Article from:

Small Talk Newsletter

November 2004 – Issue No. 23

Expense Management Experiences In A Smaller Life Insurance Company

by Pete A. Hitchcock

In this article, I will discuss some experiences we have had at my company. I don't want to imply that what we did was the best, nor do I want to promote it as the strategy to take. I only provide it as one situation that occurred in a smaller life insurance company.

At the Smaller Insurance Company Section Breakfast at last year's Annual Meeting, someone asked, "How can you get a company to realize that they need to do something about expense levels? Is it a question of reducing expenses or growing business?"

There are many ways you can persuade a company to realize it needs to do something about its expense levels:

- How do the company's expenses compare to a group of peers or to the industry?
- If the company sells products with non-guaranteed elements and is licensed in a state that has adopted the Life Insurance Illustrations Regulation, can the company use its own fully allocated expenses or does it need to depend on GRET?
- If the company has to do asset adequacy testing to comply with valuation regulations in the states it does business in, are high expenses contributing to reserve inadequacy?
- Can the company use its own expenses when pricing and developing an acceptably competitive product?

At the company I work for, when the Life Insurance Illustrations Regulation was adopted, we decided to discontinue some of our products because they couldn't pass the required testing within the regulation. The challenges at the time were both expense levels, which were too high, and production, which was too low. We decided to seek a strategy that could both reduce expenses per policy in the long run and help increase production. We wanted a strategy that was simple to understand, could be easily updated and could be monitored.

We ultimately ended up with two goals:

- A long-term goal to grow into a level of expense that would allow us to price competitively and profitably. This goal involved restraining expense growth to something substantially less than the policy growth being achieved.
- A budget that emphasized the key controllable drivers of expense for our company.

The long-term goal to grow into the desired level of expenses was based on the idea of using expenses in current pricing that reflected the goal we wanted to obtain in five years. By using this assumption, we were able to develop more competitive products. We required a low break-even year so that we could be assured of passing the required tests within the Life Insurance Illustrations Regulation even when we used fully allocated expenses. We set growth goals at 15 percent annual growth. Based on this growth rate, we projected the amount of in-force business we would have in five years. We estimated expense growth based on current and long-term projects planned.

The budgeting process that we developed focused on key controllable drivers of expense. We wanted to budget based on high-level expense categories as much as possible to keep the process simple. Each manager was made responsible for developing their budget and was expected to meet or exceed the targets set. To manage this, monthly reports were generated. Major deviations were discussed. The reports were sent to the executives of the company, as well as the managers for review.

The process contributed to the success in both reducing expenses and improving growth. But even with the improvements that occurred, we didn't completely meet our goals in the five-year period. Product distribution changed dramatically. Products anticipated to be sold were different from what was sold. Estimates for project expenses were sometimes low.

There was a temptation to extend the period and keep trying to meet the set targets. In 2004, we decided to go back to pricing fully allocated expenses based on current experience. Even though we hadn't fully met our goals, we had reduced our expenses enough that we were much more in line with the industry.

This process was simple to monitor. We worked hard as a team and were honest with ourselves each year when we set budgets and growth goals. The process succeeded in forcing us to reassess projects that would have definitely caused major overruns in expenses.

I am not convinced that the process we chose was necessarily the best, but I am convinced that by choosing a process that was simple to understand, simple to explain and simple to monitor, we achieved a measure of success. Other elements that significantly assisted were the willingness of each manager to contribute as a team player and having growth goals within our bonus plan.

Expense management is a necessary and ongoing process. Every company must keep an eye on their expenses and choose strategies that can provide success. But all companies must also remember that expenses are only one item to manage among many for a company to maintain its health and viability. ●

Pete A. Hitchcock, ASA, MAAA, is a corporate actuary and manager at Life Financial Operations Motorists Life Insurance Company. He can be reached at 614.225.1477 or at Pete.Hitchcock@Motoristsgroup.com.