GENERALLY RECOGNIZED EXPENSE TABLE FOR 1998 ILLUSTRATIONS

SOCIETY OF ACTUARIES COMMITTEE ON LIFE INSURANCE RESEARCH REPORT TO THE NAIC LIFE DISCLOSURE WORKING GROUP

COMMENTS FROM THE NAIC

The NAIC's Life Insurance (A) Committee adopted the 1998 Generally Recognized Expense Table (GRET) at its meeting on September 24, 1997, in Washington, D.C. The Life Insurance (A) Committee recommended that this table replace the existing GRET (i.e., the 1997 GRET) effective April 1, 1998. This effective date was chosen to give companies adequate time to implement the 1998 GRET. It is anticipated that adoption of the 1998 GRET, with an April 1, 1998 effective date, will be approved by the full NAIC membership at the Winter National Meeting in Seattle. It should be noted that some states may have the authority to implement the 1998 GRET regardless of formal NAIC approval. Each state's position should be reviewed to determine when the new GRET will be effective.

The Society of Actuaries Committee on Life Insurance Research established a Project Oversight Group (POG) to develop or identify a table of expenses that would qualify as a "Generally Recognized Expense Table" (GRET) for the life insurance industry.

This GRET is to be relied upon by actuaries and insurance companies in complying with the NAIC Life Insurance Illustration Model Regulation and the Actuarial Standard of Practice, "Compliance with the NAIC Model Regulation on Life Insurance Sales Illustrations."

This table will represent industry expenses on a fully allocated basis. The use of this table does not relieve actuaries and companies from the allocation of direct expenses in complying with the Model Regulation and ASOP.

The issue of expenses became a sticking point during the process of developing a Model Regulation which meets the concerns of regulators and insurers.

A compromise position on the expense issue was proposed at the 1996 Snowbird, Utah, meeting among representatives from the NAIC, consumer organizations, the insurance industry, and the Actuarial Standards Board (ASB). The proposed compromise was that the actuaries and the insurance industry would be allowed to use marginal expenses in complying with the self-supporting provision of the Model Regulation to the extent that these marginal expenses (ME) were not less than those of the GRET. GRET expenses may be used if they are greater than company marginal expenses (Note: this is not clear from the Model Regulation but is spelled out in the ASOP). Company fully allocated expenses (FAE) may always be used regardless of their relationship to the GRET. Note that company direct sales costs are in addition to the GRET.

The following relationships result from this compromise assuming that ME $<$ FAE (acronyms as previously defined):

1) If GRET $<$ ME $<$ FAE	Then use	ME or FAE
2) If ME $<$ GRET $<$ FAE	Then use	GRET or FAE
3) If ME $<$ FAE $<$ GRET	Then use	GRET or FAE

The mission of the POG for 1997 was to:

- Address any questions that were previously raised regarding the GRET that had been previously developed.
- Determine the appropriate method for developing the 1998 GRET: (1) timeliness of presentation of results to the NAIC and the industry; and (2) resolution of any issues that were raised regarding last year's GRET.
- Interface with the NAIC and insurance industry representatives throughout this process.
- Present a proposed GRET to the NAIC for its approval before the June 1997 NAIC Meeting.
- Establish the set of expense factors that are appropriate for use as the 1998 GRET.

For 1997 the POG conducted a survey of the 250 largest life insurance companies. Goals were to obtain statutory data on a more timely basis and to address questions not answered directly by published information including expense adjustments for pour-in premiums on universal life, and reinsurance and expense allocations within groups of companies and by lines of business within companies.

The responses to the survey were dismal, and therefore, once again, the POG focused on the One Source Database that was used in the previous year's study. This is a database service which provides statutory data obtained from the NAIC. The database is updated on a monthly basis; however, there is a time lag of several months on the information included.

The POG had received several requests to consider developing a separate set of factors or some adjustment of universal life pour-in premiums and had hoped to obtain sufficient data from the survey that was mailed to 250 life companies. However, only 10 companies provided data on the expenses related to this item and these data jumped around a bit. The POG felt that it was inappropriate to base expense factors on data of this quantity and credibility.

The following NAIC annual statement fields were accessed in the One Source database.

NAIC ANNUAL STATEMENT REFERENCES*

Item	Acquisition	Maintenance	Aggregate
Policies	Exhibit of Life Insurance; 12, col. 3	Exhibit of Life Insurance; 0.5* (11, col. 3 + 120, col. 3)	N/A
Units	Exhibit of Life Insurance; 12, col. 4	N/A	N/A
Premiums	Exhibit 1 Part 1; col. 3, 19a + 110a†	N/A	N/A
Expenses	N/A	N/A	P6; col. 3, 122 + 123**

* Group products to which the regulation is applicable were thought to be similar in their expense elements to ordinary life. Therefore, no attempt was made to isolate the annual statement expenses attributable to group products marketed directly to individual members of a group.

† Single premiums were weighted using 6% after reduction for any dividends applied.

** Only the estimated life insurance component of the Federal Insurance Contributions Act (FICA) and unemployment tax was included. Premium taxes and other state and municipal taxes must be considered separately.

The group again used the Life Office Management Association (LOMA) functional cost/expense factors as seed expense factors. LOMA provided expense information from its most recent expense study, but the number of participants in the most recent study was lower than the previous year and contained a different mixture of companies by distribution system. Therefore, for consistency, the POG decided to continue using last year's seed expense factors. It is anticipated that next year's expense study will contain a higher number of participants and will provide a new set of seed expense factors.

The POG was still of the opinion that expense factors should not be shown separately by type of company ownership (stock versus mutual) and should not be stratified by company size. The group again examined variations in expenses attributable to company distribution methods and decided that this refinement was appropriate. The POG did receive requests for additional definitions of distribution systems but was unable to consider such requests due to the lack of available expense study data and the dismal responses on the expense survey.

The POG again grouped expenses into the four categories of distribution systems: Branch Office, Direct Marketing, Home Service, and All Other. Companies were placed in the appropriate category based on research performed by Conning and Co. and public information (e.g., *Best Reports*) for our analysis.

The expense factors were developed based on a review of the application of the LOMA seed expense factors to the 1996 statutory results of the 200 largest life insurance companies as measured by life insurance expenses. In order to lessen the effect of reinsurance on the factors, we removed companies where the life reinsurance commissions and allowances were at least 25% of the sum of life general expenses and life commissions. The POG continues to have some concern about the wide range of variation of expenses within the groups; to alleviate concerns over the effect of these variations, the "outliers" were removed from the study. Outliers were generally determined to be those companies that had expenses that were 50% or less than or 250% or more than the expenses produced by the median factors applied to that company's units. The final sample represented approximately 80% of industry life insurance expenses. The expense factors were then derived by scaling the LOMA seed factors to cover the 50th percentile of the companies in each distribution system. This produced a set of expense factors that was generally higher than the average for the respective groups.

Tables 1–4 show expense factors by distribution system.

TABLE 1

BRANCH OFFICE

	Acquisition	Maintenance
Per Policy	$65	$33
Per Unit	$1.15	
Percent of Premium	72%	

TABLE 2

DIRECT MARKETING

	Acquisition	Maintenance
Per Policy	$91	$46
Per Unit	$1.60	
Percent of Premium	50	

TABLE 3

HOME SERVICE

	Acquisition	Maintenance
Per Policy	$53	$27
Per Unit	$0.95	
Percent of Premium	29%	

TABLE 4

ALL OTHER

	Acquisition	Maintenance
Per Policy	$73	$37
Per Unit	$1.30	
Percent of Premium	40%	

Note the following in applying these expense factors:

- All of the expense factors are to be used and the results summed.
- Premiums for single premium products should be multiplied by 6% prior to the application of the percent of premium factor.
- These factors do not cover premium taxes, state and federal income taxes, or commissions. All of these items must be considered in addition to the expenses generated by the GRET.

The factors by distribution system may be used by a company or division that meets the description of that distribution system. A company may use one set of GRET factors for a specific distribution system and another set of GRET factors for a separate distribution system but cannot mix GRET factors and the company's own. For example, a company using the GRET factors for the Home Service Division cannot use fully allocated factors for the Direct Marketing Division.

General descriptions of the different distribution systems follow. It is expected that actuaries will apply professional judgment in determining distribution system categories.

Branch Office. A company or division which operates an agency building system featuring field management people who are employees although their compensation may be largely based on production. The company provides significant employee benefits to field employees in addition to direct compensation.

Direct Marketing. A company or division that markets directly to the public through printed or other media. No direct field compensation is involved.

Home Service. A company or division that markets smaller insurance policies through an organization that resembles the Branch Office system in organizational and compensation structure but focuses on smaller policies and agent collections of premiums. Note that we have focused only on the ordinary life business of companies and have not considered industrial business.

Other. Companies or divisions other than those described above including those that market through Brokers and General Agents.

This POG included the following individuals:

Tim Harris, Milliman & Robertson (Chair)
Doug Knowling, Tillinghast - Towers Perrin
Zain Mohey-Deen, Society of Actuaries Staff
John Palmer, Society of Actuaries' Vice President
Mark Peavy, NAIC
Irwin Vanderhoof, Member of Society of Actuaries Committee on Life Insurance Research

We again thank Greg Story of LOMA for his assistance in providing the seed expense factors that allow us to use an experience-based set of seed factors. This provides a method of allocation by type of expense factor that is based on research.

Please contact any of the POG members at their yearbook address with any comments or concerns that you may have.

Note.—The Society of Actuaries decided to undertake a formal project to examine the variation in Life Insurance Company expenses. The work is being performed by Don Segal a Ph.D. candidate at the New York University Stern School of Business under the supervision of Irwin Vanderhoof and other members of the POG. LOMA and a number of their member companies are assisting with the study.

In light of this study, as per the following letter, the NAIC has consented to continue allowing the use of the GRET described in this paper until the completion of the study estimated to be the summer of 2000.

Timothy F. Harris

October 23, 1998

Dear Mr. Harris:

I am writing to you in your capacity as head of the Society of Actuaries' Variation in Life Insurance Company Expense Research Project. On behalf of the NAIC Life Disclosure Working Group, I want to express my appreciation for the work your committee is doing in researching life insurance company expense levels.

It is my understanding that the SOA is sponsoring an accounting student who is doing his Ph.D. dissertation on this topic. It is also my understanding that this student expects to complete this work in the summer of 1999, and that your committee anticipates using that work to develop a new Generally Recognized Expense Table by approximately the summer of 2000. If that schedule were met, then a new GRET would be ready for use in the year 2001. Please let me know if you envision a different timeframe. Also, the working group would appreciate your thoughts regarding the need, if any, to make adjustments to the existing GRET prior to that date. At this point, absent a compelling reason to do otherwise, the working group does not envision modifying the GRET prior to the development of a new table for the year 2001. This is in keeping with the NAIC's recently adopted Y2K moratorium.

The working group is certainly supportive of the SOA's work, and we hope that companies will cooperate in this effort. Please do not hesitate to contact me if there is any assistance that the working group can provide relative to this project.

Sincerely,
Tom Foley, Chair
NAIC Life Disclosure Working Group
of the Life Insurance & Annuities (A) Committee