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MORE ADJUSTMENT

John B. La Macchia, Jr., B.S., M.S., *Adjusting Life Insurance Company Earnings*, Standard Analytical Service, Inc., Insurance Investors Advisory Division, 3839 Washington Blvd., St. Louis, Mo. 63108, \$7.50.

by D. J. Leapman

When I use a word it means just what I choose it to mean—neither more nor less. — Humpty Dumpty.

As established in the Preface, this report does not purport to present any new or more accurate method of adjusting life insurance company earnings, but rather to present the problem in all its complexity in a manner more easily understood by the reader.

The early Chapters set the background by tracing statistically the numerical growth of life companies in the U.S. between 1940 and 1967 and in the issued shares of 11 selected life insurance companies between 1950 and 1966. The author attributes the immense multiplication in the number of these shares in great part to the wave, in the late 1950's and early 1960's, of investor-directed material extolling the life insurance company share as the epitome of a growth stock.

Between 1950 and 1964 the 30 life stocks comprising Best's Life Stock Index rose 1093% compared with the 316% increase in the Standard and Poor's 500 Stock Composite Average. However, in 1964 life stocks turned about and between 1964 and 1968 the Best's Life Stock Index fell 29.5% while the Standard and Poor's 500 Stock Composite Average rose 30.7%. Evaporation of the glamour was to no small extent attributable to the difficulty of evaluating the real earnings of life companies, affirms Mr. La Macchia.

Solvency Purposes

The report summarizes the solvency purposes of the Convention Form annual statement, its purpose and the effect of its use in depicting the operating results of a company. The report correctly deduces that it tends to stress the amount of surplus as shown by the excess of assets over liabilities and capital, and compares this to the customary emphasis on income and expenditure in the annual accounts of industrial and commercial corporations. Lack of interest in income and expenditure accounts of

life companies is attributed to the significant distortion resulting from first-year commission and other issue expenses.

Having thus set the backcloth, the author provides a simplified illustration of the effect of spreading first-year costs over five years, and then moves on to consider the additional distortion in earnings resulting from the method adopted to establish policy reserves and the use of conservative assumptions as to future mortality and interest rates.

He also refers briefly to adjustment of earnings to take into account participating policies, non-recurrent items, reported taxes and capital gains, although for U.S. stock companies these are admitted to be of less significance than the amortization of first-year costs.

The setting is completed as Mr. La Macchia remarks that company analysts are generally agreed on the need for figures of adjusted earnings, currently provided by only a limited, albeit unknown, number of insurers.

"Rule-of-Thumb" Method

Describing the various methods used by analysts to create such adjustments, the report first refers to the "rule-of-thumb" method by which a value per \$1,000 sum insured in force is attributed to each type of insurance written by the company. The usual range of values is stated to be \$15 to \$20 per \$1,000 of permanent insurance, \$5 to \$8 per \$1,000 of individual term, and \$0 to \$5 per \$1,000 of group insurance in force. Erroneously, reference is made to applying these values to the amount of insurance sold during the year, but the example logically relates earnings to the value of the increase in insurance in force.

To illustrate the lack of worth of the rule-of-thumb method, a table included shows the 1966 earnings of thirteen companies adjusted by three analysts, each using different values for the five classes into which the business in force is divided. The author emphasizes the differences in the values obtained by the three sources, but in the light of the very different assumptions made, the correlation may be considered by the reader to be much more surprising!

The author also remarks that analysts using this method attribute to different

companies identical values per \$1,000 of increased insurance of a particular type without regard to the actual expense of selling new insurance, which varies from company to company and which will evidently affect the earnings. While correct, this statement appears to ignore the reflection of such efficiency variations in the reported earnings, to which the calculated adjustment is then applied.

However, in addition to being too inexact to be useful in considering any particular company, this method takes into account the future earnings to be derived from the in-force business, whereas the author concludes, with many members of our profession, that to derive adjusted earnings figures on a basis consistent with published earnings of non-insurance operation, the adjustment should be in respect of first-year costs only. Nevertheless, this expression of opinion at this point contributed to your reviewer's confusion following the report's apparently uncritical review of adjustments recognizing the differences in interest and mortality rates between those anticipated and those on which policy reserves are calculated.

The report refers to the existence of at least 50 other methods of adjusting earnings and indicates that used in Moody's Insurance Stocks. While only sketching the method without full detail, the author indicates his view of its shortcomings which appear valid for the method as he describes it.

Lapse Experience

Concluding his cursory survey of methods used, and not even paying lip service to the actuarial profession, the author refers to the method outlined in the "Progress Report of the Life Insurance Earnings Adjustments," published by the Committee of the Association of Insurance and Financial Analysts. While pressing the view that this method comes closest to standardizing a procedure for adjusting earnings for first-year expenses, he states, however, that it is only a step in the right direction, not a solution.

The report then apparently sets out to show the significance of lapse experience on the amortization period of first-year costs. Lapses and surrenders

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More Adjustment

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are together related to business in force to determine a lapse rate, although one would assume that cash values paid on surrender would take appropriate account of unamortized first-year costs.

It is at this stage that the author becomes overwhelmed by technicalities remote from practical reality. Variations in mortality rates are exemplified as creating a need for different amortization periods for first-year costs, apparently without appreciation of the negligible absolute effect of such variations.

Now apparently creating an impression as confusing as possible, the difference in the ratio expenses-to-total-income is indicated for various companies between 1963 and 1969, after which the author apparently considers his purpose achieved.

Nothing further is added in the Summary, except this surprising comment—"the lapse rate, mortality rate and level of expense of a particular policy cannot be forecast with absolute accuracy. Thus, the task of amortizing first-year costs becomes more difficult than generally realized"—so much for those two disciplines, statistics and probability!

And finally — "the use of reported earnings as a measure of profitability and earnings growth is more meaningful than the use of adjusted earnings derived from calculations based on arbitrary rules-of-thumb!" This reviewer's verdict, after reading Mr. La Macchia's report—"Not proven," as the Scots have it!

The Graduate

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Our group was asked to rank these phrases as we thought today's college graduate would. After some lively discussion, revealing a suggestion of a generation gap, Professor Chastain compared our results with those of an actual survey of undergraduate general insurance and actuarial science students currently enrolled at Drake University.

These students ranked the assignment of the newly employed college graduate to a competent, experienced supervisor as the best way to turn the graduate on. They expressed a desire for a supervisor who could be a resource to the graduate

RETIREMENT INCOME

Committee on Employee Benefits, *Retirement Income in the United States—A Case for the Composite System*, pp. 47, Financial Executives Institute, New York, N. Y., 1969.

by Charles A. Peirce

This brief pamphlet was prepared by a Project Group of the Committee on Employee Benefits of the Financial Executives Institute. Two members of the Society—Wendel J. Drobynyk and Davis H. Roenisch—were members of the Project Group.

This study, which is admirably brief, is well worth reading since it gives the broad review of Retirement Income. It covers, among other items, the relationship of the three major sources of retirement income in the United States—individual savings, group retirement plans, and Social Security.

The conclusions reached are not surprising, coming as they do from a group of business men. What is important is that their viewpoint should have wider publicity. On the subject of Retirement Income most of the current literature, probably by number of articles and certainly by number of words, is produced by professors and legislators.

This reviewer would question whether the study devotes enough space to the subject of inflation. Despite this comment, it deserves a wide readership. Hopefully this will extend to the proponents of legislation restricting the operation of private pension plans, a group which currently includes a "filibuster" (collective term!) of legislators.

Copies of the booklet may be had on request from the Financial Executives Institute, 50 West 44 Street, New York, N. Y. 10036.

without exerting authoritarian pressure or oversupervision.

The three areas considered by the students polled to be next in importance to the graduate all maintain the graduate's identity as an individual and establish him as a worthwhile contributor in his new position. The graduate wants a real job to do as soon as possible, not a make-believe trainee position. He wants training interlaced with on-the-job learning, so he can begin to pull together his recently acquired education with his job experiences. He needs to be focused on as an individual—where he is and where he wants to go must be

considered in his assignments, his education, and his opportunities.

Ranked last on the continuum of what turns college graduates on was letting the graduate earn his salary by making his job difficult enough and important enough for him to be worth the salary he can command as a college graduate. It was suggested in discussion that what to do with the graduate after a company has "overpaid" him to get him is a very real problem in industry today.

Student responses on those things that turn the college graduate off seemed highly correlated with the classifications of things that turn graduates on. Widely chosen as the number one offense was the practice of sitting the new graduate in a classroom and talking at him, keeping him a student, and crowding all you want him to know into an initial orientation program. Students clearly objected to the "learn first—work later" philosophy, whereby the new employee first learns the business and then starts to work for real.

Also guaranteed to turn off the graduate appeared to be treatment based on the assumption that it really doesn't matter what kind of supervision he gets—the graduate can just be put anywhere, since managers will prove equally capable of helping him with career plans and objectives. Here Professor Chastain stressed that the guidance of a college graduate in his career takes special abilities, and that industry and the graduate would mutually profit from careful selection of those who will guide the new employee.

Students generally ranked as last on the list of things that turn the graduate off the emphasis put on the size of the company and the security of the graduate's job. The students appeared almost indifferent to a focus on the strength of a massive company.

Professor Chastain concluded his talk by commenting that perhaps insurance companies hiring actuarial students would avoid some of these problems, since by the very nature of the students' highly specialized technical training they could be put right to work in the area for which they had been trained. However, he stressed the importance of careful guidance in career plans and objectives for the college graduate, no matter in what area of the insurance industry he finds himself.