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MARKETING DISTRIBUTION SYSTEMS

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1. Alternate marketing styles and inherent compensation methods - present and future.
   a. Career agent
   b. PPGA
   c. Direct mail
   d. Over-the-counter
   e. Multi-line broker

2. Marketing profitability from perspective of the company, sales manager and producer.

MR. WALTER S. RUGLAND: Our task this morning is to gain additional perspective on the topic of marketing distribution systems in the life insurance business. Initially the panelists will introduce themselves and give an indication of their own perspectives.

MR. PAUL McCROSSAN: Canada Life is a medium sized Mutual Company operating primarily in four countries, Canada; the United States; the United Kingdom; and the Republic of Ireland.

In the United States we operate using a combination of General Agents, PPGA's and Career Branches. In the United Kingdom and Ireland, we operate solely using the Career Branch setup. In Canada we have 45 regular branches with a field force of 550 agents; three brokerage offices and two large PPGA's.

Since all of my remarks from this point on will be directed towards the Canadian operation and since I expect our distribution of business to be considerably different from most U.S. companies, perhaps I could outline our current distribution of ordinary business and how it has changed over the last five years.

Five years ago, just over 80% of our total ordinary new business was ordinary insurance; approximately 15% of the production was ordinary annuity; 2% was individual health; and 3% was individual segregated fund business.

Over the last five years our ordinary insurance business has grown by 110%; our ordinary annuity business has grown by 370%; our individual health business has grown by 550%; and our segregated fund business has grown by 310%. Last year individual insurance represented only about 2/3 of our ordinary production. This rapid rate of expansion in the non-individual life areas was deliberate. When we talk about profitability, I will try to outline the steps we took to establish profitability standards and how these led us to expand the non-life lines quickly.

MR. ROBERT WHITNEY: National Liberty Corporation is a holding company whose ownership includes five insurance companies. We specialize in the

marketing of individual life and health insurance policies with major emphasis on direct response marketing techniques which include some success in association and third-party groups. Some of you will recall newspaper supplements featuring Art Linkletter as a spokesman for our supplemental hospital indemnity coverage. Such coverage is our biggest seller. We also have a vigorous agency operation.

The company was founded by Arthur DeMoss in 1959, and its first efforts were directed at direct response marketing of hospital indemnity coverage to teetotalers. The purchase of National Home Life Assurance Company in December 1969 paved the way for dramatic expansion on a broader market basis which includes both direct mail and space advertising techniques.

Direct response premium income in 1976 exceeded $115,000,000 with about $15,000,000 from life insurance products and about $75,000,000 from hospital indemnity coverages and the balance from other forms of A&H. We are headed for direct response premium income in excess of $150,000,000 in 1977.

National Home, when purchased, had an agency operation selling through super general agents. This phase of the business has had a rapid growth rate in the last few years. We also have a career agent operation which was formed in January 1974 and operates in 13 states. Initially sales were based on leads developed from direct response policyholders. This method has been retained but is no longer a mainstay. Total agency premium income is currently about $20,000,000 a year, expanding at a rate in excess of 30%. About two-thirds comes from the super general agents and about one-third from the career agents.

In my later comments I will emphasize direct response, but also speak to brokerage, a la super general agents and career agent methods of distribution.

MR. ROBERT WILLETT: I come from a holding company, Jefferson-Pilot Corporation. I am in the Pilot Life Insurance Company side of it, but because I am in a holding company I can say that I represent both the managerial operation of Jefferson Standard and the "building general agency" operation of Pilot Life. Some of you who compete with us know that we do have two or three producing general agents; they are a minimal part of our operation.

My bias is toward building general agents. For illustrative purposes, draw a line across a spectrum with the manager on one side and GA on the other side. Look at the characteristics of either end of the spectrum.

A pure GA operation is one where you pay the general agent for a unit of business produced and that's all you pay him. He is responsible for agent financing and expenses. Whatever he wants to spend out of that money you give him he spends; whatever he wants to take home, he takes home. If he does not sell what you want him to, you have one choice, terminate his contract. You have no other choice, unless you can morally persuade him. You cannot do anything with your financing or change his compensation to tell him to do it your way.

On the pure managerial side is the person who is strictly on salary and takes orders from the home office. It does not matter how much he produces or how little. It does not matter how well he does his job or how poorly. He takes no risks, you cover all the expenses.

Neither one of these extremes exist today as far as I know.

On the GA side most of us come to some point where we share expenses. We come to some point where we subsidize it at least in the beginning. We do not like to call it salary, but it is like one. We have come to the point where we give him some pretty strong direction. We pay him for what we want him to do.

Managerial companies have also moved toward the middle. They have put some incentive bonuses into their program, and some of them have even charged managers for some training allowance losses and some expense allowance overruns.

Now, what you call yourself may not be what you are. We called ourselves a building general agency company prior to 1973.

In 1971 when we started an intensive study of our compensation program in order to change it, we found out we were not a building general agency company. Our general agents supposedly have training allowance risk. We found out that we collected a total of $1400 back from them in 1971 and 1972. That is for 34 general agents. That's no risk. The GA had no expense risk. We paid the expenses in his office and told him what he could spend in his office. So he had no expense risk. We began to realize that we didn't have a GA, we had a manager. We have changed that. Today our GA has a significant training allowance risk and a significant expense risk under our compensation formula. We have a building general agent today. Not a pure building general agent, because you quite frankly can find few people who can afford to be a pure building general agent anymore.

When we get into the second part of this program, I'm going to comment on where profitability comes and goes in these two operations. I wanted you to understand where I'm coming from. I'm coming from an agency department of a company that for many years called its people building general agents. Starting in 1973 we actually made them building general agents. And also, I come from an organization that calls its people managers, and they are managers, despite the fact that they have some of those little extra incentives that bring them off the far end of the spectrum.

MR. RUGLAND: We will now move on to item two of this topic of the session's agenda. Our purpose is to develop concepts on profitability and then talk about implementation, the subject of item one.

MR.WILLETT: We are looking now at marketing profitability from the perspective of the company, the sales manager, and the producer.

In the "career shop," it has been my experience in studying other company compensation patterns that there is not a great deal of difference between the managerial company and the building general agency company, if

you define profitability to the producer as to what he can take home. This is proved, in my opinion, by those companies that run both types of operations. There are a number of companies that have some managerial agencies and some building general agencies.

We are all aware that it's the net that counts to the individual producer and not the gross. There are very few individual producers who take home the gross compensation that the company pays them. I am not looking at it from the IRS point of view, but I'm saying in actual fact, individual producers do have honest expenses which they must take out of their gross compensation. I contend that the net compensation to the actual first line producer is not dependent upon the managerial system he's under, whether it be the building general agency or the branch manager approach.

It will, of course, in the case of a PPGA, but even there in the role as a first line producer, I contend the compensation does not differ radically. The extra money is provided to supply managerial services that in a building GA operation would be supplied by someone else. So, I think the first line producer is not drastically affected, at least for direct sales compensation, by either managerial system.

Now let's look at it from the sales manager point of view. I think the best way to illustrate the profitability from the sales manager's point of view is to point out that there is hardly a successful branch manager in the United States today, running a big branch, who, given the choice and the option to take that branch along, would not convert to a building general agent's contract. The building general agent's contract is more profitable to the sales manager in a successful operation. If it's not, it's not a very good contract; it is not doing what it was designed to do. A building general agent's contract should be designed to give an incentive to build a big operation. The risks of starting out as a building general agent are large enough and the lack of profitability in the early years is great enough, that if there wasn't a chance to make more money on a successful operation, no one would ever do it.

It is my belief, based on a review of the compensation of a great number of companies, that the opposite is true. If you are a branch managerial company, the profitability relative to performance, of a branch manager, is actually greatest in his early years during the building. That is why almost every building general agent, in the early years, who is struggling, if given the option to take his organization with him, would gladly trade contracts for that of a managerial company. I believe that over the long run in any medium-sized company, there is no significant difference in the total profitability to all sales managers provided by the different systems.

A great number of authorities disagree with me on that point. Some say that the losses incurred in the formative years by the building general agents are much smaller than they should be if they took the kind of risks they should in return for the kind of returns they may get. From that point of view, they give up less in the early years and, if successful, get more in the later years. On an overall basis from a profitability viewpoint, of the manager himself, the authorities say the building general

agent has the better deal.

That may be true, but I can think of 16 people in the last five years who would certainly never believe that. They are the 16 men with the Pilot Life in the last five years who didn't survive the first two years of their general agents contract.

From the point of view of the company, I believe that you will find it's more expensive for a company, or less profitable, to start a branch manager. Our general impression is that most anybody that we would like to bring on board as a building general agent, could begin at more net compensation with a comparable managerial company. So from the point of view of the company, if you're a newly growing company, I think that the branch manager system is going to cost you more in the early years.

Those same newly growing companies are making the building general agent system cost them more in reality, because in their desperate scramble to get one of those few people from the small pool of potential building general agents, they take a lot of people who lack the potential. For that reason their approach is expensive. These companies spread that word around, and people who are looking at the idea of starting career shops say, "building general agencies are too expensive in the early years; count me out." Having not gone that route, they never know whether or not they made the right decision.

If you are a company on a building GA approach, that is getting a significant portion of your business from highly successful large-size agencies, you are probably making a smaller profit than a similar company getting a large portion of their business from highly successful large-size branch managerships. Because, just as I said that almost any highly successful large-size branch manager would trade his contract for that of a building general agency, because it would be more profitable to him, it must follow that it would be less profitable to the company involved.

We see this in looking at the two organizations in our holding company. We at the Pilot Life are concerned by how little we feel that we can pay a new building general agent. This makes it tough for us to get one. The Jefferson people look at us and they are concerned by how much our successful building general agents are making because it gives them trouble with their managers. Their managers are always telling them about general agents who are producing the same amount of business but are making much more. They quietly and calmly forget the formative years when the building GA was making much less than they were.

MR. WHITNEY: I will be presenting some statistics which relate to the marketing efficiency or, in terms of the agenda for this discussion, the marketing profitability to the company of various distribution systems. As mentioned earlier, National Liberty Corporation provides the actuary with the opportunity to work with many distribution systems including direct response, brokerage (super general agents) and career agents. The latter is similar to Industrial in some respects but not in all ways.

You will see from my charts that direct response, among these three methods of distribution, tends to have the lowest ratio of marketing costs to

premium on a discounted basis over a twenty year period. This may not surprise many of you. As a generalization, it seems to be accepted -- among actuaries, at least -- that successful direct response methods can result in lower marketing costs. Still, I hope that having specific figures before you will be helpful and be of interest.

First, some caveats. The comparisons ignore the fact that claims experience is usually higher for direct response than for agency operations. Next, some part of agents' renewal commissions could be thought of as a service fee, although I doubt that the lack of agents adds much to direct response operating costs except indirectly in underwriting. Premium amounts are not the same... and there could be other caveats. I refer you to Chart I.

CHART I

WHOLE LIFE MARKETING COSTS

	Direct Response (Birthday Whole Life)	Brokerage	Career Agents
Commissions	None	Year 1 100% Years 2-10 10% Years 11+ 3%	Year 1 63% Bonus averages in all years 3%
Sales Costs	Low: 62% of new paid Annualized Premium High: 85% of new paid Annualized Premium	13% of new paid Annualized Premium	45% of new paid Annualized Premium
Lapse Rates	Year 1 25% 2 20 3 15 4+ 10	Linton B	Linton C
Interest	7% for 5 years, graded .1% per year, thereafter to minimum of 6%		
Ratio of Total Marketing Costs to Premium (Discounted-20 Years)	Low: 13.8% High: 19.0%	25.0%	27.3%

Birthday Whole Life is a traditional whole life policy which is offered by mail to existing direct response policyholders, most of whom are hospital indemnity owners. The offer is made prior to the birthday with an enticement to buy before the premium goes up. Response rates have been high enough so that typical marketing costs range from 62% of an annualized premium to 85%.

Commissions and sales costs on the agency side may be self-explanatory. Our brokerage super general agents obviously involve much less home office support, supervision, training and recruiting activity than career agents -- 13% of new paid annualized premiums versus 45%.

You will note that marketing costs as a percent of premium over a twenty year period range from 13.8% to 19% for direct response. This compares most favorably with the 25.0% for brokerage and 27.3% for career agents.

CHART II

	Direct Response Hospital Indemnity	Brokerage Annual Renewable Term	Career Agents Guaranteed Issue Hospital Indemnity
Ratio of Total Marketing Costs to Premium (Discounted - 20 years)	14% to 18%	17.9%	28.4%

Our direct response hospital indemnity product tends to have a better ratio of marketing costs to initial annualized premium than Birthday Whole Life, but then persistency is definitely not as good. So, related to twenty years of premiums marketing cost ratios are about the same for both products....in the range of 14% to 18%.

Our Brokerage Annual Renewable Term has a relatively favorable ratio of marketing costs to twenty years of premiums, namely, 17.9%. A high commission rate is paid only on the first year's premium and, of course, the premiums increase each year. Also we assumed favorable persistency starting at 15% and grading down to 5% by year 9. Based on the experience other companies are reporting after the first year, there is a question as to whether we will be able to achieve this.

We recently introduced a guaranteed issue hospital indemnity policy to be sold by our career agents. Commissions are less than on our Whole Life policy, but then persistency is expected to be worse. Thus, marketing costs as a ratio to twenty years of premiums are about the same for both products, namely, 28%.

As a closing thought, I might point out that the assumed sales costs in agency are goals which have not yet been achieved. Both brokerage and career agents are on target, although the latter is in a start-up phase and has a large gap to make up.

QUESTION FROM FLOOR: What do you include as marketing costs in the direct response category?

MR. WHITNEY: The cost of developing advertising and mailings that go out, postage, and a little bit of issue expense. We have about $10 per policy that gets included as an issue expense and part of our marketing costs because of our bookkeeping. But basically, other than this $10 issuance cost, it's the cost of getting the word out to the prospective buyer whether it's direct mail or advertising supplements in the newspaper. In our own internal bookkeeping sometimes we do this with overhead and sometimes without.

Those figures I presented do include a fair amount of overhead within our marketing operation.

QUESTION FROM FLOOR: Was that direct response to new markets rather than your own policyholders?

MR. WHITNEY: We work on both methods. We get a better response rate as a general rule dealing with our own policyholders. But, newspaper and supplements are a broad market. We get lists that we work with that would not be our own policyholders. We are into association third party groups where we have an endorsement and of course, these are not our own policyholders, so we work both methods.

QUESTION FROM FLOOR: Do your figures reflect the range of these markets?

MR. WHITNEY: Yes, that's part of the reason I gave a range.

QUESTION FROM FLOOR: What is the breakeven response rate?

MR. WHITNEY: That is hard to generalize. It really varies by product and whether it's a deviated premium and whether we are going to get a policy continuing on a regular basis. I don't have a simple statistic on that. In terms of ratio of annualized premiums to marketing costs, we do well at a 2 to 1 ratio, 50% in terms of marketing cost of premium. There are some products that we make a satisfactory profit with close to 1 to 1 or 100%.

QUESTION FROM FLOOR: Is that first year premium?

MR. WHITNEY: Yes, that is first year premium. That combines the response rate, marketing costs, renewal rate and average premium.

MR. McCROSSAN: In the Canadian Division of Canada Life, we have developed a simple conceptual framework both for pricing and for measuring profitability.

Up until five years ago, Canada Life was organized traditionally into corporate areas and three sales divisions - Canada, the United States, and the British Isles. However, these sales divisions were just that; they were not marketing divisions. All pricing and profitability analysis took place in the corporate actuarial area.

The sales divisions measured their success primarily in terms of the growth in adjusted new annualized commissions - what we call new business credit or NBC. They viewed their job as getting as great a sales volume as possible - without being overly concerned with costs or profits.

The corporate actuaries, however, measured acquisition unit expense costs in terms of volume and had many different rules to equate one plan to another plan. For example, term insurance had a volume credit of 1/2 the sum assured, whereas whole life had a volume credit of the full sum assured. They determined unit costs retrospectively and, since they had no great say concerning either agency sales objectives or expense budgets, tended to price conservatively to compensate for the known profligacy of the agency division.

The corporate actuaries "knew" the agency people were loose with money and protected against it. The agency men "knew" the actuaries were pricing with many hidden margins.

In 1971, we reorganized the company to create three marketing divisions. Each marketing division had within it its own actuarial and research staff and was responsible for both product design and profitability.

But just what is profitability? On a total company level we concentrated on statutory profits (after setting up full net level premium reserves for our ordinary insurance). However, when we got down to determining the profitability of an individual product, it became apparent that the most fundamental point was the allocation of expenses. By choosing a specific allocation of indirect expenses, we could make any product look profitable; by choosing another, we could make it look unprofitable.

Consider for a moment the allocation of my salary. The vast majority of my time is spent on what is loosely called new business acquisition. This means that my salary must be assessed to the products we sell as a new business expense. However, how should it be assessed to the various products? By volume? Per policy? As a proportion to commission? Or as a percentage of premium?

The answer is not at all obvious. If an agent sells an additional term policy, in the short run my salary does not increase. That is, it is an indirect expense. However, presumably if I am a successful product designer, new business increases in aggregate because of my efforts.

Rather than try to allocate my salary by product line, by using an arbitrary division between new policies, new sums assured, and new commissions, we decided instead to develop an expense assessment system which was completely arbitrary, which measured the success of the Canadian division as a whole. Now, while we know that my salary is assessed to new policies, new volume and new business credit, in some proportion we don't know to which, nor do we care.

This may sound quite prosaic, but it has become the cornerstone of our policy.

What are the characteristics of such an expense system? At the Canada Life, we decided that the system should have the following characteristics:

1. The units of measurement should reasonably reflect actual work units.

2. The formula should be "inflation proof." That is, if inflation continues, it should tend to generate new expense loadings faster than actual expenses are incurred by favoring the products which will tend to be sold because of the inflationary environment.

3. The expense formula should have a slight bias towards high growth areas of the market.

   I mentioned earlier that we have seen a rapid decrease in the share of our sales represented by ordinary insurance. One of our prime marketing goals is to increase the share of the market held by the Canada

Life in the ordinary insurance area. However, we felt that in order to do this, we must develop competitive products. Moreover, in order to develop competitive products we must control or reduce acquisition expenses.

We did not see how we could do this by concentrating our efforts in the ordinary insurance market -- the market we judged to be the slowest growth area in which we operated.

Therefore, the formula was designed with a slight bias towards expanding in the annuity, health and segregated fund areas, as well as the large term area. By expanding our sales rapidly in these areas we have been able to reduce our unit acquisition costs and pass the reductions through in terms of new competitive prices.

4. The formula should be directly related to the marketing objectives so that if our objectives are attained, we will generate enough expense loadings to cover our expenses.

5. Finally, the expense formula should not result in an unpalatable shift in the prices of the products we offer.

From analyses done with our company model, we determined that in order to satisfy objective one we should develop a three-factor expense standard related to new policies issued, new risk underwritten, and our measure of new commissions - NBC.

Furthermore, because our marketing objectives were set solely in terms of NBC, to meet objective four the proportion of expenses allocated using the NBC factor had to be quite large.

You might think from these "motherhood" statements that there were an infinite variety of expense standards that we could develop -- and you are quite right. However, for our company, there was a narrow solution space which met these objectives.

In the end, we adopted a Canadian expense standard under which we assess to each new policy in every line of business

$100 per policy
+ $5 per thousand initial sum assured (or $10 per $100 monthly income)
+ $1.50 times NBC units

At this stage we had a completely arbitrary expense formula which represented the sum of direct and indirect expenses to be assessed to new products.

The next stage was to start allocating portions of the total standard for various functions.

From our expense analyses we determined that branch expenses could reasonably be represented by $35 per policy plus 50% of NBC plus $2 per premium paying renewal contract right across the country. This formula reflects

the fact that a large part of branch expenses relates to the clerical work of preparing policies. In addition, many expenses relate directly to production -- for example, large producers have better facilities, larger offices, exclusive secretaries, etc.

We also determined that new business issue expenses and underwriting expenses could reasonably be represented by something like $30 per policy issued plus $2 per thousand initial sum assured.

Similarly, we established budgets for development of new men in terms of NBC, budgets for Managerial remuneration in terms of NBC, etc.

All this sounds unexciting, but the results of looking at expenses in this way are quite interesting.

The marketing division first established arbitrarily an expense formula. Then policies were repriced so that they were assessed the expenses in the formula. Having done this, we in effect began establishing feedback by setting budgets for various functions in terms of the formula.

For example, I mentioned that we determined that the branch expense standard would be $35 per new policy issued, plus 50% of NBC regardless of line of business. We were thus able to give our line supervisors and branch managers for the first time a simple explicit standard with which to measure each branch's performance. Each quarter, we prepare a branch expense analysis which compares all of the expenses in each branch against the expense allowances produced by the branch. The summary of the division standing as a whole and each branch's standing is sent to each branch manager, together with the line officer's comments. Branch managers who consistently are over expense standard find it more difficult to get funds unless they are growing very rapidly. In fact, branch managers who consistently are over expense standard have less job security than they might care to think.

We also changed our managerial contract to pay a bonus to branch managers for superior performance against the standard.

Annually we calculate for each branch the ratio of its expenses to its expense allowances. Because we place a high degree of emphasis on growth, each branch also has calculated the ratio of the current year's production to the average production over the last three years. From these two ratios a performance ratio is calculated by dividing the expense ratio into the growth rate. We then pay substantial bonuses to all branch managers who exceed the company average performance ratio. The bonus is paid to the branch manager depending on the extent to which he beats the division average and how large the branch is. The larger the branch, the larger the bonus.

Hopefully, what this has done is to make every branch manager expense conscious. Bonuses of up to $25,000 can be paid under this system. Essentially there are only two types of branches which can qualify for bonuses; branches with stable growth and very low expenses or branches with very high growth rates. In addition, the formula allocates a considerable amount of expenses <u>in proportion to policies</u> written. This has

led to an increasing emphasis on agent activity in the branches, which of course helps us to attain our overall goals.

Similarly we now explicitly budget 22% of NBC each year for new agent development. This means that we in effect assess our new policyholders for perpetuation of the company. The money, of course, is not distributed to the branches by the line officers directly in proportion to NBC, but is distributed by the line officers to those managers whom they control and whom they feel would best use the money. Successful developers of new agents get funds readily; unsuccessful managers get only a limited amount of funds. Since new agent development is the life blood of any agency, managers have become more selective to ensure that they get their proportion of these funds.

Furthermore, because we need a high rate of growth to attain certain corporate objectives, such as expanding our share of the market, we developed an incentive bonus payable to our agents based both on level of production and on the rate of growth. The higher the production, the higher the bonus; the higher the rate of growth, the higher the bonus.

Another result of using this formula directly is that because the bulk of expenses are assessed in accordance with first year commissions, particularly the large bulk of indirect expenses, the first year commission rate has in effect become a direct measure of the expense-bearing capability of the product. We can, in effect, design any product to be competitive by adjusting the commission scale.

This has not had the effect you might first guess -- that we would have commissions floating all over the place depending on the sales people's impression of the rates they need. Rather, they now seem more willing than ever to accept our word when we tell them of the price we can afford to sell that contract at, because they understand how products are priced, why expenses are being assessed and what the effect of commissions is on new business expenses in product pricing. If a product is made more competitive by reducing commissions and NBC, the credit the agency force receives for selling the product is reduced. They have to sell more just to stay even.

In fact, what has happened is that we have had a trend towards increasing commission rates, and hence assessing more expenses into certain product lines. When sales management understood the pricing trade offs, they felt that it was more important to pay our sales people adequately than it was to have the most competitive product on the market.

When we price products we then assume the Canadian expense standard expenses, as well as quite realistic but modestly conservative mortality, interest and lapses.

In addition, we build in specific profit objectives depending directly on the degree of risk.

All profit objectives are expressed as a return on investment where "investment" is the statutory loss to set up the business, and the "return on investment" is the interest rate for which the present value of the

statutory gains which are expected to eventually emerge from the business equals the present value of the new business investment.

Since we distribute par surplus using an average money approach for dividends, we ask that new par business return to surplus the investment in new business at the current average portfolio rate - approximately 8%. From our point of view, the product line with the next lowest risk is nonpar term insurance and we ask for a return in the order of 9%. Nonpar whole life insurance involves a greater long term investment risk and we ask for a return on investment of about 10%. Individual disability business involves the most risk of all -- we ask for a return on investment of 11%-15% (the longer the benefit period the higher the required return on investment).

Of course, just writing adequate volumes of new business so that our new business expense allowances exceed new business expenses does in itself not ensure that the new business is profitable.

Interest and mortality are obvious factors that can influence the ultimate profitability of any product. These factors of course are to a large extent under the control of home office through its underwriting policy and its investment policy. However, good persistency is critical to profitability. Because of this we have laid considerable stress on persistency.

Our managers' override is only paid on business which persists for 25 months. As mentioned previously, our agents' incentive bonus is only paid on business which also persists for 25 months.

We have also introduced persistency requirements in order to maintain agents' contracts with the Canada Life.

We are only willing to accept a new business persistency rate that is below 85% if it does not occur each year. Therefore we have introduced a system of automatic termination of agents' contracts if the persistency in any year falls below 75% or if the new business persistency in any 3 of 5 consecutive years falls below 85%.

We have also instituted persistency requirements for attendance at sales conferences which require 90% persistency of business sold in the first year of the 2 year conference period, or an average of 85% persistency on the business sold in the 2 years ending with the first year of the conference period.

I might mention that when we introduced these requirements, we at home office were afraid of a negative reaction from the field. In fact the reaction was extremely positive; we received calls and letters from our field force congratulating us on taking such a hard stand. Incidentally, reinstatements shot up the year after we introduced the persistency requirements.

Our emphasis on persistency has also led us to introduce a procedure of charging-back half the first year commission on business which does not last 25 months for contractual registered retirement savings sales. This puts the onus on the agent not to oversell the contractual commitment in

this tax sheltered area. Again the commission charge-back was received enthusiastically by the field, since it enabled us to introduce extremely competitive high early cash value products in their market.

In summary, I have tried to indicate how starting with expense allocation, we went to specific measures of success on corporate, divisional, product lines and branch office bases.

1. On a corporate basis, the profit margins for each product line are set in each product reflecting the assessed degree of risk for the product.

2. On a divisional basis, the Canadian marketing division operates profitably as a sales corporation if the total money spent acquiring the business is less than the Canadian standard expenses.

3. On a product by product basis, commissions and credits are now directly related to the assessment of expenses assumed for each product. Hence by definition, growth in NBC is a good measure of the division's real growth. No shift in product mix can do much harm if total NBC objectives are met.

4. On a branch basis, each branch manager has an express expense allowance for the business he produces. He is measured quarterly by actual expenses against these allowances. The branch manager's remuneration was changed to directly compensate him for his success in expanding his operation at a reasonable cost.

5. On an agent basis, the commissions the agent earns are now directly related to the worth of the business for the company.

   Further, the incentive bonus is geared to growth. To earn a large bonus, the agent must grow and help the division meet its objectives.

Each of the actions taken is a result of the concept of developing an overall expense standard and each of the actions taken in itself tends to reinforce the achievement of the expense standard. At the same time, the simplicity of the standard means that quarterly feedback loops have been easily created to monitor our plan, so that without engaging in any timely functional cost analysis we can receive timely data for our progress.

MR. RUGLAND: Paul has bridged the gap for us and discussed both topics on our agenda. Our other panelists will now comment on agenda item one.

MR. WILLETT: I approach this particular topic with the question: How do you go about designing a compensation package for the career agent organization? First, you must know what it is you want to do. This may sound easy; all of us would say we know what we want to do. From experience, I suggest to you that we as actuaries may know what we want to do, our agency department may know what it wants to do, and our corporate management may know what it wants to do, but the odds are that the three don't know the same thing.

So first you have to hammer out an overall corporate view of what it is

that you intend to accomplish. Do you intend to grow by increasing production from each producer? Do you intend to grow by increasing number of producing units within your existing agencies? Or do you intend to grow by increasing number of agencies? How you answer those questions and blend them together will make a great deal of difference in the compensation you decide upon. Additionally, do not then neglect the long term effect of that decision.

If you want to increase the number of producing units whether in existing agencies or new agencies, you are obviously going to want to weight your compensation system so that your manager or general agent makes the most money from bringing new agents on board and bringing them through successfully. But do not neglect at the same time, compensation on the already established agent. If you do, you will find yourself in a position that five years from now, the man will say, "Look, I am tired of the recruiting rat race, I have got a lot of good men and I need to continue to develop them; I am unhappy with your compensation and I just might change jobs."

When we, as actuaries, talk about job security for the agency managers, we are only talking about job security for the manager who is a failure. The man who is a success as an agency builder can move tomorrow to 50 places and not even leave town. If any of you are not believers in that, please give me a list of your successful managers. I will make you a believer the hard way.

A good way to start once you have determined your philosophy is to say there is an underlying amount you would be willing to pay in management compensation for any piece of business, regardless of where it comes from or what kind of agent produces it. Now you may determine that that number is 10% of net annualized commissions, or $2 per thousand face amount (although I don't recommend this way).

Next, determine what else requires compensation. For example, is the job one that entails recruiting new people and bringing them through the financing period. Here is where I think you have to decide whether you have a building general agency or a managerial office. If you have a building general agency, you need to put a significant amount of risk in this part of the compensation on the general agent. That risk can be put in in several ways. The most common is to pay him a significant compensation on the production of the new agent as long as that new agent is validating on the financing plan, but to give him a significant charge-back if that new agent falls under the financing plan requirements.

I am not suggesting numbers. A surprising thing we found out between 1971 and 1973 was that the numbers were the easy part. It was identifying philosophy and the job we wanted done that was the tough part. One of the jobs we wanted done, was to increase recruitment of new agents. Yet at the same time, we wanted to influence that recruitment in such a way that selection, training and supervision would be better. We do not propose that our system is perfect, but we have increased our recruitment by approximately 50% in the last three years, and we have increased our retention rate of producers contracted in a calendar year who were with us on December 31 of that calendar year by 5 full percentage points.

After the agency manager has the agent through the financing period, I believe that the next job is to provide for continued growth. The problem is to determine what is the measure of continued improvement. If you pay the agent some form of persistency volume bonus, it may well be that compensation for your general agent or manager for the continued improvement is a percentage of the agent's volume persistency bonus.

You probably will want to consider some grading down of the compensation you pay to the general agent or manager for long term agents after they cross a service plateau, such as 10 years. The purpose of this is to prevent riding an established agency until it deteriorates. I am firm with my people in speaking on this point, they all admit that they would like to do just that. They would like to establish that agency, build it to a certain size and then go play golf. You must build into your management compensation system some preventative features for that point.

Another point is a decision that is made for you once you determine whether you are managerial or GA. If you are GA, you must provide some kind of equity in the business. The best way to do that, and the traditional way, is through the renewal year overrides and through a vesting system which will vest those to him after a period of service.

One way to control expenses in a managerial organization is to financially penalize the manager if expenses are out of line. Paul has explained how Canada Life does it. We do it another way. We pay to our building GA's an expense bonus of 12% of earned commission credits. We charge-back against that bonus 1/2 of the fixed operating expenses of the agency which consist of rent, salary or clerical employees, postage and utilities. The bonus is scaled down from the first units to the last to recognize that there are some volume savings on size of agency. We allow approximately 40% more for the first five million dollars than we do for the excess.

At the end of each year, if the GA has been able to keep fixed expenses in line, there is significant money from this expense bonus segment. If not, the money anticipated is reduced. We have found this to be a powerful tool. Prior to 1973, over 1/2 of the telephone calls handled by our superintendents of agencies were requests for additional floor space, additional furniture and fixtures, additional secretarial help, or additional telephone lines. That percentage is down to around 15-20%. On top of that, we have general agents fighting us not to give them more floor space, not to give them more secretarial help, not to give them more telephone lines, because they are concerned about expenses. We believe we have control of expenses.

I have attempted to outline a simple framework around which you can determine how to compensate managers or general agents. I'm going to reiterate three points.

1. Know what it is you want to do.

2. Know how much it is worth to you.

3. Make sure that what it is worth to you is enough to make it worth the manager's time to do it.

MR. WHITNEY: In this section of my remarks I am going to outline how we utilize our expectation of claims experience and persistency within a given direct response market segment to set goals on the amount of new paid annualized premiums which should be produced from an expenditure of marketing dollars.

In the initial design and setting of premiums for a direct response product we proceed essentially as we do for an agency product. That is, we set assumptions for all of the cost factors including marketing. In the case of agency, marketing costs include, of course, commissions and sales support, training, management, etc. In the case of direct response, marketing costs include the cost of various mailings, newspaper inserts, TV and other advertising. We set overall assumptions as to the expected ratio of marketing costs to annualized premium and with actuarial assumptions for all of the other pertinent factors and profit objectives we arrive at a gross premium.

Whenever possible we market-test consumer response to a product. If we do not have a formal market-test, we certainly watch the early returns. The key ratio is new paid annualized premiums to marketing costs. In some instances there is dramatic elasticity of demand to price based on competition, disposable income and other factors. That is, when premiums are raised, and we have found this to be desirable on certain products because of somewhat worse experience associated with more and more consumer oriented features, we find that in some instances less annualized premium is placed in force for the same marketing expenditure in spite of having raised the premium per unit.

Common sense can help direct you in spending marketing dollars. For example, you don't set up an advanced sales underwriting unit unless you expect it to help bring in additional business. Measuring the cost effectiveness of such a unit or other marginal expenditures in an agency environment is often difficult. However, direct response companies have learned to be very elaborate in their measurement of cost effectiveness. As mentioned earlier, the key indicator is very simple: the ratio of annualized premium to marketing costs.

Let me illustrate this by assuming we have a product that overall is proceeding satisfactorily. Yet the claims experience varies from market segment to market segment. For example, direct mail has different claims experience than do newspaper supplements. We also find that with even as simple a product as the fixed benefit, hospital indemnity product, claims experience varies by geographical area. Persistency also varies from market segment to market segment, although generally not as widely as claims.

Having observed these variations and having made judgments on how such variations will behave after the early period for which we have actual experience...the question is, what do we do with this information? The answer is, we set varying requirements for marketing efficiency.

CHART III

% of Standard Experience	Required T/MC
50	.92
60	1.02
70	1.15
80	1.30
90	1.51
100	1.80
110	2.22
120	2.90
130	4.17
140	7.41

Perhaps the first column is self-explanatory. It is based on analysis of early claims experience. Claims are tracked according to incurred date, and with relatively short lag times for our products we develop reliable incurred claim loss ratios very quickly. And for larger volumes of business we have reliabile indicators in the early months of experience. In any event, having observed variations in claims experience, we solve for the required annualized premiums which must be produced (this is the "T" element in the second column) relative to the marketing costs which produced such premiums (this is the "MC" element). As a matter of definition, if the product is sold on an initial, deviated amount such as 25¢ or $1.00, T is the annualization of the first regular premium.

Charts such as these are prepared for various profit objectives. We also complete similar analyses for variations in expected persistency solely or in combination with variations in expected claims experience.

Our marketing people review our charges and in conjunction with top management set plans for either curtailing marketing costs or expanding marketing costs in line with realistic expected T/MC ratios. For example, in a market segment where we expect claims equal to 110% of standard, a market plan is set to produce a T/MC ratio of at least 2.22. However, if claims are expected to be 90% of standard, we would be willing to spend more marketing dollars as long as the effect of diminishing returns is not such as to reduce the expected T/MC ratio below 1.30.

The technique I have described for utilizing variations in expected claims and/or persistency to set market plans is probably not new to companies well established in direct marketing methods. On the agency side, it is likely to be more difficult to control and adjust marketing costs. Nevertheless it is hoped that those of you in agency environments will have occasion for this technique to be worthwhile and that these remarks will have been of interest.

QUESTION FROM FLOOR: In regard to agency management compensation plans which relate to expense control, have the companies who have been successful with bonuses had success by getting sales to grow or by actively controlling expenses?

MR. WILLETT: A sales management system must consist of both a supervisory system and a compensation system. You can't make either the supervisory system or the compensation system alone do the total job for you. We have taken this point of view. Our bonus system is set up to deliver a return to the person who is controlling expenses, but in a growing situation. We recognize that a GA could be killing an agency in keeping expenses low, and therefore making money on our expense bonus. We take care of that situation with our supervisory system by explaining what it's going to take to have that general agency next year. We do not try to take care of it through the bonus system.

MR. McCROSSAN: We take the opposite approach and explicitly build growth into the bonus. The largest bonuses go to the largest branches who are growing quickest. By number of dollars, bonuses tend to go to the successful growers. By number of people the split is about 50/50.

There's a place in our organization for a low expense moderate growth agency. Its growth is matched against the growth of the division as a whole which has tended to be ten to eighteen percent annual increase in commissions in the last few years. Managers just cannot sit and milk an agency as Bob would have suggested. One of the things we were concerned about when we developed this formula was that we felt we had several managers who were living off the expense margins and not growing. So in determining the factor, we had a short list of managers, whatever formula we developed, the test of the formula was that we cut these managers off.

QUESTION FROM FLOOR: I am thinking of morbidity costs on a guaranteed issue hospital indemnity plan that has a pre-existing condition exclusion. I'm wondering about the differences between the direct marketing and the agency marketed business. I can see that with the direct marketing you could have a spread of risk, but with the agent and the associated self-control of sales activities, I'd be concerned about a walk through a hospital or a nursing home to sell that policy. I'm just wondering how you balance that in pricing those products.

MR. WHITNEY: We try to do it carefully, but we do expect the agent to screen out the worst risks. It's labeled a guaranteed issue, but we expect the agent to screen. We give agents a set of criteria such as people with a history of cancer, heart attacks, etc. Then we also have a letter that goes out of the home office as a follow-up audit procedure. The guaranteed issue product on the agency side is new and has only been recently introduced so there's no experience to go by, but we have been concerned about the point you raise and try to meet it satisfactorily. We feel that because of the nature of our operation, we want to provide our career agents with products they can sell quickly and readily, that's why we went to a guaranteed issue hospital indemnity. With our experience on the broad market, the direct response side, we feel it's worth a good try. There's no guarantee it will work out and we'll have to watch it.

On the direct response side, it is truly a guaranteed issue unless you are a known speculator. We keep lists of speculators and while our legal basis for declining an application may not be 100% solid, most speculators don't complain if we turn them down, and if they should, they get nowhere with the State Insurance Department.

QUESTION FROM FLOOR: How does your experience compare for policies that were applied for as opposed to those solicited by direct mail?

MR. WHITNEY: We sell a wide range of products and use different premium methods. I can't remember too many statistics except for our hospital indemnity where we have the initial come-on premium, in some instances of 25¢, we find that of those who pay the initial premium, only between 50 and 60% will renew and pay a regular premium thereafter. We have the typical follow-up type of mailings to try and encourage people to make that payment.

QUESTION FROM FLOOR: Mr. McCrossan, what are the problems of your company for defining the profitability of participating business and how do you solve those problems?

MR. McCROSSAN: We think in terms of return on investment. Our approach to par business in effect, is that we are asking the policyholder group to return to the company, a return equivalent to what the company is earning on its average portfolio rate right now. It's not quite the same as saying I could invest in new business, or I could invest in a new investment, so then I should look at the new investment rate. Since our dividends are tied to the average portfolio rate, what we're currently asking for is that the policyholder group return the average portfolio rate on the investment in order to establish their new business.

QUESTION FROM FLOOR: Paul, I was curious in defining your charge-back situation with regard to the registered retirement plans. I believe you said you charge back commissions on terminations during the first 25 months? How do you define a termination?

MR.McCROSSAN: A termination is anything that stops premiums being paid and that includes paid up, or anything similar.

QUESTION FROM FLOOR: So it's not necessarily a surrender?

MR. McCROSSAN: Not necessarily. An automatic nonforfeiture option for our registered business is automatic paid up, and that is deemed to be a termination for the purpose of this charge-back. The policyholder actually has to make the first 25 months of premium payments.

QUESTION FROM FLOOR: I was trying to make an analogy with the IRA business in the U.S. Both of these contracts are flexible premium arrangements. You never know what you're going to get or when you're going to get it, but you hope you are going to get something on a semi-regular basis. Is this type business similar in Canada? Do you expect to get contributions on a regular basis?

MR.McCROSSAN: Yes, the limits in Canada are quite a bit higher, up to $5500 a year for a self-employed person, or $3500 less pension contributions for an employed person. We find that we sell quite a bit of contractual business below a thousand dollars a year. Above a thousand, most of what we sell is flexible or recurring single premiums. In order to justify selling the contractual plan where we do pay a standard type commission, we felt we had to offer higher cash values, so that the policy-

holder who is thinking of it as a savings device was really seeing his savings there. The only way we could do that was to introduce a commission charge-back to involve the agent directly in the persistency of the business.

QUESTION FROM FLOOR: I wanted to ask a question of Paul. You didn't mention sub-management or staff costs in your offices. Does your formula control that as well?

MR. McCROSSAN: Yes, that is an expense which is in the $35 and 50% of NBC, so that's an expense charged to the manager right in the formula and it is directly offset by the business produced in that unit.

MR. NEIL DAVIDSON: I have some comments on Mr. Whitney's description of his company's use of the Super GA approach to marketing. As I understand it, this marketing approach utilizes independent general agents who have their own field forces and distribution systems already established. Usually the agent is a specialist in one particular market or product.

At CNA we tried this approach a few years ago and terminated it recently, not being pleased with the results. The agents demanded a large amount of compensation which implied either unprofitable product design or products with high premiums in relation to benefits provided. We found that first year persistency on this type of business was often less than 60 percent. We gave large loans to some agents and much of this has not and probably will not be paid back. The point is that, although much can be saved in the way of distribution and administrative expense in dealing with so-called Super GA's, care should be taken in deciding whom to do business with.