RECORD OF SOCIETY OF ACTUARIES
1988 VOL. 14 NO. 4A

CORPORATE PLANNING/PROJECTIONS

Moderator: RICHARD K. KISCHUK
Panelists: FRANK S. IRISH
REX L. WILSON*
Recorder: JEFFREY N. ALTMAN

- How do companies plan for the future?
  - Don't plan
  - Marketing projections
  - Cash flow projections
  - Profit projections
- Concerns to be addressed in planning
  - Profitability/surplus growth
  - Sales volume and growth
  - Allocation of resources to lines of business
  - Basis of expected results
  - Dividend capabilities
  - Taxes
  - Asset/liability management
  - A.M. Best and other ratings
- Use of projections in planning
  - Type (statutory, GAAP or value-added)
  - Definition of modeling
  - Time horizon
  - Scenarios tested

MR. RICHARD K. KISCHUK: Corporate planning projections are increasing in importance in today's world. Increasingly, life insurance companies are focusing on execution of plans in addition to planning. Many companies have found that it is one thing to develop a plan and quite another to execute it. Some companies have sophisticated planning systems and fairly elaborate financial reporting systems. The problem comes in trying to determine whether the company is accomplishing its strategic objectives. In order to link the strategic planning process to financial results, you have to know where you are going. Corporate goals must be translated into financial objectives.

We are going to explore this topic from several perspectives. In talking about this topic among ourselves, the panelists felt that you really can't look at corporate planning projections in a vacuum. You must look at it from a strategic perspective because that is why you are doing the projections in the first place.

Rex Wilson is going to start off with an introduction to strategic planning. He will give us an idea of what companies should be doing, what companies are

* Mr. Wilson, not a member of the Society, is a Partner with Ernst & Whinney in Chicago, Illinois.

currently doing in practice, and some of his thoughts on how strategic planning may develop. Following Rex's presentation, I will give an overview on the topic of planning surplus. Many companies have done corporate projections, but those corporate projections have generally focused on the income statement. As a result, some companies have had to abort strategic plans in midstream because they ran out of surplus or lost their ratings. I will cover that topic and then Frank Irish is going to take us into the world of the corporate actuary with a talk about what really happens when you try to implement a process for corporate planning projections, and how you get people involved in addition to computers.

MR. REX L. WILSON: As Rick mentioned, my presentation is going to focus on the business aspects of strategic planning and then provide a brief lead into financial projections.

1. Gaining a Competitive Advantage: Strategic Planning for Insurance Companies

I would like to look at strategic planning and projections as an active management tool for gaining a sustainable competitive advantage in the fast-paced insurance marketplace. The emphasis is on two words: using and active. Let me present you with a number of questions that I intend to address during this presentation.

First, why do strategic planning in the first place? Second, what is strategic planning and more importantly, what should it accomplish? Third, how do insurance companies perform strategic planning? Fourth, how can strategic plans be successfully implemented and finally, how do financial projections support the development of a useful strategic plan?

2. Insurance Company Board of Directors Survey

Let me share with you some results of a recent survey of insurance company board members. These directors were questioned about the key issues facing their companies today and in the future. The directors believed strategic planning was the second most important issue after financial results facing their companies both today and in the future. Board members think strategic planning is important, but I still haven't answered the question as to why it is important.

3. Why Strategic Planning?

I would like to answer that by quoting a CEO of one of America's most successful companies. He was asked to identify the reasons why his company had enjoyed such long-sustained success. His reply, in comparing his company to competitors, was included in a *Harvard Business Review* article: "The difference between their level of success and ours lies in the relative thoroughness and self-discipline in which we develop and execute our strategies in the future."

The answer, then, to why strategic planning is important is because it can make a big difference in the relative success of individual companies.

4. What Is Strategic Planning?

No let's talk about what strategic planning really is:

5. Strategic Mumbo-Jumbo

It is a bunch of formulas, matricies, and processes, dreamed up by academicians and consultants during the mid 1960s and really doesn't bear much resemblance to daily life and what really goes on in a company. All too often, there is a lot of truth in what I just said.

In recent years, the business press has come down hard on strategic planning, talking about the gimmicks and disappointing results (i.e., the lack of real economic benefit). All types of processes have been followed. Voluminous plans have been documented and filed away on executive shelves. But companies have difficulty turning plans into actions. I want to emphasize that the strategic plans must be actionable and implementation is the key to strategic planning success.

6. Strategic Planning: What Should It Accomplish?

Strategic planning is a process that should focus on three things.

First, companies should take a long-range big-picture view of their activities, environment, opportunities, threats, strengths and weaknesses.

Second, strategic planning should help an organization establish its purpose and direction. What is the company's business? Who are the customers? What products will be offered? What are its priorities? What will differentiate the company from its competition, and if the company is changing and expanding, in what ways and how?

Third, and most important, strategic planning ought to establish a framework for making operational decisions. By clearly defining what business it is in, where it is going, what its priorities are, the company can formalize a set of criteria that are applicable to everyday business decisions.

This third item is important and many times it is one of the items most neglected as companies put together their strategic plans. You probably have been through the planning processes, where senior officers go away on a two- or three-day retreat and do a fairly good job on the first couple of items, taking a long-term view, discussing the issues facing the company, establishing an overall mission or vision, and usually setting a fairly broad set of objectives or philosophies the company will follow. But after two or three days of excruciating work, people are satisfied, they write a lot down and come back to the office. They document the results and put them in a three-ring binder, set it on the shelf and many times, don't get at the real work of strategic planning, which is putting actionable strategies in place which define a framework for making day-to-day operational decisions.

7. How Do Insurers Perform Strategic Planning?

I would like to address how insurance companies are performing strategic planning. Also, I would like to address the last issues, of why many times the planning process is not fully developed successfully.

8. Traditional Strategic Planning Approach

I will describe a simplistic and traditional strategic planning approach. I will be the first to admit that this is a very simplified base case orientation to planning. It is really common sense. There isn't too much magic in this approach, but I think it serves as a basic solid framework for looking at the process of strategic planning.

First, to initiate the planning process, senior management and the CEO need to get involved and send a clear signal to all employees in the company that strategic planning is important to the organization. It is my view that line management and the function heads within a company need to have that responsibility for putting together the strategies. A strategic plan developed by the corporate planning staff or by outside consultants that doesn't have a real buy in and real participation by line management is not likely to result in strategic action.

9. Internal Assessment

The second step is called internal assessment and includes examining the overall company, the business unit, and product line strengths and weaknesses. It also should include a delineation of specific issues that should be addressed in the strategic plan.

10. Environmental Analysis

The environmental analysis or external assessment, the third step, involves analyzing customers, markets, competitors, suppliers, and regulatory trends.

Michael Porter, in his books, does a pretty thorough job of describing an environmental analysis model.

11. Define Mission, Goals and Objectives

Next is the job of defining the mission, goals and objectives. This is where overall company direction is established. Some companies refer to this as defining their corporate mission or their vision for the future. In addition, specific company, business unit and product line goals need to be established.

13. Develop Alternative Strategies and Select

The next steps include developing alternative strategies, analyzing them and selecting those few strategies that are most appropriate for the company. This is where the real work of strategic planning takes place. Information needs to be gathered to support the various strategies and alternatives. Financial projections are very important in that process, and I will come back to that point later. After gathering information and analyzing alternative strategies, management must select those few strategies that are most likely to provide a significant competitive advantage and promote the company's success.

14. Finalize Strategic Plan

Lastly, the strategic plan needs to be finalized. This involves prioritizing strategies, establishing responsibility for components of the strategies, and setting performance measurement targets.

I have just described a straightforward, simple, basic, and traditional strategic planning approach. This approach needs to be tailored to the specific environment that you are working in and the specific issues in your particular company. Most of the time you don't start this process with a clean slate. You start with existing business lines, existing products, existing issues and successes. Many times, strategic planning is more a process of strategy repositioning than it is pure strategy development.

15. Representative Strategic Planning Approach

What I am going to describe next is a sample of an actual planning process. It is still fairly simple and straightforward. It illustrates the strategy repositioning aspects that I just mentioned. The example is from a group insurance company that was interested in diversifying beyond their traditional group products and was interested in looking at pension, 401K, payroll processing services, etc.

After an internal assessment and environmental scan have been performed, the planning process can be split apart. For example, strategy development for existing product lines is performed differently than that for entirely new products.

Things come back together in finalizing the strategic plan. This includes developing the implementation plans to support the strategies once they are selected and firmed up. This is another important item I would like to stress. Work plans and schedules need to be developed that answer the questions: "Who has to do what, and by when?"

Functional plans in the marketing, operations, and financial areas have to be developed to support the line of business strategies. Systems may need to be adjusted, modified, and developed in order to support those strategies. The organization structure may need to change somewhat with regard to some business lines or functional areas.

16. Financial Services Industry Survey

Now I would like to share the results of another survey of financial service executives: CEOs and planning officers who were surveyed about the use and results of strategic planning at their organizations.

Two of the survey questions were whether formal strategic planning is important and secondly whether the planning process has a strong positive impact on the organization. While this is a limited survey, there appears to be some correlation between the belief in conducting formal planning and its positive impact on company results. While the survey didn't test this, I would like to further suggest that strategic planning taken seriously and undertaken by those responsible for implementation is more likely to have positive results than planning that is not taken seriously or delegated to staff functions.

17. Strategy Implementation

As I pointed out earlier, the only effective strategic plan is one that actually provides a framework for making operational decisions. In order for a plan to be implemented, it needs to be interrelated with all of the key areas in a company that motivate, drive and influence individual managers and employees.

Most companies today perform some type of strategic planning. However, many companies that do planning and are committed to it have a good deal of frustration with what it actually accomplishes. And to illustrate this, I would like to describe the results of a survey of approximately 800 companies that were reported in *Harvard Business Review.* Over 87% of the people responding reported they were frustrated or disappointed with what their strategic planning activities were actually accomplishing. So for many companies, there is a breakdown between developing strategic plans and successfully implementing them. I want to discuss why strategies tend not to get implemented successfully, why there are implementation problems and, hopefully, add some comments about what can be done about some of the problems.

18. Why Implementation Problems?

In that same survey, the participants were asked about why they were dissatisfied with strategic planning and what was the major cause of strategy implementation problems. The results indicated that 67% of the respondents felt that strategy implementation failures were the result of poorly designed strategic planning activities or poorly managed strategy implementation processes. Now, the poorly designed planning activity really relates to those things I discussed up to this point. This includes having senior management committed to the planning process, having a practical plan that fits your organization, having line and function head responsibility for putting the plans and strategy together, and finally having well-defined specific strategies, action plans and responsibility assignments for carrying out those plans.

19. Quote -- Financial Director

The other part of the problem is a poorly managed implementation process. I found a couple of quotes that illustrate some of the pitfalls and why implementation many times is less successful than expected. First of all, "when you have two rival plans, the strategic business plan and financial plan, either you dovetail them or before long the strategic plan and the will to do it is dead." It's pretty apparent that the financial plan will get more attention than the strategic plan. This is especially true if your bonus and incentive compensation is based on the budget (financial plan).

20. Quote -- Executive VP

Another problem is doing everything piecemeal. "First the organization chart, that's done; then the plan, that's done; then the budget, that's done; then the bonus system, all that hard work but they don't fit together." All of the management processes need to be oriented toward that strategic plan. Otherwise, conflicting signals are being sent to the people in the organization and the plan is not very likely to be implemented.

21. Successful Strategy Implementation

In summary, I believe that the strategic plan in a company needs to be a center piece and a focal point for all the management processes that motivate and influence the employees' activities on a day-to-day and week-to-week basis.

Let me back up and give an example. Earlier I described a group company that went through the planning process. Let me breathe some real life into that example and explain what happened to that company.

The new products in employee benefits and financial services this company wanted to develop required different computer systems, different administrative functions, and different marketing efforts than those supporting their existing product lines. After the company completed the strategic plan and put months of effort into it and after getting all the right people in the organization involved in putting the plans together, they didn't make changes in the organization structure and they didn't make changes to systems. They didn't make changes in the compensation program to encourage management to finalize and launch those products. They didn't put sales incentives in place to actually encourage brokers and sales representatives to sell the new products. The CEO clearly stated that he wanted to accomplish this employee benefit strategy, but the company didn't make the kind of changes in the organization that were really necessary to get it accomplished successfully.

The company could have launched those new products, I believe, in the next 6, 12 and 18 months. But it actually took them around 3 to 4 years to get the new products on the street. The products are out now, and the company is having good success with them, but it took them a much longer period of time because they didn't address the pitfalls we have just discussed.

22. Financial Projections: Uses

Finally, to wrap up my part of the presentation, I will talk briefly about financial projections, their use in the strategic planning process, and selected issues regarding projections.

First of all, projections are used for analyzing alternative strategies. Part of the planning process includes looking at alternative strategies and selecting the most appropriate. Clearly, financial projections play a key role in this activity. Putting projections together lets you make a reasonable decision based on financial performance of a number of alternative strategies.

Projections are also used in sensitivity analysis by looking at the different outcomes each strategy produces on a financial basis given different marketplace expectations about what may happen.

Projections, of course, are also used to consolidate business units, product lines, and company-wide information. It's hard to make decisions about selecting strategies and at the same time have a good coherent game plan if you don't consolidate the financial impact of the strategies. Whether it is developing profit margins, REO or whatever measures need to be done, it is a key part of making the strategic planning process successful.

Finally, projections help serve as a basis for performance monitoring on an ongoing basis.

23. Financial Projections: Issues

There are several issues pertaining to projections I would like to discuss. A typical issue with respect to projections is there is often a difference between an insurance company's legal organization and their operational organization structure. And, of course, statutory and regulatory reporting must be prepared for the legal entities. By the time the actuaries and accountants finish the financial reporting for legal purposes, they are many times a little worn out and in no mood to do it over again for the business units.

The solution is a lot easier to describe than to put in place. It is necessary to have either good automated systems that support this process or have adequate skilled manpower to carry it out.

For projections to be the most useful in planning, they should be developed by product line and distribution channel. Many times your company's product lines and distribution channels cross, and this makes the projection process a very complex effort. Flexible systems help meet this challenge or the company must have a tireless staff that is willing to rise to the occasion.

Another typical problem arising from projections relates to the underlying assumptions. Sometimes the assumptions are not stated clearly or not comprehended completely by senior management. All too often, the assumptions don't represent marketplace reality or cost structure reality.

My view is that projections that are not based on well-communicated, reality-tested assumptions are worse than no projections at all. They are misleading, and they are dangerous to your company. Finally, information systems play an important role in making projections within the strategic plan a useful competitive tool.

24. Quote -- Insurance Executive

I would like to conclude with a quote from a corporate planning officer of an insurance company. He said, "We expected too much of strategic planning and were disappointed. Now we know that planning is part of a larger process, and mastering that is fulfilling our expectations."

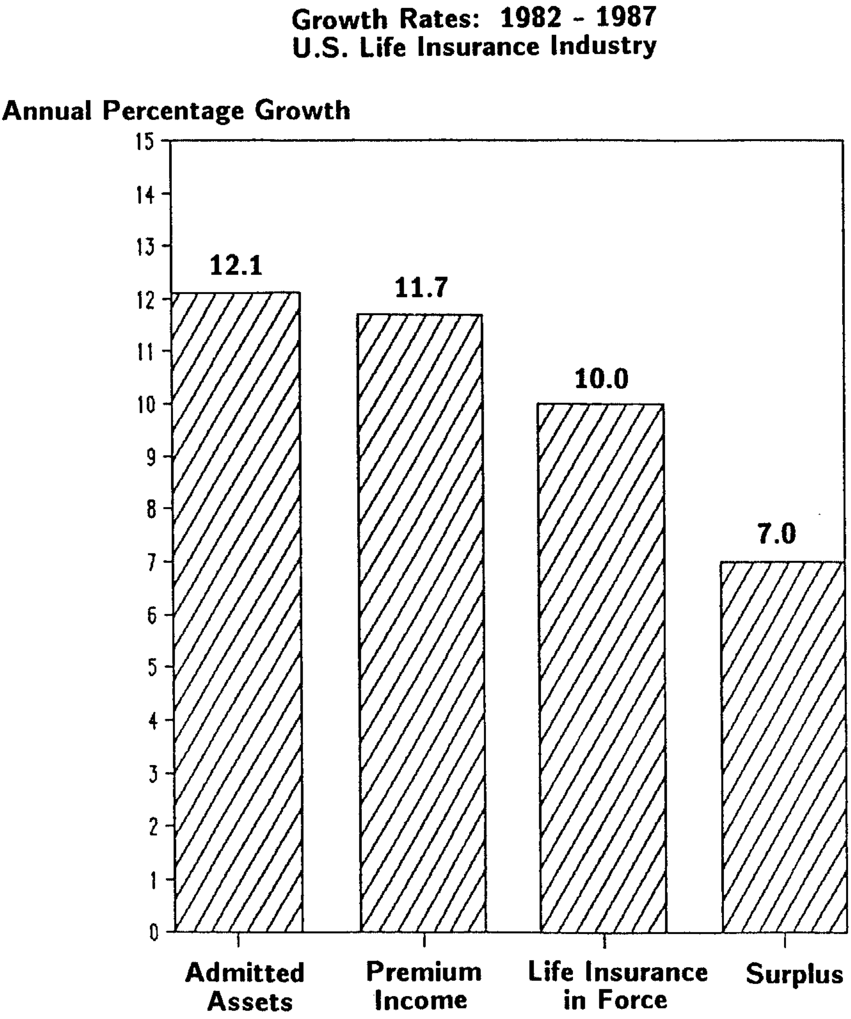
I would like to end my presentation by saying that neither strategic planning nor financial projections alone will do much to improve your company's competitive position. With the discipline and thoroughness that the earlier CEO cited, and by having all parts of the management process oriented towards your strategic plans, strategic planning and projections can make the difference between success and failure.

MR. KISCHUK: When developing corporate plans, there is always a tendency to focus on projecting profits. This is especially true with today's intense competition and narrow profit margins. As a result, companies often give insufficient attention to projecting balance sheets and surplus position. Inevitably this leads to unpleasant surprises. Often strategic plans must be scraped altogether because there is not enough surplus to carry them out. This problem can be avoided by giving equal attention to planning the balance sheet and the income statement.

Over the past several years, business in force has grown at a much faster rate than the industry's surplus. Graph 1 illustrates this by showing the relative growth of surplus, assets, premiums and life insurance in force from 1982 through 1987. Surplus has been adjusted for investments in subsidiaries and affiliates. During this period, surplus grew by 7% per year. At the same time, assets, premiums and life insurance in force grew by 10-12% per year.

Clearly, the life insurance industry has become more leveraged during the past five years. This trend is shown in the Graph 2. From 1982 to 1987, the ratio of assets-to-surplus increased from 20-to-1 to 25-to-1. In other words, leverage

GRAPH 1

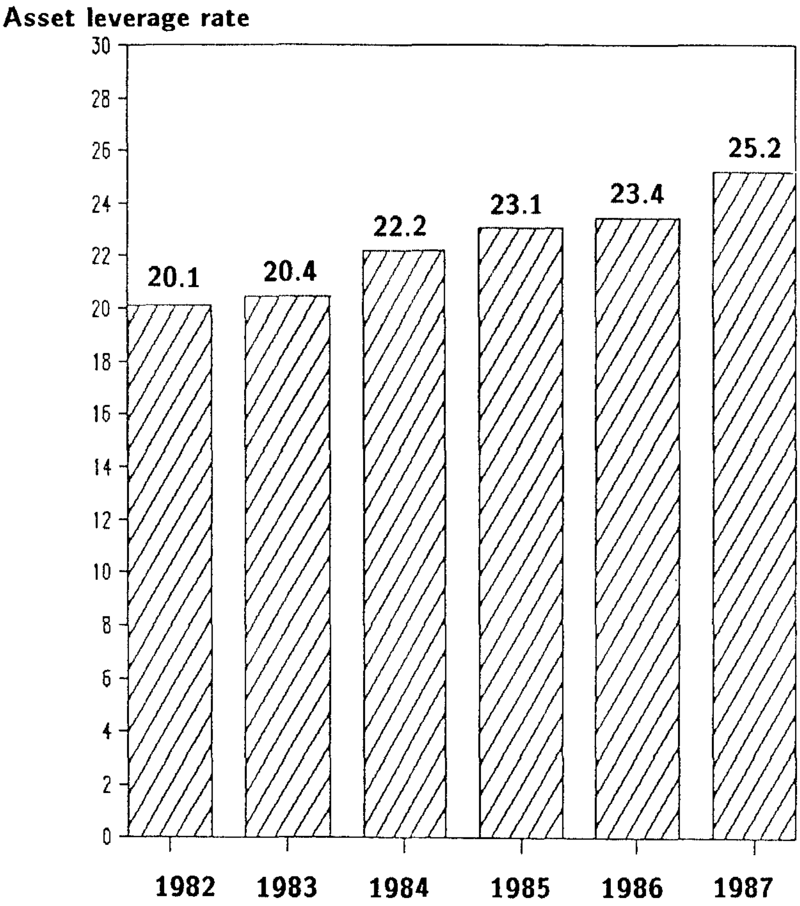


Best's Aggregates and Averages
1983-1988
used with permission

GRAPH 2

Leverage

U.S. Life Insurance Industry



Best's Aggregates and Averages
1983-1988
used with permission

increased by 25%. Other leverage ratios indicate a similar trend. The need for life insurance surplus is increasing faster than surplus is being generated.

The same picture is reflected in recent Best's rating changes. In 1987, ratings were reduced for 91 companies while ratings were increased for only 43 companies (Graph 3). In explaining the rating reductions, A. M. Best cited a number of factors. Industry profitability declined for the second year in a row, mostly due to underwriting losses in health insurance. Meanwhile, assets continued to grow at double-digit rates. Non-investment grade bond holdings increased, and there was a corresponding increase in delinquent and nonperforming mortgages. The market value of the industry's bond portfolio fell below its statement value for the first time in recent years.

This does not indicate that we are in a crisis situation. However, serious problems will certainly begin to develop if these trends continue. In order to carry out their ambitious plans for the future, life insurance companies must manage their surplus positions strategically. Surplus objectives must be part of the corporate planning process. Also, the management reporting system must include current information about the company's surplus position and there must be ongoing management action.

Fortunately, there is a financial tool that can enable insurance companies to project and manage their surplus positions. It is called the "sources and uses of funds statement." However, it is not widely used in the insurance industry. And when it is, it is very often misused. Also, statutory and GAAP financial statements include exhibits with similar titles, further confusing the issue.

The funds statement for insurance companies should focus on the sources and uses of statutory surplus. "Sources" include both statutory earnings and "below the line" adjustments to surplus, such as capital gains and paid in capital. "Uses" include shareholder dividends, increases in non-admitted assets, investments in affiliates, investments in profit centers, etc.

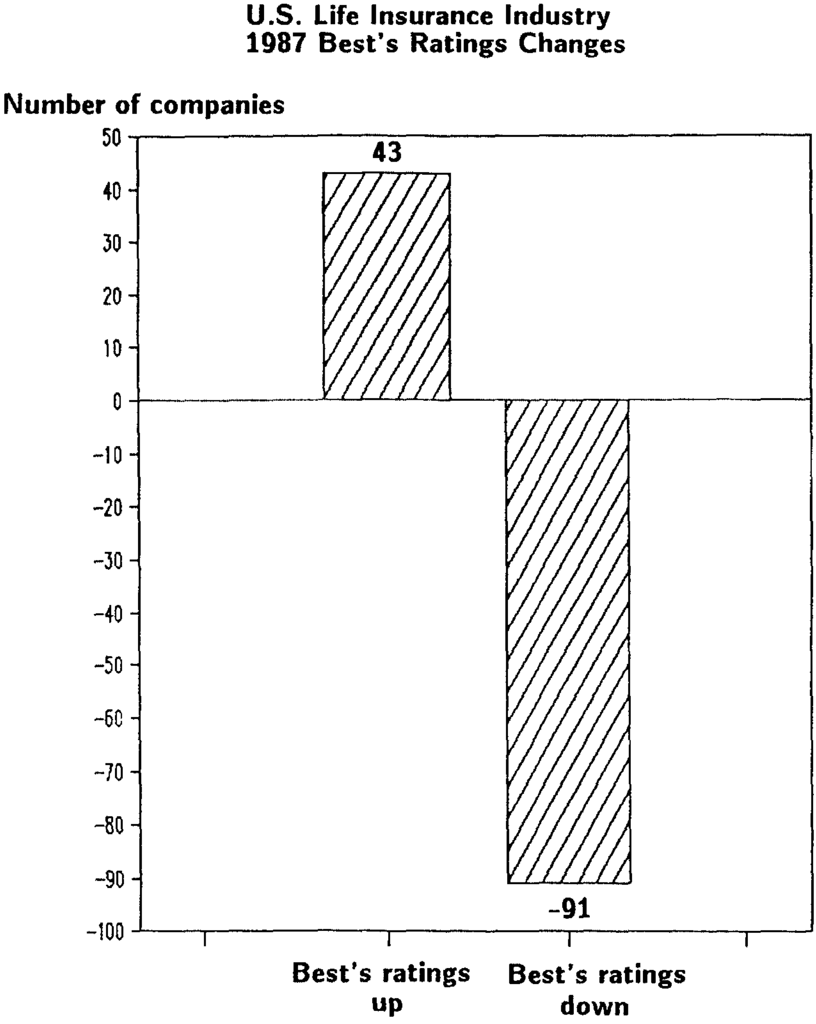
The specific items that are considered in a funds statement must be consistent with the surplus standards and surplus objectives of the company. The format of the funds statement will also vary depending upon the corporate structure (holding company, downstream affiliates, etc.) and whether the company is stock or mutual.

In projecting sources and uses of funds, there are a number of issues that must be considered. Depending upon the purpose of the projections, new sales may or may not be included. The actuary must specifically consider what margins for adverse deviation may be appropriate. And the time horizon must fit the purpose for which the projection will be used. Projections may be for a specific time period, such as five years, or the period may vary depending upon the management decision that is being considered.

It is not possible now to go into a detailed discussion of what a sources and uses of funds statement should include and what it should look like. As we'll see, even with the ability to generate these statements, most life insurance companies today would still be prone to unexpected changes in their surplus position.

Looking again at the life insurance industry as a whole, we can gain a perspective on the stability and importance of some of the major sources and uses of

GRAPH 3



Best's Aggregates and Averages
1983-1988
used with permission

surplus funds. Graph 4 shows that ordinary life profits have been a stable contributor to the industry's surplus. Actuaries spend a great deal of time and effort in projecting life insurance profits, both in the aggregate and by source. Yet this is probably the most stable and predictable source of capital. Annuity profits are somewhat less predictable, but annuity writers have developed elaborate models that enable them to match assets and liabilities and to project profits.

As Graph 5 shows, health insurance can provide significant profits in some years, but it can also generate large losses. Executives of most health insurers were surprised by the underwriting losses that developed in 1987 and 1988. The ratings of some companies were downgraded, and the ratings of many other companies have been threatened by this development.

This underscores a major deficiency in the corporate planning models at most companies writing health insurance. While large investments have been made in purchasing or developing models for life insurance and annuities, very little priority has been given to projecting health earnings. As a result, health insurance projections are generally much less reliable. Many companies have difficulty predicting health results from quarter to quarter, much less from year to year.

Capital gains are also a large and fluctuating source of surplus (Graph 6). Swings in investment gains and losses are often more significant than operating gains in planning the amount of surplus that will be available to support the company's growth strategies. And like health underwriting losses, capital losses have the potential to generate unpleasant surprises for company executives, often threatening the company's ratings. Yet most corporate planning models either ignore capital gains and losses, or else treat them very simplistically.

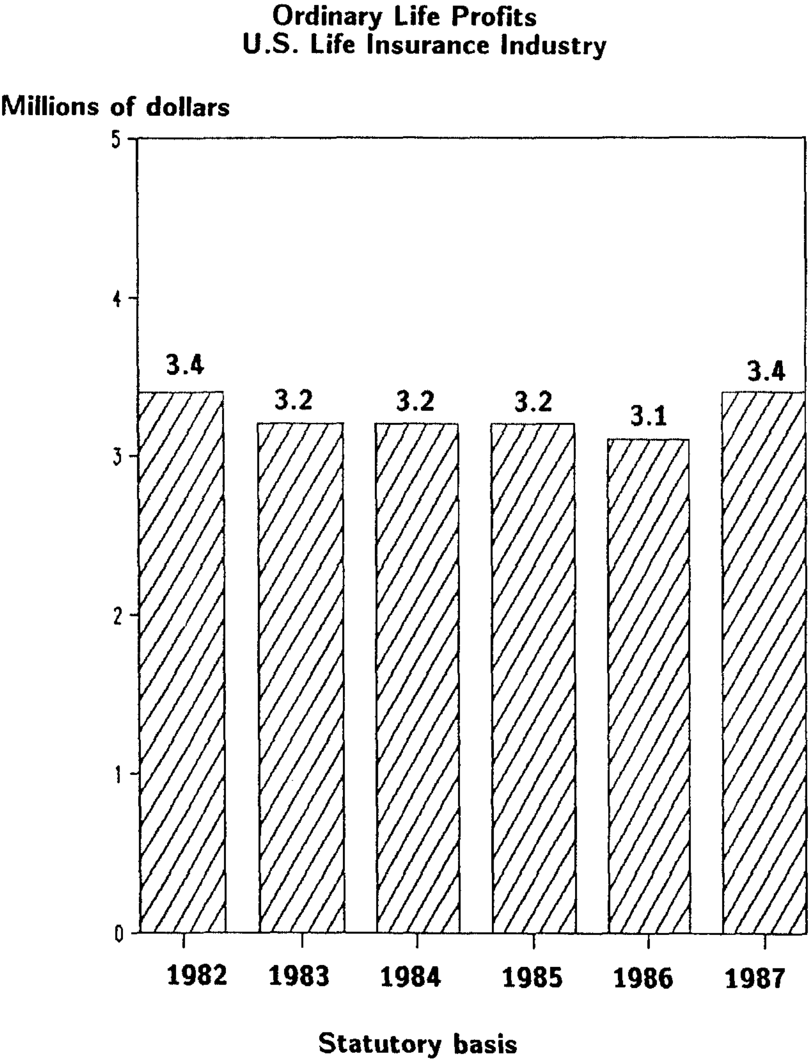
Finally, we can see that investments in affiliates have consumed a large percentage of the surplus available in recent years (Graph 7). Most corporate planning models assume that all of each year's increase in surplus will be available to support the growth of the company's in force business. Realistically, these models should incorporate management's strategies for acquisitions and the formation of new subsidiaries. Also, they should anticipate the need to fund unexpected operating losses and the growth needs of subsidiaries.

The life insurance industry's surplus position has been declining relative to the growth of business in force. While we are not yet in a crisis situation, serious problems will emerge if present trends continue. Insurance companies can manage their surplus positions by incorporating sources and uses of funds statements into the financial management process.

In addition, companies must improve their ability to project sources and uses of statutory surplus. In order to do this, companies must develop better capabilities to project and manage health results. Investment strategies must be designed to avoid surprises and to better anticipate the timing and amount of capital gains and losses. Also, corporate projections must reflect a better understanding of the impact of acquisition and diversification strategies.

Finally, it is not enough to set surplus objectives. To be able to manage the company's surplus position, management reporting systems must provide balance sheet information on a timely basis. This information must be summarized and presented in a form that can be understood at a glance by top management and

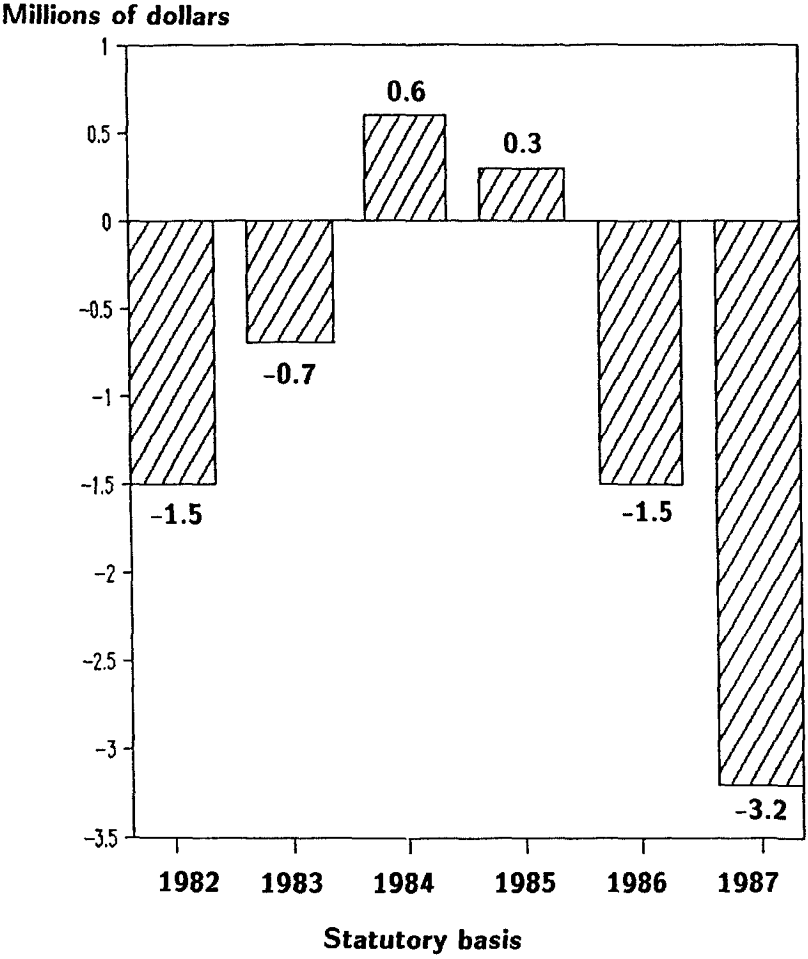
GRAPH 4



Best's Aggregates and Averages
1983-1988
used with permission

GRAPH 5

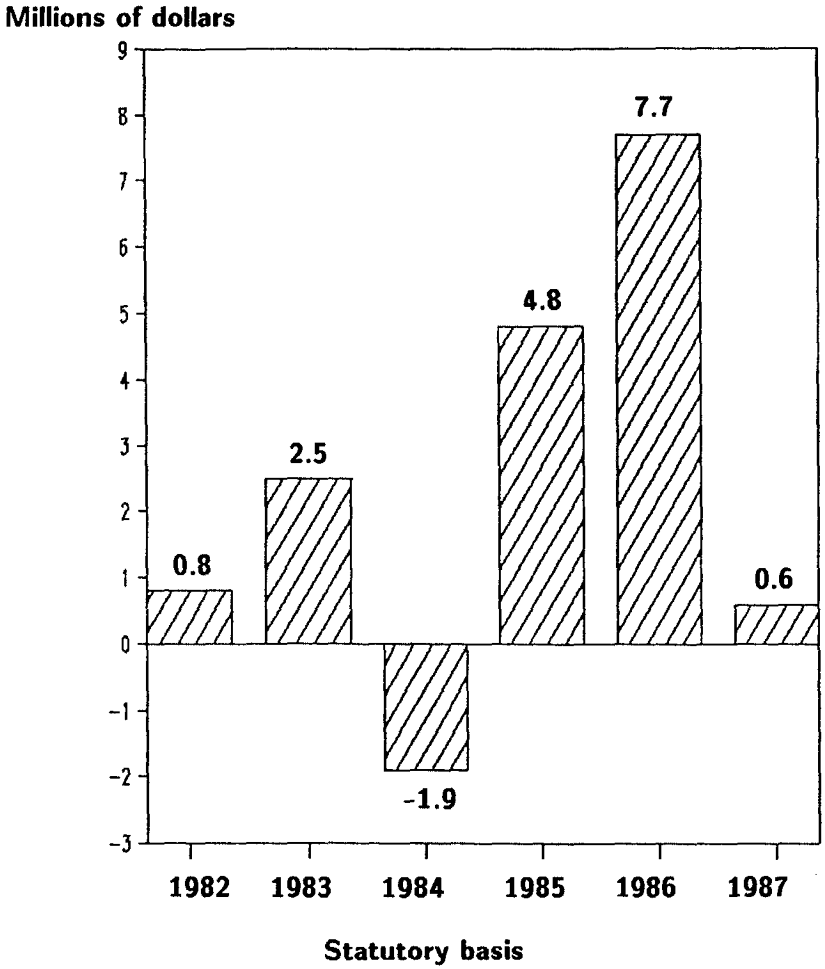
Health Underwriting Gain
U.S. Life Insurance Industry



Best's Aggregates and Averages
1983-1988
used with permission

GRAPH 6

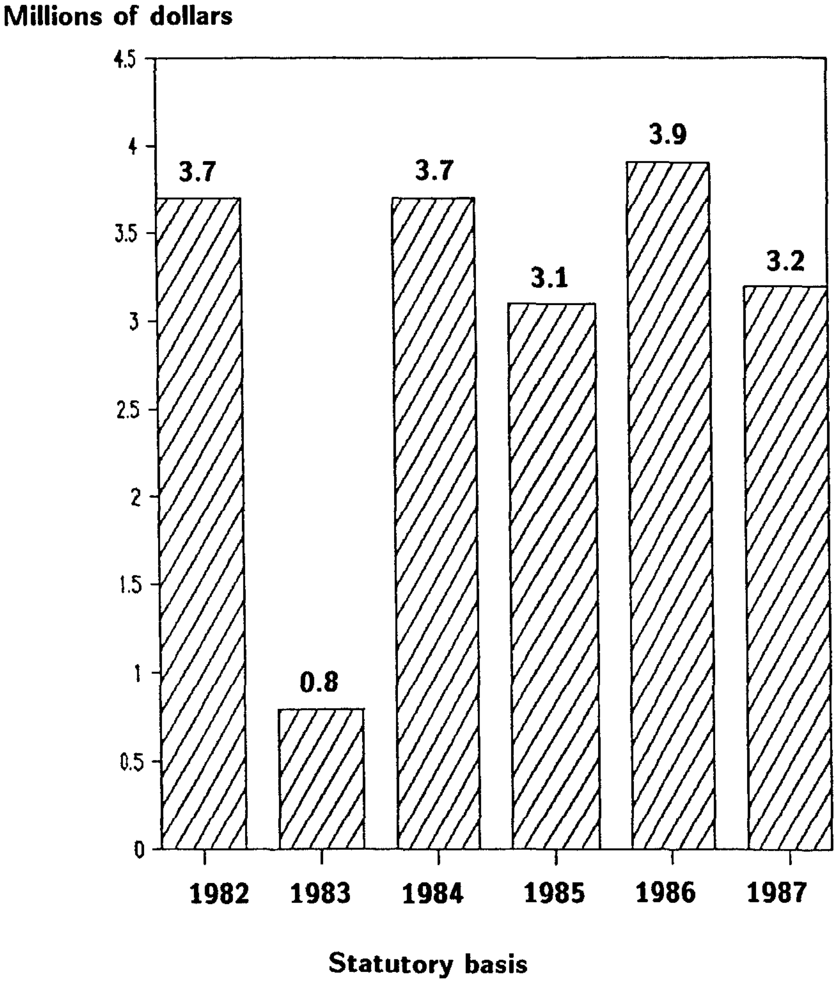
Capital Gains, Before Taxes
U.S. Life Insurance Industry



Best's Aggregates and Averages
1983-1988
used with permission

GRAPH 7

Increase in Affiliate Investments U.S. Life Insurance Industry



Best's Aggregates and Averages
1983-1988
used with permission

the board of directors. This is the only way to avoid the traditional year-end surprises and unexpected deterioration in surplus position.

Next, we will turn to Frank Irish. Rex and I have talked about fairly conceptual topics and a lot of panels will stop there and expect you to go back to the office and get excited about implementing these ideas. The first thing that happens is that you run into a lot of practical problems. Frank will give you a preview of what those problems might be.

MR. FRANK S. IRISH: When the discussion turns to the practical aspects of corporate planning projections, one of the first things we have to recognize is that a request for projections almost always appears as an unwanted burden to those who have to do the work. In most cases, the ultimate consumer of the projections is either the business unit manager or corporate management. I think we should give consideration to both types of consumers in our forum here, but the title of this forum is Corporate Planning/Projections, so the emphasis here will be on the projections that corporate management needs. Thus, we typically have a request for projections coming from a corporate functionary who is entirely outside the business unit or department where the projection has to be produced.

Everybody agrees that projections are a necessary part of running an organization. There are very few people around nowadays who say, "Why do we have to do all of this planning stuff?" (at least they don't say it out loud). But the incessant demand by corporate management for projections of all types is bound to raise the question of whether it is desirable to put as much energy as we do into the making of projections, particularly when the burden tends to fall on financial reporting specialists who already have more than enough to do to create accurate reports of the recent past. It would be wise, therefore, that corporate personnel know just what objectives they intend to fulfill by asking for projections so that the request is not seen as simply a mindless intrusion. It is for this reason that all of us who think about this subject are very careful to ask ourselves the question, "Why do we do corporate planning projections?"

The preceding speakers have already addressed the same question, so I'll try to avoid repeating in great detail what they have said. My own list of reasons includes the following:

(1) Projections tell you what the impact of your plans will be. This may seem such an obvious point that it's hardly worth stating, but unless you ask for it, you may not get it. Product line management needs to put together its plans and assumptions to determine the effect this all may have on the overall aggregates.

(2) Corporate management needs to do capital budgeting. The nature of capital budgeting varies between stock and mutual companies, but essentially it is a matter of determining that certain lines of business are going to absorb capital and others are going to be suppliers of capital. The process has to be managed, and it can't be managed without projections.

(3) Corporate management also needs to know how to allocate other resources; for example, the investment department needs cash flow projections to do its work; the personnel department needs to know personnel needs; the computer department needs to know projected computer usage, and so forth, all the way down the line.

(4) Corporate management needs to have some kind of base line so it can judge actual results in the light of what was planned. Unless plans and assumptions are turned into projections which can be compared with accounting results, it really is difficult to know whether an operation is on target or not.

If you are on the corporate side, an understanding of these reasons will help you to design your projection request competently by testing each request against the basic reasons for doing projections, and if you are on the business unit side an understanding of the reasons why we do projections will help you when you have to allocate so much of your own time and energy and that of others around you to the making of projections. It might also help you to resist an inept request from corporate headquarters.

In the actual projection process there are a number of pitfalls that one has to watch out for; many of these have to do with how we schedule the projection process and the kind of accuracy we look for. In my experience, the process of making projections places some unusual strains on the communications within an organization.

I have seen, for example, situations where the projector was unaware of a change in allocation procedure; or perhaps that the administrative department down the hall was about to institute an expensive new computer system; or the sales growth, which had looked so good on the recent monthly reports, was entirely due to a sales contest (and everybody in the sales department knew that sales were going to fall off dismally next month but the projector didn't).

In short, we have pitfall number one: the projector doesn't know everything that is going on in his own business unit, let alone everything that is going on in the company as a whole.

Pitfall number two is the tendency to straight-line variables; that is, to look at past trends and extrapolate them into the future. The projectors might do this either because they feel that the variable is unimportant, and therefore unworthy of more detailed work, or they may do it because they don't really understand the forces that determine that variable. Compare the remarks that Rick just made about understanding the forces that affect health insurance results.

And a third pitfall is the tendency to be optimistic in projections. This may arise from a simple human tendency to assume that everything will go well, but it may also arise from a manager's tendency to believe in the future of his own operation. After all, we are talking here about a planning process, and everybody plans in order to achieve good things. It is unlikely that plans will be submitted that are accompanied by projections which show unsatisfactory results. Honesty in projections is hard to achieve, and it is equally hard for the consumers of projections to sort out those which really have a chance of success.

The first two pitfalls I have spoken about can be mitigated by more attention to the projection process (that is, the problem of communication and the problem of treating some variables as straight-line trends). Provide more time for review of projections before they are stapled together and presented to top management. Let the corporate departments question some of the projections and go back to the originating departments with their questions before things get to the point where defending the projections before top management becomes a matter of pride. Let people see each other's projections and the way their projections fit together in the whole so that they might recognize inconsistencies and bad assumptions. If you have each one of your product lines estimating their investment income, for example, does the investment department agree that the total for the entire company is appropriate? Or if the investment department estimates investment income and its allocation by product line, do the product line people agree that the proper assumptions have been made about asset growth, etc.? In other words, allow plenty of time and give plenty of encouragement to interaction at a non-threatening level. Do not treat the projection process as a simple compilation of projections from various departments around the company.

I don't know, however, if these suggestions will help very much in solving the problem of optimism. This is, to some extent, a top management problem; whose projections do you believe? In some cases the top management gives the controller's department or the planning department the opportunity to criticize projections as being unachievable, or at the very least, unlikely of achievement. One should be able to look at a projection in terms of a probability distribution of outcomes; the projection should represent the median of the probability distribution. In other words, there should be a 50% chance of doing better than the projection but very rarely do the projections submitted really meet that criteria. I really don't know many managements that have successfully solved the problem of optimism in projections.

One could say, of course, that a projection is not really a forecast. For example, one of the principal purposes of making projections is to test out the impact of variables upon the future. One might very legitimately use something other than the expected value in order to test sensitivity, or to try out alternative plans. I think that when we speak of corporate planning projections the likelihood is that the projection will be viewed by everybody else as a forecast. I am a firm believer that management should delegate responsibility for the accuracy of projections by treating them as a sort of contract with the business unit manager. The idea is that the business unit manager is responsible for the achievement of the projection, and therefore won't turn in a wildly unrealistic projection. The trouble with this approach is that conditions change and business unit managers change. If you make your projections into a contract with the business unit manager, then you are going to get some who project conservatively to make sure that they achieve it; then you're going to get some who are wildly optimistic so that they can get the approval they need to go ahead with their plans hoping that if things go badly, they will be somewhere else or everybody else will have forgotten by that time, or conditions will have changed so much that it won't seem reasonable to ask that the projection be achieved.

The question of dealing with optimism and projections is very much like the problem of plan approval itself or like the general problem of making good business decisions. It's very difficult for management to know what to believe.

The relationship between the corporate planner and the business unit planner is a very tricky one in this regard. If the corporate planner thinks that it is his function to attack the credibility of every projection that he gets then he sets up an atmosphere of confrontation, but worse, he tends to place the responsibility for sound projection work upon himself rather than the business unit. Despite the fact that a confrontational flavor is almost unavoidable, nevertheless, a relationship of trust must exist. The business unit people are the ones who know what is going on; their professionalism and probity are the main defense against bad projections. And I am speaking here as someone who has spent most of his life on the corporate side and I know how much I depend on the high quality of all of those people and their work out there. This high quality can be achieved only if both sides work to achieve it. If this kind of cooperation is working well, then projections will have the potential of achieving at least one of the principal purposes which is to communicate in a useful fashion an informed opinion to corporate management about the outlook within the business unit: accounting reports could be said to be working at their best when they unfailingly represent to management what truly has been going on within the business unit, so could projections said to be working at their best when they unfailingly tell management about the outlook for the business unit.

In this way, projections will achieve another one of their purposes which is to form the basis for the capital budgeting process. Essentially, the planning process, as it works in a decentralized organization, represents proposals to utilize the corporation's resources to achieve objectives; capital is the most important of these resources. The central core of the plan approval process is the allocation of capital to its most appropriate uses. A trust in the quality of projections is obviously a key element for top management to do this job well.

If, therefore, one of the principal purposes of making projections is to provide informed insight into the outlook for various parts of the company, and if another purpose is to lay the foundation for resource allocation, then clearly the projection process should work.

So this information flows up to corporate management whenever there is a change in outlook. Ideally, therefore, projections should be made on an as-needed basis rather than the once a year that we usually see, but this puts even more of a burden on the people who have to prepare them and the people who have to administer the process. I think that the obvious answer is to make projections continuous and on line so that the projection models are available at all times and changes in assumptions can be quickly cranked through, as they say, to provide management with the signal that the information on which it has acted has now changed.

This obviously leads to consideration of software packages for projections. Clearly if projections are going to meet the standards that I have set for them, they are going to have to become computerized. And, that means, not only that computer programs have been devised to carry out particular projections, but also that the compiling process is computerized with mechanical links between the various parts of the process and that the computerization permits an openness and a review of one another's assumptions that are impossible in a paper environment. It may well be that one of the several projection packages which are available on the market is the best thing for this. I can't comment too authoritatively on this, and obviously we could get into an area of product advertisement if we went too much further, but I do believe that putting your projections on line is a solution to a lot of the problems and that this might or might not involve the use of an outside vendor.

Finally, there is the question of what horizon to use in projections. Here I guess I am repeating some of the things that Rick said and I think we both agree on this subject. Typically, corporate planning projections tend to be five years. To a lot of people this seems to be a natural and comfortable projection period. Most company operations involve a second set of projections which are for one year and are typically more closely involved with the budget cycle. In the one-year projection process, departmental plans can become contributors to what we call the financial plans through the mechanism of the budget, and a large number of people can become contributors to what we call the operational planning cycle as distinct from the strategic planning cycle. The operational planning cycle thus typically involves a lot more input of information; tends to be a lot more realistic; and forms the basis for day-to-day decision making. But as Rex warned us, clearly the one-year plan must be viewed also as the first year of the five-year plan, and an integration between the two must be achieved. There are cases when a planning horizon of even more than five years is appropriate. Typically, these are projections for the purpose of acquisition or for particular cost-benefit analyses.

In summary then, let me urge you to view projections as part of the planning process, but not as a substitute for planning. Keep an eye on the kinds of things that go wrong typically in projection work, and be explicit about the purposes of corporate planning projections, and I think you will have a better projection system.

MR. KISCHUK: Thank you very much, Frank. I think a presentation like that one is often missing in sessions like these. It ties in with the message that Gary Corbett is delivering about the actuary of the future. Technical skills are very important in corporate planning projections, but possibly the most important skills an actuary has or corporate actuaries have are interpersonal skills. You can live with less sophisticated projections if the process harnesses the input of all of the people in the organization. In fact, my own view is that many companies would be better off with a simple electronic spreadsheet rather than a complex corporate model, combined with the process that Frank alluded to that really seeks input from all around the company.

MR. BRUCE LOUGHRAN: During your talk about the planning process the need for realism is mentioned, but sometimes it is not so much optimism on the part of the people who are putting the projections together but rather what the corporate people want to see and perhaps justifiably so. If you are projecting a status quo or fairly flat pattern of earnings, someone may say: "You can get anybody to do that. Why do you have all these people here?"

I am wondering if you can say that optimism is wrong. Perhaps you may have to define the level of projections that are associated with a 50% chance of being achieved. At the same time, this would drive people to work harder to achieve their goals.

MR. IRISH: I don't know the answer; I wish I did. You know you are right. You start off with the assumption that if you come in with a plan that is accompanied by a projection that doesn't show an adequate rate of return or a very unexciting outlook for what you propose to do, then probably you are thrown out of court immediately. Therefore, why come in with a realistic projection? That is what you are asking. Isn't it the attitude of corporate management that causes this to happen? Probably so, and I don't really know the answer. As I said, corporate management has to lay the foundation for a certain kind of openness and understanding of objectives that prevents this sort of thing from happening. It is really not a projection problem, but really a management problem. As I said earlier, as with any other business decision, how does management get the true facts out of the people who are reporting to it?

As to the second part of your question, whether purposely optimistic projections can be made in order to encourage better performance and motivate people to scramble to achieve the projections. I can quote the practice in my own company where one-year projections are used as part of the incentive plan. It is the practice of management that the most likely projection will be given a score of 80% with 100% being the average bonus. In other words, you are expected to turn in a projection that is considerably more demanding than you expect to achieve. If management perceives that you are not doing that, it will take your projection and stretch it. If I am supposed to say that I have seen this operate to make people work harder, I am not going to say that. I have never seen it happen, and I just don't think it works. I think what happens is that people work just about as hard as they can anyway. I just don't think setting unrealistic objectives for them or stretching their goals a little bit really brings out any more. I would like to see a clear understanding that a realistic projection is just that.

MR. WILSON: I basically agree with Frank's comments that optimism is a cultural issue or management process issue. From experience, I see companies performing both optimistic and reasonable assumption projections with multiple scenarios of what they think may happen in the future. As an example, I do two sets of projections for my business unit at Ernst & Whinney. One is a best-case scenario where everything goes well, and another set of projections is based on what I really think we can accomplish and what I am willing to commit to for my business unit over the next 12 months and beyond. I think many insurance companies do the same types of things.

Back to Frank's point, there needs to be open communication and challenges to optimistic projections to determine if they are optimistic or realistic. Individuals need to support the achievement of their projections. They should defend and communicate their beliefs as to why they believe the projections are accurate or why they believe they are optimistic or why they believe they are realistic.

MR. KISCHUK: As Frank indicated, you don't want to have an adversarial situation where you have different sides at war with each other. That just is totally counterproductive. When companies start this kind of planning process, the first couple of years are often done in a way that is not tied to an incentive plan. It is not tied to any evaluation so that both management and profit center management can learn together. It is guaranteed that when you start planning anything there will be some big errors in your plans and you are going to have some variances that will be hard to analyze. It helps to put in place a process for analyzing variances and discussing them. It is guaranteed that in the early going, reasons for some of your variances will be poor planning and poor projections. You just don't have all of the information that will be needed at the outset to develop good projections.

DR. ALLAN BRENDER: First for Frank Irish. I would assume that you should not only be aware of inconsistencies, but, in fact, that you should expect them. To some extent you should welcome them because one of the first things that you will learn is how little people talk to each other and how little they know about the rest of the company. This is one of the biggest advantages of starting the whole process. It is a good reason to keep it ongoing. You should look to your results for those inconsistencies.

The second statement is a question to Rick. You were talking about affiliates. In Canada we are getting into the surplus allocation problem. We are using a phrase called "no double counting." I am wondering if this is what you mean. That if a parent has a subsidiary, which in itself is a financial institution, and therefore, has capital requirements to back financial guarantees, then the parent's investment in the subsidiary can't be used to reach its own capital requirements because that capital is already backing some other guarantee. So, you have to subtract all of that when looking to the parent's own plan. Is that what you had in mind?

MR. KISCHUK: Yes, that is what I had in mind. You shouldn't be able to create surplus by pyramiding companies. Obviously then you are creating surplus out of thin air. And it really goes beyond that. I think that subtracting the value of the affiliates is the first step. In some cases you may see a subsidiary, particularly one in health insurance, property casualty or other lines, that is losing money and you observe that this company is going to have continuing operating losses for a while into the future. You know that there will be a need for capital contributions to that subsidiary. In that instance, I would say not only should the current book value of the subsidiary be subtracted, but there should also be a provision made for future capital contributions to keep that subsidiary going. (This assumes there is a commitment to keeping the subsidiary going.)

DR. BRENDER: In Canada we are going to be requiring actuaries to perform projections to satisfy professional requirements and solvency testing requirements. We expect that these reports are going to be done during the summer based upon the previous year's year end. The reason for the 6- to 8-month delay is twofold. First, no one can do it all by year end. Second and more importantly, we assume that people are going to need fairly sophisticated corporate projection models in order to satisfy the professional requirements.

We assume that strategic planning is performed in the spring, and that the actuaries will be able to use this software to do the financial projections associated with the internal strategic planning for the company. By the time they satisfy their professional requirements, they will have also done the work as part of the corporation's planning and everyone benefits.

MR. KISCHUK: I thought this might be a perverse plan by the regulators to keep the actuaries from having a summer vacation and keep them busy all year round.

DR. BRENDER: No, the profession is doing this to itself.

MR. WILLIAM A. ZEHNER: Getting back to the point that timing of the projections should be made in the spring. In particular, in small companies the forecasting is now done backwards. Capital budgeting is decided upon first to develop a sales plan. Then the one-year forecast and the five-year forecast are performed towards the end of the year after all the decisions have been made. As a result, if anything has gone astray of management's expectations, there is little time to redo your capital budgeting and your commitments. I was wondering if anyone has had experience with companies calculating a baseline forecast, say at the beginning of the year in January, February, or March after the annual statement is completed for the next year, and then basing your capital budgeting on that. Then a forecast can be performed three or four months before finalization of the budgeting so you can make adjustments.

MR. WILSON: Most of the time, I see companies put together their strategic plans starting in the summer, or late summer early fall. The first part of the strategic plan is to look at sales forecast projections for a number of years out. Then comes the capital plan or capital budget and later in the fall, the annual budget for the next 12 months. This is the sequence I have seen more than any other. But the reverse, as you describe it, sounds like a problem.

MR. KISCHUK: If you look at an ideal scenario, there is no reason to redo strategic plans for every business unit and every profit center on an annual basis. If you do a strategic plan right, it should hold up for many years. That means in any given year you should only be redoing strategic plans for a subset of profit centers, and that would be mainly for profit centers where something fundamental has changed in the external environment or in the competitive environment, or it is pretty obvious that the strategic plan that you drew up simply is not working. Now with that in mind you still have to come up with a five-year plan and so forth.

Frank talks about a fairly continuous process of updating 5-year plans where even those wouldn't necessarily be redone across the board each and every year. With that kind of a process going on, continually, and as needed, you do get a baseline for the projection process.

MR. HAROLD MAGNUS*: A couple of comments. First, in a company I worked for, we had a particular problem that needed to be eliminated; the goal being zero. We developed three plans -- a 6-month, a 9-month and a 12-month plan. Then we presented them as that and said, "We don't think 6 months is doable but we really would like to have it done." We gave the people in the clerical areas who were going to have to do the work some relatively minor incentive -- ice cream socials, a couple of lunches -- if they hit that top six-month goal. They turned around and did it, but they knew that management was asking them to do a little extra and was willing to recognize them for it. Presented in that fashion, they went after it, accepted the challenge, and they did it.

I have seen places where the "gold plan" was put out there, the silver and the bronze weren't; nobody made it this year and nothing happened. Nobody made it next year and everybody quit work. The point was well taken. There is a lot of peer pressure, especially in long-range plans, to perform at a certain level that the least productive workers are comfortable with. I think plans can be self-defeating if they are just thrown out with no rewards, no penalties or anything tied to them, and no effort to keep the quality of work of staff up to a high level. Planning must get involved with the personnel side. You have to follow through with the right people and they have to be motivated to do it.

MR. KISCHUK: He referred to the clerical level and you also see this in companies beyond that level. You see companies that have expense problems and managers continually going over budget. In a lot of cases, you ask the question, "Can anybody think of an example of a manager who has been penalized in any way for going over the expense budget?" Quite often the answer is "no," and it becomes self-evident why the company has an expense problem.

* Mr. Magnus, not a member of the Society, is a Products Specialist in the Insurance Group with Electronic Data Systems in Plano, Texas.

I have a question for either of the other panelists. Have either of you noticed an impact on corporate planning projections because incentive plans are being implemented? Are projections more optimistic or more conservative as a result?

MR. IRISH: Well, aside from the question of optimistic or pessimistic, I think tying projections in with incentives certainly has one big advantage and that is it gets people to pay attention to the projection process and this is a real plus. It really begins to mean something to people when they know it is tied into the incentive plan. As far as whether it makes them more optimistic or more pessimistic, I have seen both. I really have. I have seen people who want to be heroes and turn in wildly optimistic goals, and, of course, I have seen the opposite kind of game playing. I think if you do this, and it becomes part of your company practice, you are almost bound to get to the point where everybody knows the game and comes in with projections that are just a little pessimistic, but I think that is something that happens over a period of time. At the outset, you get some very funny reactions by tying the incentive plan together with the projection system. I think the most important thing is that people begin to care about the projections and what they say about where the company is headed.

MR. KISCHUK: I might just add one point to that and it is that incentive plans don't have to be totally based on financial projections but can be based on the achievement of non-financial objectives that are part of a long-range strategic or annual plan. It is my experience that companies often need incentives that are based not just on achieving financial results, but also on the achievement of harder to quantify objectives as well.

Some companies have a hybrid measure where both financial and strategic measures tie into the incentive plan by ranking a performance measure and then comparing it to the competitive universe. Others tie the performance measure to an improvement in the standing of the company compared to competitors. Some companies avoid doing that but other companies have had very good results.

There is one question that comes up quite often, and I am sure that Frank has probably heard it. Frank, you alluded earlier to the fact that when you do a five-year plan, people generally plan for good things to happen and not for bad things to happen. I think that any of us who have worked in the area notice that when you add up the numbers, especially the fourth and fifth years of the plan, you are always very happy about the results that might be achieved. In a company that I used to work for we had a 15% ROE objective, and invariably every profit center projected that they would be achieving a 15% ROE by the end of the five-year period. I heard an executive once who paraphrased Will Rogers by saying: "I never saw a five-year plan I didn't like." Five-years is a very popular period and the question quite often comes up: "What good are five-year projections? Why do we do them?" With those things going on, is there anything that management can really rely on and use for decision making?

MR. IRISH: The good old hockey stick as we call it in Boston. If management looks at the projections as simply a set of numbers submitted to it by a business unit manager, then it is likely to get exactly that -- something that fits what management wants, will produce the desired rate of return and postpones the day when you really have to achieve that to the fourth and fifth years of the projections. I think that if you get to the point of where management is really looking at the assumptions that go into the projections (and not just looking at it as a bunch of numbers such as the accountants produce where all you look at is the bottom line), and have a dialogue with management about the assumptions, then maybe you can avoid that kind of thing.

Rex, do you have any comments on that?

MR. WILSON: I don't know if projections make a difference, but there are a lot of companies making strategic decisions that they don't believe they can achieve. On the other hand, companies are not making the 15%, 16%, or whatever ROE they anticipated and are deciding to get out of this type business venture. I think we have seen that in the last 12 months with the group health business. There have been a lot of companies who said, "We don't think we can earn the kind of return that we want for our company. We can't put the strategy in place, but maybe someone else can who has a competitive advantage in that particular line of business." So, I think there needs to be realism in the projections.

MR. KISCHUK: Here is another technique which is often used. From the corporate perspective, you don't know who is right or who is wrong, but you know from experience that some profit centers will be doing very well and others will be having problems. (If you could predict that, you wouldn't have to work for a living.) From the corporate standpoint, you really can't make corporate plans on the basis that everyone will be doing that well four and five years out. One approach is simply to make a corporate adjustment. You put something in there, a discounting factor of some kind, for the fact that you know some profit centers will be running into major problems out there.

MR. IRISH: Rick, I think it is almost always true that the amount by which some units exceed their projections is far less than the amount by which others fall short of their projections. The pluses and the minuses never seem to average out. I think perhaps one of the problems is that we are in a business where we are not on a symmetrical probability distribution with regard to results. The bad results are almost always much worse than the good results are good and, therefore, if you get a few good ones and a few bad ones, the average is going to be pretty bad.

MR. KISCHUK: Yes, if you do everything right in some profit centers you will make a small profit margin but if you make a mistake, the results are pretty disastrous in a lot of cases.

Rex, I know you work with actuaries within your firm, and undoubtedly have worked with some during your assignments with insurance companies. Do you have any thoughts on the role that actuaries play in the strategic planning process and what contributions they can make?

MR. WILSON: Well, I think that the actuary's involvement in strategic planning is essential. I worked with the actuarial folks in our firm when we worked jointly on strategic planning or strategy assessment projects. I was mentioning to Rick that last week I was with the head of our actuarial consulting practice, Bob Stein, meeting with a client where we worked jointly.

I think that actuaries within the company need to be part of either the corporate or the business unit planning team and need to be active participants in the development of the strategies and the projections and help test what the financial impact of those strategies will be. In most of the companies that I have consulted with, the actuaries are actively involved in the planning process.

MR. KISCHUK: Considering all the things that Rex presented, some of the things I talked about, and some of the things that Frank talked about, you can start to feel a little overwhelmed. How can anybody do all of that? Obviously, an actuary doesn't have time to spend all day becoming a strategic planning professional. For somebody who wanted to learn some of the basics of strategic planning, do you have any recommendations on how to go about it without getting an MBA or something along those lines?

MR. WILSON: I mentioned in my presentation that Michael Porter from Harvard has written a couple of books on competitive strategy and competitive advantage. Now those are fairly thick books; three hundred pages or so, but he develops a very sound conceptional framework for thinking about strategic planning. He illustrates with a number of examples of practice. I think his books are good, and there are other books that people can read, that are pretty good guides on how to think about strategic planning.

MR. KISCHUK: Personally I don't think there is any magic to strategic planning. It is just hard work and discipline. There are pulls and tugs on people's time. Good projections require having enough time to make realistic assumptions, and many times this is the thing that gets short shrift in the overall process.

MR. WILSON: Peter Drucker had a quote that I think is to the point. He said, "Defending yesterday is far more risky than making tomorrow." So to the extent that you spend all your time recasting and stating historical results, it is a fairly risky strategy in today's insurance marketplace.

In support of what Gary Corbett said about the role of the actuary, I think there are currently many actuaries who will want to spend their time not just making sure we accurately report on what we did last year and in the last several years, but in doing a good job in both planning and projecting what will be done in the future. I think this is the least risky position for actuaries and companies to take.

MR. KISCHUK: Frank, you mentioned the difficulties in projecting when you don't have all the answers, and, what's more, the projector may not be aware of everything that is going on. Being in the spot of the projector, do you have any suggestions on how you go about becoming aware of these things or getting plugged into the processes in order to find them out?

MR. IRISH: I guess you could walk into the CEO's office and demand that but that wouldn't get you very far normally.

A good formal planning process and a lot of good solid documentation are part of it. You then know where everybody is heading, and I mean operational planning, I don't just mean strategic planning. Are your operational plans written? Is everybody openly setting forth where they are headed? That can help. Otherwise, in a lot of things, it is just impossible for the poor guy in the actuarial unit somewhere to know what the salesman has got in the back of his head or what is happening over in the investment department. I still offer my solution which is to allow a period of discussion and cooling off after the projections have been made. People can talk about the projections and what assumptions are in them and what they imply, and that kind of exposure can be done in a non-threatening atmosphere. You can develop the kind of communication that you need to do a good job of projecting. Somebody out there put it better than I could; i.e., when you start to do this you find out how little people know about what is going on in their own company.

MR. KISCHUK: This looks like a good time to summarize. We have heard the same theme over and over. It is a mistake to think that the end product is to come up with a plan book or a corporate projection. As Frank and Rex both have said during their presentation, "The most important part of what you are doing is the communication process, getting people to talk to each other, and developing better plans as a result."