

RECORD OF SOCIETY OF ACTUARIES 1977 VOL. 3 NO. 2

EXPENSE ANALYSIS AND ALLOCATION

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PHILIP C. TURNER, JOHN MACARCHUK*

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2. Inconsistencies in expense allocations
Financial reporting versus product development
Statutory versus GAAP versus F.I.T.
Planned versus actual
By line of business
3. Allocation of marketing expense
First year versus renewal
By line and product
By marketing function

1. Analysis of Expense Levels

MR. ROBERT H. DREYER: Our first speaker is chairman of the Canadian Institute of Actuaries Committee on Expenses.

MR. DAVID J. CONGRAM: I intend to concentrate my remarks on the Canadian Institute of Actuaries expense study. The study covers 20 companies operating in Canada. Although it is termed Canadian it does cover a company's total operations. Currently, of the 10 Large Companies included in the study, which combined write over 2.5 billion of premium, approximately 45% of their Inforce Ordinary Volume and 25% of their Group Volume is derived from out-of-Canada operations. Of these combined amounts 70% is developed from United States operations.

The study was initiated by Mr. Arthur Pedoe in the late 40's; and he wrote two papers for the Society on the results. The approach continues to follow his actuarial adaptation of the well known proverb, "Better one ratio than ten thousand words." The ratios are obtained from relatively simple formulas, concentration being placed on "fitness" and "reasonableness" rather than on so-called "accuracy."

As the nature of the business operations have changed, the formulas have had to be updated. Given this caveat, over the years the ratios have been credited with giving a fairly accurate picture of expense trends in Canada.

As an example of the structure of the formula, the expected expenses are based on factors applied separately for first year and renewal to the number of policies, amount of volume and amount of premium.

The detailed factors are printed in the Committee Reports each year. Exhibit 1 indicates how the Formula "C" ratio has moved from 1948 to the present. As can be seen the Large Companies' ratio on this basis has moved from 80% of expected to 130%. In 1958 this formula was chosen, based on investigations of Canadian conditions, to develop an actual-to-expected ratio of 100%

for all twenty companies combined. This exhibit indicates that the rate of expenses has been increasing consistently since 1948. The pace appears to be slackening since 1969. It should be noted that the Actual Expenses used exclude Canadian Federal and Provincial income taxes.

EXHIBIT 1

The Canadian Institute of Actuaries
Report of the Expense Committee
Ratio of Actual to Expected Expenses

	Formula "C" Basis			
	1948	1958	1968	1975
Large Companies	79.9%	99.4%	117.1%	129.7%
Small Companies	80.0%	105.5%	129.6%	139.2%

Because of the movement of commission schedules toward front ending during the 1960's and because of the effect of inflation on per policy charges, some distortion began to develop in the late 1960's and 1970's. A new expense formula was developed known as Formula 70.

Exhibit 2 shows Formula 70 which was designed to develop an actual-to-expected ratio of 100% for the Large Companies. All taxes, not just Canadian taxes, are excluded from the Actual Expenses in this formula.

EXHIBIT 2

The Canadian Institute of Actuaries
Report of the Expense Committee
Ratio of Actual to Expected Expenses

	Formula 70 Basis			
	1969	1971	1973	1975
Large Companies	100.0%	100.8%	101.1%	107.0%
Small Companies	115.4%	116.5%	114.2%	117.2%

Although a small discontinuity arose between pre-1971 and post-1971 expense ratios due to the method of reporting Segregated Fund premiums, expenses appear relatively stable followed by a significant increase in 1974 and 1975. The 1976 results have not yet been distributed to the membership, but interestingly there has been a decline from 1975 levels, especially noticeable in the Large Companies.

Trends in expenses are affected by trends in business. To illustrate the trends I have indexed the following items. In all cases the radix has been set at 100 for 1959 (Exhibit 3). As can be seen, average new insurance

effected tripled between 1939 and 1959, and has nearly tripled again since. The average new sale in 1959 was just over \$9,000. By 1975 it had risen to \$25,000. This compares to the growth in the Canadian Consumer Price Index (bottom line) in the corresponding two periods showing only a doubling in each period. Of particular significance is the average Annual Premium per policy. This has moved with uncanny correspondence to the movement of the Price Index over the 35 years. The offsetting factor is the decline in premium rate per \$1,000. Reviewing my own company's rates over the same period, our Par rate has stayed relatively stable, our Non Par rate declined approximately 20% and our Term rates have nearly halved, confirming the trend to term.

EXHIBIT 3

Ordinary Insurance* - Large Companies

1939	1948	1959	1969	1975
Index of the average net New Insurance per policy effected				
33	50	100	167	269
Index of the average Annual Premium per \$1000 New Insurance				
162	162	100	85	74
Index of the average Annual Premium per new policy effected				
44	68	100	141	199
Canadian Consumer Price Index				
50	75	100	128	189

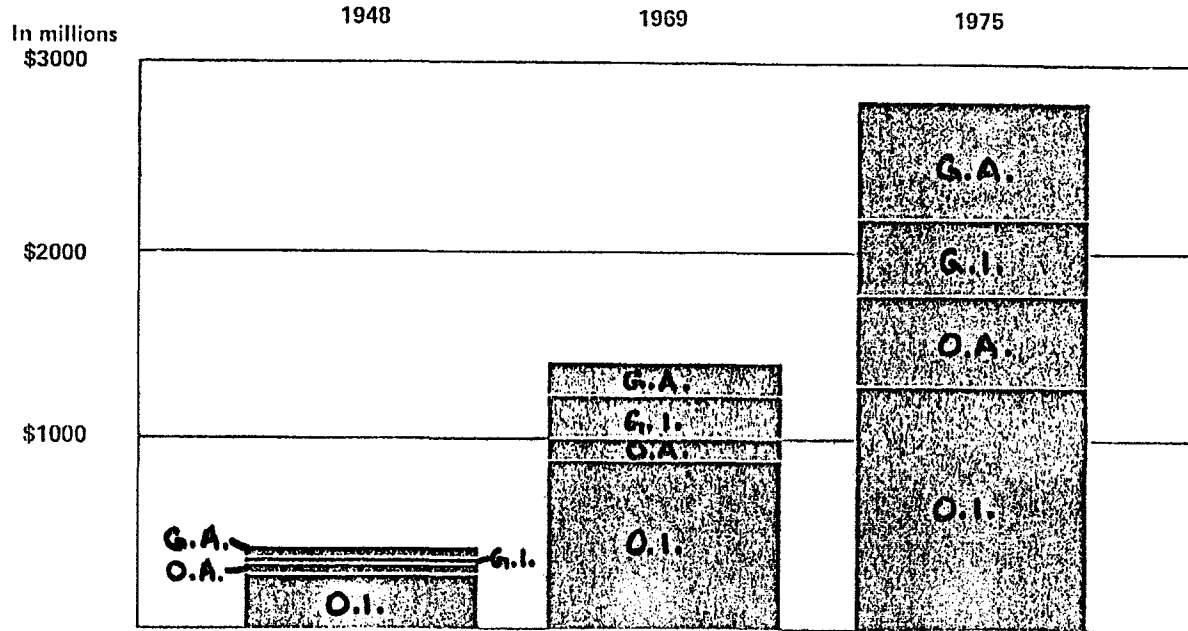
*Developed from CIA Expense Committee Reports.

Exhibit 4 illustrates how the total Premium Income and Annuity Considerations have increased over the years. Although still growing per se, Ordinary Insurance has been a continuously declining proportion of the total. The dramatic growth of Group Annuity business since 1969 is somewhat exaggerated due to the change in the method of reporting Segregated Premium mentioned above. The dramatic growth of Ordinary Annuity during the last five years reflects the introduction of lower front end load flexible premium products developed for the RRSP market. Exhibit 5 shows the effect of the changing business on the Expected Expenses. Again I have used Formula "C" for illustration. Ordinary Insurance continues to develop the major volume of expense reflecting the far lower expense rates attached to other products. Ordinary premiums moved from 80% of total to 47%; expenses 84% to 64%.

What do these trends mean for the future?

Between 1948 and 1975 total premiums from all lines increased sevenfold, expected expenses based on Formula "C" about fivefold, and actual expenses eightfold. These results must be interpreted with care. The front ending of commissions without a change in the Expected Formula, and assuming a

Insurance Premiums and Annuity Considerations
(Net of reinsurance)



	1948	1969	1975
Group Annuity	5.4%	10.5%	21.2%
Group Insurance	4.2%	14.8%	14.8%
Ordinary Annuity	10.4%	9.0%	17.1%
Ordinary Insurance	80%	65.7%	46.9%

Based on the 20 Companies in the Canadian Institute of Actuaries Expense Study.

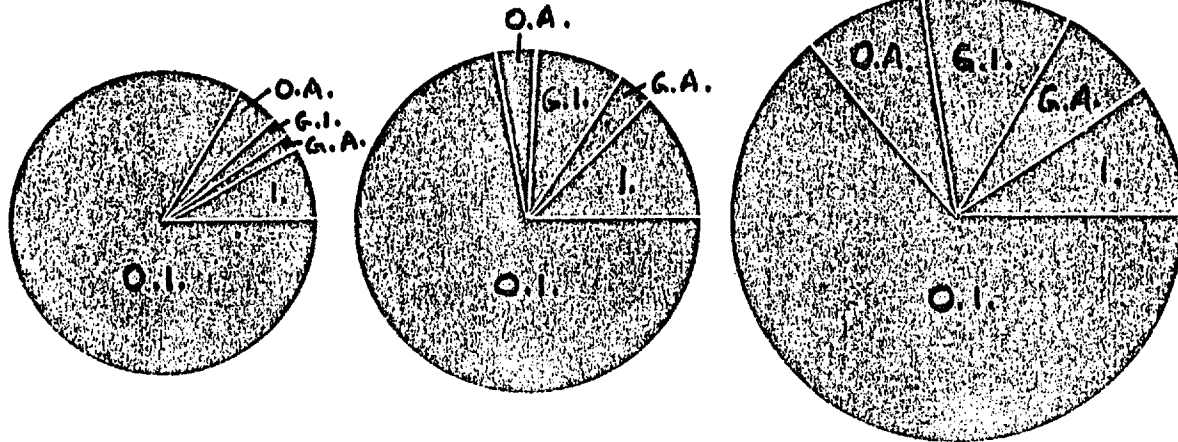
Distribution of Expected Expenses

Formula C

1948

1969

1975



Investment	8.8%	12.7%	9.7%
Group Annuity	1.2%	2.8%	6.9%
Group Insurance	1.9%	8.5%	11.0%
Ordinary Annuity	4.6%	3.8%	8.5%
Ordinary Insurance	83.5%	72.2%	63.9%

Based on the 20 Companies in the Institute of Actuaries Expense Study.

stable relationship between first year and renewal premiums, would cause an apparent although not real increase in the actual-to-expected ratio. A distinct reduction in the relative weight of first year and renewal ordinary premiums is noticeable between 1969 and 1975. Again to the extent the formula does not reflect the weights of first year and renewal appropriately, an apparent although not real increase in actual-to-expected will develop. The tax structure was changed in Canada in 1969. As I mentioned previously, Formula C excludes Federal and Provincial income taxes so this has not affected the ratio. Allowing for these items, our historical cost performance has not been good, although some improvement may be emerging.

It would appear that our ordinary new insurance volume and new premium have exceeded or at least kept pace with inflation. The ratio of first year to renewal ordinary premium has moved from the 1948 ratio of 1:7 to a ratio in 1969 of 1:7½ to a level now of 1:6. This would indicate that the expected expenses on the renewal block of business have increased faster than the inflation rate. Per policy costs which in 1958 amounted to 25% of total ordinary expenses would have only grown at the pace of the number of policies. As 75% of our ordinary business may have had some inflation protection, the rapid inflation of the last few years may not have hurt our cost ratio picture as much as one would first suspect.

The fabric of our operations is changing, little by little each year, but the cumulative effect is significant. The load of taxation looks as though it will increase, inflation remains and Consumer and competitive pressures persist. We are moving from a high margin business toward a low margin business. The amount of overhead which historically has been carried by Ordinary Insurance must soon be carried by other lines. What level of overhead can they carry? Can we adapt our operations fast enough? I see a real challenge in reversing the expense trends of the past.

MR. PHILIP C. TURNER: My remarks have to do with how one company in the United States handles expenses. As Mr. Dreyer has indicated, my background is primarily group. I do not have the strong expertise that results from actually doing expense allocations but as a group actuary I have a strong interest in the results of those allocations. At the Penn Mutual we maintain an historical expense analysis which is aimed primarily at providing unit expenses for the ordinary dividend formula. There is an annual study which takes the ordinary expenses and expresses them in terms of group policies and percent of premium, splits them by first year and renewal and home office versus agency. There is a very long history to this study. It has not been changed as much as it should, but we are moving in the direction of using more up-to-date methods, particularly the LOMA Cost Study. Our company is one of the contributors to the LOMA Cost Study. We actually use this data now to develop unit expenses for our asset shares. Of course LOMA has not been as much help to us in the group area since it has not been able to address the problem of functionalizing group expenses.

One major use we make of the LOMA results in addition to asset share work is to compare ourselves with companies which we consider to be comparable to us. Part of our company's program of goals and objectives is to be at a certain point with regard to these companies by each of several measures. To that end a group of nine companies has been selected to be used as a comparison base. Obviously no two companies are exactly alike. But enough similarities can be found to serve this purpose. Even if there is no strict comparison between our cost to perform a particular function and the cost

reported by another company, we can certainly make use of the data on a year-by-year basis to find out whether Penn Mutual is getting more or less costly as compared with other companies.

As a result of this kind of study, it became evident to our management that if we continue on the trend we are on, we would be out of the marketplace. A thorough review of our expense situation was initiated in 1975 which went right down to the very lowest operating levels in the company. Every operation was analyzed, costed out, and subjected to review by people who provide input to that unit as well as by people who used the results of that unit's work. Decisions were made as to the necessity for continuing each of those operations. As a result of this study, very dramatic results have been achieved in cost savings. Fortunately this was accomplished without excessive employee morale problems and without disruption of essential services.

Looking ahead, we are now experimenting with a new form of budgeting. When each operating unit prepares its annual budget, it has to re-analyze all of its functions and allocate its expenses to each of those functions. This is being done for the first time this year on an experimental basis. It is expected that every function will be subjected to annual review. This is comparable to zero-base budgeting. It forces each unit manager to analyze the functions performed in his unit and defend them each year in terms of their worth to the overall company goals. By defining the functions properly and allocating expenses to them, it also becomes much easier to submit data to the LOMA cost study.

MR. JOHN MACARCHUK: Analysis of expense levels by means of some standard of measure should give recognition to a number of possible differences which may materially influence the analysis. These differences may relate to the company itself, the lines of business that it writes and the particular characteristics of the company's business.

The different lines of business which may be written by a company are familiar to actuaries and need not be enumerated here. Line of business characteristics which may not always be self-evident, however, include the following aspects of a company's operations:

1. Marketing pension business to small groups on an Individual basis rather than a Group basis.
2. Marketing Tax-Sheltered Annuities on either a Group basis with strong third party sponsorship or on an Individual basis in a one-on-one sales situation.
3. Marketing to large groups rather than to small ones or vice versa.
4. Selling to the sophisticated buyer rather than to the unsophisticated buyer.
5. Aggressively marketing non-medical insurance.
6. Selling term insurance rather than permanent insurance.
7. Emphasizing single premium annuity sales.

8. Aggressively writing supplementary contracts on the lives of beneficiaries.
9. Reinsuring much of the company's business.
10. Offering extensive special services to policyholders.

The possible variations in line of business characteristics suggest the danger inherent in not fully understanding the fundamental differences in a product or company which may not be reflected in a standard of measure. They highlight the fact that dissimilar types of business may well result in significantly different rates of expense.

MR. DWIGHT K. BARTLETT: At Monumental Life we do not participate in the LOMA Functional Cost Study. However, we have for a number of years produced our own year-end expense factors for asset share purposes, etc. We have been becoming increasingly distressed during recent years at the trend of these factors. We have applied these factors to the statement data from other similar companies to obtain actual-to-expected ratios for the other companies in relation to our own expense levels. We are not particularly happy with what we have seen.

We did quite a bit of work earlier this year to try to pin down the cause of this. We were interested to find that salary expense was about half of our total noncommission expenses, and that salaries by themselves have not contributed much to the increase in our year-end expense factors. The increase has come largely from uncontrollable factors such as social security and other fringe benefits, communications and energy. We concluded that there was not much we could do in terms of direct control of expenses.

When you talk about year-end expense factors you are really talking about a ratio of your expenses to a particular base, whether it be number of policies or amount of premium or face amount.

Therefore, the long-term solution to getting our expense rates back under control is to do a better job of increasing the company's rate of growth.

MR. DREYER: I would like to ask Mr. Congram one question. In your talk you indicated that the 1976 ratio has dropped from what it was in 1975. Has your committee done any speculating on the cause of that?

MR. CONGRAM: We have done some speculating. We wonder whether the main cause is likely the Canadian anti-inflation board and the controls on salaries introduced in October of 1975 or just a greater concern about controlling costs.

In my own company, we have been concerned with how we might reduce our expenses. We have been comparing ourselves with other companies in the CIA expense study and have found ourselves in the unenviable position of being rather high. One of the quick responses was to increase our volume of business and spread our overhead over a wider base.

In looking at the expense study, it is broken down by product line, meaning individual, group, and annuities. Just taking the ordinary insurance line which is probably the major line, the expense ratio for small companies that we looked at worked out to about 132%; the expense ratio for medium-sized

companies was about 139% and the expense ratio for large companies was about 110%. (The large companies have premium income of over 250 million, the medium companies have premium income between 40 and 175 million, and the small companies have premium income of less than 40 million.) Moving from a small to a medium-sized company you might actually have an increase in expenses. You have to move into a very large company or over 250 million of premium income, if it is ordinary insurance, to achieve that saving. I can only speculate on the reasons for that.

MR. MACARCHUK: I have been associated with the variable annuity operation recently and of course that had to start from ground zero. As soon as we got into business, people began asking such things as when are you going to become profitable, aren't the expenses too high, or how are you going to get enough income to cover the expenses. The obvious approach to the problem is to spread your margins and get a wider margin to cover your expenses from your various sources of income or to reduce your expenses. In many circumstances you may be able to do both. It will depend on your circumstances.

In the mature company situation that Mr. Congram is talking about here, you probably cannot move your margins as effectively as your expense levels. However, you may be able to take your margins and broaden their base, over a period of time. One example would be through diversifying your product lines.

2. Inconsistencies in Expense Allocations

MR. TURNER: Expense allocation serves many purposes, not the least of which is to perform the chore of filling in the appropriate boxes in the annual statement. Extensive use has to be made of this data in terms of profitability of a particular product line and also in our pricing decisions.

At Penn Mutual our Controllers' Department has extensive computer programs which prepare Exhibit 5, the detailed expense exhibit. These develop our insurance expenses for each line of business broken down between ordinary, individual health and total group. Total group is further subdivided into group life, group health, group annuities, and group creditor. The expenses for each line of Exhibit 5 are really the sum of various account balances in our general ledger, adjusted for unpaid expenses. In some cases, an accounting entry will contain a code which will allocate the expense to one or more of these categories. In most cases, however, expenses are not coded by coverage line. They accumulate until the end of a calendar quarter at which time an allocation formula is applied to the sum of each account balance.

These allocation formulas are many and varied. The ones in most common use reflect company, department or divisional salary ratios. These salary ratios are obtained at the divisional level during the late summer on an estimated basis. Working through the supervisor we find out from each employee what percent of his or her work time is allocated to the various coverages described above. From this an average factor for each division is computed. These factors are then applied to the salary totals as they become available through the year. Other types of expenses are allocated using these same ratios unless they are overridden by another formula based on different criteria. Rent, for example, would be allocated on the basis of the square footage occupied by each product line.

Over the years we have had extensive discussions within the company concerning the level of nondirect expenses charged to the Group Department. In 1974 the total expenses of the group life and health lines amounted to some five and a half million dollars of which 1.7 million was nondirect, about 30%. In 1975, our expenses dropped slightly to five million because of a drop-off in business. That year our nondirect expenses went up to 1.8 million or 36% and in 1976, which was complicated by a few organizational changes, our total expenses were 5.3 million of which 2.2 million or 40% was nondirect.

In analyzing the reasons why, we find two primary culprits but they both have the same cause, which is the change in the basis of allocation made by the Controller's Department. The two particular items that caused the problem were the allocation of rent and employee benefits. The basis of allocating rent was changed from square footage to salaries. Similarly the allocation of employee benefits was changed from the percent of employees' time that was devoted to each product line to salaries. These changes caused enormous swings in the allocation between lines.

MR. MACARCHUK: Expense allocations for financial reports can be inconsistent with the allocations required for product development. The reasons for the inconsistencies generally arise from the different objectives of the two kinds of allocation.

For example, statutory financial reporting is generally aimed at reporting expenses as they are incurred. Reporting expenses on an incurred basis is consistent with the statutory reporting objective of financial solvency.

Product development expense allocation, on the other hand, is designed to achieve sound and equitable pricing. Consequently, internal amortization of certain types of expense can be highly desirable. Higher first year commissions, expense allowance and other marketing costs are examples of initial expenses which might be amortized for product development purposes. Product development and marketing constraints frequently require that a portion of these initial expenses be charged to the income of renewal years.

Start-up costs for a new company or new line of business are another example of costs which need to be amortized for pricing purposes. The abnormally high costs which are experienced under these operating conditions cannot be charged against a single year's operation. Frequently, these start-up costs should even be amortized over more than one generation of policyowners.

Amortization of first year marketing costs can be viewed as a method of avoiding a first year premium higher than that paid in renewal years. Amortization of start-up costs avoid prohibitively high product prices in the early years of operation of the business. Amortization also spreads the cost of starting the business over a number of generations of buyers.

Perhaps the greatest inconsistency in expense allocation among the statutory, GAAP and FIT bases is between the GAAP basis on the one hand and the statutory and FIT bases on the other. The apparent intent of GAAP deferral of acquisition expense is to amortize what are defined by the American Institute of Certified Public Accountants to be acquisition expenses. GAAP acquisition expenses include not only first year commissions but even some renewal commissions. These acquisition expenses must be amortized in a prescribed manner. Statutory and FIT expense allocations on the other hand generally relate these acquisition expenses to the year in which they are incurred.

For many lines of business the amount of expense which is defined to be GAAP acquisition expense can be very large. This is especially true of lines which pay high rates of first year commission such as the Individual Ordinary line. As a consequence, one would expect the inconsistency between GAAP allocations, on the one hand, and statutory and FIT allocations on the other, to be very large for such lines.

The responsibility for preparation of the FIT filing is generally considered to bring with it the responsibility to minimize the resultant taxation of policyowners and shareholders by available legal means. Internal Revenue Service employees on the other hand strive to increase tax collections wherever possible. As a result, FIT expense allocations are different from statutory allocations in some instances. Among the differences in expense allocation which may occur are the following:

- a) For statutory purposes, the income from joint ventures is carried into the annual statement on a net basis. For FIT purposes, one looks through the joint venture to the individual items of income and expense. The individual income and expense items are then carried into the FIT return as individual items of income and expense.
- b) For FIT purposes, the imputed yield resulting from Home Office rent is not considered to be Investment Yield. For statutory purposes, Home Office rent may be treated as both an income item and an expense item.
- c) Portions of commissions, expense allowances and other types of field expense may be allocated to investment expense for FIT purposes in order to reflect expenses arising from policy loans.
- d) Some portion of advertising expense may be allocable to investment expense for FIT purposes.

Inconsistencies in planned vs. actual expense allocations can readily arise with respect to marketing expense. When field expenses are allocated on the basis of actual results, variations from expected production can cause significant variations from planned expense allocations. This variation can be extreme when there are relatively large changes in new business production, when starting up a new line of business or when the company itself is a new one. For example, a sharp shift in Group Insurance production from Group Term and Health to Group Pensions in a given year can give rise to a large inconsistency between planned and actual marketing expense allocations. Marked changes in the product mix of new business also can have the same impact on marketing expense allocations when expense allocation is based on actual results.

Differences between planned allocations and actual allocations of expenses can readily arise over the life of a long-range operating plan. These differences frequently are the result of external forces. Some examples of these external forces are:

- a) Basic changes in the marketing environment.
- b) Major legal or regulatory changes which impact a company or product line.

- c) Major changes in economic, social or political conditions which affect business.

Proper allocation of expenses to the various lines of business is important for several reasons. In particular, proper allocation by line is essential to the determination of the relative profitability of the various lines and as a tool to assist the actuary in the proper pricing of the various products.

Inconsistencies in expense allocation by line can arise in a number of ways. The bases used to distribute expenses or the relative weight given to them can readily affect the amount of expense allocated to a given line of business.

The allocation of FIT by line is perhaps a classic example of the possible variations in allocation base. It can be argued that the tax is a corporate level tax which is not directly related to any of the various lines. Alternatively, the contention is often made that the FIT expense is an investment expense which should be allocated using some kind of investment income or asset base. It also has been argued that the allocation of FIT expense should be based on results of calculations which consider each line of business to be a separate company.

In today's environment of relatively favorable investment income and mortality experience, the ramifications of the allocation of FIT to major operating lines of business such as Group Term and Health, Individual Ordinary and Group Pensions is very important in companies which write several of these lines. For example, the Group Term and Health lines of business can benefit from expense allocations which use some kind of investment income base for FIT expense allocation. On the other hand, the Individual Ordinary and Group Pension lines carry the lion's share of expense when an investment income base is used to allocate FIT expense.

MR. DREYER: I would like to add one observation on the differences between GAAP and statutory. There is a classic actuarial distinction used for allocations between first year and renewal. However, under GAAP, in order to satisfy the accountants, we have to redefine our first year and renewal division into acquisition and maintenance. Some maintenance expenses are incurred in the first year and some acquisition expenses can be incurred in renewal years.

MR. CONGRAM: One has to be very careful in terms of how one is pricing and how one's actual expenses are incurred. A particularly key issue is the allocation of overhead. If you develop a product on the basis that it is only a marginal addition to your operation, and then it becomes a major line of business, this can cause some problems in terms of planned versus actual as well as some concerns as to the continuing management of that particular line of business.

MR. JAMES M. SCHENKEL: My comment concerns new lines of business. Under the statutory allocation you would incur developmental expenses and expect to have them replaced by the new line of business at some time in the future. Under product allocations, they would be capitalized and amortized over a number of years. At Home Life we have taken a slightly different view -- that this is an expense of the total company. In other words, since the growth of the company required that we go into new lines of business, those

developmental expenses should be charged to all of the lines of business until the new line of business can actually get into operation.

MR. DREYER: In carrying this a step further, when you allocate by line of business, do you have a corporate line (such as the Canadian statement requires) that you would allocate these developmental expenses to or do you spread them over each line?

MR. SCHENKEL: Over each line.

MR. JACQUES J. DESCHÈNES: Mr. Congram raised a question concerning the difference between the overhead allocation of fixed costs and variable costs. In a line of business that cannot support its full share of overhead expenses, but can support some portion of the fixed costs, it would be absurd to discontinue that line of business because the standard allocation appears to make it unprofitable.

3. Allocation of Marketing Expense

MR. MACARCHUK: Certain kinds of marketing expense are rather naturally allocable between first year and renewal by their very nature. They are expenses like commissions, formula expense allowances, and training allowances. These expenses are generally characterized by a formula which relates the expense to premiums, commissions, or other quantities which have first year and renewal characteristics.

There are, however, other kinds of marketing expense which are not so readily allocable between the first year and renewal years. They include agent advances, salaries paid to new general agents, salaries of branch office managers, advertising costs, expenses paid for new general agents, marketing conference expense, recruiting expense and the cost of marketing publications. Allocation of such expenses (between first year and renewal) must be made on the basis of commissions, premiums, time studies, salaries of agents and staff supervised or other similar bases which are relevant to the nature of the expense.

Here, as in many other facets of expense allocation, judgments should be made regarding the effects of the allocation bases selected. For example, allocations which use commissions as a base will generally allocate a large proportion of a given expense to the first policy year. Likewise, in the case of Individual Ordinary plans, relatively more weight will be given to permanent plans than to term plans.

Some types of marketing expense are readily allocable to line and product because their payment is based upon a formula which relates the expense to some numerical quantity of a line and product such as its premium volume or commissions. There are, however, large amounts of marketing expense which relate to the establishment and operation of the marketing effort. This type of expense is found in both the Home Office and the field. Allocation of this type of expense requires the development of a suitable allocation base.

Marketing expense allocation bases tend to fall into three categories. One category allocates marketing expense according to the marketing effort devoted to the line or product during a given period of time. A second category allocates marketing expense according to the actual results achieved

by the marketing team during the time period. The third category of allocation bases allocates expense on a planned or predetermined proportion basis.

The three approaches to allocation of marketing expense can give significantly different results. This is particularly so when a company or line is undergoing rapid growth. The establishment of a new line or company can result in a rapid growth situation with attendant large variations in the expenses allocated by the three methods.

The allocation base used to allocate FIT to the various lines of business can have a very large effect on the amount of FIT expense allocated to a line and product. For example, if the allocation base is investment income, the charge against higher premium plans, annuities and pension products is very large. The tax allocated to term plans, group term and health insurance and individual health insurance is relatively small under these conditions. To the extent that product pricing allocations use an investment income expense allocation base, lower premium forms of insurance become relatively competitive while higher premium forms of insurance become less competitive.

The expense allocation method currently used by some companies to allocate their FIT expense is giving rise to an expense allocation anomaly. Where a company writes a substantial amount of both Individual Ordinary and Group Annuity business, we sometimes see the Individual Ordinary line carrying a very large amount of FIT expense while the Group Annuity line carries little FIT expense or perhaps is even given an FIT credit. These results have drawn attention to the method of allocation used to allocate the FIT expense. They raise questions as to the suitability of the allocation base used by these companies.

Allocation of expenses by line and product can be affected by the nature of a company's marketing organization. For example, the allocation of field expenses can vary depending on whether the marketing organization consists of general agencies or branch manager offices.

Allocation of marketing expense by marketing function can probably be best accomplished by functional cost studies. Such studies involve an analysis of expenditures for salaries, rent, employee benefits, telephone, advertising, travel, etc., in order to identify those expenses which relate to the marketing function. The studies will then relate these expenditures to the various function categories established for the functional expense study.

The allocation of expense by marketing function can be affected by the nature of the company's marketing organization. Allocation of branch managers' salaries may give rise to expense allocations which are different from those which would result in a general agency organization of the marketing function.

MR. CONGRAM: Because of heavy office expenses, we decided that we wanted to have our branch managers involved in the expenses so as to get them more aware of the total cost of the operation. We began by introducing into their compensation plan a unit cost function which had a partial effect on their compensation. The proportion of income affected was only about ten percent of the total, but it created a great deal of attention in that area. We involved the field people in the determination of what basis should be

used for unit costs. We ranged through the usual discussions with regard to commissions, whether it should be based on a commission base, a premium base, or a volume base and whether it should be first year or renewal. The results of those discussions led to our using a first year commission base in order to keep it simple.

Our managers, as a result, have become very concerned and have become very effective in bringing their overhead costs down. Our expenses did start to vary in relation to first year commissions. Therefore, in terms of allocating the marketing expense, one must consider how your allocation is understood within the field operation. People can influence these things very greatly.

MR. TURNER: Mr. Macarchuk mentioned that certain marketing expenses were very easy to allocate, for example, commissions. During the checking of my own company, I found this is not necessarily so unless you have the right accounts in your accounting system. In recent years, as Penn Mutual has developed new products, we had the foresight to open the appropriate accounts so that these items can be readily determined in the future.

As far as the allocation of marketing expenses affect the group operation, we have a twofold problem. Number one, we are a general agency company. Our group line was established initially to provide a full line of products for our general agents. This has changed over the years, and now half of our business comes from brokers. Still, we do get into the question of the extent to which the group line should help to support the general agency system.

The second question concerns our group marketing force which is now a part of our total marketing system. They are involved in the sale of not only group life and health but also group annuities and individual policy pension trusts. The allocation of expenses to group life and health, for example, becomes highly debatable. Because the time spent on a particular group line may vary considerably from year to year, or even within a year, there can be large distortions from one year to the next.

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MANAGING HEALTH CARE

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MR. RICHARD H. HOFFMAN: We are going to participate in what I believe will be a very stimulating and considered review of a complex, elusive but extremely vital subject, managing health care. How well health care is managed in the United States will affect what future proportion of the United States gross national product will be devoted to health care and perhaps even the future health of its citizens.

Currently in the United States, there exists little management in the delivery of health care services. The health care field has been described variously as a "cottage" industry, a "non-system," and in other similar ways. What these terms connote is that the industry is essentially unstructured and unmanaged. Rarely can the responsibility or accountability for the health care services delivered to any specific population group be assigned. Of course, the attending physician and the hospital are responsible for the treatment which each provides to its patients. However, what is missing is a designation of responsibility or accountability for the total outcome of all care rendered. Many believe that this is the root cause of multitudes of problems facing the health care industry.

Although these problems are relatively easy to identify, their solutions are very much harder, perhaps even impossible, to come by. Nevertheless, many measures are being tried, ranging from full-scale complex legislative programs to relatively simple voluntary steps. Some hold great promise. However, I think we should keep in mind, that in reality, these measures are attempts to introduce some form of management or control into the health care system.

REPRESENTATIVE DIANE B. McCARTHY: I feel this morning much like Red Adair, the famous Texan who caps runaway oil wells. I know the problem, I think I know the answer. But I am not really sure I know how to cap the damn gusher!

I must warn you at the outset, there are no simple solutions. There are only many intelligent choices. As an elected official, let me give you my perception of the problem. And I might state right now, we have a rather unique reputation nationwide: we are the only state without Medicaid.

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Since 1965, Medicaid and Medicare have released billions of dollars into the health care system. In only ten years, 1965-1975, per capita federal health care spending increased by 813.6 percent. The actual total dollar increase was from 7 billion to 40.9 billion dollars annually. Even to a layman like myself, the inflationary effect is obvious. Take hospitals as just a single example: since 1965, Medicare and Medicaid have grown until they now account for 55 percent of hospital revenues nationwide. The private insurance industry in answer to the demands, especially from large groups, also grew, until today, 90 percent of all hospital costs are paid for by someone other than the person actually occupying the bed.

What is the result of this? The consumer thinks the care is free. At least he is not, as a general rule, required to reach into his back pocket before he can leave the hospital room, or the doctor's office. But he forgets something crucial to the basic understanding of the entire health care mess we find ourselves in. Somewhere, somebody has to pay that bill. We all know there is no such thing as a free lunch.

One of the most pernicious aggravations produced by the federal method of reimbursing health providers is the cost system. In the simplest terms, this means that all an administrator needs to do to generate more money is to spend more money on increased modern equipment to supply the finest care, or on wage increases for hospital personnel, without the normal market restraints on such expenditures.

And what is the government's current answer to this insidious spiral? An artificial wage and price control on hospitals. To me, this is the most unrealistic approach imaginable to a very complex problem. The United States Government can't even run the Post Office at a profit.

First, hospitals are not the cause of the problem, they are simply the most outstanding symptom. Second, a system of wage and price controls in one segment of the economy, without the same constraints on the rest of the economy, is certainly not going to control the costs. It will merely shift them to the unregulated segment. Government regulation is not the answer. We are only forcing hospitals to contain costs by rationing care. I suggest to you that this is immoral. That's right, immoral. What part does morality have in this debate, you may ask. I say that it plays a large part: if you say, I know how to save your life, but you are number six, and I have only enough money to save the first five, that, I submit, is immoral.

I also contend that limiting technology as a method of cost containment is immoral. Let me put it this way: is it more moral to not know and deny than to know and deny?

From beginning to end, the current health care shambles is a creation of the government. Unless the health care professionals act on this fact, there will be no hope for remedy.

So much for my perception of the background and the problem. What are the answers? You notice I use the plural. As a stated in my opening remark, there are no simple solutions. However, I believe there are intelligent choices.