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Chairperson's Corner

Mark A. Milton

Much has been written about the advantages of having a market-driven product development process. In particular, having products and services that customers perceive as meeting their needs will undoubtedly lead to superior sales, persistency, and profits. Having a market-driven product development process also provides the entire organization with a focus that will help it respond quickly to market opportunities.

A market-driven company is committed to continual market research, target marketing, need fulfillment, and reaching customers through the target customers' preferential distribution channels.

Most life insurance companies do not believe that they are currently market-driven. In fact, based on my experiences with surveys and a seminar sponsored by the Product Development Section last summer, I believe that very few are—although many more would like to be (or at least understand more about what it means to be market-driven).

How market-driven is your company? The following questions may help you rate your company's current practices. For each question, assign a point value ranging from 1 to 10. It also would be helpful to give this quiz to others in your organization. It's a

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Pricing in a Levelized Commission Environment

by Michael S. Taht

Since the 1980s, levelized commissions for life insurance have been proposed as a method of motivating agents to better serve their life insurance clients and to better align the cost of distribution with revenue. Today, more companies are exploring levelized commissions as a possible compensation alternative. When new products are being designed or existing products are being revised under a levelized-commission structure, there are a number of considerations, including:

- The impact of a levelized commission scale to profit-test assumptions
- Changes to product features under a levelized commission scale
- Examination of profit targets and profit measures under a levelized commission scale.

What Is the Difference between Level, Levelized, and Heaped Commission Scales?

The pattern of commission rates determines whether the scale is considered heaped, levelized, or level. Most current agent-distributed life insurance policies are sold on a heaped-commission basis.

Heaped-commission scales are characterized by large first-year commissions, followed by significantly lower commission rates in renewal years.

As with heaped scales, levelized-commission scales have commissions that are higher in the first year than in renewal years. However, levelized commissions have much lower first-year commission and higher renewal-year commissions than under a heaped-commission scale.

Level-commission scales have first-year commissions equal to renewal-year commissions. A level scale can be made to look somewhat like a levelized scale by using bonuses. Table 1 gives an example of heaped, levelized, and level commission scales.

When converting from a heaped-commission scale to a levelized- or

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TABLE 1
Typical Commission Scales as a Percentage of Premium

Policy Year	Heaped	Levelized	Level
1	55%	25%	15%
2–5	5	15	15
6 +	2	10	15

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great way to gain a better mutual understanding of others in your company.

1. The value of market intelligence is widely recognized as the foundation for all planning decisions. _____
2. Target market segments are well-defined. _____
3. Competitors are identified and well-understood. _____
4. Profitability is reported for each customer segment. _____
5. Product development times are equal or superior to leading competitors _____
6. The company is willing to think beyond existing product and technology to better serve present and potential customer groups. _____
7. All sales activities are highly focused to serve the needs of target market segments. _____
8. Organizational hierarchy is streamlined and profit responsibility is assigned for each product/market segment. _____
9. Cross-functional teams develop and implement plans for each product/market segment. _____
10. Reward and recognition programs are designed to reward results that are consistent with target market priorities. _____

Add the total score for each question to determine your overall composition score (out of 100 possible).

Very few companies legitimately score 80 or above. In fact, in a survey done last summer, the average score was 54. This can be a simple but powerful tool for discussing how your company is currently operating and for identifying strengths as well as capabilities that need improvement.

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level-commission scale, it is important to take into consideration the time value of money and future deaths and lapses. It may be preferred that the present value of commissions paid be equivalent under the heaped scale and the levelized- or level-commission scale.

Impact of Levelized Commissions on Pricing

A levelized-commission scale influences many of the assumptions underlying a profit test. The degree of influence depends on the individual assumption, the levelized-commission structure, and the overall company structure.

Commissions. The most obvious change to profit-test assumptions under a levelized-commission program is the change to the commission assumption. Under a levelized-commission environment, agent retention rates and the renewal commission vesting agreement influence the level of renewal commissions paid, and this should be factored into pricing.

Commission Chargebacks. Commission chargeback formulas should be reexamined in a levelized-commission environment. In many cases, revisions to the chargeback formula will accompany the change to the commission scale.

Distribution Expenses. The level and pattern of distribution-related expenses change under a levelized commission program. Pricing should reflect the influence of new bonuses. Also, new-agent financing programs associated with the levelized commissions in combination with anticipated improved agent retention rates will alter the cost of new-agent financing. Any changes to agency manager compensation plans will also have an impact on the level of distribution expenses.

Persistency. One of the perceived benefits of a levelized-commission program is improved policy persistency. One company reported that it experienced a 20% improvement in persistency with the implementation of its levelized-commission program. It is generally accepted that the perceived improvement in persistency should be reflected in pricing. Because commissions and distribution-related expenses are more closely aligned with revenue under a

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The Section would like to encourage articles and papers on product development topics or subjects of interest to product development actuaries. If you have an article or an idea for an article that you think might interest Section members, please contact:

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Product Development Efficiency
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conditions, product development activity will increase. Companies must be responsive to the market. They can improve their product development efficiency by devising benchmark performance measures and identifying best-practice product development and project management techniques (see Figure 3.) How efficiently they perform will determine whether they find themselves on the leading edge or desperately trying to catch up.

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levelized-commission program, the sensitivity of profits to changes in persistency is reduced. However, there still is some sensitivity to changes in persistency because of the acquisition costs related to policy issue and underwriting.

***Interest Rate*.** Because commissions are paid over a longer time, the sensitivity of profits to changes in the level of interest rates increases under a levelized-commission program. Under some levelized-commission contracts, the present value of future level commissions is guaranteed to be paid upon retirement. The payout should be designed so that it does not create a risk to the company from changes in interest rate environment.

Premium Patterns. Under a levelized-commission program, it is anticipated that agents will have more contact with their existing customer base. For flexible-premium products, this should result in increases in premium persistency and also in increases in the level of premiums paid (as compared to planned). Upon the implementation of a levelized-commission program, one company reported an increase of 20% of planned premium—from 70% to 90%—on its flexible-premium products.

***Expenses*.** The implementation of a levelized-commission program will result in a change to the level and pattern of distribution-related expenses. In their expense allocation formula, many companies will allocate a percentage of expenses to either first-year commissions and/or renewal commissions. Any expense allocation formula should be reviewed when implementing a levelized commission program to determine if any modifications are necessary. Another perceived benefit of a levelized commission program is that improved policy persistency will result in an increased block of business, if sales levels are maintained. This in turn may result in decreased unit-related expenses. Although reductions in unit-related expenses would not be recommended for base profit-test assumptions, it may be appropriate to reflect reduced unit-related expenses as a sensitivity test.

Product Design Features

A levelized-commission structure, in combination with the subsequent changes to expected profit-test assumptions, changes the economics of product profitability. The changes to the economics of product profitability may lead to changes in design features commonly found in life insurance products sold today. The following examines some common product features and possible modifications to them under a levelized- commission environment.

Surrender Charges. A proportion of the surrender charge is set in order to recover unamortized first-year commissions that are forfeited upon the early surrender of a policy. In a levelized- commission product, the amount of unamortized first-year commission is less than under a heaped-commission policy. In order to make early policy-year values more attractive to consumers, companies may choose to reduce surrender charges or shorten the surrender charge period.

Policy Loads. Companies may also choose to revisit the policy load structure existing in their contracts. Under a levelized-commission contract, there is the opportunity to match commission expenses directly with per premium loads. However, this may not be well received by the field force.

***Persistency Bonus*.** Under levelized-commission policies, it is anticipated that better persistency and higher levels of target premiums will be paid. This could increase the cost of persistency bonuses and other like features that are contingent upon the insured maintaining the policy in force for a predetermined number of years. Companies may want to revisit the cost effectiveness of these product features and the marketing appeal gained through them.

Policy Values. Changes to policy features and profit-test assumptions may provide companies with an opportunity to improve projected long-term policy values. As with any significant change to product economics, companies must decide whether to pass on gains anticipated from a levelized-commission program to policyholders through higher policy values, to pass them on to their representatives through higher commissions, or to retain them through higher profits. If gains are passed on to policyholders through higher policy values, the policyholder, the representatives, and the company may all win. Policyholders will have a better product, representatives will be able to sell more because the product is more competitive, and increased sales will improve the overall profits of the company. Companies should carefully examine this profit/competitiveness/compensation equation.

Profit Measures and Profit Targets

A natural starting point in the development of a levelized commission scale is one that is actuarially equivalent to the heaped scale, incorporating the effect of

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interest, persistency, and mortality. However, this may not be achievable on all plans, especially if a company is moving from a heaped scale that varied by plan. Allowances may be made for this; a single-commission scale for all products could be desirable because it eliminates biases of agents toward a certain product based on differences in compensation.

A levelized-commission program may alter the pattern of profit emergence. The acquisition expense is less than under a heaped-commission scale. This generally results in less surplus strain associated with the sale of a product (assuming no other changes are made to the product design) and, therefore, less of an investment in the product. The relative importance of different profit objectives may change when moving from a heaped-commission scale to a levelized-commission scale.

Conclusion

A levelized-commission scale should have an impact on a number of different profit-test assumptions: commissions, persistency, and expenses. However, the impact of a move to levelized commissions on pricing and product design is such that it may be difficult to simply change profit-test assumptions.

It is generally accepted that the current career agency distribution system is not sufficiently meeting all the needs of its customers. Also, it is anticipated that the career agency distribution system will be challenged by other more cost-effective distribution channels. Levelized commissions may provide the industry with a partial solution to these challenges. Levelized-commission programs offer companies opportunities to address these challenges through:

- Increased incentive to provide more frequent and improved customer service
- Reduced distribution system expenses
- Increases in the in-force block of business, which in turn may provide improved financial results.

However, successful implementation of levelized-commission programs requires companies to make significant investments in administrative systems and transition program costs. It also requires effective communication with the agency force and programs that address the many concerns of the agency force.

Are levelized commissions for every company? Those companies that have implemented levelized commissions have had success with their programs in improved agent retention and better policy persistency. However, these companies also expended a significant amount of capital implementing their programs. Levelized commissions can be part of the solution to improving overall financial results but cannot be the only solution.

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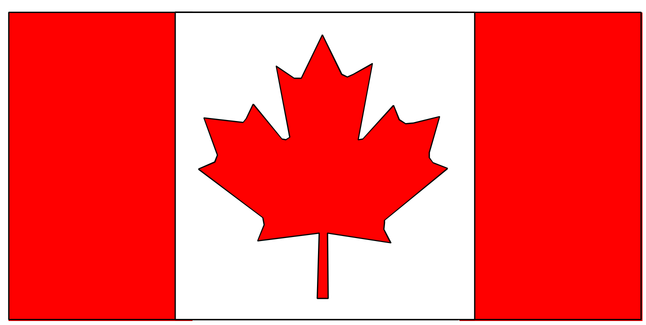
Canadian Corner: Part I. Segregated Funds—"No Loss" Proposition

by Boris Brizeli

Editor's Note: *The following is the first of two articles on segregated funds guarantees in Canada. Part II will appear in the next edition of* Product Development News.



This article briefly describes the guarantees available within the segregated fund products sold in Canada along with the various associated risks and cost factors. Part II will discuss the various methodologies for pricing these guarantees and ways of managing the resulting risks. I will strive for an intuitive exposition here and will introduce more rigor in Part II of the article.

Introduction

Segregated funds (SFs) are variable annuity contracts distributed by Canadian insurance companies. As such, they are defined very similarly to mutual funds—pools of investments in which an investor can acquire an interest by purchasing units. Like mutual funds, SFs charge a management fee for provision of their management services. Unlike mutual funds, SFs must provide two guarantees:

- ***Mortality Guarantee.*** Payment of at least 75% of deposits, less withdrawals, at time of death, and
- ***Maturity Guarantee.*** Payment of at least 75% of deposits, less withdrawals, on maturity. Maturity is defined to be at least 10 years and at most the time of annuitization.

By virtue of these guarantees and a guarantee to provide specified future annuity payments (if annuitized with issuer),

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