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FIELD COMPENSATION DEVELOPMENTS

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- o Distribution sources
  - -- Branch manager
  - -- General agent
  - -- Agent
  - -- Personal producing general agent
- o Compensation techniques
  - -- Level commissions
  - -- Persistency bonuses
  - -- Asset-based compensation
  - -- New York mutations
  - -- Negotiated commissions
  - -- Multiple products
  - -- Expense management

MR. DAVID L. BAXTER: This session is intended to address field compensation for agent distribution systems. This would include general agencies, branch managerial, and personal-producing general agents (PPGA) systems. We have avoided a discussion of brokerage, although obviously at many companies the distinction between brokers and agents is becoming less and less clear.

I'll be giving a brief overview of some of the industry dynamics which are driving change in the industry distribution and compensation systems, and then we'll get into some more specifics.

Jeffrey Stevenson is Director of Product Marketing at Mass Mutual. He'll be discussing the general agency system and career agent issues in general.

Douglas Van Dam is Associate Actuary at Penn Mutual. While Penn Mutual has a very well-regarded career agency system, it has also made some fairly major moves in the direction of branch managerial and a distribution system that is very much like a PPGA system. Doug should give an interesting perspective on branch and PPGA, particularly the key differences from the traditional career agency system.

Finally, although we've purposely decided not to talk about agent-owned reinsurance companies today, the New York insurance department has in the past couple of weeks issued a letter on this subject, so at the end of this session we think it [illegible]e to touch on this letter.

L[illegible] [illegible]ook at some of the industry forces going on both historically and pr[illegible] [illegible]e life insurance industry. Before we get into some of the doom

and gloom discussions that always seem to arise whenever actuaries talk about life insurance agents, and particularly life insurance agent compensation, let's look at some of the positive influences and results in the industry.

According to ACLI figures, in the last ten years, total industry life insurance premiums have doubled, average inforce per family has increased by 130%, total life insurance inforce has more than tripled, assets of life insurance companies have more than tripled, and even the number of life insurance agents is up 65%.

A recent Life Insurance and Marketing Research Association (LIMRA) study of agent compensation for 1983-1986 showed that life insurance agents outproduced the rate of inflation by 15% during this three-year period. That amounts to about a 9% annual increase for life insurance agents compared to the general inflation in wages of about 4%. This increase was made up of essentially level compensation for new agents, and much higher increases at the more experienced levels. For example, agents with five to nine years of experience in the business showed a 22% increase over the inflation rate. Nineteen percent of all insurance agents earned in excess of $100,000 per year.

Given these industry results and results for distribution in total, obviously someone is or has been doing something right.

The Center for Futures Research, in a paper entitled "The 20-Year Strategic Outlook for the Life and Health Insurance Industry," projects that the life insurance market itself will continue to be very healthy in the next 20 years, but there will continue to be intense competition in this business, particularly from banks looking to make inroads in the middle income market. They also project that traditional methods of distribution (general agency, PPGA, career agent distribution) will continue to be predominant, and most companies currently operating with traditional agent distribution systems will still be operating with these systems in 20 years. However, the greatest growth in market share in the insurance industry is projected to come from direct-marketed products, which will own some 20% of the market in 20 years.

These competitive trends are what have caused and what will continue to cause great cost pressures on the traditional distribution methods.

Here's some information that's sort of good news-bad news. In an October 1987 article in *National Underwriter*, it was revealed that the number of new agents in 1987 was up 5% from the number hired in 1985. Another recent LIMRA study says that agent retention is actually up, and new premiums are up. In fact, agentproduced life premiums continue to outpace all other forms of distribution. On the down side, though, renewal premiums produced by career agents are only up 1%. That is the worst increase of all forms of distribution.

If we are to look at the traditional distribution product in two pieces, as I'm sure many of you have, the first piece is the first year, which is when the agent makes his money. The second piece is renewal, when the company makes its money. Taking this very simplistic look at a product, you can see we may have a problem here. Let's go back to the LIMRA study on agent compensation, which shows agent compensation increasing 9% a year. Regardless of your current level of satisfaction with this balance of agent compensation and company earnings, if agent earnings are going up 9% and the company's renewal block is

going up 1% each year, I can assure you that your current level of satisfaction is not going to be increasing next year.

Clearly these trends are what are really driving companies to explore new methods of compensation. As you listen to the rest of these panel discussions, bear in mind the real purpose of compensation, which is to attract, retain, and reward quality producers, but just as importantly, to direct the efforts of these producers. Several years ago I took a two-year stint away from actuarial work and went to the field, and I met a lot of insurance producers. They came from all walks of life and were in all different markets, and of the successful ones, though, I think they all had one thing in common. This was that they were very profit-oriented, entrepreneurial businessmen. These successful agents go where the profit is, and for them, obviously, their revenue is commission. I believe that if companies will first determine what it is that they're trying to accomplish in the marketplace, they'll be much more successful at designing compensation systems to reward and direct their producers' efforts to achieve those results.

Now I'd like to turn it over to Jeff Stevenson, who will be talking about career agency systems, and agent issues in general.

MR. JEFFREY G. STEVENSON: Just by way of general background, let me quickly review how the General Agent (GA) system works. A GA is an independent contractor, not a company employee. His basic duties are to build and maintain a strong corps of career agents, to act as an extension of home office management in the agency for reasons of corporate policy and other communication, to exert influence over business written by career agents, to control the finances of the agency, and in some cases personal production -- although it is not encouraged by many companies.

GA compensation is designed to reward the GA for high sales levels, for high sales growth, good persistency of business in that agency and for cost efficiencies of the agency operations.

GAs are compensated in different kinds of ways. The most obvious way is through commission overrides and fees. And then there are allowances, bonuses and benefit plans.

These overrides and fees are designed primarily for personal income of the GA. They are usually a percentage of premiums on business sold, are usually heaped starting in the first or second policy year, and are at least partially vested to the GA. This way, if the GA leaves the company, there may still be some residual income coming to the GA on business sold while he was in charge of the agency. Term life insurance and other low premium forms may have rates of override or fee that are only slightly lower than rates paid on whole life insurance.

The other common way of compensating GAs is through the expense allowance system. Expense allowances are generally designed to offset expenses needed to run the agency. These allowances are usually based on earned first-year commissions sold through the agency. Some allowances are based on the contract year of the selling agent to offset development and training costs of newer agents. Some are only paid on specific products recognizing special expense characteristics of special markets for which these products were designed, or are

based on the housing status of the agent who sold the business -- that is, the core agency or any kind of satellite offices.

The third way of compensating GAs is through some sort of a bonus. This bonus can be considered a reward for a special achievement such as agency growth, quality of the business, or agent/agency productivity. These bonuses are usually paid in a lump sum payment, based on the results over a given calendar year or other 12-month period. These bonuses can be tied to company results and they can be significant when compared to the GA income from overrides and fees.

The fourth type of compensation to GAs is through benefit plans. Benefit plans for GAs must be nonqualified since the GA is an independent contractor. These benefit plans are not as competitive as with agents or other employees since the GAs tend to place a lower value on these benefits. (They tend to feel that they can set up their own benefit plans more to their liking.) Such benefit plans can be similar to employee benefit plans, such as long-term disability benefits, deferred compensation, retirement or life and health plans, or can be on a more ad hoc basis.

Legally, a career agent is an independent contractor, just as is the GA. Career agents usually contract with a GA, not the company. However, career agents are considered statutory employees of the company for purposes of employee benefit plans and social security contributions and benefits.

Career agent compensation is designed to attract and reward highly motivated self starters. Compensation specifically can reward high sales levels, high persistency of business, and in some cases high numbers of policies sold, and also continued service with the company.

The types of compensation vary as they do with the GA. First and foremost are commissions, first year and renewal.

Another means of compensation similar to GAs is through expense allowances. However, these are not usually paid directly to agents, but are passed through the GA.

Then there are bonuses paid to agents which are very similar in their nature and in their objectives to bonuses paid to GAs.

Benefit plans offered to career agents are very similar in nature to benefit plans offered to other types of employees.

Another important compensation feature for the career agent is the new agent financing plan for new agents. It is designed to capitalize new agents who need to get started in the business and would not be expected to immediately earn the level of commissions needed to support themselves. These plans are usually three or four years long and offer a level income, perhaps augmented by a portion of commissions earned. Financing plans are heavily regulated by the state of New York for life insurance companies licensed to do business there.

At the Mass Mutual we believe the general agency system is still the most cost-effective distribution system in the long run.

FIELD COMPENSATION DEVELOPMENTS

One thing that has remained a constant in the life insurance business is that it still takes an agent in a one-on-one situation to sell life insurance. Direct response will always have a small slice of the market. (I'm not sure it will go to 20%. Currently it's roughly 2-4%.) While direct response marketers will continue to be successful, agents are still needed in the majority of individual sales.

A general agency career agent-type system, however, is expensive to build and expensive to maintain. Many companies have reduced or abandoned the general agency system for short-term cost savings. This is not surprising. Declining interest rates and increased competition have brought a squeeze on profitability and more recently a squeeze on expenses. They have traded fixed costs for higher variable costs. It has been pointed out to me that of the 2,000 life insurance companies, fewer than 20 actively recruit and train new agents. The success rate for new agents is only around 25% over three years and the cost of recruiting, financing and training is tremendous. With fewer and fewer companies left in the career agency development process, and more and more companies in the PPGA, brokerage-type environment, general agency type companies face a threat from competing companies paying larger commissions to their agents. However, they also have a tremendous opportunity if they can control their field force and improve the productivity of their own agents.

What trends do we see in the field compensation area?

First, we're seeing more investment in training on the part of some companies to improve the success rate of recruits and improve their productivity. At the Mass Mutual, this investment is heavily driven by technology. Computer-based training and interactive video training systems are now in place in all our agencies and are already showing improvements in new agent productivity.

It is not inexpensive to recruit and develop agents. For companies willing to make the investment, the payoff from a successful agent can be as many as 20 years down the road. But, if the agent is in the business of brokering business, the return to the investing insurer can be much longer. The viability of the agency system depends to a large extent on agent productivity. When business is brokered, the agent's productivity drops in the eyes of the company that invested in the agent's training. The company that made the investment in the training is not winning the loyalty and losing the business. Some companies have cut back on their agent development as brokerage has attracted more and more agents because they can't afford the expense of agent development. If agents are not remaining sufficiently loyal, cutting back on agent development is not likely to make that situation any better in the long run.

I think career agent companies will be investing more and more in agent training and development in order to first attract and then retain top agents. A well-trained agent, even if he or she may occasionally broker some business, will bring a greater return than no agent at all.

The second area not directly field compensation related is in the product area. Career companies typically offer a full tool kit of products and services for protection against and financial consequences of death, disability and outliving one's retirement resources. More and more, brokered business is the result of a specially prepared product for special markets offered by some niche type companies. Furthermore, to the extent that there are special products needed, companies are lining up distribution networks whereby a particular outside

company's product might be used but there's compensation of the GA and support of the distribution system of the general agency company.

Now let's turn more specifically to the field compensation areas. The trends we see in field compensation in career companies are driven by the objectives to improve the productivity of their agents, and of course, by productivity I mean the internal business, not the total business.

The second objective of the new and emerging field compensation developments is to help retain inforce business. Again, this is motivated by competition and squeezes on expenses and profits. It is far cheaper to keep a customer than to find a new one. Furthermore, we have determined internally that a 1% change in a lapse rate can have an impact on the bottom line by several million dollars. So let's go through some of the items involved in field compensation in more detail and identify some of the things that are being done at our company to meet those objectives. I'll also comment on some items I see as potential for further developments.

PRODUCTIVITY

Career Agent Contracts

The career agent contract itself is a first source of productivity improvements. Older contracts had no production minimums, or trivial production requirements. Companies relied more on the loyalty of the agent, and the control of the GA. Current contracts must have significant first-year commission requirements, with the ability of the company to review and update those requirements yearly. This helps in the effort to capture more of an agent's total production. Agents with older career contracts can be encouraged to choose a new contract, but may not have sufficient reason to do so. Some contracts allow the company to formally or informally enforce the new higher production requirements for the agents with the older contracts. This makes it easier for companies to keep raising the minimum requirements for agents to qualify for company subsidization of benefit plans such as the health plan, pension plan, etc. Hence, the company is not paying out money for agents who aren't really producing much for the company.

New Agent Financing Plans

These can be used very effectively to develop productive and successful agents. They should be designed with corporate goals in mind. High selection standards and high validation requirements can be designed into these plans. There should be incentives to quickly terminate recruits who will not be successful, minimizing subsidy costs. In the past, we often would keep a new agent around who was just about maybe making the minimum, keep him or her going a little bit longer, and we found that the exceptions that were made just were not worth it.

To summarize, the trend here is towards better selection and an earlier determination of success or failure. With better training, we hope to get new agents more productive faster, and those who aren't going to make it will know right away and act accordingly.

Contests, Awards and Recognition

These are also designed to reward more effort and to capture more of an agent's total production. Many career companies have several contests throughout the year and several forms for awards and recognition to encourage production. To some, this may seem a bit silly at times, but these devices tend to be very effective. Not much has changed in this area over the years, except for the

introduction of the contest requirements and other things of other product groups, like annuities, disability income, mutual funds.

Volume-Based Compensation and Bonuses

Some companies offer volume-based compensation rates or bonuses. The intent of these plans is twofold: (1) to attract the big producers with the higher compensation rates and (2) to encourage agents who are already with the company to place as much of their business with the home company as possible. It should be noted that New York licensed companies cannot pay extra compensation based only on volume. Typically, however, companies combine volume compensation bonuses or bands with persistency or other factors. I'll comment more on this later when I talk about persistency factors.

Multiple Product Selling

Encouraging cross selling by the agent will again serve to increase the overall sales of the company. This can be encouraged, of course, through the training process and through the overall marketing efforts of the company. But I think there are also considerations in the area of compensation. Trying to improve overall compensation rates perhaps can cause problems for companies licensed in New York state. But I think there's potential here for some developments. We have found a great deal of synergy between some of the lines of business that we have, like life and disability income. I think if we had some agents producing a certain level of life business and being paid x% and some agents producing disability income business and getting paid y%, it would be possible to pay $x + y$ or $y + z$ if they produced certain levels of each.

GA Productivity Incentives

GAs can also be encouraged to improve productivity with the right kinds of compensation plans. Expense allowances can be designed so that high productivity will generate expense allowances in excess of the amount needed to run the agency. Most of these allowances are based on first-year commission production, but are used for expenses that are less directly related to production. There can also be an allowance generated especially for the profit of the GA, designed to reward for agency productivity.

Impact on Experience Assumptions

Aside from productivity, the career company also benefits from the captive field force by overall improvements in experience assumptions.

Mortality

Mortality rates might be slightly better in a career agency company, but the primary influence is exerted by the company's underwriting function.

Morbidity

Morbidity, on the other hand, may be influenced more by the captive career agent field force. Although it is still influenced more by the particular market the company is operating in, the field underwriting function can play a bigger part in the morbidity rates on a company's products. I'm not aware of any companies that adjust compensation rates for the relative morbidity rates of an agent's business, but if it does happen or is being considered, it might be better to apply such modifications only to the morbidity sales. I do know that some companies who operate in the PPGA or brokerage-type environment often track experience by agent and may terminate an agent's contract in the event mortality exceeds certain company standards.

Persistency Rates
The career agent has the most control over persistency rates. The company has several options to choose from in attempting to improve the persistency rates of its business through field compensation.

Level Commissions
One option that has resurfaced recently is to offer a level commission scale on new business. This way, the agent must keep the business inforce to get the lion's share of the compensation. Much of the property and casualty insurance is compensated in this fashion. Level commissions for life insurance, however, cannot meet current New York requirements unless the level of commissions is reduced far below a level that will be attractive to the field force. However, we do see level commissions for certain products like life annuities and for certain specialized life markets, notably jumbo group sales in the corporate area. As an aside, I always like to mention term insurance as my favorite level commission story. I think we've had level commissions in term insurance for quite awhile. And that level, of course, is 40-50%.

In the May 9, 1988 *National Underwriter*, there's an article on Mutual Life of Canada's move to level commissions. That's probably the first time we've had a significant announcement like that. They mention that their other objectives are managing their existing business better, increasing new sales, improving customer service, and having better persistency. The insurer expects agent retention to improve as well. Start-up costs for the program are considerable, the person quoted says, and it represents a substantial investment.

Transferrable Service Fees
Another compensation practice that has been discussed is the idea of transferrable service fees. These fees are often seen on annuities that are used in retirement plans due to the service needed to keep those plans inforce and up to date. Also, master policies such as universal life, policies designed to be incremented to as needs change later, seem to be suitable candidates for transferrable service fees. Such policies would tend to be inforce for several years and perhaps outlast several writing agents. This way, the agent who wrote the last addition to the policy would be the agent getting the service fees on the entire policy.

Transferrable service fees present challenges to both the insurance company and the career agents. As far as pricing considerations are concerned, transferrable service fees must be valued as vested commissions. However, in the eyes of the agent, they are nonvested commissions. Hence, the level of compensation must go down to continue to meet pricing and legal requirements, without any apparent benefit to the career agent. It must be emphasized, however, that there is a benefit in that the agents who persist with the company will be assigned cases that are left behind by terminating agents. The only catch to this idea is that in an agency-type company, the GA usually has control over assigning those cases.

Persistency Elements in Compensation
These two last items, level commissions and service fees, can be effective only with new sales. They cannot be applied easily to business already on the books. Adding a persistency element in the career agent compensation package has a potential to be the most effective method of improving persistency. It has several advantages: (1) it can be applied to all inforce business; (2) it can be applied to several facets of the agent or GA compensation package; (3) its

relative impact on compensation can be increased or decreased year to year by the company; (4) a design can be implemented that will reflect the agent's or GA's particular mix of business; and (5) it can be combined with production bonuses to meet New York requirements.

In designing persistency factors to be applied to compensation, several considerations should be kept in mind. From the company standpoint, such a plan must be consistent with corporate objectives, it must be easy to administer, and it must be easy to monitor.

And from the field standpoint, communication of this kind of a plan is very, very important. It must be understandable and must be received in a positive way. Here's one of the things that we're doing at the Mass Mutual. Frequent status reports to the individual agent will keep that individual posted on progress in the development of the persistency factors that will be used in the compensation plans. The definition of lapse is a very difficult topic to communicate to the field. Often, the complaint is that what the company views as a lapse is viewed as being uncontrollable by the agent in the field, such as termination from a pension plan. However, the company must impress upon the agent and GA that such lapses are no more controlled by the company than by the agent, but will still adversely affect the company's financial results. The definition of lapse that is adopted should be as close as possible to the customary actuarial definition.

The persistency element must be simple. One rate is best, and can be arrived at through a complex formula, as long as each step can be stated in English to the people in the field. The persistency element should not be expected to have an overwhelming impact on compensation, at least until the field becomes very accustomed to having this as a part of their overall compensation plan.

Although persistency has been a part of agent compensation at the Mass Mutual for many years, we just introduced a far more sophisticated persistency system last year. It will be used more widely in agent and GA compensation starting this year. After saying that you have to keep it simple, I'll now try to go into some detail in this new persistency factor.

The key relationship in this new persistency system is the ratio of an actual lapse rate to an expected lapse rate (ELR). These lapse rates are based on inforce policy premiums. If the ratio is equal to 1, the production unit (agent, GA, or other) is experiencing persistency equal to last year's company average. A ratio of less than 1 shows better than average persistency, and a ratio greater than 1 shows persistency worse than average. This ratio is all that is used to develop persistency factors for all field compensation programs.

The ELR is based on company averages during the preceding 12-month period. Premiums on policies in all durations are combined without any weighting given. First-year and renewal company averages are developed separately for internal information purposes only. For field purposes, however, the all durations combined values are used. This way, only one index need be considered in the field.

To combine all products into one group would not recognize the fact that different product groups can have very different lapse rate patterns. A particular career agent who specializes in one or two product groups, especially if those product groups tend to have higher than average company lapse rates, such as

pensions, would not be fairly recognized in the comparative lapse rate analysis. We separated our individual products into eight separate product groups for this reason, and additionally we attempted to recognize that the financial worth of lost future premiums will vary by these product types as well.

I mentioned earlier that we combine all durations without special weighting in determining the company average ELR. We recognize that different producer groups may have characteristically different average policy durations of their inforce business. This can somewhat distort the comparativeness of a given agent's lapse rates to company average lapse rates (ALR) for the same product group. We chose to have a second breakdown of the company business by producer group. We separated our career agents into five years of service groups, and also separated noncareer agents business and orphaned business into separate groups. This way, a career agent is better compared to his peers and can feel more comfortable with the way we look at his persistency.

We did separate the business into product groups for the second reason concerning the financial worth of lost future premiums. To account for this, we apply an index to the premiums to give them a weight reflecting this relative financial worth. Most products have an index of 1, but term insurance and annuities, as may be expected, have lower indices. As a simple and understandable way of developing the index, we chose the average first-year commission rate for the product group as a simplified but suitable device to determine the relative indices.

Now that we have looked at the ingredients, we can get to the actual calculation. Remember that, for the company business, we have 64 different cells: eight product groups and eight agent peer groups. For a given cell, the company average ELR is simply equal to the lapsed premium divided by the exposed premium, using the usual actuarial formulas modifying the definition of lapse slightly for field purposes.

For an agent, we would use the eight company averages that apply to his or her peer group. To develop the agent ELR, in the numerator we sum over all eight product groups the product of the following: the inforce premium the agent has at the beginning of the period, the index for that product group, and the company average ELR for that product group and peer agent group. In the denominator, we have the sum of the agent's inforce premium multiplied by the index for that product group. So we end up with the ratio of the expected indexed lapses divided by the indexed exposed premium. The interesting thing is that no two agents will have the same ELR except by sheer coincidence. Everyone has his or her own ELR that reflects his or her own business.

Once we have the ELR for a given agent, that agent will see it as a target over the entire coming year. In computing the ALR for the agent, we want to keep the agent informed throughout the year of progress toward achieving a favorable ratio. To accomplish this, we decided to compute rolling 12-month ALRs for the agent and use this in a special monthly report. The last report will have the ALR that is actually used to develop all the persistency factors used for awards and recognition and for compensation purposes.

Uses at Mass Mutual

How is this persistency system used at the Mass Mutual to encourage improvements in persistency? The most obvious is by these monthly reports and if the compensation incentive is there, the agent has something to work on all the time.

In more detail, we use the ALR to ELR ratio as a knockout factor for our various awards and recognition programs for agents and GAs. By knockout factor we mean that if the ALR to ELR ratio is greater than 1.2, the agent or GA cannot qualify for any of the awards. This includes our yearly convention for our agent leaders.

More importantly, the persistency factors are used in several of our compensation plans. The ratio of ALR to ELR, which is used to develop a factor that can go below 1 or above 1, is used for two of our agent plans and one of our GA plans. For agents, a plan we have had for years gives a yearly bonus to the agent based on first-year commissions, lives, years of service and persistency of business. This bonus is highly regarded by our agents and can be fairly substantial. The persistency factor can greatly increase or decrease the size of this bonus. Second, a new plan was installed recently for our higher-producing agents to encourage retention of more business in the company as opposed to outside brokerage. It is essentially an allowance paid directly to our career agents, the only allowance so paid. It is based on two factors: (1) the first-year commissions earned by the agents during the year (the higher the first-year commissions, the higher the percentage allowance) and (2) the persistency factor developed from our persistency system. Again, if we have a ratio of between 1 and 1.25, we multiply that by the banded allowance rates that are based on first-year commissions earned by the agent during the year. If the ALR divided by the ELR is greater than 1 (that is, worse than company average), the factor is 0. It is a knockout -- they won't get this allowance. For ratios less than .8 (meaning a much better than company ALR), the factor is 1.25. For ratios that are between .8 and 1, the factor is graded linearly between 1.25 and 1.

For GAs we also have an allowance designed specifically as a personal income allowance to encourage our GAs to develop agents and to develop sales growth, and, of course, quality business.

SUMMARY

In summary, the general agency system can be very costly in absolute dollars. From an administration standpoint, a large apparatus in the home office is required to administer these sometimes very complex compensation programs for a very complex distribution system. When looking at vested and nonvested compensation for agents and GAs, the system has to track these people after they leave the company to continue to pay them their vested compensation. The expenses required to maintain the field offices and the communication required to the field can also be very costly. Further, the expenses required in recruiting and training inexperienced people for both agent and GA positions can be very costly.

For many companies, however, the general agency system is the right distribution system. Even though it may be the right system, it will not work if the expenses of that distribution system are not controlled. To control these expenses, it is of utmost importance to maximize the productivity of the producers and to capitalize on the extra client control enjoyed by the general agency system to optimize the experience of the business on the books.

In summary, the changes in field compensation for general agency companies coming about are designed to improve productivity for the agency and to promote the retention of the business. The ones I mentioned are as follows: higher production requirements for the career agent; investments in new techniques for

agent training and development; faster validation under financing agent training and development; incentives to promote cross-selling through contests, allowances and compensation; transferrable service fees; and new productivity incentives through allowances and persistency-based bonuses. Related to this last item are improved persistency monitoring capabilities and understandable lapse measures.

In addition, I commented on increased emphasis on training and the possibility of developing sponsored outlets for products not manufactured by the company but with contributions made to the distribution system.

As for asset-based compensation and level commissions, at the Mass Mutual we are restricted by New York law. However, there is much development in both of these areas by non-New York companies, and, of course, non-New York subsidiaries of the Mass Mutual and other career agency companies.

In conclusion, in the general agency system, it is of utmost importance to maximize the productivity of the producers and to capitalize on the extra client control enjoyed by the general agency system to optimize the revenue and profit stream of business put on the books.

MR. DOUGLAS S. VAN DAM: I'm going to say a few words on a number of topics. My discussion will briefly cover trends in branch manager compensation and, to a limited extent, PPGAs. I will also give the outlook based on my experience on some of the topics outlined for this session as they affect agent compensation. I will also add remarks on other sources of income for the agent, transferrable service fees, and compensation on rollover business.

Penn Mutual is located in Philadelphia and is licensed in all 50 states, including New York. We also have a non-New York subsidiary, so we have paid some forms of compensation which would not be permitted in New York. Specifically, I will address some comments later on asset-based compensation for Universal Life (UL).

Penn Mutual distributes life insurance through GAs and branch managers, whom we call Managerial General Agents (MGAs), because we try to manage them in much the same way. In addition, in January, 1987, Penn Mutual established certain regions of the country where the soliciting agent would contract directly with Penn Mutual and there would not be a GA or MGA in between. Presumably, the individuals who would be attracted to what we call our Independence Financial Network will be experienced agents because we will not have an agent financing arrangement for these agents. This idea of recruiting only experienced agents in part of the country was and is viewed as a long-term strategy for those areas of the country where we did not have cost-effective agencies. It is too soon to discuss the success or failure of this new approach.

Penn Mutual also owns Janney Montgomery Scott, a regional stock brokerage firm, and our agents sell mutual funds and other financial registered products through our broker/dealer Penn Mutual Equity Sales.

If you do have specific questions which don't get answered in this discussion, you might try the services and publications provided by LIMRA. We have often found the information from LIMRA on field compensation helpful.

I want to speak first about the trends I've seen in branch manager compensation. Penn Mutual has not historically considered itself a "Branch Manager" company, but we have been using this as a form of field management for over a decade. I see two opposing forces at work. One is the desire on the part of companies to have greater control over the agency. The other force is the desire to reduce fixed costs and go to a more variable form of compensation. By variable I mean compensation that is proportional strictly to the amount of business produced. One way to address both concerns is to have field management be company employees with a small base salary and incentive compensation tied to production and other company goals. We have found that GAs and MGAs can peacefully coexist side by side without much difficulty.

Another trend affecting distribution through branch managers is something that Jeff mentioned and that we are seeing too; that is, the constant pressure to maintain or increase agent compensation. As fewer companies are recruiting inexperienced agents, more and more opportunities are being offered to our experienced agents, the primary thrust of these opportunities being the availability of greater cash compensation.

The trend toward fewer companies recruiting inexperienced agents is also having an impact on the expense required to recruit experienced agents. This is increasing the costs of the PPGA distribution system and adding fixed costs to a system many view as more variable costed. There are the increased costs of mailing in order to find agents interested in selling your product. There is the need for ongoing contact. Agents need to be reminded that you love them. Agents, for the most part, are not going to seek you out. They have to be constantly asked for their business. There is intense competition for PPGAs based on the speed of service.

When Penn Mutual eliminated some agency offices back in January, 1977 and had agents contract directly with the company in parts of the country where we did not have cost-effective agency operations, we recognized that we would need to provide some services in the home office which previously had been provided only by the agency office. These services included keeping track of the status of new business and keeping new business and service requests on track and moving through the processing departments. Also, even though the agents have the capabilities of doing sales illustrations on their personal computers, many agents who had used agency personnel to prepare the illustrations are now asking that these be provided from the home office, which we are doing. In addition, agent payroll had previously been done by agency personnel and now we are doing that in the home office. This level of services has a cost which should not be overlooked when comparing the costs of a PPGA operation with those of an agency operation.

LEVEL COMMISSIONS

The one area in which I have seen some movement toward level commissions is the area of flexible premium annuities. These annuities often compete with mutual fund sales, which typically have level loads and level commissions. We haven't encountered much resistance towards level commissions in our flexible premium annuities.

On the life side, however, it seems to me that I have seen as many changes toward increasing the first-year heaping of commissions as I have seen going to level commissions, Mutual Life of Canada notwithstanding. There is considerable effort involved on the part of the agent prospecting for new business and he

expects to get paid for that effort. So I don't see that level commissions would necessarily be effective in a life insurance sale. In the past 12 months, my company has discussed level commissions for life insurance only with respect to yearly renewable term (YRT) only on policies where the policyholder has a history of rolling over business and getting to the level 50% that Jeff was referring to.

PERSISTENCY BONUSES
I believe that there is a trend toward the increased use of persistency bonuses. There are several reasons for this: (1) companies are more worried about persistency after all of the rollover that has taken place from traditional business to UL; (2) it is a way for New York companies to incorporate a bonus based on quantity as well as persistency; (3) some of the interest in persistency bonuses has been generated by other companies offering the agents agent-owned reinsurance and a persistency bonus is sort of a quick and dirty way of competing with something like that; and (4) a shift back to traditional products where persistency is easier to measure as compared to a UL policy.

Persistency bonuses are less common for field management than they are for agents, who have more control over the business.

The formula for a persistency bonus will depend on the reason for which it was set up. When trying to incorporate a quantity element or to compete with agent-owned reinsurance, the formulas can get quite complicated. Then you have to ask yourself whether the agent understands how his commission is being paid. If the agent doesn't understand it, chances are it is not helping you to achieve your goal.

We have recently introduced business persistency requirements which the agent must satisfy, in addition to sales levels, in order to attend our educational conferences or conventions. These requirements cover both traditional and UL business, similar to what Jeff was describing at the Mass Mutual. We've chosen to use a strict number percentage, rather than have it as a function of the company average. This way it doesn't depend on the previous year's business, and also, the entire persistency of the company increases and it is not increasingly more difficult for good agents to qualify.

ASSET-BASED COMPENSATION
Asset-based compensation is another form of persistency bonus. In addition, it can lessen the incentive to roll over business, and assuming that one of the goals of your organization is to increase assets, it pays the agent to accomplish a company goal. That's the good news. The bad news is that it is tough to make asset-based compensation high enough, to make it significant without increasing your required interest spread. That would be difficult because most of us don't believe that our competitors are making their interest spreads today.

Penn Mutual, through our stock subsidiary which is not licensed in New York, has incorporated asset-based compensation on UL sold through this subsidiary for a number of years. We pay a number of basis points to the agent based on the nonloaned cash value in the policy. The amount that we are paying, however, appears to be too small to have much of an impact on agent behavior. Agent perception of value is very important in modifying agent behavior. Even five years into it, they don't see the value of this agent-based compensation.

If you do asset-based commissions, it will have an influence on your product design. On a present value basis at issue, when you're doing your profit studies, it doesn't seem to cost you much. It takes a number of years for the assets to build up and then in your pricing you discount that back with interest and policy persistency. But, if you don't take them into account when setting your interest rate spread, you may be having a significant impact on the product profitability several years down the road. The profits in later years may be pretty skimpy.

Despite these hurdles, I continue to believe in asset-based compensation in theory. We have included a token amount of asset-based compensation in our GA contract, in our GA expense allowance. The best thing about it is that it shows our GA that we care about growing our assets and that moving money from product to product will not increase his compensation.

TRANSFERRABLE SERVICE FEES

When we introduced UL at Penn Mutual in 1982, we believed that the increased flexibility inherent in the product would require a greater amount of agent servicing. In order that the servicing agent receive appropriate compensation, we incorporated into the pricing and added to our agent contract an assignable service fee. When an agent leaves the company and forfeits his nonvested service fees or renewal commissions, the company has the option of assigning a new servicing agent for that policy. The new agent will receive compensation equal to the compensation forfeited by the old agent.

We still will not vest UL commissions for a number of years for agents who have been with the company for several years. We will not assign those fees. But hopefully those agents will be taking care of those policies in the future even though they haven't maintained their Penn Mutual contract.

Another reason for assignable or transferrable service fees on flexible premium products is to give the agent some incentive to ask for premiums. Conversely, an argument against transferrable service fees on traditional products is that a service fee will be paid on participating policies based on the full amount of the premium that is received even though some of that premium may be the result of dividends that are being used to reduce the cash premium or even after the premium may have "vanished."

COMPENSATION ON ROLLOVERS

I'd like to say a few words about compensation on rollovers, or premium coming out of another policy issued by your own company. This is compared with replacement, where the money comes from another company's policy. Typically, full commissions are paid on new policies issued as long as the money did not come from within our own corporate structure. The trend here, I believe, is toward ever stricter rules on paying first-year commissions where there are rollovers, or money coming from within the company. Every year, it seems, we tighten our rules on rollovers. The current rules at Penn Mutual are that commission calculations exclude the larger of the premium or cash value for any Penn Mutual policy surrendered or lapsed from the time 3 months before to 26 months after the new policy is issued. For the case in which the old policy is surrendered within 26 months of the new policy being issued, we recalculate commissions and then charge back the commissions already paid. These rules apply to new UL policies issued and to our minimum deposit rescue plan.

I already mentioned an exception to paying normal commissions on replacement YRT products in which the policyholder, and for some companies, I believe, the agent, has a history of rolling over YRT policies.

OTHER SOURCES OF AGENT COMPENSATION

Our agents have lots of opportunity not only to write brokered life business but also to earn income from equity sales or fees for financial planning. There are many positive aspects of this, but as manufacturers of life insurance, we need to keep our commissions competitive so that we can compete for our agent's time. I think that we could spend an entire panel discussion on the pros and cons of career agents selling products or services outside of the products the agent's primary company considers its main product.

In conclusion, the competitive pressures we are facing are putting pressure on how we manage our sales forces. One of the primary means of managing the field force is compensation. While this has caused companies to experiment with changes in field compensation, there is no general revolution going on there. Each form of field management has its own strengths and weaknesses and the two more revolutionary forms of agent compensation I have discussed -- level commissions and asset-based commissions -- are not soon going to replace traditional compensation patterns.

MR. ALDEN L. HEAD: I've heard some rumors, Jeff, about level commissions in the New York Department. Something crossed my desk that they were considering allowing one company something in the nature of 15% if all the agents would accept that level plan. They would not allow discrimination, such as an agent taking a 55% first-year commission in lieu of the 15%. Have you heard anything about this?

MR. STEVENSON: I haven't. I think that's good news. I did ask the field compensation people before I left about the New York level commission and as far as they knew the General Agents and Managers Association (GAMA) rule was still in effect. Does anyone else in the audience know anything about that?

That's something I'm certainly going to make a note of and follow up on.

MR. HEAD: If I find anything, I'll send it out to you. My calculation on the GAMA rule is about 9% level, which is, as you pointed out, not going to sell many policies or products. You also mentioned having a company average persistency, and I'd just like to comment on that.

In our manager's compensation formula (we also have a similar one for our writing agents), we tried using a company average or a company objective, and found that a company average for poor business is still not acceptable profitwise. So we are currently in a transition phase where our old approach is being phased to a new one. The company tells them what they have to get to maximize their compensation. It's a little bit too early to tell exactly what effect this approach is going to have on persistency, but I'm watching our persistency statistics pretty closely through this transition stage. Could I ask what approach a company average has had in your company, and what you would think that imposing higher limits or company sublimits would have on your field compensation?

MR. STEVENSON: That's a good question and comment. As you were mentioning the use of a company average, it made me think that one reason you're

using it right now is because the lapse rate has been declining. In our company over the last couple of years, even just recently, the latest report is that it has declined again. I believe that lapse rates are largely tied to interest rates. I think we're getting the benefit of good persistency partly because of the interest rate environment. So if there were a swing and lapse rates increased dramatically, I wonder if it wouldn't be wise to consider going to a goal of some kind, rather than a company average. If we were experiencing 10% all of a sudden, rather than 6.5%, we might want to replace that company average with a benchmark, a goal of some kind. If we really believed that the agents did have some control over persistency, we could use that as a hook to get them to improve. I'm not aware if there were any discussions over which one to use, and what the actual reason was. I think the one that I mentioned is probably as good as any, that we were enjoying favorable persistency, so we just used the company average.

MR. H. IAN MCINTOSH: When you mentioned that you are using company average in your expected, it concerned me. We've been making some similar calculations. We don't have it in compensation yet, but I can see that coming soon. We've been calculating an expected, really based on our pricing, and then we do this at each duration. We measure the business inforce at each duration by number of policies, by face amount, and by annualized premium, then calculate an actual to expected. We break it down by each of our branches, and we can break it down by agent.

Unfortunately, our overall fixture is considerably above 100%, and we have a company goal to reduce it this year. I can see getting it into an agent's bonus formula, and into a branch manager's compensation formula as well. The problem I see with using company average is if the average is moving up you have a real problem. If it's moving down, then I think the agent or the manager starts to think that you're giving him a bad time, because last year you only had to reach whatever your figure is -- 6.5% perhaps. But this year he has to get it down to 6% in order to earn the same amount.

The second problem that I see with the way you do it is that you're lumping all durations together. And it's pretty difficult for a new agent, an agent who's only been in the business a short time and doesn't have any long-term policies, to achieve the same sort of level as the overall. Do you want to make any comments on this, Jeff?

MR. STEVENSON: Well, the last formula is much easier for the lumping of all durations together. We do recognize the problem you mentioned about the new agents, and that's why we break it down into agent peer groups so the new agent business is measured against other new agents in determining the average.

I mentioned eight different agent groupings by years of experience. One problem that immediately comes to mind is that when they look at a new agent, are they looking at years with Mass Mutual or years in the business? I imagine that they are looking at a fresh new agent off the street.

Again, on the company average, that's a good comment, and I think that part of it is maybe motivated by simplicity as well. As far as relating it to pricing, the difference there is with pricing a duration by duration-type lapse rate, and we've tried to get a simple lapse rate in combining all durations together.

PANEL DISCUSSION

MR. WILFORD A. LEONARD: We're in the process of developing a persistency, volume-based compensation plan for our field force, and as Jeff mentioned, we're taking a little different tack. We don't use a company average. We're proposing to use benchmarks and a two-way spread of volume in persistency with maybe six to eight different brackets.

My specific question -- do you have incentives in your bonus potential to the agent and the GA? If he's better than average, is there an incentive for him to be a lot better than average? Does he get more? How many brackets do you have?

MR. STEVENSON: Yes, there is, in that bonus factor, that new allowance, which is persistency and production. I mentioned that if the ratio were over 1, it's a knockout for that particular agent, and if the ratio were at .8, we have the maximum factor applied. In other words, if the allowance were 5% of commission, and he's at .8 or better, he'll get 1.25 of the 5%. In between .8 and 1.0, it's linearly graded. So .8 is better than .85, which is better than .9, etc.

It's too new yet to see what the impact will be, such as when it gets time to pay one of these bonuses and they say, "What about this policy number XXX?" and the internal administration difficulties in that respect. But so far, I think because the new persistency system is a couple years in development, there's a lot spent on systems resources and actuarial resources.

The feedback we've been getting from agents has been very positive relative to the monthly listing that provides a monthly tracking of where they're at, and where they have to be.

MR. LEONARD: One other related question -- I noticed you've got some indices by class of business, presenting the expected different levels of persistency. Did you think about doing that by age? For instance, I'm thinking that the expected persistency is going to be very different for a mature agent selling ordinary life to the age 45-55 market, versus the new agent who is working in his peer group of age 25-30. Did you give any thought to age-related persistency figures?

MR. STEVENSON: I'm not sure. Again, there's the comparison with the peer agent groups. We separate the classes of business, and we give a weighting to the various classes of business, partly by numerical revenue or an index of the feeling of what the revenue importance is, and we use earned first-year commissions as the benchmark to make that determination. For a lot of our policies, sometimes there's grading at the higher ages of first-year commission. But I don't know if there is a factor by age. That one, you'd have to ask Kevin about.

I have a question for Doug, and that has to do with the YRT commissions. When you mentioned that you are considering more level-type commissions for a policyholder who has demonstrated a history of rollovers, how do you make a determination like that?

MR. VAN DAM: The history of applications, probably from something like Equifax, and also the application asks about replacement. We haven't gotten into it too far. We don't sell a lot of YRT to start with.

MR. MCINTOSH: I have a question based on a comment that Doug made about replacements. We characterize them as in-house replacements and out-of-house replacements. It seems that one of the big reasons for replacement is that a company treats an out-of-house replacement as if it's a new sale, whereas an in-house replacement is considerably penalized as far as commission is concerned. It only takes one such case for an agent to discover that it's better to go down the street than replace in-house. I'm wondering whether anybody in the audience has taken any action to reduce the commissions that they pay on replacement of other companies' business.

MR. STEVENSON: We have not.

MR. HEAD: Provident Mutual has done this in our term product. First, our commission scale is quite a bit less than New York; 25% first year, a heaped second of 20% and then our regular 10% and less renewal commissions. So we're definitely rewarding our second-year persistency and docking the guy for first-year sales. In addition, when we come to an out-of-house replacement, we charge an extra premium to the policyholder, and believe it or not, quite a few of them are paying it and this is not commission to the agent. We've been doing this for a little over two years, so it's a bit difficult to analyze exactly what's going on here, but the lapses of that particular product are about half of what we have in product development so far, so we're sitting very pretty on it.

MR. STEVENSON: Let me clarify -- for business coming to your company from another company, you charge an extra premium?

MR. HEAD: Yes. If we know that the insured is lapsing another similar product, we charge them an extra premium for this, as though it were a substandard policy. It's a one time charge just with the first-year premium, and again, it's not commissionable.

MR. STEVENSON: What's the basis for that -- expected or lower persistency?

MR. HEAD: I'm not sure. My guess is that we just didn't want that type of business, unless the guy really wanted to stay with Provident. We're not really selling lapsed policies. We never have, and we're not ready to start now. But this was one program we decided to try and it appears that it's effective in our sales environment.