Article from:

Product Development News

October 1998 – Issue No. 47

New York's Revised Expense Limitation Law

by Jonathan Hecht, John M. Fenton, and Douglas A. French

In late 1996, a proposed revision to Section 4228 containing considerable liberalizations to the law was submitted to the New York State Assembly. However, that bill did not pass into law. Industry representatives, working together with the Life Insurance Council of New York, the American Council of Life Insurance, and state regulators drafted a new bill that modified key provisions of the 1996 bill that some constituencies (including state regulators) found objectionable. After much negotiation, the legislature passed the bill during the first week of August 1997. It was signed into law by the governor in September and became effective January 1, 1998.

This article summarizes and analyzes the provisions of New York's Section 4228. It also discusses the implications of the law on the design and structure of sales compensation plans.

Key Elements of the Law

New Inside Limits. The law contains revised inside limits, which include commission limits for agents and general agents (GAs) that apply on a per-policy basis, and expense allowance payment (EAP) limits that apply on a per-agent basis or a per-agency basis for GAs. The inside limits are similar to those in the previous law for the first year, but are very different for renewal years. In addition, renewal-year limits apply only in policy years two through four, and there are no inside limits in years five and later.

The first-year inside limits are shown in Table I. The first-year commission on life insurance is payable on the premiums received up to the qualifying first-year benchmark premium, as defined by the law. Commissions payable on premiums received in excess of the qualifying first-year premium are limited to 7% for agents and 8% for GAs. All extra commission allowances to GAs are only payable on business not personally produced by the GA. Qualified annuities are annuities issued under Internal Revenue Code sections 401, 403 or 457.

Table 2 shows renewal-year limits. The commission limits can be redistributed to an extent. Unused commission payments from the first policy year or from earlier renewal years may be shifted to later renewal years on a percentage-for-percentage basis. Unused expense allowance payments from the first policy year may be paid in later years on a dollar-for-dollar basis.

Total Selling Expense Limits

The Schedule Q limits in the old law (first-year field expense limit, total field expense limit, and total expense limit) are replaced by the total selling expense limit. This is an aggregate limit on all "selling" expenses that may be incurred for acquiring new individual life and annuity business and applies on a total-company basis. The total selling expense limit is based on many factors but is considerably less complicated than the old Schedule Q limitations. However, unlike the prior law, the limit includes expenses incurred in the home office to help produce new business.

Each year, an officer of the company must complete and sign an annual statement schedule attesting to compliance with this limit.

Compensation Based on Assets Under Management (Fund-Based Compensation)

Compensation may be payable based on assets under management instead of as a percentage of premium. This is a significant shift away from the historical New York position that compensation may only be paid when premiums are paid. Although the old laws technically permitted fund-based compensation, it was effectively discouraged. The allowable trade-off between percent-of-premium commission and fund-based compensation was generally viewed as unattractive to agents.

continued on page 22, columnn 1

TABLE 1
First-Year Inside Limits—Percent of Premium

Product	Per Policy: To Agent	Per Policy: To GA Including Override	Per Agent Including EAP	Per Agency Including EAP and Override
Life insurance	55.0%	63.0%	91.0%	99.0%
Single-premium life and annuity	7.0	8.0	7.0	8.5
Qualified annuities	14.5	16.0	14.5	16.0

TABLE 2
Renewal-Year Limits—Percent of Premium

Product	To Agent			To GA (Including Override)		
	Year 2	Year 3	Year 4	Year 2	Year 3	Year 4
Life insurance	**22.0%**	**20.0%**	**18.0%**	**27.0%**	**23.0%**	**20.0%**
Qualified annuities	4.5	4.5	4.5	6.0	6.0	6.0

Note: There are no inside limits in years five and later.

New York
continued from page 21

The law states that the per-policy commission limits may be converted to fund-based compensation, subject to the following provisions:

- For life insurance other than single-premium, a company may convert 1% of renewal commission in years two through four to 0.30% of fund-based compensation in years two through four.
- For single-premium life and all annuities, a company may convert 1% of premium-based commission and EAP to 0.30% of fund-based compensation in years one through four.

For example, instead of paying a commission equal to 7% of premium on a single-premium deferred annuity, a company may pay 2.1% fund-based compensation in years two through four (and in all years thereafter).

With prior approval from the Insurance Department, a company may pay fund-based compensation using different trade-offs as long as the factors are equivalent using reasonable assumptions.

In addition, the total selling expense limit contains provisions for fund-based compensation. The per-premium allowances in the total selling expense limit may be converted to fund-based allowances, using factors similar to those used for the per-policy limits.

Bonus Plans

As to the design of bonus plans, the law is more flexible including the use of retroactive factors, provided the maximum is within the inside limits. In the prior law, pure bonus plans were not permitted, although persistency plans with a bonus element were allowed. In addition, bonus plans were not permitted on a first-dollar retroactive basis. Requiring the use of the maximum rate does differ from the current law, which generally permits use of an average rate.

Other Forms of Compensation

Compensation plans, including salary plans, based on factors other than per-premium or percent-of-fund are permitted. A company may start a salary plan and operate under it for a period of two years. After the two-year period, the company must obtain approval from the Insurance Department to continue using the plan. To receive approval, the company must demonstrate that agents will not receive more compensation over their projected careers than they would have earned under a plan consisting entirely of commissions and expense allowances that comply with the inside limits. This demonstration must use reasonable assumptions for mortality, persistency, interest, agent sales, and agent turnover. The demonstration may be done in the aggregate for all agents covered under the plan.

Training Allowance Plans (TAP) for New Agents

The law modifies and clarifies the requirements on training allowances to new agents.

Agency Development Allowance (ADA)

ADA for new GAs is allowed on a basis that is similar to the prior law.

Prizes, Awards, Conventions, and Conferences

The law also clarifies and liberalizes the treatment of prizes, awards, conventions, and conferences relating to the expense limitations. Awards and prizes are not counted against the inside commission limitations as long as no single award/prize exceeds $250 and their total value in any year does not exceed $1,000. Also, an additional award/ prize of up to $25 in value may be paid as frequently as once a month.

The expenses associated with conventions, conferences, or business meetings are not included in the inside limits as long as they meet the IRS standard for ordinary business expenses and are not includable in the recipient's gross income for federal tax purposes. However, these expenses are counted against the total selling expense limit.

Extraterritoriality

Section 4228 remains extraterritorial—that is, it applies to all individual life and annuity business sold in the United States by a company licensed in New York State.

Product Self-Support Requirement

The law contains stricter language as to the requirement that all actively sold policy forms be self-supporting, using reasonably expected assumptions including only the expenses incurred as allocated to the new sales.

A self-support certification must be signed by a qualified actuary and submitted with the policy form filing. Also, such a statement must be submitted with any filing of an increased compensation plan. Documentation supporting the statement must be kept in the home office while the policy form is being offered and for six years thereafter. Finally, the law requires the Insurance Department to promulgate a regulation that establishes guidelines for demonstrating compliance with this requirement.

Transition Rules

The law contains several provisions designed to ease the transition from the previous law. These rules are also intended to prevent companies from subverting certain provisions:

- A company may continue to use, for a period of one year, any approved compensation plan that it was using as of the effective date of the new law.
- For up to four years after the effective date of the law, a company may continue to use an existing approved plan of compensation that provides for the payment of renewal commissions on in-force business that may exceed the inside limits of the law.
- For the first year after the effective date of the law, the total selling limit will be increased by 5%.
- Within four years of the law's effective date, if an increased commission is paid after the fourth policy year for a policy in force as of the law's effective date and the increase is contingent upon the volume of new business written, then such an increase that exceeds 1% of premium will be counted against the expense allowance limits.

continued on page 23, column 1

New York
continued from page 22

- Similarly, if an increased fund- based commission is paid after the fourth policy year for a policy in force as of the law's effective date and within four years of the law's effective date, and the increase is contingent on the volume of new business written, then such an increase that exceeds 0.30% of the fund will be counted against the expense allowance limits.

These last two provisions were included in the law to prevent a company from paying large renewal commissions on in-force business that really serve as first-year commissions and may subvert the first-year limit.

Compensation Plan Filing Procedures

The law specifies three levels of filing requirements, depending on the type of plan: informational filings, file and use, and filing for prior approval. Pre-approval of all compensation plans is no longer required.

Most basic plans require only annual *informational filings*. They include:

- Plans where the compensation percentages (including EAP) do not exceed the inside limit maximums without taking into account any redistribution of commissions
- Plans where fund-based compensation does not exceed 2.0% annually in the first four policy years
- Agency development allowance plans.

These filings should fully describe the compensation arrangements. They must be completed by the end of February following the year in which the covered plans became effective.

File and use is required for:

- Plans that redistribute commissions in years two, three, or four
- Plans that pay a commission rate in any year after year five that is greater than that allowed in year four
- Agent training allowance plans
- Salary plans that have been in effect for less than two years
- Expense allowance plans that provide goods and services as well as cash payments
- Plans that are affected by the transition rules due to certain increases in renewal commissions on business in force at the effective date of the new law.

A company may implement these plans immediately upon filing. The superintendent then has 90 days to respond. If the superintendent finds objections to the plan and the company does not satisfy them within 60 days, the superintendent may order the company to stop using the plan.

Filing for prior approval is required for plans using:

- Fund-based compensation based on nonstandard trade-offs
- Training allowance payments containing nonstandard provisions
- Expense allowance payments that are redistributed from the first year to renewal years
- Salary plans that are continued beyond two years—the filing must demonstrate that the value of the payments under the plan does not exceed the value of payments that would otherwise have been paid under a plan of commissions
- Any other nonstandard arrangement.

These filings must contain descriptive information, including assumptions and techniques, in enough detail for the Insurance Department's review. If the superintendent does not object to the plan within 90 days, it is deemed to be approved.

Impact on Various Types of Compensation Plans

Fund-Based Compensation. As mentioned earlier, fund-based compensation arrangements are explicitly recognized in Section 4228**.** These plans can be implemented, subject to per-policy limits that are similar to the limits on commissions based on percent-of-premium factors. Further, fund-based compensation plans that comply with certain standards can be included in an informational filing and do not require prior approval.

Levelized Commission Plans. Significant changes to commission plans can be made in the area of level commissions. The commission limits in years two through four are more flexible than in the old law and no limits apply in years five and later. Further, the new law contains explicit provisions for redistributing commissions and EAP between early policy years and later years, for both the inside limits and the total selling limits.

Under the inside limits, unused commission payments from the first policy year or from earlier renewal years may be shifted to later renewal years on a percentage-for-percentage basis. Therefore, commissions can be structured in a number of ways. For example, the commissions payable to a selling agent could be 55% in year one followed by 20% in all renewal years or, alternatively, 28.75% in all years. (The limits for a general agent would be slightly higher.)

If expense allowance payments are taken into account, the allowable total compensation (to a selling agent) may become:

- 91% in year one followed by 20% in all renewal years, or
- 36% in year one followed by 38.33% in all renewal years (assumes the entire 55% first-year commission limit is shifted to later years), or
- A level 37.75% in all years (shifts 53.25% of the 55% first-year commission limit to later years, in order to obtain a completely level commission design).

Per-policy commission levels are also indirectly affected by the total selling expense limit. Although this limit operates on an aggregate basis and applies to all of a company's individual life and annuity business, many companies wish to have each product stand on its own when it comes to these allowances.

The percent of premium commission allowances under the total selling expense limit are 55% of first-year premium, plus an additional 60.5% of first-year premium (expressed in the

continued on page 24, column 1

New York
continued from page 23

law as 110% of 55%), plus 12% of renewal premium. However, the 55% factor may be shifted to renewal years on a three-for-one basis. Therefore, the effective inside limits (including EAP) under the total selling expense limits may be:

- 115.5% in year one, followed by 12% in all renewal years, or
- 60.5% in year one, followed by 30.33% in all renewal years (if the entire 55% first year allowance is shifted to later years).

Therefore, the limits needed to comply with the total selling expense limit may be different from those that result from an analysis of the inside limits alone. Both limits must be taken into account in structuring a levelized commission arrangement. Of course, self-support must always be demonstrated and may also be a limiting factor in designing a compensation plan.

Since renewal-year commission limitations are considerably more liberal in the long term under the law, companies have a real opportunity to explore level commission alternatives, if desired.

Salary Plans. Salary plans will also be easier to design and implement. Salary plans may be started and operated for two years without prior approval. After two years, a company must be able to demonstrate that the plan does not provide more compensation than would otherwise have been paid under a plan of commissions and expense allowances.

Bonus Plans. Bonus plans are also permitted. Essentially, all compensation plans are permitted, provided that they do not exceed the inside limits and they comply with the total selling expense limit.

Potential Industry Reactions to the Law

The past few years have been challenging for many life insurance companies and their sales forces. Several factors have contributed to losses in the distribution side of the business including flat or declining agent productivity, deteriorating agent retention, and a shift in sales away from the core life insurance products to investment products.

To reverse this trend, companies are exploring new approaches to the selling proposition including enhanced sales support and lead generation programs, greater consumer focus, and revised compensation plans. Until recently, the existing laws on field compensation in Section 4228 have been an impediment to change. They have significantly constrained a company's ability to design flexible compensation plans that align company objectives with those of the field.

While the new version of the law does not provide complete flexibility in designing new plans, companies may implement the following changes in agent and/or manager compensation plans:

- Agent plans that defer a larger portion of compensation into later years through the use of levelized commissions (although most likely not level) and/or payments based on assets under management
- Plans that provide incentives to the field to achieve certain broad-based objectives such as increased household penetration and product cross-selling and higher consumer satisfaction levels
- Increased training allowance payments to new agents that may enable insurers to target better recruits with the expectation of generating higher agent productivity and retention
- More flexible bonus programs designed to reward agents for writing larger volumes of quality business
- Plans similar to those commonly used in non-career-agency channels (for example, grid-based payouts and asset-based trailers to stock-brokers and independent broker/ dealers).

Overall, the new filing procedures should enable insurers to respond more quickly to market developments in bringing new plans to market. However, given increased competition for consumers' savings dollars from other financial services companies (generally at lower distribution costs), it is unlikely that insurance companies will be able to use the new law to increase commissions as a means of expanding distribution. While revisions in compensation plans may help increase sales force effectiveness, other changes will likely be needed.

Jonathan Hecht, FSA, John M. Fenton, FSA, and Douglas A. French, FSA, are with Tillinghast-Towers Perrin in New York, New York, Atlanta, Georgia, and Stamford, Connecticut respectively.