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IS EVERYBODY HAPPY? A MANAGEMENT PERSPECTIVE

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Insurance companies answer to a number of competing interest groups: policyholders, shareholders, rating agencies, regulators, agents, and employees. Satisfying the needs of these different groups has become increasingly challenging. Senior executives will discuss their experiences in managing this process.

MR. JOSEPH M. RAFSON: We will try to at least partly answer the question of how insurance companies deal with their varying constituencies. This session is sponsored by the Actuary of the Future Section, the Committee on Management and Personal Development of the Society, the Smaller Insurance Company Section, and the Financial Reporting Section, which makes this the most broadly sponsored session at this meeting. I think it's an indication of the interest in moving the profession beyond the traditional technical areas into which actuaries sometimes believe that they must fit.

We'll be talking about the various groups that vie for management attention and financial actions from their companies. Those groups include policyholders, shareholders or owners of companies (and/or the boards of directors representing the owners), regulators, the SEC, rating agencies, sales forces, employees, as well as the media. All these groups are competing for management time and action.

It was suggested to me that perhaps this session should be called "Is Anybody Not Unhappy?" Perhaps the goals of companies are to keep some groups happy and some groups not unhappy. The groups they might want to keep happy are customers, policyholders, shareholders, and employees. And groups they might want to keep not unhappy are regulators, the SEC, ratings agencies, and the media.

The choices, the balancing act by management, are made at a number of different times and ways. They happen as part of ongoing business: setting crediting rates, dividends, pricing, and underwriting policies. They occur because of events that might be internally generated: mergers and acquisitions, sales force changes, and product changes. They may be event driven from outside the company: industry events, interest rate changes, and changes in the asset marketplace. The balancing act that we'll be talking about is surely more art than science and practices vary considerably.

Our first speaker will be Dick Robertson. He's an executive vice president with Lincoln National, where he's responsible for risk control. He is a past president of the SOA. I'm sure many of you know him and know of the many things he has done. We don't really have enough time to list his accomplishments. I would say that he's active in many levels of management, including being the chief financial officer (CFO) of Lincoln National from 1974 to 1992. He has been responsible for investor relations since 1976 and some of his remarks may focus on that role.

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Next will be Regina Rohner, chief actuary and senior vice president of the four companies that comprise J.C. Penney Life. She has been the chief actuary at J.C. Penney for 10 of the 19 years she has been with the company. Among other things, Regina is on the women's advisory team, which is a corporate-wide group dealing with employee issues covering some 200,000 employees. She'll be talking about employee relations as well as some policyholder issues.

Finally, Bob Schneider has been with the New England for 20 years. He's currently an executive vice president and has been the CFO there since 1991. He's a member of the company's board of directors and he was deeply involved in the recent merger transaction on many levels. I'm sure he'll be able to offer some insight.

Scott Wright is our recorder. He's a consultant to the life insurance industry with KPMG in Chicago.

MR. RICHARD S. ROBERTSON: I'm going to be speaking primarily from the perspective of investor relations, although, as a member of management, I've had responsibilities dealing with many of the other constituencies. To a significant extent, the principles and things we do are very much the same. As Joe mentioned, I've had responsibility for the investor relations function at Lincoln National for over 20 years. I was given that responsibility shortly after I was made CFO and either I've done a good enough job at it that they've kept me there or they can't find anybody else that wants the job. In any event, I still have that responsibility.

Over the years we've developed a program that I think gets fairly good marks from our constituency. We've done a number of things fairly well, and I'd like to share three general things that we do or have discovered over the years that help make for a good investor relations program and help align the interest of many of the other interest groups with those of our shareholders.

Of those three things, the first one involves the need on the part of investors and their representatives to get information about the company about how we're doing, information that is both complete and accurate. They are interested in information that is both hard and soft, that is they want numbers, and they also want ideas and qualitative things that are going on.

To address at least the hard aspect of the information, many years ago we tried to put together a comprehensive package of information that identifies things of a financial nature that the company measures itself by or ought to be measured by. We put that information together. It's a moderately thick volume that runs to about 20 pages, although much of it is historical information. We regularly make that available to the investing community, and update it each time we release additional earnings each quarter as appropriate. That information has been very well received and, in fact, I think most companies are now doing something that is quite comparable. Some probably even do better than we've been able to do over the years. But the important thing is that it gives a database about which we can have a dialogue with the people that follow us. We can use the same database in talking with each other, or with the rating agencies, or even with regulators. These are the things that we are measured by. They're the things that are considered important. They are the things that we track.

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They're the things that we expect them to track. That message can go out to whatever constituency we're talking to.

The second general thing we do is related. In addition to providing a consistent package of information about how we're doing and past information, it is important to have a clear articulation of where we're going, what our objectives are, and what our strategies are. And here, too, we talk both in terms of hard and soft data.

One thing we did many years ago is we established a firm quantitative commitment as to what our company's objective was. Our company objective is to obtain a 15% ROE. Many companies have objectives that are similar. In fact, I think that if you were to poll objectives you'd find out that 15% turns out to be an overwhelming number. We set that objective about 13 or 14 years ago and there were some reasons that were quite appropriate for doing so at the time. One is to have an objective of that kind so that people can point to something that the company is trying to accomplish. But, at the time, I perceived that we had a serious problem and that we were not using our capital as efficiently as we needed to. By getting it out there as an objective or a goal post, it allowed us to begin to focus our energy on achieving it. Interestingly, we never made that goal.

Over the years, we have consistently been turning in about a 12–13% return. But one thing that I've observed is that the competitive field has been gaining on us. When we set the objective, it wasn't a particularly challenging objective, that is, if we had met our 15% objective, we would have been no better than average. Keep in mind that I'm talking about 13 or 14 years ago. You can remember what the economy was like then. The cost of capital was about 15% so making that objective would have probably been just like standing in place.

Over that period of time a number of things have happened. Interest rates and the cost of capital have come down, and the returns produced by American business within and outside the insurance industry have come down for all good reasons. Today, that kind of ROE would put you as one of the better performing insurance companies, and indeed, one of the better performing businesses. When we re-examined it from time to time, we concluded that it's still a good objective, in part because we've raised our sights. We don't want to be an average company anymore. We want to be a superior company, so that the objective is still appropriate. The important thing is the objective is something we put forth; it is what we're trying to accomplish, what our business strategies are designed to try to get to, and it's something that we can use to communicate both internally and externally where we believe the company ought to go.

I talked about soft data and now I'm talking about strategy. In what direction are we going? Our company, like many, has made a number of strategic moves over the years. It is very important to put these in a context. We have gotten out of the health business. Why have we done this? We have been expanding our asset accumulation businesses because it's important to be able to talk, in general, as to the kind of company we are and would like to become. We do that with the external audiences so they won't be surprised when we make an announcement that we're doing thus or selling this or buying that or expanding an operation. It will help the internal audience understand as well. The ability to develop and articulate a clear corporate vision

strategy and all that is a very important aspect of investor relations; also important is the process of managing expectations of the various constituencies.

We also have helped align the interest in these various groups in that for as long as I have been with the company one of the things that we have considered important is building an ownership base among our employees. We have encouraged the employees to be investors in the company. We do that in a variety of ways. They have a 401(k) plan. An investment option is company stock. Company contributions are made in company stock, so the employees automatically become investors in the company. We actually go a step further. We vary the company contribution based on our performance which accomplishes a number of things in the way of aligning employee needs and desires with company desires.

More recently we have articulated this concept of employee ownership by establishing some guidelines as to the level of ownership that is considered appropriate. This, too, is not something that many companies have done. The idea is that as you move up in the ranks as an officer in the company, your relative investment in the company should increase, not just in absolute value, but also, relative to your salary. For example, the chairman of the company is expected to have eight times his salary invested in company stock. A lesser multiple applies to me and all the way down. For the lowest level of officers, there is a one times standard. That has been very well received partly because the stock has done well. It has been a good investment. But, it has been very helpful in aligning the interest of the employee and officer group with the interests of the shareholders. It means that as you go down the hall, it's not unusual that people will say, "How's our stock doing today, or where are we going, or how is this move we're making or change we're making likely to affect shareholder value?" These are the right kinds of questions you want people to be asking if you're going to appropriately represent the various interests.

MS. REGINA V. ROHNER: At J.C. Penney Life, our overriding concern, focus, and commitment is to our customers. Our second priority is to our employees whom we call associates. We feel that if we satisfy these two groups, then the natural result will be that the other groups (the stockholders, the endorser, the rating agencies, the regulators, and the auditors) will be satisfied. I'll address our efforts on policyholder and associate satisfaction.

Since my company is a direct-response company, our focus may be different from other companies. Our home office probably has more direct contact with our policyholders than agency companies do. Concern for our policyholders is due to two influences. The first is a commitment to customers described in the guiding principles for our business that were written by Mr. Penney over 80 years ago. Second, it makes good business sense. Due to the heavy initial expense that is incurred in direct response business, financial success of the business is dependent on maintaining good persistency. Studies have shown that a customer who is merely satisfied may consider an offer made by a competitor, but a delighted customer will not. We've not always realized the importance of service.

Over the past few years our company has made a dramatic transformation in the way we do business. We began that transformation by becoming *customer focused*. A customer-focused company puts the customer at the top of the organizational chart. It

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means managing all of the company's decisions, processes, and practices in a way that makes sense from the customer's point of view. In providing customer focus service, you do whatever it takes to meet or exceed the customer's expectations. The customer is anyone we interact with in the course of our jobs, particularly, people who require products or services from us. But the customer is not only the person who answers our telemarketing call or opens one of our mail solicitations; it is also the person who makes the calls or helps design the solicitations. So everyone in the company is responsible for the care and treatment of the customer.

Our challenge at the life company was to transform this philosophy not only into every contact with our external customer, but also to weave them into our day-to-day interactions with one another. We did that by training every single associate on the principles of customer-focused service. We started our training with senior management and carried it through the whole company. We realized very early that it would be difficult for us to expect our associates to be customer focused if their managers and supervisors were not. So we made sure our managers were role models for the customer-focused service philosophy. And once we did that we saw some amazing things happen. Our associates became more aware of the importance of customer-focused service. We witnessed a dramatic change in our company culture. We also witnessed a tremendous surge in our company growth.

In 1989 the life company reached the milestone of one million customers. We'd been in business for about 22 years and we had enjoyed a slow, steady increase in our policyowner base. Now, just six years later, we have over seven million customers throughout the United States and Canada. We've also established 35 business relationships that include many of the top oil, bank, and retail companies in North America. For us, being customer focused has become more than just a nice thing to do. It is our competitive edge, the life blood of our business.

That brings us to the question, what is customer delight? Customer delight means going beyond what is expected, beyond service with a smile, or, just being honest and courteous, or just giving what he or she wants. It's giving customers more than they thought they would get. It means doing more than the customer has asked. It's understanding the customer's needs even if the customer hasn't exactly said what those needs are. Customer delight means adding a little more, going the extra mile, and doing better than we have to.

This has required an investment not only in training, but also, a tremendous investment in equipment such as a phone switch which tracks call volumes and the percentage of calls answered within 20 seconds. Our administration system is constantly being upgraded to immediately provide the telephone representatives with the required information. Service on our 800 numbers is provided 14 hours a day. There's a separate 800 number for Hispanic customers in the U.S. and French customers in Canada and, obviously, bilingual associates answer the calls.

In today's business climate, it's not enough to simply satisfy our customers. There are too many other insurance companies who can supply similar products at similar prices. To keep our customers we have to delight them. We have to give them more than any other company can. I'm talking about an attitude and a mindset that keeps the customers at the center of our company's existence.

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People don't mind paying more to be delighted. Delight has value. If we're delighting our customers they wouldn't be tempted away even for a lower priced product, because products don't build loyalty, good relationships do. Customer delight is based on the service experience they receive each and every time they talk to someone over the phone, fill out a claim form, or write us a letter.

We conduct focus groups with policyholders to get their opinion on everything from product features to claim procedures. They provide us with general preferences or specific opinions. We bring together associates from our front lines, customer service claims and customer relations. These people talk to our customers everyday, so they know better than anyone else what's on our customers' minds. Their input is invaluable in making changes to help us delight our customers.

On a much larger scale, we track our customer service performance with a tool called the customer service monitor. We sent about 3,000 questionnaires to customers each quarter to find out if their service requests were handled to their total satisfaction. About 80% of our customers give us a rating of nine or higher on a scale of one to ten. We are very pleased with that rating, but we're constantly finding ways to make it even better. At the bottom of that questionnaire we give our customers the opportunity to tell us anything they want our service. Here's an example. "The service representative helped me in every way. When she didn't know how to answer my question she quickly transferred me to someone who did. They explained it in a manner which I understood. Since I work for the post office, I'll recommend you to everyone on my route." We also get feedback from customers who have filed a claim. Along with the claim check, we sent out a comment card asking the customer about the service they received. Because we're in the business of paying claims, this is a critical time for building relationships with our customers and those comment cards tell us that we're meeting or exceeding our customers' expectations 96% of the time. Let me read one of them to you. "I'm very pleased with the manner in which my claim was handled. I have a few other policies with other companies and your company has been the most helpful. You kept me informed of the progress of my claim and you were also very timely with the check. This means so much when you lose a spouse and are faced with all the finances."

You're probably thinking that I'm only sharing the good comments. Well, that's true. Everyday we receive piles of comments just like these. We also receive a few negative ones and they don't end up in the recycling bin. We follow up on each of them so we can continue to find ways to delight our customers. We've learned that one mistake doesn't necessarily make us lose a customer. It's how we handle the mistake that counts.

One of the secrets about customer delight is that many times it can be achieved in small ways that don't necessarily cost money, but still let the customer know that we care. Here's an example. The first thing we do after receiving a life insurance claim is to send a sympathy card to the beneficiary. We also let them know they will be hearing from us shortly regarding their claim. This is not a form letter. The envelope is hand-addressed and we use a regular postage stamp instead of sending it through the meter. Many of our customers tell us this is a small but personal and sincere gesture from our company that means a great deal to them. They know that the card comes from a person and not from a machine. In fact, a fair number of our customers even

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send us a card to thank us for our expression of sympathy. They often tell us we're the only insurance company that took the time to do it. That sympathy card is just one way that we go the extra mile, but it would not be as meaningful if other parts of our service were lacking.

As we all know, one of the secrets of success is people who have a commitment to customers. At the life company we strive to honor what my boss calls "the ultimate promise"—our promise to be there when the customer needs us the most, to answer their questions when they call, and to pay every claim as fast and as effortlessly as we can. We used to think that our relationship with the customer ended as soon as we clinched the sale. Now we know it's just the beginning and we constantly look for ways to strengthen and develop that relationship.

Our ability to provide outstanding customer service is dependent on the company's ability to employ motivated and enthusiastic employees. This is accomplished in a number of ways and I'll mention a few. Associates are empowered to make decisions at all levels of the organization. We monitor associates' perception of their chances of achievement and provide managers with training on managing diversity and accepting that people with various backgrounds have different ways of making contributions in the work force. We provide leadership training. One method is by having speakers who are recognized leaders address us on a quarterly basis. This year we were fortunate to have Bonnie Blair, Ann Richards, and Sally Ride speak to us. We provide flexible work hours, part-time hours, and a child care facility. We encourage associates to volunteer in community service work either through company-sponsored activities, such as our adopt-a-school program, or through independent activities. Through these and other programs our associates are provided with the foundation to be able to serve our customers.

MR. ROBERT E. SCHNEIDER: As many of you have probably seen in the industry, my company, The New England, has agreed to merge with MetLife, and we're in the process of going through the regulatory review that's necessary to do so. But before I make a few remarks about that transaction I'd just like to deal with some other things we've done to address the kinds of issues that Regina was just talking about. For many years I would say that our primary focus as a company has been on our field force. We're very proud of the relationship we've had with the ultimate customer, but we felt that relationship with the ultimate customer was managed by the agency force. Recently we've done many things to try and turn the focus of our home office organization more to the ultimate customer, without, in any way, sacrificing the relationship with our distribution system. We feel that by focusing on those two audiences we will address the needs of the other constituencies.

Our organization was reorganized about two years ago into a sort of matrix organization. We have individual managers responsible for our major product lines, but they don't control many of the functions that support those product lines. The policyholder service function and the systems development function report to managers who are responsible for those functional areas. Those areas have their own profit responsibilities. They receive designated amounts of revenue from the product lines and then have to manage their expenses to that revenue. At the same time, we have a scorecard that credits them not only with their expense/revenue matching efforts, but also with the profits of the lines that they support; it's an attempt to avoid focusing only on their

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own narrow concerns, and to encourage them to look at the company or the product line as a whole. We see this as a way to encourage people to take more responsibility. It's not only the sales force's responsibility to bring in customers or to keep customers happy, it is also everybody's responsibility.

The heads of both of the product lines and the functional areas report to our CEO and form the company's executive committee. That structure gives us different levels at which different types of decisions are made. Normal business decisions, such as changes in the price of the product to react to changes in interest rates, are made on a routine and everyday basis by the business units. The only major exception to that is the establishment of our dividend scale, which is both a very visible action, in terms of what the customer and field force see and a very important action, in terms of the company's financial results. The dividend recommendation is reviewed by the CEO and the board of directors, rather than being under the control of the product manager for the individual life insurance product line. However, even many external events, such as the ones Joe described earlier or some sort of fairly significant shift in the economic environment, would be handled by the business unit. Again, depending on the severity, a recommendation might be reviewed and approved by the executive committee and the CEO. But we'd expect the initiative to deal with any kind of external shock to come from our business units.

Some events which might require a major shift in corporate strategy would be driven by the CEO. An example might be, for example, the repeal of the Glass-Steagall Act and a resulting dramatic shift in the financial services landscape. I don't think that would be an event we'd expect our business units to be able to react to. There would have to be some sort of overall corporate strategic response.

Many internal decisions, which Joe called event driven, are made at the business unit level. For example, the decision to go into a new product is usually driven by the business unit. However, most of those decisions amount to a shift in corporate strategy and would be made by the CEO and the executive committee. Things like decisions to exit businesses, which we have done, or to engage in a corporate-wide expense reduction program tend to be driven by the top management team acting centrally. Of course, a decision to enter into a merger with a larger company was clearly a decision driven by and made by the CEO and the board of the company.

I'd like to talk just for a minute about our decision to merge with MetLife as an example of balancing the interests of many parties. Initially, negotiations were undertaken by the CEO and staffed by a very small number of people. That's the way to do a transaction of such magnitude. We would have preferred that there not be any publicity at all until the decision was made, and that negotiations continued to be staffed at that small team level. Unfortunately, *The Wall Street Journal* publicized the negotiations, and the more widespread knowledge made the process of coming to a decision that much more difficult.

We made this decision because we see the long-term future of the financial services industry requiring consolidation and large investments in technology. As part of a larger enterprise we will be better able to undertake those investments. At the same time, we were unwilling to engage in a transaction that would, in essence, mean the dissolution of our company. We sought out a transaction that would not have that

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effect. Now in any merger or similar transaction involving a mutual company, the overriding interests must be those of the policyholder. Any corporate restructuring transaction such as that has to pass two tests. First, is it in the best interest of the policyholders? Second, is it fair to the policyholders in a financial sense? The answers that management and the company's board of directors give to those questions will be scrutinized and reviewed by a whole series of regulatory bodies who will have to agree with those decisions. I guess I should step back for a minute and say that, in our particular case, the decision was made at the board level. It was not made by management. Obviously, the board relied on management's recommendations, but it was very clear that a decision to merge a company is of such fundamental importance that only the board can take that action. We have a very engaged and responsible board that understands its responsibilities and that challenges the recommendations and the analysis of management in order to carry out those responsibilities.

Having passed the test, at least in the opinion of our management and board, that this transaction is in the best interest of the policyholders and it's fair to them from a financial point of view, it is legally appropriate to consider the interests of other stakeholders. In other words, management and the board are not required to consider the interests of the policyholders to the exclusion of the interests of any other stakeholder. In our case, we felt the other important stakeholder were our employees and our agents. It was very important to us to structure a transaction which protected, to the highest degree possible, the interests of those groups as well as the policyholders.

Probably the next most interested constituency is the community in which we operate. We have a national presence in terms of our agency force; most of our work force and our corporate headquarters are here in Boston. Of course, both Massachusetts and the city of Boston are very interested in maintaining an institution of the size of The New England in Boston; we thought that was an important thing to consider, too.

Finally, we had to deal with the legitimate interest of people such as regulators, rating agencies, and media. However, that's a different kind of interest, and I think Joe's analogy of keeping them "not unhappy" is very appropriate. The vitality of our organization depends on having opportunities for growth and for career development for our agents and our employees. These other audiences have a need to pass on the transaction. They have a need to form an opinion about it, but it's not their future. They're merely commenting about the goodness or badness of the transaction. They are important audiences because they help to form the reaction of the broader public and the audiences about which we care the most—the employees and the agents. So with them, I think it's a matter of communication. We spent a great deal of time and energy putting together good communication packages to help those audiences understand the nature of the transaction and the benefits that we saw for the company and for its policyholders going forward. I think we've been fairly successful, although the regulatory process continues and will continue for some time.

In conducting a fundamental restructuring transaction, such as this merger, we had these three levels of concern: policyholders first; employees, agents, and community, second; and then the reviewers, rating agencies, regulators, and media third.

MR. JOE B. PHARR: My question is directed to Dick Robertson, but the other panelists can feel free to jump in. I was very much interested in your statement of

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your objective being a 15% ROE, which I think you said you had not really achieved over time, and that generally you'd been able to do 12–13%. It seems to me that ROE should vary depending on economic conditions, and they should vary between the risk that you have in your various product lines. In other words, over time, economic conditions change. Also, you may be in a very risky product line and it may be appropriate to have an 18% ROE. Do you agree or disagree that your goals ought to vary?

I would like to ask you another question. How do you communicate, from a corporate management point of view, the ROE that you want (which I contend is an accounting concept), so the pricing actuary can incorporate it into the profit models using what I think are projected economic conditions?

MR. ROBERTSON: Well, Joe, those are very good questions and quite appropriate. One of the things that I might have gotten into and I'm glad you've given me the opportunity to do so, is that over the last several years, we've tended to move away from a particular number, even though we still have that, and more toward benchmarking against other companies. One of the things that we have been doing regularly for some time is to start with a peer group of companies that we have identified in various ways and we compare a number of things, particularly how our ROE compares with that peer group of companies. In fact, our current incentive programs are based not so much on how we are doing relative to an absolute benchmark, but rather as how we're doing compared to the peer group. This addresses the first question you raised that an appropriate ROE target will vary as economic conditions vary. In fact, the same standard of performance would be lower now than it would have been 15 years ago.

I mentioned that a 15% return, when we first introduced it, would have been barely average, but today it would be very much superior performance. The particular peer group we used involves 14 companies and I believe there are three that exceed the 15% benchmark. The average is somewhere down around the 10% level, which is roughly about the cost of capital today. So by stumbling along at 12% over the years, we have, in fact, moved ourselves up to be one of the stronger performing companies. But if we're going to be one of the top three or four in this group, we have some more work to do. That is precisely the message we tell our people. And as we do things designed to improve performance we use this competitive comparison to help people realize that such improvement is not an unreasonable requirement on behalf of either ourselves or our shareholders. What was the rest of your question, Joe?

MR. PHARR: How do you communicate ROE (which is what the senior executives and the CEO probably look at) so that the pricing actuary, when he runs his models and profit tests, can use it? I contend that the pricing process needs to be based on economics. You need to be talking about internal rates of return. At the same time, you need to explain how those numbers are going to come through in your financial statement. For example, a pricing actuary may have built a 15% internal rate of return into his pricing. Let's assume he or she has everything covered—taxes, target surplus, and realistic assumptions—but the financial statements are only showing a 12% ROE. How do you deal with that issue? My experience is that it is a major area of misunderstanding for which we, from a professional point of view, really ought to take

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ownership and try to help people. The product managers and the chief executives understand this. I think that's what this session is about. How can we do that or is it a problem?

MR. ROBERTSON: We've basically said, if we need to earn 15% or whatever the number is on a corporate basis we expect each operating business to produce that rate of return. To get that we expect you to be able to price, in aggregate, your products to produce that level of return. Now those of you that have thought through this process will quickly realize that I have left out three or four things that make this far from being an identity which is what you suggested, Joe.

MR. PHARR: I suggested it is not.

MR. ROBERTSON: You're right, but it turns out it works fairly well because there are many differences and they tend to offset. They offset enough that by sure happenstance we seem to get close to the right answer by putting the same number there. But let me talk about some of the differences. The first thing is that we get leverage at the corporate level. That is if every one of our business units were, in fact, producing a 15% return, the return to our shareholders would probably be something on the order of about 18% because we are measuring our returns at the operating level on an unleveraged basis, whereas, at the corporate level we use debt. We can, in fact, get a higher return at the corporate levels for our shareholders than we are producing at the operating level.

On the other hand, we have some overhead we have to cover. While we do allocate a large amount of the corporate overhead, we don't allocate it all, so we probably need to get somewhere between 0.5–1% on equity to cover the expenses that are not being charged to the business units.

Another area involves accounting differences and here we do ask the business units to look at their internal rate of return, and how it shows up in the financial statements. If there are differences, we need to thrash those through and come to an appropriate conclusion. Sometimes it might mean setting a slightly different objective on an internal-rate-of-return basis in order to support the overall accounting return. Sometimes it means the accounting is just basically wrong and we do make some adjustments to our internal accounting to fix those things. I don't want to get into all of those at this point.

Finally, I'm going to circle back to the part of your question that involves risk. The fact of the matter is that if you establish an objective of meeting a certain rate of return, let's say 15%, you may get more or less than 15% depending on how things work out. The way the world works, the chances are more likely that you'll get less than more. There are more things that can go wrong than can go right. If we have an operation that has 12 businesses and ask each one to produce 15%, you put the risk factor in there. We're going to wind up, on average, with something less than 15% simply because not everybody's going to make their objective and the people that outperform aren't going to offset those that underperform. That accounts for an additional part of a slippage between an operating return and a corporate return. But having said all that, I think that we have about the right level of margin in there to account for all these variances, but maybe we don't. Maybe that's why we'll never be

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able to get it and, if we can't, perhaps the answer is to ask the operating units to produce a higher level of return.

You raised the question of whether a different level of return is appropriate to compensate for the risk factors. Sometimes that's true. Where a business unit has an unusually high level of risk we will usually say, all right, we need to get paid for that risk whether it's to compensate for the likelihood it may not be achieved or simply because of the fact that there's enough risk to warrant receiving additional compensation. It's not unusual in particular cases to demand a higher rate of return. This also applies where there's not a high level of investment, but where there's a moderate level of risk.

The other thing though is that in many of our businesses, the capitalization requirements are such that the risk tends to even out. We use our own internal risk capital formula for allocating capital among businesses. It's not the same as the formula that has been imposed on us from the outside for a variety of reasons and one of the reasons is that we use it to try to equalize the risk between the units. If we, indeed, equalize the risk, then we eliminate the challenge of needing to have different returns by business units because of the different risks. Now in the real world it's not that simple, but to the extent the capital allocated for the unit does compensate for the varying risk, we've solved that particular aspect of the problem. Fair enough?

MR. PHARR: I am satisfied with your answers.

MR. DAVID J. CHRISTIANSON: I appreciate the contrast you've shown. We had one person talk about complete focus on the customer. We had another one talk about ROE and another talked about expense bogeys and profit bogeys and I'll note that there's a fairly wide range. Regina, I wanted to direct a few questions to you. You said you grew from one million to seven million policies. Is that right?

MS. ROHNER: That's right.

MR. CHRISTIANSON: Good. You said you're a chief actuary, too?

MS. ROHNER: Right.

MR. CHRISTIANSON: You didn't talk about any profit measures or anything else and your company's grown from one million to seven million policies. How did you do that? Another question I have is regarding sales practices. I assume you have all your contact in a direct fashion with the customers. Do you have sales practice problems? If so, what do you do?

MS. ROHNER: One of the ways that we keep the emphasis on the customer is with a requirement that senior management must monitor an hour of phone calls a month. Also, our organization is organized in a team fashion so that many of us serve on teams that are varied. For example, I have people that are serving on a billing team to make sure that our billing routines are maximized and are most efficient. So there are ways that all senior management is in contact with the customer even though our immediate job does not seem to be that way.

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In terms of sales practices, we sell through direct response. Many years ago, our main way of selling was through billing inserts and we moved from that to the stand-alone direct-mail packages and we evolved from that to telemarketing. Now most of our sales are through telemarketing and we don't have problems so far. We don't have problems with the sales illustrations that we're seeing so much of because all of the benefits in our products are guaranteed. We have no illustrations that we have to make because of nonguaranteed benefits, premiums, or interest rates, so that has helped us somewhat. We're very careful to tape all our calls. We ask some personal information to confirm the sale such as the person's mother's maiden name or place of birth; that's individual information that we keep on the record. If a person calls in and says, no, I never bought this, certainly, we're willing to refund anything that the customer has paid, but we're able to confirm that the sale was made by saying, "We know we talked to you because we know your mother's maiden name was Gilroy." So far we have not had problems with sales practices.

MR. CHRISTIANSON: What would be your chief responsibilities as a chief actuary?

MS. ROHNER: Same as any other chief actuary—primarily financial reporting, pricing, and managing the people. What's a little different from other companies is we have a large percentage of the actuarial staff that spends time monitoring the profitability of all the solicitations that are made. Since the solicitation cost is variable it's not like a commission where you know exactly what your initial expense is going to be. The solicitation cost varies with every mailing depending on the response rate and the paid rate of the product. So a large percentage of the staff does marketing analysis and monitors the persistency on a monthly basis. Other than that it's the same as what everybody else does I'm sure.

MS. DEBORAH K. SLOAN: I heard a few comments about rating agencies with respect to a major merger change. I'd like to hear comments from the panel and anybody else in the audience as far as what kind of ongoing communication goes on between your company and the various rating agencies, and what you see as a need to keep them satisfied. I'm particularly concerned about this because I have an appointment with A.M. Best on my way home from this meeting.

MR. SCHNEIDER: First, there seems to be no way to keep them satisfied, but I found when dealing with them that the main thing that they want is no surprises. Typically, we've had annual contact with each of the major rating agencies. Either we visit them or they come to our place and we present a day-long presentation. Senior managers review the company's results for the last 12 months and address concerns of the agency. Also, whenever there is anything unusual in the company's affairs, we try to communicate with them before it becomes public knowledge. I think that openness goes a long way toward maintaining confidence that the company is in control of its business. The thing that they hate the most is to be told one thing and then something else happens; after all, they're in the business of predicting what's going to happen to a company. Dick, you've probably dealt with them more.

MR. ROBERTSON: I agree. I have observed that as a starting point, the rating agencies want the same kind of information that a professional investor wants, and that includes some of the things that you talked about. So, as a starting point, they receive everything that our investors or the people that analyze our investments for investors

receive. It is possible to provide them with nonpublic information. In particular, it is both possible and advisable to give them advance notice of any major strategic transactions that are taking place. Often we'll want to do that partly to help get their reaction so that we'll know in some respects how to manage the process for buying a company which increases our leverage. We'd like to know whether or not it's going to affect our rating, and if it does, it may even affect the way that we finance the transaction.

Also, the rating agencies have an even higher level of interest in the kind of soft information that management can provide about where we're going, what our objectives are, and what our values are. It is appropriate to meet with them on a regular basis. The typical process is to communicate these to them annually. To the extent that these change from year to year, help them understand what has changed and why those changes have taken place. We will generally provide them with our internal projections which, of course, is nonpublic information. But in so doing, it's very important that we help them understand the degree of credibility that ought to be assigned to those, that is these projections have varying degrees of optimism in them and we don't want the rating agency to have an inappropriate expectation based on what those projections say. Having said all that, I think that the basic answer is that their interests are not significantly different from those of the other financial constituencies, investors, and to some extent the kind of financial information we share internally with our employees and our staff.

MR. WILLIAM J. BRIGGS: I have a story to tell and that will motivate a question to Mr. Robertson about employee stock ownership. A relative of mine worked for 35 years for a major national corporation; it's not an insurance company, but a name that would be recognized by everybody in the room. As Mr. Robertson's company does, this company strongly encouraged employees to buy stock in the company and made it extremely easy for them to do so. This relative accumulated a fair amount of shares of this company. It was essentially his only investment. Shortly before he died, this corporation made a major strategic blunder in a line of business in which my relative didn't work. The result was years of litigation that was finally settled at enormous cost to the company and a by-product of this was a decline in the value of the company's stock which has endured for the better part of two decades. Ten years ago my relative died. His widow is holding this large block of stock that is under water. She does not expect that its value will come back to the original investment in her lifetime. She's relatively young; she should live another 20 years, but she doesn't have any hope it will ever come back.

My concern about employee stock ownership plans is not for the chairperson. If the stock price plummets that means the chairperson will go into his or her retirement with only one Porsche and only two country club memberships. I can't say that at your level I'm concerned either. But what about the hourly employees or the rank-and-file employees? Is there a concern? Has your company or anyone thought about the fact that when you encourage employees to own stock, many of them will end up owning essentially your stock and that will be their only or their most significant investment, even though every investment book I've ever read said diversification is the first order of business in investment? An hourly employee has a great deal invested already in your company. He or she has his career, life insurance, group insurance, major medical insurance, and disability income insurance. What do you say to somebody

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who says, "I already have enough invested in this company, why should I buy this stock?"

MR. ROBERTSON: Well, first of all, let me take the easy part of the issue and that involves the officers of the company, especially those who have high responsibility and great influence on company results. This is an issue that frequently comes up and it is not unusual for someone to come and say, "My financial advisor says I should not be investing predominantly in company stock; I should be diversified. My financial advisor says if the company fails to perform well, we'll have a financial problem. My financial success is entirely dependent upon the financial success of the company." Keep in mind we're talking to officers. The proper response is, yes, that's exactly where we want you. We want your financial future to depend entirely on the financial success of the company. That's why we have you on board. I agree with you. That is not the right answer for someone at the employee level, and I think we would be concerned if we were to put somebody in that position. That is why, among other things, the guidelines we have for employee ownership actually stop at the lower level of officer, but they also grade down significantly based on one's level of responsibility. When you get down to the employee level, I think that an employee should have enough stock in the company to have a financial interest in the performance of the company, but one's entire livelihood should not depend on the success of that investment.

Of course, in the particular sad story you told, the right answer is that person should have had a better life insurance agent because in that particular set of circumstances, that would have been the most important financial source for the individual. I don't worry about the doubling up of the life insurance and other benefits. Even in a worst-case basis those are secure for people, for employees and other people whether or not they're investing in the company. I don't disagree with your basic premise which is that there are limits as to how much employee ownership is appropriate, particularly for people that are not in a position to have more than a minor influence on the course of action of the company.

MR. ROBERT J. LOMBARDI: I have a question for anybody on the panel. I was wondering about the dynamics of dealing with a tough environment with both the internal and the external forces, tax laws, market conduct issues, and whether, as each company faces those issues, you have a tough time trying to satisfy all the constituencies. You make everyone a little unhappy when you keep a few factions happy and the rest are totally unhappy. How would companies deal with the issue of meeting financial objectives?

MR. SCHNEIDER: I guess I would turn back to what Regina had said at the beginning of her remarks. I think that in this day and age, the best way to ensure the success of a company is to provide a value proposition that the ultimate consumer finds attractive. If you do that, I think you will have something that you can work with to at least keep all the other constituencies satisfied enough to conduct business. But if you fail to have that value proposition that the ultimate consumer finds attractive, you're going to run into real problems. I think that the customer has to be the most important focus.

MR. ROBERTSON: In an ideal world, it would be possible to align all these interests. It is often possible to achieve a fair amount of alignment. That is the objective on the part of customers of getting good service and a fair price. Some financial security is not inconsistent with the objective of the investors of getting a fair return on investment or the employees of having secure, rewarding jobs. And all of these can be put fairly close together by a concerted effort on the part of the management of the company. But in the real world it is true that trade-offs have to be made. There are a lot of examples. One that a CFO has to worry about is that there is a trade-off between shareholders and financial security and policyholders and, for that matter, financial security of creditors involving the degree of leverage a company should have. The rating agencies and the shareholders can have interests that diverge. In that particular case, and in many other cases where trade-offs have to be made, it is usually helpful to establish a standard and live with it. The standard, in this particular example, might be that a company with a particular scope and operations would have 25% of its capital coming from debt. We'd be uncomfortable with any more than that; if there is any less, we feel that we're not maximizing our shareholder objectives.

You may answer that a different way. You may say we think that we ought to be a company that has a certain minimum financial rating as measured by the rating agencies and that may be appropriate, too, although that can be a little difficult, because they keep moving the target. Sometimes it's appropriate for us to move our standard with the moving target, but sometimes it's not. So, generally, I've had better success establishing an objective relationship. Use that as a basis of discussion with the various constituencies, in this case, the rating agencies. To the extent that their evaluations and their standards are changing we may need to consider moving the standard, but I think it works out easier to have a standard that's easy to relate to. The same thing happens in the pricing area. How do you balance competitiveness, the interests of customers and agents, and the needs for profitability? This is why return objectives of some kind, whether it be ROE, profit margin, or whatever become quite important. If it's necessary to significantly deviate from them, it is appropriate to begin asking the question of whether this is a business we should or ought to be in. That often leads to a very good strategic evaluation and maybe the right decision is to get out of the business.

MR. STEVEN C. CHAMBERLIN: Some of you have touched briefly on sales practice issues, but I was just wondering if some of the sales practice problems that have plagued some of the bigger companies have some repercussions on the industry as a whole and if your companies have felt a need to try some public-relations-type campaigns to address those issues or if you feel the problems of some of those companies have hurt your own sales at all.

MR. SCHNEIDER: We haven't seen anything directly in our sales, but personally I don't think there's any question that the type of publicity that the life insurance industry has received for the past couple of years is a bad thing for the whole industry. We're in the business of taking money from people who trust us to return it years later. These problems and the type of publicity that they generate go at the very basis of that trust.

I agree with various commentators who have blamed some of the flatness of industry sales on sales practices and on people's unwillingness to trust companies. It's not just

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the companies that receive the worst publicity that are affected. Obviously, the problem is worse for them, but I think all of us get tarred with the same brush. Clearly, there's a great deal of activity going on in every company to address the issues to the extent that the companies individually feel they need to be addressed. There's ACLI activity trying to create a code of conduct. I think all of that's helpful, but it's going to take years to get over the impact of these problems on the reputation of the industry. There's not much any of us can do about it today, but it's something I think we're all aware of, even if our companies haven't been directly involved. It's bound to be a negative influence on the ability of the sales force to sell our product.

MR. ROBERTSON: You mentioned that I gave up the CFO position about three years ago and the hat I am currently wearing involves the whole concept of risk control which covers many things. It includes asset/liability management and much of the actuarial function, but it is my belief that perhaps the greatest risks that the industry faces today and, by inference, perhaps the greatest risk even our company faces today, is the loss of confidence on the part of our customers because of practices that take place both on an industry basis and that take place in every company that may well have been accepted practice in the past but simply aren't accepted practice today.

It is not a public relations problem. It is a company behavior problem. It is caused because of a misalignment of the interests of our customers and our distribution force. And by that I'm not blaming the distribution force. We set the standards and those standards are changing and every company, indeed, is going through the process of educating everybody that's involved with customers in any way that a new standard is applicable.

I fear that we're going to see significantly increased regulation as a result of both mistakes that have happened in the past, and a generally increased level of expectations on the part of the public. This is not confined to the life insurance business. In fact, we're probably not the worst offenders. The most grievous errors have taken place in the securities business and many companies have paid a lot of money as a result of things that they and their representatives have done that they should not have done. To some extent what's happening to us is a spillover from that business into ours, but we have our own sins to atone for and need to do so. I have heard some say that the basic agency compensation system is going to be under challenge and that may well be. Certainly, aspects of it will. But I am virtually certain that in five or ten years there will be some fundamental changes in the way we represent ourselves to the public.

We do business in Great Britain. Great Britain has gone through a very substantial regulatory change caused by many of the same things that are going on in the U.S. To sell a life insurance policy in Britain today you have to go through a procedure that is many times more complicated than what it takes to sell a security. There is disclosure at several different points that must be acknowledged through a signature by the customer. It is almost as if you have to start out and explain to somebody why there's no reason in the world they ought to buy your product and then convince them to go ahead and buy it. There's a lot of good in it, too; I don't mean to be critical of it. It requires a very high level of professionalism on the part of the agent and the company, including a thorough researching of the needs of the customer, something a good agent does in this country, but there are many agents that don't do it. I view this as a very

serious problem and I resist people that tell me that we need some public relations activity to fix it. That's not where the fix is going to have to come.

I want to ask Bob something. I've spent my entire career working for Lincoln National, and, particularly at a stock insurance company, and I spent a great deal of time establishing financial objectives for the company and promulgating those objectives and explaining to people why they're appropriate and adjusting them when they're not. It makes the management of the company much cleaner in many respects because there's always a performance standard we can relate back to. In the final analysis, we have an independent, objective party out there that's evaluating our performance in terms of the stock performance of the company. If we fail too badly, they have some very severe penalties. They can put us out of business and many companies have been put out of business as a result of poor performance, generally, through a merger or acquisition situation. I've often felt that it must be much more difficult in a mutual company environment to attain the same clarity of objectives when you don't have one overriding consideration and I'd be interested in any perspective you can give on that.

MR. SCHNEIDER: I think that mutual companies have probably been struggling with that for ten years. If you go back more than that, mutual companies had to produce a respectable level of surplus, and the margins in the business were such that the actuaries could do that, no matter what anybody else did. I remember Jim Anderson of Tillinghast giving a speech in which he said insurance company managers believe that there is no problem that an increase in sales cannot solve, and until very recently they were right. Recently, however, external audiences are imposing things on us that will make the standards that have to be followed clear. Rating agencies have made a big change. You mentioned what investors were used to. Before mutual companies had to deal with the rating agencies; we didn't have any similar demands. Rating agencies now, as you say, identify similar criteria that investors demand of stock companies. They're asking mutual companies to demonstrate how they can meet those same kind of financial tests in order to keep the ratings that are necessary to do business. The agencies have become a substitute in some ways for the institutional investment market.

I also think that as mutuals convert to GAAP accounting they will acquire the other thing that has been missing, which is some at least reasonable level of comparability in financial statements. Every mutual company that I know of has had some sort of internal accounting, but, results on that basis are neither published nor comparable between companies. Published results on a more comparable basis will start to impose more discipline on mutual companies. The existence of the rating agencies and of more publicly published information that's comparable will give us a basis that allows us to have the standards you refer to.

Internally, we've struggled with some of the things that I think a stock company automatically knows. For example, what is the cost of capital for a mutual company? You can't go to the market and observe betas or create a capital asset pricing model. We've tried a couple times and it doesn't make much sense. I think that the environment is starting to change in a way that will make financial standards more obvious, but it hasn't completely happened yet.

MR. ROBERTSON: I have a fair amount of respect for the rating agencies, although I can be probably as critical of them as anybody. In fact, they need to substantially

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improve their level of performance from what they've done in the past, and I don't see any signs they're doing it. But doesn't it bother you if they, indeed, are the final arbiter of a company's performance?

MR. SCHNEIDER: Yes, I think they have been very wrong in some cases. They have the ability to change their rules at the drop of the hat. But, nonetheless, they introduce a way of formatting statistics and looking at them with some consistency. Companies are getting a framework for analysis. There are companies that have done things that they know are going to cost them a rating notch because they believe it is the right thing to do. I think that's how you have to manage your business.

The agencies at least put on the table what things are important, but I think they have influenced companies to an excessive degree, particularly in their investment policies. Nonetheless, their existence has imposed a certain discipline on mutual companies that no one else had imposed before. I wish there were some other arbiter, though.

MR. ROBERTSON: I have a suggestion—you could issue stock. I tease some of my mutual company friends from time to time by saying the biggest advantage stock companies have over mutual companies is that there is independent accountability imposed on stock companies. The biggest advantage mutual companies have over stock companies is there is no independent level of accountability established on mutual companies.

