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Small Life Insurance Company Expenses

By L. Allen Bailey

Walk into any small life insurance company, sit across from the marketing director and ask why sales results are so poor and one will no doubt receive the response that "our rates are too high." Typically this statement would be quickly followed with the comment that "commissions are also too low." Sit across the desk from the CEO and ask why operating results are so poor and one will no doubt receive the response "marketing results are extremely poor and unit expenses are way too high — we just can't compete with the big boys." Go into the actuary's office and ask why rates are so high and one will no doubt receive the response "the numbers don't lie — they are what they are."

What is one to do then? One approach is to make the following assumption. That is, a small life insurance company (SLIC) will remain an ongoing enterprise and will do all it can to grow responsibly out of its current predicament. If SLIC's management team can adopt this concept (and for the moment ignore any surplus constraints), then several new lines of thinking can be implemented (or at least considered) in the pricing of new products. One of the most important assumptions in pricing traditional as well as interest-sensitive life insurance products is that of expenses.

Traditionally, insurance company operating expenses have been divided into acquisition and maintenance expense categories. Though further subdivision of these expenses categories may vary from company to company, representative categorization of these unit expenses is shown in the table on page 4.

In order to accurately price any life insurance product, the pricing actuary must adequately and accurately assess all assumptions impacting rate levels. These assumptions include mortality, persistency, investment income, commissions, expenses, various taxes, and, of course, profits. Though statistical significance levels may impact the credibility of mortality studies in a small company, the actuary certainly should be able to establish credible unit expense values for acquisition and maintenance functions in a small company such as SLIC. For purposes of this discussion, we shall focus our attention on one strategy that will allow a company such as SLIC to take a different view of expenses when it comes to pricing new products for general distribution.

The first thing that must be determined is actual unit expenses being incurred by the company for say the last 12 months. After these unit expenses are determined, the actuary may then calculate what marginal expenses are for SLIC. Marginal expense definition can vary from company to company depending upon the analysis under consider-

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Terry Long (past chair) has stayed as a meeting representative for the past several years.

Alice Fontaine (LHATF liaison) and Norm Hill (PBA representative) helped start our blast e-mail articles this past year, with timely information regarding PBA issues that impact smaller insurance companies.

Leon Langitz has continued to help with our section metrics.

Rob Hrischenko graciously stepped in to be our *smalltalk* editor, and has worked to transition our newsletter to an electronic format.

Some of our current council members have been very active as well.

Sharon Giffen (incoming chair) was presented a monetary award by the SOA for her paper entitled, "Sustain: An Industry Speech About Success As a Niche Player in 2020." Congratulations Sharon!

Jerry Enoch (secretary/treasurer) jumped right in his first year to take over this role. He also provided valuable insight and leadership for our member survey that was done at the beginning of 2010.

"All of these people and many more have made this an enjoyable experience for the past three years. The SIC truly has an incredible team."

Don Walker (meeting representative), who has served with me for the past three years on the council, was instrumental in helping organize and participate in the council's inaugural financial webinar last winter.

Karen Rudolph (CLIR liaison) has helped with several research projects in the past year. One research project was the recently published "Cost of Implementing a Principle-Based Framework for Determining Reserves and Capital Survey Results" that focused on the potential costs and readiness of life insurance companies to implement a principle-based framework for reserves and capital.

Bob Omdal, a SIC Council member, was also a member of the POG for this survey. SIC is also helping to support a new research project that will look at the challenges and opportunities of reinsurance for smaller insurance companies. Karen Rudolph will be the POG chair.

Bob Omdal and Phil Ferrari (meeting representatives) have helped coordinate our sessions at various meetings over the last several years. Phil initiated the SIC's participation in the SOA's ERM Symposium this past spring with a session focused on ERM for the smaller company.

Dan Durow, along with Jerry Enoch, has worked to help update the SIC website over the last year, and worked to make it more current and up-to-date. I encourage you to visit it at the SOA website on a regular basis. The SIC is working to make this a viable medium by which to communicate with our membership. Dan, the SIC has also enjoyed your pictures of your incredible ice and sand artwork over the past year.

And what would any section be without the wonderful support we get from the SOA staff? Meg Weber and Jill Leprich have provided invaluable assistance and encouragement in all our endeavors. And Jacque Kirkwood, our SOA staff newsletter editor, has helped *smalltalk* maintain its excellent quality. Thank you all for everything you do!

All of these people and many more have made this an enjoyable experience for the past three years. The SIC truly has an incredible team.

As consultants, we are sometimes encouraged to volunteer for marketing and exposure reasons. These reasons certainly have validity, but in the past three years I have learned that I get so much more out of the volunteering experience. I encourage you to volunteer now. The SIC Council is a great place to get started if you have never volunteered.

I appreciate the opportunity to serve as the chair of the SIC Section for the last year. ●

END NOTES

[1] A road bicycle racer who works for the benefit of the team and its leader. Domestiques help execute team tactics in races like the Tour de France."

ation. For purposes of this discussion, marginal expenses are assumed to be incremental (or additional) expenses associated with the addition of one new policy. Hopefully, the infrastructure of SLIC is such that existing functions such as underwriting, policy issue and administration are in place. Further, it is quite likely that the existing resources are not being utilized at capacity. Marginal expense definition in this scenario then provides a way for a company to determine the marginal cost associated with adding a new policy and can assume (for pricing purposes) that the existing block of business will continue to support fully-allocated expenses.

Though some elements of judgment will be needed to arrive at a measure for marginal expenses, the metrics can be determined generally using a strict analytic approach. Through the years our firm, Allen Bailey & Associates, Inc. (AB&A), has performed this type of analysis for numerous companies. Below is a table summarizing results for a recent study undertaken by AB&A.

SLIC LIFE
Summary Expense Levels

	Acquisition Expense				Maintenance Expense
	Sales	Issue	Underwriting		
Line of Business	% Prem Issued	Per Policy	Per Policy	Per $1000 Issued	Per Policy Inforce
FULLY ALLOCATED Traditional Life	126%	117	332	178%	98
MARGINAL (1 x Current Sales) Traditional Life	37%	34	147	79%	25
MARGINAL (2 x Current Sales) Traditional Life	19%	17	74	40%	25
MARGINAL (3 x Current Sales) Traditional Life	12%	11	49	26%	25

As the reader will clearly discern, marginal expenses will be impacted by the level of assumed future production (obviously the higher the volume of production, the lower the marginal expense). As the reader will also clearly distinguish, any actuary will be able to produce a more competitively priced product using marginal expenses in lieu of fully-allocated expenses. This, in turn, should enhance production.

Some companies' management will not allow a marginal approach to pricing. I have also seen one company where marginal expenses were actually greater than fully-allocated expenses (this is certainly a rare exception to the general rule). Generally, for small insurance companies the approach outlined herein is a valid but temporary approach to pricing products for sale in the market.

The use of marginal expenses in determining rates for new business is an approach that can be applied responsibly as long as company management is aware of overall impact this approach has on unit expenses, including those of fully-allocated expenses. By no means can a marginal approach be used forever. Without some sort of original and responsible thinking when it comes to pricing, SLIC will not have the ability to last in this market. If it cannot be a viable player in sales, then whatever SLIC's unique properties allow it to compete more effectively against larger carriers will never be brought to bear.

Implicit in this discussion is one very important assumption. That is, existing surplus will allow the company to grow out of its current expense dilemma. Most forms of organic growth will require meaningful amounts of invested surplus in order to fund growth that typically is accompanied by meaningful first-year surplus expenditures. A statutory pro forma of company performance in an accelerated growth scenario should be undertaken. Only in this way can management be assured that the company can grow responsibly out of its current expense dilemma scenario. If existing surplus is not sufficient to fund desired growth, there is other "original thinking" that can be applied, responsibly, to temporarily relieve pressure on this limited resource.

Lastly, expenses are but one assumption that can be reviewed originally and responsibly when helping a company like SLIC achieve desired market penetration in targeted lines of business.

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