RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 2

INCENTIVE COMPENSATION IN THE LIFE INSURANCE INDUSTRY

Moderator: R. THOMAS HERGET
Panelists: WILLIAM R. BRITTON, JR.
MICHAEL J. COREY*
DOUGLAS R. JORDAN**
Recorder: R. THOMAS HERGET

- o Developing a compensation plan strategy
- o Use of incentive compensation in the life insurance industry
- o Performance measures used in annual plans versus those used in long-term plans
- o Special problems of mutual insurance companies
- o What features are important in attracting key executives?

MR. R. THOMAS HERGET: I'm Tom Herget and I'm the moderator of this session. As you can see we have saved the best for last at this meeting. As an incentive for you to attend, we have recruited a topnotch panel. We're going to be talking about incentive compensation in the life insurance industry today. The general need for a plan will be talked about by Mike Corey. Plan design will be talked about by Doug Jordan. And performance measures will be addressed by Bill Britton.

Our first speaker will be Mike Corey. Mike is a familiar face and name to many of you. He is the founder and CEO of Chicago Search Group. It's an 18-year-old firm, the largest retained search firm in the insurance industry. They've got a large practice, focusing in all industries, not just financial services, in which they have a major practice in the insurance industry, particularly in executives and actuaries. They're based in Chicago with other offices in Philadelphia and London. Mike is no stranger to insurance, having hands-on experience at Washington National way back in, what, the 1930s? Mike will be talking about the necessity of goals and objectives. We can paraphrase this loosely as "change or die."

MR. MICHAEL J. COREY: 1930s? Actually it was the 1930s, I think. This is my 89th meeting. I was talking to John O'Connor. I'm sure people walk around saying, "Who the heck is that guy? I've seen him here every time there's some kind of meeting going on." But, in 22 years, I've only missed one meeting. So, you can tell how much I love being here. It's nice to see a lot of you.

As you may notice, our panel comprises consultants. And we're about to talk about a subject that's near and dear to all of our hearts, fair pay for skilled work and fair

* Mr. Corey, not a member of the sponsoring organizations, is President of Chicago Search Group in Buffalo Grove, Illinois.

** Mr. Jordan, not a member of the sponsoring organizations, is Senior Manager of KPMG Peat Marwick in Hartford, Connecticut.

effort. For those of us who have been in consulting, we find ourselves frequently involved in a remarkable phenomenon. That's receiving fees for telling clients what they already know. We'll talk about something that all of us know about, at no fee, something that is near and dear to those companies who wish to succeed in the future, the necessity of dealing effectively with the entrepreneurial culture of the future.

A few weeks ago, I was having lunch with a very good friend of mine in a wonderful English pub and he mentioned to me that he was leaving his company. And he was leaving a very high level position in which he had received a very attractive severance package. While he was eating his shepherd's pie, he made a statement few of us will ever hear in our lifetime. He said that he was grossly overpaid by his company for the job he was doing, as one of their most senior executives. This extremely talented person had reached the point that everyone fears. His talents were being underutilized in a high paying position. Of course, he stated the inevitable, that for many years he was being grossly underpaid when he made the greatest contribution to the company. The fear of being overpaid and underutilized is universally an overachiever's nightmare. The reason is simple. The executive is vulnerable to greed, having established his high salary and a lifestyle that is hard to change. The executive changes his or her business style from being an offensive player, the style that got them to the top, to a defensive player, and spending more time protecting their job rather than being a proactive decision maker, taking the type of career risks that a successful offensive player must take to move forward. My friend will do very well in finding that new position that will suit him, and move his career forward. But most people in his position are not nearly as fortunate. Incidentally, I bought lunch.

What creates the variables for underpaying or overpaying employees? The answers for all industries are very complex, but let's look specifically at the insurance industry, and see what effects compensation philosophy and compensation change. Everything starts with the word historical. Consider what the world of insurers was like in the 1950s, 1960s and 1970s. Home office salaries were reflective of an industry mania, let's pay what everybody else pays, slightly more if the person is good and has a nice personality, and slightly less if the person is slightly tarnished. Where did the midpoint mentality come from? It came from information that everyone shares, Life Office Management Association (LOMA) surveys, schedule Gs or your Hay salary system, a system that is also used by all of your friendly competitors. Actuarial salaries were even easier to determine. You merely had to buy the John Hancock survey and skew your salaries to your company's size or location. But what about agent's commissions? Attend any Life Insurance Marketing and Research Association (LIMRA) meeting or call up your friendly competitor or senior agency officer and you can get all the information you need.

Historically there were very few variables in the insurance industry in the 1950s, 1960s and 1970s. And then came ERISA. Actuaries were delighted. And then came universal life. Agents were not delighted. The two major variables became obvious going into the 1980s: supply and demand and lower profit margins. The market place changed in the late 1970s and 1980s, distribution was changing, agents' financing was a major issue, companies were becoming product driven, terms such as lower cost production was in vogue, and actuarial salaries had doubled and tripled because of supply and demand.

Consequently, agents were making less money because margins were smaller. The game had changed. Unfortunately, the pay systems had not changed as quickly. Today, many insurers are prisoners of salary administration, compensation systems whose insensitivity to the corporate vision and individual expectations frustrates valuable managers, and hence, inhibits strategic initiatives. To continue to survey other peer insurance companies continuously confirms the prevalence of comparable pay systems in other companies and market rates that fall within a narrow, predictable range.

It is not easy to break out of the historical way of paying staff without first removing the chains of our past. Many salary administration systems have taken on a life of their own within insurance companies, unrelated to company strategies or business conditions. In these instances, organizational politics often influence the pay process more than job characteristics and business priorities. Also, crisis too often dictates the necessity for change. A famous actuary and a friend of mine, Bob Shapiro, once said, "Using current compensation plans as a management motivator is analogous to a heart surgeon using a valentine as a road map."

Contribution to the bottom line is now more valuable than perceived power. Knowledge is now more important than the number of people supervised. The rest of the business world is bringing their executive closer to the customer. The executive not close to the customer has become underutilized overhead. Underutilized overhead is not beneficial for the company or the overachiever executive because that phenomenon creates underachieving defensive players whose growth is slow because of the lack of decision-making and the lack of risk taking. This is where salary differences are important between traditional and progressive companies. And, as we all know, the vast majority of insurance companies are traditional. Traditional companies tend to play it safe. They are more concerned with issues such as internal equity and market rate of pay. Senior management of the traditional environments generally is more comfortable with reactive pay systems than proactive, incentive driven systems, which takes greater creativity in developing and more effort to effectively monitor. Less traditional thinking inspired a number of companies to develop creative incentive schemes such as agent-owned reinsurance companies or phantom stock-like equity participation programs for agents and home office staff, for example, companies such as Life USA or Interstate Assurance. But many of us already know that.

Pay systems should reflect and support the underlying strategies of the business. When an organization develops or modifies its strategic thinking, it needs to consistently modify the way it defines success, appraise individual performance and reward its people. The rapid changes and increased uncertainty in the business environment begs for simpler, more flexible pay systems which can respond to changing jobs, new values, and new measures of performance. New measures of performance need to reward highly successful performers differently from average performing employees. Spend more money on the better people and less on the mediocre. Does your company do that? I would bet that your company direction is creating new job descriptions which are forcing exceptions because they do not fit within old formulas or rules. In your company, do the highly successful feel underpaid? Do your average performers seem to be content with their compensation levels? If the answers are yes, then you risk losing your better performers, and your average performers have no reason to strive to change. Of course, your average performers won't leave. In your company, are your executives entrepreneurially inspired and entrepreneurially compensated? If not, you may be left at the starting gate with all those companies whose rate of pay systems are buried deeply in the sand. Too often, I see clients who are willing to pass on talent in order to maintain internal equity. In my 22 years in this business, I continue to be amazed by those companies that pay fees to firms like mine to replace talent that has left because the company did not want to disturb internal equity. The negative financial and emotional tradeoffs aren't even close.

How can an insurance company link its pay system to its business plan? The company starts with the corporate vision and supporting business plan. If the company's current pay system cannot support the corporate vision, then design the ideal pay plan within this context. Emphasize job characteristics, performance standards and appraisal approaches that send messages and rewards consistent with the company's future desired values and strategies. The insurance company that develops a clear corporate mission, consistent goals and appropriate strategies, that confirms how success will be measured and defines the culture that will nurture success. A company that will establish the types of individuals needed to be successful, establish pay systems that allow the company to attract, reward and retain the right people, and discourage the wrong people. A company that establishes the mix of base pay and incentive pay that will motivate and reward decision makers commensurate with performance, that company will win every time. But, of course, all of us already know that. All of us already know also that insurance companies are seeking ways to define and leverage their special capabilities. Thus, consistency in pay across historic insurance company functions and market rate of pay should no longer be a key objective of the pay system. The protected, nonaggressive business environment of the past is gone forever. Old formulas and gentlemen's agreements are no longer effective or valid. Change or die. Most companies should simplify their approach to base salary systems, expanding the breadth and variations with incentive pay plans. Future success depends on effective recruiting, motivating and obtaining the right people to do the right jobs to achieve company goals. The pay system should be the cornerstone of this process.

Within the past few weeks, I had an opportunity to have breakfast with a highly successful employed senior executive of a very major life insurance company. Our conversation centered on the difficulty of changing culture and direction in a large company, especially the difficulty of creating an entrepreneurial environment and atmosphere within a company's management ranks. He talked with awe about a large noninsurance subsidiary of his company where everyone from senior management on down had some type of entrepreneurial connection to the subsidiary's client base. He was intrigued by the subsidiary's employees at all levels, and how they shared the taste of success and the agonies of failure. What made the conversation especially interesting to me is that this highly skilled executive felt that it would be virtually impossible to impart that entrepreneurial feeling to the subsidiary's parent. Historically, his company developed from the egalitarian culture of the past and it dismayed him to know that it was almost impossible to move toward a more entrepreneurial culture of the future. Incidentally, he bought breakfast.

Whether it is my friend's company, a mutual company or stock company, a pension company, individual life, personal lines, commercial lines, the problem is the same for all. Your stockholders or policyholders will demand that you succeed in the future. Your short-term objectives of today will turn into the long-term objectives of tomorrow faster than we all think. The problem is the same for all. The problem is where do you get the best people to run your company? How do you keep them and motivate them toward success? And I think that's worth repeating. Where to you get the best people to run your company? How do you keep them and motivate them toward success? If you don't have the answer for that problem then all the great products, the most sophisticated management information systems, and slick advertising programs won't do you any good. If you don't answer that problem, we'll probably be having dinner one day talking about how you are being overpaid because nobody knew how to measure your value when you used to be employed.

MR. HERGET: Thank you Mike for your loud and clear message. Next I'd like to introduce Doug Jordan from KPMG Peat Marwick. Doug will be telling us about plan design. Doug has had management experience at Pepsico and Northwest Industries. He joined the consulting world, first with Wyatt & Company, then TPF&C and now is Director of Regional Compensation Practices with Peat Marwick here in Hartford. So, with no further delay, I'd like to introduce Doug.

MR. DOUGLAS R. JORDAN: I'm going to spend the next 25 or 30 minutes talking about incentive compensation planning. The focus of the presentation is going to be on incentive compensation primarily at the top of the organization, the management level, the senior management level and so on. The message that I would hope you come away with is that the movement that I see occurring and the things that I think are most powerful in an organization are taking compensation programs like those we're going to be talking about, and moving them down in the organization to include virtually all of the employees. That's for both short and longer term incentive compensation programs. First of all, incentive compensation programs, because they're variable, not only pay off with results but don't pay off when the results are not there. If they are designed properly and are cost effective, you will be able to control your base compensation cost and delivery. You then really begin to leverage the incentive part of the program.

I think these plans are also very important in terms of being able to focus employee behavior. They focus the behavior on both short and longer term objectives and goals that the organization has. I think they can also be a very effective way to communicate the mission that the organization has and, again, the goals and objectives and key performance indicators that the organization would have. And I think finally, if they're designed right, they really do work and can be very effective in an organization.

I'm not sure how many of you saw *The Wall Street Journal* article. But there was an article on page one; it talked about the fact that a survey done by one of the consulting firms found that only 37% of the senior management group that they surveyed felt that the key management of the organization really understood the goals and the objective, the business direction that organization had. Only 37%. And when they moved down to the middle management group, they felt that only 4% really understood the direction of the organization. And again, I think from an overall standpoint, the things that we're talking about, properly designed incentive compensation plans, can go a long way towards enhancing the understanding that employees at all levels of the organization know what the organization is trying to achieve.

Let me overview what I'm going to be talking about and then also what Bill Britton is going to be talking about. I'm going to spend some time talking about background issues and compensation in the insurance industry. I will spend some time talking about compensation strategy or philosophy. And then I'll go through some basics of incentive compensation design, both short as well as longer term. Then I'm going to turn it over to Bill who's going to spend time talking about some of the really tough issues in terms of designing performance criteria for both short and longer term incentive plans.

I think, as many of you are aware, the insurance industry does pay incentives. But they typically pay them at lower rates in terms of the percentage of incentive opportunity that's available both short and longer term. And, in addition, there are fewer participants typically in an insurance organization than you would find in general industry. But again, this is changing. If you look at short-term, 12 month incentive plans, you find that about 90% of the insurance organizations respond to plans like this. A lot of plans, obviously, reflect the competitive pressures, that is what other people are doing. I think this makes some sense but I certainly don't think it really ought to be the prime driver of whether or not an incentive plan is in place. Other financial service businesses influence the existence of plans. I think, more importantly, as you begin to move down to some of these other reasons, another fact is that they are a way to control fixed costs. Again, you pay when they do well, you don't pay when the organization or the employee doesn't do well. The plans, based on my experience, really do make sense.

Longer term plans are much less frequently found in insurance companies. Mutual companies don't have stock, although that's not any preclusion whatsoever for not having a plan. The lack of a competitive need and discomfort with performance measures can preclude their existence.

Let's talk about developing a compensation strategy. To me, a compensation strategy really begins with an unvarnished look at the business. Step back and say, what is a business, in terms of its mission; what is it trying to accomplish, both short and longer term? How can the compensation programs be designed to enhance the direction of the business? I think it starts off with a definition of the competition. Is it similarly sized organizations or is it organizations that are larger, perhaps your target size? Also very important in terms of determining design is who you attract from and where employees might be going. What's the competitive position that the organization would like to achieve? Is it the 50th percentile? Or, as many companies are beginning to do, is it taking base pay down to less than a 50th percentile position? Or, could you hold it constant and move it up at a much slower rate than the rest? This begins to level with both short and longer term incentive plans, again controlling that fixed cost. The competitive positioning is extremely important.

Next is, the mix of the compensation elements: base, short-term, and longer term. Clearly, at the top of the organization, you want to have the bulk of the incentive compensation. This "at-risk" bay, at the longer term, has perhaps three to five years before there's a payoff. As you move down through the organization, the mix begins to change depending on where the employees have their primary focus and the areas on which they can impact. There is a number of considerations from a mix standpoint.

The linkage to business goals goes without saying. That's crucial and that's an area, from design standpoint, where many programs really fall short. They don't achieve that good linkage with the business plans. I think that's part of what that Journal article is saying: that either linkage isn't there, or it's counterproductive, or it's moving people in the wrong direction. So, linkage is very, very important.

Integration within a business is important. If an organization has different subsidiaries or entities, they're probably not all at the same level of development. Some may be entrepreneurial, start-up operations. Some may be in a decline or renewal. Whatever it may be, should have a real bearing on the kind of compensation program that you might develop. The entrepreneurial start-up may have a stock opportunity. Though the company may be cash poor, leveraging more of the compensation in a stock element is a good longer term design.

The importance of compensation is the way that it's communicated. It reflects the kind of a message that you're trying to get across to employees. Does the plan hold an automatic, traditional type increase? Or is the message that employees, each year, have to work to renew the compensation that they're going to get? The base compensation level may be moved to a competitive or 45th percentile rate, but wouldn't go above that. Maybe we slow down the growth in the rest of the salary range and eliminate everything from the midpoint up and really begin to move the at-risk or variable compensation element. From a message standpoint, if designed right, it can be powerful.

Let me move now into some of the basics of compensation design. We're going to talk about two kinds of programs, annual and longer term.

Annual plans typically pay off at the end of the year, though some are designed so that the payoff may be two and three years down the road. Longer term plans have the payoff, goals and objectives set three to five years in the future before there's any payout.

Annual plans are primarily focusing on this year's results. They incorporate the short-term financial success, the operating plans, and the budgets that the organization may have. They are designed to develop a proprietary interest and an ownership sense, on the part of the employees, whatever level they may be in. You need to begin to communicate to employees the direction of the organization and how the compensation program really links in and ties in with that.

The longer term enduring results are what the organization would be striving for. Bill is going to spend time talking about the value drivers. We are talking really about enhancing the value of the organization, whether it be shareholder value, if an organization is public and has stock, or whether it be another kind of a value driver that you would have if the organization does not have stock. Lower cost to policyholders over the longer term, the financial safety nets, and obviously, the growth in products and other elements are important for the longer term standpoint. The reward mechanisms would be built to focus on this, making sure individuals knew what the drivers were, and then rewarding based on the attainment of the objectives and goals.

On the left side are elements that, depending on where the organization is and its focus is, would help determine the weight that you might have on the short versus the longer term. If it's a short market cycle and the planning is more the short focus as opposed to the longer term, then you might have more of the emphasis on the annual incentive plan as opposed to the longer time frame and the longer focus which might drive more on the long-term incentive part of it. But the key from my standpoint and experience is the balancing that you would want to achieve with a short and a longer term incentive plan. You have a balancing decision to make that you must be able to communicate to employees. So the balance part of it is extremely important from a design standpoint.

There basically are three different approaches to short-term annual incentive plans. One would be a profit pool where an organization might say that we're going to distribute to the employees in the plan, say 5% of our profits, either before or after tax, whatever the parameters might be. Or you might put in a threshold that we're going to distribute x% of profits after we have attained a certain return to the shareholders or some other threshold measurement that would really serve as a door opener. Once the door is opened, the pool would go into effect and would pay off. If it's a public company, one with stock, you're concerned about obviously taking care of the shareholder. Once the profit pool is put together it could be distributed in a number of different ways. It could be based on the employee's actual salary or their midpoint. It could be based on goals or targets that they might have had, and how well they had done from an achievement standpoint and so on.

Another approach, the second one, would be a target plan. And this is probably the more typical plan that, based on my experience, I would recommend you look at. Here, you typically would be setting some sort of either short or longer term targets and they could be any of corporate, divisional, strategic business unit, department, or a particular unit. Based on the achievement of those individual or departmental goals, there would be a payout. Depending on where you wanted to focus, you could put most of the emphasis at the individual level, or you could put most of it in a unit or a department level.

The reason I said I would recommend you think more seriously about a target plan is that a target plan tends to be a lot more action-oriented. Each year, you go back in, re-examining the short-term focus and the targets that you would have. As a result, the program is a lot more dynamic. If you look at some of the organizations that have used the first approach, the profit pool approach, those programs typically don't get updated. Everybody is comfortable; the focus that the organization has begins to shift. If you've got the target plan, you're going to be able to go back in and look at the shifting focus the organization has and design a program to really impact on that. The fixed pool plan tends to get static; it loses a lot of the dynamism that I think you can build into a plan.

Third, the commission plan. Obviously, x% of sales, 3% after meeting a certain threshold or something like that, is what you're paying an individual in a typical commission type arrangement. But usually a target plan is the one that I think would make the most sense to most organizations.

The rationale for installing longer term plans ties to an attraction and retention standpoint. This plan focuses on longer term priorities that the organization has, and requires a way to communicate to employees what that longer term focus is and the subsequent priorities. This must support the business planning process and linking, where possible, the executive and the owner interest, whether it be really the owners of the business internally or the external part of it. It should give key executives the chance and opportunity to accumulate capital over a period of time.

Let's discuss some of the criteria for effective design and for long-term incentives. It must reinforce the mission that the organization has its key longer-term goals and objectives. Well-designed programs should not be influenced by short-term, and often uncontrollable, factors. They tend to have that more longer-term focus.

Let's spend the rest of the time talking about longer-term incentive plans. They should offer an opportunity to communicate the performance objectives. Make sure that individuals understand what the objectives and the goals of the organization are. Provide a reward that is adequate enough to change behavior. There is an old rule of thumb that says, if an incentive opportunity is less than 10% of an individual's salary, it probably won't motivate behavior very much. And for those of you who have been reading some of the recent literature, a lot of individuals and a lot of organizations are beginning to say that incentives will be at least 10%. More often they're moving up to the 20% range, both short and longer term. The 20% is not just at the top, but also moving down in the organization. Again, since it's variable, it should pay for itself. It only pays off when there are the results. So, why not make it significant enough to focus the behavior of people and get them to pay attention to the incentive plan.

The message is that individuals who can contribute to the longer-term success of the organization really belong in the long-term strategic outlook that the organization has. The senior management team must consider similar positions in other kinds of competitors' organizations. I believe that we're going to see a dramatic increase in short-term incentives, and the longer term incentives coming down in the organization also fairly rapidly.

There are different types of long-term plans. There are stock place plans, nonqualified stock options, incentive stock options. These kinds of programs incur no cost to the organization. Stock awarded to individuals, or options available for individuals to exercise, are the most common. In terms of the size of those grants, they're typically about equal to an individual's salary in terms of the grant that's provided. So if an individual is making $150,000 or $200,000, the value of that stock option grant is probably going to be about the same as their level of compensation.

Cash plans are widely used, probably not quite as widely used as the stock based plans. They're based on financial performance, internal measurements that an organization would have, or bringing in the external peer measurements that an organization might want to bring into play. The options or the stock grants are more related to the value and the increase in the value of the organization. There are a lot of discussions about whether they really are, because of the fact that they're subject to the variations of the stock market. Vagaries of the stock market cause value to go up and down, which may, in many cases, really not reflect the value of the organization from an internal standpoint. So if you have stock, you still may want to consider some of the cash based plans that we're going to be talking about.

The cash plans most often are going to be related to profit growth or a return on investment type of measurement, something that is value driven and based on improving the value of the organization, either internally from the shareholder's standpoint or whatever that mechanism might be. Some of the programs that I've seen would be phantom share plans and performance unit plans.

A phantom share plan, in essence, is a program that simulates stock. It has a ring of stock, it sounds like the stock type program, and it typically is based on a value being established on the day of the grant. Then, over a three or five or seven year period of time, as that value increases, that parallels the individual's amount of compensation or cash that they would get. From a negative standpoint, because it is a cash-based plan, the organization has to make a charge to earnings and begin to recognize that expense, where with a stock program, you don't have to do that. The main thing is that cash-driven plans need to have their impact charged to earnings.

There are some problems with cash-driven plans. Selecting the right measurements and putting the right weight on them is difficult, but not insurmountable. Some of the traditional accounting approaches may not really reflect the reality of the organization. Again, Bill is going to spend more time talking about that. And very frankly, in any kind of an organization, targets that are three to five years out really are very difficult to set. But one positive is that it begins to force a better longer term planning process. And if a new longer term plan is put in each year that will pay out in three to five years, an organization has a chance to come back and will begin to refine that longer term planning process.

Why would the phantom plan be appropriate and appealing to a lot of organizations? It's based on the improvement in the value of the organization. We talked about the return on equity, or the GAAP or intrinsic value, or whatever it might be that's of value to the organization begins again to focus the employee's behavior on improving that value. Phantom share plans, because they are used very often in a mutual type organization, can simulate the public company stock. You can do a number of different things with phantom plans to put a different twist on them and make them very appealing from an employee standpoint. Using them from a recruiting standpoint is appealing in terms of offering them to individuals when they come in the organization. I think there is a number of twists that you can put on the program. And it can begin to reduce some of that difficulty that you might have with a longer term goal and target setting that we talked about.

Let's review some basic criteria for both short and longer term plans. Both the short and the longer term measurements need to be based on the short and longer term business plan. The goals need to be stated in as measurable and quantifiable a way as possible. On that point, I don't think that you really want to eliminate discretion or some subjectivity from an incentive plan. I think you need to have some of that built in to make a judgment call. How much I think depends on how comfortable the organization and the participants are in having some discretion and variability built into the program. If it were possible, it should be quantifiable, hard numbers that individuals can relate to. And that gets us to the last point.

The plan needs to be designed so that employees feel that they can impact on the results. The corporate senior management group wants to put a short-term plan in that's based solely on corporate results. They have about 25 divisions and plants as part of that corporation. And while the message will clearly be that corporate performance and corporate results are important. I have a concern when you get down in the bowels of the organization. There it gets a lot more difficult for people at the plant level or at the division level to understand how they can impact on that corporate result or its expression, such as return on assets. My sense is that not only do you need a corporate measurement but you also need to get at other kinds of measurements that the employees can feel that they can impact. This is especially true if you begin to jockey with the base pay delivery and put compensation at risk, such as companies like DuPont are beginning to do.

MR. HERGET: Thank you Doug, for an excellent discourse on the futures of plan design. Now, I would like to introduce Bill Britton. Bill is a Vice President and Principal of Tillinghast. Bill has been in their Hartford office since 1981. Before that, he spent 15 years at Connecticut General in the actuarial area. Bill has had a lot of experience in translating these concepts Doug's been talking about explicitly into the insurance environment.

MR. WILLIAM R. BRITTON JR: Some of you may have noticed that I was a replacement for Bruce Nicholson on this panel. Bruce recently left Tillinghast for reasons unrelated to the subject of the panel, namely incentive compensation or performance measures. But when he did leave, he asked me to substitute for him. I was delighted to do it, because this is an area that I've become involved in with several insurance companies. As actuaries we have a particular perspective on performance measures. This is also an area where you get to work with neat people like the ones who've just spoken.

Today, we'll look at some general considerations in establishing performance measures for incentive compensation. We'll look at the kinds of measures you might want to consider or use for annual plans. We'll then take a look at measures for long-term plans. And finally we'll take a quick look at some specific mutual company considerations.

Let's take a look at what performance measurement does. First of all, you can use it to evaluate progress against plan. Second, you can use performance measurement as a way to communicate how you're doing to both your management and your Board. You can also use performance measurement to identify the drivers of profitability in your business. Any good performance measurement system should be able to identify these profitability drivers so that your managers can focus on them. You can also target areas needing improvement so you can focus management attention on the things that need to be improved.

A performance measurement system can drive your incentive compensation system. Sometimes we get involved with a company because they're looking for a basic planning tool with incentive compensation in an outgrowth. At other times, we get involved with a company because they're looking for a better way to incent their managers, and then you see all the other things that a good performance measurement system can do.

A good performance measurement system will satisfy several criteria. It should be a common denominator for all lines of business, which may be difficult. For example, in the pension business we want to measure asset growth. When you look at your individual business, you may we want to measure new premiums. For other businesses, you may look at commissions, or loss ratios, or claims paid. Whatever you might look at, you find when you try to add them all up, you get vegetable soup, something that makes no sense at all. So a good measurement system should find a way of having a common denominator. Ideally, that common denominator will be profitability.

A good system should be understood by the management and Board. I had a conversation earlier with an actuary at a mutual company. One of the things he said was that his Board originally wanted to go to GAAP because they only understood 50% of statutory earnings. Now everything's perfect . . . they don't understand anything that's going on with GAAP. So it is important that whatever system you have, it's understood by the management and Board. And also, and I think Doug made this point as well, you need to isolate the results that are controlled by management, because a performance system should pay for good performance and should focus on the things that are controllable by management.

It's been said that, "If it can't be measured, it can't be managed." There's a corollary that says, "If it can be measured, sometimes it still can't be managed." But the fundamental axiom is that to manage it, you must measure it. No set of measures is right for all companies. Every company has its own particular culture, its own particular history, its own systems, and its own particular configuration of businesses. You need to design something that fits you.

You should use no more than two or three measures. If you use a number of measures, you get people trying to do a number of things that typically will be in conflict. If you use too many measures, they diffuse managers' focus. Keep the measures simple and keep them relevant to what you want managers to do. Finally, if you are looking at both a short-term plan and a long-term plan, you will want and need different measures for the different plans.

Let's take a look now at annual plans. Performance measures for annual plans are usually based on some combination of growth and profits. You would usually have an overall corporate goal that should be satisfied. In some cases it must be satisfied before the plan will pay. You then will have some divisional goals that will be a component. And finally you may have some personal goals.

Personal goals could be quantitative or qualitative or both. They would include things like, how well did you manage the expenses in your area, how well did you control staffing in your area, and how well did you perform the projects assigned to you. So an annual plan usually will be a mix of corporate, division and personal goals.

Doug mentioned the problems when you only have a corporate goal. Actually, I've run into such a situation recently. And I don't know really how the plan works, but it is a smaller company. It's an unusual company; it has a profit sharing plan that, for the last three years, has averaged 60% of salary for all of the employees in the company. Now, I'm not sure if they are satisfying all of the divisional goals or personal goals or if they're focused or anything else, but they're real happy. I would not recommend this as a plan to accomplish a number of objectives, but it's a very happy employee group.

Growth measures for annual plans can take several forms. Most companies use their primary measure of sales. That's convenient because when you adopt a plan where you want to have as little cultural change as you can. If they're used to looking at first commissions, first four years' commissions, first-year premiums or whatever, you would usually adopt that as the measure of growth. You could also look at alternatives such as growth in assets for pension plans or lines of business where the profitability is asset-based. Increase in market share is also used by companies. But you could only use that if it's really meaningful for you. Typically if you're in individual life insurance, the market share is so small that it's very hard to measure, so that it's hard to measure improvement. But if it's measurable and meaningful, you can use market share.

You should avoid combinations or weightings of more than two or three measures. When you start combining things or weighting them, you can get some funny results. A certain amount of combining may be necessary, but you've got to keep the number of combinations and weightings limited.

It's very important that you have results available throughout the year so that people can see how they're doing and can begin to take corrective action. Sometimes you can get into a situation where things go so sour that there's no motivation to continue. Here, you may want to tinker a little bit and make some adjustments in the plan, because some unexpected and uncontrollable external event occurred.

Sales measures are frequently used because they are simple, easy to understand, and easy to track. But they have a fundamental deficiency, which is that you can't tell profitability from looking at a sales measure. Also, sales measures don't really give any recognition to other things that you're trying to control, such as expenses, lapses, mortality, and investment results. This could be accomplished by introducing these components in your overall system, but that begins to get complicated again.

Profit measures for annual plans usually take one of several forms: statutory profits, GAAP profits, or some surrogate for profitability. Statutory earnings have a number of advantages as a profit measure for annual plans. Many companies have historically only looked at sales. All of you who are familiar with our industry know that if you ask almost any top executive if he had a good year, the response is yes, sales were good, or no, sales were quite poor. For an organization that historically has been focused on sales, a statutory earnings measure can begin to move management to see the importance of profitability. I've seen it work in some companies, typically mutual companies, where they've started to get the managers to understand the importance of profitability. For companies with limited statutory surplus, either for solvency reasons or for growth reasons, it may not just be a nice nuance; it may be important for survival and continuation as an organization.

However, statutory earnings have some fundamental flaws that we're all familiar with. Losses are caused by new sales, regardless of the profitability of these new sales. High withdrawals can increase earnings with gains from lapses on a statutory basis. Statutory earnings can lead to paying out rewards for what really was poor performance during the year, if you didn't meet your sales plan, or you had poor persistency, and your earnings blipped up. Or you could have penalties for good performance, because you sold too much business, or because too much business was retained.

GAAP earnings are an improvement over statutory because they better reflect this year's earnings. Particularly for stock companies, GAAP earnings are taken seriously by analysts. As more and more mutuals move toward a form of GAAP or modified GAAP, they are taken more seriously there. But GAAP can also be misleading. You can still have losses incurred in the year of sale because you're not able to defer all of your acquisition costs. For FAS 60 products, you're likely to have increases in earnings in renewal years, just because of the conservative assumptions that were used to set your GAAP pattern of earnings. One of the problems that's emerging now with the advent of FAS 97 is that you've got an inconsistency among products, depending on what GAAP method is used.

FAS 60 earnings emerge as a level percentage of premiums. Given a premium persistency pattern, your theoretical GAAP earnings should have a nice smooth flow over time. But, in actual practice, when you look at the amount you are allowed to defer, your GAAP earnings can default back toward the statutory earnings pattern.

One of the major problems is that your GAAP earnings are dominated by your in-force business. However, most of the time and effort of your senior management people are new business related. But the effect of this year's sales will not flow into profits for a number of years into the future.

Surrogate profit measures for annual plans can be used either instead of or in addition to your other measures. You can track planned expenses versus actual, pricing expenses versus actual expenses, target claims ratios versus actual, target spread on new investments versus actual spread. You can expand the list for key measures for a line of business or for your company.

For long-term plans, many of the considerations for annual plan performance measures also apply, but you want to look for more consistency with your long-term corporate goals. It's much more important that your long-term measure or measures be suitable for all lines of business and that they be common, because it's critical to get all of your senior managers pulling in the same direction. It's also important to get management and the Board to understand the measure, know how it works, and to buy into it. For long-term plans, we've seen more of the use of a single measure that combines long-term growth and profitability, whereas with annual plans, we see more of a variety of measures with separate ones for growth and profitability.

Possible measures for long-term plans would include common stock for stock companies and many stock companies have long-term plans based on stock. The difficulty with common stock, as Doug mentioned earlier, is erratic, short-term uncontrollable factors. Further, stock frequently doesn't reflect intrinsic value. Also, there can be short-term or longer-term deviations in the stock value based on factors outside of management on control.

Statutory measures could include growth in surplus, growth in adjusted surplus or growth in free surplus. GAAP values, typically growth in GAAP equity, are also used for long-term plans. These measures suffer from many of the things we talked about with annual plans. In addition, if one of your important missions for the year is to put on profitable new business, neither the statutory nor the GAAP value is going to show you how well you did. Most of those earnings are going to emerge in the future, and most of the GAAP profits reported this year again are from the in-force business.

As a result, we have been using value added as a performance measure, particularly for incentive compensation plans. A value added performance measure looks at the change in the "embedded value" of a company during the year. Value added is based on the approach that's used to value a company when considering its acquisition. Appraised value has three components: the surplus, the present value of profits on the in-force business and some measure of the goodwill of the company, which in actuarial appraisals would typically be taken as the present value of profits on business to be written. In measuring performance little, if any, recognition should be given to the third component, since that's something that management will or may be able to do in the future. Thus, we would typically focus on embedded value, which will be surplus or free surplus (if you're using target surplus) plus the present value of the contributions to free surplus from your in-force business, all discounted at the hurdle rate.

One of the conveniences of value added is that having gone through the initial calculation, you can then very easily calculate what your expected value will be during the year. It's simply your hurdle rate times your beginning in-force value, plus your net investment income on free surplus, plus the value added by the new business that you intend to write. Now as you go through the year, you're going to have deviations in all of those items except the first one.

One of the uses of value added is that it's very easy to allocate results by line of business. You could look at your total value added and break it down into components by line of business. If you look at the value added for any particular line during a year, it'll be the earnings that are distributable on the business that was in force, less the beginning in-force value, plus the ending value. And the sum of those will give you your return. You can calculate a return on equity by dividing the actual return, the value added during the year, by the beginning of the year in-force value.

Another use of value added is in variance analysis. We've worked with companies to develop what we call performance modules. For example, the marketing performance would take into account the sales volume, the mix of business that actually got written, and the expenses that were actually needed to write that level of business. For the administrative area, you would look at actual your administrative expenses versus planned. The risk module would consist of the risks inherent in the business: mortality, morbidity, lapse, surrender. The investment component would look at the required interest against the actual investment income.

To summarize, the best performance measure is the increase in intrinsic value of the company, or value added. It combines both sales and profits into one single measure. It reflects the effect of this year's earnings that really won't emerge until future years. And it can be used as a single measure of performance, so that you can plan your value in the future.

On the other hand, companies have not gone to value added, since it's yet another scorekeeping system, and we've got enough scorekeeping systems already. It can also be expensive to install. It's more work to maintain than the other systems, and you've got to be careful with changes in assumptions. For example, if you change your future estimate of persistency, or mortality, or the investment margin you're going to get, all of the future value of that change will be brought back to the current year. So you've got to be careful hcw you change assumptions or you can get some perverse effects.

One of the obstacles to installing a value added system is the calculation of the value of in-force business. You have to have sophisticated financial models. It's hard to install an incentive plan at the same time you're trying to build the system. You may think that the cost of the models is not worth it. And if the only thing that you got out of this was a way of divvying up profits, it would not be worth it. But one of the advantages of a value added system is that you get a very good planning tool, a very good measurement tool, for progress reviews. And you begin to get your key managers, particularly in the sales and marketing areas, understanding a lot more of the economics of the business, the relationship between price changes and profits. They begin to understand that if they want to be competitive, there's a distance that they can go and still have profitable business, but at some point it's not worth it to be that competitive.

One thing that companies have done while they're building a system is to use another approach to value added for incentive compensation plan purposes while they're building up their capacity to do the numbers. One way you can do that is by looking at the value added in excess of the hurdle rate, which equals the present value of profits from this year's sales, plus investment income on free surplus, less the hurdle rate times free surplus.

To compensate for the difference between actual and expected, you can easily adjust for expense and investment income margins. Typically, companies using their shorthand approach would ignore any gains or losses expected from mortality or withdrawal experience.

Well, let's turn now to some special considerations for mutual companies. For mutual companies, you must consider the philosophy of the company. Why is it in business? What are the long-term financial objectives of the company? You must take into consideration the impact of dividend scales. There's an axiom that a mutual company's growth, as long as its capital is only internally generated, can't exceed its average return on surplus.

Any performance measurement system for a mutual company faces what we call the dividend dilemma. If you measure the value increase after dividends, then you penalize the managers who raise the dividends. If you measure before, then you don't measure the true profitability, because you're ignoring an important part of the expense of doing business and paying your owners and policyholders.

You can resolve the dividend dilemma by setting a hurdle rate that's equal to your long-term growth rate. Then dividends can be set to provide the hurdle rate. And if you want a higher rate of growth, you'll need a higher hurdle rate annually or lower current dividends.

Mutual company performance measures include increase in adjusted statutory surplus, value added in excess of the discount rate that I discussed earlier, or value added where the dividend scale increases are considered value added, and distributed to the policyholders.

MR. HERGET: I'd now like to open the microphones on the floor to any questions that we may have. Please state your name and company so we can include it in the *Record.*

FROM THE FLOOR: I was a little surprised not to see much mention of working competitive results into an incentive plan. Seems to me if you don't do that, you're relying very heavily on how good your business plan was and may find out that it either wasn't much of a challenge or perhaps, even was too challenging. I was just wondering if anyone had any comment on working competitive measures in?

MR. JORDAN: Very good question. I think that with a short-term plan, working in some of the competitor data, the peer data, is more difficult because of the timeliness of the data coming out and the time lag that you have. But I think with longer term plans, especially, it's very important to have the competitor peer data built-in in some way, weighted somehow. It is a very important part of the overall measurement criteria. And I think in a public environment, that gives the shareholders that degree of assurance that they're doing as well, if not better than they would in another competitor type organization. And I think those companies that are not public, it again gives that degree of assurance that the performance is at least equal to or better, or whatever the appropriate measurement and yardstick would be. But I agree with you, I think it's very important and we did not focus on that.

MR. BRITTON: Just two additions to that or comments. I would agree that it should be considered but I think that for a long-term plan, there are also some imperatives that you do need to make certain objectives regardless of how the competition does. Over a long period of time, I think you need to say, we want to increase the value of this organization and it should be at a respectable rate. Second, I think that there's a danger in introducing the competitive element to too great a degree in that there's an opportunity to select competitors that may not be performing with the market. If you do it, you ought to make sure that the group of competitors is representative, a tough group to compete against and not just companies that are composed like you are or operate in exactly the same markets that you are.

MR. GLEN M. GAMMILL: I guess one thing I might say is I like GAAP. And one thing about the competitive situation, concerning comparability on a value added basis, it's difficult to get companies to share value added information. But, beyond that, I think I've sort of gone beyond the accounting model phase now. I think that there is no, whether statutory, GAAP or value added, perfect accounting model. I think you have to look at the underlying economics of the company and start to design plans that accomplish the overall economic goals of the company and then fold the accounting model on top of that. And whatever the accounting model tells you as to whether or not you've met your economic goals or not, that's how you should reward management.

MR. HERGET: I've got a question for the panel. Have you had any experience or advice on how frequently you might communicate a person's position in a plan throughout a year? I don't think you'd want to wait till the very end of the year and announce where they stood. You might like to inform them throughout the year where they stand to provide additional incentive. But to do that of course, requires you to evaluate the entire plan and make some commitments that you've got to remember you've made six months later. Do you have any feel for what might be an optimal frequency for determining and communicating results?

MR. JORDAN: I would think at a minimum you'd want to communicate at least on a quarterly basis. If you've got results, on a monthly basis, with budgetary results, that's probably a very good time to communicate the results and where people stand in terms of their performance and expectations. If there are changes or modifications that need to be made or adjustments in the performance criteria, I think that it's appropriate, to make some fine tuning the performance criteria. But I think minimally on a quarterly basis and probably more frequent than that if it's possible.

MR. PAUL E. PETRY: I've got a specific question for Bill Britton. You mentioned free surplus, which is the difference between actual surplus and target surplus. But my question is, on what basis? Statutory?

MR. BRITTON: Statutory.

MR. PETRY: Isn't there a chance now that you're understating real surplus, if there's hidden surplus in the balance sheet?

MR. BRITTON: What we look at, if you think of the appraisal methodology, is spendable profits, or the distributable profits to policyholder owners. And those will be limited by statutory surplus and further limited by the need to keep some degree of solvency above just having assets equal to liabilities, which would be measured by the target surplus. So it's really the amount of money you could distribute to your owners.

MR. PETRY: In that formula, you take some net investment income rate, a portfolio rate, times that free surplus?

MR. BRITTON: Right, or whatever assets are backing free surplus if you've got an allocation system.