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AGENCY COMPENSATION AND CONSUMERISM

1. What are the objectives of a compensation system - from the standpoints of the insurance company and the agent? When do these objectives conflict?

2. What services should be performed by the agent? Are there factors serving to force a redefinition of the agent's job?

3. How does the consumer view agent's remuneration? Does the consumer value the services of the agent?

4. In what ways do existing commission structures influence an agent's advice to his prospect?

   a. Effects of the Section 213 limit on term commissions;
   b. Minimum deposit selling practices;
   c. Biases in the marketing of pension products.

5. What is the impact of inflation on the earnings of agents? On the services to purchasers of small policies? What can be done?

6. What changes can be made to improve agent compensation scales?

   a. Is front-ending of commissions in the consumer's interest?
   b. Should all renewal commission be non-vested?
   c. Do persistency bonuses work? How should they be built in?

7. Is regulation of fair value a reasonable and necessary government function with respect to life insurance? Is commission and/or expense regulation a good way to achieve this result?

DISCUSSION OF QUESTION #1

MR. MICHAEL B. HUTCHISON: The primary objectives of the agents' compensation system of the life insurance industry, as culled from extensive reading of many sources, are as follows:

- to motivate our agents to sell to the unsuspecting public the largest possible volume of high-priced, high-profit, permanent insurance (instead of the decreasing term insurance coverage the public really needs);

- to discourage the agent from offering any post-sale service, so that policies will lapse early, contributing large "profits on surrender" to the company coffers;

- to keep agents' incomes at such a low level that none of them ever become successful enough to become nuisances to us in our comfortable ivory-tower existence;

- to ensure, by use of the old actuarial technique of overwhelming with complexity, that neither our agents nor the public ever really understand, and thereby acquire the right to criticize, our compensation systems.

Ridiculous? Sure! You know it and I know it. But every one of those "objectives" can be found in print in consumerist utterances of the day, and even in the speeches of people from within the industry, sometimes taken out of context but sometimes not.

Why are so many people ready and willing to believe such nonsense? Part of the problem is that we in the industry can't seem to agree, not so much on the purpose of the compensation system, but rather on the purpose of the agent.

There are, I believe, three different perspectives on the role of the agent. Until a company has decided how it views its agents, it will have difficulty setting objectives for the system of remunerating them.

The traditional view is that the agent is the seller of the policies we sell. This is the viewpoint of most of our critics and of most Home Office personnel within the industry. With this viewpoint, the compensation system is, simply stated, "payment of what the company thinks is a fair price for the services rendered by the agent to the company".

Historically, we have defined the "services rendered" as selling the policy, and have paid the bulk of the agent's remuneration for that service. (Even renewal commissions are really just deferred sales compensation, designed to stabilize agents' incomes). In recent years we have attempted to expand the definition of "service rendered" to embrace conservation and post-sale service, but in large measure the effort has foundered on such things as our inability to clearly define "service", the limited capacity of the agent to render all services, the economic reality of having to pay more for more service out of premiums held at present, and declining levels by competition, real or imagined.

A second perspective on the role of the agent is to consider him as the buyer of the policies we sell. This perspective has arisen with the growth of the brokerage system (which is in itself a refutation of a couple of my earlier rantings) and is the view held by many agents and brokers, but by very few home office people. Under this scenario, the agent is buying insurance for his client, not selling it for the company, and the objective of the compensation system becomes the payment of what the agent thinks is a fair price for his services. In the context of wage and price controls, agent compensation becomes "price", instead of "wage".

Reference is sometimes made to "reverse competition", resulting from companies bidding up the price of an agent's services. The validity of this argument depends on a rather low opinion of the agent, which I believe does him an injustice.

The bulk of our agents have a much more responsible view of their obligations to their clients than do most home office people. My company's experience in the brokerage market has taught us that, to a broker, a "fair price" for his services is not by definition the highest price. He won't provide his services for nothing, but at the same time he is conscious of his

obligation to secure coverage for his client at reasonable cost.

Anna Maria Rappaport, in her recent paper in the Transactions, referred to the fact that free market forces do not have the opportunity to function in the life insurance business. At the client level, that is probably for the most part true, for a variety of reasons. However, I believe the disciplines of the market place do function under the brokerage system in determining this fine balance between the price of an agent's services and the premium paid by the client.

This brings me to a third perspective, that the agent is neither simply a buyer nor simply a seller, but rather an integral part of the bundle of services we sell - "we" in this case being the entire life insurance industry, insuring companies and distribution outlets alike. In other words, we don't sell insurance policies, with the agent as a detached middleman between the company and the buyer. Rather, we sell what you might call "the planning and funding of future financial security", which embraces not only the risk pooling, risk assuming, investment management, and administrative services underlying our policies, but also, and perhaps most important, the services of a competent agent in counseling the client concerning his program of financial security.

This view of the agent is probably not widely held by people within our industry - either in home offices or in the field, or by consumerists or regulators or politicians - but it just might be the way the forgotten man, the consumer, sees it. Most people really don't want a pile of paper written in legalese, called a Super Executive Slam Bang Preferred Risk Whole Life. They want to protect their future financial security, within their ability to do so, and they want, and are willing to pay for, someone they can trust to give them advice on how to do it. Maybe we should concentrate more on giving them what they want, and less on reducing the industry-endorsed, actuarially-certified, interest-adjusted, mortality-justified, persistency-amended surrender value comparison index for the SESBPR Whole Life.

Under this third scenario, the quality, not just the price, of the agent's services enters the picture. The objectives of the compensation system must include the maintenance of a community of high calibre agents and the motivation of agents to achieve that high calibre. We must concentrate more on making the service worth paying for than on simply reducing the cost of the service.

So to answer the question, (or perhaps to evade it), I think we must first decide what we think our agents are, before we can start worrying about how to pay them.

MS. ANNA M. RAPPAPORT: The objectives of an agents' compensation system should include the following:

1. A sufficient number of agents earning an adequate living are available to serve the needs of the public;

2. The system is attractive enough to bring new people of good quality into the business;

3. The system provides for reasonable methods of (a) getting new

agents started and (b) helping them make the transition from the training period to being on their own;

4. Payment is reasonable in proportion to the services rendered;

5. The method of payment provides for adequate incentives to the agent to perform the services which the company wishes him to perform;

6. The system provides the industry with a means to deliver to the public the service it is paying for.

MR. MICHAEL TERNÉ: The assumption that first year commissions represent a fair return for the work of an agent in selling a policy would appear inadequate when the sale of extremely large (jumbo) policies is considered. Such compensation is in excess of either the work performed by the agent or, alternatively, the value of the business to the company, especially where substantial reinsurance is involved. However, the existing commission structure encourages such sales. A possible solution involves the grading of commissions by amount of the policy sold, a practice being followed in group insurance. However, such graded commissions probably would have to be adopted on an industry-wide basis in order to succeed. Therefore such grading currently awaits either the attention of state regulatory authorities or, more probably, the development of a higher sensitivity to cost on the part of the "jumbo" buyer.

MR. MELVIN L. GOLD: In order to meet the competition on large term policies, a number of companies are starting to cut commissions on jumbo policies.

CHAIRMAN HAROLD G. INGRAHAM, JR.: With respect to policies for amounts in excess of a company's retention limit, a logical case can be made for adjusting both the agent's commission and the general agent's expense allowance applicable to the reinsured portions of the coverage, as an offset to reinsurance costs. However, although equitable, such an action would inevitably provoke "shopping".

MR. GOLD: The objectives of the company, the agent, and the consumer almost always conflict. The conflict must be resolved by compromise. Setting premium rates is a prime example of the conflict and compromise.

MS. RAPPAPORT: The potential for conflict exists whenever there is a different level of compensation paid on different products offering a solution to the same consumer need. Examples of this conflict can be found in different commission levels on fixed-dollar and variable annuities.

Objectives can also conflict when there are different values placed on persistency and the growth in the book of business. If the agent is paid so as to provide a much greater incentive for new business than for persistency, then there may be a conflict between his interest and that of the company.

MR. GOLD: My feelings about the American agency system can be best described by paraphrasing Churchill - it is undoubtedly the worst method of distributing life insurance, except nobody has come up with a better method.

DISCUSSION OF QUESTION #2

MR. HUTCHISON: There seems to be agreement that the first service an agent renders occurs when a consumer first buys a policy. Where we start debating is over the post-sale service. Our problem is in defining this post-sale service and how the agent should be remunerated for it.

There are strong arguments that the agent should do something to earn his renewal commissions. One company I'm aware of requires evidence that some service has been performed before renewals will be paid. Arguments for non-vested renewals rest on this assumption.

On the other hand, there are companies and agents who believe renewals are merely deferred sales remuneration, and that post-sale policy service is the responsibility of the company, not the agents. The telescoping of renewals and the appointment of salaried service personnel are consistent with this belief.

Our chief problem seems to be our failure to differentiate between policyholder service and client service. In the context of policy service, we tend to think of service as changes in beneficiary designation or in premium frequency. It has been suggested that agents are not interested in performing this kind of service, and will "service" a policyholder only if the possibility of a new sale exists. That statement is probably true. Unfortunately, we think of this as a criticism of the agent, not recognizing it as a definition of the service the agent should be performing.

When we wrench ourselves from the straight jacket the word "policyholder" creates, and think of that policyholder as a client, we will realize that the real service desired by the client and performed by the agent is that of keeping the insurance program up-to-date by continuing revision, including the purchase of additional coverages. Is not a continuing client relationship what our agents should be establishing with the consumers of our products? If so, and if, as has been suggested, every consumer buys insurance seven times in his lifetime, then maybe, when viewed in terms of clients instead of policies, our present remuneration systems are not unreasonable. We pay something each year the client-agent relationship exists, with additional remuneration when the agent's services lead to revisions in the client's insurance program. We discontinue remuneration when the period during which the client might be expected to have amended his program has expired without any revisions (evidence that the agent was not, in fact, providing the client service required).

The solution to these problems lies in creating in each of our clients a better appreciation of the services to which he is entitled and which he should demand from his company and agent; and, perhaps more important, a realization of his own responsibilitites to keep his insurance program up-to-date and to request service when he needs it. I'm reminded of the story of the minister who visited an absent parishioner to find that he had been hospitalized for a month; he and his wife greatly resented the minister's not having been there when they needed him. After hearing praise heaped on the family doctor for his assistance in this crisis, the minister commented, "Thank the Lord the good doctor happened to drop by at just the right time".

Perhaps if we can educate the client to request service when it's needed, rather than hoping his agent will drop by at the right time, we'll go a long way toward solving the problem.

Two final points on client service are worth mentioning. If we are confused as to what services the consumer needs, the consumer himself is perhaps even more confused. He's constantly hearing about the lousy service he's receiving, but isn't really sure what he's missing. Secondly, it is financially impossible for us to provide the service our critics suggest is required to all of our existing policyholders with our existing field organizations. To do so would require massive expansion of our manpower and substantial increases in our premium rates.

MS. RAPPAPORT: In an outline form, an agent's job description might read as follows:

1. Finding customers;

2. Making the sale;

3. Providing administration from time of sale to policy delivery;

4. Providing service after delivery.

Many agents following that description are having difficulty earning a living. This may lead to a redefinition of the job, a redefinition which should be aimed at attempts to increase productivity. The greatest need is for the agent to be able to make a larger number of sales. To accomplish this, he needs to spend more time in front of more prospects, conducting more sales interviews.

Methods of prospecting is one area in which there will be substantial redefinition of the job. For example, better prospecting methods to reach the lower income portions of the population must be learned if we are to provide coverage for this group. Prospecting systems based on employer sponsorship of the insurance program are a possible method.

Another area in which there may be redefinition is service. The published discussions of my recent paper in the Transactions indicate a variety of viewpoints on service and on whether the agent should perform service.

DISCUSSION OF QUESTION #3

CHAIRMAN INGRAHAM: The 1972 MAP survey, sponsored by the Institute of Life Insurance, contained a series of questions structured to elicit consumer attitudes toward the size of agents' commissions, the perceived effect of compensation on objectivity, and the additional cost incurred by the commissions.

Respondents were asked the following question:

"Let's say a person buys a life insurance policy which he pays for in premiums of $100 a year for 20 years. This comes out to a total of $2,000. How much of all this money paid to the insurance company do you think goes to the agent as a commission for selling you the policy?"

The responses to this question were startling. Although the agent's commission on a whole life policy with a 20-year premium of $2,000 usually falls in the $125-135 range, less than 15% of the respondents made a correct estimate. Over 50% of the respondents were far too high, with the median estimate of all respondents being $258. This is an unfortunate misconception, in view of the widespread impression that the agent sells for the highest commission. The same suspicion was reflected in the high proportion (7 of 10) who questioned the agent's objectivity in making recommendations.

A follow-up question asked whether the agent commission system "adds unnecessarily to the cost of life insurance", or if "the services provided by the agent make it worth the additional money". Nearly 40% felt that the agent adds unnecessarily to the cost, which indicates a significant minority interest in by-passing the commissioned agent, despite his counseling functions.

When asked to explain their attitudes, those who felt that the agent's services are not worth the cost talked primarily about the commission itself, but also mentioned high-pressure selling tactics and the feeling that the agent's services are unnecessary or inadequate. Those who thought the agent does not add unnecessarily to the cost focused mainly on the personal attention and the value of the information the agent provides.

When the public's evaluation of the advantage of having an agent was related to belief in the agent's objectivity, some interesting findings resulted. Among those who thought the commission affects the agent, just under 50% felt he is worth the additional cost. In contrast, among those who believed in the agent's objectivity, only about 20% thought he adds unnecessarily to the cost.

MR. GOLD: I would draw a different conclusion on the public estimate of the relative size of agent compensation. If we compare the present values of commissions and premiums, using interest and persistency, we would find that the public did <u>not</u> overestimate the value of commissions.

MS. RAPPAPORT: The public does value the service of the agent. The 1974 Institute of Life Insurance MAP study states that 68% of the respondents agree with the statement "It would be a mistake to eliminate the life insurance agent, because of his ability to recommend a life insurance program that is right for different people's needs."

I believe that the public wants to deal person-to-person with agents whose advice can be trusted. Most people want an agent who will take an interest in them, personalize his advice, and provide continuity of service.

CHAIRMAN INGRAHAM: It should be noted that the NAIC's Model Regulations for Variable Life Insurance require written disclosure of sales commissions, expressed as a percentage of the annual gross premium for each year and for the life of the VLI policy.

Also, the Fiduciary Responsibility provisions of the recent pension reform legislation may place many life insurance agents in a fiduciary capacity if they "furnish investment advice to a plan for compensation, or have authority or responsibility to do so". It is possible that such

an agent will be required by the Department of Labor to disclose to the employer or plan sponsor, at the time of sale, the amount of commission and/or fee income that he will receive, as a condition to receiving such compensation.

DISCUSSION OF QUESTION #4

MS. RAPPAPORT: One of the major weaknesses of the present compensation system is the vastly different compensation for different product solutions to the same need. This is a particular problem when a choice between term and permanent, or term and "minimum deposited" permanent, must be made.

MR. HUTCHISON: The impaired neutrality of the agent (when his contract motivates him to sell particular policies, whether that's what the client needs or not) does not result so much from the objectives of the compensation system as it does from mechanical flaws in the system.

A company may have an objective of complete neutrality of the agent and still encounter these problems. For example, my company recently discovered that an agent could receive a larger dollar commission for a whole life policy than for a thirty-payment life policy of the same amount at the same age. When we had established our commission scales some years ago, the relationship between the OL and L30 premiums was considered in ensuring consistency. In the intervening years the differing movements of the interest, mortality, persistency and expense elements have radically changed the relationship between premiums on the two plans.

Unless we adopt monstrously complex and ever-changing compensation systems that no one will comprehend, we'll continue to have these inconsistencies.

Even if we eliminated real inconsistencies, I doubt that we would rid ourselves of imagined ones. One of the often-cited criticisms of our industry is that an agent receives maybe $100 for selling a $10,000 Whole Life policy, but only maybe $25 for selling a $10,000 Term policy, and will therefore try to sell the Whole Life policy. The statement is probably impossible to categorically refute. However, it ignores the economic reality that it's easier to pay the agent $100 out of a $200 Whole Life premium than it is to pay him $100 out of a $50 Term premium. One might just as well argue that by paying $100 for a $40,000 Term policy and only $25 for a $10,000 Term policy, we bias the agent in favour of the $40,000 sale.

The criticism also overlooks the fact that, by selling the policy with the $200 premium (either the $40,000 Term policy, or the $10,000 Whole Life policy, or something in between, depending on the client's needs) instead of the policy with the $50 premium, the agent is performing a greater service, not only for himself and for the company, but also for his client.

There's an interesting contrast between the attitudes of companies and the attitudes of agents concerning these inconsistencies. Home office personnel tend to believe that agents will always gravitate toward the plans paying the highest remunerations; i.e., if an inconsistency exists between two plans, agents will always sell the high-commission plan.

Frankly, most agents don't understand their contracts, or their ratebooks, that well (an interesting testimonial on agents' contracts as a motivator).

Those that do, strongly resent the company's making their interests diametrically opposed to those of their clients, a dilemma which the knowledgeable agent will resolve, as often as not, by selling the contract that is best for the client, and hating the company for it.

Any product bias in an agent is usually created, not by contractual commission differences, but rather by incomplete product knowledge or by biases instilled in him by the training he has received. If a company doesn't offer a full range of products, a new agent's training will obviously bias him in favour of the products his company sells. Those agents of that West Coast company don't sell so much term insurance because they are more ethical than other agents, or because their contracts are biased in favour of term insurance. They sell it because they are trained to sell it.

The consumer is much more affected by the way a company regards and treats its agents than by the mathematics of the remuneration system. If a company considers its agents as policy peddlers, then that is what the consumer will get. The service rendered may be less expensive but will also be of much lower quality than if the company considers the services of a competent agent as a vital ingredient in its "product" and gears all its efforts, not just the compensation package, to this end.

MR. GOLD: There are all kinds of agents, with different motivations; whether we like it or not, we must admit that many agents will look first at the compensation level in deciding what policy to sell.

MS. RAPPAPORT: The Section 213 limits on term insurance commissions are definitely against the interest of the public. It is very difficult for an agent to earn a living selling term insurance. If term insurance is good for the public, then the distribution system should be such that the agent can afford to sell it. As a minimum, the same commission limits should apply to term and whole life.

MR. C.F.B. RICHARDSON: The limitation, under New York law, of first year commissions on term insurance has always seemed to me totally unjustifiable; I have never seen any rationale which would support that limitation.

MR. PETER F. CHAPMAN: A number of consumerists have made the statement that paying first year commissions at the same percentage of premium for both term and permanent insurance is in the best interest of the consumer since it removes the agent's conflict between his own economic interests and the welfare of his client. This statement is true only to a limited degree. It is based on the premise that the agent sells on the basis of the amount of premium dollar which he feels is available, or can be made available, for life insurance.

The fact of the matter is, however, that many agents are trained to sell on the basis of need for protection, as they ascertain that need. This determination of need ranges from "kitchen table" planning to sophisticated computerized estate analysis. The agent who sells in this manner will always have his own economic parameters to think about when recommending an insurance program involving varying combinations of term and permanent. The weight which he gives to his own interest will vary considerably from agent to agent.

MR. GOLD: With respect to minimum deposit selling practices, agents like the minimum deposit sale because they get whole life commissions while making a term sale. That is understandable as a by-product of the existing commission structure. But why companies permit a situation where the first year cash value plus commissions plus dividend is greater than the premium is beyond me. How can this be rationalized? Agents can finance the sale and make money.

MR. THOMAS J. KELLY: A few years ago, one of our examining actuaries at the New York Insurance Department advised me that, when he brought this situation to the attention of the president of a young company, the latter appeared shocked, and immediately set out to correct the situation.

MR. HUTCHISON: The experiences of some of the "pioneers" in the minimum deposit field who introduced, to their sorrow, products with commission plus first year cash value plus dividend greater than the premium, should have taught most of us a lesson. Also, I wonder whether the disappearance of some of the independent computer firms, which specialized in the "round and round the mulberry bush" type of minimum deposit schemes, lessened activity in this field; it certainly must have caused some enormous post-sale service problems for agents and clients who were relying on such firms to tell them where the next premium was coming from.

CHAIRMAN INGRAHAM: Although computer illustrations based on "minimum deposit" or "piggy backing" marketing approaches may produce substantial sales, such practices also may result in a significant number of lapses or replacements if the selling agents subsequently leave the company and the purchasers then discover (through unsuppressed premium notices) what the coverage really costs.

MR. GOLD: The IRS's 4 out of 7 rule makes these minimum deposit plans more difficult to sell than formerly.

CHAIRMAN INGRAHAM: Many policyholders maximum loan their policies in every year and deduct the loan interest - adopting a "catch-me-if-you-can" attitude with the I.R.S.

On the subject of commission biases in the marketing of pension products, there are four that readily come to mind:

(i) Individual policy pension trust (IPPT) vs. group pension
(ii) Tax-sheltered annuities (TSA's) - individual vs. group products
(iii) Fixed annuities vs. variable annuities
(iv) IRA market - Retirement Income contracts vs. annuities

Companies marketing both IPPT plans and group pension plans such as IPG's or deposit administration group annuities are confronted with the problem of maintaining some form of consistency in commission payments. Consistency does not necessarily mean equality in dollar amount. A commission difference between IPPT and group pension plans often may be justified because the agent is (or should be) performing services which save the company expense elsewhere.

Nevertheless, a company may be well-advised to impose an upper limit (in terms of covered lives, volume or first year aggregate contributions), beyond which group annuities and not IPPT's will be deemed the appropriate

funding vehicle. This could help to remove any "competition" as to commission sales.

Another troublesome area relates to the prevailing practice under IPPT's of using the pension trust commission scale without any grading adjustments for plan size when additional coverage is issued to existing plan participants as a result of salary increases or benefit liberalizations. Increases in pension trust coverage occurring after issue often involve more of a servicing than a selling effort; it is difficult to justify paying 50% first year commissions on such small policies. On the other hand, the servicing of IPPT plans may involve a considerable amount of time and effort; a strong argument can be presented for paying service fees transferable to the agent actually assigned to servicing (or, in some cases, conserving) the case.

In TSA situations - particularly in the case of large city school systems or universities - one insurer may not be the sole carrier. More important, since the majority of plans are employee-pay-all using "before-tax" dollars on a salary reduction basis, enrollment of eligibles is discretionary and involves intensive individual selling effort on the part of agents.

Both group and individual fixed and variable annuities are made available for such TSA cases. While the group and individual annuities differ in the usual ways with respect to policy provisions and extent of guarantees, the overriding difference is really the lower sales loads imposed on the group TSA contracts. However, if essentially the same enrolling effort is required regardless of which vehicle is used, from the annuitant's standpoint a case can be made that agents may not be adequately compensated under group TSA's to provide the same degree of personal service as would be the case under individual policy TSA's.

Some companies have priced their variable annuities on a low and level load basis, with essentially flattened commissions at the mutual fund level. In a number of cases, these companies have continued to offer fixed-annuity contracts with high "front-end" loads and substantially fronted commissions. This situation creates a marketing bias.

A similar situation exists today in the IRA market, to the extent that companies are marketing Retirement Income contracts (with relatively high first year commissions and relatively low early-duration cash values) together with annuity contracts (with relatively low first year commissions and a level load structure).

On these IRA products, a relatively high early-year policy lapse rate is likely, since many IRA policyholders will become active participants in qualified plans. This raises a question as to the suitability of Retirement Income policies in this market - due to the relatively low early-year cash value compared with the total premiums paid.

MR. GOLD: The company actuary is responsible for informing top management of such commission biases.

DISCUSSION OF QUESTION #5

CHAIRMAN INGRAHAM: During the past ten years, in the marketing of individual policies, we have seen a decline in premiums per $1,000 of in-

surance, a higher average size policy, an increase in "minimum deposit" business and a pronounced shift in the mix of term and permanent insurance. Also, starting allowances for agents under Training Allowance Plans have dramatically increased, thus making successful validation more difficult. All in all, there is considerable evidence in the industry that agents' earnings have not kept up with inflation.

However, at New England Life (NEL) at least, where there is a heavy marketing emphasis placed on sales to executives and professionals of business insurance and pension trust plans, the evidence appears to run counter to the industry trend.

Consider the following table, comparing the increase in the Consumers Price Index (CPI) to the increase in the NEL non-pension average policy size over the past 20 years (CPI indexed to 100 in 1967):

	CPI	NEL Avg. Pol. Size
1955	80	$10,000
1965	95	18,000
1975	145	37,000

Moreover, not only the average policy size outpaced the CPI; the average premium and average first year commission per sale at NEL did so as well.

Why has this happened? Probably because of NEL's increased emphasis on sales to sophisticated customers. However, this type of marketing strategy earns a price tag - a shrinking market base and a continuing difficulty in developing and retaining young agents.

MR. GOLD: Whether the agent is keeping up with inflation depends on the class of agent; sophisticated agents who cater to the corporate and deferred compensation market are doing well. Personal-producing general agents have also been keeping pace with inflation. Other agents have not.

MS. RAPPAPORT: Inflation is resulting in an abandonment of the small policy sale. It is essential that we find a way to service the lower income markets and to sell smaller policies. Different methods of prospecting and mass marketing may provide a solution. The public believes that it has a right to adequate support of dependents upon the death of the breadwinner. If private industry does not provide the insurance product for such support, then people will look to the government for the coverage.

MR. KELLY: I agree with Mrs. Rappaport. If the industry abandons the small policyholders, there will be demand for death benefits for this segment of the community through some other vehicle, such as expansion of Social Security. We have seen a trend by private insurers away from the small policy (industrial and monthly debit) markets. Continued inflation has made the cost of many small, individually-underwritten policies prohibitive. Has the industry exhausted all possibilities for mass merchandising such policies?

MR. HUTCHISON: We could keep our agents in the lower income markets by giving them more help with what we have traditionally considered their job. Instead of relying entirely on the agent to prospect for his own clients, we could do some of his prospecting for him. This would mean more effective use of his time in that he would be selling more, prospecting less.

During inflationary times we in the Home Office can help our agents more by improving their effectiveness than by simply paying them higher commissions. If you have $100,000, and try to spread it among 1000 agents by increasing remuneration, each agent receives $100 - hardly a cure for inflation. If, instead, you spend the $100,000 for some new product or support facility so that each agent sells $10,000 more insurance, you accomplish the same thing, with the potential for accomplishing much more.

DISCUSSION OF QUESTION #6

MR. HUTCHISON: The difference between the sales charges of life companies and those of other financial intermediaries is not due to the fact that our companies are forced to deal through agents while other financial companies are not. Banks and trust companies have their distribution costs too; somebody has to pay for those branch offices on every corner. Rather, the difference is because their method of allocating their costs among the users of their services is quite different from ours. This results from the thinking process fundamental to the financial intermediary.

A financial intermediary is a capital mobilizer. It brings together the people who have money and the people who need money, and makes its profit on the "spread" between what it charges the borrowers of money and what it pays the providers of money. That's how a banker thinks, and it is therefore perfectly logical, from his point of view, to recover his costs from that spread. He has no hang-ups about equity among generations of depositors, or between persisting and terminating depositors. As long as the spread is sufficient to cover his costs, including distribution costs, he sees nothing wrong with attracting new money with the "no-load" pitch and charging the costs of attracting that money to his old depositors, or to the widows and orphans, whose funds we dutifully deliver to the bank or trust company when our policyholders die.

The philosophy and the distribution system of the mutual funds is a little closer to ours in that they pay commissions to their field men as we do. However, their thinking is firmly locked in the perspective of agent as peddler; we've all seen how ineffective their system is in maintaining a knowledgeable community of mutual fund agents when the market falls out of bed.

A life company, on the other hand, is not, I submit, a financial intermediary! Despite the views of some of our associates in investment departments that a life company is a big asset management pool, with an unsightly weight on its rear-end through which the money flows, the primary function of life companies is not the mobilization of capital.

It is true that we do mobilize long-term capital, capital which might not otherwise be mobilized and which makes a major contribution, both economically and socially, to the societies in which we do business. However, this is merely a by-product of our primary function, and one for

which we are unlikely to ever be given the recognition and credit we think we deserve. One only has to visit one of the capital-hungry countries in the Caribbean or elsewhere to hear well-meaning, but perhaps poorly informed, politicians tell us what a lousy job we do in mobilizing capital as compared to other financial intermediaries. In the short term, and that's what counts in their minds, they're right. They can't wait for the long term, where our performance is impressive.

Our primary raison d'etre is not the mobilization of capital, but the establishment of programs of future financial security for individuals. In the performance of that function, the existence of a community of competent agents is vital.

Moreover, we have this fetish for equity, generated largely by actuaries, which leads us to the conclusion that the cost of maintaining this community of agents should be borne by those who avail themselves of its services. Since most of these services are rendered when a policy is purchased, we charge the cost of these services to the buyers of our policies in the form of a "front-end load". Thus, instead of forcing the persisting policyholders to pick up the tab for the in-and-outers, as do the banks, we attempt to charge each policyholder equitably for the services he receives, whether he persists or not. In our eyes, that's fairer than the way the banks do it.

MS. RAPPAPORT: In any management system, compensation is one of the strongest methods of motivating the compensated person. Under current agent compensation systems, the strongest incentive is for new sales; much less incentive is provided for persistency. We need much stronger incentives for persistency.

However, I am opposed to the leveling of commissions. New agents have a difficult time earning a living and making it through the transition period from salary to full commission. Leveling would simply result in the need to increase the financing provided for new agents, and it might also make it necessary to lengthen the period. I believe that compensation should be tied to the desired results, but that compensation for making the sale should be paid at the time of sale or shortly afterwards. I am also in favor of including substantial persistency factors in time-of-sale compensation.

MR. KELLY: High first year commissions may also be partly responsible for twisting. A more level scale of commissions might reduce the temptation to twist life insurance policies.

MR. GOLD: We are "boxed-in" by the current system; because of competition it would be very difficult to reduce first year commissions unless perhaps compelled to do so by a 213-type law.

On the subject of vested renewal commissions, I would prefer a totally non-vested scale. Renewal commissions are not a form of deferred sales compensation. Unfortunately some companies, especially smaller companies, must pay vested commissions in order to obtain business.

MS. RAPPAPORT: I believe that vesting is against the public interest. A discussion of vesting and renewal commissions appears in the paper I presented last year. The key topic which must be considered in such a

discussion is the purpose of renewals and whether or not renewals are accomplishing that purpose.

MR. KELLY: I agree that non-vested commissions could be beneficial, at least to the company and the insured, particularly if there was a leveling of first year and renewal commissions. Transferable renewal commissions would then receive public acceptance as compensation for continued service to the policyholders. A terminated agent with vested commissions will normally not offer services to policyholders who remain with the insurance company which he left. From another viewpoint, non-vested but transferable commissions might be used to assist a new agent in getting started in a given locality. This could reduce the required level of subsidy while he is being trained. I believe this approach is used by some property insurance companies.

MR. HUTCHISON: Many companies are attempting to create incentives for persistency with persistency bonuses. Do such bonuses work? My answer would be a qualified yes (or maybe a qualified no?). You cannot simply slap a persistency factor into the agent's contract and say, "There! We've solved our persistency problem." To improve persistency requires a long, hard fight on many fronts to create an awareness of quality business.

On the other hand, if you do embark on such a program to cultivate an attitude, you had better put your money where your mouth is. Otherwise, the field won't believe that you're sincere.

My company has found that persistency incentives are more effective at the manager or G.A. level than at the agent level. If your manager is persistency-conscious, he'll create the desired attitude among his agents. Without him, you're dead.

Further, the persistency incentive should be an integral part of the compensation package, rather than simply an add-on. You simply cannot afford to make the add-on big enough to divert the agent's attention from his primary source of compensation - sales. On the other hand, if you build the persistency incentive in, so that you pay more for the sale of good business than for the sale of bad, (or even penalize for the sale of bad business), you will get better results.

MR. GOLD: Caution is necessary on the way persistency incentives are built in; otherwise you may pay more than expected when persistency improves. Another imperative is that the bonus formula be a simple one. I've seen so many situations where a good agent sours on the company because of a misinterpretation of the company's formula.

MR. CHAPMAN: Mutual Benefit began paying a persistency bonus in 1974. The bonus is based on each agent's persistency in relation to total company persistency for the year in question. While this measure does have certain shortcomings, it is readily accepted by the field force as a realistic standard. This acceptance outweighs the advantages of a more rigorous absolute standard. In applying the actual to expected ratios, each of the first 10 policy years is considered separately within each of three major categories: permanent, term, and qualified pension and profit sharing business. The agent actually receives three separate bonuses, each of which eventually will be based on ten full years of expected persistency.

We have realistic hopes that our persitency bonus will, over a long period of time, improve company persistency. I have heard some actuaries and marketing officers pronounce their persistency bonus program to be a failure on the strength of what I believe to be an inadequate test period.

In the opinion of most knowledgeable people, persistency is determined at the time of sale. If an agent is motivated by the prospect of potentially increased income resulting from more persistent business, it will take him some time to change his selling style and still more time to develop a significant book of business written with his new attitude. Overall company results thus won't be affected for quite a while.

Persistency bonuses are also helpful in recruiting and training new agents since the general agent will make the persistency bonus an integral part of his recruiting presentation. This, in turn, will gradually contribute to the accumulation of a more persistent in-force.

MR. RICHARDSON: I have never seen any proof that the introduction of a persistency bonus improves persistency, which I believe is determined at the time of sale. This does not mean that I am opposed to persistency bonuses. On the contrary, the agent who writes high quality business should be paid more than the agent who writes poor business.

DISCUSSION OF QUESTION #7

MS. RAPPAPORT: As discussed in my recent paper on agent compensation, I believe that expense and commission regulation is a good way to handle the question of fair value for a life insurance policy.

MR. GOLD: The regulation of fair value is a legitimate concern of government, but I worry about a growing, stifling, and self-perpetuating bureaucracy. But why only life insurance? An equally compelling case could be made for cosmetics, drugs, etc. I'm also unhappy with the concept of expense control, particularly with respect to nonparticipating business, since what happens after the sale doesn't affect the consumer. With respect to participating business, it is a different story since obviously expenses affect dividends.

Rather than a law limiting expenses, I would prefer a regulation dealing with a product's loss ratio. It works with health insurance and I see no reason why it could not work equally well with life insurance.

There were good reasons for the introduction of Section 213 in 1907, in view of all the questionable activities that abounded. However, today, some sixty-eight years later, conditions are far different and I question the need for its continuation. I'm particularly unhappy with those sections of the law dealing with expense reimbursement. Companies expect to pay out a certain percentage of the premium for expenses. If a general agent's expenses are low, he has no alternative but to fake expenses. What a horrible situation, a law which makes honest people become liars.

If we need a law limiting expenses, why not one that does so in toto.

We really shouldn't care whether a company distributes the product through a management system, general agents, or personal-producing general agents.

Section 213 should be repealed, if not in its entirety, then certainly those aspects dealing with expense reimbursement. The New York Insurance Department has much more important things to do than to snoop around in a company's expense vouchers.

MR. KELLY: No statute or regulation can guarantee honesty. If some fake expense vouchers have been submitted under Section 213, this should not be considered as justification for summarily repealing the statute. It probably indicates that the statute should be completely restudied and, if necessary, overhauled. As I recall, a few years ago the New York Insurance Department held some meetings with industry representatives to discuss alternate approaches to meeting the objectives of the statute. However, there has been no activity of this kind since that time. Of course, a comprehensive restudy of Section 213 would require a great deal of time and effort by many actuaries, attorneys, and other life insurance experts. I feel that it would be worth the effort.

It is my understanding that Section 213 has a very significant indirect effect on sales compensation outside New York State. For example, I have heard that many well-managed companies which are not subject to the limits of Section 213 pay first year compensation to agents (and general agents) that is just a few percentage points of premium higher than the total amounts of commissions, overrides, and expense reimbursement allowances payable to general agents of New York-licensed companies. A possible explanation may be that the cost of these compensation and allowance programs must ultimately be borne by the policyholders. Therefore, a company which sustained significantly higher sales expenses would eventually have to reflect them in the increased cost of insurance and thereby make its products less competitive.