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## CORPORATE PLANNING/PROJECTIONS

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MR. MARK A. TULLIS: Most of you are familiar with the recent survey that ranked actuaries as having the number one job in the country. However, you might not be aware that a number of the 256 jobs surveyed are also performed by many of us in our day-to-day activities. In the top ten were computer programmers, systems analysts and paralegals. Our topic is corporate planning and projections, so we'll put on the hat of job number nine, astrologer.

\* Mr. Porter, not a member of the Society, is a General Management Consultant at CRESAP in New York, New York.

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John T. Porter missed the boat when he decided not to become an actuary. Lately there's been a tremendous increase in interest within the insurance industry in planning and projections. This is evident in numerous articles in the industry press as well as in sessions like this one. Our panel consists of a general management consultant and two actuaries with responsibility for planning and projections at their companies. I believe it's not coincidental that both actuaries on the panel have mutual company backgrounds since without the rigid shareholding reporting requirements placed on stock companies, mutual companies are freer to develop management control cycles to best meet their needs.

Instead, he's a general management consultant with CRESAP in New York. John specializes in helping companies improve their organization and management processes and over the past year John has been involved in a number of major insurance company projects. Recently John has been selected as one of the leaders of a CRESAP/Tillinghast joint venture to provide general management consulting services to the life and health insurance industry. John will be speaking on business planning from the perspective of business management.

MR. JOHN T. PORTER: I'd like to talk about business planning from a general management perspective, focusing on strategic and operations planning processes for companies. I'd like to share some views and observations about planning in general, and express some of my opinions about what would work for insurance companies as they consider improving their planning processes. In the process I will try to put our topic, financial projections in planning, into an overall focus.

I want to organize my remarks around three broad questions. The first is "Why plan?" In other words, "What are we talking about (at this conference) and why are we talking?" The second question is "What kind of planning makes sense?" Here I'll make some specific observations on what makes sense for insurance companies. Third, "What will it take to plan?" In other words, "What will it take to make planning a reality rather than a theoretical exercise?" Finally I'll summarize my remarks and return to the central theme of financial projections in the planning process.

There are at least seven reasons why companies undertake business planning. The first, and most generally applicable, is that planning is essential if management is to guide the company proactively, rather than just react to events as they occur. Second, planning can provide a systematic process for identifying sustainable competitive advantages and designing ways to exploit them. Third, planning is needed to rationally allocate the scarce financial and human resource of the enterprise. Fourth, plans provide the framework of goals and standards needed to effectively evaluate performance of individuals, functional units, and the company as a whole. Fifth, planning can be an important tool for senior management when change is needed. Planning can help translate new broad visions and directions into concrete actionable programs. The sixth reason is closely related to number five. Planning is a very effective tool to communicate. It is used primarily to communicate with the internal management team and the board of directors, but planning can also serve a role in communicating to external audiences. Finally, in many competitive industries planning is simply a requirement to survive. Planning, when it's well done, can make companies more effective and more efficient. It can give them a competitive edge, and in a competitive industry, that edge may be necessary simply to stay in business.

There is an increased interest in business planning for insurance companies. I believe there are some reasons why they particularly must plan and improve

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their planning processes. The first reason is that the business has a shrinking margin for error and no room for complacency. You face increasing competition for the dollar of an increasingly sophisticated consumer. The competition is a zero sum game and comes from both within and outside the industry.

As a result of both competition and the advent of interest-sensitive products, you face declining profit margins, which in turn can create capital scarcity for growth and new investment. For mutuals, the limited internal generation can mean an absolute scarcity of capital unless downstream holding companies are put in place. For stock companies, internal capital scarcity spells a greater dependence on external markets and a greater sensitivity to how the company is perceived in those markets.

You face this difficult environment in a period of accelerating change. A large portion of your revenue comes from products that weren't in existence five to ten years ago. You face changes in regulation and, as I alluded to earlier, you face a difficult and changing consumer. To remain in the game, insurance companies will have to have sharpened planning processes in place.

Accept for the moment that some kind of business planning is required, I'd like to focus on what kinds of planning make sense for insurance companies. Planning is an industry in itself, and changes continually take place in the models put forward. Planners always have new, better, faster ways to do business planning at both the strategic and operational level. There's the grandfather of planning models promoted by the Boston Consulting Group, with its emphasis on the learning curve and a matrix of cash -- cows, stars, dogs and question marks. There's Porter's framework for planning. These models are now being supplanted by the latest great planning idea -- an idea that, I believe, will make sense for insurance companies. The concept that planners are putting forward today is value-based planning, or shareholder value planning. I will address this concept as a framework for planning by pointing out some advantages and tying them back to some of the characteristics of the insurance industry.

A key advantage of shareholder value planning is it's the first model that directly focuses on owner value and tries to find ways to maximize it. The basic premises of value-based planning are that the role of management is to maximize owner value of the enterprise and that value is defined as a risk-adjusted, net present value of realistic future cash flows. An important but subordinate premise is that the risk is line-and-product specific and, therefore, the overall risk profile of the company is the weighted average of the line or product risk. These are familiar tenets to all of you because they basically reflect the same set of assumptions or premises that go into the efficient market theories and the current modern theories of investment. Value-based planning simply says that managers should look at their companies the same way the markets that invest in their companies do. This is fairly straightforward and clearly holds for stock companies. I think it seems reasonable whether you make weak or strong assumptions about the efficiency of the equity marketplace. With some modifications it also represents a sound approach for mutual companies, because it promises to current policyholders economic efficiency in the investment and growth decisions made by management.

The second reason I advocate value-based planning is that it's a close match to industry characteristics. Industry characteristics dictate, to a great extent, what kind of planning should take place. I think a rigorous financially-driven planning process makes a lot of sense for the insurance industry. At one level,

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this seems almost obvious. How effective can planning be for a company whose product is financial instruments without a strong financial component? But there are more specific reasons that I would advocate a value-based approach. The industry deals with long product lives, the complex profitability resulting from high front-end loads and long payment streams, complex and extensive distribution processes, and multiple products (bringing with them the problems of portfolio management). Together these factors make it difficult to make fully rational economic decisions under either GAAP or statutory accounting. Value-based planning provides a rational approach to making investment decisions. You are in a mature industry with limited differentiation opportunities so I wouldn't tend to advocate planning approaches that are aimed at trying to find one great idea to capitalize on. Creativity in insurance company planning is more likely to come in the details and how you put those details together, rather than in a single market niche or great product. You have constraints in capital and narrow margins which means the planning process you use should be able to make close calls between different investment or strategic decisions that you confront.

Finally, your planning needs are evolving and the industry's interest in planning is increasing. As planning changes and takes on a greater priority within your company, the value-based concept provides a highly structured and disciplined approach to integrating the process. This can be valuable in bringing people on board for the planning effort.

My third argument is that you can integrate hard and soft aspects of planning through the discipline of a value-based analysis approach. One of the central challenges of business planning, as opposed to budgeting or even detailed forecasting, is that you have to unify very different types of information and ideas from different parts of the organization to come up with a unified strategy and line of attack.

Historical performance assessment involves highly quantified objective data that can easily be broken down and analyzed in detail. On the other hand environmental assessment, another key input to strategic planning is softer information that at best can be broken down into a series of scenarios with assigned probability. You will receive disparate ideas and perspectives from different functions and different business unit strategies; and these must be reconciled. The visions and values of the company represent soft input that will ultimately impact what the strategy will be. Goals, objectives, functional strategies, new ventures, etc. all have to be brought together, and the assumptions underlying them have to be clearly understood. Value analysis makes the "soft" assumptions that you use in your planning explicit, and it allows you to test the sensitivity of your results to those soft assumptions.

One of the pitfalls you can face, however, in value-based planning is to become too enamored with the financial projections and the valuation that results from the process. The financial analyses produced are no better than the operational plans that underlie them and are no "harder" than the softest of the assumptions. The value is in the discipline of the analytical process itself, rather than the projections that you create.

I think value-based planning can be particularly useful for insurance companies because it builds on existing strengths. There are no basic concepts in value based planning that are new to insurance industry management. Value-based planning hinges on dealing meaningfully with the time value of money in overall business planning, which is certainly not new to any of you. This is not the

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case in some other industries that have adopted value-based planning and are using it effectively. It also requires the ability to create sound financial projections and to deal with uncertainty in those projections. These, again, are talents and skills that you bring to your companies that managers in industries don't have.

Finally, value-based planning can help integrate the planning cycle, one of the key challenges that you have in any planning process. This is not a new or revolutionary concept, and I am sure you are all familiar with it. Strategic planning sets forth the basic mission, opportunities and strategies of the company and it makes basic working assumptions about environment. Operations planning translates those strategies into action programs by line of business and by function, and it begins the process of allocating resources against the activities of the company. Performance planning and budgeting breaks near-term plans into greater detail, provides detailed resource flows associated with them, and provides a feasibility test for the plans that have been put in place. Performance monitoring also evaluates actual results versus the plan and provides a key input both to performance appraisal, at the individual and line-of-business level, and to the next planning cycle.

The key challenge most companies face when they try to implement an integrated planning process is linking the different planning stages. Many companies will go through an annual or biannual strategic planning process but never drive from that stage into what the line-of-business plans will be. As a result, strategic plans that look at environment and assumptions are prepared but never really made actionable by carrying them into the rest of the planning cycle.

The value-based approach makes financial control a linking mechanism that you use to integrate the planning process. In other words, the basic financial control cycle for lines, products, and the company as a whole becomes central to each stage of the planning process. At the strategic planning level, you would develop basic assumptions and goals. Goals could include risk factors, hurdle rates, profit targets, leverage policies, etc. Assumptions about investment return, market growth, and competition would probably also be established at the strategic stage of the planning process.

The next stage is profit testing. As line-of-business and product plans are developed, you'd test the net present values using the established hurdle rates for existing products and lines as well as net present values for a new product or new venture that you are contemplating. During the budgeting process, these value estimates and the factors underlying them can be consolidated to provide a model of the company and to ensure that the strategic goals for corporate performance are being achieved. Finally, in monitoring performance, you can analyze surplus, calculating and analyzing variance from the profit tests that were done during the operational planning stage. Taking a value-based approach provides an integrating mechanism that can start from the overall vision of the CEO and extend to the detailed analysis of line and product performance.

You can ignore everything I've said so far and still have a very effective planning process for an insurance company. Planning doesn't fail because the wrong techniques are chosen or the wrong methodologies are adopted. Planning fails because of human resource and organization problems. It fails because the organization as a whole doesn't step up to the challenges of planning. I think there are at least seven planning requirements that a company has to accept before it can be successful.

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The first requirement is commitment and involvement of key line managers. One of the messages we continually deliver when we help with planning processes is that line management cannot delegate planning responsibility. Staffs can provide support and analysis, but planning is ultimately one of the key line responsibilities, particularly of senior management.

Second, planning requires patience. The organization needs time to learn how to plan. The positive results of a planning process don't come in the first planning cycle. I think it's fair to say that strategic planning and operational planning don't really hit their stride for at least two to three years.

Third, you require change in perspective. There has to be less tendency to treat planning as the forward projection of last year's performance. If you're going to take on the expense, trouble and disruption of developing a meaningful planning process, it should be because management is prepared for fundamental change in how it operates and where it's going.

Next, you need multiple skills. Planners alone do not create a good planning process. You need the input of all the different functions -- finance marketing, actuarial, and operations. They all have to be an integral part of the process.

You also need to educate people about planning. Planning is not an inborn skill, nor is it always a part of our formal educations. So you need to teach people how to plan and give them feedback when they're planning effectively.

Planning also requires pragmatism. You don't create perfect plans. The plans you should shoot for should be those that are necessary to effectively move the company forward in the direction you want to go. Planning, more than any other activity I know of, can suffer from analysis paralysis. You have to find ways to move it forward and make it actionable.

Finally, particularly for value-based planning, there is a need for new management information. This need comes in two forms: first, you need basic data and information to institute the planning process itself; and second, you need to carefully scrutinize the performance monitoring processes and management reporting to ensure that the key indicators of planned performance are the indicators that are reported against on an ongoing basis.

Let me try to tie everything together and bring the topic back to financial projections. I want to leave you with three concepts: First, planning and integrated formal planning processes are becoming a survival requirement for insurance companies. Second, value-based planning, which carries with it the need for financial projections and makes financial analysis an integrating mechanism for the planning process, can be very useful, particularly if you haven't had significant planning exercises before. And finally, the planning that you do has to include much more than just financial projections. Financial projections provide a mechanism, but the real action in planning has to be in the operational and product decisions that you make.

MR. TULLIS: Bob Hohertz is valuation actuary at General American Life, and he described his job to me as actually being the closest thing General American has to a valuation actuary. Bob has spent his entire career with General American -- most of it as an actuary, but he does have extensive experience in other areas as well. He told me earlier that if you don't believe being an actuary is a good job, you ought to try heading up policyowner service for a few years.

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General American has recently implemented GAAP accounting and Bob is currently heading up a project to implement a sophisticated financial planning and projection process at General American. Bob will be sharing some basic ideas about insurance company planning and projection.

MR. ROBERT D. HOHERTZ: When I first put together my notes, I thought I was going to be after Sid LeBlanc and the first thing I was going to do was agree with a comment that I think he's about to make. And that's that planning is certainly not the same thing as forecasting and modeling. But, if you're like me, and perhaps you aren't among the very top levels of management, a lot of our jobs are based on modeling as we normally think of it. There's nothing wrong with this because no matter what you do in the way of planning, you need to have some idea of the consequences of certain actions you are going to take. So, many of our jobs are more likely to deal with projections than with what we might consider planning. Then I'll go over some of the things we have experienced in the past and try to draw some generalized concepts from them.

The first thing I know is Rule Number One for projections, and most of you know it too. However your projections come out, the one thing you know for certain is that it will not happen that way. And the corollary that I think I have managed to sell to my management at this point is that if you can't be right, be consistent.

I've been around long enough to know that when the first computer model came into General American -- I don't know who we bought it from -- it's probably just as well -- it ran on a 4K 1401 IBM computer, and you can imagine its sophistication. Our controller came around to the actuaries and asked us what the reserve increase was going to be for the following year. We happily gave that to him based on looking at what it had been for the past few years. He went to agency and asked what the premiums were going to be and, as you can imagine, the result was that he came back and asked us why we were going to lose \$3 or \$4 million. And this was in an era when a good gain for our company would have been about \$.5 million. We immediately found out that agency had turned in premium projections which were lower than they had actually produced in the past two years. We asked them how they could do this, and they said they were in the third year of a five-year plan and they couldn't possibly deviate from it, and that's what the premiums were going to be. We actuaries said that was ridiculous; and that the reserve increase was going to be something else. Somehow I got out of that because I was a mere actuarial student, and I don't know how it ever got resolved. But that does point up the idea that if you can't be consistent, your plans are not going to be worth anything.

Now, consistency is not always easy to achieve. I dug up a quotation that Francis Bacon made in 1620. "Human understanding is of its own nature prone to suppose the existence of more order and regularity in the world than it finds." My staff, at this point, would agree heartily with that.

In the simpler days of the late 1970s and early 1980s my company used a home-grown trend-based forecasting system which actually worked very well; in fact, a little bit to our disadvantage because nowadays management wants to know why we can't project nearly so well as we did at that point. With the trend system, if you can identify a manageable number of relationships, and if you can quantify their interactions and keep up with them as they change, it works. But that's an awful lot of *ifs*. There is the advantage that it seems like there's very little need to validate a trend model. Once you've put it together it's

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almost a self-validating thing because you're only looking at the past, and you have created it to fit what you have seen in the past, so it automatically works. It's a relatively low cost sort of device, and certainly brings out the artist in the forecaster.

The problem, and it has a big one which we have run into lately, is that it does not predict shifts in the relationships. A prime example of that is a change in the mix of business. If you have forecast something like your ratio of net to gross premium to build up a statutory reserve, for instance, and the mix of business isn't what was expected, it's difficult to explain exactly what went wrong. This sort of a system also breaks down quickly with modular types of coverages such as what we're offering now: for example, a whole life plan with a lot of add-on riders that can either build up the cash value or the insurance. We also have some fairly complex agents' compensation systems. I was reminded of this a couple of months ago when one of the members of my staff was trying to project the cost of a bonus system and he looked at me very wistfully and said, "If I only had about three years worth of experience with this, I could tell you what it's going to be." But without that, it was such a complicated sort of relationship that we finally tried to pick something that was reasonable, and luckily it was fairly close to what the results were -- getting back to the artist in all of us.

We will always have a place for trend modeling. For instance, we're not going to try to do any better type of modeling with small blocks of business and small impact items, which for a company like ours would be things like waiver of premium, additional indemnity, supplementary contracts -- things that will not be worthwhile trying to put together in cells. But other than that, we are moving, and I hope it's forward, to cell modeling. There, of course, what we need are the basic characteristics and behavior of plan/age cells modeled under certain assumptions. And all of this is a little more complicated than I first thought it was going to be.

One of the first questions was -- "what assumptions?" The two choices that seem to be fairly obvious are pricing or the latest information we have. I believe that most of you would think the obvious answer, if you're going to use it for forecasting, is putting in the latest information. Well, in our forecasts, general expenses will undoubtedly always be just a summation of budgets put together by the line areas. If we don't do that, they aren't going to have any ownership in the plan, and actually that's one of the most important things they can be putting together for the projections. So in our particular case, we are going to feed into our cell model the expense assumptions contained in our pricing. Of course being a mutual company, that's our latest dividend scale rather than what was put in there maybe 10 or 15 years ago by an all-seeing actuary. What we will get out of that system, if we are lucky, is a set of product-expected expenses -- something that we can test budgets against. In fact, if I could iron out a couple of minor problems, I would love to use this as the start of our budgeting. In other words, to the policyholder service areas and say that the product now in force and what we are going to sell is going to give you X dollars, to work with over the year. Now you budget within X dollars or explain why you are going over that and how we're going to recoup those costs in the future, because anything else you do is going to injure our product competitiveness.

One of the other things that we definitely have to do for a cell model is find out what we have in force. That's really not a very difficult process. If you have

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a lot of fairly sophisticated computer records, which we do, that's just a fair amount of number crunching that can best be done on a large mainframe. Grouping it may not be quite so straightforward. For instance, as we found out, we really don't have many endowments left in force. Most of you probably don't either. But if we don't put a cell in for them, we will be missing a certain amount of cash flow, maturities, things that will swing our gain probably further than we want in tolerance when we are forecasting. So we can't just eliminate it because it is a category which is not high in either premium, cash value, or insurance in force.

Another far-from-simple thing we are running into in choosing a cell is whether we use one particular risk category -- because we issue smoker, nonsmoker, male, female, preferred, standard, and rated business -- with size bands, so you can get almost an infinite number of combinations. One of the choices that we have played around with, of course, is blending these. I think that at the present time, even though that might give us more of a feeling of doing things right, that's probably spurious comfort. I suspect that the amount of refinement we will get by trying to run before we can walk is just going to give us a false sense of security, so we are going to grit our teeth and try to have one particular risk category substitute for all of them. And that's going to lead me to my next comment which is that the real art in a cell model is assembling the cells and validating them.

We have actually tried to do cell modeling at least twice before. Once was a long time ago and I'm not sure what happened to it, but in the late 1970s we tried to put together a cell model pretty much in our spare time. I think we had a part-time student working on it two days a week. She developed a tremendous amount of useful information for us but never did develop a validated model. This causes me to worry that when we get pretty close to validation there's going to be a strong temptation to resolve our remaining problems with a shoehorn, and once we do that my confidence is going to vary inversely with the amount of force needed to get the foot into the shoe. Keeping the balance after that is going to be the next trick; in other words, validating over and over again. I'll be happy to face that problem once we get the original one validated.

If this is all done *right*, however we define right, we expect our model to handle a lot of the shifting relationships. It should respond pretty well to our changes in sales mix because we should be able to find out how much of our forecasting error is due to changes in it. Of course, it will handle some changes in assumptions: mortality, lapse, sales volume. We are resigned to the fact that it is not going to work well when the changes are in the basic characteristics of the cells themselves, such as a shift in average issue age or risk class. If we do use blending later on, once the blends are no longer correct we have a basic, built-in problem.

I have other uses in mind for this model than just coming up with what the gain from operations is going to be at the end of the current year or the next three years. Just developing calendar-year contributions to gain by cell, I have a good map of earnings by plan and duration. This gives me a good way to communicate with the product actuaries because they are used to looking at things on a policy-year basis, and where they say there may be a certain amount of drain from new business, I can usually up that by about 50% to 75% once I go calendar year. It's particularly "fun" on something like a YRT product, where in the first policy year we may be looking at something like a 20% to

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30% of premium drain and I can come along on a calendar-year basis and put up the reserves and show them that it's more like 130%. It opens a few eyes.

Also, it's going to give me a basis to split our dividend scale into its components of interest, and mortality and expense. Why do I want to do this? We look at earnings by source, and I've found that's been a very useful tool both to explain things to management and to get our forecasting better. Up to now we have just included dividends in a lump, like an expense. I've become a convert to the thinking now that we should split dividends into their components so that instead of just looking, for instance, at net investment income versus the interest required by the reserve system, I want to throw in the interest required by the dividend scale as well to give us a much better idea of exactly what we're doing. How will I use the model to do this? I already have the cell points picked out, and even though it isn't validated, I don't expect them to change very much. We have a couple of summer students sitting there with pencil and paper calculating the dividends by component. I'm going to add all of these up, weight them by the amount of insurance in each cell, develop percentages, apply them to our dividend liability, and I think I'll probably come close enough to the type of analysis that I want.

I've already talked to you about the development of expected expenses for budgeting purposes, and we're very close to having that sort of an analysis too. And, finally, I intend to use this model to produce range forecasts because, again, since I can't get it right, I might at least be able to bracket what our gains are going to be over a given period of time. I can do this with trend forecasting as well, but it is so difficult that I haven't been able to get anyone very interested in it. In fact, at the present time, I can't really see that our top management is asking us to do any kind of range forecast. I'm going to have to try to make that sale, but I think that once they see them, they are going to appreciate them a great deal. I would like someone to comment later on when you think it might be appropriate for us to tell management what they should be looking at, rather than letting management sit around and think up questions that we probably can't answer.

Before I quit, I'd like to give you something totally different from what I've been talking about -- a management exercise that we went through several years ago that's more nearly like planning. To give you a little background, about four years ago my company participated in the University of Southern California Futures Group study, along with about 10 other insurance companies and several other institutions, one of which was the United States Postal Service. (We actually produce some of the greatest mail volume of any industry and they were quite interested in finding out whether we were going to continue doing that for their own type of planning, so they were willing to put in some money to go in with us.) The topic of this exercise was alternate futures for the life and health insurance industry. This was reported in the trade press about three or four years ago, but in case any of you don't remember that, a number of forecasting techniques were used and it was very interesting to see what type of things were done by a professional group.

First, they participated in a literature search. In other words, if someone has already done our work for us, let's find out about it. The chances are that the literature will not reveal about 10 people all agreeing exactly on what this future is going to be, but you can get a lot of useful information by digging around and seeing what people have said. They went one step further and commissioned a couple of gurus in the industry to come up with individual

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forecasts. Of course they didn't agree, but this produced a lot of questions for the rest of us.

We sat around trying to assign subjective probabilities to things such as: life expectancy will be increased to 80 at birth by 1985. From this, the professional futurists did a lot of mathematical trend extrapolations. I recall some of that vividly because this was in 1983-1984, and some of these trend extrapolations told us that by 1988, by now, no one would be selling anything but universal life, and no one would have anything left in force except universal life. I don't know about your companies, but for us that is not an accurate picture. They didn't expect it to be but this was a baseline to work from.

Probably the most sophisticated thing done was a two-round delphi study. They took the material that had been developed, sent it off to quite a number of people who had agreed to participate, industry experts so to speak, and asked them to try to assign their own probabilities and tell us what they thought was going to happen. All this information came back to the University of Southern California, where it was compiled and sent back to everyone with the message: here's what everyone else thinks, do you want to change your mind? Next, they did something called cross-impact analysis which they defined as what influence the occurrence of one event would be likely to have on the occurrence of another. They had fairly sophisticated models to use, and the result of this entire exercise was a nominal future. That's close to trend extrapolation and the one most of us work with, in fact, when we work on year-to-year forecasts. But then they went ahead to say that they had refuted this nominal future by building a number of alternate futures and scenarios based on the delphi and cross-impact results.

Six of these were presented to us in detail. I don't want to go into great detail but the first was a high technology one -- strong breakthroughs. By now we should all be having our own visual phones at home and be able to work from our homes -- things of this sort. In the year 2005 or such, under this scenario, they saw the insurance industry lagging well behind a lot of other industries in being able to apply this technology, and therefore struggling. The second was a high-interest-rate scenario, and there they decided that insurance companies would most probably be able to respond very quickly and found us to be very successful. The third was one with rapid swings in almost everything -- they called it "Who's on First?" -- and there we, along with most of society, ended up shaking our heads, very dubious about our ability to survive.

The fourth was one that gave us a return to grass roots value, very much stability. And oddly enough, they say that we probably would not end up reacting to that as quickly as we should, and even though our future would look good, it would not be as good as most of us would think. The fifth was a divided-society scenario, one in which the people who worked in information services had everything, and everyone else was living in a state of semiliteracy and semipoverty. The industry was also divided as to the companies that were haves and have nots. The sixth future was one that featured almost complete deregulation. There the insurance companies who survived were no longer insurance companies but full-service financial institutions.

Whether any of these things were right or even had any probability of being right isn't terribly important. In fact, by the time they accumulated the joint probabilities of any one of these given futures, any one had less than a 1% chance of occurring. But they suggested a use for the scenarios and at my

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company everyone in management at the second vice president level and above met for one day. We split into seven groups so that each group would have an actuary, an investment person, someone in administration, someone in accounting, and someone in sales. Each group was given one of the scenarios and a couple of hours to sit down and sketch out strategies -- to make sure that our company could start where we were than and end up on the winning side, or at least have a fair chance of winning, under the scenario that we had. And then we had a chance to explain to everyone else why we did what we did.

The next logical step from this would be to try to find the common denominators in all of these strategies and try to make sure that you weren't doing anything that would close any of the options that you would need if any of them would come to pass. To some extent we did this, but it's quite hard to keep management, at least below a certain level, focused on a lot of alternate futures. Most of us go back to our offices and start to concentrate on what it is we actually do day to day. So again, when we open this for discussion, I would love to hear about other companies' methods to try to keep people focusing on the future, or whether you think it's even useful to try.

MR. TULLIS: I'm sure you're all familiar with the giant northeastern mutuals and the giant New York mutuals. Sid LeBlanc is with the giant Cajun mutual, Pan-American Life, where he is Senior Vice President, Financial Planning and Control. Pan-American has been on the leading edge of innovation over the years in that it was one of the first companies to come out with an update program in the late 1970s and was also one of the first companies to develop a series of universal life products. Along these lines, Pan-American has undergone significant evolution in its planning process in the last few years, including the use of financial projections. Sid will be speaking on what planning is and asset risk for universal life.

MR. SIDNEY A. LEBLANC: When I was asked to be on this panel, I was told I could talk about anything I wanted to and it was suggested that it would be controversial to encourage questions. When you think about it, that's a fairly easy assignment. I do plan to talk about two somewhat unrelated topics: (1) what is planning? and (2) universal life surplus needs. In covering these, I will cover most of the topics the moderator had in mind for me.

What I'm going to talk about is how we organize thinking about planning? The topic in the program is corporate planning/projections: are they synonymous -- are they required? It's my opinion that projections are a useful, but not a necessary tool in the planning process. I'll talk about that a little more later. There are a lot of uses for projections. Some of them are, (1) tax planning, particularly with the alternative minimum tax and loss carryforwards; (2) finding the impact of your plans on your financial results; and (3) cash flow testing.

Is planning setting goals, objectives and strategies? This is clearly one approach. We hired six expensive consultants (I guess that's redundant) and had a three-week senior management retreat. A committee of 16 people talked about our goals and decided that our company goal was to "do good and avoid evil." We had some concern about some of the words, but it's something we think we can live with. I'm being only a little facetious. I think if you go through this goals/objectives process, you have to make sure you control the process toward the ultimate objective of planning.

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So, what is planning? My definition is: planning is any technique which causes a company to focus on the right issues. That is, how do we organize our thinking about the future? Any way that works!

What are the types of issues we might be focusing on? Does the company want to be relationship driven versus product-driven in the individual insurance? Connecticut Mutual and Pan-American Life aim for the identical ultimate customer for our individual insurance product -- the upper-income, small business owner, financially secure individual. But they are a relationship-driven company and we're a product-driven company and this means a whole different set of answers. Connecticut Mutual is a career company. They want a relationship with their agents. They want to be everything to their agents. They must have variable life for their agents. They want to have every type of product. They don't want that agent to go anywhere else for anything else. If they don't have a product, they'll get one.

Pan-American is product-driven. We want to have the best universal life product in individual insurance -- not the best, you'd have to be crazy to be #1 -- but in the top quartile in terms of compensation and product. So, our theme is focus, focus, focus. We don't have a health product. We don't want to have one. If we could have a very good one that it wouldn't detract from our focus on universal life, we might have one; but we don't need one.

One thing that happens in our company since we're organized along profit center lines is that a lot of our planning tends to become profit center planning. If you're talking about vulnerability to provider organizations in a senior management group, the group senior vice president talks about it and the other people tend to listen and not contradict him. They don't want him contradicting them when it's their turn. But this causes some problems on certain issues -- for instance, should we divest or acquire group operations? Asking your group vice president, "Should we divest your operations?" Is like asking him, "Are you asleep?" or "Are you having an affair?" There is only one answer to those questions. Other issues could involve critical mass or demutualization. These are basically big-picture items, which says something about where we're going to be five years from now.

So, given that those are the issues, how does a company focus on these issues? The answer varies by issue, it varies by company and it varies by period. What's right for Pan-American today wasn't right for Pan-American ten years ago. What's right for Pan-American isn't right for Prudential. Projections are clearly one technique that help you focus on the issues. It will probably show some things that bring up issues. The main reason for having projections in a planning process is either to set what issues you want to talk about or to help you decide on those issues once you decide what the issues are. Clearly, if you're a \$100 million asset company, you don't do projections, but yet you can still do planning. Budgets are similar to projections. If your budget next year says you're losing money, you've brought up an important issue. Setting goals, objectives and strategy is a technique.

To continue, if you have a vision of the company in the future and you have a road map to get there, that's talking about a lot of issues. A senior management retreat is typical. You go to a nice place, you work your tail off, and then you can't enjoy it.

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We've talked about strategic business unit planning. If you want to think about demutualization, you don't do that in a planning process -- you assign an ad hoc committee or a group of people to review it. Anytime you do pricing, you likely bring up some issues. You price a product today in the industry and you've got an issue of what to do about the underpricing in the industry. When you do pricing, you also bring up critical mass. When you do surplus studies, you bring up issues and I'll talk a little bit more about that when I talk about universal life. When you do financial reporting, you hopefully bring up issues. Financial reporting is a whole lot more than just reporting accurate numbers. You should be saying why the numbers are what they are and what it means.

I'd like to change the subject now and go on to universal life surplus needs. The purpose of the surplus study is to understand risk. Now, this isn't why you would start out on a surplus study, but this is probably the best byproduct you'd get out of it. Once you understand risk, then you need to decide how to manage it or charge for it. Those are really the only two alternatives. You can't ignore it.

As an example, let's look at universal life risk. I think that the primary risk in universal life is not mortality, despite AIDS, but investment. As an illustration of how I might come to this conclusion, I've done a very crude calculation. What's the chance of mortality increasing 20% and what happens if it does? If you have a 20% increase in mortality versus what you assumed in pricing, it might cost you 2% of premium. It's in that magnitude and you can argue whether it's 4% or 2%, but it's not a huge number. How often do you have a 20% increase in mortality versus expected? Once every hundred years? The 1918 influenza epidemic and AIDS -- maybe every 70 years. What happens if interest increases 40% -- that is, from 10% to 14% or from 5% to 7%? Well, your loss then might be more like 30% of premium. Then, again, you can argue whether it's 30% or 15%, but it's a whole lot bigger number than the first number. And, how often does a 40% increase in interest happen? Well, it's happened three times in the last 25 years. That is fairly frequent. I feel that the investment risk is by far the more important risk on universal life. Actually, all the comments I'm making about universal life could be equally applied to whole life. It's just a little clearer that they're applicable in universal life.

The first investment risk is the C-1 risk, the risk of defaults. Insurance companies can diversify and reduce the C-1 risk, and insurance companies are very good at assessing credit risk and diversification, so this is something they can handle. For the C-3 risk, asset/liability mismatch, you can't diversify. If you've invested in 10-year maturities, you've invested in 10-year maturities and it may be a bet the company type of issue. It's the hot topic today and it well should be.

To understand the C-3 risk on universal life, what you need to do is test a number of interest scenarios and, within those scenarios, you need to vary the policyowner and asset holder behavior by the interest scenario. If interest rates go down, it's not that great -- we still have to pay most of our interest, we have calls on your bonds and so profits really don't go up. But, you're all right. If interest goes up, then all of your policyowners go away because they can get 14% at the company across the street and there will be insurance companies paying the higher rate.

According to the studies we've done, in order to completely avoid the C-3 risk, we would need to invest in 2-year asset maturities. I'm sure nobody out there

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is investing in 2-year maturities and neither are we. If the 2 sounds a little low, I think it might be worth noting that the rise in the interest rates causes pricing losses, even if your profit stream remains the same, because you're discounting at a higher interest rate -- you have less profits to offset the acquisition loss. I might also mention that I'm assuming here on either universal life or whole life that, if interest goes from 10% to 14%, the response is not to zero dividends or zero excess interest. That would kill your marketing operation and the future viability of the company. If you do that, maybe your profitability is all right, maybe you can say you've got a longer asset risk or longer possible maturity, but I don't think that's in the future.

Now, given that we have some understanding of the risk, the first question is, can we eliminate it? Some companies have done that. They've done variable life. You can do it by investing in 2-year maturities. That would probably cost you about 150 basis points versus what you're earning today. That's an important number because that says that we're giving the insured an option that's worth 150 basis points and we give it to him at no charge. This is a clear example of the underpricing in the industry. A lot of companies are pricing with forward pricing on expenses or whatever they want to call it (the fact that they don't have all their expenses in their premium), but the mismatch risk here is clearly substantially in excess of any expense overruns.

Now, if you don't want to eliminate it, how can you reduce it? One thing you can do is put in a surrender charge. A lot of companies have a back-loaded product, which has a surrender charge that reduces your risk. You can shorten maturities. If you're investing in 10 years, you can go to 5 years. You can stay at 10-year maturities and add an interest rate hedge. You're ahead by staying at 10-year and adding an interest rate hedge because you've maintained your credit risk. On our group pension portfolio at Pan-American, which is about three-quarters of a billion dollars, we invest long and hedge to shorten it up and we charge the cost of that hedge to group pension and we require them to make satisfactory profit after paying for that hedge. When it comes to universal life, if we wanted to charge them 150 basis points to shorten the cost of the hedge (at 100 basis points), they can't afford to pay it because you guys are pricing too aggressively . . . so ease up.

When we can't charge for the guarantees that we're giving, that says we need some contractual change. We need something in the contract to make the policyowner pay for it. Now, I haven't heard of anything working, outside of going to variable life. One thought that I had goes back to excess interest chargebacks. Some of the early universal life plans had a contractual arrangement where if the guaranteed rate was 4%, the excess rate was 6%, and the total rate was 10%, then, if you surrendered, the company could withhold its 6% excess interest on the last 12 months. Companies quit doing that -- it wasn't competitive; it's a one-way street, it hurts the insured. Why not make it a two-way street? If interest is up, have an excess interest charge; if interest is down, credit excess interest twice for the last year. I had suggested that and our salespeople said we couldn't do it because we would be the only company doing it. So, again, why don't you guys do it or something else to protect ourselves against the universal life risk? We have a lot of intelligent people in the Society of Actuaries and I'd like to think that someone would come up with something that would protect us.

The risk is higher today due to the rollover mentality that we have among our agents today. It's a whole lot easier to sell rollover than it is to sell needs.

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There's a whole lot more agent mobility. Agents go from company to company and they take their business with them. The independent agent makes for a whole lot more rollover. If the company down the street has a 1% higher interest rate than you do, the agent has rationale to roll it over and get the new first-year commission. And there's a lot more awareness of interest rates among the ultimate consumer of life insurance.

I think it might be worth noting that all these topics apply to whole life insurance, as well as universal life. If we had an interest rate spike, whole life insurance would fare a whole lot worse today than it did in 1980 and 1981. If you can't reduce the risk or eliminate it, you need to charge for it and the profit levels in universal life or the old whole life profit levels are not satisfactory.

MR. EDWARD L. ROBBINS: I know this is not a meeting on FASB 97, but I thought I might say a few words on this issue, because FASB 97 may have one particularly far-reaching implication for corporate financial planners. When you look at some of the significant departures of FASB 97 from traditional GAAP, you find that probably the major point of departure -- from an administrative point of view -- is the dynamic unlocking requirement. The statement appears to say that the deferred acquisition cost has to be reexamined each financial period, and perhaps recalculated from inception, based on new assumptions that reflect emerging experience.

This is exactly the opposite of the lock-in principle under traditional GAAP. When you speak to actuaries about this new unlocking requirement, you hear much gnashing of teeth; but if you explore this concept a bit further, you may be able to see some additional benefit from this type of exercise.

What this may mean when carried to an extreme is that, for each cell in a company's model, you start out at issue with completely projected experience, and as time goes on you do two things. First, you true up your past experience. Thus, each year you replace projected data with actual data for that year. Second, you redirect the still projected experience to more closely conform to that past experience.

In summary, this means that for those who wish to interpret FASB 97 rigorously they can end up with a data base they've never had before, that they could use for some new purposes. Basically, they've created a data base for both a forecasting tool and a tool that can monitor past experience -- what some are beginning to call a backcasting tool. Let me run through a brief example of the kind of use it can be put to.

An actuary prices a product to return 18% on invested surplus. Five years later we ask the question, "Is it on track to return that 18% from issue? What return are we really going to get?" Conversely, we might ask, "What do we now have to do with our Cost of Insurance (COI) charges and/or interest spreads to achieve the 18% from inception, or should we redefine our objective and conform our product to that new objective?" Naturally this type of scenario can take place with any other pricing profit objective, such as 7% of premiums.

Up until now, the pricing actuaries in many companies have not been held accountable for their work, in the sense of monitors on whether their original pricing objectives are being realized. To sum it up, forecasts are really pretty limited in their use unless you have the ability to monitor them. Now it appears

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that there may be a monitoring device available to look over the pricing actuary's shoulder.

MR. LAWRENCE E. EDWIN: I'd like to direct my comments towards Bob Hohertz, regarding cell modeling. I've done extensive cell modeling work in the last year and have put together all kinds of numbers. I found that I had a hard time validating results to reality, at which point I found myself at a loss as to what to do when the numbers didn't validate. I guess my thinking about it at this point is that there is probably an optimal level of sophistication that you want to put into your forecasting, beyond which the cost of that sophistication is more than the benefits that you accrue from it. One of the things that it costs you is lack of flexibility. And so, I wanted to hear your comments on it.

MR. HOHERTZ: I mentioned already that in the company history we have tried playing around with this before, but without any success. We ran into a little bit of what you are talking about -- being able to get all the pieces but not being able to put them together into anything decent. One of the comments earlier that John made was that it takes a lot of commitment. Also, in our case, we've gone outside. We've actually asked someone who has done this several times to come in and work with us on this particular project. Instead of trying to reinvent that particular wheel, we're going to see whether anyone else can walk us through the steps. I don't mind saying that once we've seen what those steps are, I hope we can do it for ourselves in the future but at this point I sympathize with you a great deal because I am sure that's exactly where we'd be sitting right now on our own.

MR. DENIS W. LORING: A couple of the issues that were mentioned in the program were issues of return on equity, performance measures and that level of planning. I think there's a standard canonical answer to the question of what the acceptable return on equity is on your business. It's 15% after tax. It seems that whatever planning method you use, one always ends up with 15% after tax. I'd be curious to know if anyone can actually achieve 15% after tax and then how do the business and line heads deal with their actual results when top management asks why you haven't achieved the 15% after tax that everyone else in the world seems to achieve.

MR. LEBLANC: I would agree that 15% is always the answer. There are some areas in our business where you can get 15%. It's clearly not individual life insurance right now. I would like to think that some of our stock brethren are concerned and are going to help that problem probably quicker than the mutual companies. One of the advantages that you get when your goal is 15% is that it allows the president of the company to go to the profit center heads and say, "You're below what you should be and you have to improve what you're doing." It allows you to set more aggressive goals to try to improve.

MR. JEFFREY D. MILLER: I can respond to that question with two cases that we have had recently where companies have in fact been earning 15% after tax, and I think they're operationally interesting cases. One is a life company subsidiary of a mutual property casualty company, where the property casualty agents are actually selling their universal life business and they actually have control over their field force. And they're actually marketing in the small business market in the Midwest. That's a situation where clearly they're not in the head-knocking competition of the brokerage market and the like but that's a situation where we have seen over a long period of time a 15% after-tax return on investment.

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The second situation we've seen is a company that is in the brokerage market but with extremely low expense levels and extremely high production and that's another situation where 15% after tax has been achieved and is projected to be achieved in the future.

MR. KIN K. GEE: I'd like to direct my comments to John Porter, if I may. You seemed to have dismissed some of the classical strategies such as low-cost producer, product differentiation and so on that are traditionally used by non-insurance companies to gain competitive advantage. Please comment a little bit on what I believe are the number of insurance companies who are successful in employing these strategies. On the mutual side you've got Northwestern Mutual, probably the noisiest quiet company that we know, whose strategy has been a low-cost producer and who seems to be achieving that. Among the stock companies, you've got the ICH and Conesco; they are examples of companies whose strategy is product differentiation. These companies seem to be doing well and I am sure there are other examples.

MR. PORTER: I don't dismiss these as strategies or the techniques used to arrive at them. What I was trying to get at is that there is a need for a framework for developing these strategies. You have to have exactly those kinds of operational strategies for product, market segmentation, cost of production, and so forth, to make any sense out of a value-based planning model. Value-based planning helps make sure that the operational strategies or line-of-business strategies match the goals and objectives of the company. Strategic decisions and strategic reasoning still have to take place. What I was trying to emphasize is that insurance companies need a methodology that binds those qualitative ideas back together into a quantitative structure to test the ideas and make sure they match the goals and objectives of the company.

MR. MICHAEL R. TUOHY: In response to Denis Loring's question as to the 15% and can anyone make it -- we did a recent survey for one of the seminars we were running for about 150 life companies on what their pricing objectives were. And it may be surprising to some that a third of those companies don't even regard rate of return as a relevant pricing objective and of those that do, the universal constant 15% does happen quite often but there is quite a variety around that 15%. Also, what was interesting, and I think Sid brought it out, was that the expenses that are being assumed in pricing now generally reflect some favorable economies of scale, continuing into the future, in the majority of companies. The question was asked whether companies are using some sort of stochastic process to look at the investment risk in pricing, and very few companies are doing that. So if you add the three things together, a third of the companies aren't looking at the most relevant profit measure. Most companies are cheating on their expense assumptions, and the vast majority of companies are ignoring investment risks on universal life. It's not surprising that we end up with the prices we are quoting at the moment.

MR. THOMAS F. EASON: Let's expand the 15% discussion a bit more. I'd like to suggest for your consideration that we have new options in dealing with questions as to what kind of return is indicated. The stochastic processes that Mike referred to have indeed begun to penetrate into the actual processes of pricing products, establishing reserves and in fact almost the day-to-day operations of companies. There is room for a great deal of intensive study of the relationship between expected return on the capital committed to a line of business and the risk that's involved. Fifteen percent is clearly not a magic number. It may well be that the magic number is to cast things in a totally

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different perspective. What is the risk-free rate of return to start with? For example, a portfolio of single-premium deferred annuities sold through a fairly closely regarded field force may have a maturity that averages somewhere between five and eight years. Risk-free rate of return relative to the investments needed to match the expected maturing liabilities could very well be something like five to eight-year treasury bonds.

The next question, of course, is what the risk is that you take from the options that are built into the provisions of the specific contract that you are dealing with. Do enough stochastic testing as to the risk that you entail when you have changes in mortality, those that you can't adjust for right away, changes in expenses either because you didn't reckon those properly in the first place or because inflation starts to hit you again, and the myriad of other factors that are involved. Do enough stochastic testing and you should be able to measure over a wide range the risk to which you are exposed.

Now you have one simple step left. Translate that risk into the amount of money that a prudent person would expect to make for taking the risk. Perhaps we're talking about a version of analysis of the cost-of-equity capital translated to life insurance products generally. I think I see a question in here for Mr. Porter because I believe it ought to be a generalized business concept. Are we ready to develop things along these lines and replace the 15% with a number that really does relate to the risks in the business that we're in product by product?

MR. PORTER: Why wouldn't we want to do that? The single 15% number is antithetical to the things I was saying, particularly to the idea that the risk (and therefore the return) you have to expect should be line and product specific. I would advise you to look at your company as a portfolio of businesses; one of your business' risk-adjusted rate might be 20% while another business' rate might be 5%. We've got to start making such breakdowns in order to support the kinds of decisions that a company has to make in a more difficult and volatile environment.

MR. LEBLANC: One other comment, Tom, in agreeing with your point, is that I think it's important to note that if we did have contractual provision which protected ourselves in an interest-rate spike, we would have substantially reduced our risk and therefore could give a much better product to the insured. I guess another way of looking at it in terms of my presentation was that arguably you could pay 150 basis points more if you were contractually protected. It would make you a whole lot more competitive.

MR. JAMES C. HACKARD: Our company is organized somewhat differently, I suppose, than most. We are a wholly-owned stock subsidiary of USAA Property and Casualty Company and as such, the stated goals for our return on equity is that we return to our parent at least as much as they could earn on an investment of comparable quality. Basically we have a range that we're compared against and if we deviate not just on the low side but on the high side, we're viewed as not meeting our objectives. We feel that if we return on our return a greater percent to our parent than they could earn elsewhere, then we have let down the members of our association and that money should be going back to them. Frequently that means we have competitive resources that we use to keep our interest rates high but we don't have a specific 15% objective. It's generally stated as a goal which I think today ranges between 10% and 12.5%.

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MR. GEE: It seems that a number of companies I've been working with have not historically made great use of actuaries in their corporate and strategic planning process. I wonder if the members of the panel can comment on that, both in terms of the historical usage of actuaries in the planning process as well as prospectively with the introduction of new additional techniques.

MR. LEBLANC: From our viewpoint, if planning is trying to focus on the right issues, then the people whose attention you want to focus on it are your senior management people who may or may not be actuaries. In our case, we've got some who are and some who are not. Despite what I said about projections, we do projections. That clearly involves actuaries and gets them involved in the process, but in our case the primary planners have to be the president of the company and the people who run the profit centers.

MR. PORTER: I'd agree with that. Others can speak more knowledgeably about the historical role of actuaries, but from my perspective actuaries have a vital role, to the extent that they're part of the management team and should, therefore, be part of the planning team. They have a direct contribution to make to the strategic planning process. I can't conceive of an effective strategic planning process without actuarial involvement, both in determining what the key issues are and in providing the kind of staff and analytical support it takes to do the planning itself.

MR. HOHERTZ: It might depend a little too on whether you view your company as a financial institution or an insurance company. That isn't necessarily synonymous. Traditionally, we actuaries have had the strong roles in an insurance company and so historically, in my company certainly, we have been very definitely involved in a lot of the planning exercises. But as we get larger and evolve into something different, which we may or may not be doing, I think that it's quite proper to have a lot of the other disciplines well represented.

MR. GEE: I guess that the basis for the question is the fact that I've seen in a number of companies one of the first steps of strategic planning is to bring in an outside management consultant firm such as McKinsey or SRI, as opposed to, say, CRESAP/Tillinghast. I'm not picking on Tillinghast or any other actuarial firm in particular. The Society of Actuaries has a task force that has been charged with trying to grapple with the question of the future of the actuary and the actuary of the future. One of the issues that we're trying to address is whether through our selection/recruiting process, we somehow manage to only recruit individuals (who eventually become FSAs) who tend to be more, quantitative and analytical than some of the broader perspectives that might be needed for strategic plannings and other functions where actuaries can play an important role.

MR. HOHERTZ: We use both McKinsey and Tillinghast.

MR. TULLIS: Historically, Tillinghast has been an actuarial firm as opposed to a strategic planning firm, whereas McKinsey has concentrated on planning.

MR. ROBERT STEVEN PASTER: When you try to calculate an ROE, perhaps especially in a mutual company environment, it's not always entirely clear what is meant by equity. Some companies use a surplus needs or required surplus concept and therefore calculate a return on surplus needs or return on required surplus. That required surplus or surplus needs dollar amount is itself intended to be a risk-adjusted measure. And I wonder if you do couch your 15%

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goal in terms of return on surplus needs or return on required surplus, whether you feel a need for that 15% to be risk adjusted.

MR. EASON: With what should you reckon your return on equity? What should be the base on which you reckon in a mutual insurance company? If you have a line, for example, that requires a good deal of benchmark surplus, contingency surplus, required capital, whatever your favorite phrase is, and you insist that you make 15% on that, it would seem that you were almost double counting against the line of business. Harkening back to what I said earlier, why not do a calculation that says when you're including the required surplus, you expect your result to come back to the risk-free rate of return because the required surplus is there to handle the fluctuations?

MR. TULLIS: Can I ask you a question on that, Tom? If it's actually used to handle fluctuations, doesn't that mean there's some risk involved in utilization of the surplus?

MR. EASON: Surely, and if you use it all up, you wind up making the risk-free return. I'm not sure that this matter has been really explored to my satisfaction in any of the actuarial literature and I'm not anxious to be on the record as having formed opinions on it yet. I think it's a wide-open question. I think it's a major question now, and I think it can only be answered after we have done a better job in identifying what we mean by benchmark surplus with the stochastic testing processes alluded to earlier. I'd invite anyone with ideas on that to be in touch with me for a special reason. We had a meeting earlier of the section council of the financial reporting group and identified topics for the Vancouver meeting next year. I'm supposed to identify the subpoints to be discussed on a couple of proposed major presentations dealing with these very subjects, so I'm still formulating the questions. I think there are some fairly pat answers around, and I don't believe we have given enough thought to these matters, just as we haven't thought enough about what 15% means in a variety of contexts.

MR. EDWARD JOHN BONACH: I'd be interested in hearing how companies are using their planning process and projections in A. M. Best ratings and agencies' ratings.

MR. HOHERTZ: I'm not sure that we are using them directly but we certainly keep an eye on leverage and other things that we might be concerned about in keeping a good rating. It's certainly one of the things we have started looking at in the last couple of years.

MR. ROBERT H. STAPLEFORD: We go through a formal strategic planning process once a year and try to link that up with our operational process. A problem that we've run into, at least in my opinion, is that we try and reflect all that's going on, new ventures and such, what's going on in the economy, and our time frame ends up being about three years. But the minute you get beyond about one year, everyone says, "Well, you can't really trust those results. It's just too volatile -- with new product development, economic developments, and such." What time frame are people using and how do you avoid getting blindsided by getting too short in your planning process because of all the changes going on in the financial marketplace these days?

MR. PORTER: You'll see a lot of range in the time frame of strategic plans, and some components will be more long-term than others. A five-year time frame

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for relatively quantitative aspects of strategic planning is not unusual. But as you point out, the environment is volatile. One of the things you can do in a strategic planning process to deal with this volatility is to define a range of scenarios and to use those scenarios as a framework for operational planning. In other words, you charge a line-of-business manager not only with coming up with a plan but with testing that plan under a number of scenarios to see whether it will be effective under the different outcomes foreseen. You should also charge that manager with some contingency planning for the disaster or windfall opportunities that might occur. A company can sometimes have a tendency to fixate on whether the strategic plan is accurate or not. As I said earlier, strategic plans start becoming obsolete before they're completed, but they do give the management team a common framework of contingency plans that they can look at and pull together behind. In a lot of ways, the planning process is a lot more important than the plan itself because of the way it brings the management team together.

MR. STEPHEN N. STEINIG: Some of the previous speakers have talked about the confusion and what the denominator should be in the return-on-equity equation for mutual companies. I think we could also discuss what the numerator should be. Normally, whenever actuaries talk about return on equity, they're talking about GAAP earnings and some type of GAAP surplus. At New York Life, one of our broad corporate objectives is to make certain we maintain a very strong statutory statement. To do that, we think it makes a lot more sense to manage the company looking at statutory results, rather than manage it for GAAP profitability, but then be concerned with how the balance sheet comes on a statutory basis. Trying to define equity broadly as our surplus on a statutory basis, we find that 15% is an unrealistically high target rate to earn and looking at our brethren mutual companies, we'd say that they don't seem to be growing their surplus certainly at anything like 15%. What you could get on your surplus if you did not invest it in the growth of your business, but only in a treasury bond of some kind, are risk-free returns after tax which are very, very low because of the equity base tax. If you apply the concept of risk-free return to your surplus, you end up deciding you don't need much of an after-tax return at all to do better as an after-tax return by investing it in growth in your business to do better than the risk-free return of just letting your surplus be idle.

MR. TULLIS: Just to pick up on that, it's not only mutual companies but stock companies that have a lot of trouble with both the numerator and the denominator as well. If you decide to make GAAP equity your denominator, you can get into all kinds of questions about how you allocate GAAP equity among lines of business and among different products. And there's sort of a trend in thinking that a number of people have come to where the numerator should really be distributable earnings whether measured on a GAAP or statutory basis. The earnings are really available for distribution outside the company, taking into account changes in required surplus and tax payments and things like that.

MR. LEBLANC: How you would define the numerator involves how you would treat the surplus tax. Do you say that the after-tax earnings on your product are after the surplus tax or do you ignore the surplus tax on it?