



**ALLEN BAILEY & ASSOCIATES, INC.**

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# Expense Study

**A Detailed Account of the Process & Reasoning**

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# Expense Study

## A Detailed Account of the Process & Reasoning

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A trait that is present in almost every successful insurance company<sup>1</sup> is the ability to make available and use current experience studies. The discipline to create and then maintain mortality, persistency and expense studies provides the only means to assess any product's performance relative to the assumptions used at time of pricing.

Only by comparing emerging actual to expected expenses can a company determine if expenses are at an 'appropriate' level. Information and/or data available from such a study can then be used to take action or make decisions, if needed, that will bring this component of income in line with pricing assumptions.

For these reasons, and in order to properly perform in a macro sense, a company should periodically determine the level of its unit operating expenses. Keeping current an accurate measure of both fully allocated and marginal (or variable) expense levels also provides a company essential metrics used as outlined below.

## Rationale

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- Such a study, over time, reveals changes to this important component affecting profitability. The study allows management to study reasons for changes (up and down) over time and also provides the figures needed to measure its unit expenses relative to those of other similar size carriers.
- Auditors and examiners frequently request experience studies. Even if the expense study is not audited, per se, company management with the discipline to produce such a study is consistently perceived more favorably. This discipline, combined with current recent company experience, will lead to a better-informed management team and similar, resultant decisions.
- Expense study results are also needed to properly meet cash flow testing requirements and to produce illustration actuary certifications.
- An expense study also is a fundamental requirement to accurately price new products (or reprice existing ones).
- A byproduct of any experience study leads to a better-informed board facilitating discussions that will enhance the ability to better understand issues and to lead.

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<sup>1</sup> For purposes of this discussion a 'company' is defined as either a traditional insurance carrier (stock or mutual company) or a fraternal benefit society.

## Objective

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- At outset, the objective of this analysis is to develop the fully allocated, actual per unit, per policy and percent of premium expenses actually incurred for each line of business. These results are further developed to produce unit expense factors for each of the various functions present in the company. These include functions such as sales, policy issue, underwriting, policy maintenance, claims settlement, etc.
- The second objective is to establish a template that allows a company the means to gather information needed to produce unit expense levels at any point in time, both initially and in the future.
- The third objective is to develop marginal, or variable, expense factors. Very few, if any, small or mid-sized insurance companies can price, or reprice, their products using fully allocated expenses and expect to produce rates that are competitive in the market. Thus, most companies are forced to price products by considering an alternative, yet reasonable, assumption for the expense component. Generally, companies apply marginal, unit expenses in the ratemaking process.

This assignment includes work with senior management to define then develop marginal, unit expenses appropriate for that carrier. One reasonable definition of marginal expenses that is common in the industry is: Marginal expenses are the actual, direct cost incurred to issue a new policy. Treatment of overhead expenses varies but, generally, is not included in development of marginal, unit expenses.

## The Process

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In order to generate the most accurate study possible the process involves receiving input from each department manager. Securing the knowledge and insight of each department manager will ensure AB&A can generate a report that most accurately reflects a company's experience, along with any unique traits. Most crucially, department managers must be aware that senior management views this project as a priority and that managers are expected to invest the time and effort needed to produce accurate data as input to this process. As a rule of thumb, we expect each manager to spend, on average, 1.5 to 2.0 hours, perhaps less.

At outset, AB&A will have a brief discussion with this assignment's leader(s) to assess aspects unique to the organizational structure of the company. Based on this information, AB&A will develop a template survey. Each manager will use the survey to produce, for each employee, an allocation of time using specific guidelines. Any manager requiring assistance with the survey will have someone available in our office to provide immediate guidance and answers to all questions. But it is important to understand that nothing in this process involving company staff is difficult or onerous.

Generally, each employee will estimate the amount of time spent on various lines of business (life, annuity, etc.), if applicable, as well as an estimate of the percentage of time that particular employee uses to perform each function to fulfill his or her job (e.g., sales, underwriting, maintenance, investment, overhead, etc.). The completed survey provides the needed allocation of time to produce the detail that makes each company unique.

AB&A will walk the managers through the items in the survey and explain the logic it entails prior to beginning. Typically, an entire department's survey is completed in less than a half-day, maybe as short as an hour or even less, depending on the function.

Other than periodic discussions and communication with the project leader and possibly seeking clarification regarding responses from the various managers, this completes the process from the company's perspective and the direct involvement of company staff.

## **The Result**

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With the detail from the completed survey AB&A produces a final report. In the final report unit expenses on both a fully allocated and marginal basis are delivered for each line of business and in aggregate.

For each line, expenses are divided into: Acquisition, Maintenance and, where applicable, any additionally required classification.

Lastly, Acquisition expenses are further developed showing Sales (% of premium), Underwriting (\$/policy) and Issue (\$/policy). These summary tabular results vary depending on the company. Similarly, the specific expenses can be customized to reflect the company's desired allocation basis (that is, % of premium, per \$1,000 of Face Amount, \$/policy).

This section of the report is also customized to present appropriate benchmarks. These benchmarks may be other specific carriers that represent a given companies 'peers' or competitors, a specific index of similar sized companies or a distinct type or group of carriers (e.g., fraternal benefit societies).

AB&A will also present an Executive Summary which includes observations and specific recommended action items AB&A believes company management should consider. The summary section of this report may be further customized depending on the company and any specific guidance given to AB&A to analyze as a part of the overall tasks.

One final remark is worthy of note. Our assignment is to analyze expenses and nothing more. It is not our role nor is it our intent to analyze the recipient of a company's expenses. Such judgment is beyond the scope of this assignment and, in reality, is a task which we are not qualified to undertake (nor one we wish to undertake).

*The estimated cost to undertake this work and produce such a report customized for your company can be provided upon request. It includes data preparation/manipulation and organization, development of the template, or worksheet (a tool of ongoing use for updating future reports which can be done independent of AB&A for companies desiring to take this work on, internally, at some future date).*



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