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STRATEGIC PLANNING

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This teaching session will cover the strategic planning cycle: vision, mission, values, strategies, objectives, tactical plans, and resourcing. Discussion will include the role of actuaries in setting and maintaining or revising their companies' strategic plans.

MR. MARK F. HOWLAND: We have organized our topic into two areas: the annual planning cycle and day-to-day strategic behavior. Annual planning is handled differently at every company. Some companies do it well but may not do a complete job. Perhaps they do not explore scenarios, or tie plans to budgets, or plans to mission statements. Others may not plan at all, opting to stay the course and take things as they come; this is not good.

What can we, as actuaries, do to foster the planning process? And what important contributions to this process are incumbent upon us to make? Dave Ricci will respond to these issues. Dave's career has taken him from insurance companies to consulting and back. He is currently responsible for planning and development for TransAmerica Reinsurance.

Now we all know that the insurance world does not sit still for the year and let us carry out and execute our annual plan. Changes occur and opportunities arise. New ideas are expressed, and some companies are impulsive, perhaps forgetting their plan and their vision, or perhaps taking on a project without properly assessing it. How should a new opportunity be evaluated in light of a company's plans and goals? And how can an actuary assist in this evaluation, this day-to-day strategic planning? Michael Shumrak will tackle these questions.

Michael has worked with both insurance companies and consulting firms. He now manages his own firm in Atlanta, specializing in customized product offers, market-driven business units, and strategic business plans.

MR. DAVID A. RICCI: I will talk about the strategic planning process. I've been involved in this type of effort since my early days as an actuarial student. The first obvious goal of a good strategic planning system is to have a reasonably well-defined mission statement, strategic intent, or vision statement that you might review periodically. It's important as a reference because it should drive all the other plans that follow to include strategic objectives and minor objectives included in that mission statement. Second, the corporate philosophy is not necessarily a driving factor, but it is the fabric or the foundation on which to build. Basically there should be something that guides you into how you ought to act when you're carrying the plans out. Obviously, most of these principles are fairly absolute. They are things like we won't cheat our customers, we won't lie to our agents, and so on. However, there may be some very significant, subtle changes in the direction that a particular company might take, and it's important to realize that in the planning process.

Now we come to the planning cycle which is kind of a misnomer. It really is more of a regular event, but there is plenty of overlap like concentric circles. Basically at some point in this process, and probably throughout the entire year, focus is given to taking a look at the ongoing strategic initiatives, and how well they relate to what's currently happening to the original vision or strategic intent.

After that, there is soul-searching to develop some kind of modification of the long-term objectives. That will lead sometime in say the first or second quarter to a recast of the business plan or at least the beginning of that process, where detail, production and profitability goals are examined. And then that whole thing probably culminates when the report of the third quarter is due. At that point, hopefully, it's kept as just a so-called living document. And then from time to time the current year is examined against the plan, and then forecasts are obtained which would be modifications of that. Generally management loves to say, "We never modify our plan. Once we put it down on paper that's it." But, obviously, there's just so far you can take something like that, particularly in today's world when things change so frequently.

What are the actuarial accountabilities in this whole arrangement? Let's go over what I consider to be the key areas. First, the strategies that come out of the initial soul-searching process at the beginning of the planning cycle will need some interpretation. What's needed is someone who can communicate them effectively in financial terms that measure results and using some type of modeling effort. I think that's the greatest role that an actuary can lend to the process.

In the process of doing that, one must be sure to not assume the role of the person that's actually creating the strategy. This is a pitfall that every planner gets into at some time. Once that happens there is no plan because the people that are responsible for it ultimately will never accept it. So, it is a very fine line to draw. Many of the people who are responsible for the strategies probably don't have a very good idea for how they can create something that's actionable and has numbers attached to it. They maybe have an idea, a concept, or a market suggestion. So it's a very facilitative role, and once you cross the boundary from facilitation to direction, you lose all of your value added.

Another way that actuarial accountability is quite important in the process, is determining the risk and reward for the various strategic units. This is a very complicated process. We talk about it in terms of the sufficient frontier and the determination of risk measurements. What you're trying to do is define an overall level of tolerance. It will vary substantially by unit, particularly if you have a fairly large organization in which some units are going to be supporting other units at different points in time.

Risk tolerance is somewhat the same issue, but I'd like to refer to it more as the utility theory. You need to communicate with the strategic business heads to determine exactly how far they want to go. How ready are they for new markets and new products? They can come up with the idea, but if they don't understand what the real risk is behind it, you might find out that their tolerance for it is not as strong as you thought it was. And, of course, scenario testing is very critical.

What's often overlooked is that there are certain scenarios which people don't want to deal with. You know, it is kind of like your mother-in-law coming to visit. You don't want to deal with a situation, so you put it off until the moment comes.

There are many critical and environmental issues that need to be discussed in the regular planning process. Because sometimes knowing when to fold and knowing how to survive the worst of times is often more critical than knowing how to generate profits during good times. I think many well-intended planning processes tend to break down at the point when they're trying to do a scenario test. They say, well it's in a 95% range so why should we worry about it?

Many times the actuary will be called on to determine the amount of capital required. This might have both subjective and objective values. Obviously objective values are considerations for rating agencies, the NAIC, and risk-based capital requirements. But there are also subjective measurements. Particularly when you consider that you're probably not always analyzing the entire unit, but rather little blocks of units, which have much covariance as it were. So the amount of strain that you associate with a particular strategic business will have much to do with how you view the contribution of that unit at any particular point in time.

We've recently undergone what's known as an embedded value-added project at the entire corporate level at TransAmerica. Part of that process was determining what our critical values were at the subline level and then going through this benchmarking process which I'll touch on briefly.

Also progress reports and variance analysis are extremely important. I think it's important for the actuary that's accountable to be able to describe exactly how performance is being measured. Obviously a plan works generally from absolutes. There might be ratios involved, but obviously the bottom line is, we're supposed to make so much pretax GAAP income, or after-tax GAAP income, or so much value-added whatever the particular measurement is.

When a different production on an actual basis comes into play, the ability to translate that back to the plan in a meaningful way is extremely critical. And finally as all things happen, there are certain times when a reforecast needs to be performed based upon the actual results. And that's going to be important going forward, particularly if this happens in the early part of the planning cycle.

In terms of strategic evaluation, everyone is familiar with the baseline corporate model. In general these models are more similar than different between companies. You have a data base. It's strategic business unit specific. Some of the models tend to be a little more driven by a microcellular analysis than in the macro. I have a bias in that particular area in terms of the diminishing amount of returns you get from increasing the number of cells that you use for the analysis. The way we accomplish scenario testing is kind of a controlled manipulation of the key factors. I just don't mean critical factors which are controllable, but I'm also talking about our uncontrollable environmental factors as well. They're usually determined by the profit center or strategic business unit (SBU) heads. In fact, it's very important to bring them into the process at the beginning and while you're doing the scenario testing.

As I mentioned before, another good thing to know is how well you can cope with disaster scenarios. Can you immunize yourself against the situation? Will you outshine the competition? Because bottom line, that is what you're trying to do. You wouldn't be in the planning or strategic business if it wasn't a competitive thing between you and everybody else in this room.

Then you have to determine if you're not at the place you want to be, what are the trade offs? Can you afford to do it? Or can you afford not to do it? I think that's probably even the better end.

Value added has two basic measurements. We employ both of them at our company. One is kind of a GAAP approach where you take the after-tax GAAP earnings and the after-tax interest on required surplus and subtract the cost-of-capital rate times the average GAAP equity for whatever the period is, or broken down for sufficient periods of time.

The embedded value added is a little more actuarial so I think most of the people in this room will fall in love with this more than the GAAP, which is obviously a very manipulative value. And obviously the embedded value added is pure! Anybody can tell that.

What you're doing in embedded value added is determining the present value of distributable cash flows at the beginning and at the end of the year. The difference between that less the cost of capital plus whatever you distributed during the year is equal to your embedded value added.

It's a very good measurement if you're honest, which is a real big if. And honest means don't put too much into future production. Don't defer too much in the way of expenses, because now you're just GAAPing something that was pure to begin with. So why not just do the GAAP thing instead of that.

If you maintain a reasonable amount of integrity in doing this, I think you can come up with some valuable numbers. Maybe too valuable because I think it would be sensitive in many ways to ask them what the real worth is of the company you're analyzing.

There are different means of determining risk: sensitivity and volatility analysis. What I mean by sensitivity is the absolute, usual sense of the word. Is this line highly dependent upon projected growth rates? If it is, how reliable are they? Take a look at the past and how well the profit center manager has been able to project growth rates before. If it's just another fantasy on some people's part, maybe we ought to discount the whole value. Of course, I don't want to get into the directive mode. But many times I think it's important to point out to people when they tend to be a little bit overly optimistic. Volatility to certain types of product risk is important to measure as well. And then, of course, there's the overall environmental risk which should be factored in.

Obviously the capital requirements on a statutory mode or a cash flow means you're talking about risk-based capital. GAAP equity follows the GAAP balance sheet, so it's subject to all of the pitfalls of that measurement, such as deferred taxes and also deferred acquisition cost (DAC) assets, as well as the difference in the GAAP liabilities and statutory liabilities.

It becomes very important for the actuarial planning support person to have a fine understanding of the nuances between say risk-based capital, or required surplus and GAAP equity. Even though I think many times when we were doing this project, people would say, "Oh, we'll get to that later. Don't worry about that." You know that, obviously, if you're working for a stock company, it's going to be one of the first things people are going to want to know. Because all of the analysts have been geared into this GAAP concept. And they will not just change because you said, "Well this is a much better measurement." So it becomes critical to be able to understand the differences between the two.

With regard to short-term measures, I mean that many companies I've worked for in the past have been very concerned about when the project is going to break even. They wonder how long they will have to support the project with cash flow. And to the extent that there's a very low tolerance for a large amount of cash outlay, it will be important to discuss some short-term measurements.

By the expression *surplus accumulation,* I am referring to the classic asset/liability management model.

Reward measures are also important to consider. By return on investment (ROI), I mean internal rate of return. I think if you establish a ROE and an economic value added (EVA), you establish all three of them. You establish some kind of investment amount, whether it's required surplus or some measurement based upon production volume or whatever. The way we defined ROE is as a GAAP measurement. And EVA is what I explained as the embedded value-added approach.

Of course, there's a traditional GAAP and statutory earnings projections. Much as it would not like to admit it, most management is stuck with the GAAP analysis, if they're in the stock world. And they're also bound by some statutory requirements, particularly considering how very dear cash is these days.

Not that arrangements can't be made with wonderful companies like ours, but there is a strong necessity for knowing what the cash-flow implications are. And I just added that last point to note that both absolute and unitized measures are important. You want to be able to assess the importance of a reasonably riskless investment which is driving large sums of profit, but at a very low rate of return, maybe even a negative EVA. Perhaps it's coming in at 10% and your cost of capital is 11.25%. That will be negative every year. A big distribution, but a negative rate of return.

That might be offset on the other end by an investment that is generating huge rates of return. However, that investment is very volatile and needs that kind of cash infusion, which you couldn't get if you didn't have the other line of business.

Sources of capital? How much? Well, we could talk about shareholder requirements. What is the requirement for cash on hand? Beyond the stock price, the rate of growth of the stock, and the equity involved, the stockholders' interests probably don't go much further than that.

Regulatory rating agencies often can be, let's just say, unreasonable. I know one agency in particular is in the process of refining the NAIC standards to eliminate the covariance, which I think is a big mistake.

It is also important to consider risk, as it is related to product and market; a good assessment of what the product and markets are. And how you feel they're going to change at least in the near term is going to dictate how much capital you're going to be required.

There also are sources of capital alternatives. You can use other segments. In the stock world you can have a public offering. You can raise debt and sell acquisitions and, of course, there's financial reinsurance.

Benchmarking is what I was talking about before. I think this has been very helpful to us in the process of going through some embedded value-added approaches. First, you must determine critical value drivers and, in this case, you must have two properties. They have to be controllable, and they have to make a significant impact. If they're not controllable there's no need to benchmark them, because there's nothing much you can do anyway. You may want to take a look and see what the variability is historically, but there's no management action that can be performed. And if they're not significant, why would you look at them anyway?

You take a look at the historical analysis as more of an internal study. Also, picking a significant peer group is extremely important in doing the analysis. Obtaining the data is also important. There are many CD ROMs available that have at least the NAIC statement blank data, of course. There also may be other ways in which the data can be obtained, be it through consultants or groups, as long as you don't violate the antitrust provisions.

It is also important to remember sensitivity analysis. What is the appropriate range, depending upon the performance of that critical value driver? Is mortality important? Are expenses important? Is distribution a big issue? Many times distribution is like that thing in the corner you don't want to worry about. But it still is there, and if it's a very significant issue, it should be addressed.

Monitoring progress is extremely important. It involves using the traditional measures of plan versus actual, adjusted plan versus actual. Also, take a look at margins. I think to be a reliable traditional measure, all it has to be is accepted by management. Because if it doesn't like it, there's no sense beating your head against the wall and making that comparison. Management is just not going to accept it. And if it does like it, then there's no reason you shouldn't give it to them.

The way embedded value added works generally in the planning mode is that your assumptions in terms of the block of in-force business at the beginning of the year are designed to be as realistic as possible. The only embedded value added you will generate at that point is the embedded value added that is a result of new business that is produced during the year. Because you've discounted everything at the same assumption, it's like taking down a mortgage. You know what the end result will be because you're assuming that whatever the group assumptions are, they will remain the same.

Later, just much like you would reevaluate the adequacy of a block of pension business, you see how your actual assumption is measured against the assumptions in determining the value added. And there's an adjustment that's made based upon your actuarial error. Once this process gets in place, I think most companies would look askance at those considerably significant and consistent actuarial errors that generate positive value added. That might tend to make them believe that there was a little sandbagging going on.

Performance studies can either be leading or trailing. A performance study can be something that indicates a problem that may not show up in the GAAP sheet or the statutory sheet or, a study can be initiated by a specific issue or problem. Then the whole forecasting process must be repeated, which is much easier to do in October than April.

In summary, this is a staff position. You have to sell the line officers. You have to get their ownership and let them buy into it. You have to give them the opportunity to participate in every phase and to criticize your wonderful calculations no matter how well you did them. You have to modify the process so that they fall in love with it.

The second point is, and I don't think I could emphasize this enough, I think there is an occupational hazard that we all tend to fall in at one point or another where we're so concerned about getting the cells correct and drawing lines through actual historical data, that we lose the actual value of the model in determining what will happen next year. So what I'm saying is don't sacrifice any accuracy just to make it more precise so that you feel better about the number that came out.

It is vital to be timely. You have to bring it in on time. If you don't do that, people will just complain and create hassles. You need to be complete; in other words, everything that you think is important to be there should be there. If there's a key ingredient missing then it calls the whole process into question. You also must be actionable, meaning whatever you come up with, you have to be able to say, now I think we've given you the tools to be able to correct this or to move on or to do it. It's not sufficient to say, "Gee, I wouldn't want to be in your shoes."

Know your role. I think it is more like know your value. And I think it is important to know what your value is not. You're not the scheduler or controller. You're not the person to say, "Your report is due in two weeks from Tuesday." Or, "I have to tell the president that your report is late."

If people don't understand what the schedule is, and the president doesn't consider it important, then the process is meaningless anyway. People must have that value. You can't impart it into them. You're not the high mathematician. You're not bestowing upon them what they think is their profitability. They have to come to grips intellectually with whatever results you develop.

You're also not the provider of critical assumptions. Although I think more often than not you can provide the task force environment where those assumptions can come out. You can provide the atmosphere that allows those people that are empowered with those kind of decisions to develop the critical assumptions that are necessary to coming up with a good plan.

The example outlined in Tables 1–2 and the list below features XYZ Life, whose corporate mission is to be a major segment provider. It wants to at least be known in this particular niche market as a major segment provider. So the company decided it wanted to have two times the current market share in five years. Generally, that means the company's number of customers must increase 15%. It doesn't necessarily mean the business needs to increase 15%. That has certain growth implications and certain constraints which you have to consider. You're not going to double your market share and halve your profitability.

Criteria for a successful alternative:

- Achieve 15% Growth
  - Maximize high growth potential lines
- 95% confidence in dividend distribution
  - Maximum first year strain
  - Minimum return on capital
- 90% confidence in EVA target
  - Minimum return on capital
- Other considerations:
  - New ventures
  - Corporate culture
  - Trackability
  - Product modifications
  - Surplus management alternatives

Basically, that's the problem and the issue then is to assess these various product lines, see which are now contributing or are the cash cows or the growth lines and which aren't. Then determine by analyzing the volatility that's on those sheets exactly how you would suggest to move forward in terms of emphasis of those lines in order to achieve this 15% growth.

TABLE 1
XYZ LIFE
(COST OF CAPITAL = 10.5%)

Product Line	Embedded Value—BOY	Distributable Cash Flow	Cost of Capital	Embedded Value—EOY	EVA	Growth Potential
A	$350.0	$35.0	$36.8	$355.0	$3.3	5.0%
B	160.0	(12.0)	16.8	191.0	2.2	25.0
C	50.0	(4.0)	5.3	65.0	5.8	18.0
D	225.0	10.0	23.6	250.0	11.4	12.0
	785.0	29.0	82.4	861.0	22.6	12.5

TABLE 2
XYZ LIFE

Product Line	Distributable Income		Return on Capital	ROC Range	
	First Year	In Force		Low	High
A	($20.0)	$55.0	11.4%	10.0%	12.5%
B	(16.0)	4.0	11.9	2.5	15.0
C	(10.0)	6.0	22.0	12.0	25.0
D	(20.0)	30.0	15.6	9.0	20.0
	(66.0)	95.0	13.4		

MR. H. MICHAEL SHUMRAK: The life insurance business, I think, is under siege like no other time in its history. You have new competitors such as banks only just beginning to get started, yet they're producing a significant portion of annuity sales. You have mutual fund companies whose mutual fund products are underlying an increasing share of variable life and annuity, subaccounts, and products sold.

A recent survey of CEOs tells us that the most important strategic issue right now to them is distribution channel profitability. For many companies, the profitability of the recently sold business is much thinner than the in-force business that's running off the books. And so the combination of this and companies' efforts to adequately match the capital that they're putting up for their risk is reducing companies' capacities to undertake exciting new ventures to grow. All of these factors, I think, have put many pressures on companies to quickly seek out and execute new business strategies that truly provide solutions to these challenges.

An Atlanta paper quoted the CEO of McDonald's, Michael Quinlan, as saying, "The U.S. business environment has become increasingly competitive and hostile. Not only must we stay focused strategically, but we must make important tactical decisions on almost a daily basis." I think to achieve profitable growth in the increasingly competitive landscape means that we must transform the static perspective of the annual plan that's completed at one point in the year, into a proactive day-to-day strategy formulation process. It would temper long-term strategic vision with short-term opportunism. A term I like to use for it is, strategic market planning.

I'd like to discuss how actuaries can make unique contributions to the strategic marketing process through their involvement in three particular areas. The first is what I call product-to-market development. The second is financial performance measurement. And the third is strategic alliances.

We define product-to-market development as the process of designing, pricing, and positioning, product offers to fit distinctive customer buying situations. It is a market-based process as opposed to a product-focused process. Annuities don't define a market but preretirement savers with middle incomes do. We'll discuss how actuaries can become key players in transforming market-based customer profiles and buying situations into attractive products that produce profitable results.

We define financial performance measurement as the process of evaluating and reporting the actual results of our efforts to market these products and services. Advances in computer technology and our progress in risk assessment methodologies have dramatically increased our ability to develop a comprehensive set of analyses, some of the things Dave's described and many others. Unfortunately the myriad and often conflicting array of measures sometimes overwhelms us and often misleads us. Particularly marketers and other nontechnical managers who are typically driving strategic business units strategy formulation are very frustrated by the Catch 22 of the conflicting performance measures they face. We'll discuss how actuaries are among the best-suited to work from an understanding of their firms' strategic initiatives, to effectively link them with performance measures.

We define strategic alliances as any business arrangement undertaken by a business unit to acquire, share or divest one or more business risks of functions with an outside entity. And I'll define a strategic business unit as any organizational unit where there's a strategic plan, and where there's some sort of a manager who is responsible for both sales and the bottom line.

Years ago, for many of our companies, the business unit was the entire company or at least sort of the legal product division, such as group life or individual life. As a result, we see an ever increasing array of partnerships between insurers and reinsurers, vendors, stock brokers, banks, and so on, to deal with a variety of strategic business unit issues, including gaining access to new markets, tapping external sources of capital, and reaching critical mass to leverage operating capacity. We'll discuss how actuaries can play a major role in the design, pricing and evaluation of these ventures. Now let's turn our attention to the product-to-market development process. Recall that we defined this as designing, pricing and positioning product offers to fit distinctive customers' profiles in buying situations. First, let's start by comparing and contrasting this product-to-market development process to the generic approach many of us use. Too often we're asked to develop the best performing product. Subject to labels of sales and profit objectives, we then solve for the lowest price and the best product performance, and then maybe compare it to some competitors' results.

Many companies that primarily distribute through agents consider their agents to be their primary customers rather than the end buyers. In many cases the product design and product performance parameters are dictated and described by the agency with limited consideration of the end buyer's point of view.

Recently, we've started to see companies talk about focusing more on their customers' and the end buyers' needs. Then they proceed to build the best product they think the customer needs from their point of view. The trouble with this is that on the surface while this appears to be a customer-oriented point of view, unless the market is us, with our lifestyle situation and our understanding of the business and our products, we're not connecting with our real prospects through this process.

Those companies that are committed to following the traditional paradigm that the agent is the primary customer, are basically ceding their potential relationship with their customers, even despite all this dialogue that we're focusing on the customers. They're only ceding that to the distribution system.

So for them, I think, the real end buyer-driven product-to-market development is fairly limited or maybe impossible. Instead, in these cases, the product-to-market approach I would use would focus on a realistic assessment of the profitability of the distribution channel. An analysis would focus on which agents or agencies are producing the most profitable business. When we have seen some of these analyses done for the industry or certain companies, many of them aren't that profitable and aren't producing reasonable return on investment.

But, again, the companies are ceding the decision making process so they get what they deserve. Incidentally, this problem is not confined to the agency distribution channel. We work extensively with insurers involved in alternative distribution, particularly direct marketing. Some direct marketing SBUs focus on running access to markets and customers through third-party marketers and endorsed lists and such.

Typically, these lists will produce higher response rates, which sounds like it should be good. But in many cases, while the higher response rates drive down the cost per sale for the month of the direct marketing part of the cost, the very high sales commissions and fees paid to both the brokers and the people who own the list, end up in very highly loaded products. A recent assignment might illustrate the point.

We were asked to evaluate a direct marketing campaign of a health product to a large bank. The high response rates resulted in the present value of marketing cost to premium of 12% which is far lower than the industry average for individual agency-sold business, which might be let's say about 30%.

But then about 28% of premiums were going to pay the marketers and the owners of the list. So we are up to 40% for total marketing costs. If you add 10%, say, for a pretax profit margin, and another 10% for other expenses, we are left with less than 40% of premium to provide the benefits. So obviously this bank's customers didn't get a very high-quality product. As actuaries we can help our companies identify and evaluate these situations.

A number of companies have reconsidered this agent as a customer paradigm. They're shifting strategic objectives away from sales-oriented targets toward profitability and customer satisfaction.

I think product-to-market development has its greatest opportunity for strategic leverage when the company focuses on the end buyer as the customer. Direct marketing companies naturally start with this premise but they often discover, as we discussed, they must rent their prospects from outside sources. So they may never own these customers that they develop through these efforts.

Let's look at the most successful direct marketers. They primarily, and sometimes solely, focus on markets and sales sources where they can either share or own customer relationships. So they have an opportunity for customer relationship and multiple product sales.

While developing this kind of an approach from scratch involves probably the greatest amount of up-front expenses, companies view these costs as an investment to acquire a valuable asset. By computing the lifetime customer value of new customers, measured as the expected profits from the various products and services sold to customers, we can determine how much we can invest to acquire them.

Actuarial expertise is also critical to the monitoring process of tracking actual customer value compared to the value assumed upon acquisition. So-called marketing databases are used in combination with predictive models to help identify new products and determine when the customer is ready for the next product offer. To date, most of this modeling activity and database marketing activity has been dictated by marketers and sort of run by nonactuarial statisticians. And they mostly focused on just response. I think as actuaries, we're uniquely positioned to sort of bridge the gap from responsiveness to profitability.

As actuaries, we can design and price product offers rather than products. We can suggest pricing bases that are relevant to strategy. And, we can link the market modeling and the predictive modeling to the real profitability of our business as well as if we were in the agency business.

Now that we've covered the product-to-market development process and how it can support our business strategies, let's turn our attention to financial performance measurement. Earlier our definition of financial performance measurement was the process of developing, evaluating, and reporting financial results of our efforts to implement our chosen strategies.

The first step is to know how well we did compared to how we thought we'd do. Once we have done that the second thing we want to do is, assuming there are differences, and there usually are, find out what they are in terms of our strategy and our strategic premises.

And then the third step, once we know the answer to the second question, is to sort of stop and ponder, is this telling us that we're able to validate our strategic premises, or that we should modify them?

All of this sort of logically applies that in our development of performance measures we just logically link them to our strategic premises. But as we'll see it is often not the case.

Since most companies report on both a statutory and GAAP accounting basis, a natural starting place to search for performance information should start there. And if this works out, this is great because we don't have to go develop other measurement systems. Some of the useful performance measures from statutory accounting include the statutory capital requirements including risk-based capital. This represents the amount of capital in the business. The positive increase in these capital requirements in part represents new investments in the business. And if the sign is the other way, it's money we can take back out of the business, or statutory earnings.

GAAP accounting provides us with some additional sources of information: GAAP earnings, GAAP ROE, and GAAP profit margins as a percent of premiums or assets. For a growing number of companies, the most important financial measures look for SBU performance or evaluation of actual versus projected statutory earnings and GAAP ROE.

How effectively do these measures tie to our strategy? This of course depends on the strategic thrust of the business unit. Some years ago when there weren't SBUs and there was the entire legal line of individual life or group health, or maybe the entire company, maybe these results matched the strategy. Strategic direction was formulated by top management for the functional orientation. They closely tracked the statutory definitions in lines of business. As a result, functional managers typically couldn't control or be held responsible for both the sales and profits like they are today with SBUs.

In today's increasingly competitive, fast-moving environment, we've seen many companies rethink their approach to strategy and organization. As we've said, they've organized a number of SBUs. Why the SBUs? One reason is the senior management of many companies wants to create a sense of urgency and empowerment throughout their organizations, giving them an entrepreneurial responsibility. Another reason is today's competitive pressures dictate that business needs to be organized around markets or distribution channels rather than legal product categories. Now let's evaluate these traditional measures through an example.

We have the startup SBU whose strategy is focused on specific market opportunities such as young professional women, preretirees, and say certain other ethnic groups. Based upon the characteristics of the target markets and their lifecycle states, the SBU plans to use predictive modeling and customer information database to offer their customers a sequence of product offers.

The business unit strategy is to maximize market penetration by setting customer acquisition allowances for the first product offer based on an evaluation of the customer's lifetime value, as we described before. This was defined as the present value of all product sales expected to be made to the customer. The leverage of knowing when and how to make these next offers was expected to result in greatly reduced acquisitions costs.

This would be used both to increase the composite customer profitability and the product quality to the customer. While the SBU referred to this concept of lifetime customer value in its business plan, it was still subject to the primary measures that were applied to all SBUs, which were GAAP earnings and GAAP ROE. In addition to these measures, top management also looked at the incidence and the magnitude of the capital requirements. In other words, how much increased capital was going into supporting the strategy? Now let's consider how well the traditional performance measures related to this unit's strategy.

First let's consider GAAP earnings. As a newly initiated SBU, startup cost, lack of scale, and the margins for adverse deviations used to set up GAAP dictated that this unit, even if everything else went right, would be losing money anywhere from four to six years. Unfortunately, the unit was told by senior management it needed to make money by the fourth year or sooner. It felt it was in a Catch-22 situation and it was. The current GAAP accounting rules were not developed to measure the economic success of this type of market-driven business strategy. GAAP accounting is based on the product industry rather than the customer market.

Now let's consider the GAAP ROE measure. Most of what we said about GAAP earnings applies to ROEs, but things get even worse. The difficulty is that for many of our products on a product-by-product basis and by policy year, the GAAP ROEs aren't level, and they typically might increase by policy year. What this means is the faster you sell, the longer it takes to get to the ultimate product pricing ROE.

In our example, the SBUs' strategic premise for maximizing value was to quickly gain a significant penetration in each of these target markets during the early years of the operation. This way they could, as soon as possible, have many people to go back to and cross sell. However, senior management not only wants to see GAAP break even by the fourth year, but it would like to see a 17% ROE by the sixth year. Good luck.

A more effective approach, of course, is to gain senior management's approval of a more relevant performance measure. In the case of our example, a good measure link and strategy to performance is this lifetime customer value measure.

An initial value would be determined during pricing. When customers are first acquired, their expected lifetime value would be reflected in the current period's reporting results. As actual experience on the first sale and later cross-sales to customers became known, the value would be updated as of each reporting period. Lifetime customer value in this case clearly links marketing strategy to financial performance measurement.

When the SBU's marketers or sales people set their new customer acquisition allowances, the measurement of their performance doesn't end after they've sold the first product or even after they've met their sales quota for the year. Instead, the initial and updated value of the business they produced continues to be measured each year.

One useful measure that I like to look at is return on distribution cost invested, which is sort of an index of marketing effectiveness. It is the present value of the distributable surplus produced by the marketing situation divided by the present value of the distribution costs. Instead of discounting it at the hurdle rate, I'd discount it at the earned rate because much new business doesn't have more of a profit than the hurdle or even less, so I want positive numbers to at least have an index. It is useful to compare that across different products and distribution opportunities.

Another useful measure is a benchmarking measure. It is the distribution cost per dollar of revenue, which is like the present value of the distribution cost divided by the present value of the revenue. There are premiums for protection products and spreads and surrender charges for spread products, just to give you a feel for how much of the dollar is going for marketing.

Many retail insurance products, as we said, can be 30% or more, and some of our competitors are way under 20%, selling mutual funds and bank products. And while they have certain differences these days, many of their elements are finding their way into the products we sell.

Another interesting measure is economic value added. It is similar to the lifetime customer value I'm talking about, but you wouldn't get into predicting future sales beyond the current year.

As actuaries then, I think we have the expertise to take a leading role in helping senior management and SBU managers understand the key issues surrounding the choice of appropriate and applicable performance measures that link to our strategies rather than being just tied to accounting rules. Again on the accounting rules, they're important but I think they should be viewed more as constraints; where if those numbers are worse beyond a certain point then that's probably unacceptable, because we are in a world where the analysts and competitors are looking at those numbers.

Now that we've covered the relationship between strategic market planning and performance measurement, let's finally look at strategic alliances. Earlier we defined strategic alliances as ventures where we're trying to share, acquire, or divest one or more business functions or risks with an outside entity. The scope of these ventures range from very simple situations like fronting arrangements to very complex joint ventures involving two or more parties where they're creating new businesses, new markets or even a new company. And, as we have said, historically most strategic alliances were reinsurance or simple mergers and acquisitions. The array today of the players, of course, includes everybody from marketing companies, system vendors, banks, brokerage firms, investment companies and many others. Let's look at some of the forces that have driven this proliferation of strategic alliances.

We live in a fast-changing environment. I think many companies when looking at strategic alliances historically would say, "Well it might be interesting but we can do things better for ourselves." But they are finding that they can't generate every internal resource to capture opportunities quickly enough on a cost effective and timely basis. Even the largest companies are typically doing some of their systems vending for certain products like variable life through vendors rather than through constantly updating home-grown systems.

Another factor is the increased use of SBUs to define smaller and more entrepreneurial businesses. This results in increased internal competition for resources. This, coupled with the great pressure on SBUs to make a big hit quickly, makes the SBU feel like it is going to get the best and the most responsive resources and often pushes them to look on the outside.

We also see continued pressure to improve distribution productivity. So if you have a capacity of lots of product and product support, and you're not getting enough sales from your traditional distribution system, you have to go out there and find other sources of sales.

Financial problems like real estate portfolio problems, reduced profitability, new business and increased capital requirements, have made it more difficult for companies to fully absorb the risks, both financial and capital, to support new growth. This is another reason to look to the outside, and we see even today the largest mutuals emerging to solve some of these problems.

Finally, the historically segmented financial services industry, banks over here, and insurance companies over there, has shifted and blended to almost a single overlapping marketplace. So again we've seen the stockbrokers and the bank accounting for an increasing share of all the annuity products. We can't ignore that, so therefore, again we need to look to the outside through strategic alliances.

With this increase in strategic alliance activity, how can actuaries get involved? Three areas are: screening and due diligence of prospective partners, structuring and pricing of the venture, and evaluating the venture.

Every strategic alliance, of course, involved reliance of one party on the other. Therefore it behooves us to do all we can up-front to minimize surprises later. And I think the particular area where we can help is in assessing the financial suitability of these partners before we even start talking to them.

Due diligence process is a much more detailed process and typically would take place once the parties have a reasonable understanding that they share the same objectives and it looks like there's a doable deal. And again there's much analysis of financial information and operating information where we can help. But the area where we can make the greatest contribution is in the area of structuring and pricing the venture.

As actuaries, depending upon the scope and nature of the venture, we can involve anywhere from one to all three of these items. Product service pricing, if we're offering our product for use through outside distributors, or directly to a new source of end buyers, we have to reevaluate the basis for our product price in terms of the differences in the distribution cost and the differences in the expected buyer behavior. For example, if we already had a product we had developed and we're selling a no-load variable annuity directly to loyal customers and then now we're going to sell it through stockbrokers, you have to reprice that, and reconsider it.

In situations where the strategic alliance might involve a proprietary set of new products or starting a new business, we have to expand this sort of pricing analysis to more of a full-blown business plan analysis. Not only that, but we probably have at least two sets of company measures to look at, ours and our partners. As actuaries, I think we could meet the challenge of trying to sort through the two sets of measures and have it tied to one strategy.

The third area is what I call decomposing or unbundling product service components. If both parties to a strategic alliance are life insurers, and all the risks will be shared, of course, coinsurance would fit the bill. But what if the deal covers only limited aspects of the service such as marketing, investment management, or policy administration. In these cases, we have to decompose the economics of the product or the service we're providing into the key elements, such as bearing risk, managing spread or record keeping. Recasting the internal economics of products and services for this purpose is certainly a challenging area where actuarial expertise is critical.

Finally, we should play a key role in designing risk/reward sharing elements. To date, many of the strategic alliances where an insurance company partners with a noninsurer, such as a broker or a bank or another source of end buyer that's not an insurance company, there's very little risk sharing. For the most part, the originators of the business get paid commission, service fee, and other expense allowances which aren't a function of the quality of the business they produce.

I guess an exception would be the producer-run reinsurance companies where their success is limited to the larger operations and the big producers. And I guess another area where there's some profit sharing is some of the persistency production bonuses.

But more recently we've actually seen a trend toward ventures that more closely align the interests of both parties, even if one isn't a life insurer. For example, we've worked with brokers, banks, and some investment companies to develop marketing programs that share both the upside and the downside risks.

In general, these work by putting a portion of the marketer's compensation at risk and then later releasing it along with a portion of the profitability as it materializes, or if it materializes. Obviously, this is an area where actuarial expertise is essential.

Finally, we certainly should play a key role in evaluating the results of the venture. As actuaries we can make major contributions. We should identify and develop performance measures that are relevant to the strategy underlying the venture. We should educate both our senior management and the managers of the partner company as to what to focus on so we don't end up with distorted perceptions based on accounting results that don't relate to the strategy. Strategic alliances will provide actuaries with substantial challenges and opportunities to contribute for years to come.

Let's recap. To achieve profitable growth in the competitive financial services landscape today, we have to transform the static annual planning cycle to a more of a day-to-day strategy formulation process. We call it strategic market planning. We also discussed how as actuaries, we can contribute in three key areas: product-to-market development, development of relevant financial performance measures that link to our strategies, and assisting in the design, pricing and evaluation of strategic alliances.

As the great Chinese military strategist Sun Su said, "All men can see the tactics whereby I conquer. But what none can see is the strategy of which great victory has evolved." Good luck in your day-to-day strategic market planning.

MR. HOWLAND: Dave, you discussed facilitating versus direction setting and trying to make sure you keep the two separate, so you don't lose your credibility or your contribution. However, in smaller companies like my own, I'm responsible for both the provision of the data and voicing an opinion on it. Can you help direct me in that?

MR. RICCI: I was addressing the technical half. But, obviously, you can take that too far. I think the most healthy relationship is one like Michael described where you use the best parts of your ability to work with the strategic business units to form a strategic partnership where each side appreciates what the other is doing. In smaller companies this is even more important because you have those other services that you need to provide and bring to the table which are very critical. My remarks are more or less addressed to those of us that are starting out in this.

I have a question for Mike and it is more of an observation about the lifetime customer value. For example, the Japanese companies selling computer chips flooded the market with low-priced chips and grabbed the market share. Then when the other competitors were gone, they raised the prices up. It seems to me that this concept of lifetime customer value, if you're honest about what you think the potential is on an ongoing basis, and you can honestly assess how easily you can change those margins as you increase market share, would be a very powerful tool.

MR. SHUMRAK: That can be, I guess. However, I wouldn't say that there's a great number of companies or, even in the case of my practice, clients that actually use it. Again, I think it is a missionary process that will take time, or maybe competitive forces will force the issue. So, unfortunately, we don't get to apply this much. But I think the real successful companies can.

Again in the traditional direct response paradigm it is not so much a loss leader, then you sell them more of the same thing. It is more that you may not have lower distribution costs the first sale out, but you do make money on it. It's more that if you focus on markets where there's a reasonable expectation you could sell them other products and services, then this has applicability. If you're dealing through a distribution system like most traditional agents, or even direct marketers that find one product that works, then just sit back and ride with it. It doesn't mean much because the expected deal is just the first sale. So I think the real question is whether it is viable and realistic, whether there will be these other sales? If so, why shouldn't it be factored into the pricing strategy?

MR. RICCI: Yes, so I guess the conclusion that we often come up with when we do competitive studies and we say, "Gee, that company is selling it for a song." They're just listening to you.

MR. SHUMRAK: Right. Or, the other situation that's confusing, because nobody puts a sign out, you might see a no-load variable annuity with a mortality and expense that's astronomically low. And it is, say Vanguard or Fidelity cross selling an annuity to customers they already own who are in touch with them. You know if they can do that then you can do that too. But, there's no sign out there saying, "they're not trying to acquire some new relationship, they're just milking an existing one."

MR. ALAN W. FINKELSTEIN: I did what you may call a strategic planning type of approach to a program we were involved in, a mortality risk reinsurance of the CD returns on annuities. I developed a corporate model which I discussed with the senior officers of our current company. Then I tried to take into account some of the environmental factors for this type of product. For example, with something being marketed through a bank we expect that not everybody will hold the money until they retire. One thing that I didn't count on was the unfavorable ruling by the IRS. One of your slides on strategic evaluation of scenarios included uncontrollable and environmental factors. How do you go about selecting environmental factors? And how important is this in your modeling process?

MR. RICCI: There's very little reflection as you're well aware of in this area. Probably much less than should be warranted as people spend more time agonizing over the obvious than they do looking at the things that are going to happen. I know everybody was taken aback by the *Black Foot* ruling.

But then again, by the same token, you see another environmental impact that says maybe the walls will come down altogether. And so rather than to think about something you might market directly to banks, maybe you should think about something you might market directly to the distribution system and work directly with the brokers to find the product. We were in the same position as you. We were looking at something where you'd have a transfer of the longevity risk, as it were, on these products. I think it has real potential, not only because you're dealing with such large volumes, but also because there's such a countercyclical aspect to it that makes it kind of appealing in terms of some of the risks. But then environmental factors showed up.

The way we generally do it (I'm aware of organizations that do a better job of this, where they actually have people that spend most of their time thinking about bad things) is on a regular basis, probably quarterly, we talk about the impact of certain strategic initiatives that we're currently undergoing. We have a database that we try to maintain that brings in certain events that have occurred recently. Then we try to come up with a reasonable idea about what that is leading to. In the example you mentioned, with the *Black Foot* ruling, it seemed that all the current stuff was leading towards a much different result. So I don't know how you would have avoided being blindsided by that one.