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SURPLUS MANAGEMENT STRATEGIES

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After the panel is interviewed, the audience will have an opportunity to ask questions on the topics discussed, including risk-based capital (RBC), reinsurance, growth and profitability, cost of capital, and required surplus.

MR. MELVILLE J. YOUNG: My two fellow panelists are David R. Ludke of Providian, previously known as Capital Holding, and Barry L. Shemin of John Hancock. David is managing director of risk management for Providian and prior to that he was with American General for three years and also spent many years at Travelers. Barry is senior vice president and corporate actuary of the Hancock. He's been there over 25 years. During that time he's had line responsibilities for group insurance, guaranteed investment contracts (GICs), individual life and annuities, and long-term care. He is currently the company's corporate actuary. The first question is, How has the increased focus on capital changed how management is managing the company. Barry, do you want to kick it off?

MR. BARRY L. SHEMIN: I tend to think of these things in three categories. One is what the company is doing in the way of financial activities. Another is what the investment people are doing with the asset side of the balance sheet. The third is what the product people are doing out on the firing line.

Let me mention several things about activities spearheaded by the financial organization. I won't try to cover everything, but I want to start with a few things mutual companies have been doing, maybe because I'm from a mutual company. Not all of them are applicable to stock companies, but some of them are.

At first there was a whole series of asset-related restructurings that were as much form as substance. These involved transmogrifying mortgages into bonds, for example. Then, subsequently, many mutual companies issued surplus notes. There was a session just before this on surplus notes, and although the pace has slowed down quite a bit, I sense there is a feeling that maybe there's still some supply available. So that's still a possibility, although, obviously, it's not easy to do. You have to be a certain size and credit rating to make that work.

An item that's a little less common is to try to unlock some hidden values on the balance sheet. I'll mention one that has already occurred and another that I would like to raise because I wonder why it hasn't been raised already. The one that has already occurred amongst a number of mutual companies is trying to spin off part interests in subsidiary companies so that they are traded on a public market. The company can then revalue their remaining share at market rather than book value. These often are companies started from scratch and are valued at very little on a balance sheet. For example, I think the earliest ones were by General American Life, which spun off their health care company and their

reinsurance company by selling minority interests. They have since sold larger shares. They not only got cash for the piece they sold, but they also were able to substantially add to their admitted asset values.

Several companies have spun off investment subsidiaries. This has typically taken the merger route rather than a straight spinoff. The New England and Pacific Mutual have both done this. This approach can be considered with any operation of a company that, first, can be formed into a separate legal entity, and second, is carried on the books at a relatively low value. You set it up as a separate company, sell off a minority interest, or merge it with somebody else in that business. Then you can revalue the piece that you keep at whatever the market's trading, which is expected to be much higher. The NAIC will take a haircut of anywhere from 5% to 40%, but the ones that are out there have averaged very close to 15%. So although you have to take a haircut from market and it will increase the future volatility of your surplus, it is a way to increase a mutual company's capital base.

The one that I wonder about is why so many companies still own their home office buildings? I know one of the reasons is that the real estate market hasn't been good for a while, but it's getting better, and I think many companies have buildings that they may have acquired or built quite a while ago. They are, perhaps, worth more than they're carrying them for at book value. We saw virtually every bank sell and lease back its headquarters when risk-based-capital-type measures went in for the banking industry, but as yet insurers haven't done that. Is it because rating agencies say they'll look through it? I'm not sure, but that's the one I wonder whether we'll see more of down the road. So there are a few examples to get us started. Dave may want to add to that or perhaps some folks in the audience would like to throw something out.

MR. DAVID R. LUDKE: Let me add a few things. Let's think about this in a different way. How has the increased focus changed in capital or changed the way we run our business? This was an interesting question to me, because, in many ways, not much. One of the reasons is because the company I work for has been, for an extended period of time, extremely focused on capital and return on capital, so focusing on capital as a part of our day-to-day management process wasn't really a change. In fact, if anything, we may be overfocused on capital as a management tool.

In the last couple of years there has been increased focus on capital from external constituencies. Not only the NAIC, but also the rating agencies have shown us that capital isn't a static measure. It's a very hard thing to manage and as we watch the dynamic, one of the things that has definitely happened in the last couple of years is that managing surplus has become more complex.

If I look back five years to how we managed capital, our focus was primarily on an internal focus—what capital did we, as management, believe was appropriate for us to hold to support business? That has changed dramatically in the last couple of years, and the capital we now manage to and are required to manage to is driven by external constituencies. And we have changed the way we think about this to be the greater of all the requirements that would be placed on our business. One, of course, still is the internal risk-based capital. What, as a prudent manager, do I think is appropriate to hold? But there are five other requirements and one is the NAIC. That's probably the easiest one to meet. The other four

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come from rating agencies and they're all different. They all have slight variations in formulas and what's just as important is they all had different redundancies that they require to maintain reasonably high ratings. The play out of those things across lines of business and throughout our company changes from year to year, so the standard is extraordinarily dynamic and very difficult to manage.

MR. SHEMIN: We've also found the capital management process to be much more complex for the same reasons that David says. In fact, we've pretty much jettisoned our own internal capital measure and are using the NAIC RBC measure with some variations of our own. There were certain things about the NAIC measure that we couldn't stomach, but we decided that, on the whole, it wasn't that bad as a starting point. We then take that modified RBC measure and look for a major difference from the rating agencies' formulas, to make sure we don't have some measure that the NAIC measure treats very kindly, growing very rapidly and setting off alarms somewhere else.

Separate account products of various kinds are one class of products that can be treated very well by the NAIC measure. The rating agencies have different approaches to them. Some of them are at the other extreme, being much too harsh and not recognizing the ability to pass experience back to contractholders. So by watching all of these things, although we use only one measure as a base for return-on-equity-(ROE)-type calculations, we have to be aware of all the others to make sure that we don't trigger alarm bells at one of the rating agencies.

MR. LUDKE: We abandoned our internal measurement. In fact, it disappeared from use and I'm not sure when it really expired, it was just superseded. Your point about different treatment is interesting. We have something we call loophole rule which we put in place a couple of years ago because we started seeing some classes of business being treated in ways that were inconsistent among rating agencies, or may not have made any sense with regard to the risk. A loophole rule says that we are allowed to design products or investment strategies that exploit a loophole in capital allocation from the agencies which surely do exist from time to time. But if we choose to do it, we need to have a clear exit strategy in place or we need to be able to deal with the higher capital requirements when the loophole gets closed. What's inevitable is that somewhere along the line, one of the rating agencies is going to notice that a derivative product is really the equivalent of some other investment, or an annuity in a separate account is really the same as an annuity in a general account and the loopholes start to close. That has been a tough thing to design in the process, but it is vital to make sure that we make sound business decisions.

MR. YOUNG: Barry, could you address capital allocation, business unit reporting measures, target capital measures, and how those have been impacted?

MR. SHEMIN: There have been some shifts there. What we used to worry about in capital allocation was return on equity (ROE). Did a venture or an existing line of business' future plans show an attractive ROE on a GAAP basis? GAAP for us is not a pure stock company basis but something very similar to stock company GAAP. That's still important, but what's equally important is how much statutory capital the venture is going to use. So we're not in a position to just let a line of business expand, even if its ROE is attractive, without taking account of whether we're going to be able to afford the statutory

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capital. There are certain lines that you're not going to be able to control very well. You're not going to tell the agents to stop selling life insurance, so you must leave some room for that to use up statutory capital. On the ones where you do have discretion, you have to be choosy about which ones you're going to fund. We've tightened that process. Now capital allocation is a more important part of the approval of annual business plans.

As to business unit reporting, there has been a somewhat more subtle shift. Our main measurements remain on a GAAP basis, but we're looking at what business units do on a statutory basis more than we used to. We're holding them accountable at least to some degree to try to conserve statutory capital, in addition to producing attractive GAAP earnings. The other shift is from GAAP earnings growth to GAAP ROE. We always measured both, but nobody really paid much attention to GAAP ROE, because to calculate it, we went through a process of truing up the unit's capital so that you had the right denominator. Whenever we tried to explain that to anybody their eyes would glaze over. But now that's more important; we still true it up and we still explain it and it's being used more because using ROE instead of dollars of earnings growth gives business units an incentive to use their capital more efficiently, rather than corporate financial folks like me banging on them to try to design their products to have less surplus strain. They have more incentive because it's going to affect their earnings directly because of the measure that we use. Those are some examples of how the increased capital focus has changed some of the measures.

MR. YOUNG: Dave, I'll let you comment on the above if you'd like to, but can you also comment on how the increased focus has impacted Providian's investment policy?

MR. LUDKE: We allocate capital to business units based on the combination of the assets and liabilities assigned to them. We allocate all the capital. We're a stock company, so we do GAAP reporting, but our capital focus is statutory because the rating agencies are measuring us based on statutory results.

From an investment perspective, we have been very concerned about capital, because different investments have different capital requirements. Interestingly, this has attracted more attention than it has really caused different results. Within a reasonably prudent investment portfolio, the kind of portfolio that we would be likely to buy anyway, we find that there isn't much difference in capital. All of our portfolios seem to converge on about the same kind of capital requirement and while capital requirements scare us away from making large commitments to joint ventures or exotic assets, we probably wouldn't do that anyway. We normally keep a moderate exposure to junk bonds, and that carries a capital penalty with it, but it's not as big a deal as we feared it would be.

Interestingly, one of the key constraints to us is S&P's requirement on capital. Their requirements focus more heavily on the liability side than the asset side of the balance sheet. It's not because their formula focus is where they require redundancy. Liabilities get a higher weighting. The other key for us is that A. M. Best has a pretty strong requirement. Their redundancy is a little more uniformly distributed.

MR. SHEMIN: On the investment side, we were one of the companies that had been adding significant value through investments in mortgages and real estate, and we've had to

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make significant adjustments. It's not that our mortgage portfolio was so bad. It actually has performed fairly well, but the mere fact that we had between 25% and 30% of our assets in mortgages was enough to draw a great deal of unwanted attention. In addition to some securitization we cut back, for a while, on new investments in commercial mortgages. We're investing in them again, but not at the same percentage. I think our percentage is down near 20 % and we expect it will stay around there.

Investment in equity real estate had been limited to fairly unusual situations and now is nonexistent. We used to invest in agricultural mortgages and that has been greatly restricted even though the spreads were attractive. So it has had some effect and it has put a great deal of pressure on our bond investment people because our specialty has been privately placed bonds and mortgages. Now it's privately placed bonds, some mortgages and we're expanding our capabilities in public bonds. So I think it has had a substantial effect on our investment activities. It is not causing us to be uncompetitive in the business lines, but we have to try harder in the sectors that we continue to operate in. Fortunately, the need to control the deployment of risk capital has also meant that companies are not increasing their guaranteed liabilities in large amounts either. So, to some extent, the increased investment restrictions and decreased supply of attractive investments did contribute to a somewhat lower demand for investments backing up spread products as we've shifted some of our focus to other-than-spread business.

MR. YOUNG: I thought we'd give some nonpanelists a chance to comment on how this has all affected the industry.

MR. ZAFAR RASHID: Well, I guess one thought I had is that there are plenty of creative ways to squeeze the last dollar out of surplus, but I'm not sure that's where the industry's focus ought to be. I think it's more an issue of profitability. I'm reminded of what a physician friend told me some time ago. The most common request he gets asked is, "Doc, I need to lose 25 pounds; I need a crash diet." And he invariably asks the patient, "What are you going to do after you've lost the 25 pounds?" The automatic answer is, "Well, I'll go on a maintenance diet." And he tells them, "Well, why don't you go on the maintenance diet first, and if you can make that work, you won't need the crash diet?" And I think there's a similarity to that in the insurance business. I think if our business lines are profitable, the surplus will take care of itself. If we don't make our business profitable, then all of these shenanigans and approaches are just buying a little more time and are really not solving the basic problem.

MR. SHEMIN: I agree with half of what you're saying. I agree very much that you have to make the business profitable going forward and that is an increasing challenge. I think that in the wake of the failures in 1991, or thereabouts that the industry had to do things to shore up its capital base that could not be accomplished by increasing product profitability. After all, increasing profitability in products is a function of improving your business operations by adding value. It's not a function of increasing your prices. Therefore, it takes time and I don't think the industry had the time to adjust to that. But I think now the industry has adjusted and there is not the same concern about solvency, so there is and should be much more concern about earnings levels and profitability going forward. So I very much agree with you on that.

MR. FRED TOWNSEND, JR.: In 1991 to 1993, the industry raised surplus helter skelter. In 1991 they had to meet the solvency scare. In 1992, there were the rating agency needs. And then in 1993, the initial RBC ratio that would be reported was raised. So the industry just raised surplus. There was no surplus management, except for the way you met your RBC objectives. The industry capital ratio rose from 7% in 1990 to 10% at year-end 1993, which I think is pretty amazing considering the New York restraints on surplus accumulation for mutual companies. When everybody knew where everybody else was on RBC, we saw a substantial reduction in new surplus infused into the industry in 1994, and a continuing net outflow of \$1 billion in just the first quarter of 1995 alone. In 1994 and 1995 companies are returning to surplus management.

Many corporate activities that had been delayed during the surplus accumulation period of 1991 to 1993 are now in full swing—mergers, acquisitions, divestitures, sharp expense reduction programs—and we're finally getting back to the profitability of the business. I think people are trying to build up their return on equity, bulking up the profitable lines of business and downsizing or disposing of the nonprofitable lines of business. This is how you're going to accumulate surplus on a real basis; you must skip the artificial transactions: the sale and lease back of home office buildings, sales of investment management subsidiaries, and the sale of reinsurance departments. You not only have to price your products profitably but you also have to get an early return on surplus so that the surplus grows along with growth in force. And so we're moving toward the management process of 1994 and 1995.

The Hancock reported a 24% increase in surplus for 1994, which indicates a fairly decent job for a large company. Two days later S&P downgraded it. How is S&P looking at the industry these days? Why would they do something like that?

MR. SHEMIN: Well, we had lengthy discussions with S&P. They have some concerns about our mortgage exposure, even though we disagree with them. Our capital deployment tends to be somewhat more aggressive than other companies that remain AAA. They downgraded us one notch to AA+, and if you look at some of our ratios, that's where you would come out. Nonetheless, we felt we had proven management structures in place that produced excellent earnings patterns. I don't think the first quarter's statutory results were factored into the equation at all, because the analysis and discussion that went on occurred well before then. As Dave referred to earlier, their formula is different from some of the others, and we tripped over some of their trip wires, which we discussed with them. What it came down to is, if you're trying to maintain AAA rating, you can't have the slightest blemish. As you know, they've had more downgrades than upgrades. Their view of the industry has declined, so it's just that much harder to stay at AAA. Despite the fact that quarterly results were okay, our statutory growth in 1994 had been actually slightly lower than 1993, although still healthy, and that was enough to trigger a move. Maybe we should have had them talk to you first.

MR. TREVOR E. HOLLAND: Well, first of all, as far as raising capital and improving the balance sheet are concerned, you did refer to some transactions that General American has gone through over the last few years. Starting with going public with the reinsurance company, I can't remember offhand what we raised in the way of surplus by the partial sale of the reinsurance operation, but the most recent sale was the sale of our GenCare HMO to

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United Health Care which, on a pretax basis, raised about \$300 million. To restate what the last gentleman had to say, our CEO puts it very succinctly when he says our balance sheet is in order and the time has come to concentrate on the income statement. On that point I agree with Mr. Shemin when you say that giving the responsibility to each of the lines of business to produce acceptable ROEs has a tremendous impact on the efficient use of capital. However, my question is, have you put any thought into what acceptable ROEs are for the each of the different lines of business?

MR. SHEMIN: I can describe the process we've been moving towards. I don't think it's perfect yet, but we're trying to use a benchmarking process where we try to develop ROEs for each business based on what external competitors in that business are earning, have earned, or are expected to earn. I think the people in the business lines would say it's the greatest of all those three. We've done studies on some of the lines which have given us indications of what might be appropriate. We don't think we can do external studies for every line of business, because competitors that are restricted to those lines do not exist, so we're still working on that piece of it. But we're trying to set earnings targets based on ROEs that are determined based on competitors in the business and are adjusted for either trends in the business or our position in the business versus our competitors. We have some businesses where we're at the superior end, and we have some business where we're at the other end. We try to take that into account, but the idea is to set low, multiyear targets that will move us up to at least average. So we're trying to use an ROE-based set of benchmarks that will then translate into dollar earnings for each of the business units.

FROM THE FLOOR: Can you provide a range of numbers?

MR. SHEMIN: The numbers probably range from negative for one business unit to probably in the 20s, so there's quite a bit of recognition of where the business is. By the way, for our traditional participating life business, we're competing against mutual companies. Data aren't publicly available. We believe the returns there are probably a bit lower, in part because the risk in the business is fairly low due to the dividend margins. We think those might be perhaps in the 10% area and others might be around 12% on the average, but I think it depends; some might get up to 15%. I think it depends on what outside interest rates are. At least on a lagged basis, there is movement in equity rates of return depending on fixed-income interest rates. It doesn't move in tandem, but over time I think it moves. You used to hear more people talking about 15–20% and now it's 12–15%, and those are just some ballpark figures.

MR. YOUNG: Dave, before you add the Providian point of view, I'd like to follow up Trevor's point about General American. I don't have all the numbers at my fingertips, but what I remember is they initially sold about a third of their HMO. They were having trouble with the rating agencies and the value that they were allowed to hold it at. And my recollection is it was something like \$20 million for a 100% ownership. They went out and had it valued at something like \$60 million. So Dick Liddy, the CEO, thought it would be worthwhile to sell some of that and get some of that money in. They went to the market. The marketplace valued it at \$100 million. They sold about a third of it. They kept about two-thirds and last year they sold the rest. At that point, the market value of the company was \$500 million. I think the net gain, before tax, for General American, was between \$300 and \$400 million.

I think the reinsurance division is even more interesting because it, likewise, raised a significant amount of money. The cash raised for the 38% that they sold went into surplus. The market valued the new company at about \$500 million, and since it had been a department prior to the restructuring, it had been valued at zero. As a result of the transaction, General American received about \$180 million in cash and they had a valuable asset on their balance sheet for the 62% retained. But this gets to Fred's point. In addition to raising capital and making its company much healthier, Liddy ended up positioning the different companies or different operating units within his mutual company to be able to act as a stock company and to be managed as a stock company. David, do you want to comment on this?

MR. LUDKE: Yes, our return on capital targets are very much driven by a share price. As a stock company, we believe we have virtually unlimited access to capital if we can make our return on capital targets. That's the kind of returns the stock market demands of us and, as a result, that's the way we come at our return on capital targets. We look at what our stock beta is and how our peer stock companies are valued. We try to estimate, so there's a little more art than science in some of this, what kind of return the capital markets are requiring of stock life insurance companies or companies in our business? From that, we would derive a total company return on capital. Now there's art in trying to attribute that to various lines of business because generally, when you look at the stock market, you try to impute return on capital requirements from the capital markets. You can't find pure plays. You can't find a pure home service company, a pure credit card bank, or a pure GIC producer. When we look for specific lines of business that go for that, we must use a lot of estimation. But one of the things we do know with reasonable certainty is what the total company is worth and at what price we can issue shares, or at what price we can buy them back. If we have got too much capital, clearly the easiest thing for us to do is buy them back in the marketplace and reduce our capitalization. But that means we can be in and out whenever it's appropriate to raise capital if we can beat our hurdles and add value to shareholders.

MR. STEVEN P. MILLER: One of Omaha's famous residents, Warren Buffett, has a philosophy—he will not hold his managers responsible for how much he paid for their company. The philosophy being that if he paid too much, it's not their fault. If they're doing a good job, they're producing the kind of income that's available. Let's say you are doing a wonderful job managing your business. You are producing an acceptable return on equity. All of a sudden, because of peer pressure, because groups of people decide we want the life insurance industry to be a safer industry, a less risky industry, they require you to pay more for your business. It seems to me that the logical result is that a good manager will now have a lower ROE target because he will have more capital to do exactly the same thing that he was doing previously. However, I don't see that happening. I just want to know what kind of comments you have on that.

MR. YOUNG: I guess we could turn that around to ask if there really is a capital shortage in the industry?

MR. SHEMIN: I think that's a very good question. I think you're seeing low ROEs, but I'll get back to that. Here's a paradox. If you look at the life insurance industry as a whole, you can make a case that has too much capital. You can see the symptoms of competition,

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the depressing effects on returns, particularly in individual life insurance markets. The core business has very slow growth; for the industry as a whole, it's not growing at all. You can make a pretty good case that, except for certain growth segments, the industry has too much capital and too many companies. However, when you talk to individual companies, they all tend to feel that they don't have enough capital and, certainly, the mutuals all feel this way. I don't know that stock companies would all feel this way. Some, but not all of them, have ready access to capital markets. Some of the smaller ones might feel like these mutuals. What's the answer? Does the industry have too much capital, and if so, why do the individual companies feel that they don't have enough? Are they all thinking that they're going to be the survivors, the ones that are going to grow, and therefore need more? Of course, that's not true.

I do think that there is a sequence of things that ought to happen with higher capital standards. First, ROE should go down. What that should mean is that supply should go down. People should pull capital out of businesses that are capital intensive, because it's not worth the investment anymore. Eventually supply and demand gets into balance, and returns should reach appropriate levels.

MR. MILLER: That should happen only if the risk remains the same. Now that the risk to the investor has changed the investor ought to get a much lower risk premium.

MR. SHEMIN: I think the comment was that if the higher measure of capital is a symptom of lower risk to the investor, should the return be lower? I think your point is that because there's more capital backing up the business, then the investor should be willing to take a lower return. But I don't think higher capital leads to lower risk. Risk is a volatility measure, and it really doesn't respond to how much capital there is backing up the business. It responds more to the fluctuation in earnings, which I don't think has gotten any lower. So capital should leave the business and allow the restoration of margins. I don't think capital has been leaving the business, or at least it hasn't yet, but if we do see consolidations, then that probably will be a way for capital to leave the business and restore profit margins.

MR. YOUNG: A question that follows the additional point that Barry just raised is how do you meet earnings objectives as new sales growth shifts to the narrower margin products?

MR. LUDKE: Yes, in fact, one of the biggest challenges that we, as well as other companies, are faced with right now is because of the shift that's going on in the marketplace from high-capital to low-capital products, and that assuming that return is, indeed, tied to capital deployed, are we going to have earnings growth? You may have growth in return of capital (ROC), but if we have growth in ROC by winding capital down rather than making return go up, do we have a vital growing corporation? And the real challenge is to replace moderate volumes of risk-based high-capital business with very large volumes of service type business of very low capital business. It can be done, but it just requires a different kind of management.

MR. SHEMIN: If you look at the analogy, it really applies to virtually all the businesses that insurance companies are in. In the life insurance business, variable life is gaining share and universal life has gained share, and they pass on more risk to the policyholder. In the

annuity business, variable annuities have become much more popular. Maybe that's temporary, but I don't think so. I think the baby boom passing through the accumulation years is going to be semipermanent change even the next time the market goes down.

In the medical business, for maybe five to ten years, there has been a significant shift to administration contracts passing the risk to either employers or providers, not insurers. And even in the GIC business, which was a pure risk business, you find synthetic and alternative GIC structures growing rapidly. They pass on significant risk to the plans themselves with the insurer performing more of a smoothing function rather than a risk-absorption function.

Let's discuss where this shifting might lead if it continues. As Dave said, you've got to grow by quantum levels to keep your dollar earnings up as these shifts occur. I think what you might see is actually a move away from return-on-capital measures. A return-on-capital measure doesn't mean very much for a mutual fund or investment management company, and it probably doesn't mean very much for a variable annuity company. Alternative GICs have very low capital requirements, and you should be earning more than a strict ROE basis would produce. Just as some companies try to use different measures for certain products or businesses already (term insurance might be an example), it may be that we'll see the slow decline of ROE measures as equity becomes so small that it's not the relevant indicator of performance anymore.

MR. LUDKE: In fact, maximizing ROE as a business goal really assumes that equity is a scarce resource. If a scarce resource becomes something else, like management time or ability to sell business, then the key to successful management isn't to maximize ROE, it's to maximize return on that other scarce resource.

MR. SHEMIN: The important thing about this trend isn't how we measure it; it's the fact that margins are going to be narrower and the insurance industry tends to be at the high-cost end of the financial services industry. It is even more important to develop business strategies that can make a profit on these very narrow margins when in competition with other sectors of the financial services industries that are already used to dealing with those thinner margins.

MR. YOUNG: There has been much discussion about expense control, both internal and external. Do you want to comment on that general subject? What do you see happening with your respective companies and within the industry? There has been a great deal of discussion of levelizing compensation and using a more cost-effective distribution. What do you think is happening?

MR. LUDKE: What I see internally, what I think all of us are seeing, is a great deal of attention on expenses, staff levels, and cutting of expenses. There is also some focus on trying to cut distribution costs. In the businesses that I'm closest to that has been pretty tough, because much of the distribution costs are coming from third-party commissioned distribution and that has been tougher to bring down. But I expect that the attention to expense control is going to stay there. It probably will get more acute if we shift to more fee-based, low-capital businesses. Expenses become a vital part of the profit. They became almost the whole picture rather than just one of the pieces.

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MR. YOUNG: It's probably hard to find a company these days that is not involved in some sort of downsizing in response to expense control pressures and that's why we have sessions on reengineering and other such topics. However, the tougher part is trying to reduce distribution costs, either by leveling them or otherwise. Here there are far fewer success stories, and if anything, there are some trends that go in the other direction. Much of the market activity, including the new life insurance sales illustration regulations that are being proposed by the NAIC, will have the effect of hurting sales force productivity by placing more constraints around the sales process. More extreme changes of this type have occurred in Australia and England leading to a reduction in the size of agency forces between one-half and two-thirds. Something perhaps not quite that bad, but something very significant like that could happen in the U.S. Even though you'd be left with a more productive sales force, you also would be left with many headquarters and perhaps field overhead to deal with from an expense-reduction viewpoint.

MR. YOUNG: One of the points that was raised in a recent Tillinghast survey (I think it was the chief actuary survey) was that mutual companies seemed to be very focused on cutting cost of distribution and stock companies do not seem to be. Does this say something about tied distribution?

MR. LUDKE: Well, maybe it says that mutual companies haven't had the impetus to face up to that before. That's possibly one thing it could say.

MR. SHEMIN: It probably says something about third-party and owned distribution, too. Many stock companies don't own their distribution force and using third parties gives you much less control, although sometimes I'm not sure who owns whom. By the way, on the capital front, a career distribution system is very expensive, not only to maintain, but to set-up and grow from a capital viewpoint. Look at the sequence. First, you have to recruit inexperienced agents. The cost of that recruiting is substantial because you need many people doing many things just to bring bodies in the door. Then you have to provide financing, because they're not going to earn enough money in their early months. The financing might run anywhere from 6 to 18 months, and then they're going to start writing, you hope, decent levels of new business which, in turn, lead to statutory strain on the company. So you have got this double cycle. You first make an investment in five agents to keep one and then that one sells business for which you must put up capital. Out of the profits on that business that come down the road, you must pay for both of those capital expenditures. So it's really no wonder that one of the reasons why the career systems of the mutual companies haven't been growing is the extremely large capital outlay it takes to keep them growing.

MR. YOUNG: The last question I'll throw at you is how XXX or other reserve requirements are impacting product design.

MR. SHEMIN: I guess I said I'd take a try at that, although it turns out neither of us have products that are impacted very much. I think particularly in the companies that write large amounts of level premium term and some whole life or universal life term surrogates, you see redesign efforts going on to make those products balance-sheet friendlier, and you also see some aggressive pricing during the window of opportunity.

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I think we are finding that the technicalities of XXX do affect a few products that we didn't expect them to, and there is a fair bit of work actually going through your product portfolio and testing everything. Here again, is a little more overhead that we have to bear. If you want to comply, you have to take a close look at it because if a product doesn't quite make it into one of the safe harbors, you might have to set up significant additional reserves.