our business or what it tells us before it gets out of hand or before it gets away and we cannot take advantage of it, is really one of the primary driving factors for us. The other is that it is a public company. Since I am responsible for investor relations, I would like to know what I am going to have to tell all of our stockholders and the analysts that follow our company before the quarter ends. My boss, the CEO, does not take particularly kindly to surprises. Certainly you have to question what you learn from a benefit fluctuation in a month. It could be a death claim or a disability claim. In fact, on the disability side, I have had that argument with our actuary many times. We agree that you cannot tell anything long-term about the business in a month, but you should be watching it to see if trends are developing. You should not wait until the end of the year or the third quarter when you do the claim development study to find out that something went wrong that you should have known about four or five months ago.

My boss would die and go to heaven if he could get the answer in five days. He and I are the only two in the organization who believe that it is possible and all the people who do the work say it is impossible. We get our results in ten business days and the analysis two days following, at this point in time. Throughout our organization there are probably 20 people involved in the preparation of the financial statements and the analysis of them, both accountants and actuaries, and we are adding more people in the area for that reason. We want to get more timely information and want people to spend more time with it in relation to what it means to the business, what is developing in the business, and being able to identify those things quickly.

FROM THE FLOOR: Paul, you mentioned that in your statements, your approach to your reporting system gives you great credibility with your parent and the noninsurance people that you are dealing with. What aspects of the system do you think create this credibility? Is it this source of earnings approach you are using or what?

MR. KOLKMAN: We use both the source of earnings approach and the supporting analyses. They understand what it costs, on a GAAP basis, to write business and they can see how big that is. When sales go up, they expect to see costs get bigger and it does. They know they make money from business in force and they can look at that. They know they make it from premium margins and from spreads and they can look at basically a matrix display of where that is coming from, more business than plan, less business than plan, more profitable business than plan, less profitable business than plan. So they can look at this stuff and they feel that they have an understanding of what is driving their bottom line. It provides a level of understanding, comfort and credibility.

FROM THE FLOOR: Regarding the source of earnings approach, are you using your GAAP numbers as a basis for that? Do you run into any problems with unlocking type issues and that sort of thing?

MR. KOLKMAN: It is GAAP. We really do not look at statutory other than that we produce statutory results, but we just keep them within the actuarial area.

FROM THE FLOOR: And there's no problem in doing a source of earnings analysis against your GAAP assumptions? You do not run into anything getting unrealistic over time?

MR. KOLKMAN: No. Not really.

MR. JAMES F. REISKYTL: You both use the terms *when things go wrong* and *actionable.* I can understand a lot of this reporting and I probably am a little skeptical, at best, of this monthly value. But I would like to know specifically -- what do you do? Do you change your disability income (DI) claim practices because you do not like the DI claim results? Do you change your product because sales are not right? Do you change your agents' commissions because things are not working out? In other words, give me a specific action, other than the fact that you realize that you did not meet your plan. Tell me how your management actually changes the way you are running your business.

MR. KOLKMAN: The only things that are actionable on a short-term basis are the margins on new business and some of our investment practices and expense management activities. You may find expenses in an area beginning to outrun plans. If, in looking at an analysis of that related to volume, you find that there is no reason for that, you can do something about it. Or, if you find that in your new, existing, and terminating business display, it is getting out of whack in one of those three areas, you can find out what you can do about it. We had surrender problems in some of the older blocks of business in the last few years, but they have largely gone away now. Based on the deviations, we got a lot of attention at first, and then a lot of support from our parent in trying to do something about that business. Also, the investment rate may lag for one reason or another and it may cause inforce margins to slip. That will pop out right away. We decide whether or not to do something about it. A new line of business that is starting up is doing some pricing that they should not be doing and they give a little business away. This shows a little growth and that pops outright away. On large mature blocks of business or claim practices, there is nothing you can do. But you know what is causing the problem. So you will have actionable areas and inactionable areas.

MR. DURHAM: I would agree with what Paul said, but I have some thoughts, for example, on our disability business. To the extent that we see variations in claim costs, we right away focus upon the claims administration area. We want to find out what, if anything, has changed in that area. If they are closing more claims, why? What product are they coming from and what benefit in particular is doing it?

Much of it is in the area of the expense and investment side. Also, as we look at our joint ventures and client company arrangements, we need to know where our actual costs are relative to the fees that we are charging those companies. If it is a concern that surfaces whether or not the business itself is profitable that we are writing, our management might be inclined to shut it down, and not wait until it was proven 15 different ways that in fact it is not. In our case, it is probably a little simpler because we have fewer lines of business to deal with. But it is also relevant, for example, in our variable life line of business. On the expense side and also on the persistency side we have so many distributors signed up selling that product that it is important to monitor the lapse experience of each. With the AIDS scare, are we selling a lot of single premium variable life business in San Francisco? Is that where the claims are coming from? Those are the types of things that we would look to and take action on.

MR. MICHAEL E. DUBOIS: How often do you review what is going on within that black box to make sure that you believe what is coming out, and how much time does it take when you do that? How do you handle questions about expenses which cannot be directly allocated to a single profit center?

MR. KOLKMAN: We review the expense allocation factors every year when we do the plan. Everything is done on a time charge-out basis or a volume driven charge-out basis. The lawyers keep track of their time by subsidiary or by profit center for example. For certain areas that cannot be allocated that way, such as the personnel department, we have had to adopt simpler rules. There is a general principle that if there is anything that we can do that will keep track of time or keep track of volumes by profit center, we will do it, and those are then reviewed, say annually, when we do the plan. Regarding the second question, there are not many of those, and we do personnel cost just by head count, for example. Those wind up to be a pretty small percentage of what we do if we insist that most people in most areas at least keep track of their time by profit center.

MR. DURHAM: Our allocations are pretty much transaction oriented, and most things go direct. For example, in the personnel area, the sheer cost of the personnel department, the people, the benefits associated with that, and the rent are allocated essentially on a head count basis. If department A hires or initiates a job search, whether we use an executive search firm, advertising or whatever, those costs are charged directly to that cost center. I would tend to agree with you that very few are not possible to place accurately. In our case, the one area that is questionable is the expenses of the holding company. The lines are not thrilled with that allocation.

MS. ANITA L. JONES: You have each talked about the importance of monitoring actual performance against a free set of operational plans. Could you tell us whether you ever find it necessary to change the operational plan within a calendar year, or with what frequency you take a current estimate of probable end-of-year variance from that predetermined plan?

MR. KOLKMAN: We do not change the plan during the year. We come up with a plan near the end of the preceding year, in October, for example. There will be variances between the time the plan is produced and year-end and we take those into account just after the end of the year. We try not to change the bottom line, but do change a lot of the factors in the plan, or even the bottom line if necessary. But then as the year starts, we do not change that, we simply explain variances, and if, come January, you find out you blew something in the plan in some line of business, then it becomes a public embarrassment for whoever did that for the next twelve months. That has beneficial consequences also.

MR. STEIN: I have a question on the cost systems and making profit centers out of natural cost centers. That is, within any organization, there is a budgeting process that would define a whole series of cost centers, whereby natural expenses, meaning salaries or rent, are accumulated for management purposes. I would like to ask both Paul and Jim whether in their processes they have gone so far as to adopt standard costing or transfer pricing systems in an attempt to turn cost centers into profit centers for management purposes by using standard cost per unit of volume.

MR. DURHAM: We have, in that the structure of the income statement is set up in such a way that, although we have not done this yet, it will allow us to feed in the different components of the pricing cost. Then we can model that against the volume to compare against what actual costs are. Yes, there is a way for us to look to see where we picked up efficiencies or where we are inefficient. We have not done it yet, but we have the capability and the intent to do it.

We also do not treat any cost centers as profit centers. We tried years ago to do it with the sales and marketing area and abandoned that. We may go back to do it again in the future and we are currently trying to work something out with the investment area. There is a sense that it should be treated as a profit center. There would be a mutually agreed-upon investment strategy that would either be modeled by us or somebody outside. Performance equal to that would be just fine and performance in excess of that would be their profits. I think that is going to come out more as a measure of their performance to be used for incentive compensation purposes, rather than actually reformatting things and showing the investment area as a profit area. So far we have not done anything there.

PROFIT CENTERS -- MANAGEMENT REPORTING

MR. DICKE: I've been asked to discuss profit center reporting as it applies to mutual companies. Apart from fastidiousness about the word *profit*, mutuals also have traditionally had limited need for this form of reporting because they were typically single line companies.

The reorganization of a company on a profit center basis generally follows diversification of the company into new lines of business. Mutual life insurance companies only began such diversification, for the most part, after World War II with the creation of group lines. But the process accelerated with the "insurance product revolution" of the late seventies and eighties, which saw the creation of variable and universal product lines, sometimes in the parent, sometimes in subsidiaries.

Recently, the integration of the financial services industry, which began in the early eighties and is still in progress, has seen mutual life insurers diversify even further through the purchase of noninsurance financial service companies. Finally, the consolidation of the life insurance industry has seen high-surplus mutuals, prompted in part by the imposition of the so-called "equity tax," turn into voracious acquirers of small stocks, especially those with specialized distribution systems. Often it is desirable to monitor these acquired lines of business separately, even if the basic product is similar to one being sold elsewhere in the organization.

In short, the last twenty years or so has witnessed the emergence of the diversified mutual company in the life insurance world. While conglomerates are common among stock companies, and while horizontal integration is a natural goal of any business, it nevertheless troubles some thoughtful observers that mutuals -- companies supposedly organized to promote the interests of their customers -- should venture into activities so far removed from their basic purpose.

There are many, of course, myself included, who feel such diversification is not only essential for survival, but also desirable as regards its impact on the vitality of the enterprise. However, even those who feel this way need to do some clearheaded thinking as to the relationship of diversification to the basic purposes of mutual companies. I believe that one of the best aids to such thinking is a well-designed management basis statement showing results by profit centers.

To begin with, if we are going to do clearheaded thinking about the purpose of a mutual company we need to write down that purpose in a way that permits us to make quantitative statements. What I mean is this: for quantitative purposes, we can say that the economic goal of a stock company is to maximize total return to stockholders, subject, of course, to certain constraints. What is an analogous statement for mutuals?

Traditionally, it would be, "Minimize the cost of coverage for participating policyholders." For practical application, however, this needs amplification. Specifically, we must ask exactly who are the participating policyholders? How should cost be measured? What constraints limit the minimization? We have done a lot of thinking about these questions at Provident Mutual in the past few years. A complete discussion of this subject would fill another entire session. Luckily, for our present purposes, we can be content with partial answers to these difficult questions.

First, cost of coverage must represent retrospective, historical cost, measured at the point of contract termination, rather than any form of prospective cost illustrations. That which is to be minimized must be some form of actual cost of coverage, not a marketing promise.

Second, the participating policyholders for whom costs are to be minimized cannot be limited to current policyholders, but must include future policyholders as well -- otherwise the minimization could imply that immediate break-up of the mutual is in order. The lack of right to the break-up value of the company is one of the ways a mutual policyholder's rights are more limited than the ownership rights of the stock company's shareholders.

Furthermore, it may be desirable to limit the class of policyholders for whom costs are minimized to those who stay the course and terminate only through policy maturity -- payment of an endowment or death benefit. While policyholders who surrender prematurely should receive reasonable value, it is not possible for the company to minimize the cost of coverage for them and remain viable.

Given these definitions, we can apply the statement of the economic goal of a mutual company to the diversification questions. On this basis, the proper role of diversification in a mutual is seen to be to invest currently superfluous statutory surplus in a way that provides the highest aftertax rate of return.

When I speak of investing surplus I am, of course, including the activities of selling new life insurance business, assuming reinsurance and similar involvement in insurance activities, as well as purchasing securities. The sale of an insurance policy involves expense and reserve strain, which must be funded from surplus, as well as the setting aside of what is often called required surplus. Particularly in a mutual company, with access to capital rather limited, it is important to be aware of just how large an investment has been made in internal insurance activities and what rate of return these activities are earning.

It has often been said that if a mutual is dependent on internally generated surplus, then its long-run growth rate is limited by the return on invested surplus it achieves. This applies to the surplus invested in the sale of participating products, and it also involves surplus invested in the nonpar line. If the nonpar lines don't produce the necessary return, it can only be obtained by reducing par policy dividends.

In other words, nonpar insurance lines may be viewed as a form of investment. For many reasons, including the equity tax, these methods of investing surplus usually produce aftertax results which are better than those obtained by simply investing in securities. For such lines, the term profit is clearly appropriate, even if they are operated by a mutual company. There is no difficulty in calling the net earnings of nonpar or essentially nonpar lines of business profit, especially if these lines are viewed as investments. However the concept of *profit* is harder to define for participating lines. We shall discuss this point further.

We have established that nonparticipating lines of business may be viewed as a way of investing surplus at a high rate of return. But the higher return achievable for these lines of business must eventually accrue to the benefit of participating policyholders if the mutual principle is to be served. Will this really occur? How can the diversification strategy be monitored and its effectiveness in par cost minimization be measured? How can the effectiveness of investing in nonpar insurance lines and noninsurance financial services be compared to the effectiveness of holding additional surplus in the form of securities? A well-designed management basis statement is, I believe, the answer.

Before I go on, let me be clear that, in addition to this purpose, which I have perhaps belabored a bit, mutuals have of course the same goals in using a management statement as do stock organizations. These may be summarized as, (1) monitoring pricing, and current management performance; and planning and decision making about utilization of capital. It is possible, as we shall see, to design a management statement which gives all these kinds of information.

The first step in designing a management statement is defining the balance sheet. There are two aspects to this: (1) calculating GAAP adjustments, and (2) allocating statutory assets and liabilities to lines of business. At Provident Mutual, we began by developing a management statement for the company as a whole. Only when this was complete did we turn to the problem of line-of-business or profit center allocations. The GAAP adjustments I just mentioned posed no problem, because they were calculated on a line-of-business basis to begin with.

What I am calling GAAP adjustments include any adjustments to reserves, and deferral items, deferred cost and deferred taxes, as well as minor items. In the case of Provident Mutual's management statement, there is another important adjustment: a deferral mechanism for capital gains and losses. We defer realized and unrealized capital gains and losses and release them to income on a 15% declining balance basis.

I might say parenthetically that this approach, which mimics the Canadian statutory approach, has been very helpful in reflecting common stock income properly in the "book value" environment of insurance financial statements. The adjustments made to capital gain reporting were not, of course, initially on a line of business basis. However, they clearly will follow the appropriate statutory assets. Thus the development of line of business balance sheets hinges on the allocation of statutory balance sheet items.

As we analyzed the problem, we saw three basic issues emerging: (1) the amount of assets to be allocated to each line must be determined; (2) specific assets (and thus investment income) must be allocated in the amounts already determined; and (3) a corporate line of business must be established to hold free surplus. The amount of statutory invested assets to be assigned to each line of business is equal to the statutory net liabilities plus required surplus. I alluded to required surplus previously. It is set by formula, with the formula reflecting C-1 and C-2 risk at least. (A formula approach to C-3 risk is, I think, possible, but I haven't seen it worked out in a way that I find satisfying.) Risks are traditionally classified by actuaries as C-1 (risk of asset default), C-2 (risk of underpricing) and C-3 (risk of loss due to changes in the interest rate structure).

This management basis asset allocation is very different from the statutory allocation. The statutory approach is historical in nature, with line surplus representing the accumulated gains or losses of each line. Lines may end up with surplus far in excess of that required for current risks, while others may have negative surplus. This allocation procedure masks the current performance of the various lines. For example, a line with an accumulated loss is charged with interest on that loss and may never be able to show a profit, regardless of current performance. The management basis allocation replaces the historical approach with an approach based on capital needed. In effect, each line is treated as a subsidiary that is capitalized at a minimum level.

Note that this approach requires annual rebalancing. That is, there is no guarantee that the earnings of a line will exactly provide for the capital expended in strain or set aside as required surplus. Thus we require a mechanism to achieve this rebalancing. (We will return to that later.) Also, since there is no guarantee that total required surplus must equal actual statutory surplus, a mechanism is needed to achieve balance. This is where the corporate line of business comes in.

It should also be noted that this approach is consistent with book profit pricing. That is, book profit pricing assumes a certain allocation of surplus to each product sold and tries to maximize return on that investment. Asset share pricing, on the other hand, is based on statutory accounting. Rather than an allocation of surplus, asset share models simply track the historical development of surplus, whether positive or negative. It can be shown that book profits produce the same pricing as asset shares if the return on investment (ROI) for the book profit model is set equal to the aftertax return on assets held in surplus.

The perceptive individual will recognize that the structure of the management statement I have developed indicates my feelings as to the appropriateness of book profit pricing for mutual company participating products.

Exhibit 1 shows the balance sheet of XYZ Mutual. As can easily be seen, the allocation of assets is based on reserves plus required surplus. The surplus occurring in the corporate line is the excess surplus not required to back current risk. This is often called vitality surplus or free surplus.

EXHIBIT 1

XYZ MUTUAL
BALANCE SHEET

	Total	Individual	Group	Corporate
Statutory Invested Assets				
Net Statutory Liability	2,200	1,500	700	
Required Surplus	120	50	70	
Free Surplus	120			120
"GAAP" Assets	100	90	10	
Total Assets	2,540	1,640	780	120
Policy Liabilities	2,100	1,450	650	
Deferred Cap Gains	50			50
Total Liabilities	2,150	1,450	650	50
Management Basis Equity	390	190	130	70

It is not sufficient, of course, to determine only the amount of assets in each line's balance sheet. We must also specify just which assets are to be assigned. For large companies, this assignment often is accomplished by actual segmentation of the general account. In such cases, a mechanism is still needed to choose assets to be moved in or out when rebalancing occurs.

In the case of Provident Mutual, a pooled allocation approach is used instead. Five classes of assets are defined:

Class A = long-term bonds and mortgages

Class B = short-term notes and cash

Class C = policy loans

Class D = common and preferred stock and real estate

Class E = subsidiary stock and securities

Using an allocation approach is consistent with the way my company is currently managed -- namely, with investment decisions made centrally by the investment division. This division has been given the goal of maximizing the total return on Provident Mutual's portfolio, subject to various constraints. Particularly for our size of company, it was felt that the company as a whole can absorb greater investment fluctuation than the lines of business could separately.

To reflect this management structure, we decided to allocate the types of assets to each line that it would tend to hold if it were a freestanding subsidiary. One possible allocation procedure for XYZ Mutual is back 90% of statutory net liabilities with Class A assets and the remaining 10% with Class B assets; back surplus with Class D assets; put all Class E assets in the corporate line.

Exhibit 2 shows how the balance sheet of XYZ Mutual looks if this procedure is adopted. Note that the company held insufficient Class A assets, since the investment division chose, instead, to invest in Class D assets, so the Corporate line, in effect, created what was needed.

EXHIBIT 2

XYZ MUTUAL
BALANCE SHEET

	Total	Individual	Group	Corporate
Class A	1,400	900	630	(130)
Class B	250	100	70	80
Class C	500	500		
Class D	230	50	70	110
Class E	60			60
"GAAP" Assets	100	90	10	
	2,540	1,640	780	120
Policy Liabilities	2,100	1,450	650	
Deferred Cap Gains	50			50
Total Liabilities	2,150	1,450	650	50
Management Basis Equity	390	190	130	70

Again, this conforms to the primary role played by Provident Mutual's Investment Division in determining investment mix. The investment division has considerable discretion and thus managed like a profit center. In the example, if it earns more on the Class D assets than it must pay to the insurance lines to cover its Class A "debt," it will show a profit. If Class D earnings are not sufficient to accomplish this, the corporate line will show a loss.

The third issue in developing a line-of-business structure for our management statement was the definition of the corporate line of business. The investment profit center has been included in the corporate line. However, the primary purpose of a corporate line is to hold free surplus. Free surplus may be thought of as a revolving capital fund. Line profits flow in at the end of each year and growth, as well as acquisitions, are funded from free surplus. An important part of the management statement is the exhibit entitled, "Statement of Changes in Equity" which traces the equity of each line from the beginning to the end of the year. Exhibit 3 shows how this statement looks for XYZ Mutual.

EXHIBIT 3

XYZ MUTUAL
STATEMENT OF CHANGES IN EQUITY

	Total	Individual	Group	Corporate
Equity, Beginning of Year	390	190	130	70
Net Income	39	19	26	(6)
Transfer to Corporation		(19)	(26)	45
Capital Contribution From Corporation		20	20	(40)
Performance Dividends	(9)			(9)
Equity, End of Year	420	210	150	60

Note the line marked "Performance Dividends." This is a concept which we are currently studying at Provident Mutual. If adopted, it would close the circuit on the idea that nonpar lines should ultimately benefit the par policyholders. Performance dividends would be paid out of the corporate line and would represent free surplus determined by the Board of Directors to be unneeded at the current time. The allocation of such a special award would require an extension of dividend theory. Conceptually, at least, the allocation would properly reflect contributions to the development of free surplus in the first place. As a practical matter, at least as far as individual participating policies are concerned, allocation based on reserves or cash values might be appropriate.

One useful consequence of separating performance dividends from what might be considered experience refund dividends -- the policyholder dividends shown in the Individual line of business -- is that the earnings of the Individual line are more nearly representative of the performance of individual division management than would otherwise be the case.

If performance dividends are included with Individual line policyholder dividends, every dividend increase would decrease the earnings of that line. Such earnings cannot be considered profit -- they are rather more equivalent to retained earnings -- i.e., *profits less shareowner dividends.* Retained earnings are not a standard typically used by stock companies, because unlike earnings, they do not measure management's performance and are not comparable from company to company. When performance dividends are removed, the results of the Individual line should be comparable to those of stock insurance companies. The management of the Individual line can, hopefully, be held accountable for producing a reasonable return on equity (ROE) on this basis.

Let me emphasize that such a split in dividend award cannot be defined without some degree of arbitrariness and judgment. Furthermore, the very fact that additional dividends are paid will likely have beneficial effects on the Individual line. Only time will tell if this approach is successful. The alternative is to change the goals of the Individual line each time a dividend scale is changed. The ROE goal of the Individual line would then be qualitatively different than for nonpar lines or noninsurance business. This difficulty is the reason the term profit is hard to define for participating lines in a mutual company. Performance dividends are intended to solve this problem.

Now let us look at the income statement for XYZ Mutual (Exhibit 4). Both the insurance operating lines have acceptable return on equity, adjusted for the different level of risk involved. However, because the Corporate line failed to produce investment income on the large position in Class D assets sufficient to offset the allocated credits to the operating line, it shows a loss for the year. Since capital gains are brought in on a levelized or smoothed basis, this may be acceptable in the short run, especially if there was a recent shift to common stock, as has occurred in many companies during the recent bull market.

EXHIBIT 4

XYZ MUTUAL
STATEMENT OF OPERATIONS

	Total	Individual	Group	Corporate
Net Income	39	19	26	(6)
Equity	390	190	130	70
Roe	10%	10%	20%	(9%)

If this is the case, the deferred capital gains will soon begin to show up and may mandate a performance dividend in the near future. The large group profit will also increase the ability to pay performance dividends -- or to support rapid growth without cutting into current dividends.

Before I close, I should mention that subsidiaries cause special problems for mutual profit center reporting. Subsidiaries could be handled in one of two ways. First, the common stock of the subsidiary could be considered to be the investment. Normally, this does not reflect the true value of the subsidiary in the mutual context. Alternatively, a consolidated statement could be used, with each line of business in the subsidiary receiving assets equal to statutory reserves plus required surplus, etc.

This includes subsidiary participating lines. Each subsidiary would then have a Corporate line for its free surplus. One advantage of this approach is that subsidiary par surplus can be seen to have value to the parent as a source of scarce surplus, even if earnings are not convertible into stockholder dividends. (Of course, the new business could only be written in the subsidiary participating accounts.) This allows mutuals to put value on stocks with restricted par accounts that would not be realistic for a potential stock acquirer.

Our management statement is in place and producing useful results. For it to achieve its full potential, there are two steps yet remaining to be taken: (1) improved cost allocation procedure and (2) source of earnings breakdowns of line of business results. Improved cost allocation procedure is the subject of a major project currently underway. The second report must await the completion of the cost project. We expect that this will allow us to see, much more completely, just what causes successes and what causes failures. Such actionable information will enable management to improve overall return on equity, and ultimately reduce the cost of coverage to the policyholders.

MR. ROBERT MYLANDER*: You stated that you calculated required surpluses according to published material like that put out by Lincoln National and you ended up with a substantial amount of free surplus. I am assuming that you

* Mr. Mylander, not a member of the Society, is employed by Northwestern Mutual.

had a positive free surplus. Does that mean that you would feel comfortable if your company would go out and spend all of that free surplus?

MR. DICKE: We set two goals for managing surplus when we took our strategic capital plan to our board. One of them was that we would very much like to stay in that positive position and try to see that we have returns on our products to enable us to stay there, considering the rates of growth that we project. The second goal was that we do not keep too much of that surplus sitting in free surplus. Frankly, that kills your return on equity for the company as a whole. When you start reporting to the board, which we do for these kinds of results, it becomes very apparent that if you want that to be used as a measure of management, this statement really implies that you should move toward reducing free surplus. Obviously, it is a tricky thing to manage so that you do not go below zero.

MR. RAY M. PERISHO: I would be interested in your comments on your ROE targets, your par line versus your nonpar line. Also, how do you measure your management performance? Are you going over to the adjusted basis?

MR. DICKE: Let me answer the second question first. Yes we are. That was, in fact, a first motivating factor, trying to find a way to measure the performance of management and to use it for an incentive compensation plan. That was one of the major reasons for developing this statement. As far as the actual goals, I do not want to mention what our goals are because I do not think it is highly appropriate. We express our goals, as well as our returns on investment, after all taxes, including surplus tax. We take the point of view that the surplus tax is an asset tax which has to be taken off. We tend to say that the return on a bond that we are holding would probably be 2 or 3% after taxes. The numbers I might use are quite a bit higher than that, but they still might not relate to the numbers you are used to using if I gave them to you. For rates of return, there has been a certain amount of discussion about whether they should be the same for line or different. Our general attitude is that we should see them somewhat higher for riskier lines. The choice of that return affects our dividends a lot so we want that to be a very stable number for our par line. We have a tendency perhaps not to change that as often as we might for a nonpar line. Recently, we have taken to accepting a lower rate of return for our nonpar lines than we had before, but we kept our par line where it was.