LIFE PRACTICE NOTE 1995–13
December 1995

Expenses

Introduction

This practice note was prepared by a work group organized by the Committee on Life Insurance Financial Reporting of the American Academy of Actuaries. The work group was charged with developing a description of some of the current practices used by valuation actuaries in the United States. This work group was originally formed in 1992 and issued the first set of Life Practice Notes that year; changes have been made to this set of practice notes on an annual basis to reflect additional information on current practices.

The practice notes represent a description of practices believed by the work group to be commonly employed by actuaries in the United States in 1995. The purpose of the practice notes is to assist actuaries who are faced with the requirement of adequacy testing by supplying examples of some of the common approaches to this work. However, no representation of completeness is made; other approaches may also be in common use. It should be recognized that the information contained in the practice notes provides guidance, but is not a definitive statement as to what constitutes generally accepted practice in this area. Moreover, these practice notes are based upon the model Standard Valuation Law of the National Association of Insurance Commissioners (NAIC). To the extent that the laws of a particular state differ from the NAIC model, practices described in these practice notes may not be appropriate for actuarial practice in that state. This practice note has not been promulgated by the Actuarial Standards Board, nor is it binding on any actuary.

The members of the work group responsible for the original practice notes are as follows:

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LIFE PRACTICE NOTE 1995–13
December 1995

Additional review for the 1995 Life Practice Notes was provided by the following members of the American Academy of Actuaries' Committee on Life Insurance Financial Reporting:

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Comments are welcome as to the appropriateness of the practice notes, desirability of annual updating, validity of substantive disagreements, etc. Comments should be sent to Donna R. Claire at her Directory address.

Q. For which expenses is provision commonly made in cash flow testing?

A. Actuarial Standard of Practice (ASOP) No. 22, *Statutory Statements of Opinion Based on Asset Adequacy Analysis by Appointed Actuaries for Life or Health Insurers*, section 5.5, states the following:

> Reserves and related items . . . are considered to make adequate provision for the obligations and expenses of the company, provided satisfactory results are obtained.

The expenses to be considered normally include administrative expenses, investment expenses, and overhead expenses.

ASOP No. 22, section 5.3.1(c)(iv), states the following:

> The asset adequacy analysis should take into account all anticipated cash flows such as renewal premiums, guaranteed and non-guaranteed benefits, expenses, and taxes.

Q. Must acquisition expenses be considered?

A. ASOP No. 22 focuses on the cash flows arising from in-force business, and these do not normally include acquisition expenses. However, it is possible that a business in its first year of testing may still have acquisition expenses associated with it, which would therefore be considered expenses related to the business being tested.

LIFE PRACTICE NOTE 1995–13
December 1995

Q. How may expense assumptions be checked for reasonableness?

A. In the 1993 survey of appointed actuaries, 30% of those replying stated that they reconciled the numbers used to annual statement numbers. Of those replying, 55% used a survey of their own company's expenses. Some used industry data, such as the information on expenses from the Life Office Management Association (LOMA). In the above survey, a few respondents stated that pricing expenses were used.

Note: At least one regulator has opined that using industry data alone as a standard for an expense assumption is not acceptable, since it implies that (1) the company does not have a good management information system, (2) the company is covering up a pricing problem, or (3) the appointed actuary is not taking his or her job seriously.

Q. Some pricing actuaries assume that expenses will decrease over time, as economies of scale are reached. May this be reflected in testing?

A. One way that some appointed actuaries are reflecting possible changes in future expense levels is to split the expenses into fixed and variable expenses, with different assumptions for each. Fixed expenses would normally be increased to account for general price inflation. Another current practice is to use pricing assumptions, but to also do a sensitivity test which assumes that the level of expenses remains at the current level. ASOP No. 7, *Performing Cash Flow Testing for Insurers,* section 5.5.2, states the following:

> Considerations that might affect the projection include . . . expense-control strategies . . . .

Q. Should insurance expenses be adjusted for inflation?

A. In the survey mentioned in the question above, a number of appointed actuaries stated that the expenses were adjusted for inflation. One way to do this is to have per-policy (and fixed) expenses increase with the level of inflation appropriate to each scenario. Another comment was that certain expenses, such as those as a percentage of reserves, would automatically increase as the level of reserves per policy increases over time. The level of inflation appropriate to a given scenario may usually be determined by consideration of the long-term average real returns on the projected investments.

Q. Should sensitivity tests be done on the expense levels assumed in testing?

A. ASOP No. 7 states that the appointed actuary should consider the sensitivity of the model to the effect of variations in key assumptions. For some products and/or companies, expenses may be considered a key variable. The 1993 survey of appointed actuaries showed that at least 17% of those surveyed did some sensitivity testing on expenses.

Q. Should a provision for overhead expenses be included in testing?

A. There are many definitions of *overhead* in use. Additionally, there are many opinions as to the proper allocation of overhead to tested lines of business.

Certain overhead expenses, such as management salaries, are typically recurring expenses. A number of appointed actuaries assign these expenses to lines of business in proportion to the direct expenses of each line. Others perform studies to further break down the overhead expenses into *acquisition expenses*, which are not normally included in the cash flow testing, and *maintenance expenses*, which are included.

Certain overhead expenses are extraordinary. For example, some appointed actuaries argue that some expenses, such as those associated with seeking to acquire a new block of business, are extraordinary in nature, and should not be considered obligations of the in-force business being tested, but rather should be assigned to the new block of business after it is acquired. Other actuaries point out that a certain level of extraordinary expense occurs each year, and therefore include it as part of the administrative expenses used in cash flow testing.

Q. How are investment expenses typically handled in cash flow testing?

A. A number of companies develop investment expenses as part of their company expense survey, and these values are used in cash flow testing. Some companies develop formulas that only charge at acquisition and disposition of the asset. Many companies develop a formula of investment expenses as a number of basis points per year for each asset type. Some appointed actuaries directly reflect investment expenses; others project an earned rate that is already reduced by the investment expense assumption.

LIFE PRACTICE NOTE 1995–13
December 1995

Q. How may investment expenses be checked for reasonableness?

A. The results of this question were similar to the results regarding insurance expenses in the 1993 survey of appointed actuaries: 43% of those replying stated that they reconciled the numbers used to annual statement numbers; 40% stated they used a survey of their own company expenses. Some use industry data obtained from a consultant, while at least one stated that the numbers provided by the investment department were used.