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THE FLEXIBLE COMPENSATION MARKET

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- o This session will explore new methods, ideas and approaches to provide adequate compensation to agents and appropriate profits for insurers while maintaining customer values.
  - -- Product design
    - -- New products
    - -- New features
    - -- Mix and match
  - -- Flexible compensation in a branch office shop: A unique approach to profit
  - -- Fee-for-service providers
    - -- Agent/company issues
    - -- Pricing considerations
  - -- Rebating -- equity or disaster?

MR. WILLIAM C. CUTLIP: I am Chief Actuary for General Life of Wisconsin and the panelists include: Philip K. Polkinghorn, who is a Consultant with Tillinghast, a Towers Perrin Company out of Jacksonville, Florida; Haluk Ariturk, who is a Vice President and Chief Actuary for the Acacia Group in Washington, D.C., and Donald A. Skokan, who is a Assistant Vice President and Associate Actuary for the Colonial Penn Group in Philadelphia.

Our approach is going to be to present you with a potpourri of ideas on various ways in which companies have come to grips with the dilemma facing agents today -- how to earn enough to eat in a highly competitive marketplace which demands consumer values and profits for insurance companies as well. Phil is

going to give you some background as to the emergence of the need for flexible compensation and some product solutions to that. Haluk will describe how a career branch office company has tied flexibility to profits. Don will take on the fee-for-service arena and how products can accommodate that, and I will present you with some ideas on new ways to view rebating.

MR. PHILIP K. POLKINGHORN: I am going to talk a bit about forms of flexible compensation that have been with us for a little while. Five or ten years ago, these flexible compensation methods would not have been around but they are becoming more and more common. In the past, companies offered some flexibility in compensation, but it was generally to provide convenience and did not change the overall cost to the consumer. What we are going to talk about today are primarily methods of flexible compensation that enhance or detract from the ultimate cost of the product to the consumer. Before I get into some specifics on methods used to make compensation flexible and improve product values, I would like to talk a bit about the forces that have led to flexible compensation.

I think the first and perhaps one of the most important is that commissions are an easy target. Many companies are already pricing with target expense rates that are below their actual expenses, they have reduced profit margins about as low as they feel they can, and they have come to the conclusion that the simplest way to improve the competitiveness of the product without sacrificing further on the financial side is to work a balancing act with agents' compensation. Agents' compensation is a purely variable cost and the effects on profitability are easily understood.

The second factor that I think has led to a need for flexible compensation is greater consumer awareness. People are demanding more competitive products. Columnists such as Jane Bryant Quinn write that the typical level of agents' compensation on whole life is 55%. Recently, they have become more sophisticated and they even include the typical level of overrides. This sort of publication probably reaches a fairly sophisticated audience. However, similar-type comments often appear in periodicals such as *Consumer Reports* and local newspaper articles. So regardless of your market, more and more of the public is getting the message that there is a high first-year loading associated with permanent life insurance.

The next force that has led to a need for flexible compensation will surprise some of you. I'll bet many of you did not know that your marketing departments have been looking at and studying AIDS for a much longer period than the underwriting department. That is because AIDS stands for Alternative Insurance Distributions Systems. While the majority of life insurance is still sold by individual agents, we are finding that more and more insurance is being sold by alternative means and the individual agents must compete with these alternative insurance distribution systems. Additionally, the characteristics of our individual agents are changing over time. There has been a proliferation of agents who call themselves financial planners and many agencies have changed their nature from a tied agency to basically an independent agency.

In the remainder of my section, I will talk about some tools that companies have used to make products more competitive and to balance the compensation to pay for it.

The first has been with us for quite awhile. It is the paid-up additions rider. This rider is often referred to as an increasing whole life rider, plus-units, or some other name. Under this approach, a portion of each premium (the portion can vary from year to year) is used to purchase fully paid-up insurance -- participating insurance. This rider has been used to meet a number of needs. The rider has a single premium-like commission so it has very low loading in the early years. It can be used to enhance early year cash values. It can also be used to shorten the vanish period to a period shorter than could be achieved by the dividend scale on the base policy by itself. In the corporate-owned life insurance market, public corporations are required to include as a hit to earnings the difference between premiums paid and the increase in cash value. So in that market, agents could sell a plan that was heavily skewed toward the paid-up additions rider and increase the cash value to premium ratio in the first year. The use of this rider has been spreading primarily from a cost-of-living device and a device used to improve the vanish year to a device used to improve flexibility of traditional products and to improve the long-term performance of these products.

Are any of you familiar with Northwestern Mutual's Comp-Life? Essentially, it turns out to be a combination of participating whole life, paid-up additions, and term insurance. For your information Table 1 what happens to the cash values

at selected points in time if you divide up the total premium between the base plan and paid-up additions riders. The far left column is 100% base plan cash values, using dividends to purchase paid-up ads. In the second column, we have 50% of each annual premium purchasing the base plan and 50% is purchasing a paid-up additions rider. In the far right, only 25% of the premium goes to the base plan. You can see that in early years, there is a phenomenal difference in the cash values. The difference narrows in percentage terms over time but there is still quite a difference at the end.

TABLE 1

Ordinary Life Cash Value Comparison
$3,000 Annual Premium
Base Plan -- Rider

Year	100% - 0%	50% - 50%	25% - 75%
1	363	1,773	2,487
6	13,031	18,331	21,298
11	37,566	46,334	51,607
16	75,046	89,040	97,811
21	130,009	152,477	166,786

If you remember, I mentioned the added flexibility. The traditional products can be made nearly as flexible as universal life if you combine par whole life, a paid-up additions rider, and a term rider. If you leave the term rider out, you can see what happens in Table 2. The more paid-up additions rider you use, the lower the initial death benefit is. It can take quite a while for it to catch back up.

TABLE 2

Ordinary Life Death Benefit Comparison
$3,000 Annual Premium
Base Plan -- Rider

Year	100% - 0%	50% - 50%	25% - 75%
1	147,964	72,218	40,845
6	160,455	103,441	78,729
11	188,531	145,221	128,026
16	232,674	202,175	192,428
21	293,849	277,881	276,848

It did not take companies offering universal life long to come up with some flexible compensation ideas of their own. Probably, the most common is the use of universal life with a term rider. Initially, companies offered universal life with a term rider where there was nothing special about the term rates but the

agents could overcome the minimum premium requirement by balancing the face amount between base plan and the term rider. While companies recently have developed term riders that improve the long-term performance of the contract, the method for doing this varies depending on whether the contract is a front-loaded contract or a back-loaded contract.

For a front-loaded design, if you could envision for a moment a contract that has a per $1,000 first-year load that is very high and you were going to sell a $100,000 contract, you could just as easily sell $50,000 of base plan which would cut your front-end load in half and $50,000 of the term rider which could have the exact same charges as the base plan. Your long-term values would be improved. The agents' commission would, of course, go down. For a back-loaded design, if you do not have lower cost of insurance rates for the term rider, the only values that will improve are the earlier values when your per $1,000 surrender charge is based upon a lower face amount.

When developing this sort of rider, there are certain Section 7702 issues that should be addressed. The key one to remember is that the death benefit of your term rider cannot be used to satisfy the corridor requirement. This can result in purchasing more pure insurance than was wanted in the later years of the contract.

Tables 3 and 4 are some examples of universal life with a term rider using the same splits between base plan and rider as I did with par whole life.

TABLE 3

UL Cash Value Comparison
$3,000 Annual Premium
Base Plan -- Rider

Year	100% - 0%	50% - 50%	25% - 75%
1	0	539	1,765
6	15,230	18,549	20,207
11	42,725	46,591	48,469
16	82,708	87,844	88,805
21	142,423	149,490	146,404

These three scenarios all produce equivalent profits for the insurance company. However, you can see that the longer term values are better depending on how much rider you put in. The anamoly I spoke of earlier where the

death benefit from the term rider cannot be used to meet the corridor requirement shows up in the far right column. When you take 25% of normal commissions, the 21st cash value is lower than when you take 50% of normal commissions. This is because the death benefit from the rider could not be used to meet the corridor so we ran into a corridor situation rather early on. You can see from the 11th year on, we were buying more pure insurance from the third scenario than under the others.

TABLE 4

UL Death Benefit Comparison
$3,000 Annual Premium
Base Plan -- Rider

Year	100% - 0%	50% - 50%	25% - 75%
1	250,000	250,000	250,000
6	250,000	250,000	250,000
11	250,000	250,000	257,875
16	250,000	250,000	398,313
21	250,000	296,625	356,063

There is a solution to this. It is to convert the rider to the base plan once you hit the corridor. A more complicated way would be to convert only enough of the rider so that your corridor increase was matched by a decrease in the rider. In Table 5, we converted the entire rider at the point we hit the corridor. You can see in this example, the values progress as you expect. They get better the higher the percentage of the term rider. The early year values are phenomenally better.

TABLE 5

UL Cash Value Comparison
$3,000 Annual Premium
Base Plan -- Rider

Year	100% - 0%-	50% - 50% (1)	25% - 75% (2)
1	0	539	1,765
6	15,230	18,549	20,207
11	42,725	46,591	48,118
16	82,708	87,844	89,460
21	142,423	151,145	153,963

(1) Rider years 1-17

(2) Rider years 1-9

I was a bit dismayed when I first looked at the 20th year values to see that there was perhaps an 8% differential in 20th year cash values for as much as a 75% give up in commission. I looked at the Tillinghast Universal Life Analytical Study. If the company that was in 100th place based on the 20th year value were to increase their 20th year cash value by 8%, they would move into the 33rd position. If the company that was in the 20th place were to increase their value by 8%, they would move into 4th place. A number of the companies in the top divisions have low commission products.

We could also defer some of the benefit of the lower commission to the later durations. That is what we have done in the far right column in Table 6. As you can see, I have two 50/50 splits. In the last 50/50 split, the cost of insurance rates for the term riders are a bit higher in the early years and lower in the later years than under the first. You can see that in the first year, I have a $539 versus a $415 cash value. There is a little bit of give-up, but by the 11th year my last scenario is better than the 21st year. My 50% commission scenario produces better values than the original 25% commissions. So you can build in a little bit better long-term values with relatively minor changes to the early year values and improve your break-even year at the same time.

TABLE 6

UL Cash Value Comparison
$3,000 Annual Premium
Base Plan -- Rider

Year	100% - 0% /	50% - 50% / (1)	25% - 75% / (2)	50% - 50% (3)
1	0	539	1,765	415
6	15,230	18,549	20,207	18,299
11	42,725	46,591	48,118	47,179
16	82,708	87,844	89,460	89,613
21	142,423	151,145	153,963	154,223

Rider years:
(1) Yrs 1-17 (2) Yrs 1-9 (3) Yrs 1-16

There are some other examples of flexible compensation products in the marketplace today, but these other examples tend to be more obscure. The first is flexible load universal life. There are only one to two products like this that I am aware of where commissions are based on the loading structure for the universal life. If you change the loading structure, commissions change dollar-for-dollar.

In the group universal life market, some companies have developed products that have flexible compensation features where the loading and the compensation also change dollar-for-dollar. However, in this market, the range is so narrow as to make the flexibility less important. Also, in this scenario, unlike the individual market, the loads can be taken down to a zero fee-for-service type basis. Mr. Skokan will talk a bit about fee-for-service in the individual market later.

The third example is pretty common. It is becoming more common today than it was perhaps a few years ago. It is probably becoming very common outside of New York. It is the practice that some companies have of offering products that overlap the market. One has a lower commission and higher consumer values; the other has a high commission but not so good consumer values. This sort of product puts the agent in a dilemma as to which person gets which product. I have had agents tell me that it is embarrassing to have another agent come behind you and replace a policy you sold with the policy of another company. You can explain and say why you do business with company X; but they have a real fear of someone coming behind them with a product from the exact same company that beats the one that they sold.

Before I leave you, I would like to talk about a couple of rules of thumb that I have with respect to flexible compensation. First, I would say clearly define your objective. Do you want to have high early cash values or are longer term cash values more important in your market?

The second rule is the agent's rule. The differences in product values should always at least equal the difference in agent's compensation accumulated with interest. If they do not, you are asking the agent to sacrifice his income to sell a more competitive and more profitable product. In other words the policyholder wins, the company wins, but the agent loses.

The last rule is to remember that the flexibility you develop in compensation might be a lot like the flexibility in universal life. It is there, the end users of the product like to have it there, but the flexibility may not be used that often. I think agents will tend to select a level that they are happy with on these products in the ordinary individual life market and use that level pretty consistently. They will pick the level of flexibility they want.

I think the examples of methods we have talked about thus far are relatively straightforward to develop. The mechanics are there and you can provide your agents with a fair degree of flexibility without designing a great number of products.

MR. HALUK ARITURK: I am going to discuss some of the profitability pitfalls of the flexible compensation environment from the perspective of a branch office company. I will first briefly describe how this environment makes the traditional methods of financial management of branch offices obsolete. I will then offer a simple method of dealing with that (at least an attempt to deal with that which we have adopted at the Acacia Group).

The complexity introduced by the flexible compensation products, as well as some of the new sources of agent compensation, like packaged investment products, financial planning fees, etc., can be summarized in two points. One is the substantial variance of full marketing allowances by product and the second is the variance in proportion of marketing allowances that is going to agent compensation. What I mean here by marketing allowance in life products is the pricing assumptions for full distribution costs.

The first point there is what I believe we have all lived with since the emergence of universal life. The second is perhaps a little bit more subtle. If some of you are fortunate enough not to have experienced the reality of that, let me explain. I think it comes about for a number of reasons. First, agents have an increased awareness of total marketing allowances in some of the new products. Second, agents perceive that in some of the new compensation sources, they not only have to handle distribution but perhaps also play a major role in the production of life financial planning fees. The third reason would be a somewhat unrealistic expectation in terms of improvement possibilities for policyholder values when you lower commission. This usually leads to cutting the rest of the marketing allowance perhaps a little bit more than the cut in commissions. The result of all of this is that it is no longer possible to manage a branch office by setting production goals in terms of gross revenue and then fixing an expense budget. You need something more dynamic than that.

Let me now describe to you the approach we have taken at the Acacia Group. The need for this arose perhaps more from the new products like packaged

investment products, etc., than flexible compensation, although flexible compensation did play a major role. Our starting point was the belief that the most effective way to deal with this was at the branch manager level. We needed to develop a simple measure of profitability to take care of the variances in proportion to marketing allowance by revenue. We set out to go through the whole spectrum of our products and simplify the pricing assumptions for pooled distribution costs.

I am going to show you an example here with some hypothetical numbers to describe the process. What we said we wanted was a common denominator for all gross revenue sources which reflects the relative amount of marketing allowance in that relative source and would be a simple, mathematically weighted summation. I have provided examples of three products (Table 7). The first one is the universal life premium. The first column is the total marketing allowance per $1 of gross revenue from that source. In this case, it is $1.20. The next column shows the ratio of each marketing allowance to a target premium. Basically, we are converting all revenue into something that is analogous to first-year target premium. We are going to call the new common denominator "Equivalent Client Dollar," (ECD). Fancy names always help sell ideas to marketing people so this worked. The third column here is to illustrate the need for simplicity whereby we combine a number of revenue sources into one ECD factor category. We ended up with four or five of these categories making the calculation easy.

TABLE 7

ECD CONVERSION RATES

$1.00	Marketing Allowance	Ratio to Standard	ECD Factor
Life Premium			
FY Target	$1.200	1.000	1.00
Excess	$ .065	.055	.06
SPVL	.07	.058	.06
Fee-for-Service	.90	.750	.75

Once you define ECD this way, it follows by definition that for each dollar of ECD production, the total marketing allowance is $1.20, wherever that ECD

comes from, whether it is the flexible compensation product, or an investment product. It makes the financial analysis very easy.

The next step is to determine how much of that $1.20 is to go to branch office expenses. There we run into a pitfall as I described earlier. Not all products have the same breakdown. I am not going to go into a lot of detail at this point, but think of the marketing allowance breakdown as being made up of agents' compensation and benefits, manager compensation and benefits, and then call everything else marketing overhead. What we have done is use the marketing overhead as a balancing item. That has worked rather well in our planning and monitoring efforts so far.

Let me show you an example of how we use the branch office expense standard that we have set up in the compensation of the branch manager (Table 8). In this example, I used a standard of $.30 per ECD for all production and an additional $.08 per ECD for inexperienced agents. That helps adjust for the disparity of a growing agency versus a mature one. I have provided two scenarios here which show a very simple profit statement for a branch office.

TABLE 8

Branch Profitability

	Scenario 1	Scenario 2
Branch ECD		
Inexperienced agents	100,000	200,000
Experienced agents	650,000	1,800,000
Total ECD	750,000	2,000,000
Expense Standard		
Basic ($0.30 per ECD)	225,000	600,000
Supp. ($0.08 per inexp. agt. ECD)	8,000	16,000
	233,000	616,000
Actual Expenses	303,000	466,000
Net Gain (loss)	(70,000)	150,000

In the first example, the total ECD is $750,000. I have applied the $.30 per ECD to that and got $225,000. The supplemental $.08 gave me another $8,000. The standard here is $233,000 against an actual of $303,000. So there is a loss of $70,000.

The most significant part of this program is to ask the branch manager to share in the profit and loss that arises from the operations. We have done that with a two-tier approach (Table 9). The idea was to have two-tier percentage sharing with the thought that you could emphasize expense control at the branch office. We wanted to have a higher percentage at the initial range and then a lower percentage thereafter. I have provided here 60% for the initial range and 15% later.

TABLE 9

Branch Manager
Resource Management Bonus

	Scenario 1	Scenario 2
Total Branch ECD	750,000	2,000,000
Branch Gain (loss)	(70,000)	150,000
Breakdown of Gain (loss)		
Up to 6% of ECD	(45,000)	120,000
In excess of 6% of ECD	(25,000)	30,000
Manager Bonus		
60% share	(27,000)	72,000
15% share	(3,750)	4,500
	(30,750)	76,500

In closing, let me point out that this simple method was developed in the larger context of a complete redesign of our field compensation system. We have used the ECD concept in almost all phases of field compensation as well as in marketing planning. In addition to what I described today and perhaps more importantly, this concept helped us instill a sense of pricing responsibility in our marketing organization.

MR. DONALD A. SKOKAN: I would like to share some information with you about a relatively new method of distributing individual insurance products -- what I will call Fee-For-Service (FFS) distribution. Not only is this a new method of distribution, but it has also created a new breed of insurance products. Many of you know them as no-load products.

FFS represents the ultimate in flexible compensation. Fees can be charged in any amount. In fact, under FFS, it is up to the consumer and the agent to

establish their own mutually agreeable compensation and service arrangement. It is hard to imagine a more efficient method to determine agent compensation.

Let me get some housekeeping out of the way before I continue. The opinions expressed here are my personal opinions, and not necessarily those of my company.

Also, terminology can be a problem, so I would like to define my terms. FFS products are often called no-load insurance, but I have found that is a misnomer. I learned that lesson the hard way.

In discussing a newspaper article on no-load products with one of Jane Bryant Quinn's associates, she took me to task on the term *no-load.* You see, there are loads in our products -- percent of premium loads and monthly administrative charges -- and in Florida, where we do a significant amount of business, even the selling agent must receive a nominal commission. So there are loads in our products -- both for the consumer and, in Florida, for the agent. The reporter won: the term *no-load* is inappropriate and not a good term to use as you go out beyond the insurance industry to describe the breed of products that we are introducing. We tried to use the term *low-load*, but found that to be so vague; it is not really descriptive of what we are trying to accomplish.

At Colonial Penn, we expect the individual who distributes our products to provide analytical services to the client and we expect the client to be charged an appropriate fee for those services. So FFS appears to be the best terminology for us.

Also in this presentation, I will use the term *agent* rather loosely. Generally, it is there to represent the ultimate distributor of our product to the consumer. I do not particularly want to get into agent, broker, or planner. I will use a generic term agent.

Now let me give some of our background before I continue. Colonial Penn does not have its own agency field force. Most of our marketing is done by direct response solicitations, but we also maintain relationships with marketing organizations who maintain their own field forces.

Three years ago, a separate unit was formed at Colonial Penn to develop FFS products and distribution. Why did we do it? More generally, why are other companies and agents getting into FFS? Lets look at the question from three viewpoints.

From the company viewpoint, we stood to gain an increase in volume and premium revenues. For example, at Colonial Penn we recently sold a $20 million policy in the FFS unit. Since the company's average policy size from direct response solicitations is less than $2,000, that one policy is the equivalent of over 100,000 typical Colonial Penn policies. I think it is safe to say that the company has increased its volume. A second reason is the opportunity to increase profits. I am not suggesting FFS policies are more profitable; just that additional revenue should translate into additional profits. Finally, the company gained entrance to the upscale marketplace. We wanted to enter markets where there were more insurance and financial needs and more money to meet those needs.

Now let's move on the field viewpoint. Today's life insurance agents are threatened -- threatened by level commissions, legalized rebating, banks, stockbrokers, financial planners, etc. Life insurance agents have not come running for our products. But with the threats that they perceive, there are some agents who believe fee-selling is the coming thing. And those agents have signed on with us.

FFS products allow agents to enter a more lucrative market. That market provides them with more upscale clients who have more needs and more money. Also, many agents see FFS as a more professional method of doing business. Disclosing fees and services does strike me as being more professional than undisclosed compensation. In my opinion, it is certainly more professional than letting an agent play the term rider game which Phil described earlier.

Most important, though, agents who sign on with us believe these products are a viable way to protect and increase their income. I think that is a critical point -- the agents we work with see FFS as an opportunity rather than another threat. Incidentally, I should mention that, unlike life insurance agents, true financial planners have actually sought us out. FFS products fit their markets and method of operation very well.

OK, so the agent benefits and the company benefits. How about the consumer? I think it is obvious the consumer gets a better product. Today's illustrations are not much help in making that determination, but logic tells me that when a company removes the vast majority of marketing and distribution expenses and the agent replaces those expenses with a fee, which is often lower than the agent's commission alone, the product will be better. The consumer also benefits by establishing an FFS arrangement. On the surface, many would argue this statement, but I believe explicit fees command explicit services.

Put yourself in the consumer's place. FFS -- by its nature -- requires the agent to disclose compensation. If the fee is out of line for the product and service that you, as the consumer, expect, you can go elsewhere.

Case in point: I am aware of a large multilife case where the fee requested was in excess of $100,000. Although the fee was less than traditional commissions, one of the principals balked because the fee equaled his annual income. Although the agent did not succeed in this case, I think it is a success for FFS and efficient distribution, in general.

Service after the sale is also questioned on the FFS method. It seems obvious to me, though, that by establishing a small retainer fee or a set of fees for certain services, a consumer can easily insure that post-sale service will be available. Again, it is the explicit nature of the fee that compels service. Undisclosed renewal commissions just don't match up to that.

Realistically, I suppose the verdict is still out as to whether the consumer is getting a better deal or not. But the fact that consumers are actually paying fees, in addition to premiums, every day in increasing numbers is evidence the consumer is benefiting.

Now let's move on to a more technical level. How does one price an FFS product? The first step is obvious: remove all the agent's compensation, general agent's compensation, health and pension benefits, sales bonuses, training allowances, conventions, and perhaps even some of the home office marketing expenses. I do not want to get into our numbers, but each of you can add that up for your own company. It is a big piece of change, I assure you.

The more difficult question is what one does with all that extra money. It could be used to provide additional profit to the company, or used for a quicker break-even year. If you go through this exercise, though, I think you'll arrive at the same solution we did.

The extra money has to go into the product as enhanced consumer values. If it doesn't go to the consumer, you'll end up with a policy similar to commissioned policies. When that happens, it is obvious an agent will sell the product with commission built in rather than your FFS policy.

Another point we have discovered is that the biggest advantage an FFS product has is in the early policy year values. While traditional contracts are paying agents and imposing surrender charges, FFS products are generating substantial, real cash values. First-year values can be very important, even if the consumer plans to keep the policy over a long period. For example, we often sell policies where first-year cash values exceed first-year premiums. When a business owns the policies, cash values are assets of the business. On the business' books, the premium outflow is offset by the cash value asset. That is called zero net outlay, and it is a powerful sales tool.

Other thoughts on product design: We haven't found enough advantages of an FFS term product versus a commission product to justify a fee. Nor does there appear to be enough advantage in the smaller face amount market. So we have set our minimum policy size at $100,000.

One last point on product: in addition to life, we have looked to other lines of business for compatibility with the FFS concept. This has resulted in an FFS disability product, which Colonial Penn introduced last year.

Just who is distributing our products? First, we have dealt with some personal-producing general agents (PPGAs). In several instances they have purchased a policy on their own life but have done little else. I suppose there is some satisfaction in that, but there is very little volume. Our best success has come from the concept of a managing general agent (MGA). We have established MGAs in various locations to represent us and recruit agents and brokers. They promote and train their recruits on the use of FFS products and, more important, how to charge fees.

Our MGAs have required some initial support as they move from their traditional compensation to FFS. The up-front money is also necessary, we have found, to get and retain their attention. Compensation after the transition is based on overrides on business produced.

At the producer level, our best success has come from people who are committed to fees as their primary income.

Given Colonial Penn's direct response expertise, we have also trained some telemarketers to sell our products. We have not taken the offensive here yet, but telemarketers are used for requests that come directly to the company. It appears to work quite well.

We have also experimented with universal life products in our retail sales outlets. This has not gone too well, but the reasons may be more internal than external.

Fees are a critical element in FFS. We have little direct knowledge about the fees charged -- we are simply not involved in the fee setting.

My secondhand information may be worth mentioning. To a large extent, our agents are still in the learning process. I am told of three basic methods of setting fees. First, some agents try to approximate the commissions they would have received. This can take the form of a simple formula, say a percent of face or premium. Some agents also impose a minimum fee. One agent I know requires a minimum fee of $10,000 to work for a client.

Second, they charge substantially less than traditional commissions, and try to make it up on volume. Some are charging a flat fee of $2,000 for any policy, regardless of size. Obviously, this can be quite a savings on a large policy when compared to a commissioned product.

Third, they simply charge $X per hour. One agent I know sets up an account for each of his clients. He simply bills them for his time. The interesting thing he does is that he credits their account with any commissions he receives when he sells a commissioned policy.

Fees are regulated in most states, and true to form, the regulations vary substantially from state to state. Fees can be charged in about 35 states. However, some states allow only consultants or brokers to charge fees. Some states allow only fees or commissions -- but not both.

For tax purposes, fees for financial planning are probably not deductible for individuals, unless they and other miscellaneous deductions exceed 2% of income. Fees charged to businesses are generally deductible.

Perhaps you have wondered why this is happening now. I can offer a few observations. First, many captive field forces are becoming inefficient. Companies incur high costs to support and maintain a field force, and there is an increasing lack of agent loyalty to the providing company. FFS offers agent loyalty to the providing company. FFS offers an alternative distribution method. Second, the advent of the true financial planner creates a natural demand for FFS products. Third, deregulation, via the antirebate challenges, provides a favorable environment for flexible compensation products like our FFS products. Fourth, aggressive companies and brokers are seeking more volume and upscale markets. FFS offers a quick entry. Finally, I truly believe FFS is a better consumer product. Articles are beginning to appear in major publications describing the products. As the products gain visibility, I believe the upper income markets will eventually be served primarily by FFS products.

In conclusion, flexible compensation is coming -- in fact, it is already here as this panel has described. The real question is one of magnitude -- how much of the market will ultimately fall under flexible compensation products?

MR. CUTLIP: I would like to spend a few minutes talking to you about rebating. This report was prepared late last week so that I could give you up-to-the-minute information on what is hot and new in the rebating area. Here it is: nothing is new. It is still bubbling with controversy but nothing really has happened since the Florida Supreme Court ruling last June modified the rebate prohibition. Even that wasn't definitive since it called for new regulation which does not even exist yet.

Here's a survey of what has happened:

1. The Florida Supreme Court did not rule the entire antirebate statute invalid. Instead, they focused on the narrow issue of allowing an agent to reduce the amount of commission he or she will earn from selling insurance. They maintained the integrity of the rest of the statute including the prohibition of illegal gifts or other inducements to purchase.

   Since then, the Florida Insurance Department has maintained that their goal and function is to prevent unfair discrimination amongst classes of policyholders and to protect the solvency of the insurers. With that in mind they have stated that, in their opinion, any agent who rebates must do so in equal percentage for all policyowners.

   Apparently, they feel that this approach has minimized the amount of rebating currently taking place in Florida. It also has created an air of confusion and pressure on the agents as some of their bigger clients have begun looking for those rebates.

   The department is supposed to produce new regulations but apparently they are not hurrying to do so.

2. In California, the Superior Court in February, 1987 denied a Consumers Union request to immediately declare rebate laws unconstitutional. The judge said she found the laws to be a reasonable exercise of the legislature's authority and noted their recent reaffirmation of those laws. However, there is a case which is expected to go to trial before the end of the year.

3. In Oklahoma, an individual agent filed suit against the insurance department but did not seem to have a very strong case nor any financial backing.

4. In Georgia, a suit filed in April was dismissed on the ground that the agent who filed the suit failed to show that he had been harmed or prevented from doing business because of the antirebate statute.

The issues surrounding rebating focus in these areas.

The proponents claim repeal would result in: (1) lower cost to the consumer, (2) better values, (3) a leverage opportunity to demand service, and (4) a free market approach which would avoid discriminatory practices.

Opponents argue that:

1. The vast majority of the insurance buying public purchases small amounts of coverage and would not be in a position to negotiate for rebates.

2. Churning would take place with a search for rebatable first-year commissions each year causing insurer solvency problems.

3. Rebating would affect the reliability of cost disclosure information.

4. Rebates would cause tax reporting problems for agent commission purposes.

5. The consumers' processing for bigger rebates would cause agents to press the companies for bigger commissions so the agents could offer the rebates and still earn a living. The bigger commissions would then be reflected in the pricing and would end up reducing values to the consumers who had pressed for bigger rebates in the first place.

On this last point, a friend and I recently had a discussion on the subject in which she suggested that the big commission problem could be avoided if the industry would give itself a whack on the side of the head and take a fresh look at our business.

What she suggests is a wholesaler approach which is closely akin to what Mr. Skokan described with the FFS basis but one which would require that all policies be on a wholesale basis. This approach would do away with fixed consumer prices the way striking down the fair trade practices act did a few years ago. With this approach, the insurance company could set prices tied to the value of the products; the higher the value, the higher the net cost.

Agents would have these products available to them at the wholesale price. They could then apply whatever mark-up they felt was necessary for them to do business. They could charge that mark-up in any way they wanted to --

percentage of premium, a percent of the assets, a flat fee amount, or whatever they wanted.

The advantage of such an approach is that the insurer can focus more directly on customer value and vie for agents to distribute their products on the basis of these values and the kind of service the insurers are willing to provide to agents. The customer can then choose the amount of service wanted from an agent and pay appropriately for that service. It would be a concept akin to choosing between buying the same item at Marshall Field's or at K-Mart.

This would force insurers to show much better value for dollars spent and would create sharper consumer competition, rather than focus on agent competition, which is currently being done. This, of course, also changes the world of regulation, disclosure, pricing, and consumer education in ways we have not even thought of yet.

Is this heresy? Maybe, but it does present some interesting possibilities which might make a nice debate sometime in the future. In any event, the current point about rebating is that it is still in the middle of a muddle with no good answers or even good questions at the moment. However, get your antennas out and raise your awareness level because it is likely to be kicked around hotly until some form of change emerges.

MS. ANNE M. KATCHER: Can you comment on products that offer agent's compensation based on the policy's cash value and what do you think the future is for this type of compensation method?

MR. POLKINGHORN: I believe that sort of compensation has a great future. Perhaps there are some problems that need to be worked out in New York state. I am aware of one product that is approved with that type of compensation structure in New York. But if you ignore New York for the moment, I think it is a good thing from both the agent's standpoint and the company's standpoint, particularly with flexible premium products. With flexible premium products, one of the big concerns of the companies is premium persistency. If premium persistency is not there, the funds will not be there and if the funds are not there, this form of agent compensation will not be there. So, I think it would

be a good thing for companies to blend away from perhaps the other forms and add in a percentage of fund value.

MR. CUTLIP: One comment I would like to make is that if none of you have ever priced this -- do so before you offer it. At a previous company, we had an asset management fee that was a percentage of the accumulation value. The idea was to help persistency at the company. There was even some limited question as to the value of this from the agents' perspective. Back when interest rates were high and replacement was going on very fast, they did not care a whole lot about this. In the past year, as it has become harder to sell insurance, it became a much more critical item and they were looking at it from the persistency standpoint.

We priced it with the idea that it was a nonvested commission so we took agent turnover into account such that at the end of ten years, we said 10% of the agents remained and priced it on that basis. It was not terribly expensive.

As we began to hear from the agents who thought that this really was a good value to them, we realized that we were talking to the longer term agents, the ones who had been around for awhile, the ones who were likely to persist with the company. Suddenly we began thinking our agent turnover assumption was too low and that maybe we would have a 50% agent retention instead of only a 10% agent retention. We did some quick pricing on it and found ourselves hoping that we really would have that agent turnover in the future. If we don't, these products will have been underpriced. So, be careful when you go into something like that.

FROM THE FLOOR: Has anybody seen FFS applied to annuity products?

MR. POLKINGHORN: I think it falls under the same category as Mr. Skokan's term example. For annuities and single premium life, the commissions are not high enough in the first place to make it worthwhile. The fees would not be that much lower.

MR. JOHN A. ROSE: Mr. Ariturk talked about having ECDs and using them in a flexible premium product, but the example he gave was based more on products that were clearly defined. One was a flexible premium product; maybe

another one was a single premium whole life. Is it now fair to say that on a flexible premium product so much commission generates so much expense regardless of whether it is on a small face amount or a big face amount and regardless of the mix between term and whole life commissions paid on the product?

MR. ARITURK: One example we have of flexible compensation products is the term rider attached to our universal life product. In that example, it works exactly the same way. We basically price the term rider where you have the option of either going zero or say a low percentage and doing the same mathematical calculations to arrive at an ECD value for the term rider. At the point of sale, you will have two sources of revenue at work: the base policy and the term rider. They will have factors applied differently so it will take care of itself.

MR. ROSE: I just was not sure if you took into account that $10,000 of premium is harder to sell if it is all high commission than if some of it is low commission.

MR. ARITURK: Yes. That is the primary purpose of the term rider. The method I have described helps us avoid issues where the office has produced $5 million of premium which is mostly term rider and little base.

FROM THE FLOOR: The use of the FFS method in pricing assumes that there will not be any need for service during the renewal period. If an insured needs some service after the issue they will have to pay the agent extra to get that service. Are you worried that with that kind of situation, policyholders are going to be more inclined to seek those services from the insurance company rather than pay an extra fee for getting those services at a later date?

MR. SKOKAN: That is not a very large concern for us. I have to admit that we have not addressed that to a great extent since, as I mentioned in my presentation, we are only three years into this. I would say that Colonial Penn particularly is very customer oriented because for the vast majority of our business, there is no agent to intervene. We are set up with a whole bank of 800 numbers and a whole floor in one of our office buildings with people who do nothing but deal directly with the consumer. So, I think we are equipped to handle that, should it come up. Time will tell whether people will deal with their agent or will deal with the company directly. I would say that in the

markets that we are dealing in (the upper-income market), the person is more likely to want to call the personal agent rather than call the unfamiliar company in Philadelphia. My inclination is to think that this will not be a big problem and should it arise, we are equipped to handle it.

MR. JEFFREY C. HARPER: I have a question for Mr. Skokan regarding the source of their business. Do you have any interest from property and casualty agents in selling life on an FFS basis?

MR. SKOKAN: We have received a lot of requests for additional information from the field. I would say generally, I am not aware that it has been property and casualty agents that have made those requests. They have come mainly from financial planners and life insurance agents, who I think, are interested in having our policy as one of the arrows in their quiver. They are not necessarily wanting to do fee business as a primary source of income. I am not aware of any property and casualty agents that have contacted the company, although we have not checked the calls that have come in.

MR. MARK ANTHONY HUG: Do any of you know how the proposed GAAP rules may affect flexibility of products with respect to FFS or level compensation?

MR. POLKINGHORN: I would take a guess that for the most part it will not affect things much, other than any differential in treatment between riders and base plans. If you could argue that the term rider should be GAAPed like a term product and you defer the commission piece of the term rider and amortize that over premium, then you have got more of the product on the old rules than on the new rules and perhaps that would be advantageous. I would think anything that lowers the total acquisition cost would be advantageous -- old rules versus new rules.