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EXPENSES AND MANAGEMENT

by Ardian C. Gill

With a superabundance of inflation-driven forces threatening the life insurance industry, the problem of expense control sometimes seems an artifact of an earlier era. Yet, after assembling and studying data on expenses of ordinary life insurance, I am persuaded that the subject needs current and constant attention because (a) if ignored, a small expense problem will almost inevitably rise to major significance, and (b) expense control is a measure of the effectiveness of management in difficult times.

This second point deserves elaboration. In an expanding market, said Hamermesh and Silk, *Harvard Business Review*, March 1979, a high-expense, high-profit operation is possible, but in a stagnant or declining market (such as characterizes individual life insurance today) efficient manufacturing and distribution are essential for continued profitable operations. A company's ability to produce a life insurance product at competitive cost is clearly related to its level of expenses; hence any index that measures a company's expense level and trends has particular value in a non-expanding market as a measure of its ability to manage.

The difficulty of measuring management effectiveness is compounded in the life insurance industry because of product complexity and inconsistencies in accounting practices which render the usual earnings per share figure invalid for mutual companies and at least suspect for stock companies; thus some other index is needed.

Expense Studies in Canada

Beginning with Arthur Pedoe's work (*T.S.A.* XIII(1961), 1), various formulae have been employed in Canada to measure expense trends and levels.

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A cordial welcome to our newest Associate Editor, Deborah Adler Poppel, F.S.A. 1980. Deborah's first contribution to our columns was "Ode to A Part Three Student," April 1979 issue.

WHO ARE THE NEW FELLOWS?

by Deborah Adler Poppel, Associate Editor

The quintessential new fellow is a 28 year old married man who has been taking exams for 6½ years. At least, according to the respondents to a questionnaire prepared by Benjamin N. Woodson, Fred A. Deering, and Thomas P. Bowles, Jr. for presentation at this past spring's New Fellows luncheons. The questionnaire was sent to all who had reached fellowship in May or November of 1981, and about 160 (60%) responded.

The demographic data, however, was less interesting than the response to subjective questions. The majority of respondents were bullish on the actuarial career, feeling that it offers job satisfaction, economic rewards, and challenge. Most would encourage others to enter the field, but some specified "clear caveats regarding difficulty of achieving success."

But reaction to the industry in general was much less favorable. Only 25% feel that the short range (5-7 years) future of the industry is "Bright", with 15% calling it "Dim", and the balance "In-between." Interestingly, they felt the long range (10-15 years) prospects to be better—45% "Bright" and only 2% "Dim."

When asked if the industry provides any disservices, a startling 50% gave marketing-related answers, ranging from "overzealous agents" to "failure to educate the public" to "toleration of

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FINAL-SALARY PENSIONS IN THE U.K.

by Kenneth G. Buffin

"Valuation of Final-Salary Pension Schemes," a paper by R. B. Colbran, F.I.A. submitted to the Institute of Actuaries in London last April, contains much of interest to North American actuaries, including a review of major ways in which United Kingdom and North American actuaries differ in their approaches to valuing these plans.

The author observes that our profession's advice determines the amount that British industry takes from working capital and shareholders' funds to be set aside in pension funds, and thus actuaries *greatly influence the national economy*. The paper stresses the actuary's responsibility to ensure that employers neither be misled into thinking that their pension liability is less than is likely nor be encouraged to overprovide. The author mentions the importance of achieving stability of pension costs as a percentage of payroll and acknowledges the concerns of participants for benefit security, and of accountants for proper recognition of liabilities.

Operating in an environment of relatively little regulation, the U.K. pension actuary relishes this freedom but desires that the Institute give guidance to its members on acceptable practices. Indeed, one of the author's main recommendations is that the Council of the Institute act to discourage members from using one particular funding method, the "Discontinuance Target Method," in widespread use in the U.K. for insured pension plans, which, as he undertakes to demonstrate, results in lower contribution levels than do methods designed to produce stable contribution rates over a long period.

The Aggregate Method, used most commonly by consulting actuaries, has

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to have now passed the then largest such companies. I will not predict the same for life companies, but it's worth noting that they are not immune from the need cited earlier to improve manufacturing and distribution costs. It will be a test of management skills to bring that about; it is hoped that the index will reasonably measure the success achieved. Recent results suggest that some, such as Company O have managed their expenses (ergo their affairs, well, while Company H seems headed elsewhere in a handbasket. □

Pensions in U.K.

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the merit of simplicity in producing a single contribution rate without separate normal cost and past service cost components, but the author notes that a separately calculated new entrant rate would usually be lower than the aggregate rate, and he acknowledges that the method produces a tapering of contribution rates over an extended period owing to the usual influx of new entrants. The method's inflexibility is another disadvantage; this makes its popularity in the U.K. surprising to North American actuaries.

In commenting on the principal U.S. methods, the author expresses puzzlement that, in inflationary conditions, supplemental liabilities not covered by normal contributions are funded in the U.S. by annual payments in constant dollars rather than as a level percentage of payroll, the prevailing U.K. practice; also the use of multiple amortization schedules for different items of unfunded supplemental liability is regarded in the U.K. as unnecessarily complicated. In discussing the Frozen Initial Liability Method the paper criticizes as actuarially unrealistic the concept of a uniquely determined frozen liability but acknowledges its accounting nicety.

The Discontinuance Target Method

The author presents a number of problems associated with the Discontinuance Target Method. This system, unfamiliar to many North American actuaries, takes into account future benefits over only a limited period, commonly twenty years; salary increases are projected only to the end of that period although interest, at the valuation rate, is taken into account beyond that; common practice is to assume an influx of new entrants to maintain a stable membership during the limited period.

The general effect is to produce a contribution rate lower, often substantially so, than by more conventional methods. The method, widely used by life companies for insured pensions, has, says the author, "undoubtedly been sustained by the selling of schemes on initial outlay rather than yield on the underlying contract." The paper attacks the method as "undoubtedly the least satisfactory of all the methods described," and appeals for a strong lead from the Institute's Council to discourage its members from any association with it. Conceding that the Institute cannot insist that an employer fund at a certain rate, the author suggests that possible contributions at lower levels can be revealed provided the employer is told of the full potential cost on an actuarially acceptable method.

Valuation Assumptions

The paper also treats critically the much-favored U.K. concept of valuing assets as discounted values of future income, and states the author's strong preference for market values.

A common U.K. practice is to set assumptions implicitly so as to allow for future pension increases. Comments the author:

> "In practice the actuary will probably compromise somewhere in the wide range between a low real rate and the current rate of interest . . . He may prefer to present the valuation as on a high rate of interest with a specific, related, pension increase rate. Tactically, however, the actuary may find it easier to have his views accepted if he uses a more moderate rate of interest and merely mentions that in times of high interest this will give some margin to augment pensions."

The author's closing plea is that actuaries freely admit the possibility of variation and make sure to show employers the nature and extent of their risk.

Ed. Note: FIASCO, July 1982, reports a packed house and plenty of controversy in the discussion of Mr. Colbran's paper. Readers may borrow copies of both the paper and the FIASCO article ("Retired Hurt") from any of the many Institute members on this side of the Atlantic. This newsletter welcomes discussions. □

New Fellows

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high, if not unconscionable, commission levels." Few saw these failings as a challenge to pick up the gauntlet, as only 5 of the 160 cited marketing as their primary career interest. (14 and 16 respectively gave it as their second and third choice.)

A solicitation for opinions of the exams and the educational system resulted in a not-surprising deluge of comments, about half of which were favorable (or at least not unfavorable). Most of the criticisms centered on out-of-date study notes, emphasis on memorization, and the use of the exams as a tool to limit the size of the profession. Some questioned the statistical validity of the exams, i.e., whether the "best people" are passing. And finally, one helpful respondent enhanced our historical perspective by informing us that "the exams were harder when I used to be a student."

In response to "What are the most important characteristics for success (on the exams)?" amid the expected (persistence, discipline, technical ability), one lone respondent answered "Preparation H". □

Deaths

N. Douglas Campbell, F.S.A. 1939
John K. Dyer, Jr., F.S.A. 1946
Ralph E. Kennon, F.S.A. 1925
A. Ross Poyntz, A.S.A. 1935
George T. Prentice, F.S.A. 1928

Contributions to the Actuarial Education & Research Fund, 208 S. La Salle St., Chicago, IL 60604, in memory of a deceased member, are acknowledged to the donor and member's family. □

JORDAN BRAILLED

The Iowa Commission For The Blind reports that they have completed brailling *Life Contingencies*, and a student is using the product. The Commission is able to make a duplicate for somebody else, perhaps for less than $100.

We would be pleased to put anybody wanting a copy into touch with the Commission. And we hope that the student who acquired that first copy will let us know how satisfactorily the book is fulfilling its purpose.

E.J.M.