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NEW FORMS OF AGENCY COMPENSATION -- IMPACT ON PRODUCT DESIGN AND COMPANY PROFITABILITY

Moderator: PHILIP K. POLKINGHORN
Panelists: TED BERNSTEIN*
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Recorder: PHILIP K. POLKINGHORN

- o What new forms of compensation are being utilized?
  - -- Fee for service
  - -- Agency captives
  - -- Other
- o What is the impact on product design?
  - -- No load products
  - -- Lapse rate assumptions
- o What is the impact on company profitability?
  - -- Will captives siphon off profits?
  - -- Will agent loyalty increase?

MR. PHILIP K. POLKINGHORN: The speakers will address new forms of agency compensation ranging from providing agents with top compensation and reinsurance profits, to providing no commission at all and selling on a fee basis. I would like to introduce our panelists in the order that they will appear. First is Mr. Robert W. MacDonald, President of ITT, Life Insurance

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** Robert W. MacDonald, not a member of the Society, is President of ITT, Life Insurance Corporation in Minneapolis, Minnesota.

Corporation. It is not an exaggeration to say that he is a controversial figure in the life insurance industry. I think he takes a little bit of pride in being called "Benedict MacDonald," the "Anti-Christ" of the life insurance industry, and some other nice names. Most of us first came to know Mr. MacDonald in 1982 when he made headlines by saying whole life was not a good buy and announced that ITT Life would sell only term. Mr. MacDonald is a CLU and is listed in *Who's Who in Insurance* and *Who's Who in America.* Numerous articles have been written about him in *The New York Times, The Los Angeles Times, The Wall Street Journal, Forbes,* and *Money.* Mr. MacDonald has recently written a book -- I even purchased a copy to get him to come here. It is called *Control Your Future* and is aimed toward the agents to help them to succeed in the future. Mr. MacDonald is here today to expand on those thoughts, and while we may not agree with everything he has to say, we are pleased to have him join us.

Our second speaker is Mr. Harold G. Ingraham, Jr., President of the Society of Actuaries and currently with Tillinghast/TPF&C in Hartford. He was with the New England for many years where he worked a bit on their producer owned reinsurance company.

Our last speaker will be Mr. Ted S. Bernstein, President of Assured Enterprises in the Chicago area. He has been in the life insurance industry for eight years. He attended the University of Wisconsin and Northwestern University. He entered the fee-for-service area about four years ago, after spending the early part of his career in tax-oriented sales. His firm, Assured Enterprises, has recently been featured in *Fortune, Financial Planning,* and local Chicago business publications.

MR. ROBERT W. MACDONALD: Phil, I want to tell you that I sincerely appreciate that nice, noncontroversial introduction that you gave. As many of you know, I am not particularly popular at a lot of insurance meetings around the country. In fact, sometimes when I go to insurance meetings I feel a little bit like Dial has failed me; I feel a little bit like William "the Refrigerator" Perry at a Weight Watchers meeting. As you may know, I have gotten some rather interesting introductions around the country. In fact, about a month ago I was down in Texas to debate the president of a company about the future of the life insurance industry and the program chairman got up and made two interesting comments. He said, "Well, I've got this biography here on Mr. MacDonald and it says that he is a CLU, but after reading what Mr. MacDonald has to say, as far as I am concerned CLU stands for Communist Life Underwriter." He then said, "Now ladies and gentlemen," (this was a big meeting of the National Association of Life Underwriters this is the most important meeting of the year. We are going to have a debate here between Mr. MacDonald and the president of this other company and it is going to be a real battle of wits today. How brave of Mr. MacDonald to come here only half prepared." Anyway, what a country -- only in America. I appreciate, Phil, that you have put me on first so that you have the two experts come up later and show what a fool I am when it comes to compensation. I must admit that speaking before the Society of Actuaries is an interesting experience for me. I feel a little bit like a layman called to the Vatican to discuss church theology with the college of cardinals.

Of course, Northwestern Mutual is claiming they have reinvented it and they are selling it today -- "It's the new wheel." Anyway, I was encouraged as an agent to view actuaries as the high priests of our industry.

Despite the fact that the *National Underwriter* a couple of weeks ago ran a piece in which my name was mixed with such personalities as Hitler, the Marquis de Sade, John McEnroe, such subjects as pornography, and such words as evil, destruction, snake oil and the like were used, here I am addressing this distinguished group and I hope that you feel properly ashamed. Perhaps surprisingly, this is not the first time that I have been invited to attend your annual meeting. The last time was in Miami when I was forced to debate the merits of a product with the chief actuary of one of our major companies. I do not know if it grew out of his frustration in trying to communicate with me, but shortly after the meeting my advisor retired.

Anyway, aside from not knowing what I am talking about and not being able to understand you, I am at another disadvantage. I can't follow all the rules of speaking that say to get your audience warmed up by telling some funny stories. While I give about 40 speeches a year, most of my speeches are to agent groups and I have to confess that most of my jokes are about actuaries. Now I am not going to take the chance of repeating those jokes today, as I am sure you have all heard them. I will tell you one thing. The agents absolutely love them; I mean they think it is the greatest thing in the world. Left with nothing to do, I guess I should get to work, but I have got to protect the innocent. Our chief actuary, Peyton Huffman, likes to be a member of this group and wants me to point out that he accepts absolutely no responsibility for what I am going to espouse today. Peyton and I have worked out a very good relationship. He never comes out of his office, and I never go into it.

I think it is fair to say that in the last few years in the life insurance industry, the operative word has been *change*: dramatic, rapid, convulsive, real, and continuing. In fact, we have seen more changes in our industry in the last five years than we experienced in the previous fifty. An industry that was content doing what it had done so well for so long was suddenly forced to face real structural changes. We had to deal with new products, strained distribution systems, high lapses, shrinking profits, banks, taxation of our products, rebating and that great destructive evil of mankind -- unisex-rated policies. Now while all or at least most of those are important issues, we are here today to discuss the specifics of compensation. We will do that, but since I am not qualified to speak on the technicalities of compensation, I am going to take a little different approach. I would like to provide a general overview of compensation as I believe it will be impacted by the changes that we are going to see in our industry. Let me point out also that when I use the term compensation, I am including all acquisition costs.

As far as I am concerned, the allowables and some overhead priced into the product and allocated to a company's marketing department or the underwriting and issue department, should be part of any discussion on compensation. Too often the discussion of compensation stops with the agent. Why should we always assume that it is only the agent who has high cost and is inefficient? Is it fair to question the efficiency of the agent without challenging the efficiency in our own house? I think not. So that I don't get too theoretical and esoteric, some of the specific examples I use will be of ITT, Life's emerging compensation system. First of all, I admit that most of what I discuss and offer today will be based on personal opinion and conjecture. Other than my experiences, gut feelings, and feedback from a lot of people around the country, I have no basis to prove that my conclusions are actuarially sound. I guess that puts me on the same ground with you actuaries when universal life reserve requirements are discussed. I am the first to admit that I don't have all the answers. In fact, as many of my critics suggest, I may not even know the question. In order to understand my conclusions, I think it is important to understand some basic tenants that lead me to my beliefs. If you disagree with my givens, then in all likelihood you are going to disagree with my conclusions. If you will allow me to expound on some of my beliefs, in a fairly rapid order and not especially in priority, you will see some of the conclusions I make.

Right off the bat, I am going to tell you that focusing on compensation is a mistake. There seems to be a general feeling that if we can somehow magically change the compensation structure, then the problem of profitability from today's products will somehow automatically go away. Let me suggest to you that compensation is not our problem. It is rather a symptom of the real problems that we face. Treating the symptom will make it go away, but such an approach at best only offers temporary relief and the real sickness remains. Soon the symptoms return and they are stronger and harder to dispel. On the other hand, if we can treat the sickness, then the symptoms of the sickness will go away. Increasing, reducing, or leveling compensation will not solve our problem because our problem is not compensation. Our problem is an inefficient distribution system. Our problem is waste in our home office marketing efforts. Our problem is an industry not experienced in competition experiencing irresponsible competition. If we can find a way to improve the efficiency and productivity of our distribution system, clean up our act in the home office, and move the pendulum of competition back to the middle ground, we will find that compensation was not such a big issue after all. Real competition is fine and I think long overdue in this industry but I do not believe that trying to drown the competition in our own blood is our best approach.

Unfortunately, I am not particularly optimistic that we will be successful in solving these problems. Most of us either don't want to know what the problems are, or if we do, we don't want to face them; or we don't know what the answers are. As a result, we spend our time talking about the symptoms, while the problems get more difficult every day. It is a lot easier to sit around blaming the agents for our problems than it is to come up with ways to help agents operate more efficiently. It is a lot easier to blame the marketing department for recruiting agents who write poor quality business, than it is to recognize that most marketing departments do not know the first thing about recruiting and marketing. It is a lot easier to raise the dividend a little or hold the current interest rate a little higher than it should be, so we can meet this year's sales goals even though the business we write may damage or even destroy the company in the future.

I have departed from my appointed rounds. I have been invited here to speak on compensation, not to make us feel uncomfortable. I will address the compensation issues as I see them today, but I hope that you will allow me to interject somebody's personal thoughts about our real problems because I think they will focus in on how we have to structure compensation. The basic compensation structures I will make are based on the belief that the industry, at least for the next decade, will be structured fundamentally as it is today and that ten years from now we are going to be facing the same problems that we face today -- at least those of us will who are still around.

First of all, I do not believe that the agents are at the root of the compensation problem. Since agent compensation makes up the largest part of our acquisition costs, it is logical to think that if we can eliminate the agent or at least reduce the amount that we are paying him then our problems will go away. The search for such a solution seems to have become the holy grail of this industry. Today it is very chic and it is very modern to suggest that sophisticated mass marketing will replace the agent and solve all of our distribution and compensation problems. A couple of weeks ago I picked up a Philadelphia newspaper about one of our older career agent companies (I won't tell you which company) announcing that they were going pell-mell into television and direct mail marketing. The company hired some guy from Herbal Life or some such company to come in and run the firm. (I guess in their defense they must have thought that Herbal Life was a west coast life company or something.) But quite frankly, I belief that such approaches are a waste of time. It is my conclusion that no matter how sweeping the changes our industry is to see, the need for basic mortality protection products is not going to go away. And despite what many would hope, believe, or try to do, the need for someone to sell those products' will always be present. Whether we like it or not, and I happen to like it, we might as well face the fact that we are going to be stuck with the agents. I know we hate to admit it, but the truth is, quite frankly, we need them more than we need us. Life insurance as we know it is a very personal and human purchase and I do not believe that people will ever be comfortable or well served by a machine, or a mail box. Oh, I know we can sell some types of policies in the mail and on television but when it comes to really substantial volumes of true life insurance, I think we are still going to need the agent.

Now don't get me wrong, I admit that there is a distribution problem. It is obvious to anyone, even we nonactuaries, that we can't pay whole life commissions on the new breed of products that do not have anywhere near the profit levels of whole life. In fact, there is still an open question as to whether there are any profits at all in the new products. I think we have aimed our artillery in the wrong direction. The problem is not the agent, the problem is not what we pay the agent, the real problem is how we ask the agent to function. Today, the average, successful agent spends about 80% of his time prospecting and servicing and only about 20% of the time actually selling. Now that is not a very efficient use of the agent's talent. As we are discovering, that is a very expensive way to sell today's low margin products. In fact, this situation I think exacerbates the compensation issue we face today. The agent seeks higher and higher commissions to offset his cost, while we face diminishing returns on the new products we must sell to be competitive. Now, if you accept my conclusion that the agent is critical to the sale, and I accept your belief that compensation levels, or at least today's payment structure, is a problem, then we are going to reach the inescapable conclusion that the only way we are going to solve our problems and the agent's problems is to find a more efficient way for the agents to apply their trade. Now, let me stress that more efficient does not mean either less income for the agent or less agents. Many fight stream distribution or restructured compensation because they have used as anti-agent suggestions. I believe that such attitudes are short sighted. If we could find a way to help the agent make more efficient use of his talent then compensation questions from home offices and agents will become a nonissue.

What if you could go to your best agents and offer them a system, which for the same effort they expend today could guarantee you three times the sales volume, and you could cut commissions by 50%? Notice I said cut commissions -- that does not mean reduce income for the agent. Actually, for the above scenario the agent's income would be increased while our unit costs would be reduced. But that can only be accomplished if we find a way to get the agent in more selling situations.

Now there is another thing that is going to have an impact on our compensation and how we structure what is happening with the career agency system. For what it is worth and it is probably worth only as much as I am getting paid to give this speech, I think that we have seen the end of the classic career agency system; not the career agent but the career agency. Today's career agencies are being transformed into some sort of all purpose financial workshop. The solid core of the agency system has been undermined, when in television commercials we see Prudential's Rock of Gilbraltar floating away or when we see some companies so ashamed of the life insurance business they find it necessary to change their name. Renee Richards may have changed names and a few other things but that does not make him an attractive female. I think the idea is that since there will be a multitude of products for the agents (or whatever the companies will call this guy) to sell, then he will be willing to accept lowered and level compensation and voila all of our problems are gone. I don't think it works that way; in fact, I think this approach will substantially increase costs all around and will make our compensation problems more acute. I happen to think that we are now selling and developing products that the consumer will buy and keep and we ought to concentrate on selling them the best way we can.

Compensation will also be affected by the fact that in the future companies and agents will contractually drift apart, but in reality will work better together. I envision companies identifying themselves as pure manufacturers and leaving the marketing to those who can actually sell. The major marketing organizations in the future will be independent groups of agents controlling large blocks of premium and working in specific markets that can get new agents into production quickly and efficiently. This will allow the companies to do what we do best and that is push paper -- and the agents to do what they do best and that is sell insurance. The result will be better efficiency, less total acquisition cost, increased income for the agent and higher profits for those of us in the companies. Now I would not be surprised to see a great irony in this situation. Today many of the big companies are crying because so many other companies are stealing their agents away after they put out all the money and put in all the time in to train them. I could see a time in the future when the big companies will steal agents from the independent marketing organizations so they can populate their fancy financial factories.

Of course, the other major factor in compensation planning will be the structure of our products. It is obvious, at least to me, that the major structural changes made to our permanent products are here to stay. I don't know if anyone is selling nonpar today. If they are it can't be much and I can assure you that it is not going to stay in force for very long. The drop in interest rates and inflation, coupled with the so-called upgrading of the traditional par whole life policies has masked the problems that they face but this is only a temporary solution. For all the reasons other than current interest rates, universal life and its future derivations will be the dominant products of our future. Our traditional compensation systems have yet to recognize this basic structural change in the product. We had better recognize the change in it and educate our agents to it or we will have some real problems.

A couple of other quick points. Let's not use the evil spector of replacement as an excuse to reduce or level commissions. It just won't work -- agents are not going to buy it. Besides, I believe the replacement has reached its high water mark and is receding. There was much justification for the agent on the consumer's point of view five years ago but changes we have implemented have eliminated much of the attraction, and A. L. Williams not withstanding, the agents know it. If we use that excuse today, the sellers of our products are going to know that as usual, we are two or three years behind the times.

Now, how does all of this rambling tie into the specifics of compensation? I think we are or should be going in the same direction with agents and compensation as we are with the policyholder and the product they buy. With policyholders there is a movement, with some braver than others, to transfer the investment risk from the company to the insured. It is fair and logical to suggest that if the policyholder is to share in the gains from investment income then they should also share in the investment risk. In future policies, if the company wins -- the policyholder wins. If we lose, they lose. Agents are going to have to be placed, I believe, in that same position. After all, compensation is a form of profit sharing. I think we should formalize that concept. In other words, if a company makes a profit on a policy sold by an agent, then the agent should share in that profit. If the company receives less than anticipated profits or even a loss, then I believe that agents should also share in that experience. Now this may sound like the tired and typical persistency bonus plan that has always sounded great but has never worked, but it is not. I am suggesting that in the future, rather than simply an incentive, compensation should be in the form of an incentive *and* punishment within the limits of competition and conscience. The level of compensation paid is meaningless so long as the company receives the required return on investment on the policy sold.

What I am suggesting is that we design our compensation system so that the agent has just as much interest in the profit from a policy as the company. If you think that sounds like I am describing the popular concept of agent-owned reinsurance companies (AOCs) you are wrong. AOCs, at least as far as I have seen them to date, have a number of flaws. First of all, the risk/reward of the plan is too long termed. Thinking that most agents have the patience to wait ten years for profits to emerge from a block of business is just not realistic. The very nature of the agent means that he needs to respond to immediate stimuli; whether it is instant gratification of the sale or the penalty of a chargeback of poor quality business, the stimuli must be like the cattle prod and be immediate. Agents cannot be expected to respond to positive or negative stimuli that is more than ten years away. While there will be exceptions, particularly at the very large producer level, I am talking about the general population base of agents. I think it is difficult to make agents real owners of reinsurance companies because most have usually spent next month's commission check last month and they don't have the cash flow necessary for the needed surplus contribution to the AOC. Likewise, with the inefficiencies in today's distribution system, most cannot afford the needed reduction in commission to reduce or eliminate the strain. Since I would not suggest that companies are willing or even able to put up all the surplus strain and then share the profits with the agent, we have to recognize that most AOCs will in fact be illusory or at best, simply long-term bonus plans and may not have an immediate effect on production generated by the company. The agents will soon recognize that their ownership is really illusory and walk away from the plan.

Now I do not mean to suggest that the idea of AOCs is bad. I think it is a great idea. It is just that there has to be a much tighter loop. There has to be a closed loop between the agent and the benefit that he will receive from writing business in the company that he owns. The reinsurance concept for most agents is just too nebulous. While most of us are not in a position to do this, if a real AOC could be established, that is a situation where the agent owns a portion of the company actually issuing the business, then I believe that we would see very large amounts of good quality business placed with that company. Agents will strongly respond to being a capitalist rather than a captive. If you have the ego gratification of ownership as a direct owner of the company then I think the AOC can be extremely successful. Thus, the key to successful compensation systems will be the company's ability to tie the agent directly to the profitability of the business he writes. If the company wins, he wins; if the company loses, he loses. No system short of a literal partnership with the agent is going to be perfect, but since we don't live in a perfect world we should accept the best we can.

There are a couple of quick points I would like to make that both we and the agent must understand if we are going to develop compensation systems for today's products. On the one side, the agent has got to give a little and on the other side, we have got to give a little; actually it is not a question of giving, it is a question of understanding. All of us understand that we cannot pay the same level of compensation on the investment portion of the policy as we pay on the mortality portion, but agents brought up selling the unbundled whole life product have got to learn this concept. By the same token, companies must remember that whole life was structured so that if the insured needed more insurance or wanted to increase the savings portion, the agent received new compensation because a new policy was sold. With the flexibility of the new products, it is realistic to believe that an individual could buy a single policy and use his flexibility to adjust changes for his (if you will excuse the expression) whole life. In other words, changes in mortality needs and savings objectives can be handled all within a single policy. How can we seriously ask an agent to stay with and service a client if in reality the best advice that the agent can give the insured is to never buy another policy? I don't think we can. At least not without a different type of long-term compensation. I think there are two points we have to consider in any future compensation structure. First, the agent will be tied both by risk and reward to the profitability of the business he sells and second, the agent's basic compensation will vary with the changes and the performance of the policy.

Now please allow me to get specific about these two concepts. I think the best way to do that is to use ITT, Life's compensation system as an example. Since we are not in a position to use the AOC concept as I would like and because we, like you, have not solved the real problems of our industry, I acknowledge that these are stopgaps and are imperfect. But they are the best that we could come up with at this time. To tie an agent to a product for either risk or reward required that we first had to be able to define profitability in a way that both the home office and the field could understand. As I am sure you have discovered, this is not especially easy with universal life type products. Persistency, the traditional Life Insurance Marketing Research Association (LIMRA) standard for measurement of product profitability and sales force productivity was ill suited to the universal life generation of products. We could easily find ourselves in situations where ITT, Life was still reflecting a policy as being in force while no premium income had been received for several months or even years. Revision and design of a new qualifier was essential for efficient and aggressive pricing as well as for identifying and rewarding or penalizing the producing agent. I should point out that in an attempt to accomplish this objective we tried for the possible rather than for the pure scientific purity. The measuring device had to be readily understandable by the sales force. What resulted is what we call the profitability index or PI. The system gauges premium received on each policy as a percent of the expected premium for the first 24 months of the policy's life. The expected premium derived by our loving actuaries depends, of course, on the lapsation rate inherent in the pricing structure of the product. Since policies sold, for example, in the blue collar market might be expected to have a different premium flow than those sold in the higher income market, the system had to be capable of assessing the profitability of a variety of policies all with different pricing assumptions which are all within the same system. Under this system, if the actual collected premium equals the anticipated collected premium then the agent's profitability would stand at 100. The agent would have earned exactly the commissions we have priced into the product and we would have earned our price before profits. We have an agreement with our agents that we will pay them approximately 60% of the excess profits that will emerge from this block of business.

Now conversely and I think this is the most important point, if the agent's profit index is below 100, then he is giving us worse than priced-for business; we have over compensated him on the sale and we will receive lower than priced-for profits. In these cases, we literally charge back 60% of the anticipated loss and profits and I do mean charge. We slap the hit right out of his commission account and collect the money. Now I should point out that both the profit payment and the charge are done in a lump sum rather than in an actual change in the commission structure, which would be an administrative nightmare. We run the profitability index monthly but apply the credits or charges on a quarterly basis. For example, an agent has a PI of 105. Let's say that his portion of the increase in future profits equals an 8% increase in basic compensation. We simply look at his earned commissions and send him a check for 8% of it. As long as the agent's PI remains at 105, he would get an 8% payment each quarter. If the agent has a PI of 95, it may mean that his share of the loss on future profits on his business calls for a 10% reduction in compensation. We again look at his earned commission for a quarter and drop a 10% charge on his commission. Now I don't need to be hit over the head to realize that agents that keep getting chargebacks each quarter are going to soon be fed up with us and leave for another company that does not penalize them for bad business, but that is fine. The system is doing exactly what the marketing departments have difficulty doing and that is driving away poor quality producers even if they produce a substantial amount of business. Of course, the agents with high PI are going to be encouraged to write business with us.

Now, does the system work? I don't know, but I can tell you that so far we are pretty satisfied. We implemented the system exactly one year ago and when we did our first run, the company index stood at 79. We were obviously selling business that would not return a very acceptable level of profit. After a year of working with our agents, and paying a few bonuses and taking many large chargebacks, we have lost a lot of producers but the last quarter, PI for the company was at 90. We now have 23 organizations that are above 100 and you would be surprised how busy our reinstatement and change department has been. I recognize this system is not perfect. There are a full list of deficiencies. The program only takes premium flow into account and not mortality or expenses. The measure of profitability only goes 24 months and there is no reward or penalty beyond that period. The agent gets his excess profits in the first and second year while the company must wait the ten years for any excess profits to emerge. I believe that on balance, this system has been able to override many of the problems because it gets to the core of the message we are trying to give to the agent. It ties at least a portion of the agent's compensation to the actual profitability of the business being written. To me, the message is the key -- even if in some cases the message is negative. Obviously, I haven't gone into all the details about this system and about the concept, but if you really want to find out how the thing works you have got to call Peyton Huffman at ITT Life, and he will get you squared away.

A second compensation concept which and I think is a key one with our products is one that encourages the agent to stay with and service flexible premium policy. Since a portion of the company's profits (especially if the current trend in product development continues) will be based on asset build up, the agent should be compensated relative to the same system. In other words, the agent should receive two forms of compensation. One relates to the insurance or mortality portion of the policy and the other relates to the asset build up in the policy. What we have done at ITT, Life is install a system that pays the agent a percentage of the excess interest credited on the policy each year. Thus, the larger the accumulation in the policy, the more income to the agent. This compensation is nonvested but is paid over the life of the contract. It becomes a new form of renewal income but it is income that encourages the agent to see the long-term interest of the policy.

For example, assume that we have a policy with $100,000 in accumulation value with a guaranteed interest rate of 4% and a current interest rate of 8%. The excess interest is 4% or $4,000. The agent receives 10% of the excess interest or $400. Under such a system it can be illustrated that the compensation in the 10th year could actually approach what he earned in the first year. The message to the agent is that if you stay with the policyholders and the company and/or if you get them to increase premiums on accumulation, you will be rewarded. I like a percentage of excess interest better than a specific asset based commission because it has some self-limiting features. Under the plan in use at ITT Life, the upside risk is controlled by stating that the bonus will not exceed 100 basis points. Thus, once the current interest in our example were to go above 14%, the bonus percentage would freeze. This is of course to prevent us paying a large portion of the excess interest and making the product noncompetitive. By the same token when it goes down, the interest rates go down and the compensation goes with it. Don't get me wrong; I am not suggesting that the programs we have implemented are perfect. We are still paying more than we can reasonably afford to pay based on the inefficiency of our distribution system and home office operation and our agents still tell us that we are not paying them very high commissions. Our programs however, as good as we think they are under today's conditions, are really still only addressing the symptoms. The symptoms seem to be receding but I know the real problems still face us around the corner and we are turning that corner very quickly.

MR. HAROLD G. INGRAHAM, JR.: I am going to focus my remarks today on two primary areas. First, I want to talk a little about the impact of changing compensation patterns on individual insurance products and then I am going to talk about the impact of producer-owned reinsurance companies from the standpoint of a mutual company operation in a career distribution system. Some of the implications of producer reinsurance companies in that environment are considerably different than some of the considerations that Bob was focusing on. First lets talk about changing compensation patterns on the individual insurance products. One of the most serious problems facing insurance companies today relates to control of acquisition costs in order to maintain or achieve a competitive edge in their products. The fact is that products being sold today -- whether they be interest-sensitive or traditional -- do not have profit margins sufficient to cover their acquisition costs or to support the cost of sustaining a career agency distribution system. In fact, some universal life products being marketed today actually seem to have negative spreads between interest rates currently credited and the rates being earned on the underlying assets.

Despite the need to keep these costs down, traditional high front-end sales commissions on life insurance products remain a major part of most companies' acquisition cost structures. Companies price products on the assumption that they can recoup these expenses from continuing premium flows. High front-end commission structures place the persistency risk with companies -- not the producers. Paradoxically, high front-end sales commissions, which must be amortized over several years, are a major stimulus to replacement of in-force business. In many cases replacements have been occurring well before companies could recover their acquisition costs. LIMRA has estimated that replacements, including roll-over premiums from the cash values of replaced policies, made up about 45% of the industry's 1984 annualized new premium. Most of this was money from traditional products flowing to interest-sensitive products. Partial remedies to the problem of controlling acquisition costs include commission chargebacks, back-end loads, persistency bonuses, transferable service fees, and commissions based on accumulating assets or costs of insurance.

COMMISSION CHARGEBACKS -- Approaches such as charging back some portion off first year commissions, if less than the scheduled premium is paid on the second year, certainly help in the pricing exercise -- but they are only effective and enforceable in career agency shops.

BACK-END LOADS -- While it is still too early to measure the impact, these loads will have on persistency, companies using them have managed to reduce much of their surplus strain and shift much of their lapse risk to agents and policyholders during the early policy years.

PERSISTENCY BONUSES -- These bonuses reflect the fact that persistency is really a proxy for true profitability measurement. They are typically based on production and some measure of persistency based on premiums, renewal commissions or growth in cash values.

TRANSFERABLE SERVICE FEES -- These fees provide agents with an incentive to conserve the business of terminated agents. The flexibility of universal life and its inherent need for more policyholder service has motivated a significant number of companies to pay transferable service fees in lieu of vesting commissions to writing agents. Incidentally, perhaps the flexibility of universal life has been oversold. More companies seem to be talking yearningly about the advantages of "scheduled" premium life insurance. Of the universal life premiums sold in 1984, one company reported receiving only about two-thirds of the premium that was projected on those sales for 1985. Another company redesigning compensation schedules for its new generation of universal life has decided that the higher commission versions of the product will require the original premium to be paid for at least five years. What's particularly interesting here is that over two-thirds of universal life business sold currently is on a monthly check-o-matic basis.

COMMISSIONS BASED ON ACCUMULATING ASSETS OR COST OF INSURANCE -- For non-New York companies, there are two innovations that align agents' interests more closely with those of the companies' interests. In the case of asset value commissions, companies pay agents a percent of the cash value of excess interest credited to the accounts each month, thus encouraging the build-up of account values. Similarly, paying renewals based on the costs of insurance not only encourages agents to keep policies in force, but more importantly to seek increases on in-force accounts. Both of these factors can increase agents' incomes significantly over time, thereby providing long standing agents with substantial renewal incomes. The extreme pressures on companies to reduce acquisition costs, and the uncertainty surrounding their attempts to recoup those costs because of replacements, has led to increased interest in more leveling and less fronting of commissions. However, for obvious reasons, many established agents resist any changes in their compensation plans. A company that intends to convert all of its agents to relatively low first-year commission contracts can reasonably expect an increase in agent defections to companies that continue to pay traditional high first-year rates. As one senior marketing officer put it -- "We don't want to be lead car in this funeral procession."

Companies wishing to move toward more leveling to forestall the agent defection problems will probably have to shoulder much of the transition expense. One rather expensive way to try to win agents' approval of more leveled commissions is to pay the same renewal rate on both their new and existing business. Also, for career companies, the transition to a more level commission scale will result in doubling -- or even more -- the ongoing cost of financing new agents.

And the New York Insurance Department provides a profound disincentive to leveling for companies doing business there. If a company wants to reduce first-year commissions and correspondingly raise renewals, the increased renewals must be determined without benefit of interest, lapse or any other discounts.

The two individual life products where a pronounced degree of commission leveling has already taken place are flexible premium retirement annuities and yearly renewable term. The commission leveling on the annuities reflected a competitive response to other available funding vehicles, such as mutual funds in the IRA, HR-10 and 401(k) markets.

While YRT may not have been initially priced as a yearly replaceable term product, poor persistency experience suggests that it has been sold on an anticipated short-term basis -- whether or not re-entry was contemplated. Many companies have accepted the premise that the duration of YRT will be short and they have switched to a more level commission structure to accommodate the expected lapse experience.

It stands to reason that companies in the best position to make a significant move to more level commissions are those whose agents do not rely primarily on high first-year commissions for their economic security. Multiple-line companies and companies that specialize in the sale of mutual funds and tax shelters fit this bill.

Two additional issues may accelerate a move to more level commissions -- SEC regulations and possible changes in anti-rebating laws. As a practical matter, commissions on fixed and flexible premium variable life are constrained by the SEC's rather draconian sales load restrictions. In effect, these rules limit the amount of cost that companies can pass on to policyholders if lapse takes place. The net result is that the break-even point is typically longer for SEC-registered products. An environment in which agents could negotiate their commissions with clients should give companies further incentive to change their compensation structures.

The Florida Supreme Court recently ruled that the state's anti-rebate law is unconstitutional. The drive to permit commission rebates is likely to spread to other areas of the country. And if the Florida case does lead to similar action elsewhere, the entire market structure of the industry will be at risk. For example, if rebating were allowed, agents conceivably could offer healthy clients the opportunity to replace traditional level premium products at less cost than if the policies were renewed. Also, if agents were under pressure from their prospects to divulge -- and share -- part of their commissions, they themselves might prefer having options for level commissions.

There are two insurance companies -- Lincoln Benefit Life and Bankers National -- that currently market no-load, no commission life insurance through fee-only financial planners. I believe that very few companies will introduce similar competing products. Minimal public understanding of this type of life insur ance, and thus low demand, makes no-load life a niche market product now and probably for years to come.

I also want to talk about the impact of producer-owned reinsurance companies. As I mentioned earlier, life insurance companies have experienced an erosion of their profit margins in recent years. One major problem has been the replacement of profitable existing books of business with narrow-margin interest-sensitive products, while the costs of doing business has continued to escalate. Another factor has been the redistribution of superproducers due to the emergence of producer-owned reinsurance companies (PRCs) -- formed so that the superproducers could share in the profitability of their own business.

These PRCs are reinsurance companies owned, in part or in total, by a group of producers who capitalize on the reinsurance company through the purchase of shares. An agreed-upon percentage of the producers' new business -- say 50% -- is then reinsured in the PRC through an agreement with a direct writer which receives the new business. The producers will realize a gain or loss on their ownership shares of the PRC, depending on the quality and quantity of business as it emerges over a span of time. The potential future profit is typically in addition to the current contractual compensation received by the producer. There are two basis types of PRCs -- agent-formed and sponsored. In an agent-formed PRC, producers form an insurance company into which an agreed portion of their new business is reinsured by the direct writer. Within this type, one variation is where every agent shares in the PRC in direct relation to his or her paid-for production. In a second variation, certain agents are designated as general partners versus all others as limited partners. Under the sponsored PRC version, a party (it could be an insurance company, or agency, or holding company) initiates the formation of the PRC and promotes the sale of stock and insurance participation in the PRC to unrelated third parties.

Perhaps the most significant factor in forces leading to the formation of PRCs has been home office competition for increased production coupled with the growing unrest of experienced agents -- particularly superproducers. Top agents recognized that they were a valuable company asset. Their block of business was not only significantly larger than other agents' business, but was also of much higher quality. They felt that they should not be treated like all other agents; that their needs and problems were different and needed different treatment. In essence, superproducers were saying that they contributed as much to the bottom line as key home office employees and they should be getting a share of emerging profits. PRCs were perceived as possibly providing the mechanism.

What are the benefits of PRCs to superproducers? Some of the additional economic rewards include: for career agents, additional up-front expense money based on production above an agreed-upon threshold (i.e., $100,000 of annualized first-year commissions); joint case work among members of the producer group, who operate synergistically with partners across the country; profit potential from equity ownership in the PRC; more after-tax income -- this relates to deferred compensation plans and the very low corporate tax rates applied to small life insurance companies such as PRCs; and buyouts on predetermined bases of a producer's business in the event of death, retirement or disability. There are also a number of non-economic rewards. These include: being part of a producer group that is typically on the leading edge of product uses and marketing strategies; being more influential in the product development process, especially in very specialized markets because of the strength of the producer group; a marketing advantage in having a national identity, as do accounting and consulting actuarial firms; and ego-satisfaction.

What are the benefits of PRCs to direct writing companies? (1) It brings the agents on the same side of the profit table with the direct writer. By sharing in profits and losses of the business they write, the superproducers will have greater incentives to write quality business that will stay on the books. (2) PRCs can be important in attracting an increasing flow of production from major producers of other companies, and in training a larger share of the production of the direct writer's own career agents that otherwise would be placed outside. (3) Companies with PRC affiliations believe that their aggregate profits will increase even though a portion of the profits is shared with the producer group. The superproducers will be more conscious of the persistency of their business, or mortality risks, and of replacements because of their effect on the profit margins of their business placed with the PRC. (4) Unit costs ought to decrease, as a result of more and better business. (5) In career-agency companies, PRCs help to address the inevitable adversary relationship between superproducers and their general agencies or managers. These superproducers tend to resent a compensation system that allocates overrides and expense allowance on their business to field management whom they perceive as contributing little or nothing for them at this point in their careers.

Agents qualifying for a producer group must have very successful records and must be capable of producing a continuing high volume of quality business. The minimum requirements for stock ownership in a PRC are based on annualized new premiums or on first-year commissions, excluding bonuses. The average minimum production requirement per agent currently is running at between $250,000 to $300,000 of annualized first premiums. Participation in a PRC may be by individual producers or by preexisting groups of agents. For example, an independent agency could become the stockholder with the PRC stock split among all producers or partners. In some cases, new participants must be approved not only by the producer group but also by the direct writer.

For non-career building (independent agency) companies, the typical compensation contract, for superproducers in a PRC arrangement is a Personal Producing General Agent (PPGA) contract. Along with the PPGA contract, there may be a deferred compensation arrangement. Also, the superproducers are usually eligible for production and persistency bonuses -- but on qualification bases more stringent than for other company producers.

In career-agency companies the basic compensation contracts for PRC superproducers typically is the same as held by other career agents in the company. However, there is a recognition that the superproducer operates differently from other agents in the agency and, thus, should earn an additional flow of upfront money.

For example, in one career-agency company, the compensation for its participants is as follows: For production below a predetermined threshold level of first-year commissions, currently $100,000, the agent receives the same allowances and services from general agents as in the past. For production above the threshold level, the agent receives additional compensation in the form of first-year expense allowances (subject to Section 4228 limitations, since this direct writing company operates in New York), plus deferred compensation in renewal years. So, the more a qualifying producer drives his sales above the threshold level, the more upfront money he or she receives.

On the other hand, care was taken to assure the company's general agents that they would not be financially hurt by the PRC arrangement. Thus, for each career agent joining the PRC, the general agent is protected up to a different threshold level higher than $100,000. This higher threshold level is based on the agent's average first year commissions in the preceding two calendar years. By protection, I mean that the general agent's share of allowances up to the different (and higher) threshold level will be based on his past arrangement with the superproducer.

This, of course, means that this particular company is double-paying allowances for production between the two thresholds. It puts pressure on this company to recruit outside producers, where no such general agent protection is required and where in fact there would be a positive threshold spread. As mentioned earlier, this company went to great lengths to get its general agents to understand that they would not be losing any of their income under the PRC arrangement -- and that there would be the potential of gains to them through new superproducers affiliated with the agency and/or through existing superproducers who bring more of their business home because of the PRC.

In most PRC arrangements, one class of commonstock is issued -- giving all stockholders an equal vote. A superproducer's financial investment in the PRC should be large enough to make the producer seriously committed to the success of the PRC. In some existing PRC arrangements, the initial investment requirement per agent ranges from $2,500 to $100,000. When the initial investment per agent is low, the PRC's sponsoring company funds the balance of the capitalization. When it's as high as $100,000, the superproducer may be required to invest 15% to 25% of it, with the remainder capitalized through loans from the affiliated direct writer. The loans are repaid to the direct writer, through the retention of deferred allowances by the PRC. Other programs fund the PRC by reducing the superproducer's commission scale on business placed in the PRC.

The reinsurance agreement is the mechanism which allows the superproducers to share in the profits and losses of their business. Most PRC arrangements being formed today provide for 50% of risk transfer into the PRC by the affiliated direct writer. There are lower percentage agreements. And there are some based on a graded percentage share basis -- the higher the production level, the higher the reinsurance percentage. The PRC reinsurance agreement is usually on a YRT or modified coinsurance basis in order to enable the direct writer to hold the reserves.

One issue to be addressed is whether the superproducer should participate only in the profits, or losses, of his own PRC business -- or whether the experience of all PRC participants should be pooled. If the experience is segregated, a separate series of stock is issued to each participating producer. In a totally pooled arrangement, all business produced by participating agents is pooled for both mortality and persistency experience. In other arrangements, superproducer shares in the PRC are pooled for mortality experience and segmented for persistency experience.

Another important decision involves the treatment of profits. Are they to be paid out as dividends or retained in the PRC? In most cases, the profits are retained -- and may be used to fund buyouts, or to fund fringe benefits, or to lower superproducer thresholds.

What factors will make PRCs succeed? Let me start by posing an axiom here. Success will be based on the synergism resulting from mutual respect, trust, communication, cooperation, and commitment between and by the PRC producer group and the affiliated direct writer. It's the mutuality of objectives that really drives the success factors. For example, it's to the advantage of both the company and the PRC to recruit new producers into the PRC, to increase production and to improve mortality rates in the persistency of business. It's advantageous to both the company and the PRC to have competitive products and quality service. Each entity must depend upon the other for ultimate success in such a marketing arrangement.

It should be noted that in direct writing companies where the producer group constitutes its major marketing arm, the participating superproducers may play a significant role in product development and pricing assumptions. With their consulting actuaries and their software vendor contacts, the producers can get heavily involved in product development with the company and have a very strong say in defining the profit assumptions.

I will go over these points slowly, because it kind of focuses on some of the things that Mr. MacDonald was saying -- all is not peaches and cream with these agent-owned or producer-owned reinsurance companies. Some of the risks concerned are the following.

1. A producer group creates a new force of one strong voice. Demands may be made by the producer group to make key decisions; (i.e., new product development or pricing and underwriting).

2. Will the direct writer be satisfied with the projected product profitability, or will the direct writer be able to respond quickly enough to satisfy agent needs relative to product needs? The direct writer undoubtedly will find that it is much simpler to deal with agents as individuals rather than as one feisty, organized group.

3. How will the profits of a primary direct writer be affected when a producer group decides to make reinsurance agreements with two or three other direct writers?

4. As I noted earlier, the company with the PRC affiliation will be giving away some of its profits unless the producer reinsurance company is used as a vehicle to recruit superproducers from other companies and the share of quality business produced by the direct writer's own superproducers is increased.

5. To maintain harmony with its own distribution system, the career agency direct writer must create a balance between the superproducer group and the other producers in the organization. In particular, the company must effectively communicate to its remaining producers the reasons for the PRC arrangement. The company must explain the qualifications for participation and the perceived effects of the PRC in the company and in the remaining producers.

6. Also, the company would be very ill advised to develop products or support systems for the exclusive use of the PRC producer group.

7. Failure of PRC producers to realize profits can happen if the super producers, for whatever reasons, refuse to drop out in the early years. If that happens, they will be faced with the fact that stock liquidity afforded by the public market doesn't exist. There are limitations of the resale of such stock and the PRC may not be capable of repurchasing the stock.

8. Possible changes in the federal tax law runs the gamut from the possibility of losing the favorable small insurance company tax rates for the PRC to further loss of policy loan interest deductibility. Any negative legislation could stunt the growth of the PRC.

9. Let's assume the PRC producer will select the best risks for PRC participation. It follows that the remainder of his business might well be suspect and some companies are leery of accepting such business.

10. The best reinsurance arrangement for PRC participants is to have the ceding direct writer guarantee to credit the PRC with investment earnings equal to those of the direct writer, with expenses no greater than those of the direct writer. However, some PRCs are currently not sharing in the investment gains of the direct writer -- and this limits the potential profits of PRC participation. The mutual company direct writers particularly assert that since the superproducer may directly influence persistency and mortality but not interest earnings on the business they bring in, the interest margins should be passed on to policyholders in the form of dividends or excess interest credits, rather than reflected in the PRC. However, now that the 1986 Tax Act has eliminated the favorable capital gains tax rate which would have otherwise applied to the disposition of PRC stock, the superproducers of the future may look for direct writers having superior investment performance who are willing to share it with the PRC.

What are the alternatives? More upfront money and benefits might mean higher commissions to independent agencies, more lucrative bonus plans, or special support services. Or it could mean access to products of other companies or seminars for top producers.

Other alternatives might include stock option plans based on the agent's production and persistency or some sort of profit sharing. This might mean use of a production/persistency matrix to qualify agents for more expense allowances; or it might relate to rewarding the superproducer on the basis of the book of business of the entire agency with which he is affiliated.

As PRCs continue to emerge, other companies will expend more efforts to romance their own superproducers to retain their loyalty. Should these alternative incentives and profit sharing plans prove reasonably successful, then growth in the PRCs will be arrested. In this regard we should also keepin mind that there is only a limited number of superproducers out there.

What's ahead? I believe that profit sharing through PRCs or other means will eventually be available to producers below the superproducer level, and to general agents and managers as well. This will reflect an effort to bring the entire distribution system on the same side of the profitability table as the home office. I believe that we will see the emergence of a number of national marketing organizations providing multiple distributor representation for marketing choices and independent counseling credibility -- tied in with the opportunity for equity participation by producers in an affiliate PRC facility. In one instance -- Forth Financial Reserves, LTD. in Virginia -- such an arrangement is apparently now available to producers for no entry fee and "no qualification other than realistic performance."

Finally, in the development and operation of a PRC, superproducers are hiring their own actuaries and lawyers to negotiate agreements and to consult in compensation and product development with the manufacturer -- the direct writer. There is nothing to stop any PRC from forming its own broker dealer or affiliating with an investment management entity. It is also quite possible that some PRCs will eventually perform many of the marketing functions now handled by the career agency companies -- such as the recruiting, training and supervising of new agents. One gloomy forecast is that some direct writers will gradually move down to a role not dissimilar to that of third party administrators. Well, time will tell.

MR. TED BERNSTEIN: It is a big honor for me to be able to present my thoughts, especially with such a prestigious panel. I have spent the last several years of my life working very closely with actuaries in the research and development of no-load life insurance products and the distribution system. I would like to share a cute story which happened to me this week while I was preparing my remarks for this meeting.

I was in my office late one night when I was interrupted by the telephone. The person on the line identified himself as a new person in the life insurance industry. What he was hoping to do was to tell me about the universal life insurance products that he was representing for his companies. I quickly interrupted him and said I would just like to have him answer one question. "The contracts you are trying to teach me about tonight -- do they pay a sales commission?" I asked. He said with great emotion and great fervor, "You betcha they pay sales commissions." I quickly said, "Thank you very much, but I would not be interested in life insurance contracts of that type." There was a dead silence on the other end of the phone and I am convinced that nobody had prepared him for that objection.

Why market on a fee basis? This is an often asked question and it is one that has a very simple answer. The traditional model no longer works successfully. It is not as efficient as it used to be. The traditional model is less effective for all members of the model, including the client, the distribution system, and certainly for you, the insurance companies. As Harold mentioned in his comments, there is intense pressure on profits today. This pressure is of a magnitude the insurance industry has never felt before. It is this very pressure which led me to market on a fee basis. It alleviates that pressure on profits and creates a system of interdependence. A new model of distribution which is extremely profitable for all members is what I am here today to discuss.

To learn how to alleviate that pressure, it is essential to look at how we arrived at where we are today. Where are we today? What is the current state of our industry? As Bob explains, there has been an acceleration in the rate of change over the past ten years in this industry. Some results are that consumers are more alienated from the suppliers. There are new players such as banks, security firms, and other institutional giants fighting for their share. There are also new products, universal life, variable life, and now even universal variable life. Along with all of these product innovations is a new laundry list of technical terms to intensify the confusion. Finally and unfortunately, the distribution system has failed to keep pace, which has led to a serious communication breakdown.

Let's take a moment to explore the historical events which have led to this breakdown. There had been one method for life insurance distribution in our industry up until the 1950s. While the career systems dominated through the late 1950s, the emergence of the brokerage industry was developing. The brokerage system enables the small company to take on the giants. They were successful in this effort by staying outside the state of New York while it had effective regulation enforcement. Also, the smaller companies competed for the agents with commission. They remained outside the reach of the effective enforcement of New York laws. The attention shifted from policy values to exceptionally high compensation packages. I can remember being lured by companies offering me 105%, 115%, and even 130% commission. Therefore, we have the eventual demise of the career system. I was warned by my company and urged, as a matter of fact, not to use such a strong visual aid. However, my instincts told me there is no one better to use the visual aid of death on than life insurance actuaries.

What are the harmful side effects of these historical developments? The educational systems falls apart. Why? The companies have made a decision that they cannot afford the luxury of training agents. As I have pointed out, new agents and existing agents are susceptible to the brokerage environment and the career companies cannot be assured that the agents they will train will remain loyal today. Therefore, the agents' understanding and ability to communicate the information about the product's benefits suffers. The agent's performance -- their ability to sell the product with a solid base of knowledge -- suffers and the industry loses control of the clients' understanding of the product and at the same time loses control of the distribution system. I have heard it argued that today the distribution system is in control of the insurance companies. What does this signify? Unfortunately, the powerful attraction of high brokerage commissions combined with the industry loss of control, leads to an increased frequency of replacement. As these developments occur, consumer confusion intensifies and he is no longer capable of understanding what he is buying. It is an all too frequent complaint from the consumer that life insurance is underhanded. What he really is saying is that he does not have the ability to become educated enough to understand his purchase and as an uneducated consumer he is ripe for exploitation. Where are we headed? Where are we going?

Ultimately, these developments have given our industry a bad public image. There is not a high degree of trust between the consumer and other members of the distribution system. Therefore, the consumer and suppliers are pulled even further apart allowing for others to lay claim on our market share. As this gap widens, profitability will plummet even further. We don't have to look very hard to see evidence of these developments. For the first time since 1906, the rebating laws in one of our key states were overturned. As Harold mentioned, who is to say which states will be next and how many more states will follow Florida's lead? Although some claim rebating will not be harmful to our industry as a whole, we need only exam the impact it is certainly going to have on lapses. Why will lapses increase in an environment of rebating? The clients' attention will be on the free cost of insurance, which is attainable by the distribution system's ability to rebate the high first year commission. However, what happens next year? The client is faced with a choice. Does he continue the policy which offers him little or no additional rebate, or does he seek out an agent willing to share new first year commissions, available simply by evidence of insurability at another company, and on and on and on until you, the insurance company, are left with those whose adverse health does not permit this game to continue? Suddenly, all intrinsic benefits take a back seat to consumers' magnified interest in the rebate. As we all know consumerism has swept through our country. There have been many instances where consumerism run amuck seemed to be a threat to a particular industry. Although trying to improve an industry on a consumer's behalf often produces positive benefits. Consumerism has a negative connotation when changes are produced by an outsider with limited knowledge of that industry.

It is our responsibility here not to miss the opportunity to determine our own future. We have the ability to internally deal with the inefficiencies I have outlined today. In 1985 Jim Anderson addressed this issue intelligently and squarely in his speech "Let The Real Revolution Begin." Jim said that the life insurance industry is moving toward a fee-for-service distribution made up of no-load, or low-load policies. And, furthermore, the current distribution system will have to learn to adapt or be faced with a lesser number of players controlling a huge client base. This is precisely the kind of proactive thinking, instead of reactive thinking that we need now if we wish to stay in control of our destiny.

Now, we have talked about the disadvantages of the old system and it's shrinking profits. What are the advantages of the new system, one which Jim Anderson has advocated? The fee basis system begins to bridge the gap I discussed earlier. Separating the acquisition cost from the product begins to simplify the real cost of life insurance. Also, it heightens the clients awareness of the increased efficiency of the new distribution system. What are the benefits to the consumers? For the first time the client is represented by a distribution system which has only his best interest in mind. A sense of trust begins to develop as the client is in the position to evaluate the real value brought by the producer. Lower cost for comparable protection allows for increased volume because more of the client's premium is spent on the cost of the insurance as opposed to a significant portion going to the traditional loads. One of the chief features is the high early year values. We feel that this is in the best interest of the client. He has flexibility in the event he feels he needs to change his decision for any reason.

No surrender charges can exist in a true no-load life insurance distribution system. We do not anticipate, however, that once this policy has been bought it is susceptible to replacement. The consumers will question an approach from the traditional system because of their new understanding of the effects of commissions. Additionally, an approach from a noncommission product will require additional acquisition costs. Assured Enterprises guarantees it's clients that we will never charge another fee again if for any reason our client wishes to move from one company to the next. I think that is an excellent guarantee for the suppliers and/or you the insurance companies. Your distribution system would be faced with working for free, if in fact we had to move one thousand, two thousand, or three thousand policyholders. Of course, one of the advantages of separating the acquisition costs, or in another words, paying consulting fees is the possible deduction of those fees. We urge all of our clients to seek the advice of their independent tax counselors for this guidance. And finally, the deterioration of education is a side effect with harmful implications as I have mentioned earlier. Also, in a fee-for-service environment, members of the distribution service must stay knowledgeable to justify the fees that they are entitled to. This is the type of self-policing mechanism which automatically occurs in a fee-for-service environment.

Are these consumer advantages achieved at the expense of other members of the fee basis system? Absolutely not! One of the most important benefits of no acquisition costs is the fact that there is no drain on surplus caused by new business. Our experience has been 100%. Although we have only been marketing these products for three years, all indications point toward high persistency. Conversely, the industry statistics indicate that 25% of all policies will lapse by the end of the second year. I think the fact that this purchase is made with a high level of knowledge is of equal importance. It guarantees client understanding of both the short-term and long-term benefits, thereby assuring persistency. Industry statistics also suggest that the more knowledge at the time of purchase, the more persistency you are going to get. Our unique relationship with a national accounting firm, Laventhol and Horwath, is an example of your decreased dependence on the traditional distribution system, thereby opening up opportunities to firms with a large client basis. The emphasis is on networking, the pooling of resources and the reduction in prospecting costs. As Bob pointed out, the companies will be viewed as manufacturers, focusing their attention on developing the best product they are capable of producing. An intangible but also significant benefit is the new perception by the public that the insurance company is consumer driven instead of distribution driven, as Jim Anderson pointed out in his 1985 article. The ultimate result is an enhanced image as a whole for the industry, further bridging the gap which I referred to earlier.

Up until now, I have demonstrated the advantages to the consumer and to the supplier. I am sure you are all wondering what it is about no-load life insurance that allows the distribution system to become profitable again. It is essential that the benefits that you, the supplier, enjoy are reflected in the types of products we, the distribution system, bring to the market. A real sense of teamwork is essential in communicating the stability of this system to the consumer. Our position in the new model has been redefined as being the link between the consumer and the supplier. What then is different from the traditional system? It is simple. It is our ability to represent only the client. Therefore, a heightened feeling of trust develops between the consumer and the supplier as the client is assured there are no hidden motivations; or in other words advise without the bias caused by commissions. A redefinition of these terms leads to an increased professional image. Insurance that is bought, not sold, is one of the models that Assured Enterprises uses. An enhanced professional image of the distribution system -- about the way the marketer feels about himself -- is created in a fee-for-service environment. There are upfront fees and invoices, and we are able to bring total disclosure. There are no hidden costs or fees again. Our clients have told us that charging fees in advance is far more professional. In some cases, fees are paid even if insurance is not bought. The ability to charge fees creates flexibility in determining the value of each particular client. For example, discounts for volume is a practice which many consumers feel is more proportional in terms of the actual amount of work done. At Assured Enterprises we discount as more life insurance is purchased; the proportionate amount is decreased. In keeping with the theme of flexibility, the fee environment allows the distribution system to spread fees over time which is a key selling point when the fees become substantial. Tax deductibility, of course, should not be a sales tool or part of the materials. It should only be used as icing on the cake.

As networking among fee-for-service firms increases, prospecting costs will reduce because the distribution system finds ways to plug into these other firms' client basis. Additionally, the credibility of being endorsed by a large accounting firm, a large bank, law firms, etc., create a more legitimate environment for successful sales. And finally, third party endorsement is also beneficial for a successful sales process for the distribution system. Naturally, there are no restraints on determining the market for no-load products. However, it was a conscious decision on our part to focus our efforts on the business community and the upper income end of this market. The simple and obvious reason for our decision was the fact that this market is accustomed to paying for professional advice -- especially for intangible products and services.

This then completes the analysis of how fee-for-service will naturally increase the profits for all the members of the new model. The philosophy of interdependence becomes clear when the benefits to one are caused by providing benefits to the others. The importance of you, the insurance companies, to willingly reflect all benefits such as no drain on surplus, high persistency, and increased volume cannot be overemphasized. Eventually, there will be no gaps between the members of this system. The consumer will have made acquisitions based upon sound financial decisions. His feelings about the distribution system which delivers the policies will be markedly improved and the suppliers will experience real profits in the early years. Today, there are approximately ten life insurance companies offering no-load policies. You folks have the opportunity to be among the leaders in the most significant shift toward legitimization and profitability this industry has ever faced. We can certainly sit back and wait for the other guy to lead the pack, or worse yet we can have our future handed to us by outsiders. However, we can seize the opportunity to orchestrate our destiny by taking the first steps toward the system guaranteed to assure our survival. "Let the real revolution begin."

MR. WALTER N. MILLER: I think that Mr. MacDonald gave us a pretty good message on the fundamentals of what we are confronting and what we really should be looking, and I think those remarks were well worth our attention. Mr. Ingraham, one footnote on producer reinsurance groups that I think deserves underlining is that you can do the best job that you can in setting up a marvelous PRC, considering the market in which these superproducers, as you term them, are operating. But if your company is not a company that has great pricing fundamentals and is very nimble and is able to move very quickly in product development, including changing what you developed maybe three or six months ago, you really have no business in that market if you want to succeed. The best or most attractive compensation arrangements on the face of the earth are not going to help you very much.

I don't have any doubt that this fee based method of distribution is going to be more apparent in the future than it has been in the past. I guess I doubt that it is the smooth, untraveled path to salvation and legitimization, a term, which I must confess, bothers me for all of us. Somebody with no background listening to this presentation would be entitled to believe that the Florida anti-rebate decision is one which is the precursor of the inevitable falling of all the rest of the dominos and that it is going to change the world so much that we can just say RIP to the career agency system. The fact of the matter is that the Florida anti-rebate decision was one of the most rotten cases of judicial reasoning on record and lawyers for both sides agreed with that -- it was four to three. There are excellent reasons to believe that with proper preparation that decision won't be repeated. I would suggest to many people here that one of the best ways to react to the Florida anti-rebate decision is not to sit back and wait for the dominos to fall and figure out what other distribution system we are going to use, but rather to fight any attempts to weaken any of the other anti-rebate laws as vigorously as possible. I suspect that might be a much more productive action for most of us. I think one problem in administering a fee based system from the standpoint of the public interest (which I don't think always will coincide with the distributor's interest to the extent suggested here) is that there is a real problem as far as cost comparison and disclosure is concerned. I do not believe that it is fair to say that the consumer gets a reasonable picture when he looks at some cost comparison index for a no-load policy versus that for a policy sold under a career agent distribution system. Despite the upfront disclosure of the fees from the fee-for-service people, there is still something missing there. I hope that as fee-for-service spreads, which it will, some things are done about that.

Finally, let's get back to the suggestion that the fee-for-service distribution system is the one that is going to take over everywhere, and we should all jump on board as we rush toward the bright new world. There are a number of us here that have a legitimate place in the world, providing coverage to probably the 95% of the people who are not in the upper income target market. I am not so sure that the distribution system we have, might not be more adequate than the brave new world that has been suggested here.

MR. POLKINGHORN: Ted, would you like to address this? I know you had some ideas on where it became more feasible for commission based sales versus fee based sales when we were talking last night.

MR. BERNSTEIN: Walt, I have thought about many of the comments that you just made and I could not agree with you more about many of them. My reference to the target market being the business environment -- the upper income end of the business environment -- was simply our easiest way to break into the fee-for-service-market because these people are accustomed to paying accounting fees, legal fees, actuarial fees, all types of fees-for-services and products which are intangible. I believe fee-for-service fits in most other areas of the marketplace but probably not in the bottom part of the market, where small volumes of life insurance are sold. I think the acquisition costs in those areas are what that system was built upon and serve that market very well indeed.

MR. MACDONALD: I agree with Walt and I agree with Harold and I agree with Ted, too, on this. I give a lot of talks to financial planning groups and I have found that most of those people don't sell anything -- they just go to meetings all the time. I think that the fee based compensation has a niche, but it is in the very upper income brackets -- not in the market, quite frankly, that ITT, Life is aimed at -- which is the middle income group. I think there are two reasons why it will not fit into the vast market that we are really talking about.

One is as was pointed out. Maybe at the very high income level you are used to paying fees for accounting services and lawyers' fees, and so on and so forth and you can be trained to pay fees for insurance. I think that is possible but in the middle income market the consumer is not used to paying fees for insurance services and I think most importantly the agent is not trained to ask for fees. The biggest problem you have had with a lot of agents in terms of increasing size is asking for bigger amounts of dollars. I think that the agent has a difficult time asking for fees at that lower level. I think the fee-for-service basis has a very important niche in the future but I see it more toward the higher income end than certainly the vast market.

MR. INGRAHAM: I did say that I believed that no-load life insurance -- right now and for some time to come -- is really a product with a niche. I think Bob has just restated that it may meet a specific narrow need right now where you have high income people that fee based financial planners are talking to. I did not understand who was selling no-load life insurance but I read this article in *Financial Planner* that mentioned these two companies -- Lincoln Benefit Life and Bankers. I called one and asked about sales. They said that there was one group of fee based financial planners in Pennsylvania. They had developed a special product just for that one group. All of the rest of their agents, and I guess they are using sort of a PPGA system, were selling conventually priced products with some sort of commission load built into them. That was really a trial balloon with them. They are reasonably satisfied that this one group of financial planners is marketing the product that they developed for them. There was another company, I think in Indiania, that tried this some years ago and it did not go over, so they withdrew the product. I understand Lincoln Benefit Life is one of the Sears affiliates. I don't really know what the interelationship of their marketing is with Allstate is but I suspect they are meeting a different market segment's need totally.

FROM THE FLOOR: I have one additional point worth mentioning about where fee-for-service fits and what place -- if it is going to fit in the middle market. One thing we don't want to lose sight of is the fact that once we bring the policy to the consumer's attention and he sees low costs and shops for comparable policies, which we encourage him to do, he sees amazing first year and early year cash values with no surrender charge on them. He learns how to pay fees really fast.

MR. WILLIAM C. CUTLIP: Bob, you commented on two year persistency -- the bonus counting program you have still does not match the profit stream that the insurance company has to take the risk for over the longer term. Is there any anticipation that you would eventually spread that out?

MR. MACDONALD: I think that is a good point referring to when I addressed the fact that it really doesn't spread out the risk over the long term. The agents get in short term what we get in long term and as I said, I don't believe it is a perfect situation, but we are trying to deliver a message. I just find it difficult tying agents' compensation, particularly independent agents that we deal with, over the ten year period. I just don't think you can hold their attention that long. As I mentioned I think the stimuli has to be shorter. Our hope is that if we can get the product on the right track, we will be better off as we come along. But it is a problem and as I said, I think the best way is a true AOC where the agent really is involved. But it is difficult with this profit thing to balance it out because agents just don't think long term normally.

MR. CUTLIP: You also mentioned helping with the prospecting to bring out the effectiveness, but let me give you the myth from the actuary's standpoint -- then you can tell me how the salesman really operates. Doesn't the prospecting for an individual agent really vary by the local market and also by the personality and style of the agent? How could you design something from the company's standpoint that really helps them with that prospecting?

MR. MCDONALD: I think you are right and again, you are raising issues that we could talk about forever. I think we are going to see, what I call in the book field, marketing organizations evolving which are independent marketing organizations that have established a market niche. It may be in the high-income level, it may be in payroll deduction, it may be in a variety of things. But they have got a marketing niche and a natural prospecting type point. As Harold mentioned late in his speech, we are going to see the recruiting, training, and supervision away from the home office and out into the field where I think it belongs, which is going to help us in the total overall acquisition costs. I think the problem that you run into in terms of prospecting is that if you trade dollars with the agent, if you could make it more efficient for the agent to see more people, I think they would be willing to trade dollars with you. I think one of the best ways to do it is to get banks involved in insurance because I think banks will just be centers of influence for agents. I think they would be willing to share their commissions with the banker if they could be more efficient. We have a telemarketing operation in which we charge agents about $30 a lead. We don't have the capacity to handle all of the people we have lined up to use it. My point is if we can focus where we really need to focus and that is make distribution more efficient, then I think the compensation becomes less of a problem. We can build into it, we can look at spreading it out or restructuring it, but unless we change how the agent works, unless we help them through a variety of ways, I think we are just stymied where we are at now.

FROM THE FLOOR: Mr. Bernstein, you talked about the fact that in three years you still have 100% persistency on the business you produced. That is admirable. What is the advisors' motivation to continue the persistency? It seems to me that from the insurance company's standpoint the most difficult kind of persistency would be if you had gone on a fee-for-service basis and you really were not getting compensation from the insurance company, and then something better came along in terms of another product. It seems it would be very easy to shift the client over to the new product. We're back with our same old problems of trying to cover our expenses and profit in a very short period of time.

MR. BERNSTEIN: The motivation by the distribution system to service it's policyholders should be enough because that is what is right. He should do it. There are other options that were mentioned in both presentations here today that I would be happy to discuss with you later.

MR. POLKINGHORN: What big cost are you trying to recover now that there has not been a commission paid on the product? Is persistency that important? If the policy lapses after three years, you lose future profits but chances are you have broken even and perhaps made a small profit.

FROM THE FLOOR: I question that. Again, you're into a competitive environment so you may not be covering your spread initially. I also think you have the initial issue costs that have to be set up, and the basic overhead cost that you put into an acquisition approach, so there are still some substantial early year drains there that do not let you get your profits back initially.

FROM THE FLOOR: I have a question on the PRCs relating to questions that Walt and Harold raised in their presentations. What kinds of demands have been placed on companies that have been involved so far with any PRCs? Have the agents really become profit motivated with those demands or are they still looking at something that is going to make the product more competitive and a lot easier to sell and not worry too much about the long term profits?

MR. INGRAHAM: The original producer reinsurance entity was one put together by the M Group and I know some of you in this audience are familiar with the M Group. It is a marketing organization of top producers that formed a reinsurance company, M Life, and they have arrangements with Security Life of Denver and Pacific Mutual. Now, the persistency over the first few years of the business written by these people is phenomenal. Further, the mortality experience is exceptionally good, too, which indicates that they do a fair amount of field underwriting that may not have been fully appreciated up until now by home office people. I wish we had time to get into a discussion of how the profits should be shared, because in these instances, they are also sharing not only in mortality and persistency experience, but they are getting a slice of the investment action too. The mutual company actuaries can debate this for the time probably allocated to another panel. I think I should caution all of you to keep in mind that in a medium-sized company that embarks on one of these ventures, it could be that over half of their business that comes in is controlled by the producer groups. As Walt said, if you are not at the cutting edge of product innovation and pricing and design, that business can evaporate awfully fast because there are other entities out there.

The other point I will make may dispel some smug comfort that people have had over the last couple of years relative to variable life,and variable universal life. You hear that career shops like the idea of a product that has to be marketed on a basis where the agents put the business through a particular broker dealer. Keep in mind that these agents and producer groups can form their own broker dealer and so the shoe then is on the other foot. If you want to have your variable life sold by them, then it has to be put through their broker dealer and not your broker dealer. Let me summarize what I have said. There is evidence that business written by these people is more profitable which suggests that the rest of the business is being dumped on other companies. The motivation from the standpoint of companies who want to do this is that you are holding on to the business of your top producers. You are going to get more, better quality business to spread your unit cost but you run the risk that producers are going to start dictating your priorities and that is another culture shock that companies who get into this may not like. Another environmental change that the companies may not like to see is the producers sitting down in the home office with an actuary at their side who represents them. I predict there will be some adversarial situations emerging as a result.

MR. FREDERICK S. TOWNSEND JR.: Bob MacDonald raised the point about productivity and total acquisition cost improving the productivity of the home office as well as the sales force. He then later said that some companies would be better off if they were product manufacturers and left the training of the field force, etc. to outside marketing organizations. I have been going around visiting some general agents who have been enlisting in these PRCs and I find it interesting that one of the advantages or benefits which has arisen in the eyes of many of these general agents is that they significantly increase their production by joining these producer groups. Some general agents who already had a very large production base indicated that they had doubled or tripled their production since joining these groups, which indicates that the groups they are with are imparting greater sales knowledge, techniques, and aids to these agents than the large companies that they had been affiliated with before had been able to provide to them.

MR. INGRAHAM: Let me sight a specific personal situation that I encountered while I was still with NEL. They formed their producer group last year. One producer had a client -- it was a pension situation that had come up and the producer had sold other products with the client. Because of the networking possible within this producer group, he was able to call on somebody else in another part of the country to come in and address the particular pension issue and as a result a major sale was made that might otherwise not have been made.

MR. WILLIAM P. SUTTON III: Harold, you described the relationship of the career company with these producer groups. If I heard you right, you said that you tell the agent he is going to get more, the field manager is going to get no less, and the company is going to share its profits with the producer group. What is in it for the career company?

MR. INGRAHAM: I will answer that in two parts. As I pointed out, the career company is hoping to get a substantially increased amount of business it would not otherwise have gotten, or it is going to arrest what otherwise would have been a decrease in business. To the extent it gets that increase, the general agent is getting a lot less so you are just hacking up the same pie in a different way and also you are getting a broader base of business to cover unit costs. The other point that is that it only works because of this double paying condition that we are addressing now. Minimum satisfactory results will be achieved when the ratio of outside to inside producers is 1 to 3 or 1 to 4.

FROM THE FLOOR: Harold, now that you no longer have to go to 501 Boylston Street for your living you can be honest with us now. Did you experience an increase in production when you introduced the program.

MR. INGRAHAM: To the best of my knowledge they haven't but I think maybe the jury is still out. It has only been in operation for a year and a half. You have to ask yourself would their production have been less than it was last year if it had not been for the producer?

MR. POLKINGHORN: They also have not reinsured a dollar's worth of business yet so there may be a correlation. Bob, does every ITT agent participate in your program?

MR. MACDONALD: Not directly in terms of the compensation because we have about 11,000 agents licensed. We deal with what we call the field marketing directors and we tie the compensation directly to the block of business that is located in their hierarchy. We believe in control of premium so we tie their compensation to this profit structure just from a mechanical standpoint. We have noticed that a number of them have begun to push, the chargebacks down, and so on and so forth. But we don't get into the administration of it because we just deal with the marketing organizations. What we have seen is that these marketing organizations, as a result of the fact that their income is impacted directly, have either terminated the poor producing ones or they have just not hired them and they have sent them to other companies.

MR. SIMON BERNSTEIN*: First of all I would like to say that I sat and listened to all three and it was a pleasure for me as one of the marketers to see that the distribution centers are not going to change and that there is going to be a varying amount of different types of distribution centers to let all of us who think differently, market differently. I would like to make just one comment with regard to someone who has taken much time to change my mind about marketing a no-load product. After all, I came from a background of selling high commissions, working for, by the way, both companies that sit up there, and representing both of those companies. It is interesting to me to note the comments with regard to the distribution center of no-load have only an appeal to the wealthy. I think that is somewhat misleading. We are finding that in marketing to the general public, to the middle class, the no load has a wide acceptance in the mass marketing vehicle. We are embarking on an Hispanic program in which the no-load product is definitely an advantage; it works better, it functions better, it has better profitability to all concerned and it is easier to take care of. We also have found that in our conversation with the larger companies involved in the distribution of policies through such institutions as banks or savings and loans, the no-load also has a function. My only point here is that if you are going to market there why not recognize the change? As it took me a long time to do it, let's not wait so long to see if we can't get that business.

* Mr. Bernstein is not a member of the Society.