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## Session 84CS
## Failure to Plan is Planning to Fail: An Experience of the Strategic Planning Process

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**Panelists:** DORN H. SWERDLIN
**Recorder:** WILLIAM R. HORBATT

*Summary: This session targets managers of small- to medium-sized life insurance actuarial consulting firms. In this session, you are responsible for the long-range planning for your actuarial consulting firm. You are first presented with the basic elements of the strategic planning process. Next, you review with the group the state of the insurance industry. Finally, you participate in a case study where you develop an actual strategic plan for the hypothetical life insurance firm.*

**Mr. Dorn H. Swerdlin:** I'm vice-chairperson of the Actuary of the Future Section, and this session is jointly sponsored by the Actuary of the Future Section and the Financial Reporting Section. We will talk about strategic planning and we'll do a case study.

**Mr. William R. Horbatt:** We found that organizations reach their optimal performance when they function at the intersection of three different spheres. On one hand you have the environment. What's happening around the entity? This will be true whether you're in a consulting firm, you're an insurance company, or whatever. The next thing is the organization's own internal capabilities. Finally, the issue that is a driving force management preferences. If your senior management doesn't want to do something, it's not going to happen.

What are we seeing right now in the environment? If you think we've missed some critical issue, feel free to bring it up. Demographics. We've got the baby bubble. We have the aging of America. Starting in the 1970s we've had a real run-up of real estate prices, as this population bubble moved into the home owning and family nesting stage. That baby bubble is now just beginning to enter its 50s, and the demands in our marketplaces are shifting as a result of that. They're no longer interested in insurance products to the degree they once were. They're now interested in accumulation products, retirement savings products. There's an increased customer sophistication occurring. We're seeing, for example, a migration from people buying fixed investment products such as fixed interest, single premium deferred annuities (SPDAs), and GIC accounts, and their 401(k) plans, to equity investments.

**Mr. Swerdlin:** Excuse me, Bill. Another thing and in line with that, is the 401(k) market. I think the consumers are really getting more sophisticated and starting to really understand what all these charges are that had previously been hidden and misunderstood. They're starting to be much more aware and conscious consumers, especially in that area.

**Mr. Horbatt**: We're seeing more comparison shopping. Individuals will not just accept what an agent brings to them.

**Mr. Swerdlin**: Continuing with the trends in the economy, we're seeing increased efficiency with all the technology and computers and smaller and smaller world. Companies are reengineering to be much more efficient and much more flexible. There's a clear shift from paternalism to individual responsibility, and, as I mentioned, the 401(k) plan is a good example of that where the participants are actually participating in their own retirement as opposed to the old days when it was just employer money going in. There's been a clear shift from defined benefit to defined-contribution plan in the marketplace. It used to be that there was the insurance industry, the banking industry, stock brokerage, and the stock market industry. They were all very distinct and there were clear lines. As you know, today the lines are getting blurred, and companies are doing business in all of those areas and more in the financial service industry. All of a sudden, where you might have competed only with insurance companies before, you find yourself competing with mutual funds and banks and stock brokerage houses and all sorts of places.

You have the phone centers with the voice response units. Of course the Internet has significantly changed how we communicate, how we do business. We're driving down to the ultimate customer. I keep giving examples from the pension industry because that's my business. It used to be our clients were really the employer; they're the ones that paid our fees. But more and more it's becoming the participant, the employee, that we're focusing on and trying to please and trying to keep happy.

**Mr. Horbatt:** We're seeing that same thing in the insurance industry where the agent was king. Now there's increased emphasis on what the consumer wants to buy. I don't see the major companies taking, let's say, the giant leap where they'll actually disregard the agent, but the agent as the king is something that's waning. The government is always an external influence, and, having served as the deputy mayor of my town, I got to see this first hand. Long term, government is going to reflect whatever's happening in the world around it. The issues that are important to the people are going to ultimately determine who's elected and what policies are set. In the short term there's political expediency.

**Mr. Swerdlin**: We shift to internal capabilities, and the first thing we look at today that we probably didn't think much about in the past is culture. It's a very important factor in how successful the company's going to be in the future. It includes risk tolerance, which means, how much is the company willing to take a chance and venture into new areas? Or is it conservative and wants to stick to a pretty strict game plan?

As companies in the future are going to grow, they're going to have to be flexible and be ready to make the changes, otherwise they won't survive. Companies will need to incorporate continuous learning. You may have heard of a learning organization, which is a phrase coined by some people out of MIT. It's important that the employees of a company continuously learn, and management really needs to focus on keeping its people trained and developed and make sure they grow. Otherwise the corporation or the organization won't grow and won't learn. Then you're doomed to mediocrity or worse.

**Mr. Horbatt**: Let's go back to risk tolerance. There's a really good article in *The Wall Street Journal* in the past week where Sprint decided to make what I would call an ultimate gamble, and sometimes I view strategy as simply gambling. How willing is a company to make choices that are going to, let's say, bet the ranch? What's happening at Sprint is Sprint is going to try to jump over the current phone technologies, which is basically a single line from end to end exclusively in use by a customer to a digital transmission. They've been working on this in secret for a number of months, and it was just announced a week or two ago, but they're betting the ranch on it. They're betting that their customers do want the enhanced data services and will pay the price for it, and they're going to get the lead. They will probably have a 12-month lead over any other competitor. They'll have an ability to: get the higher margins that you have when you first enter a market and to develop enough market share that it puts their competitors at a disadvantage.

**Mr. Swerdlin:** The biggest part of the bet, or at least a big part of the bet is whether their timing is right, and whether the market is ready to buy those things right now. It's always a big risk.

**Mr. Horbatt:** But they're saying theoretically, they can cut the costs of telecommunication services by 90%. Think of it, if they go out to the customers right now and say we'll cut your bill in half, they still could theoretically have a 40% profit margin.

**Mr. Swerdlin:** Does anybody else have any examples of strategies that companies have made? Your own company or any other company?

**Mr. Horbatt:** Another issue of your internal capabilities is your cost structure. Where is your firm in, let's say, the life cycle of a business? Is it a start-up with relatively junior employees, relatively low cost, not much overhead, or is it a mature company? Does it have a lot of mouths to feed, including some high-paid mouths? Relative efficiency. Dorn has talked about traditional competitors and non-traditional competitors. Think of the companies that are involved in, say, Wall Street trading stocks. Now that the Internet's soft trading has come along prices have just gone down two notches from where they were before.

**Mr. Swerdlin**: On internal capabilities, what are your company's assets? That includes what kind of technology do you have at your fingertips? Do you own it? Do you buy, do you lease it? Intellectual capital. We talked about learning earlier. Are your people up to speed with what they need to know to do the job they have to do and to make your company grow? Infrastructure. Do you have the right people in place? Do you have the right plants in place, the right clients, that sort of thing, to make it a going concern and to grow in the future? Flexibility, as I said earlier, is very important for the future. Moving, being able to change, the rate of change is continuously increasing. You've got to be flexible enough to stay with that and pick your choices as you go along rather than be in a position where you can't move when it's time to move. Of course, we all need capital, need money, to run the company and to keep it going.

**Mr. Horbatt:** Yes. This is a good example. Dorn has his own firm, Swerdlin & Company, a firm that started out as a pension consulting firm, about 20 years ago. He started out doing defined benefit work, and that was virtually all the business you were doing, and you were dealing with the technologies of that day which weren't very sophisticated. I assume that you eventually had to get a mid-range computer to do your valuations, but look at the change. Now you're predominantly a defined contribution administrator.

**Mr. Swerdlin:** Right. When I had defined-benefit plans I did have to use a computer valuation system, which I just leased. I gave the data to the guy, and he ran it and gave me the results back. It was back in 1980 there were no PCs to speak of. The first computer I bought was a PC. It was in 1983, and it was a word processor that cost me $6,000–8,000. Times have changed. But the market changed from defined benefit to defined contribution. I had to switch as the market did.

**Mr. Horbatt:** Yes. Look at the assets you have now. Your staff is trained primarily in defined contribution. That's your infrastructure. Your technology. You've put in a mini-computer now because you have to do record keeping.

**Mr. Swerdlin:** Right.

**Mr. Horbatt:** Your intellectual capital. You've got several senior level people running different operations.

**Mr. Swerdlin:** Right.

**Mr. Horbatt:** You've got capital issues because things like the tax law requires that some things can't be immediately deducted. What you may have less today is flexibility. You're a bigger firm. You're 30 people.

**Mr. Swerdlin:** Right.

**Mr. Horbatt:** Your firm cannot change as before. You can't turn on a dime that you once could.

**Mr. Swerdlin**: On the other hand I've got more capital than I did 18 years ago. Even though I was flexible, I might not have been able to jump on some things because I didn't have the money to do it back then.

**Mr. Horbatt:** Right. I look at ourselves like we're part of a large accounting firm. We've got a lot of limitations. We've got the same things that Dorn has but probably to a slightly higher degree. Tillinghast and M&R have the same problems. Why did Tillinghast develop a standard actuarial software system and M&R didn't? It was primarily because they had a more rigid, organizational structure. They could allocate capital. That was a good example if you're looking at internal capabilities. Back at that point in time you know that the hierarchical organization structure of a Tillinghast will be more effective in something that requires a large capital investment versus the more true partnership that M&R is.

**Mr. Swerdlin:** The third of the three spheres is a management preference, and that just means what do the people that run the company want to do with their company? One issue is whether you want to build versus buy. What we mean by that is, for example, in my case with my little firm, we have over the years bought out some smaller firms, basically bought some block of plans from smaller firms. That's one of the ways we've grown over the years. You can choose that. You can choose either that or you can choose just to build internally. The risk aversion comes up again.

**Mr. Horbatt**: That goes beyond just blocks of business. When I came into KPMG, I had been part of a small management consulting firm, the Franklin Group. KMPG bought us, and we became members of this new firm. You can buy resources or you can buy blocks of business.

**Mr. Swerdlin:** What we've done is bought the plans. Actually, although in two of the three cases people have come along, so we've bought them, too, in effect. Risk aversion. Who are the people who have the most to lose or to gain? How do they feel about the risk? Are they going to take a chance or are they going to keep it close to the chest? You also have internal pressures. Which is the dominant one, the marketing attitude, which is let's bring in as much business as we can, or the cost-cutting attitude, which is let's make sure that we keep the expenses down as much as possible. These things can obviously be in conflict if you ever work with the marketing people.

**Mr. Horbatt:** If you look at the economy right now, we've just gone through a period of time where the U.S. economy has just demonstrated tremendous financial results. It's been a time period where the critical elements have been things like reengineering, changing our cost structures. The question that management consultants are asking today is, has that really run its course? Have we really gotten the low-hanging fruit off the branches? How are companies going to survive and succeed? There is at least a movement among that community towards saying that marketing is now going to be more important for success.

**Mr. Swerdlin:** Next is how you rank your stakeholders. Every company's got customers and employees and shareholders, and where do you put them? In recent years a lot of companies have realized that customers maybe have not been as important as they were in the past. They need to get more attention. The same with employees. But every company has their own way they look at those three things, who's more important than whom, and who gets what when, that sort of thing.

**Mr. Horbatt:** Sometimes you can just tell. If a company uses the term stakeholders, you know that the stockholders are not the highest priority.

**Mr. Swerdlin:** Probably right, yes.

**Mr. Horbatt:** I've seen that in firms. Generally, the most successful firms from a financial standpoint will not use that terminology, or, if it is, it's a footnote because they're driven by different objectives. One final thing we want to mention to you before we go into the case study is just some generic strategies, and these are the two major strategies to be the low-cost provider or to be a niche marketer. The low-cost provider just drives its costs down. It knows it's going to develop a market based upon those low costs. Then you have the niche marketer who focuses on some market, meeting its needs better, and, by doing that, it bests its competition.

**Mr. Swerdlin:** Any questions so far about the concepts that we've presented this morning?

**Mr. Horbatt**: What we're going to do is ask you to break up into two groups. We're going to give you a hypothetical situation. What you're going to have to do with that situation, is you're going to have to understand your organization's strengths and weaknesses and identify potential new services. Because this is a meeting for life insurance and financial reporting, we're going to assume that our participants are members of, or employees or partners of, a life and health insurance organization. You can pick what you want to be. You can be a partner in a large, national, consulting firm, whether it be KPMG or Tillinghast, or you can be part of a small group of people just be a member of a local consulting firm. Now the fun.

Newt Gingrich is elected president. Congress privatizes Social Security one nanosecond later. Don't you love it? Under the new law employers have the right to establish their own private plans providing they satisfy certain minimum requirements. Other firms, such as banks, insurers, mutual funds, also can set up these kinds of plans and market them. Finally, this is the kicker, every citizen has the right to opt out of social security into a private plan. If you're working for ABC Manufacturing, Ford Motor Company, you don't have to take their Social Security plan. You can go out to Merrill Lynch or Prudential and buy your own.

What do we know about it? The American Academy of Actuaries Task Force on Social Security reviewed the law, and they concluded several things. First, that the expected gains and investment performance in private plans far outweigh the expected increases in expense levels for private plans. From a retirement income perspective it works. Second, expected claim costs for medical insurance in private plans is expected to gain efficiencies from managed care. Therefore, the thought is the deliverable of medical services through Medicare can be done through this mechanism. Finally, the expected claim costs for disability and life insurance benefits are expected to be approximately the same as they are under the current Social Security program. The question you've got to ask is, what changes will your company make in its strategic plan to respond to the introduction of privatized Social Security? Each group has to decide what kind of a consulting firm it is, but you can do that by consensus. Here are some things you should consider as you're going in. How will the change affect your existing clients? What kind of consulting firm do you want to think that you are? Maybe you want to ask, am I a little firm, a boutique? You have to decide what kind of firm you're starting with, and then you can decide how the change in the law's going to affect you.

**Mr. Horbatt:** Then you have to ask the question, How is this change in law going to affect your clients? Are you going to lose clients? Will your clients need different services? Do you have the capabilities to provide those services? Does it open new markets to your firm? What are they? What skill sets do you need for these markets? Finally, what is your expected competition in this market? Is it going to be your traditional competitor or are there going to be new people out there trying to clean your clock? Then ask yourself does your current business model match the opportunity? Do you want to remain as a consultant or should you become a manufacturer? Is there something better to do because of this opportunity than what you're doing right now? You don't have to stay the same. Should you become a distributor? A middleman? Any questions?

**Mr. Swerdlin:** What would be an example of a distributor?

**Mr. Horbatt**: It could be life insurance agent. It could be a managing general agent.

**Mr. Swerdlin:** Who has a question about it? Get to work.

(THE GROUP SPENDS TIME DISCUSSING THE CASE STUDY)

**Mr. Swerdlin:** By the way, the conversation that you've just had is really the most important part of this process. We'd like to hear the summary of it and that sort of thing, but the process you've been through is really the most important part. I was listening in on both conversations, and I think you had some very interesting and very insightful outlooks on these things. But if you're ready, let's go ahead. Tell us what happened.

**From the Floor:** Basically, we positioned ourselves as a large life insurance company. We have an existing pension operation. We had a group health operation. We had a life insurance operation. We really looked at this as a big opportunity—but a threat at the same time. We had pictured for ourselves those three operations, and we asked, How do we need to bring them together, given that there would be this new market of individuals who could opt out of plans? We could be in the individual business. We needed a new operation and a broker between the existing operations.

**Mr. Swerdlin:** Who is your customer going to be?

**From the Floor**: We had two layers of customers, and we have individuals as customers because of this opt-out capability, but we also had employers as customers. We thought it was very important that we had existing employer relationships, and we may only have pension business with them, but we looked at this as an opportunity to try and get health and life business with them at the same time. We would initially want to set something up where we were trying to encourage them to have those other businesses with us, maybe with some expense savings or set up some structure where they could get all three products, essentially, from us. One of the things we wanted to do was guard against the opt-outs from our own business because we thought that was a threat that didn't really exist now. We had opportunities and threats from this change in the law.

**Mr. Horbatt:** That was good to focus, to say you were going to set up a unit that would just focus on this new opportunity.

**From the Floor:** Yes, we were going to set up a new unit trying to focus on the new opportunity.

**From the Floor:** We talked about other things, a strategy that was in layers. What things do we need to do immediately to be ready for this change, and what other things might we want to do down the road? We weren't really interested in somebody getting just individual health business with us. If individuals were going to want the products, it would have to be some package. We might do individual pension business, but we wouldn't do individual product sales.

**Mr. Swerdlin:** For profitability reasons.
**From the Floor:** Yes, we talked about other things that might happen down the road. Maybe we would look to acquire a mutual fund company. We weren't sure

that we could even do individual health as part of a package, we might need to have our brand on somebody else's health policy to make that work. We also saw another opportunity potentially down the road of being an administrator, for a fee administer other people's plans, if we were able to develop that capability, but we didn't feel internally we would have that capability to start with.

**Mr. Horbatt:** That's very good.

**Mr. Swerdlin:** Thanks a lot.

**Mr. Horbatt:** You're going to be focused. You have a game plan that's incremental in stage, so you're not going to shoot yourself in the foot by overreaching. Good thoughts. What kind of company are you guys? Nobody ever told me that. These guys are an insurance company.

**Mr. Swerdlin:** At one point in time they were a big consulting firm.

**From the Floor:** We're a big consulting firm that's all things to all people. We do employee benefits consulting, and we have a client base of life insurance that typically has been serviced by different people, but this opportunity would have a tendency to bring them together and be hitting us on all of our strengths. Let me just say parenthetically that personally I would get a lot more gratification out of finding an opportunity and making something out of it as opposed to this, which is basically having an opportunity crammed down your throat. You have no choice on this when this happens. Whether you like it or not, you have to respond, and we viewed this as a huge wave through the system, that we have to respond to, and it would tend to dominate. The comment about them setting up a special unit to address this, that makes sense. But it occurs to us that the other units, other than this one, might not be too relevant anymore if this is as big a wave of new money into the system as they anticipate.

Among the things, to be honest with you, other than what kind of firm we were, we talked a lot. I don't know how many things we settled, but we talked about the idea of being a provider of focused expertise. This would be an opportunity to be a provider of focused expertise to consultants, to people who were going to be the providers. We didn't look at ourselves as much of a provider, even though on our employee benefit side we had back-office operation, and this seems to create demand for that. That isn't what we focused on initially. We focused on the expertise of going to banks, going to insurance companies, going to employers, and telling them how to respond to this opportunity and being known as the consultant of choice to help them identify best practices in responding to this opportunity. I think that's what we decided we'd like to do. There might be better, bigger opportunities in other areas, and maybe the back-office operation is one of them, but we decided we didn't want to do that. We also talked about how there might be niches, very profitable, lucrative niches off of this, that a firm could go into, say consulting. It might not even have been clear initially what that is, and that's one of the problems with focusing on those niches.

The secondary, ancillary issues off of this is that they're not as defined in the early stages, and that might have to wait a couple years down the road to identify certain niches that emerge from this. Our initial response would have to be "We're the experts and we'd like to have banks as a client." That seemed natural. We talked about life insurance companies being our clients and because of this big opportunity with them, we could assist them in responding to this opportunity. Then we took a natural extension of that in saying this is an opportunity for banks very similarly, and so they would be clients. However, it occurred to me that historically employee benefits consulting firms haven't had banks as clients. Would you agree with that?

**Mr. Swerdlin:** That's my impression, too.

**From the Floor:** Yes. Yet here I'm talking as if they'd be a potential client, and that, while it's true, almost not more so than in the past, and in the past it hadn't been done.

**Mr. Swerdlin:** Actually I was thinking, smaller banks are clients. We have several.

**From the Floor:** As an employer?

**Mr. Swerdlin:** Absolutely right, as an employer.

**From the Floor:** As an employer, yes, just like an oil company.

**Mr. Swerdlin:** Anybody else.

**From the Floor:** Let's face it. When there's a lot of money suddenly available to be invested, banks are going to want a part of that. They're not going to sit on the sidelines, and they're really not now. They've played, I think, a varying role over time, there have been times where they were key providers of employee benefit accumulation dollars. I know mutual funds are really taking off, and maybe some of those are owned by banks, I'm not sure, or related to banks. Right now if an insurance company considered themselves as losing a percentage of that accumulation dollar, the first thing they think of are the mutual funds may be more than banks, but banks would be a response. Mutual funds could be a potential client. They could be a competitor. They could be all that. But when you take the philosophy that your small niche is to be all things to all people, it opens up the whole world.

Some of this may currently be not in the employee benefits field, but creating joint ventures with banks. It would be similar to what might be done now where the bank says we can provide all the investment expertise, and we might be a consulting firm which would provide a lot of the front-end design and advisory, but some of that's done now. It's just that there'll be so much money moving through the system that all the existing opportunities will just be magnified, and there'll be some more, but a lot of it sounds like an extension of what's going on now. It's a combination of having clients who are life insurance companies and advising them on their products. We see the individual market as being a major response here, although we're not sure from the way you worded it, but it sounded like an employee could maybe opt-out and go buy an individual product. You tended to talk in terms of plans, just like the individual IRA market now. There's going to be a lot of advice to insurance companies on the individual side, on their group side, and employee benefit side. There may be a coming together of employer consultants versus provider consultants in a way that there hasn't been in the past. With ERISA you couldn't be an expert in both, and this would start to bring it together a little bit.

**Mr. Swerdlin:** One more possible client for your consulting firm could be a stock-brokerage house because they're trying to get your money.

**From the Floor:** They could be a client, and they could be a competitor.

**Mr. Horbatt:** I'd like to thank you very much, and I hope you enjoyed the process. In the back of your book you have a sample strategic plan, and that could be good if you're going back into your organization and there is a planning process. We used a small pension consulting firm as an example. It's modeled after Dorn's firm, but to protect the guilty we haven't named it as such, and we took certain liberties.

**From the Floor:** I thought you were going to put the answer back there.

**Mr. Horbatt:** There is no answer. We had a seminar yesterday on mergers and acquisitions, and we had groups negotiating with each other, and they said, well, what was the right price? And we answered, we don't know.

**From the Floor:** See, that's what a good consultant might do—focus on the niche where there is no answer, and there are low expectations.