

# Agency Companies Have Higher Expense Ratios

## *The 2000 Ordinary Life Overhead Expense Study*

**E**XPENSE MANAGEMENT IS A KEY INGREDIENT in a life insurance company's ability to offer competitive products and generate an adequate return to investors. For several years, Milliman & Robertson, Inc. has produced an annual study of life insurance industry expenses to estimate overhead expense for the ordinary life line of business.

This investigation analyzes the level of home office expenses a company incurs in its ordinary life business. Although it includes home office acquisition (issue and underwriting) expense, variable policy maintenance expense, and home office overhead expense, it excludes commission and agency-related expense. It does include marketing and developmental expenses incurred in the home office, since an important consideration in expense management

A premise of our study is that truly variable expenses don't differ materially from company to company. We developed formulas we believe reflect typical variable acquisition and maintenance expenses that are based on functional expense studies and the expense of various underwriting techniques. Underwriting procedures vary by face amount and issue age from company to company, so this formula is necessarily an estimate. Nonetheless, it reflects typical un-

**TABLE 1** Life insurance industry overhead expense

	1995	1996	1997	1998	1999
Weighted average	9.9%	10.4%	11.1%	11.0%	11.1%
Arithmetic mean	12.0%	12.2%	12.7%	12.7%	12.5%
Median	10.8%	11.2%	11.4%	11.9%	11.6%
Expense per policy in force	\$56.00	\$57.00	\$62.00	\$62.00	\$62.00
Expense per thousand	\$ .99	\$ .96	\$ .99	\$ .96	\$ .92
Ratio to variable expense	196%	204%	216%	217%	218%
Number of companies	333	333	333	333	333

is how much a company can afford to spend continuously for these items.

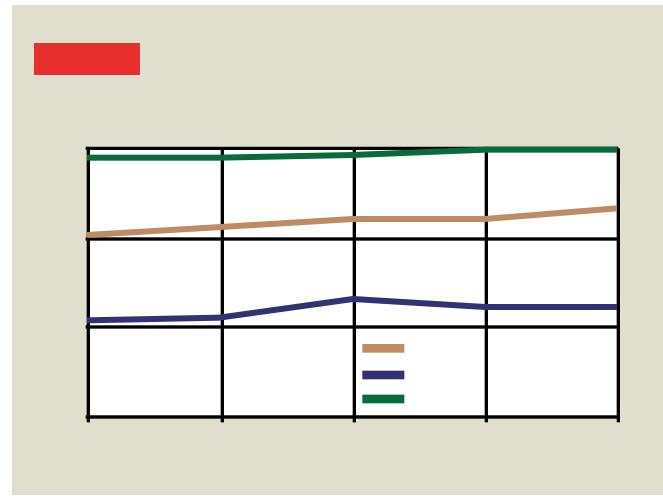
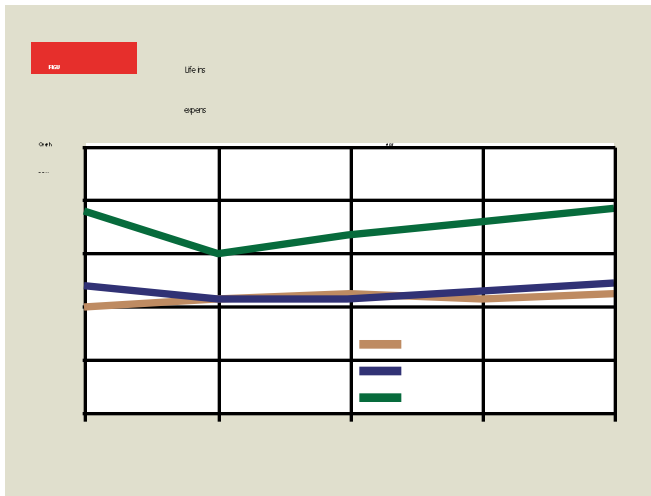
For the purpose of this study, the ordinary life insurance industry in the United States was represented by 333 companies. The companies selected for the study accounted for approximately 84 percent of the total ordinary life face amount issued in the United States in 1999. Expense results were calculated for the industry as a whole as well as for various segments of the industry (i.e., mutual/stock companies, large/medium/small companies, career agency/brokerage companies).

**RAVI K. BHANDARI** AND **JULIETTE M. BURDEN** ARE ASSOCIATE ACTUARIES; **SUSAN L. HUNT** IS CONSULTING ACTUARY AND PRINCIPAL; **BRADLEY M. SMITH** IS CHAIRMAN OF THE BOARD OF THE DALLAS OFFICE OF MILLIMAN AND ROBERTSON.

derwriting expenses incurred by companies that issue fully underwritten business and expect a mortality level consistent with those in the annual Society of Actuaries mortality study of the ordinary life line of business.

Using information available from statutory financial statements as well as the unit expense factors developed for these studies, variable expense for policy issue and maintenance was imputed for each company. Overhead expense was defined as the excess of general insurance expense over the imputed variable expense. Table 1 presents the overall results of this year's study.

As Figure 1 shows, ordinary life overhead expense as a percentage of premium for the industry exhibited a steadily increasing pattern over the period from 1995 through 1997, but has remained fairly level since then. However, individual company results show that



not all companies experienced the same pattern or results. Although average results are reported, individual companies' results show a wide range of expense levels within the life insurance industry.

Companies that incur agency or branch office expenses, categorized as general insurance expense in their statutory annual statement (as opposed to companies that compensate their agents/brokers with larger commission payments to offset their operating expenses), generally have higher expense ratios. Similarly, companies that use a direct-response marketing approach will have a higher level of home office expenses because they incur additional costs in the selling process, in lieu of paying agent commissions.

Results are calculated for a five-year period using data from calendar years 1995 through 1999. The results are expressed as a percentage of direct ordinary life premium income (excluding single premium). Therefore, a company with a large amount of assumed business will have an expense percentage higher than appropriate because no expense is being defrayed by policies assumed through reinsurance.

The weighted average is the ratio of the total fixed overhead expense to the total direct premium income (excluding single premium) for the ordinary life line of business for all companies included in the study.

The arithmetic mean is the average of the results for all the companies included in the study, with no weight given for company size.

Expense per policy was calculated as the total ordinary life overhead expense divided by the average number of ordi-

nary life premium-paying policies in force during the year.

Expense per thousand was calculated as the total ordinary life overhead expense divided by the average number of thousands of direct, premium-paying ordinary life insurance in force during the year.

The ratio to variable expense is the ratio of overhead expense to direct variable expense (i.e., acquisition and maintenance expense).

The quartile breakdowns provide additional insight into the distribution of results. Approximately 25 percent had overhead expenses in excess of 18 percent of premium, approximately 50 percent had overhead expenses in excess of 12 percent of premium, while 25 percent of the companies had overhead expenses less than 6 percent of premium.

Figure 1 shows the results from 1995 through 1999 for company groups based on size. Large companies are defined as companies with more than \$100 million in ordinary life premium, medium companies as those with between \$25 and \$100 million in ordinary life premium, and small companies as those with less than \$25 million in premium.

In past studies, the overhead expense ratio was inversely related to the size of the company (i.e., the smaller the company the larger the overhead percent). This relationship is generally true for the years in this study. However, the results for the large and medium companies aren't significantly different.

In Figure 2, the results for stock companies are compared with the results for mutual companies. The stock vs. mutual classification was determined as of the end

of the first year of the study (i.e., 1995). Hence, if a company demutualized in 1996 or later, it was still considered a mutual for all years in the study. For purposes of this classification, stock subsidiaries of mutual companies were considered mutual companies. Also, companies within fraternal and affinity organizations were considered mutual companies.

In general, ordinary life overhead expense is a smaller percentage of ordinary life premiums for stock companies than for mutual companies. This relationship holds true when differences in distribution systems and costs associated with these distribution systems are considered. It also holds true when considering company size.

A company in business for the long term must issue policies that yield a reasonable return to investors and that compete for policyholders' attention. To compete for capital and market share, companies must have unitized expenses that compare favorably with those of its competition. The overhead expense results calculated in this study provide a benchmark a company can use in evaluating its own position within the industry or some subset of the industry. A company with expenses consistently higher than average may find it difficult to offer profitable products at a competitive price. A company able to reduce its overhead expense levels should have a competitive edge.

The complete study is described in more detail in a report available from the authors in the Dallas office of Milliman and Robertson at (214) 891-7300. The complete report contains more information about the methodology of the study as well as more detailed results. ●