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DESIGNING A FIELD COMPENSATION STRUCTURE

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- o Some specific designs -- New York and non-New York
- o Pressures for change -- inflation, interest rates, production, etc.
- o The design process -- case studies
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MR. ALBERT E. EASTON: As you know, field compensation among life insurance companies in the U.S. is sharply divided between companies that operate in New York State and those that do not. The point is often made that the strictness of the New York law helps to prevent unbridled competition, even among companies not licensed in New York. That is certainly true to a point, but the importance of the New York law is sometimes overemphasized. If the New York law were a lot less generous than it is, it would be much more difficult for New York companies to compete in other states, and if it were more generous, the industry would probably not have grown as well, and as strongly as it has.

The careful fine-tuning of the New York law to provide fair compensation to sellers, reasonable profits for companies and acceptable cost to consumers has been a source of strength to the industry for nearly 85 years, even among companies not licensed in New York. On the other hand, it has tended to discourage innovation. Innovations in field compensation (agent-owned reinsurers are one example) have tended to start with non-New York companies and then be adopted, or adapted, by New York companies.

Our first speaker will be Bob Clark. Bob is the President of Meridian Life Insurance Company in Indianapolis, a non-New York company. He is a graduate of the University of Connecticut and holds a Masters degree in Public Administration from the University of Hartford. Before becoming President of Meridian, he spent some time as chief insurance officer for Wolper Ross and as a senior officer of Hartford Life. Bob will be describing the process of field compensation design in a non-New York company, with specific reference to what's going on at Meridian Life.

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MR. ROBERT CLARK: Early in my career, someone said to me, "If you want to know what's happening in a life insurance company, take a look at your sales compensation plan." The more I learned about the insurance business, the more I became convinced that field compensation was an integral part of life company operations, and in some cases the driving force behind the company. As President of Meridian Life Insurance Company, I came to appreciate the difficulty of designing the most effective plan to support achieving business objectives. Key questions requiring resolution included: How do you know if your compensation plan is correct, if you are not sure of the profitability of your product? If your company's strategic objectives are a significant change from the past, then how do you adjust your compensation plan to support new objectives? Where do you start? Who should be involved? How much can you change at one time? How do you know when more changes are required? The approach used at Meridian Life was to include a review of field compensation plans as part of the five-year strategic planning process. The first part of our planning process was an environmental assessment, and the second part was a review of the company's strengths and weaknesses. We needed to know how well the existing compensation plans were working, before we could begin to plan for the future. This review process, conducted by an actuarial consulting firm, led to the development of a cost model to determine if the plans had kept us within product pricing allowables. The results from the cost model were also used as input into profit testing our products. So in Meridian's case, the strategic planning process was the trigger for reviewing field compensation plans. Now, let's take a look at some of the factors which influenced us in designating our plans.

The external factors or environmental factors include state requirements, federal tax law, and the competitive environment. Internal factors include company's strategic objectives, the company's annual business plan, motivation of the agency plant, motivation of the sales force, cost of administration, and pricing allowables. Key environmental factors include: the state requirements, the federal tax law and the competitive environment.

Let's look at the implication of federal tax law. The tax-favored status of life insurance as defined by Code 7702 provides a substantial incentive for the purchase of life insurance products. The exclusion of the death benefits from the beneficiary's gross income and the tax-favored status of "cash value" products really influence the amount and type of insurance purchased. The tax treatment of certain transactions, such as policy loans and surrenders, can have a dramatic effect on the amount and type of products purchased. The most recent example is 1988 Technical and Miscellaneous Revenue Act (TAMRA) and its impact on the sale of single premium life insurance. The changes in tax treatment of annuities, as well as the clarification of the tax status of "living benefits," further illustrate the influence that federal tax law can have on the design and marketability of products.

The premium produced by these tax-favored products provides the fuel for field compensation plans. If the inside cash build-up was taxable, it would require more effort to sell products which would produce less premium, have less consumer benefit, and consequently produce less income. The tax-favored status of our products, to some extent, subsidizes the payment of our distribution system. Clearly, designing a field compensation plan requires consideration and the analysis of current and proposed federal tax law.

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Meridian Life markets universal life, whole life, term, and annuity products. The recent changes in tax law did not have a major effect on the marketability of our life portfolio, because we were not in the life single premium market. The annuity changes did influence the amount of annuity business we wrote, and the uncertainty of tax treatment on living benefits has provided the rationale for us to delay entering this market. Our field compensation remained the same throughout these changes, with the exception of annuities. We lowered the credit in the sales staff and agent compensation plans, because as a small company, we wanted to shift the emphasis to products covering more overhead and producing more profit. I might add that, if the 1988 TAMRA did not reduce the attractiveness of large cash deposits, it would have reduced our generous credit for excess universal life premium in the current compensation plans.

As Marshall Lykins will explain, state requirements can have a dramatic effect, or very little effect, as in Meridian Life's situation. Meridian Life is a midwestern company with little aspirations to incur the additional cost to do business in the state of New York. So essentially, the New York State regulations will keep us from expanding to that state.

Most likely, many of you have had some experience with the extraordinary influence that the competitive environment can have on compensation plans. How many companies have tried to lower commissions with the introduction of universal life, only to find out that the competitive environment would soon change that approach? Those of us competing for the same agents, or trying to retain some degree of exclusivity of distribution systems, need to consider the competitive environment. The question we must ask ourselves is, "Are we mindlessly imitating poor compensation practices, and handing out too many contracts?"

Meridian Life is a property and casualty affiliate, so one would think the competitive environment would not be a critical factor in designing our compensation plan. I quickly found out that this assumption was wrong. Our agency survey revealed that even though we had less than 800 agencies, there were in excess of 100 different life companies doing business within our distribution system. Our survey told us that our compensation plans were not competitive, especially for the agencies we wanted to attract most, the ones with life specialists. We also concluded that we were handing out too many contracts to nonproducers who did not value the privilege of doing business with our company. The analysis of this environmental factor surfaced major weaknesses.

Each company should have a five-year strategic plan which clearly sets and communicates the direction of the firm. This plan states "what" the company will be and is most often the chief executive officer's vision, put to writing. The supporting plans or the "how's" to make the vision a reality must support the vision. It's vital that compensation plans provide the incentive to fuel the achievement of the company's strategic objectives. Meridian Life's strategic objective is to become a major financial contributor to our parent company, providing a constant stream of income to offset the cyclical property and casualty revenues.

Our five-year strategy calls for improving the company's competitive position, and diversifying its distribution system, so it will be a recognized regional life company. Our actuarial consulting firm audited our compensation plans and concluded that the existing

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plans did not support this strategy. We realized that it was necessary to make changes which would support the new strategy.

It is admirable to be guided by a five-year strategic plan, but we must also live with the realities of meeting the current annual business plan. The greater the change between the current annual business plan and the last year of the five-year strategic plan, the more likely there will be contention within the system.

Meridian Life's five-year plan calls for the diversification of our distribution system, but the first two years of the plan focused entirely on the existing distribution system. We took great care in fixing the broken parts in our compensation plan (we were too rich with low producers, the bulk of our current distribution system, without compromising our long-term objectives of increasing compensation for larger producers). Essentially, we treated our compensation plans as a dynamic factor, which would be reviewed each year.

There are four internal operational factors which should be considered. The first is motivation of the agency force. It's obvious that compensation plans must be designed to motivate the agency plant. The real estate industry provides an example of the dramatic effect resulting from a creative approach to compensation plans. ReMax Realty Inc.'s innovative compensation plan of 100% commission to agents, with monthly overhead and franchise fees to ReMax, Inc. propelled this firm to second place, behind Century 21 in the field of residential real estate franchises. Motivation of the agency plant is quite a challenge in the insurance industry, especially if the agency plant is a diverse group. To meet its strategic objectives, Meridian Life must motivate a distribution system with different agents -- property and casualty agents with little life experience, as well as small- to medium-sized personal producing general agents.

Some of the features of our agency compensation plan are as follows: We have three different agent contracts, which pay top base commissions from 60-95%, and renewal commissions of 3-13%. We have two different production bonus plans, which pay bonuses from 5-40%. We have a persistency bonus plan which pays from 1-5%. We have an annual incentive trip, either foreign or domestic, based on achieving commission benchmarks. The trip is taxable since it is recreational. We have recognition as a "master agency," after meeting certain criteria for production and growth. This entitles the agency to educational benefits, cooperative advertising, recognition in the local news media, and incentive trip credits. We have a special bonus plan which awards an additional 5% to profitable property and casualty agencies that meet certain life production requirements. This bonus is paid as part of the property and casualty profit sharing program. We have regional production contests which result in local trips and awards. We also have company-provided advanced underwriting software. Essentially, even though we're a small company, we have a menu of contracts and awards which attract targeted producers. Our recent audit of agent compensation plans did prompt us to adjust compensation, because we had the potential of paying too much to the more productive agents. We found that our old agent compensation programs were profitable at the aggregate level, but not profitable on a marginal basis, for the more productive agents, the agents we hope to attract in our strategic plan. How many of your companies have even looked at the marginal cost of doing business with your best producers?

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The next element, motivation of the company's sales force, can be just as challenging as motivating the agency plant. Ideally, this variable expense should be rewarded in proportion to the amount of profitable sales produced. Our worst nightmare is that this variable expense transforms into a fixed expense which seeks the path of least resistance to unprofitable sales. Understanding your product's profitability, constantly measuring total acquisition expense, and auditing the results of compensation plans at the micro-level can keep you on the right track. You must know if your salespeople are doing what you want them to do.

Meridian Life has two compensation plans for sales personnel. The basic sales compensation plan for our regional sales people includes a base salary, company car, expense account and educational courses. Then we have quarterly and annual bonuses, based on the amount of commissions over benchmarks. The benchmarks are developed as part of the sales planning process, and the expense budgeting process. Essentially, the benchmarks are set at a level which keeps acquisition costs within allowables, assuming that the sales plan is met.

We also have an executive sales compensation plan for the regional directors, which is based on achieving regional sales plans, and keeping the regional acquisition expense within allowables. So at Meridian Life, we have open-ended bonus plans which are governed by acquisition expense ratios. We compliment these plans with sales recognition awards for our most productive people.

A compensation plan which motivates the agency plant and the company sales force cannot be effective over the long term if it doesn't keep the sales acquisition expense within pricing allowables. Understanding and controlling the important factor of pricing allowables is at the heart of designing an effective field compensation plan. The "control" task requires the development of functional costs, so that they can be measured against product pricing allowables. Again, we see a consistent theme of knowing where you are before you can make changes and develop a plan for the future. Meridian Life installed a personal-computer-based cost model, which provides a comparison of functional costs. This model assists us in measuring progress in controlling acquisition costs, as well as measuring progress and controlling underwriting costs, policy issue costs, administration premium collection, and so forth. The results of our cost model indicated that our sales acquisition costs were within allowables. So our task was clear: make sure our revised compensation plans would keep us within allowables, while providing the motivation to achieve the business plan.

The last factor, the cost of administrating a field compensation plan, can easily be overlooked in the excitement of implementing a new plan. You should ask yourself, "What would it cost to accurately administer the plan?" Each step of the process, especially if it's manual, can have unexpected pitfalls.

At Meridian Life, our plans are administered through both automated and manual systems. Our commission system is automated and our sales division administers the incentive trips, bonus awards and other incentives.

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When reviewing our compensation plans, we did identify an error resulting from the structure of a worksheet which included some annuity premium in the calculation of life persistency bonuses. Needless to say, the situation was corrected when the plans were revised.

An effective field compensation plan should result in both short- and long-term profit. A profit model is essential in our business. At Meridian Life we're revising our profit model to reflect the changes in our product portfolio, and the changes in our cost structure. We plan to run the model on a semi-annual basis, and measure the effectiveness of our total operation.

In closing, effective field compensation plans are vital to the success of our business. Many factors influence the final design. I don't believe there is any one "right design." However, I do believe the more comprehensive the approach, the more likely you are to get what you expect.

MR. EASTON: Our next speaker will be Marshall Lykins. Marshall is Vice President and Actuary of New England Mutual Life. He is a graduate of the University of Chicago, and holds a Masters degree in Actuarial Science from the University of Michigan. This is his 20th year with New England and he has been working in field compensation for at least 10 of those years. He is a member of the core committee working on modernization of the New York expense law.

MR. MARSHALL H. LYKINS: Compensation structures can vary by size of company, whether the company is licensed in New York or not, or whether the company is a mutual company or stock company. I think from our experience, the most relevant criteria that would determine a compensation structure are the type of field force in place, and how the company relates to that field force. I'd like to do essentially three things. First, use my company, New England Life, as an example of how to develop a compensation structure. Second, go over some agent compensation trends. Third, I'd like to talk about what impact New York regulations can have on a compensation structure. And, in addition to this I'd like to discuss my experience with the core committee, a committee working with the New York Insurance Department to modernize the New York regulations.

New England Life is a large eastern mutual company, licensed in New York. More importantly, however, it's a general agency company. It's a company that sells all of its business through some 90 general agencies in all 50 states. It sells a wide range of products: life, annuity, disability income products, and both individual and group sell mutual funds. It's a leading seller of individual pension plans, although that represents only about 15% of its business. It sells variable life, it sells universal life, it sells adjustable life. As I mentioned though, the principal criterion that has affected how we structure our compensation system, is the fact that we sell our products through general agents. These general agents are quite independent, which is not to say that they sell for other companies. They're independent in how they relate to the company. The company has, unlike other general agency companies, relatively little control over its general agents. The company does attempt to recommend to its general agents standards by which to do their business, but for the most part, the company allows the general agents

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to run their businesses as independent businessmen. This is what has affected our compensation structure probably more than anything else.

Prior to 1985, our compensation structure for general agents was quite a patchwork quilt of factors. We had about 12-15 different components of our structure. Every time we came upon some new wrinkle in compensation, we added a new factor, or modified an existing factor. We rarely ever eliminated an existing factor. The result of this was that we ended up with so many different ways of compensating, that our general agents found it very difficult to focus on what they were doing. Each factor was put in with a different objective in mind, and for the particular general agent this confused them frequently. The general agent wouldn't concentrate on any more than two or three factors at a given time. The general agent would decide which of the factors he was going to emphasize, and he would try to maximize his income from these factors. Whether or not this was to his overall benefit, or much less the company's overall benefit, was very unclear. This also led to a good deal of trying to work one factor against another.

In 1985, we effectively started over, and scrapped our old system. In order to get rid of an existing compensation schedule, you need a strong leader. You need someone from the top management of the company, someone with credibility, who can lead, announce the case for a change, and make logical compelling arguments for these changes. This person needs to be flexible in terms of the details. When the revisionists come out of the woodwork, unless you have a strong person at the top who can enforce the principles, this kind of a change won't work. The second thing you need is good communications and participation by those involved. You also need your agents and your general agents to participate in the process. You need periodic review and updates. In essence, what you have are what appear to be labor negotiations. For example, there is the self-interest of those participating in the proceedings. There are also the effects of personalities of the individuals who are involved in the process. Third, there is the failure of these individuals to see the big picture. All of this results in a good deal of "pork barreling." What you ultimately need is a method of checks and balances between labor and management, or field force and the home office. Then, you need the individual as I mentioned before, to tilt the balance somewhat in favor of the home office, so that at least the basic principles are being upheld. This person must be able to see the big picture, and be flexible enough to allow for changes, but not to the extent of sacrificing the basic principles. These are the components that are necessary during the transition period.

Whenever there is a major change in compensation structure, there is disruption, unless the changes are phased in over a period of several years. This will involve having some short-term costs to the company, but these are necessary in order to make dramatic change. Finally, there will always be some special situations. There will be some particular general agents who are more adversely impacted than others. As actuaries, we don't like to see special treatment. We like to have mathematical formulas applying across the board. In practice, however, especially where radical change occurs, the particular exceptions must be considered.

The most confusing thing about our compensation structure at New England Life is the multiplicity of factors that existed. Our principal objective in making a change was to

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simplify the entire structure. From a patchwork of 15 different compensation components, we reduced our compensation structure to essentially four. First, there is a first-year allowance to our general agents, or "new business allowance," which is a percentage of first-year commissions. It is completely production driven. Second, there is a renewal compensation that is a percentage of premium where part of it is vested, part of it is nonvested. Third, there is a bonus for our general agents. It is a function of premium in-force growth and manpower development. The fourth component is called our "developmental programs." These are programs that are essentially start-up programs with a duration of three years. They provide financial assistance to our general agents in developing second-line manpower, i.e., specialists in the agency, supervisors in the agency, and assistant general agents. We eliminated anything relating to cents per thousand that we had in our old formula, transferrable service fees on pension plans, and a .2% payback on certain lines of business.

In addition to these changes, we also were interested in controlling expenses. But, we felt that our general agents were too independent for us to have control over their expenses. So, we modified one of our factors, which was to pay half of the general agent's rent. We were on the lease, but the general agent paid half of the rent, and we paid the other half. What we decided to do, however, was to no longer pay any of the rent. The general agent would pay the entire rent. What we would give him instead was a percent of the first-year commission, as a replacement for the old factor. In essence, we would be giving him a production-driven amount with which he would use to pay the rent. Based on mid-1980 numbers, he will have enough money to pay the rent. If he is able to keep rent under control, relative to production, he will benefit from that. In the past, the company and the general agent would have shared in this savings, but in the future, the general agent will bear that savings. Conversely, if the rent is rising more quickly than the production is, then the general agent bears the cost, not the company. By doing this, the company has protected itself effectively from rent risk. This solution may be more particular to our company, which has relatively little control over our general agents, than to other companies where they have much more control, much more of a presence in the agency, and much more an ability to tell the general agent what he should be doing.

Another component of our new structure involves the distinction between and the balance between, new agents and existing agents or experienced agents. Under our old formula, if we add up the various factors, we could be paying as much as 115-120% of first-year premium to the general agent, on the business of a new agent. We could be paying as little as 40% on the business of an experienced agent. If the rent and the other components are added together, there is a differential of almost three to one. As you can imagine, business that should have been experienced agent business, frequently was listed in the name of a new agent, because of the greater income the general agent would receive. What we did to change this was to tilt this scale. We would still pay more money to new agents. The new business allowance would grade down to only 50% for the experienced agent, instead of the 80% I mentioned before. This gives less of an incentive for the general agent to place the new business in the new agent's name in order to receive the additional income. The incentive is still there of course, but to a much lesser extent. We did this because we felt that in this business, 70% of our business comes from agents who are beyond their 5th year. We needed to provide more

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services to the experienced agents. Thus, we decided, that of the total pot that we had available, we wanted to redistribute it, in order to pay more to the experienced agents, and less to the new agents. Hopefully, we would be paying enough to new agents to give the general agent enough incentive to do the recruiting that we need to survive.

We also modified our growth bonus. Our general agents are required to do essentially two things: to sell new business and to develop new agents. Our growth bonus essentially rewards for doing those two things. In other words, the growth bonus is a percentage of growth and premium in-force, so that the growth and premium in-force are essentially sales minus terminations. So there is a slight persistency adjustment. The growth and premium in-force, multiplied by a factor of 2.5%, are then multiplied by a manpower factor, which can range from 1-3. One can effectively triple the 2.5% of in-force premium growth that one would receive as a growth bonus. Therefore, one would get from 2.5-7.5% of premium in-force growth, depending on manpower development. Manpower development is based on a valuation of our manpower, at the beginning and end of the year. We examine the full-time agents under contract in each agency, we attach a value to each of those agents, then we add up the value for the agency and compare the beginning and the end-of-year values. To do this, we gave the general agent a rating of 1-3 based upon the growth in the manpower value of the agency. Three represents a 20% growth in manpower value, and one represents zero growth, or actually, a declining value. Thus we reward both sales, offset by terminations, and manpower development, as measured by a formula that attaches a value to an agent. The value is dependent upon the agent's commission level averaged over 3 years, his length of service with the company, and his age. All the things being equal (i.e., the same level commissions, average commissions, and length of service), an age 25-year-old is worth more than an age 55-year-old. Based on these three criteria, we value each agent, aggregate that value for the agency and compare the beginning and end-of-year values.

Next, we examined our developmental programs that provide the general agent some additional income with which to develop second-line management (i.e., specialists, sales managers, and growth risk managers). We reduced the period of time for these programs from 5 to 3 years, and we required the general agent to finance one-third of the cost, but not to charge for successful completers. These are different from the way they used to be, and are intended to provide some risk sharing on the general agent's part. Relative to new agent hiring, we provided an opportunity for the general agent to clean house, amongst new hires, between six and nine months after hire. By reducing the general agent's share of loss on terminations within that time period, from 75-25% prior to that six-month period, and back to 75% at the end of the nine-month period, this gives the general agent an incentive to get rid of people who don't appear to be likely to succeed. If he doesn't, and they later fail, he must pay more of a penalty for that.

To summarize, we've done several things. One, we simplified the system by eliminating all the various factors, and tried to allow the general agent to more accurately determine what we're expecting of him. Two, we've transformed any reimbursement types of expense items into production-driven expense items. Now our entire formula is almost entirely a production-driven formula. Three, we've changed the tilt in compensation between what a new agent would receive, versus what an experienced agent would

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receive in favor of the experienced agent. However, we're currently still paying more on the inexperienced business. Fourth, we've provided a growth bonus that rewards for growth production through growth and premium in-force and manpower development, through a factor that values the existing manpower force. And fifth, we've implemented developmental programs that provide for risk sharing on the general agent's part, over a short three-year period in developing new second-line management.

Other changes include the fact that we decided to emphasize growth more than we had. We also changed our compensation on brokerage business to make it more comparable to what a new agent would receive. Thus, there wouldn't be the temptations that existed in the past to either name full-time agents as brokers, or vice versa, depending on where their income was greater. We did this because we wanted to encourage brokerage business. And, in fact our brokerage business is up from 4% or 5% which it was prior to 1985, to close to 15% today. We changed retirement programs for general agents, to give them more sufficient retirement income.

These are several of the changes in addition to the five things that I mentioned. But, certainly the simplicity and production-driven nature are the things that should be noted. The program has been in place for five years and, although there was a little tinkering in the last five years, it wasn't until this year that we made any significant changes. The growth bonus, as designed in 1985, was paying out something like \$4 million a year; with over 90 general agents this was \$40,000 plus, on average. It was felt this was probably too much to put into an incentive such as the growth bonus. Second, the volatility of the growth bonus was unacceptable, because the effect of the manpower factor (the factor that ranged from 1-3) was based upon the evaluation of the agency's manpower. An agency could easily vary from 2.5% of in-force growth one year, to 7.5% the next, and back to 2.5% in the third year. That kind of variation could result in income that would vary from \$150,000 one year to \$50,000 the next year, and back up to \$150,000 in the third year. This kind of variation was deemed unacceptable for purposes of operating income. This made it very difficult for the general agent to be using this money for operations, since the amounts were so unpredictable. A solution, therefore, was to cut back on the magnitude of the growth bonus, roughly in half. Instead of variation from 2.5-7.5% of in-force growth, we'll be paying out an amount that ranges from 0-4% of premium in-force growth. The old growth bonus averaged about 5% of in-force growth; the new one will average just about 2-2.5% of in-force growth. If the growth factor itself is being reduced from 2.5 of in-force growth to 2% with a carve-out (a carve-out meaning that the first x percent of growth won't count at all towards your growth bonus), the manpower factor that ranged from 1-3 is reduced to 1-2. The effect of those two changes is to reduce the growth bonus almost in half. The money being shifted into the new business allowance, which used to range from 80-50% will now still range from about 80-53%. Thus much of the money that was taken out of the growth bonus has been put into more experienced agents. The other change that was made this year was to introduce a bonus for supervisors, or second-line management, which is based on the performance of their unit. This would be both for the sales managers, who are recruiting and training new hires, as well as for brokerage managers.

I'd like to mention a few of the agent changes that we've made in the last several years. This year we introduced what we call a new client bonus for our agents. It's a

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percentage of first-year commissions, varying from 2-6%. It's similar to the Northwestern Mutual new client bonus, with the purpose to encourage agents, especially experienced agents, to continue to enlarge their client basis. What we've seen happening over an agent's career, is once they develop a clientele of 100 people, 150 people, or whatever, they stop prospecting. They effectively just continue every year to return to their existing clientele. This new allowance hopefully will encourage them to try to develop new clients. The second thing we did was change our persistency bonus for our agents. There are two things I'd like to mention about that. One, is that it's based upon a long-term persistency. There does seem to be a trend in the industry toward lengthening the period of time that is measured in calculating persistency bonuses. The second thing is that we discarded any actual persistency measure. What we found with our old persistency bonus, is that agents didn't understand how the bonus was calculated. Therefore, we don't think it was operating as an incentive to improve persistency. The new bonus, provides a percentage of in-force premium, established at the beginning of the year. During the year, a deduction is made that is a percentage of lapsed premium. So, there is no lapse rate calculation at all. The percentage of lapsed premium varies between pension and nonpension plans, (it's lower on pension plans than it is on nonpension plans). Specifically, it ranges from 20-35% of premium, as a lapse charge. At the beginning of the year, we establish a pool of money for each agent, of roughly 2% of in-force premium. We charge from 20-35% of lapsed premium during the year, and at the end of the year, whatever is in that pool is the agent's bonus. There is also a bonus enhancement at the end of the year. It is based on the commissions credited during the year, and the number of policies sold during the year. The agent can get up to a 50% enhancement for each, for a total enhancement of 100% of whatever is in the pool at the end of the year. In other words, the agent receives 2% of in-force in the beginning of the year, reduced by a lapse charge during the year, and then enhanced by up to 100%. Again, the two things I'd like to emphasize are the lack of any actual persistency calculation, and the use of long-term persistency.

I would like to mention several other things relative to agent trends that exist at New England. One is the interest in asset-based compensation. As a New York company, we're not permitted to use asset-based compensation. We did have a proposal into the state of New York to allow us to pay a quarter of a percent of assets on universal life policies. The state has not approved this, and they've indicated they will not approve it for anyone at the moment.

The second trend is, in addition to shifting the expense risk and the need to control expenses from the home office to the general agents, we are encouraging our general agents to shift this expense risk to their agents. Many of our general agents who house agents are charging those agents rent, and crediting them with an expense allowance. Well alternatively, this is equivalent to paying them a lower expense allowance on the first \$10,000 or \$20,000 of production, than on higher production levels. They are also charging them for things that may, in the past, have been given to them for nothing.

The third trend involves a reinsurance company for agents. Back in 1985, we started a reinsurance company, called Mega Reinsurance, which was licensed in Arizona. We sold the stock of it to our top producing agents. We do a lot of their administrative work, but they are the owners of this company. We reinsure half of the business that they sell to

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us. We've had a good deal of discussion with New York on this kind of arrangement. New York claims that the entire arrangement is compensation oriented, and to some extent, it may be right. Certainly the motivation for it has something to say for that. Nonetheless, it is a true reinsurance company. The agents have the risk, and that was the intent from the beginning. Their compensation under this arrangement is essentially fourfold. They do receive some additional first-year allowances. This money goes to them individually; it doesn't go to the reinsurance company. It effectively makes them personal-producing agents (PPGAs). Second, they receive some additional renewal income which does go to the reinsurance company. In normal coinsurance, we give the premium to the reinsurance company, and the reinsurance company gives us an expense allowance. In this situation, the reinsurance company does not give us an expense allowance. What they retain from the premium then, in the renewal years, includes this extra renewal commission, if you will, that we're providing to the agents. This renewal commission essentially also makes them a PPGA, since it gives them much of what we would have been giving to the general agent, and it gives them money to operate their company. The third component is a mortality risk sharing. Since this is a true reinsurance company, if the mortality of the experience on this business is favorable, then the agents benefit from that. We are protecting our policyholders in this arrangement because the mortality objective that must be met is essentially what we would have expected from the mortality of this business, had the reinsurance company not existed. In other words, we looked at the experience on the mortality of these people, prior to 1985, and set that up as a standard by which we would measure their subsequent mortality experience. A similar philosophy affects the fourth trend in compensation, persistency sharing. Again, we examined the persistency of the business of these agents prior to 1985, and set that up as a standard by which we would measure their subsequent experience. If these agents improve on that experience subsequent to the formation of the company, then they will benefit from that. On the other hand, they're taking risks too, because if the persistency is worse, they effectively will have to pay us back some part of the difference.

The final thing relative to trends in agent compensation, is what I'd like to call the corporate-owned life insurance (COLI) market. This is really life insurance that's being purchased, usually by large corporations, for the purpose of providing postretirement medical benefits. What they're doing is buying large quantities of life insurance, in effect as a funding vehicle, the assets from which will then be used to pay for postretirement medical benefits. This type of sale usually carries along with it much lower field compensation. There is some question about whether or not this will be viable in the long run. It's only a matter of time before Congress does something about it, but nonetheless, it has been a growing business in recent years, and some companies have effectively been specializing in it.

I'd like to go on to the third aspect of my discussion, the impact of the New York regulations on compensation design. The existing New York regulations have affected companies in several ways. Companies that have wanted to pay level commissions, or even lower universal life commissions (which are even somewhat less heaped than is traditional), have had a problem doing so under the New York regulations. Persistency bonuses for universal life currently are not permitted in New York. First-year compensation payable, or expense allowances in first-year compensation, payable to agents, have

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also been a burden for New York licensed companies. Finally, the current regulations provide an unlevel playing field for different kinds of companies. PPGA companies versus general agent companies, versus branch office companies, have different limitations applied to them. The effect of these limitations is to give an advantage to one or more of these types of companies. These are problems that from the industry's viewpoint need correcting.

From the department's viewpoint, the current regulations have some problems also. From their viewpoint, Schedule Q is of dubious effectiveness. It is too generous, in terms of its limits, resulting from the fact that the limits are probably no longer appropriate. In any case, most companies have tremendous margins and effectively, needn't be concerned with Schedule Q limitations. So, the department is quite interested in making Schedule Q a more effective regulatory tool. The department is also concerned about the regulations that apply to universal life. The department was very slow in coming up with regulations for universal life, and to this day, is very concerned about the existing regulations. Their concern from the beginning has been that companies have been using universal life as a vehicle for paying annual premium compensation on what the department considers to be single premiums. They would like the universal life regulations to be changed from what they currently are. The industry, with the department, has set up what we call a core committee, to help modernize these New York expense limitations. Out of this core committee, hopefully, will come some resolution to both the problems the industry and the department feel exists. The core committee is looking at some drafts that would dramatically change the New York expense limitations, by making them more of an aggregate expense limitation, and trying to get rid of a lot of the inside limits that currently exist, particularly, the agent level limits. The core committee would also like to improve the playing field to make the regulations more appropriate for all types of companies. The core committee would like to make universal life more comparable, in terms of the regulations, to traditional fixed premium plans. The most immediate thing that is likely to come from this review of the New York expense limitations, probably within the next month or two, is some regulation that will redefine an experienced agent versus an inexperienced agent. Regulation 50 defines what an experienced versus an inexperienced agent is. Regulation 50 has been variously interpreted by companies, to permit the financing of agents who, according to the department, are clearly experienced agents. Consequently, the department has insisted that the industry come up with a revision of Regulation 50 to redefine the distinction between experienced and inexperienced agents. If the industry doesn't do it, then the department will. There is a draft of a definition circulating now, and probably within the next month or two, you're likely to see it.

MR. EASTON: Our final speaker is Paul Laporte. Paul holds both bachelor's and master's degrees from the University of Connecticut. He is an Associate of the Society of Actuaries and he is Assistant Vice President of Financial Research for the Life Insurance and Marketing Research Association (LIMRA). In that position, he heads a staff responsible for, among other things, research into field compensation. He will be describing some of the other trends in field compensation, with particular respect to the level commission plan now being used by the Mutual of Canada.

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MR. PAUL D. LAPORTE: At LIMRA, in the financial department, we have literally hundreds of compensation contracts on file. So when Al Easton asked me to speak on trends in agent compensation, it gave me the opportunity to step back and look at the forest among the trees. The lapse rates in the mid-1980s jumped to three and four times the historical rates in renewal years. Companies really had to do something to stop the bleeding. A persistency improvement measure that companies used to react to some of these lapse rates, was to change their commission replacement rules. They needed to react to universal life and other new products. From the agent's point of view, however, these changes were too complicated, and too restrictive, and often, they took their business elsewhere. Other companies changed their persistency bonuses. I guess I'd like a show of hands here, of those companies that really feel that their bonus is effective and get their money's worth from their persistency bonus. There must be someone. I think that's the case with a lot of companies. They just feel the need to have a persistency bonus, and hope it works. It isn't having the effect that we really would like. Now the next companies used product changes. They introduced surrender charges, usually in the first 10 years. Also, now we see companies having interest kickers, usually later than that. As one of my colleagues remarked, "products are now looking more like tontines every day."

In Canada, several companies have introduced levelized commissions. I'd like to go over Mutual of Canada's level commission plan. I feel it to be the most innovative and exciting change I've seen in the 16 years that I've been following agent compensation. Basically, it consists of two factors. The first is a 15% lifetime level commission. This 15% is paid identically on the first year, and on the last year of the plan. Thus, there is no incentive for an agent to replace, because they've also taken the 15% commission, and recommissioned existing business, when they introduced it July 1, 1989. Actually, agents are now being paid 15% on all their existing business, and anything new that they write for all policy years. Obviously, this is a large cost to the company. It is also a transition from the old system to the new system. They took a \$25 million hit last year on their annual statement, when they had to increase their reserves for this recommissioning. The second factor is a 45% growth commission. This pays 45% of the increase in premium in-force on a monthly basis. So, for their veteran agents, this essentially gives them the incentive, not only for service, but also for sales.

I'd like to mention some of the biases against the level commission plan. I think you'll also see that the Mutual of Canada has met these problems. When anyone is first mentioning level commissions, the first reaction I get is, "If we were the first company in the United States, we would lose half of our agents." Another is that financing is just too costly. There's no way the company could pay the extra amount of compensation. A third reaction is that the company would have a lack of sales motivation by paying a low commission rate and wouldn't have the incentive for agents to produce, and/or eventually they would coast once they have their book of business built up.

The Mutual of Canada's financing plan essentially pays a \$2,000 initial level payment. They decided, so they wouldn't have any problems from a discriminatory point of view, to not vary that. There is no other financing level. It's only \$2,000, so they wanted to avoid problems that Prudential, Allstate and State Farm had in California. But, if there is a flaw in their plan, it is because they're finding that \$2,000 is fine for an agent in

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Nova Scotia, but in Toronto it's not just high enough. They then take the \$2,000 and decrease it by \$150 per month in the first two years, and \$200 in the third year. So essentially, they really have a three-year financing plan. The total investment for the subsidies is \$42,700. This seems high, although it's just within New York limits. When you take into account that their retention rate is almost 40%, their cost per survivor is probably lower than the typical company.

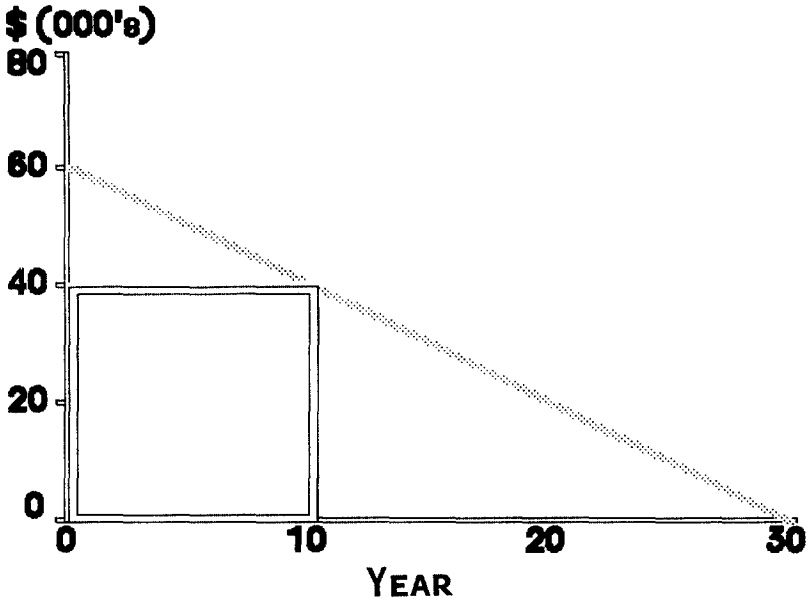
If I were to have a second trend in agent compensation after paying for improved persistency, it would be as Marshall mentioned, shifting the expense management, not only down to the general agent level, but really down to the agent level. For Mutual of Canada, they pay 20% of the total commissions to their agents, and then their agents are charged for rent, clerical salary, telephone, etc. But, because they wanted to maintain their managerial company, and they wanted to maintain an incentive for their agents to remain in the agency, they subsidized some of these costs. For example, for the first \$15 of rent, the company pays 25% of it. For the next \$10 of rent, the company pays 20%; for anything over \$25, the company pays 15%. In addition, Mutual of Canada pays for all common space areas. The factor that made the agents buy into this is the fact that they're now building equity in their business. Before, they had little or no vesting. This way, when an agent terminates, they calculate present value of the future commissions. They do this by taking the persistency and mortality scene in the pricing assumptions, and vary it by the type of plan and age of policyholder. Then, they take 75% of that amount, and spread it over a 10-year period, using an 11% current interest rate. The remainder, the other 25% in the first 10 years and anything paid after the 10th year, goes to the servicing agent. For example, if you had an agent who had \$400,000 premium in force when he terminated, they would take the present value, again using pricing assumptions, of the commissions. Using 75%, this would be about \$250,000. That \$250,000, now spread over 10 years, at 11%, would give the retiring or terminating agent \$40,000 per year. It would be an annuity certain for 10 years. On Graph 1 the remainder, the diagonal line, shows what the actual commission is that might come in off of that business. The servicing agent would receive anything below that line, but not including that box. It would be the excess in the first 10 years, and then anything that is thrown off from the 10th year on.

Although Mutual of Canada has had this in effect for less than a year, they have had some encouraging results. Their persistency has improved 25%. They had an overall lapse rate, which was already low at 7.5%, but is now down to 5.6%. In addition, although their sales have been flat, their premium growth has gone up 10%. They've also experienced a 7% manpower gain. One of the main problems with level commissions, as I mentioned before, is a fear of losing your agent. Actually, out of the 1300 agents that they had last June, all but 15 of them signed up for this new contract. The reason these agents didn't leave is they would have been walking away from the re-commissioning at 15% under the existing business. To make sure these agents stay, the 15% is going to be spread out over 20% per year, for the next five years. In addition, by signing this new contract, these agents are signing a one-year noncompete clause, as well as a nonreplacement clause. So, their hands are really tied to staying with Mutual of Canada. These agents have also experienced a 17% increase in their incomes, so they do like the system.

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GRAPH 1

\$400,000 PREMIUM INFORCE
\$250,000 COMMISSIONS



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I would like to review some of the expected gains from a levelized system. First of all, this type of system motivates proactive conservation. A couple of weeks ago, I was talking to the chief marketing officer at Standard Life Insurance of Canada, who has a similar system to Mutual of Canada's. One of the things he's noticed since they implemented the system is their agents don't ask about new products anymore; but, they ask about riders to old products, their reinstatement policy, etc. Thus, there really has been a change in their attitude. This system provides less motivation for internal replacement, or in Mutual of Canada's case, no incentive to replace. Second, a levelized system reduces the acquisition expense. Banks are much more deregulated in Canada than they are here. I realize because of what's happened to savings & loans, deregulation has slowed down in the U.S., but last month in Delaware, the Senate failed by one vote to have a two-thirds majority to allow banks to not only sell insurance, but to underwrite insurance. This was backed by Citibank. The author of the bill said that as soon as he gets that one extra vote, he intends to reintroduce it again.

As I mentioned before, a levelized system promotes total premium growth and in Mutual of Canada's case, in less than a year, they've already had a 10% increase. In addition, it enhanced agent retention. Now, this is really the key. I think in any modeling or any studies that we've done, if you really want to save on your expenses, you need to improve your agent retention. Believe it or not, the Mutual's goal is to have a 50% four-year retention rate. Note that they are exclusively a life company; they do not sell property and casualty insurance.

I would like to mention some other trends in agent compensation. Marshall mentioned asset-based compensation. Again, in New York, this currently isn't allowed. But in other companies, non-New York companies and in Canada, there are three different ways that it is currently being paid. First of all, they use a percent of cash value of usually 25 basis points, although I've seen it as high as 40 or 50 basis points. Second, they use a percent of excess interest over the guaranteed interest rate. I've only seen a couple of companies do that, and in both cases, it was 5%. Finally, they use an asset growth bonus. I have seen a couple of companies do this in New York. They treat it as a bonus and not as part of the agent's commission. So really, in one case it was a percent of their growth in cash, or agents' growth in cash values.

For example, using a universal life policy with \$700 of premium, look at it in terms of a normal 4% commission rate and in asset-based, a combination of 2.5% of premium and .25% of assets. You can see, in their early years, an agent's compensation is less, but in later years, it really takes off. I think agents believe this is even worse than level commissions, because it's actually increasing commissions.

Another trend in compensation, and again, Marshall mentioned he has added this to his compensation plan, is policy compensation. For example, a company pays a bonus of 2-6% of first-year commissions, grades it by the agent's years of service, and the number of new clients. Looking at the minimum amount required for a 2% bonus, an agent in his 4th year needs 31 new clients, whereas an agent in his 18th year, will only need 17. This recognizes that it's much more difficult for an agent who is already managing his income to get more new clients.

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This third one isn't really a trend, it is just a pet peeve on my part. I don't know if anyone here pays reduced compensation on premium of smokers. There are only two companies that I can think of and one is Pacific Mutual. It pays a reduced commission, instead of 55%, I believe they pay 45% on premium of smokers. The other company is Mutual of Canada. When they went to their new system, instead of paying 15% on the entire premium, they only pay 7.5% on the excess of the premium for a nonsmoker versus a smoker. The reason why I say this is a pet peeve is although I'm not a fanatic in terms of antismoking, I just don't understand why an agent should receive up to 50% more in commissions, just because he sold a policy to a smoker versus a nonsmoker.

Again, another trend that has been mentioned is shifting expense management to agent level. Mutual of Canada has done this, but so have Equitable, New York Life and many general agents. What's happened now, however, is instead of an agent saying to his manager, "I really want to have a larger office. I want to have my own secretary," he is saying, "Well, I could really live with the smaller office. I could share a secretary with Joe next door. And, when our lease comes up, why don't we move out to the suburbs instead of that stately new building across the street downtown?"

Finally, another, again it's not really a trend, but just something I thought I'd mention, is anyone aware of Mutual of New York's accelerated commission program? Whenever a commission payment is made, it automatically is transferred to the agent's checking account, so that he has access to it on a daily basis. So now at Mutual of New York, they like to say that every day is a payday.

MR. PHILIP K. POLKINGHORN: Mr. Laporte, you mentioned the Mutual Life of Canada plan and the Standard Life Plan with levelized commissions, and the growth bonus which is 45% of increase in premium in-force for Mutual Life of Canada and, I believe, 50% for Standard Life. Do you have a feel for an experienced agent, what proportion of his or her income would come from new sales? And what proportion would come from servicing business?

MR. LAPORTE: Obviously it's going to adjust as the agent increases.

MR. POLKINGHORN: But, for an experienced agent, who has been around for a while, I heard an estimate from one of those companies that the proportion was 50/50.

MR. LAPORTE: I believe that occurs somewhere around the agent's 10th year of service.

MR. POLKINGHORN: I guess one of the problems I foresee is when you discussed the product changes that people have made to address the persistency problem. For many of our clients, we see that the products aren't very sensitive to renewal persistency. Thus, when I envision them with level commissions rather than heaped commissions, I can see a situation where the company might make money based upon standard lapses, or perhaps even an improvement over their current level. But, if lapses were to improve dramatically, the products might be losers. Have your clients done any of that sort of analysis?

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MR. LAPORTE: Well, I don't think they would actually be losers. I mean it depends on how you set up your products. I know there are products out there that have such a surrender charge to them, that the companies are almost hoping that they'll lapse. I guess, you can look at it that way, but you also have to look at it from a consumer's point of view. I wonder when the agents sell this product, are they making their clients aware of these surrender charges?

MR. POLKINGHORN: Quite apart from that, I can envision a front-loaded product being lapse supported, if commissions were truly level. Then, when someone lapses, the company is released from the liability of having to pay 15% of premium into the future.

MR. LAPORTE: Well, in addition, when you look at the 15%, things are a little different in Canada, and I don't think policies here would support that 15% commission rate, as well as the 45% growth in commission. It probably would be something less than that.

MR. POLKINGHORN: But to your knowledge, then, haven't these companies taken a close look at how important, valuable and difficult the servicing aspects of the job are versus the sales aspects? It seems that servicing business is very valuable to the company, but it seems far less difficult than getting out and selling new business.

MR. LAPORTE: That is why they've added that growth commission. When Mutual of Canada was first developing level commissions, originally, they were thinking of just paying a level commission rate. Then, they realized that this wasn't going to do it. They had to have something in there for production. That's why they introduced that, in addition to adding a 45% growth commission.

MR. POLKINGHORN: Have you had any sort of sales results from Standard Life and Great West that you could tell us about?

MR. LAPORTE: Yes. I mean, all of them have kept up with the industry, if not better.

MR. POLKINGHORN: So sales have been industry average, and premium income and totals have been going up because of the improvement in persistency?

MR. LAPORTE: Yes, and I also think Great West Life doesn't have a pure level commission contract like Mutual of Canada. But, their four-year agent retention has improved from, I believe, 15% when they first introduced it, to 24% now. I think what they are hoping for is that part of their gain will be from agent retention, agent persistency, and maintaining that increase in premium growth, without their production suffering. But, they really wanted to get their agent off this replacement cycle. I think that was their main motive, as well as reducing the acquisition expense, since they feel it's an investment for the future, because it's more deregulated in Canada. Thus, they would be able to compete better.

MR. POLKINGHORN: I guess one final question. How do you feel about the impact of the commission financing arrangements on any sort of move to level commissions?

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MR. LAPORTE: You mean similar to A.L. Williams?

MR. POLKINGHORN: Yes.

MR. LAPORTE: To be honest with you, that's not really getting at the problem. All it is doing is shifting the risk from the insurance company to a bank. In addition, the insurance company is paying for the shifting of the risk. I just wonder whether the banks realize what they're getting into. I went to a session on surplus management, and they said they were setting up reserves of 10% for this. I really feel that all the company is doing is shifting the risk over, and it's not doing anything to change the agent's attitude. The agent is still getting a high first-year commission.

MR. POLKINGHORN: Right, no behavioral changes, but the capital cost to the insurance company is reduced.

MR. LAPORTE: I would rather see companies do what Mutual of Canada did but, if they don't have the surplus that Mutual of Canada had, I'd rather have them go out when they recommission the existing block and find a bank that will finance the recommission. Then they're accomplishing the same thing, but they are also changing the agents' attitudes.

MR. EASTON: Now Phil, you mentioned improving persistency in a levelized commission world. Do you think a company can actually lose money if persistency improves?

MR. POLKINGHORN: Yes, if you look at a situation where commissions are level or nearly level, and Paul is right, the products in Canada are a bit different. But, imagine that you have your normal renewal commissions, but now you've got an excess equal to the difference between the normal and the renewal. Also, imagine that as a policyholder persistency bonus, rather than a commission to the agent, every time a policy lapses, you're relieved from having to pay that. I guess when we've looked at level commission alternatives, for some clients, the profitability was sensitive to too low a lapse rate. If lapse rates were too low, the products didn't meet the company's profitability standards. This is all purely actuarial, quite apart from different people having different philosophies on the relative importance and difficulty of the sales aspect of the job, versus the service aspect. I guess some of the people we've dealt with in compensation-related issues feel that a lot of the replacement during the mid-1980s was only partially compensation related. A number of the companies' lapse rates have fallen back in line, and they view the tough job that an agent has to do, i.e., getting out there and selling new business. Compensating agents disproportionately for servicing business is really not what the companies want to do, because they feel that servicing business is not that difficult. They may be wrong, but they feel it's less difficult to service business, than to go out and sell it. The companies have seen their lapse rates fall back into line, partly because of some of the things they've done to their products. They feel they shouldn't have to pay for not moving business, of which 90% is not going to move anyway. Then they examine level commission alternatives and see that they have some of the lapse support they're getting scared about, in terms of policyholder persistency bonuses.

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MR. JOEL I. WOLFE: Mr. Lykins, I'd like to know what your experience has been, subsequent to the point where you've in effect transferred the expense risk from the company to the general agent. I assume, he in turn then, transfers that risk to the agent for things like rent and secretarial services, etc. In actuality, since your contract is with the general agent, I'd like to know what has happened when the general agent has had problems collecting these debts from an agent, and if the debts are of sufficient magnitude, where you're looking for a large amount of money from the general agent, does the company end up paying?

MR. LYKINS: Yes, especially in 1989, which was a flat year for us. Some of our general agents were having problems, for two reasons. If they were not able to transfer the risk for the rent, then they were having shortfalls in cash flow. Also because, in those cases where they had been able to transfer that risk, but an agent wasn't able to repay a debt, then they were also experiencing a shortfall. I think we've yet to have enough experience to see how that will fall out, but there is definitely going to be a problem for the company, even if they've insulated themselves, if some of their general agents are going to be running into financial difficulties. We may have to step back in and help out. So, we're not entirely off the hook there, even though it looks on paper as if we've transferred that risk.

MR. ELLIOT C. ECKSTEIN: The question is for Mr. Lykins regarding the growth bonus. Is the growth in premium in-force figures for the aggregate company? If so, how difficult would it be to measure the growth in premium in-force from an individual agency or product line?

MR. LYKINS: We perform the calculations at the agency level, as opposed to the company level. So, each agency's growth in premium in-force is calculated. We pay 2.5-7.5%, or under the new arrangement, 0-4% of the agency's growth in premium in-force. We break that down on a per-agent level for purposes of monitoring and recordkeeping, but we perform the calculation and make the payment at the agency level. What we treat as premium in-force is all premium relative to the servicing agency. Thus, if the agent moves from one agency to another, he effectively takes his premium with him, and the new general agent becomes responsible for it. This goes into his growth in premium in-force calculation. Of course, from that point on, he gets the new sales from that agent.

