

# RECORD OF SOCIETY OF ACTUARIES 1991 VOL. 17 NO. 1

## MANAGEMENT OF EXPENSES IN A LIFE INSURANCE COMPANY

Moderator: PATRICIA L. GUINN  
Panelists: WILLIAM H. CASH\*  
J. PETER DURAN  
FREDERICK W. JACKSON  
Recorder: ANTONIO GONZALEZ

The panel will discuss various aspects of expense management in life companies:

- Cost accounting issues under FASB 97
  - Definition and treatment of fixed, variable, deferrable, nondeferrable, maintenance and overhead costs
  - Allocation to products and lines of business
  - Recoverability
- Intercompany and other expense analyses
  - Types of analyses and their problems and benefits
  - Coordination of accounting and actuarial expense statements
  - Communication to management and use in managing the business
- Measuring and improving productivity
  - Measures of productivity
  - Discovering productivity improvement opportunities

MS. PATRICIA L. GUINN: *First speaking is Pete Duran. He's a Fellow of the Society of Actuaries and a consulting actuary with Ernst & Young where he's been for the past three years.*

He's also Chairperson of the Society's COVARA committee, the Committee on Valuation and Related Areas. His practice revolves around measurement and analysis of financial performance. He will address expense analysis under FASB 97 and GAAP issues related to expenses analysis.

Next we have Rick Jackson, who is also a Fellow of the Society. He's Assistant Vice President for Variable & Universal Life Products at State Mutual. Rick's background has been in product development, but for the last year, he has been responsible for in-force management. And therefore, he's learned that expense management is a large part of his responsibilities.

Finally, cleaning up the slate, we have Bill Cash. He's a Vice President of Towers Perrin, and he has 20 years of general management consulting experience. He's worked with a lot of clients within a number of industries, but for the past several years, he's focused on organizational effectiveness studies primarily for companies in the insurance industry. Our recorder for this session will be Tony Gonzalez.

MR. J. PETER DURAN: *As Tricia mentioned, I'm going to be speaking about some issues related to expense analysis under FASB 97. My portion of the session might turn out to be the most technical of the three. I've been chosen to*

\* Mr. Cash, not a member of the sponsoring organizations, is Vice President of TPF&C/Towers Perrin in New York, New York.

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go first on the theory that, after lunch, there's nothing like a few good equations to warm up an audience of actuaries. So I'll try to do that.

Just as a reference point, under FASB 60, expenses only had to be divided into basically two categories: so-called deferrable acquisition expenses and everything else. The deferrable acquisition expenses as you know, are those that meet certain criteria. First, they must both vary with and be directly related to the acquisition of new business and, second, that they be recoverable.

In practice, we see that a lot of judgment is involved, and practice varies from company to company as to which expenses are categorized as deferrable. And the issue usually revolves around an evaluation of whether a particular expense or category of expense in fact does vary with the production of new business. It gets a little hazy sometimes when you have expenses that are not directly variable but that vary in a step-rate pattern or over a period of time longer than a year. For example, product development might be partially deferred in some companies. But basically, we have the deferrable expenses and everything else. Recoverability, of course, means that the present value of the future cash flows on the policy discounted at the earned rate is sufficient to cover the deferrable expenses at issue.

Under FASB 97, we need greater expense analysis. Expenses need to be divided into four categories. We've still got the deferrable acquisition expenses. And one question that had come up originally when FASB 97 came out was whether the same definition of "deferrable acquisition expenses" applies under FASB 97 as applied under FASB 60. The best thinking currently is that the same definition is appropriate. The AICPA has recently come out with something called "Practice Bulletin No. 8" in which that issue was specifically addressed, and AICPA took the position that there has been no change in the definition of deferrable expenses.

But beyond the deferrable expenses, the nondeferrable expenses should be categorized into three groups; the first being nondeferrable acquisition expenses; i.e., those that are acquisition-related but fail to meet, for example, the variability criterion or the recoverability criterion. Another category would be direct maintenance expenses. Direct maintenance expenses means those expenses directly related to the actual maintenance of policies, excluding so-called overhead expense. And again, there's room for interpretation as to just what is a direct maintenance expense and what is not. The reason it's important to segregate out the direct maintenance expenses is that the expected gross profits that are the basis for expense amortization under FASB 97 have the direct maintenance expenses subtracted out of them, but not the overhead. I'll come back to that point in a minute.

Ernst & Young, my firm, has recently done a fairly extensive survey of practices under FASB 97. I've been talking about what we perceive to be the theoretically correct way to implement it, but in fact, the practice varies quite a bit. We did a survey of 23 stock life companies, many of which were our clients, but not all. We asked first whether there was any change in the definition of deferrable expenses between FASB 97 and FASB 60. Some 77% said no there wasn't. Actually, I find that a little bit surprising. I would have thought the percentage would be higher. It's not clear why there would be a difference in the definition. Although one thing I've heard advanced is that companies that have old blocks of business that were accounted for on a

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statutory basis under FASB 60 sometimes switched them over to a GAAP basis under FASB 97, and so created some deferrable expenses in years gone by. But basically I'm a little surprised that percentage isn't higher.

Another issue we asked about was recoverability testing. Recoverability testing under FASB 60 and for most companies under FASB 97 is done at the earned interest rate; i.e., the future cash flows are discounted to issue at the earned interest rate and compared against the expenses that would be deferred that are eligible for deferral. Deferred expenses in excess of the present value are written off. Well, it turns out that a number of companies, in fact, do this recoverability testing at the credited rate, and it results in a more liberal definition of deferrable expenses. The reason that's done is presumably for convenience because, under FASB 97, you have to calculate an amortization rate, and that amortization rate is calculated at the credited rate. If recoverability testing were done at the credited rate, saying the expenses are recoverable would be equivalent to saying that the amortization percentage is one or less. So it's convenient, but according to the AICPA at least, it's not correct.

Another issue is deferral of cost generated by "excess" premiums. By an excess premium, I just mean a premium, for example, on a universal life policy in excess of the fully commissionable level. A typical commission structure might be say, for a non-New York company, 95% of the base premium and say 5% of the excess premium. I'm talking about the portion of the premium that's above the fully commissionable piece. There are commissions in premium taxes that are generated by that premium, and we found that 45% of the companies defer those. Thirty-two percent defer the commissions only, and 23% defer neither. So the practice is all over the map. We feel that it is not only justifiable but also actually proper to defer those commissions and premium taxes on the theory that excess premium is a piece of new business, like a piece of single premium business that's being acquired.

A final point in the survey that I want to mention that's related to expenses is which expenses are charged against the expected gross profits; the expected gross profits being the amortization base. We found that 32% of the companies do not strip out overhead expenses in determining the maintenance expenses to be charged against the expected gross profits. Or another way of saying that is that 32% of the companies in fact do charge overhead against the expected gross profits. Again, this is at variance with the practice bulletin, although it's not totally clear just from reading FASB 97 which way you're supposed to do it.

The other related matter is nondeferrable acquisition cost, for example, fixed marketing cost. That would be a first year expense. We found that 36% of the companies are charging those against expected gross profits. What happens when you do that is the first year expected gross profit is reduced, and usually it's reduced substantially, for example, to zero or less. The result of that practice is to defer the nondeferrable acquisition expenses because the amortization is against the expected gross profit. If that expected gross profit has been reduced to zero, there's no amortization. So while it's not a direct deferral, the net effect is that a portion becomes deferred.

I want to talk about source of profit analysis, but in order to introduce that, I need to say a few words about FASB 97 income structure. If we have reported GAAP income on a FASB 97 basis, the pretax income can be thought of as coming in two

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pieces, what I'll call FASB 97 income and other income – these are not standard terminology. The FASB 97 income is the income within the FASB 97 model. The other income is income outside the FASB 97 model, items of income that FASB 97 in effect doesn't deal with. The other income is simply the interest on surplus (GAAP surplus, meaning GAAP liabilities less DAC) minus the nondeferred acquisition expenses and minus overhead expenses.

And then we have the rest of it, what I call FASB 97 income (Chart 1). That's equal to the expected gross profits plus the increase in the DAC less the deferrable expenses. There has to be interest on both those items because in this model we're thinking of the deferrable expenses as happening at the beginning of the year. The EGP is expected gross profits. DAC with a superscript "E" is the DAC at the end of the year; similarly DAC with a superscript "B" is the DAC at the beginning of the year. "DE" is deferrable expenses, and "i" is the earned rate. So that's a very straightforward equation, expected gross profits, in effect, less deferrable expenses plus the increase in DAC adjusted appropriately for interest. You can show that it's equal to one minus the amortization rate times the expected gross profits with an adjustment factor. I was referring to the amortization rate earlier, and you can think of that as the deferrable expenses over the present value of the expected gross profits. With a typical amortization rate of 75%, 75% of the expected gross profits are needed to amortize expenses, the remaining 25% drops through to the bottom line. In the opinion of many actuaries, if the FASB had done this right, that would be the answer. But in fact, the DAC is amortized at the credited rate, not the earned rate. So we have another term in there, an adjustment term, which is the spread, the difference between the earned and credited rate on a beginning DAC balance. But basically it's the compliment of the amortization rate times the expected gross profits.

CHART 1  
FAS 97 Income Structure

$\begin{aligned} \text{FAS 97 Income} &= \\ &\text{EGP} \\ &+ \text{DAC}^E - (1 + i)(\text{DAC}^B + \text{DE}) \\ &= (1 - a) \text{EGP} - (i - i^c)(\text{DAC}^B + \text{DE}) \end{aligned}$
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Now, there are various ways to do source of profit analysis. Basically we're interested in a comparison of actual reported income compared with planned income. So we want to have actual income being equal to planned income plus deviations due to a number of your standard actuarial items: interest mortality, persistency, and expense. And I also put in sales there sometimes, if we're doing what I call a prospective source of profit analysis.

Whether we're doing a prospective or retrospective kind of analysis is a key issue. The prospective analysis requires an assumption be made about sales levels for the coming year. We're looking forward at the coming year. And the resulting analysis should identify variances due to different sales than assumed in the plan; i.e., what I call volume variances. Here's a simple example: if there's a commission rate of 100% and sales vary, sales are only 80% of expected. Well, then commissions are only going to be 80% of planned. But that variance is purely a volume variance. It

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has nothing to do with expense control. It has everything to do with the fact of the expense structure being partially fixed and partially, in this case, variable.

Some companies use standard costs in doing their DAC; i.e., there's a formula basis for cost, and basically that is the amount that's deferred to the extent there are actual expenses to cover it. Another issue is factors versus work sheets. The way the GAAP system has been implemented has a lot to do in practice with the way the source of profit analysis is going to work. Under FASB 60, it was common for a factor approach to be used. There would be DAC factors applied to amounts of business in force. Under FASB 97, we found that 73% of the companies we surveyed in fact use a work sheet approach, and we recommend the work sheet approach as being one under FASB 97 that gives the company greater control, a dynamic work sheet, greater control and greater insight into the actual amortization of expenses.

Let me illustrate two examples more or less at the extremes. First is what we'll call "Company A." Company A is doing a retrospective analysis, and the expected level of profit is the level that's built into the assumptions that underlie the expected gross profits and the DAC. Under FASB 97, the assumptions are supposed to be best estimate assumptions. It's reasonable to base the plan on the assumptions that underlie the expected gross profits and the DAC. So Company A, in other words, is looking at the results as they emerged after the fact, and I'll assume it is not using standard cost.

With respect to expense variances, which is the topic we're talking about, the analysis is extremely straightforward (Chart 2). Overhead nondeferrable acquisition expenses and maintenance expenses dropped through 100% to the bottom line. This is all on a pretax basis of course. Current year deferrable expenses don't drop through 100% because they're mostly deferred.

CHART 2  
Source of Profit Example  
Company A

Nature of Variance	Impact of Variance
Current Year Overhead	100%
Current Year NDAE	100%
Current Year Maintenance	100%
Current Year Deferrable	$100 \times (1 - R^1)\%$
Current Year Nonrecoverable	100%
Previous Year Deferrable	$100 \times (R^B - R^E)\%$

If  $R^1$  here is the ratio of the DAC factor (this company is using a factor approach) at duration one divided by the DAC factor at issue (let's say that that's 92%), well then, only 8% drops through in the current year. Current year nonrecoverable expenses, of course, drop through 100%. And we also have an item for the effect in the current year of prior year deferrable expenses which drop through based on the ratio of the DAC factor at issue to the DAC factor at the beginning and end of the year. So all that's saying is, if in Policy Year 5, 10% of the expenses are amortized, then if there

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was a variance five years ago in deferrable expenses, 10% would drop through this year. Usually that's ignored.

Company B is a lot more sophisticated than Company A. It does its expected based on a plan and the assumptions that underlie the plan; i.e., what I've referred to as a prospective analysis, including the anticipated sales level for the coming year. Again we're going to assume Company B doesn't use standard cost. And in the projection of the plan, Company B projects fixed and variable expenses separately. The variable expenses are projected in conjunction with and vary with the level of sales. There's a little subtlety here about the definition of variable expenses. Under GAAP, the deferrable acquisition expenses are supposed to vary with the production of new business. Certain expenses that may not vary directly or may vary over a period of time, longer than a year, will often be included in the category of deferrable. Here when I'm speaking about variable expenses, I mean those expenses which vary directly in that same year as a function of sales.

So Company B projects the variable expenses by projecting sales and whatever variable expense factors go with sales, and it projects fixed expenses separately. If we were to lay out the source of profit formulas for this company, it would be quite elaborate, more than even an audience of actuaries that's hungry for formulas would want to see I think. So the problem is a lot simpler if we just look at volume variances (Chart 3). What happens if everything comes out according to plan except that sales are different than expected? Then a lot of the formulas simplify considerably. This is my attempt at illustrating that. Net income, or FASB 97 income is equal to the expected gross profits. And then I've broken the DAC into the piece that relates to variable expenses and the piece that relates to fixed expenses. The DAC on the variable expenses ( $DAC^V$ ) at the end of the first year is minus the variable expenses (VDE) accumulated with interest. And similarly the DAC on the fixed expenses ( $DAC^F$ ) is minus the fixed expenses (FDE) accumulated with interest. And we can say that's approximately equal to a volume factor (V) times the unit expected gross profits (UEGP) times one minus an amortization rate for variable expenses ( $a^V$ ) minus an amortization rate for fixed expenses ( $a^F$ ). So if we need, let's say,  $a^V$  to be 35% and  $a^F$  to be 40%, that's saying that it's anticipated these first two equations are on a planned basis. It's anticipated that 40% of the gross profit is going to be needed to amortize fixed expenses, and 35% to amortize variable expenses.

CHART 3  
Source of Profit Example  
Company B

VOLUME VARIANCE
$NI = EGP$ $+ DAC^V - VDE (1 + i)$ $+ DAC^F - FDE (1 + i)$
$NI \approx V \times (1 - a^V - a^F) \times UEGP$
(Change in NI) $\approx (\text{Change in } V) \times (1 - a^V) \times UEGP$

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Well, what happens if there's a change in volume? Then you want to know what's happened to the change in income. We know that the variable expenses have moved in tandem with the volume. The fixed expenses have not moved at all; at least that's the way we're conceptualizing this. And it's pretty easy to show that the change in net income is just equal to the change in volume times the unit expected gross profits times one minus the amortization rate for the variable expenses only. When the volume changes, the amortization rate for variable expenses doesn't change. If you needed 35% to amortize a given unit of variable expenses, you still need 35% to amortize any other level of variable expenses, because that's moved completely in tandem with the volume.

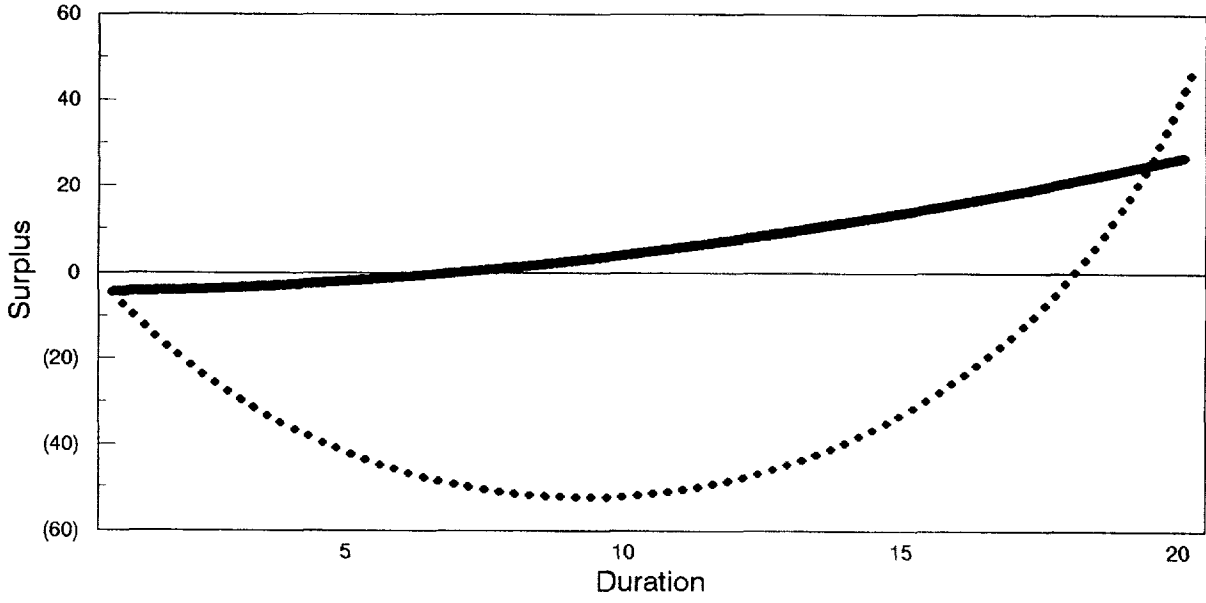
The fixed expenses, though, are a different situation. When volume changes, let's say it goes up, the amortization rate for the fixed expenses goes down, but it's applied to a higher level of gross profit. And the two exactly offset. Another way to think of it is, if on a planned basis 40% of the gross profits were needed to amortize fixed expenses, then when there's been a change in volume, you still have 40% of the expected gross profits on a planned basis amortizing the fixed expenses. And the additional expected gross profits just drop straight through to the bottom line. Another way to say this is, if there were no variable expenses and the volume shifted, the entire change in the expected gross profits would drop through to the bottom line.

MR. FREDERICK W. JACKSON: I will be discussing expense management at State Mutual. First of all, let me say that I'm relatively new to expense management responsibilities. My perspective is one of a pricing actuary who's lately leaned more toward in-force profitability management and expense control. However, this area of interest is not all that recent: my first four years at State Mutual still found me focused on getting new products developed, tested, and approved by the states. State Mutual's universal life emphasis has recently introduced a front-end-loaded universal life product and variable universal life second-to-die and first-to-die universal life products. It is a medium-sized company with \$8 billion in assets.

The appointment of a new CEO in mid-1989 coincided with a different emphasis for some of my work. The CEO came with a strong financial services background, but little insurance experience. However, his bottom line focus was immediately apparent. He wanted to know what drove the profitability of State Mutual's major product offerings and how management action could influence profitability. By early 1990, he had requested a newly formed actuarial unit to report on the profit incidence of our two major universal life offerings. After we showed the CEO two profitability graphs for those two UL offerings, he was quick to favor the lower surplus strain offering.

The first graph shows the think line (Chart 4). Both those lines represent 5% growth each year, new business layered on each year on top of each other. The dashed line represents a no-front-end-loaded low surrender charge product. The solid line is a 6% front-end-loaded heavy surrender charge product. As you can see, there's quite a difference in the surplus emergence on the two products. A risky higher ultimate payoff was not felt to be worth the significant up-front commitment of capital. The company decision to emphasize a front-end-loaded universal product was conveyed to

# Front-End-Loaded vs. No- Front-End-Loaded UL Product





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the field in home office marketing elements. Relative compensation levels were tilted in favor of the front-end-loaded product. By year-end 1990 front-end-loaded products constituted the majority of our universal life sales.

At the same time, a strategic decision was made to become a lower cost provider (Chart 5). Taking that front-end loaded product with its surplus emergence is the top graph. We did some profitability analysis for the CEO showing him what would happen if we had a 10-15% expense improvement. Needless to say, he was very interested in the second graph and said, "Get to work." In graphic terms, the profitability projection showed that the 10-15% improvement in expense efficiency could be expected to replace the top or the bottom graph. Alternatively, we could hold profit requirements constant and improve our competitive position. We wanted to give ourselves the option to better our competitive position or to improve profitability -- two desirable choices.

By the second quarter 1990, a new head of individual insurance had come on board, and the CEO had delegated responsibility for implementing the strategic expense initiative. The head of individual insurance enlisted the support of the new actuarial unit and the accounting department to begin to address the potential for improved expense efficiencies. Like the CEO, the newest player possessed strong business skills but had little familiarity with the workings of insurance products.

*In this context of a clear mandate to improve expense efficiency, I'll try to describe some of our successes and some of the dead ends. We found the overall process to be as informative as the end result we are targeting. There are no illusions that our expense management efforts will ever be anything but an ongoing process. Expense management as an ongoing process suggests a diligent, continuous effort to control expenses. This might be the way to describe how an unnamed midwestern mutual company with very competitive expense performances is believed to operate.*

At the other end of the expense management continuum would be reliance on one-shot measures, such as lay-offs, early retirement programs or restricted travel. At least two New England insurers have recently implemented staff reductions in excess of 15%. I doubt that any of us would prefer the radical surgery approach over a long-term health maintenance program. At State Mutual, we have not felt compelled to put much emphasis on one-shot measures, but have instead chosen to take a close look at how we can improve our long-term expense management process.

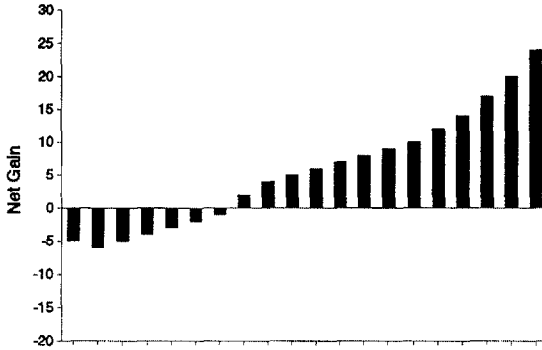
I'd like to talk about actual to expected expense formats now. In communicating our message to top management we made considerable use of graphics, attempting to pass on "actionable" information in as concise a format as possible. Historically we sought to measure our performance against our own assumptions. Are we meeting pricing assumptions? Where have we been? Where are we going? The Lotus spread sheet (Chart 6) is a relatively straightforward application of expense drivers of new and in-force business. It's a format an actuary would have little difficulty with. I said that to my people when I showed it to them, and they laughed at me. I guess I see why now. It's not a very readable format. If an actuary studied the lightly gray column for maybe 15 minutes or a half hour, he'd figure out what's going on here. Look at the top four lines. The last invisible number there is really our budgeted expenses for 1991. We work down through a series of columns of applying expense

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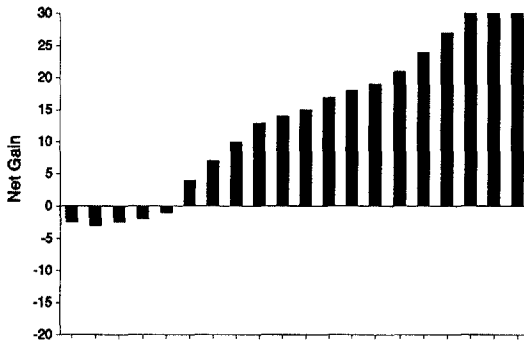
CHART 5

IMPROVED EXPENSE EFFICIENCY IMPACT ON NET GAIN  
Front-End Loaded UL Product

Current Scenario



Expense Improvement Scenario



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CHART 6

TOTAL INDIVIDUAL LIFE

ACTUAL EXPENSES	** 1990 **	*** 1991 Projected ***				
		70% Sales	85% Sales	100% Sales	115% Sales	130% Sales
TOT INDIV LIFE EXPS	50,030,000	49,933,467	51,613,733	53,294,000	54,974,267	56,654,533
+ Taxes, Licen, Fees	6,177,000	5,984,000	6,204,000	6,424,000	6,644,000	6,864,000
- Service Income	499,345	200,000	200,000	200,000	200,000	200,000
Total	55,707,655	55,717,467	57,617,733	59,518,000	61,418,267	63,318,533
<b>PRICING EXPENSES</b>						
<b>ACQUISITION</b>						
Per Policy	212.00	212.00	212.00	212.00	212.00	212.00
% Prem New Target	0.37	0.37	0.37	0.37	0.37	0.37
Exch Target	0.078	0.078	0.078	0.078	0.078	0.078
Excess	0	0	0	0	0	0
<b>MAINTENANCE</b>						
Per Policy	47.00	47.00	47.00	47.00	47.00	47.00
% Prem	0.0280	0.0280	0.0280	0.0280	0.0280	0.0280
% Prem Tax	0.0280	0.0280	0.0280	0.0280	0.0280	0.0280
<b>EXPENSE DRIVERS</b>						
New Trgt Prem	44,529,436	39,000,000	45,000,000	51,000,000	57,000,000	63,000,000
Exch Trgt Prem	3,872,429	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000
New Excs Prem	22,495,668	13,500,000	17,500,000	21,500,000	25,500,000	29,500,000
Exch Excs Prem	1,283,002	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Total New Prem	72,180,535	59,000,000	69,000,000	79,000,000	89,000,000	99,000,000
New Policies	27,000	22,286	25,143	28,000	30,857	33,714
New Vol(000's)	4,435,795	3,271,429	3,785,714	4,300,000	4,814,286	5,328,571
Inforce Policies	340,000	341,394	344,137	346,880	349,623	352,366
Total Premium	287,044,702	272,000,000	282,000,000	292,000,000	302,000,000	312,000,000
Total Exps	58,873,346	54,018,531	58,027,446	62,036,360	66,045,274	70,054,189
Actual Exps	55,707,655	55,717,467	57,617,733	59,518,000	61,418,267	63,318,533
Pricing Exps	58,873,346	54,018,531	58,027,446	62,036,360	66,045,274	70,054,189
Actual Pricing Ratio	94.6%	103.1%	97.8%	95.9%	91.6%	90.4%

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drivers to assumed premium and volume levels, and we come up with what our pricing expense is. We take the ratio of those two and come up with an actual to expense ratio.

When we showed this to nonactuarial types, their eyes began to glass over, and we realized we had lost our audience. Too many numbers and too busy a presentation failed to capture the interest of nontechnical people. We quickly retreated and graphed the results (Chart 7). Instant understanding followed. The actual to expected graphics were much more easily grasped. Performance relative to pricing was immediately clear to the head of individual insurance. He felt he was getting some kind of response when he asked the question, "How are we doing on expenses?"

Chart 7 takes us back six years and forward one year into the current budget year. One of the keys on the graph are the two dotted lines. Those two dotted lines really replace the one line that we had in there that represents our pricing expenses. In the interest of confidentiality, I've put in the two dummy lines there. But whatever actual to expense measure you would want to make would be measured against where that line is. If you look at the lower line and assume that your expenses would be overpricing, you can see that in 1985 we were relative high. In 1986 we came down in expenses, and then had a trend going back up to 1988 and 1989 where the expenses would be considerably higher than expected. The 1990 and projected 1991 budgets would show that we're improving. This got the attention of the nontechnical new management.

Suffice it to say that whether we're at 75% or 125% of pricing, our senior management is committed to bringing down the height of this last bar each year. Finding a communication breakthrough in this graphic context, we gave more information prospectively and focused upon 1990 and 1991. We took our 1991 planned budget levels, expected or pricing assumptions, and laid out actual to expected ratios for 1991 under a few different life production alternatives. The resulting graph generated some meaningful discussion, particularly around the recognition that less expense and a lower production environment did not necessarily translate into improved expense efficiency.

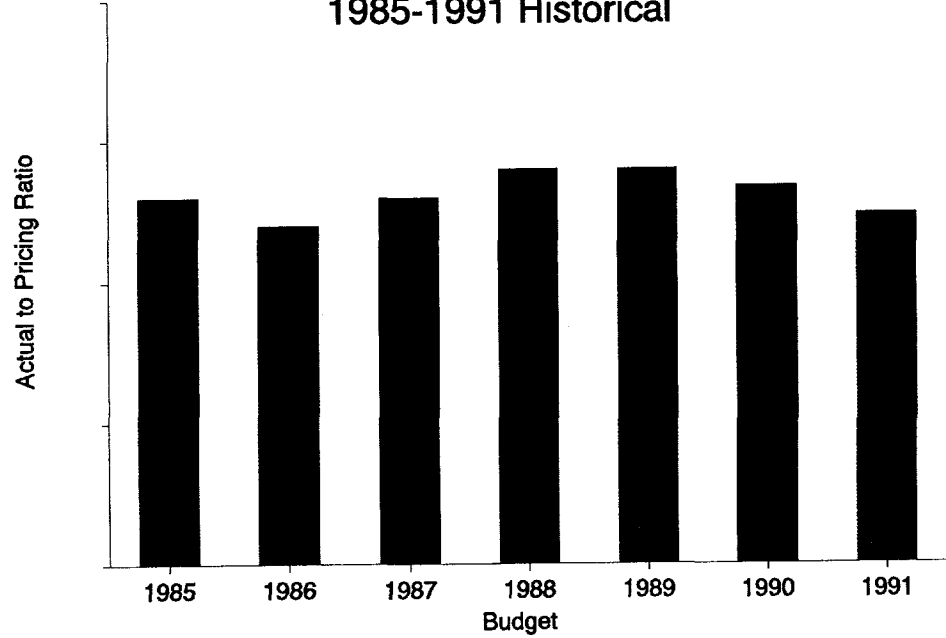
In Chart 8 we've got the 1990 numbers on the left and the fourth bar in the middle shows expected sales levels, what the pricing drivers would produce. Let me run through the formulas. I guess the very simple message was, "Don't just cut expenses. Keep production up." It wasn't intuitively obvious to the new management that things like closing agencies might cut expenses, but they might also drive production down. Expenses could be cut, and you might actually be worse off. If our sales went to 70% of the expected sales levels, we would actually be worse off in 1991 even though we had cut expenses in our home office. On the other hand, if we improved our expected sales levels to 130% of the assumed sales levels, then we would be much better off in getting toward our goal of improving our expense efficiencies.

We go one step further as Chart 9 shows. We went to major line expense breakdowns, looking back two years and forward into the current year. We also had a table showing actual expenses, pricing expenses, actual to expected ratios and

CHART 7

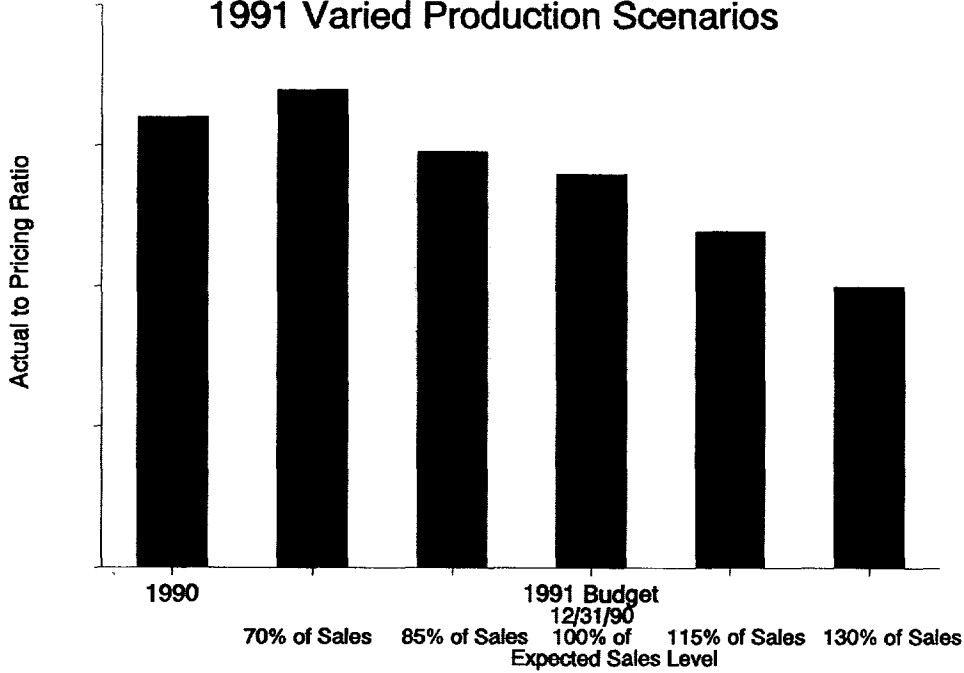
# INDIVIDUAL LIFE EXPENSES

1985-1991 Historical



# INDIVIDUAL LIFE EXPENSES

## 1991 Varied Production Scenarios

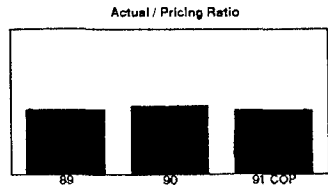


MANAGEMENT OF EXPENSES IN A LIFE INSURANCE COMPANY

CHART 9

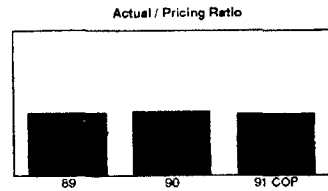
\*\*\* TOTAL INDIVIDUAL EXPENSES \*\*\*

	Actual 89	Actual 90	Proj 91
Actual Exps	X	X	X
Pricing Exps	X	X	X
Expense Shortfall	X	X	X
Actual/Pricing Ratio	X	X	X



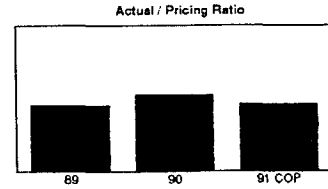
\*\*\* LIFE \*\*\*

	Actual 89	Actual 90	Proj 91
Actual Exps	X	X	X
Pricing Exps	X	X	X
Expense Shortfall	X	X	X
Actual Pricing Ratio	X	X	X



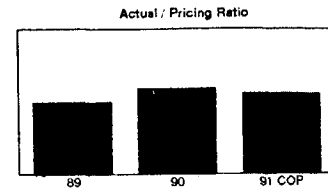
\*\*\* ANNUITIES \*\*\*

	Actual 89	Actual 90	Proj 91
Actual Exps	X	X	X
Pricing Exps	X	X	X
Expense Shortfall	X	X	X
Actual Pricing Ratio	X	X	X



\*\*\* HEALTH \*\*\*

	Actual 89	Actual 90	Proj 91
Actual Exps	X	X	X
Pricing Exps	X	X	X
Expense Shortfall	X	X	X
Actual Pricing Ratio	X	X	X



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absolute dollar variances. The top part of the graph represents what we just saw in Chart 8, but we broke out on the right expense shortfall numbers, dollar amounts that went along with the actual to pricing ratios. This way we could see in total what was going on. I didn't include the other three charts that went along with health, annuities and life because each of the areas could have very significant ratios or very different ratios and we really wouldn't give them a measure of the absolute dollars of expense overage or shortfall that we were really looking at. So this is also a useful tool for us. Again, we were looking to put useful information on one sheet of paper to inform top management concisely just how we were doing on expenses.

Now I'd like to talk briefly about industry expense comparisons. Although most of our expense efforts have focused upon performance against our own internal measures, we've looked at outside studies for two main reasons. We wanted to compare our pricing targets to industry averages to assess the reasonableness of those targets. We also wanted to assess our own performance relative to our competitors. We had some interesting discoveries as we examined outside studies and determined what the usefulness might be to State Mutual's effort to become a lower cost provider.

State mutual's universal life focus affects how we establish our expense drivers in the pricing. Significantly lower compensation is payable on premiums in excess of target premium levels. We wanted to be sure that a study of relative company performance explicitly differentiated between high and low compensation premium. Many of the published studies seemed to rely on annual statement data that we felt would be inadequate from my company's perspective. We felt that the Cresap/Tillinghast study incorporated the methodology necessary for an accurate assessment of our business.

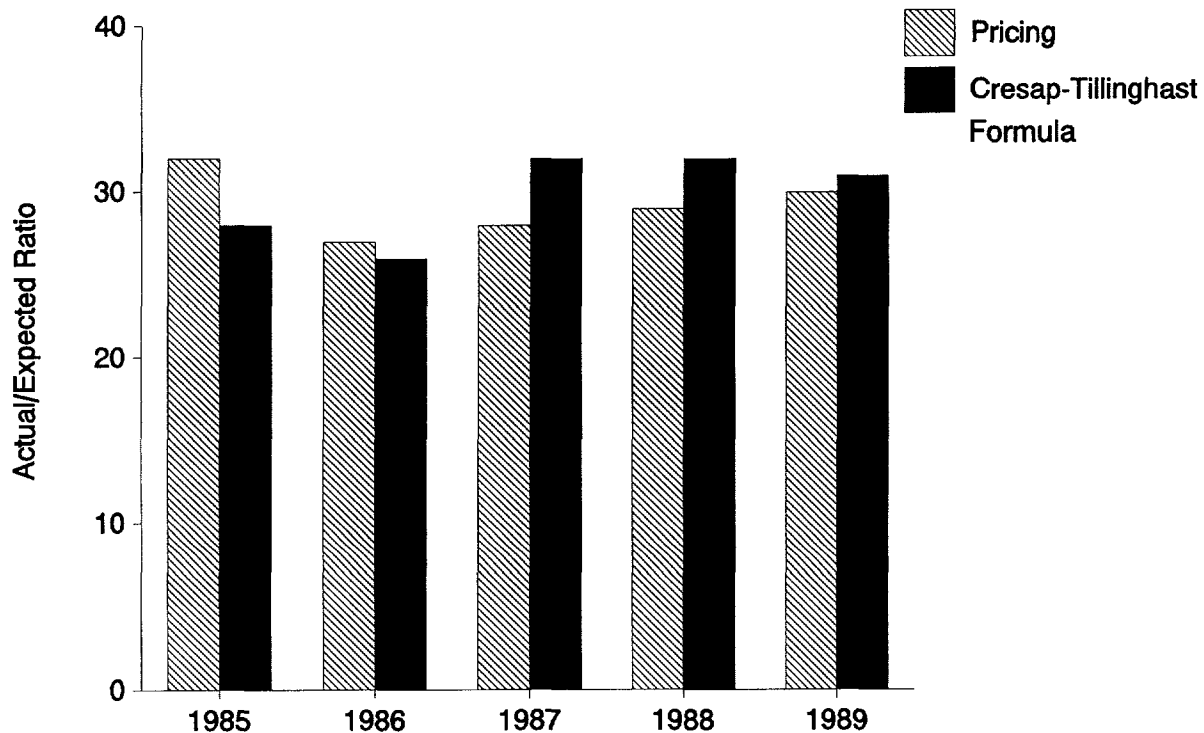
When we received the results of our survey, our internal efforts were influenced in several ways. We made Chart 10, actual to expected ratios. Choosing the second line to work with, what we're looking for is a comparison of how good our pricing drivers were. We had some drivers that had been in place for quite a while, and we wanted to examine whether they were consistent with the rest of the industry's drivers. We found in 1985 and 1986 the formula numbers from the Cresap/Tillinghast study produced acceptable expenses given our level of in-force business and premium, and found that the Cresap/Tillinghast formula produced slightly lower expenses. Whereas in 1987 and 1988, the formula produced slightly higher expenses. By 1989 we felt we were pretty much in line. This is really a validation that our pricing drivers, assumed pricing levels, were in sync with the rest of the industry.

In talking with the Cresap/Tillinghast people about these drivers backing up formula expenses, we found some significant differences on how we would break out our expenses into acquisition and maintenance elements. That realization along with issues raised elsewhere has caused us to reexamine our expense splits on acquisition and maintenance.

A related issue which resulted in a clear-cut dead end for us was an attempt to track trends on a functional basis. We thought Charts 11 and 12 to be pretty impressive graphical displays. In Chart 11, we have the acquisition piece broken out above, again on an actual to expected basis. Then we split Chart 11 on the bottom part into premium percentage pieces and dollars per policy. We're trying to track functional trends here. Chart 12 shows the maintenance function. We split that into many



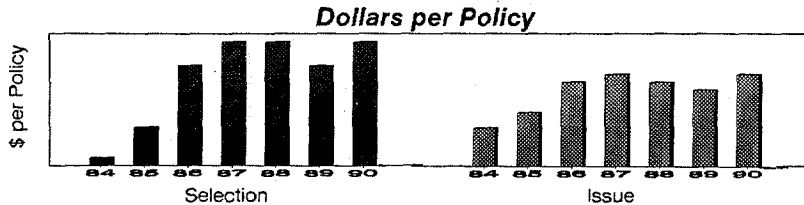
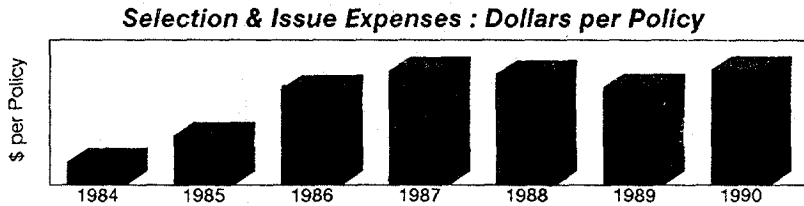
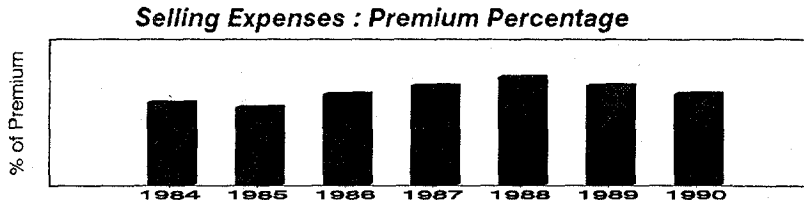
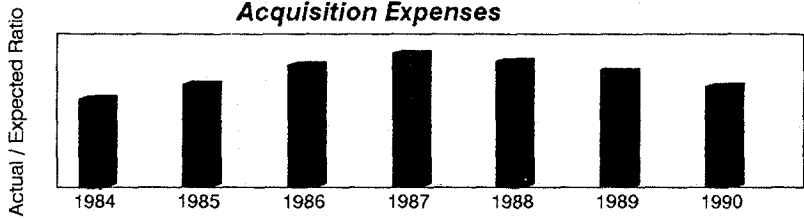
# INDIVIDUAL LIFE EXPENSES



PANEL DISCUSSION

CHART 11

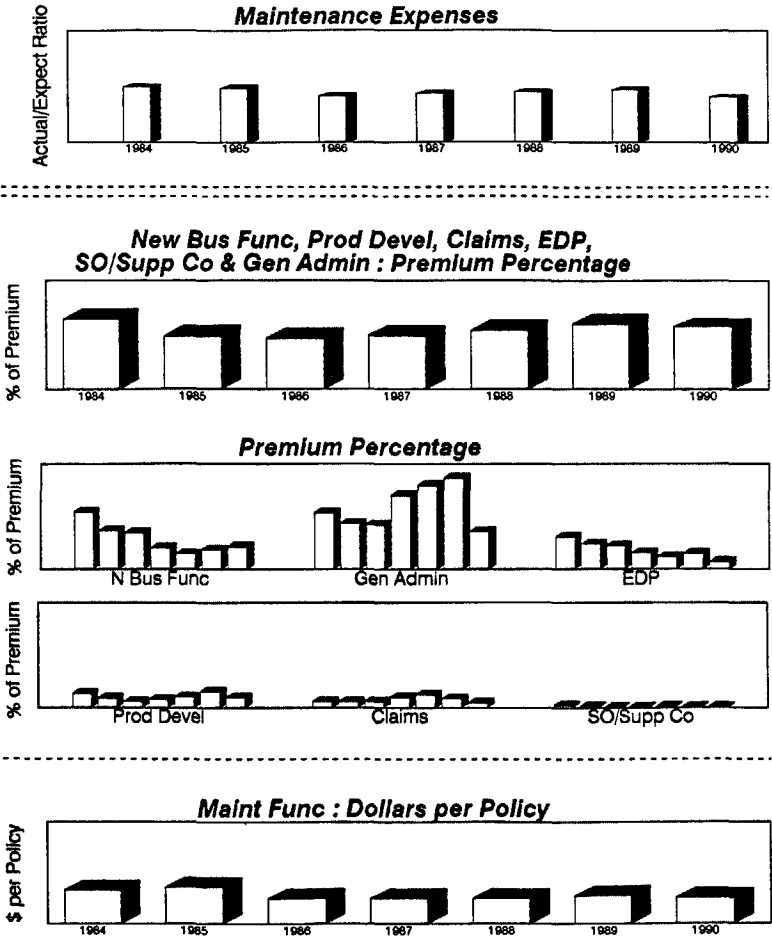
**INDIVIDUAL LIFE ACQUISITION BY FUNCTION**



MANAGEMENT OF EXPENSES IN A LIFE INSURANCE COMPANY

CHART 12

**INDIVIDUAL LIFE MAINTENANCE BY FUNCTION**



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different pieces: premium percentage, new business function, product development claims, and dollars per policy. The bottom line here was as pretty as the graphs seem to be. We decided they were useless to us. Internal reorganizations, inconsistencies of functional definitions back through time and acquisition definitions that were too closely tied to GAAP methodology made us realize that meaningful trend lines on a functional basis were just not possible for us. In this light, we also decided that the Life Office Management Association (LOMA) effort to compare functional costs industry-wide, although admirable in its scope, would not help State Mutual.

The last area I want to talk about is our collaboration with the accounting area. Throughout 1990 and into 1991, we have had varying degrees of success working with our accounting area. Where the communication and cooperation have been good, the results have also been useful. Where the two areas have not communicated well, we've had problems. For the most part, as owners of historical data and the current budget years projected numbers, accounting has been very cooperative in getting our actuarial area the numbers it needs to do expense analysis in a profitability context. Only in a few instances, because of staffing limitations in accounting, have we had to wait any length of time for needed data.

One effort I would consider a dead end was a first attempt to put up an executive information expense presentation on a PC. The intent of the work was to provide useful historical information on expenses for individual insurance management. One basic flaw doomed this effort from the start. Actuarial, accounting and individual insurance never once sat down in a room together and discussed how the results could be used by the three areas. Without a translation to unit cost terms, resulting displays failed to factor varying first-year production levels into the expense equation. The result was, again, impressive graphics but information which was not actionable. Two to three months of development effort bore no fruit. The PC graphic presentation is not being used at the present time and hasn't been updated since October 1990.

Currently, members of the actuarial and individual insurance areas are completing an interview process with the element heads of all home office areas generating expense for the individual insurance area. One of my marketing buddies puts it this way: "We get each head of a cost center into a conference room, bolt the door, pull the light down over the table, get out the rubber hoses and brass knuckles, and say we're not leaving this room until you get expenses down." It's really not that bad, but we have made an effort to find out where the expenses are being generated in each area, and try to identify primarily whether they're acquisition related or maintenance related.

One goal of this exercise is to replace expense allocations by time with measures more responsive to shifts in sales, maintenance work, and other activity-driving actual expenses. Another goal from a pricing expenses perspective is to build up from a cost center basis a clearer picture of what drives State Mutual's individual insurance expenses. We'll probably end up revising our pricing drivers in 1991. An expected additional by-product will be a high level of confidence in the resulting acquisition maintenance splits which emerge from this effort.

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Meanwhile in the accounting area, a concerted effort is made to implement activity based costing. One of the goals of this accounting initiative is to better identify direct costs and tie them to specific product line areas of the company. A goal in common with the actuarial based effort is improvement of expense control capabilities.

We hope in our communications and miscommunications with the accounting area, we have recognized the advantages of cooperative effort. Meetings are presently under way between members of the individual insurance area, the accounting area, and the actuarial unit to assure that the two separate projects complement each other and do not work at cross purposes. Ideally, the two efforts can be dovetailed with the result being a significantly improved expense management capability at State Mutual.

One of my primary responsibilities when I return from this conference will be to drive the coordination process between accounting and actuarial on this critical issue of expense management.

MR. WILLIAM H. CASH: I'm pleased to be here to tackle the issue of expense management in life insurance companies from a slightly different perspective. Peter has laid out some of the intricacies of working your way through and properly accounting for expenses under FASB 97. Rick has described several of the challenges that he faced in finding, communicating and ultimately acting upon useful performance measures in the expense area. I'd like to spend our remaining time giving you some suggestions on how you can properly recognize and rise to the challenge of controlling expenses, some keys to doing that successfully, and finally how you might maintain control once you've achieved it.

Improved organizational cost effectiveness is essential to success in the 1990s. What we mean is that successfully deploying and managing resources will be a source of competitive advantage, as important as product innovation, delivery capability, risk bearing capacity and so on. To achieve organizational cost effectiveness, we need to return to the basics, doing well those few important things which matter. Second, we need to identify and monitor those five or six critical indicators of success or failure. And third, we need to carefully balance every request for improved or additional service with the need to maintain or lower our cost base.

In many companies recently, better service has become a paradigm of sorts. But you need to look at service improvements in terms of their impact on price and profit. One large life insurance company was able to reduce its annual expenses by several hundred thousand dollars merely by curtailing the length and diminishing the quality of its quarterly and annual reports on certain of its mutual funds. These were hardly important to the company's overall long-term success, and the quality of those reports, probably not read by one in a hundred of the people who receive them, just had escaped management. But once it was brought to management's attention, it worked on those things, and I think the annual savings was in the neighborhood of \$600,000. It's an example, a frill if you will, that particular company just didn't need.

To accomplish required results, an organization must be able to adapt to changing work requirements. We all know the pace of change is accelerating and that work requirements are changing and getting more demanding for everyone. Among other

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things, the environment in the 1990s will be characterized by increased competition, not only from within the industry but from nontraditional sources as well; a much changed regulatory environment, either more relaxed or more assertive; changing demographics, which have a major impact on our customers and employee population; emphasis on capital adequacy; and sophisticated technology and its ability to serve as a marketing back office and productivity tool.

All of these will serve to dramatically change the way organizations must behave in order to achieve desired results in a cost effective manner. These environmental changes or trends should cause companies to reexamine their strategies which in turn will cause them to redefine work requirements and the role of an organization in producing desired results. The match between results and requirements is termed effectiveness or doing the right things. The cost of doing things right is efficiency. You need to pay attention to both of these. While the focus of this session is on controlling expenses, in my experience, doing the right thing and making effectiveness improvements can have a far greater payoff, and we shouldn't forget it.

Achieving organizational cost effectiveness requires paying strict attention to at least six key points:

1. Recognize the problem. All organizations can be streamlined. There are few exceptions in my experience. Determine where your organization has an opportunity and focus there. Alternatively, many companies have chosen to take cost effectiveness as a company-wide project, recognizing that opportunities abound and that no one function area or unit is immune.
2. Commit to solving the problem. You'll need a strong commitment among the management ranks to successfully tackle cost effectiveness issues and to sustain a cost effective position over time. Establishing clear, quantifiable and measurable goals is one method of demonstrating this commitment.
3. Face reality. The problem won't go away. There are no quick fixes. And in the area of expense control, white knights are unheard of.
4. Establish a strong vision. Develop a vision of cost effectiveness for your organization and communicate it again and again. Here, goals can help you as well.
5. Have the courage of your convictions. It's a painful process and often a long one. Don't give up.
6. Don't delay. Stagnation will only make it worse and is very demoralizing to those in your organization who understand how debilitating this condition can be.

Achieving cost effectiveness can be relatively easy, albeit arbitrary and short-lived. Across-the-board budget cuts are a frequently used technique for achieving near-term savings. Eliminating frills or nice-to-haves such as first class air travel doesn't require much in the way of analysis or judgment. Similarly, with any level of turnover or

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attrition, hiring freezes can have an immediate impact on the bottom line. The problems with many of these efforts is that they are temporary. They have failed to address fundamentals such as refocusing on organization strategy or redefining or eliminating work. In addition, arbitrary short-term efforts have the unfortunate consequence of penalizing the good manager who has attempted to run his or her organization in a cost effective manner.

Remember that right-sizing kinds of actions are not easy. It takes commitment in terms of management buy-in and resources to identify the areas where true and sustainable improvements can be achieved. On the other hand, done properly, the process will be perceived as objective, and the results should prove to be lasting. To echo a point Rick made, instilling a productivity culture is one way to insure that you don't have to do the job over and over again. I'm fond of telling some of my clients that I don't want to see them again, at least not on this particular subject.

In identifying and addressing cost effectiveness opportunities, it is important to look at all the components of organization, and to do so deliberately and systematically. One way to conceptualize this is to recognize that the organization is more than structure, although such things as spans of control, reporting levels and principles of structure, such as whether to organize around products or functions or geography or whether to be centralized or decentralized, are all important. The message here is to examine other components as well, including your culture: how do you communicate, what is the risk-taking profile of your executive group, does entrepreneurship flourish in the organization, and so on. You also need to look at management processes: the planning, control and information systems that are used to run the business. You need to pay attention to the resources and how they're employed, and resources can be defined many ways. They obviously include capital and facilities, but you can also look at resources as the skills possessed by the employee population, by the market position and other things.

Finally, you need to address the ability of the organization's human resources to manage and integrate these components and to insure that they are working in concert. My experience suggests that unless this human performance element is finely tuned, a critical link of integrating the other four aspects of organization will be missing.

Another way of tackling the fundamentals is to pay attention to performance and to cost drivers. The first step is to determine where activities are performed. Next, examine how they fit with each other and how effective they are in performing the overall mission of a function. Finally, look at present and future needs in terms of cost, levels of service and value of output. At this point, you'll be able to judge whether opportunities for improvement exist and, if so, what alternatives there are for capitalizing on them. One of my clients recently asked us to look at the product development function, and we found that product development occurred at 28 different locations in the company. We were able to eliminate this fragmentation and duplication by some consolidation and redefinition of roles and responsibilities. And the client has already seen a remarkable increase in quality and quantity of output.

Understand and pay attention to your cost structure. While efforts to examine and eliminate work can occur throughout an organization, and while major savings are

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often achieved by aggregating literally hundreds of small recommendations from administrative areas, make sure you understand where the costs really reside. In a typical life company, for example, you can't expect to eliminate 20% of the administrative budget if you exclude the distribution system from the same rigorous review as that which you would employ with other units. After all, it typically represents 60% of cost, and more important, it frequently offers substantial opportunities for effectiveness and efficiency gains.

Too often, top management decides to exclude some or all of the sales force, sales management, the branch system, sales compensation and the like from productivity improvement initiatives. In addition to naturally eliminating the overall results you can obtain, the decision has the unfortunate effect of setting up a "we/they" mentality within an organization.

In performing organization cost effectiveness reviews, assess your current and prospective capabilities rigorously and honestly. It could lead to some surprising conclusions. For example, if an important function such as sales is judged to be competitively weak, greater use of independent brokers may be called for. Similarly, if investment management performance lags far behind industry averages, you should consider retaining outside management expertise. At the other end of the spectrum, if claims investigation and adjudication is a strength but not critical to achieving competitive advantage, you could consider selling this service to others. The important point here is to be honest in your evaluations of your own capacities and creative in considering alternatives. One organization I'm familiar with recently streamlined its entire Information Systems (IS) organization, improved responsiveness and has made significant gains in managing projects and operations to budget by simply going outside and buying site management and project management experience.

A variety of analytical techniques can be used to identify and evaluate productivity and cost reduction opportunities. The particular technique or techniques employed will depend primarily on the nature and importance of the issue or opportunity, as well as on the resources and time required to exercise it. Frequently these techniques are employed simultaneously to explore the same issue from different perspectives. I will describe several specific techniques. These, of course, do not, represent the universe of analytical techniques, but have proven to be very effective when employed properly. Organizational analysis looks at span of control, reporting levels, fragmentation, duplication, missing functions and so on. Cost/benefit analysis examines the value of an activity versus its cost. Make/buy analyses are employed to determine the most effective and efficient source for performing a function or activity. And by the way, I should say that cost should never be the sole criteria in that kind of analysis, and unless the analysis shows that the cost of doing something outside or inside has a differential of 10% over the existing cost base, I wouldn't bother with it.

The efficiency of a company's distribution system, particularly its branch office network is often a major opportunity. Activity analysis is a thorough and rigorous means of identifying unnecessary and duplicative work, albeit an expensive technique to employ. Process analysis is aimed at work simplification, while functional assessments compare a unit's practices and procedures to accepted, or in some cases, best business practice. An analysis of mission and role is intended to identify activities or functions that do not support achieving business requirements. In effect, "Does the



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activity or function add sufficient value?" is the question you should be asking. Finally, customer input, focus groups or user satisfaction surveys can be particularly useful in assessing the value of staff services.

Ineffectiveness and inefficiency rarely would be found in organizations were they equipped with proper planning and control systems, and the will and judgment to act on what these systems showed. The first line of defense against inefficiency rests with planning and budgeting systems. These systems allow you to test whether the organization continues to be focused on critical success factors, whether strategic milestones are in sight, and whether results achieved are consistent with the company strategy. A performance management system, which permits management to track actual results on five to ten strategic indicators, is vital to determining success or failure in progress or delays. Other programs, such as executive incentives, must incorporate links to strategically important performance indicators, and sales incentives must support decisions about product emphasis. Finally, of course, the results of performance-managed programs need wide communication throughout the organization, and sometimes externally as well.

In summary, management can significantly improve cost effectiveness by following five key principles:

1. Recognize the problem and rise to the challenge by committing time and resources to its permanent solution.
2. Success will depend on the extent to which an organization is willing to tackle the fundamentals; namely, get at the real causes of work, and change them or eliminate them.
3. You need to focus on the large cost elements and go beyond boxes on an organization chart. Instead, think in terms of improved processes, noneffective use of resources, changing culture and so on.
4. Assess your current situation honestly. You can't "wish" the problem away. Also, be sure to look for creative solutions to problems and creative ways to capitalize on strengths. Enhancing revenues is considerably easier to take than reducing costs.
5. Finally, use constructive planning and control tools to measure progress. Identify those few measures of performance and track your progress against them. If you're good at doing the aforementioned, those progress reports should look pretty good. Communicate them widely and acknowledge the contributions of all employees to achieving cost effectiveness.

I would urge you to remember that sustaining cost effectiveness is a continuing challenge, and the trick is to change your culture so it becomes second nature to everyone. As we all know, culture change is not an overnight endeavor; in fact, it is likely to take several years. And so my final word would be: Start now.

MR. STEVEN A. SMITH: I have a few comments and then a question for Rick Jackson. While my comments generally relate to our business, which is the general

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agency brokerage business, conceptually some of what I'm going to say would probably also be appropriate for a career agency force. The discussion has thus far addressed expense control from the standpoint of controlling expenses at an insurance company. I am going to talk about the other side of the equation: reducing unit expenses through increased sales and also by obtaining other "expense monies" to help cover fixed costs. In the past, First Colony Life was able to significantly reduce its unit expenses by simply reducing our price by enough to get a significant increase in the business that was being placed with us. A general agent might do business with five companies or 20 or 30 companies. If you are getting only 2 or 3% of that general agent's business, you might be able to increase your share from 2-10% or from 5-15%, without increasing that general agent's total business merely by cutting your premium rates so that they are sufficiently competitive. However, you just can't increase your share of the general agent's business forever. In the brokerage arena, if you get to where you have say 20-25% of a general agent's business, there just isn't any way that he's going to give you too much more of his business because he doesn't want to have too much going to one company. We therefore realized that we needed to do something else to try and get more business out of each general agent with whom we did business.

The plan that we developed was to make our general agents more productive so that they could do more total business at a lower cost. This was a difficult challenge since each general agent was doing business with five to 30 different companies, each of which has different rules and regulations for underwriting, issue, applications, etc. It's a complex situation. In any event, in order to help our general agents get more productive, we developed a system called "PDQ" which stands for "Policy Data Quickly." It's a total administration system for a general agent. We have installed the system with something like 60 of our general agents at this time. We hope to have 75 on board by the end of the year. All of the general agents who have received the system installation have indicated that it has made their offices significantly more productive. If they get twice as productive and produce twice as much business, and if we continue to get the same share, we get more business, and it helps keep our unit expenses down on the sales side. An extension of the PDQ system is something we call "PDQ Express," which is kind of a communications network from the general agents to brokerage company home offices. At this stage, a number of other life insurance companies have bought into our "extension" system, PDQ Express, so that a general agent with our PDQ system can electronically gain access to his policy data over a communications network for each of the companies with which he does business that has PDQ Express.

The combination of these two systems has helped make our general agents more productive, and we think we have gotten at least our fair share of their increase in business. We have accomplished our objective of reducing unit expenses on the sales side by making our agency force more productive.

We are in the general agency brokerage market, but I would think that the same kind of technique, if there was a good way to do it, would work with a career agency force. In fact, it might even be easier because you're only dealing with one company.

There is another entirely different thing that we have done, given that we've gotten down to where we have pretty low unit expenses, to leverage our existing plant even

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more. Our unit expenses are probably on the order of half of those of many of the large companies, and Lynchburg, Virginia, is a low cost area; so we have been able to get into what we call "private labeling." I believe that there are other companies that are attempting to get into private labeling as well. The theory is that if you can manufacture policies quickly and efficiently, then you can get a bigger base and, in effect, drive your unit costs down by doing product development, policy underwriting, issuing, administration, calculating reserves, etc., for other companies that are less efficient. Even though you have low costs, you can conceivably lower them even further, and we are doing that as well.

I'd like to share a few internal productivity measurement standards that we have developed. A number of the panelists have suggested that trying to measure productivity is a good thing to do. In doing so, however, you want to develop measurement criteria that will result in actionable responses or actionable ratios. We have thought about it a lot, and we have come up with things that we think are fairly actionable for departments such as underwriting, issue, claims, data processing, etc. We haven't figured out good ratios for the actuarial department yet, however.

Once we started constructing the ratios on a monthly basis, almost all of the ratios miraculously got better. People were being measured, and they started being more efficient. I just thought I would list a few of them.

In the issue area, some ratios are: new files without errors, submits per hour, issues per hour. We have something called the Express Connection, and we have set a standard that those cases must go out in a certain number of days. So the performance statistic is the number or the percentage of those cases that go out within the designated time frame. For regular business, once it gets to issue, what percentage of the business is getting mailed within two days?

In policyholder services, we have reissues within 21 days, the percentage of vouchers correct, requirements completed per hour, surrenders or cancellations within 10 days.

For the claim department, we calculate hours per claim payment, forms mailed within two days and things like that. In the company's word processing unit, we calculate typing lines per hour, documents in one day, documents without error, average days in pending, average days to mailing. For underwriting, we have hours per completed case, and so on and so forth. Data processing is on the CICS System, and we calculate the percentage of the time that the system was available for use when it was needed. We have found these and a number of other ratios to be extremely useful.

And now to my question, I guess for Rick, but anyone can answer. You suggested that measuring actual to expected expenses as a way of understanding what's going on in measuring your productivity. In calculating expected expenses, assuming that you mean pricing expected expenses, there are two ways to do it. One way would be to use current pricing expenses, and the other would be to use historic pricing expenses.

If you take your in-force distribution on the historic basis and apply the old unit expenses, the result might tell you how you're doing as compared with your GAAP

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reserve and deferred acquisition cost assumptions. Some of the policies are old, and they have older expense assumptions in them.

The other way would be to use current unit expenses in determining expected, to measure how you're doing against current pricing targets. You get a different answer, depending on how you calculate "expected expenses."

The question is, which method do you think is the most meaningful or actionable and why? And what is it that you do?

If you use current expenses, you may have \$25 per policy in for something. That's your current pricing factor, but four years ago it may have been \$35 per policy. And if you're charging only \$25 per policy, depending on how you split first-year-end renewal, there's \$10 per policy that's in some older gross premium that's somehow not getting taken into account. How do you take that \$10 into account?

**MR. JACKSON:** I view pricing expenses as a forecast of expected expenses. They should be based on historical results to the extent that those results seem to be a good predictor of future expense levels. We review and revise our expense assumptions on new and in-force business regularly, since, as a mutual company, we are not overly concerned with the GAAP concept of "lock-in" of assumptions. We want to know where we are, at least annually, with respect to our pricing assumptions. Our management is very interested in the actuarial area's profitability projections for in-force business as well as new issues. By using assumptions most reflective of where we are now and where we think we are going, we can provide alternative profitability projections to management, which enable it to estimate outcomes of possible actions it is considering.

We are most concerned that actual experience of our main profit sources – expenses, interest, and mortality – in aggregate, is consistent with product pricing objectives. If there is shortfall or gain, we have options to adjust price accordingly. Unfortunately, due to contract restrictions, we cannot always exactly match a pricing variance such as a per policy cost, by a corresponding change in per policy charge.

**MR. SMITH:** But in response to that comment, if you're trying to answer the question, "Are you reproducing Exhibit 5 expenses?" you need to take \$35 a policy into account on some policies and \$25 per policy on others. You get two different answers. One, if you use historical unit expenses, then you are answering the quarterly earnings question from a source of profits basis. The other way looks at a different question. Maybe you need to do both, but it's extra work.

**MR. ARMAND M. DE PALO:** I'd like to begin by just making a comment on the last speaker. In most mutual companies, if you generate expense savings, it's passed through immediately through the dividend scale as higher dividends to that class of business. So that may just really be a stock company question concerning nonparticipating business.

The question or the issue that I want to raise is most of the analysis in the presentation was done on the assumption that the numbers you have are correct and the allocations to a line of business are appropriate. That's probably true with a monoline

## MANAGEMENT OF EXPENSES IN A LIFE INSURANCE COMPANY

company where everything is done in one company and it's a zero sum game. But in actual fact, many companies are either multi-line companies or have subsidiaries. As an example, in the early 1970s, Guardian did something that's a major help on expense allocations. We adopted a profit center basis and put most of the functions in the major lines of business. Where companies remained on a functional basis, they had to deal with the allocation of what part of that function got allocated to which line of business. Especially in a mutual company where there aren't bonuses involved through profit center offices or management, there's really very little incentive if the allocation of expenses isn't right to your profit center. You say, "Well, that's what I've been allocated," and you sort of go along with it. As you open up subsidiaries, though, one of the notable things that happen with a subsidiary is that it only picks up a portion of the marginal expenses. Now if someone actively allocates overhead to the subsidiary, it tends to be underallocated. And I'd like to ask that question to anyone on the panel. I know that State Mutual does have a subsidiary; so the speaker may want to address the question of subsidiary versus parent's allocation of expenses. Unless the allocation is correct, you really can't tell anything about a trend, because if someone comes in and fixes an allocation, it could look like you've worked wonders and no fundamental change has occurred.

MR. JACKSON: For internal management purposes, which is my main focus, we consolidate results in State Mutual and SMA Life to assess profitability. Like Guardian, we allocate expenses on a profit center basis, or more precisely, on a product line basis. As you know, there is not any one right way to allocate expenses.

MR. KENNETH FAIG: To what extent do you believe that technology can be utilized to reduce expenses?

MR. JACKSON: I'd say there is substantial opportunity. We characterize it as immense, but it certainly applies to the whole policyholder service/underwriting issue chain. There's substantial opportunities to improve productivity through systems gain. What the number is, I have no idea. It's going to vary by company. And that's not the only place. You can use technology to reduce expenses in the way you do employee record keeping and a host of other areas; like financial systems and so on. But the area I focus on is underwriting: writing the policy, issuing the policy, and application.

