

The Need for Expense and Efficiency Measures for Financial Institutions

Michael Bayard Smith

Tillinghast / Towers Perrin, IBM Building, Suite 200, 815 South Main Street, Jacksonville, Florida 32207-8186, U. S. A.

Summary

Expense and efficiency measures for products offered by financial institutions need uniformity and refinement to respond to current and expected changes. Analysis of business operations and philosophies needs to be incorporated for effective management of expense information and accurate recognition of expense risk.

Résumé

Le Besoin de Mesures de Frais Généraux et d'Efficacité pour les Institutions Financières

Les mesures de frais généraux et d'efficacité pour des produits offerts par des institutions financières ont besoin d'être uniformes et raffinées pour répondre aux changements actuels et prévus. L'analyse des opérations et des philosophies des affaires a besoin d'être intégrée pour une gestion efficace des informations de frais généraux et une reconnaissance exacte du risque de frais généraux.

INTRODUCTION

Throughout the 80's there has been and into the 1990's there will continue to be increasing competition in the financial services marketplace. The lowering of traditional geographical, institutional, and regulatory barriers will further intensify the competition. The foment of new market players with fresh ideas will create innovative products. The increasing competition and innovation will put considerable pressure on the pricing and planning functions. A significant concern will be the measurement and management of expenses.

Accordingly there is a strong need for expense and efficiency measures that can be applied across geographical and institutional boundaries so that new competitors can understand their markets and compete in them effectively. The sections to follow will discuss traditional measures and their limitations, will suggest a framework for improvement and will recommend further areas of investigation.

TRADITIONAL MEASURES

For a particular product the associated expenses can be related to the price of the product. Several issues immediately arise:

1. How are "associated expenses" determined?
2. How do the expenses vary with the price?
3. How are efficiency, quality or service issues reflected in calculated expense provisions?

Allocating expenses to products or companies within a business enterprise presents a challenge. Clearly there is a need for a framework which both satisfies the current

informational and financial reporting needs of management and supports product development and profit testing in a changing environment.

Certain portions of the expense provision vary directly with the price. For example, in an insurance application, commissions and premium taxes are usually percentages of premium. Other expenses may be relatively fixed while others may vary in ways unrelated to price. It is essential to segregate the components that directly vary with price from the components that do not.

Quality and service may or may not be apparent in the price, given market structure and operation. In fact, quality and service frequently depend more on qualitative than on quantitative factors. Significant changes in quality or service may require changes in expense provisions.

In the context of regulated pricing there has recently been a relatively novel standard promulgated for property-casualty insurance in California. In the aftermath of Proposition 103 there have been regulations which disallowed entire categories of expenses (e.g., advertising and political contributions) and capped other expenses at a predetermined "average level". Although such measures ignore operational realities, one of the stated intents is to reward efficiency in the marketplace. A significant omission is the lack of recognition of the differences in operational environments and philosophies (especially in such areas as customer base and service level) that may hold for insurers competing for the same risks in California.

The California regulatory actions signal the need for expense measurement techniques broader than expense ratio calculations. If insurance companies are to be compared and the rates for their products regulated with reference to an expense measure, the

measure needs to capture the absolute level of expenses relative to the level of service, the customer base and the inherent quality of the product. Only then can there be a realistic efficiency standard for expense measurement.

Until such a realistic efficiency standard is developed, there will exist a significant expense risk for insurers operating in California. Regardless of how accurately insurers may estimate actual expenses, the expense provision allowed under the current regulatory environment may significantly understate the actual expenses required to develop, distribute and administer insurance products in California.

STEPS TOWARD IMPROVEMENT

How can companies competing in the changing environment measure, control and predict expenses in a reasonable and prudent manner?

First, a general expense framework applicable on a broad-based geographical and institutional scale needs to be developed. Such an expense classification system would allow new entrants to analyze markets and compete rationally. Such a framework would also allow existing competitors to assess historical actions and plan more appropriately for the future.

Second, operational expense measures need to capture the totality of a particular product, including its quality and service aspects. In addition, the costs of research and development and strategic marketing initiatives need to be estimated and related to a reasonable lifetime for the business developed.

If a multi-faceted enterprise participates in a product, then the expense aspects need to be analyzed on a consolidated basis so that "hidden" profits and losses due to transactions between related business segments are minimized.

Third, expense components that traditionally have varied with price need to be reconsidered and re-evaluated in light of competitive economic realities. For example, the "true" acquisition cost of a higher-priced insurance policy may be the same or less than the cost of a lower-priced policy. The concept of commission as a fixed percentage of premium needs to be analyzed versus a "fee for service" concept.

Finally, it needs to be recognized that the changing competitive environment for financial services will result in some, potentially disruptive, expense "mistakes". Thus, a related consequence is increased risk both for the solvency of such firms and to the economy as a whole as the cost of insolvency is passed along to the general public.

With improved expense classification systems and measurement techniques, competitors can compete with better understanding of market dynamics and costs of participation. The product development process will be better informed and will proceed more effectively.

Increasingly consumers are becoming more concerned about the prices of financial services. Reaction to consumer concerns will benefit from understanding the expenses associated with particular products and endeavoring to control costs or to enhance products.

RECOMMENDATIONS OF FURTHER ANALYSIS

How can the financial services market progress on a reasonable basis?

There needs to be continuing effort to analyze and model the expenses of financial institutions on a consistent international basis. Realistic starting points may not currently exist for certain input parameters, but a convenient starting point would be a comprehensive survey of expenses within the financial services sector. Aggregate modelling of the financial services sector as a whole (with full recognition of its associated expense risks), its current linkages, and predictable changes to the linkages should be undertaken. Also, it is important to consider scenarios in which a dramatic unexpected event with significant expense ramifications (stock market crash, energy crisis, war) may occur which might significantly disrupt the system as a whole.

In conclusion, it is clear to say that expenses, which currently are considered a relatively static portion of financial operations, will require further analysis in the future. The competitors that best understand their products and the "associated" expenses will prosper in the face of the unprecedented change taking place globally in the financial services sector.

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