TRANSACTIONS OF SOCIETY OF ACTUARIES
1956 VOL. 8 NO. 22

EXPENSES

A. What have companies done to control office expenses? What forms of budgets are used and how do they operate? How effective have such controls been?
B. What steps have been taken to reduce the expenses of
   (1) Special settlement options?
   (2) Policy changes and conversions?
   (3) Not taken policies?
   (4) Attendance at meetings of various kinds?

MR. J. E. BOOHER, introducing section A, stated that the Prudential has been using a budgetary system for 20 years. The budget compares actual expenses with expected expenses determined by applying unit costs during a selected base period to the current volume of transactions. The section is the smallest administrative unit, followed by the division, the department and the regional home office. Regional home office and department budget reports are prepared quarterly, while division and section reports are made monthly. Each department holds budget meetings bimonthly to discuss the budget reports. The ratio of actual to expected expense is called the "budget ratio." The continual reduction in the budget ratios satisfies them that their budgetary system is very effective in controlling costs.

MR. R. C. PERRY said that the guiding principle for the State Farm Life Insurance Company in making projections, forecasts and budgets is expressed by the following quotation from *Leviathan* by Hobbes: "The best Prophet naturally is the best guesser, and the best guesser, he that is most versed and studied in the matters he guesses at, for he hath most signes to guess by."

Budget activity is aimed at a realistic appraisal of what can be expected and the budget is not viewed as a watchdog of the treasury. The Performance Budget includes estimates of new business and business in force, *all* items of income and expenditure, changes in asset value, and changes in liabilities. The budget therefore includes a projection of the insurance account, the balance sheet, and a gain and loss exhibit.

Mr. Perry then described the treatment of the expense part of the overall Performance Budget. In accord with the principle "The best guesser is he that is most versed and studied in the matters he guesses at," budget figures originate with the individual administrative departments, rather than with a central budgeting authority.

The company divides administrative departments into 10 groups of departments, three in the home office and seven in regional head offices. During the fourth quarter of each year, each department prepares a budget for the following year for each quarter classified by ledger account, thus reflecting both the incidence as well as the dollars of expense. The budgets, including estimates of new business, of all departments are reviewed and consolidated at the home office to produce the over-all Company Performance Budget.

The approach to budgeting of salaries is on the basis of a work measurement program. After an individual department has developed figures for the volume of new and old business to be processed and administered, the number of times each major operation is to be performed in servicing that business is determined. By applying the theoretical unit time to the number of anticipated operations of each type and summing the results, a figure is developed of the total theoretical hours it is anticipated the department will require for each quarter. Since a part of the plan is to determine periodically the actual theoretical hours of work performed, the current actual salary cost per theoretical hour is known. This figure, adjusted for any unusual factors, is applied to the anticipated theoretical hours to obtain the anticipated salary expense. This indirect approach to salaries helps avert the psychological problems which sometimes occur when salary estimates are obtained by consideration of individual people and their individual salaries. Examination of the number of operations to be performed in connection with the development of theoretical hours is also useful in allocating expenses which are a function of volume of operations.

The Performance Budget is not intended to control expenses. While each department is informed on a quarterly basis of its actual expenses in relation to the expected, no attempt is made by top management to bring any department before the bar of justice for exceeding the budgeted expenses. The company believes that an intelligent department head will exercise restraint where restraint is desirable. The development of a realistic Performance Budget, free of artificiality, permits management to evaluate the situation and, if the situation warrants, to apply restraint or make needed adjustments in plans long before the actual expenses are incurred.

MR. LOUIS GARFIN stated that for a number of years the Pacific Mutual had used a budget system under which the head of each department presents for approval an annual budget of his anticipated expenses for the coming calendar year. In general the system has proved very helpful but it has been difficult to evaluate the agency department expense budgets. In 1952 an attempt was made to answer the question "How much can Pacific Mutual afford to spend for all agency costs if all other phases of the company operations continue to follow essentially the same pattern as in the previous year?" For the Life Department the word "afford" was defined by the criterion that any year's new business should have liquidated the investment in that business (with interest) by the end of eight years after issue and start to show a reasonable margin after that time.

Asset share and model office calculations indicated that the eight-year criterion would be met if, in the aggregate, agency expenses attributable to ordinary life insurance were limited to 97% of the first year premiums and $7\frac{1}{2}$% of premiums in renewal years. Similar percentage factors were developed for accident and health lines and single premium and annuity contracts, using less calculation and more personal judgment than for ordinary life insurance. Tests indicated that this approach was fairly simple of application, was acceptable from the long range point of view, and was practical in terms of the dollar amounts produced.

This formula approach was first used for the budget for 1953. The percentages were reviewed and modified twice, the present percentages being 94% of first year life premiums and $7\frac{1}{4}$% of renewal premiums. From the total amount obtained by applying these percentages to the anticipated premiums in each category, the estimated amounts of contractual commissions and expense allowance items are deducted. The remainder is considered to be the normal amount allowable for agency department expenses in the following year's budget.

While theoretical weaknesses in the formula and its application are recognized, the company feels that this formula approach has been quite successful in accomplishing its principal objectives. Agency expenditures, while not kept strictly within the budget formula limits, have been brought substantially closer to the limits developed by the formula. Amounts budgeted for special programs and nonrecurring projects have been considered and approved separately from the normal basic expense budget. This causes management to recognize, when it undertakes new projects for expansion programs, that the excess costs involved must be considered as "investments" of company surplus, to be evaluated in terms of the program objectives and the likelihood of eventual recovery of the "investment." Management has developed a sense of confidence in the formula approach and finds the guideposts provided by it extremely useful in this difficult area of expense budgeting.

MR. J. E. MATZ discussed the practices of the John Hancock. Monthly comparisons of actual expenditures with corresponding expenditures of the previous year are presented for the major items of expense of salaries, travel expense, mechanical equipment, stationery and printing, furniture and fixtures, books, newspapers and periodicals, and telephone and telegraph toll costs. Of these, forecast expenditures are included only for salaries and travel. Emphasis is placed upon these controllable expenses rather than upon a complete picture of all expenses.

Total salary costs are subject to the limitations imposed by a job classification system and company regulations with regard to maximum increases for individuals. In addition to these usual rules, there are two additional controls: one is the determination annually of a maximum dollar limit on the salary increases which may be granted within each department; the second is effected through a limitation on the complement of each department.

For home office expenses such as furniture, mechanical equipment, stationery and printing, control is effected by rather tightly restricting the right to requisition and also by channeling all requisitions for major items through a designated representative of the budget committee whose function is essentially similar to that of a watchdog assigned to prevent unnecessary or exorbitant expenditures.

The simple comparison type of budget described up to this point has been unsatisfactory in taking account of fluctuations in volume of transactions. For this reason the company has been shifting, for those areas where work unit measurement is appropriate, to a standard cost budget similar to the type used by industrial concerns. The results of application of this budget in uncovering spots where work procedures could be improved have been quite gratifying to date.

Measurement of results of cost control activity is difficult, especially in view of the increasing cost trend of recent years. Perhaps one of the most appropriate measures of determining results is a comparison of a company's own expense trends with those of competing companies. As part of a routine annual comparative study of 18 companies the ratio of home office salaries to "available premiums" has been computed. The term "available premiums" represents John Hancock's own particular formula for adjusting annual statement premiums for this purpose. While this measure is at best a crude one, the trend that it exhibits is probably valid. Over the period 1951–1955 the ratio for the John Hancock remained almost constant, while for the other companies it rose by about 17%. If machine rentals are added to salaries to reflect the effects of mechanization, the ratio for the John Hancock rose 3% as compared with an increase of more than 16% for the other 17 companies.

MR. J. C. NOBACK, in introducing section B, described the new settlement option program adopted by the Northwestern Mutual as of January 1, 1956. The essential elements of this program are that the company (1) provides contractually that each beneficiary can obtain by her own action all the benefits anyone else can secure for her in advance, thus reducing the need for endorsements; (2) allows interest accrual on death claims from the date of death; (3) allows each beneficiary a year in which all contract guarantees are held open; (4) allows "first taker" contingent beneficiaries the same rights that direct beneficiaries have; (5) provides contractually that any beneficiary can transfer funds from a dispersing option to a life income option at rates in contracts being issued on the transfer date.

This program—and especially the provision to pay interest from the date of death—has resulted in the number of endorsements for the first 9 months of 1956 dropping to 48% of what they were during the first 9 months of 1955.

MR. E. B. WILLIAMS described the steps taken by the New York Life to reduce the expenses of settlement options elected during the insured's lifetime. A few years ago about 60% of such elections were adaptable to preprinted settlement agreement forms requiring only the insertion of names of beneficiaries and their respective interests. Today, despite an increase in the variety of such forms, only a little over 40% can be handled in this way. Settlement agreements have become much more complex in recent years due, among other things, to better trained agents, increased emphasis on programming, and increased public knowledge. In some companies, at least, more liberal optional methods of settlement have been available when elected by an insured during his lifetime than are available to a beneficiary, and this has tended to increase the number of elections.

Recognizing that the best time to determine the needs of beneficiaries is when a policy matures by the death of the insured, the New York Life has recently liberalized its rules so that generally speaking a beneficiary payee may elect any kind of settlement arrangement which the insured could have elected during his lifetime. The principal effect of this liberalization is to make available to beneficiaries an interest payment option for a period of time to be followed by an income option.

Many agents agree that it is preferable to furnish an outline of possible alternate settlement programs to be kept with a policy for future reference than it is to tie the hands of a company and the beneficiaries with a complicated settlement agreement which cannot be altered after the death of the insured. The New York Life is hopeful that its new practice will not only reduce the number of complicated settlement agreements requested, but that it will also result in settlements better suited to the beneficiary's needs.

MR. J. M. MILLER outlined the activities of the New York Life in reducing the expenses of policy changes and conversions. The company's policies issued prior to January 12, 1954 contained provisions for changes to higher premium plans and for original date term conversions upon the payment of the difference in premiums with compound interest and proper adjustment for the difference in dividends. The necessity of using various dividend scales and calculating interest charges complicated the computations. Policy forms adopted in January 1954 and currently in use do not state the basis of such changes. The rule now being used in most instances is a charge equal to a percentage of the difference in terminal reserves. Waiver of premium reserves are ignored and double indemnity reserves are used only in certain areas where the difference in reserves is significant.

The importance of change calculation work in this area is greater than the number of completed changes would indicate, since the company has found that the change is actually made in less than 40% of the cases where computations are made for a change to a higher premium plan.

Recently tables of reserves in book form have been distributed to local offices so that the approximate cost of making changes to higher premium plans can be quoted from the local offices in order to reduce the number of change computations in the home office.

Processing of changes has been expedited by placing several change calculators adjacent to the department processing the changes. Computations made by the more experienced calculators are spot checked only. When a request originates in the local office where the policy is on record, the local office simultaneously furnishes the status of the policy regarding premiums, loans and dividends.

The measures taken in the last two years to improve procedures and simplify rules have enabled the New York Life to handle an increased volume of cases more quickly, with fewer personnel, and without the overtime work which previously had been necessary.

MR. E. B. WILLIAMS discussed the steps taken by the New York Life to reduce the expenses of not-taken policies. Two of the best ways to cut down on not-taken policies are to facilitate the collection of sufficient money with the application to bind the company if the risk is approved as applied for, and to discourage agents from submitting applications in cases where there is little likelihood of the policy being placed.

In 1954 when their new policy series was introduced, a new application form was also introduced under which the company agreed to be bound to a properly qualified risk on the basis of a partial payment of less than the full first premium provided the amount paid with the application was at least equal to a monthly premium for the policy applied for and was not less than $10. Previous practice had been to require payment of the full first premium in binder cases. At present the company is receiving the full first premium or satisfactory partial payment with approximately 45% of new business applications.

The company charges the agent a fee when a policy issued as applied for is not placed. In the usual single policy case, where a contract is issued as applied for, the fee is $2.00 if the case is nonmedical and $5.00 if medically examined. While these fees cover only a small proportion of the cost involved in issuing the policies, they discourage agents from submitting applications in cases where there is little or no chance of placing any business.

In cases where extra policies are requested in connection with an application, a policy fee of $3.00 is charged for each policy canceled, except that one policy may be canceled without a fee when the amount of insurance delivered and paid for is $5,000 to $9,999, two policies when the amount is $10,000 to $24,999 and three policies when the amount is $25,000 and over.

MR. BOOHER stated that attendance at meetings of various kinds is controlled by the Prudential's Expenditures Control Committee. Only management approval is needed for attendance at company expense at meetings not requiring an overnight stay. For other meetings, not more than two persons in the entire company may attend without prior approval of the Expenditures Control Committee. The company has found that this system of control has reduced the attendance at outside meetings with a resulting decrease in expenses.