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NEW YORK STATE COMPENSATION ISSUES

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- Persistency bonuses
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MR. ARMAND M. DE PALO: We are delighted to have with us several of the industry experts on Agent Compensation.

I am Armand de Palo -- Life Actuary for the Guardian Life Insurance Company, and I am also the Chairman of the committee to modernize Section 4228. All our speakers have agreed that some type of change is needed. This is a massive undertaking that will take at least three to five years to complete. Our speakers will set the stage for why the modernization is so critical. I will close the discussion with a short summary of the current activities, then allow questions between the panelists and, if time allows, with the audience.

Dan McCarthy, a consultant with Milliman and Robertson, has worked on many companies' plans of agent compensation, both under New York State Insurance Law (NYSIL) Section 4228 and plans outside New York State. Dan will be addressing these differences and how NYSIL Section 4228 influences non-New York companies and how it has competitively restricted what companies doing business in New York can do for agent compensation. The review of what is done outside New York State is critical in any modernization of a law that governs the marketing of insurance in a very competitive financial marketplace.

Joel Wolfe, an Actuary for the Mass Mutual, has specialized in agent compensation and has worked extensively on this subject with the industry and with the Life Insurance Marketing and Research Association (LIMRA). Joel will explain how Section 4228 affects companies doing business in New York State from the company's point of view, and from an administrative point of view of the problems that exist to comply with this law and its regulations.

Bernard Packer, Assistant Chief Actuary for the New York State Insurance Department (NYSID), has worked on agent compensation for most of his working career and will cover why this law exists, who it protects and what its purpose is from a regulatory point of view. He will cover the problems the regulators currently must face in today's marketplace and how this law must change to adapt to today's and future realities.

I would like to start the discussion with Dan McCarthy.

MR. DANIEL J. MCCARTHY: In the early 1970s it was my experience that companies not licensed to operate in New York had on the average a considerably higher rate of aggregate agent compensation than companies operating in New York State. It is my belief that it is no longer true to anywhere near the same extent. But there are some other differences that are still effective. In the early 1970s, a number of companies operating outside New York, but not licensed to operate in New York, specialized in forms of guaranteed cost insurance. In those days we used to call it nonpar insurance, not realizing it was guaranteed cost. And because many of those products tended not to be sharply competitive on price, they were in fact sharply

competitive on agent compensation and it was common to see compensation packages well beyond an aggregate amount allowed under New York Law.

In my experience, that situation has changed not because of New York Law but because of increasing competitiveness from the industry because of the product revolution. In preparation for this session, I reviewed my notes of 6 recent instances in which I or someone working with me was called upon to advise a company operating outside New York and not licensed in New York as they contemplated the possibility of entering the New York market. In addition to thinking about how they might do that, whether to bring the parent company in or to establish a subsidiary or whatever, inevitably at some point in the conversation a discussion of agent compensation would come up.

And usually the conversation begins: "Well let's look at what we are doing now. This is a non-New York licensed company. Tell us if you can, what changes would be required to operate under New York Law." It has been our experience in answering those questions that the changes that would be required are not changes that would reduce the aggregate amount of compensation paid or services provided or other money spent on the sales force. However, there would be significant changes required in terms of the nature of the distribution of that money both in formulas by which it was distributed, how much of it went to the top producers or bottom producers, and all kinds of ancillary questions about bonuses, prizes, conventions and various things which add up to money, but which if you look at them in the aggregate would not be prohibited in the aggregate by New York Law.

First, I would say that regarding companies operating outside of New York in contrast to those operating in New York, there is no longer in my judgment a significant difference in aggregate overall compensation level. I can give you counter examples just as 15 years ago, I would have exhibited a counter example for cases in which there was a significant difference. But the world has changed in that regard in my judgment. However, there are still very significant differences in compensation structure defined broadly to include all of the ways a company delivers money, goods, services, pats on the back in some tangible form, etc., to compensate its sales force.

The differences in particular go to two things: First the distribution of compensation between the top producers and the rest of the sales force. It is my experience that companies not subject to New York restriction will tend to have compensation structures which will distribute proportionately more money to their top producers and proportionately less to others, assuming the same aggregate amount, than companies operating in New York. Companies who do that have made a judgment and we will not debate whether it's right or wrong for this purpose. We need to understand that they have made it and that those top producers are worth that extra amount of money that is paid to them. I'm not saying I'm defending that proposition, I'm saying that there are people who have made that decision.

The second thing that I observed as being different is that the basis on which compensation is calculated, leaving aside for the moment all aggregate production, differs in many respects outside of New York, and this is particularly true on flexible premium contracts where compensation is paid other than in relation to premium. Whether we talk about compensation paid on increases in face amount not accompanied by premium at the time or compensation of a more fund-based or asset-based nature, companies have made the judgments that there are ways in which they would want to compensate people for the forms of behavior they want.

Imagine the law as the ship, and imagine the regulations, the circular letters, the opinions, the practices, formal and informal, precedences, etc., as the barnacles that adhere to the bottom of the ship over time. We have accumulated a law which did not contemplate current products. Therefore, you might say the ship is not modern in design. But we have a ship which has acquired on its underside large amounts of crustaceans, etc., which get in the way of its ability to perform as a ship.

I really think that we have two problems that are overlapping, but different, as we contemplate changing the law. First we have the fact that the law made certain assumptions that are no longer completely valid. It assumes certain kinds of products which no longer exist. It assumes certain types of distribution arrangements which no longer exist. I would not say that those assumptions are completely invalid, but they are no longer completely valid. Second, we have inevitably built up around the law a structure; the current structure wasn't inevitable, but some structure was.

The structure has arisen to deal with certain situations or things that either the companies wanted to do or regulators wanted to achieve at different times which have taken the law beyond its own simple words. In short, I think that the process which is before us is different from the process we would be encountering if the current section 4228 had been enacted yesterday with no body of interpretation. What we actually have is a law which has functioned in much like its present form for the last 35 years plus and in some respects like its antecedents which go back 60 years. We have accumulated regulation and practice that go beyond the law itself. Let me give you a couple of examples.

In one of the committees set out to do the work that Armand described, we have been talking about the kinds of regulatory tools that are required, assuming now that as framework, there is a law. Assume that the law will regulate forms of compensation and other kinds of expenses in some fashion or another. Take that as a given for the moment. Then ask what kinds of tools do you need to go along with that. Well, one thing that would be nice to have is some kind of audit of complaints.

Currently, I would say no formal structure for such an audit exists. I say that because for domestic companies the triennial or quinquennial examination simply does not accomplish that for the most part and for nondomestic companies operating in New York, they are not examined by New York at all. So given that form of regulatory tool doesn't exist, what has happened is that a filing of a particular plan of compensation, or the filing of some change, has become in effect the occasion for some kind of an audit. Now it is understandable because an audit may be a really good thing to have and no formal mechanism exists for it. What has happened now is that it comes up in a form which was not originally contemplated to be for that purpose.

I would say that if the law says you must file X it doesn't necessarily mean that you should use the filing as the basis for doing an audit. So that is an issue that I think can be dealt with in the larger context of regulatory tools. In the absence of those tools, what has happened? I would say that today, technical compliance with law and regulation governing compensation on the part of companies licensed to do business in the state of New York is lower than it has been for some time. I am tempted to say lower than it has ever been, but I don't have the historical perspective to say that. But I will say lower than it has been for some time.

Notice I said technical compliance. I would not assert that companies are paying in aggregate more than the aggregate limits of the law. In fact, simple analysis of Schedule Q would prove the opposite. But I do say that technical compliance, taking into account things that are required to be filed in advance and approved before use and taking into account all the nuance of laws, regulations, circular letter, etc., is lower than I can remember it being. That's partly because the law itself, as I suggested before, doesn't fit the products to the circumstances. It's also, I believe, because the general pace of change of company operations and complexity of company operations have grown in a way to which the law and the regulatory structure have not responded. I say, not critically, but I think factually, that that is one of the reasons this group has been organized. So, if I come back again to the nature of New York regulated versus non-New York regulated companies, I would say that a company which is fully complying with every requirement of New York, including all of mass filing and approval requirements, has far less flexibility of operation than a non-New York regulated company.

What has happened, in fact, is that companies while making, I would say fair good-faith attempts at compliance are not complying literally. That's not a good situation in the long run. What it means is we need a structure first in which the law deals with today's realities and, one would hope, with a little bit of flexibility for whatever tomorrow's realities may be. Second, we need to re-think the regulatory structure underlying the law, particularly in relation to kinds of decisions that companies would reasonably want to make about the form of compensation both in terms of the way it is distributed across products and the way it is distributed across different levels of producers in the sales force.

In my judgment, the law, including its regulatory structure, doesn't react adequately to that and there are clear distinctions between New York and non-New York companies in the way that plays out. Finally, in addition to changing the law to address those issues, I believe we need to re-think the regulatory structure essentially from scratch to figure out, in the context of a law that does deal with today's realities, how compliance can be reasonably achieved while at the same time providing companies with the flexibility to meet changing situations. But we are not there,

and we have a long way to go. In order to achieve that, I don't think it is going to be particularly easy. But if the law is going to continue to be meaningful, or is going to be meaningful in the future, I think that is something we are going to have to achieve.

MR. DE PALO: Now, I would like to introduce Joel Wolfe, who will look at the law from a company point of view.

MR. JOEL I. WOLFE: As Armand has already stated I am employed by a large mutual company which is licensed to do business in the State of New York. We distribute our products through the general agency system with the preponderance of our sales coming from career agents. I have spent the better part of my career at Mass Mutual with the accountability for New York expense limitations, as well as overseeing the general level of field expenses in the company. I sit on the American Council of Life Insurance (ACLI) Subcommittee on New York Expense Limitations and I am an active participant in the joint industry/New York Insurance Department effort to rewrite Section 4228 (formerly 213) and its accompanying regulations.

I am sure that most of you are aware of the general nature of Section 4228, so I will not attempt to give an in-depth review of this statute. Just be advised that the original purpose of 4228 was to limit a company's field expenses and total expenses so as to prohibit the manufacture of a product that was too costly to the New York policyholder. I believe that this still remains the primary goal of this statute. Also, this statute is extra-territorial in its nature. That is, it applies to all business of an insurer, if that insurer does business in the State of New York. Although this quality of the law is oftentimes misunderstood by some and intensely disliked by many others; no company has yet successfully challenged it in a court of law.

There are those who think that 4228 is generally applicable only to individual life and annuity business. Although this is true for many of the provisions of the law, it happens that the law applies its qualitative provisions to all lines of business, including disability income, group life and group annuities. These qualitative provisions include limitations on bonuses and prizes which a company can provide its field force; a prohibition against paying any commission which is not agreed upon in advance of the payment of premium (this is the section that precludes most retroactive changes in compensation agreements); and the general provision which states that every policy must be self-supporting in terms of the interest, mortality and expense assumptions inherent in its pricing.

The prohibition against bonuses and prizes generally prevents a company from paying extra compensation to the agent that is based solely on the volume of business which he produces. Also, a company may only give out prizes of "small intrinsic value." The prohibition against bonuses and prizes applies not only to the company but also to the company's managers and general agents. Thus, no manager or general agent may grant any prize or reward to an agent, even though the company does not directly reimburse him for the expenditure so made. This applies equally well to the retroactivity provisions. That is, no manager or general agent may structure compensation to his soliciting agents which is in violation of the "agreed upon in advance" doctrine. As a practical matter, these prohibitions are oftentimes unworkable, especially in a general agency company. The reason is that in a general agency distribution system the agent contract is between the agent and the General Agent (GA). Thus, if a company had 4,000 career agents, for example, it is quite possible that 4,000 different agreements exist as to the payment of expense allowances and other compensation. About all a company could do would be to ask their general agents to comply. The monitoring of this compliance becomes so unworkable and expensive as to defeat the stated purpose of Section 4228.

It may be interesting to note that recently the NYSID has suggested that the reach of 4228 to the Disability Income and Group Lines is not restricted to only the qualitative provisions outlined above. Rather, they have attempted to extend the 4228(h) subsection limiting renewal commissions to group insurance as well. I believe that this has arisen because several companies have tried to "back door" the restrictions on Universal Life (UL) asset-based compensation by wrapping their UL in the form of group insurance.

I would now like to outline Mass Mutual's cost of having to comply with Section 4228 and its accompanying regulations. It is generally the case that the larger companies are better able to absorb the cost of 4228 compliance than the smaller ones since several economies of scale are available to us. Most of the same functions must be performed in all companies subject to New

York 4228. And, although Mass Mutual may have more agents and agencies than a small company, most administration is now computerized and the same person can handle a larger volume with the aid of the personal computer. I would guess that the unit expense of compliance in the smaller company is greater than that at Mass Mutual. What is the point of this argument? You have to ask yourself the following basic question: Are the costs of compliance worth the savings in expense; that is, wouldn't a prudently run company save more money in compliance costs than it would spend in extra field expenses?

As an example:

Mass mutual spends approximately $125,000 annually in complying with Regulation 49. This consists of the diverted salary and benefit costs of the staff that tests and monitors; the staff that processes necessary forms and audits complaints, the staff that does the necessary systems development "exceptions processing" which results whenever a new flexible premium universal life or variable universal life product is developed; the expense involved whenever one of our allowance plans is changed and is applicable to Universal Life; and the diverted salary costs involved with senior sales, actuarial, and law division personnel in furnishing opinions on how best to "fit" a compensation plan into New York Law.

The approximate annual cost of compliance with Regulation 50 is an additional $25,000-50,000. This includes the time of the Law Division in its review of the prior experience of potential recruits, as well as the time spent by our recruiting and selection area. There are also costs associated with Regulation 93 (the Agent Convention Regulation) both in the Law as well as in the Marketing Division for the people setting up the conventions. So, between Regulations 49, 50, and 93 the annual cost of compliance approaches $200,000.

There also exist nonrecurring substantial costs associated with 4228 noncompliance. Many companies form non-New York subsidiaries or New York only subsidiaries (commonly known as "pups") in order to avoid the far-reaching extra-territoriality of the law. In this area the legal, actuarial, and other costs can be substantial. Finally, Mass Mutual has frequently incurred the "ad-hoc" costs of paying lobbyists to help us gain New York's approval of several compensation programs. Such nonrecurring costs of forming subsidiaries, paying lobbyists, etc., can run well into seven figures. Thus, compliance with New York Section 4228 and its accompanying regulations can become extremely costly.

One additional point in this area which is worthy of mention is the latest industry versus NYSID controversy regarding flexible premium plans under Section 216(b). It is the NYSID's intent that a company, in order to pay agent bonuses, expense allowances, and other percent of premium compensation on Universal Life, track its premium persistency throughout various durations of the contract. It does not matter that the contract allows the policyholder ultimate premium payment flexibility, nor that a Universal Life policyholder can "pre-pay" several years worth of renewal premium in the early years of the contract. The creation of an administrative system to track the premium histories and persistency of premium will create an undue burden on our industry, a burden which, in my opinion, far outweighs any savings that might result from those companies and agents who market "dump-in" type Universal Life products and "overpay" their field force in order to do it.

So, we have a law which has far-reaching impact. A law that is very complicated and potentially very expensive to administer. What impact does this law have on the way we design our products? Can we design a life insurance product with essentially level commission? Under today's law the answer remains no. Wouldn't a level commission product provide much higher early year value for the policyholder? A higher early value which with the benefit of compound interest could really grow? Isn't better early value combined with competitive long-term values a positive for the consumer? A company's overall profitability could also be improved because of the better policy persistency. A level commission environment for life insurance, assuming all companies level commissions, would place much less incentive on the agent to churn his business. Also, wouldn't the payment of higher renewal commissions better compensate the agent for the service he/she provides policyholders in renewal years? The current 4228(h), along with the "Gemma" interpretation does not allow a company the benefit of using agent turnover assumptions or an interest rate higher than 3% in the discounting of agent renewal commissions. Thus, we are essentially precluded from pricing our products with level commissions.

Current New York law also does not allow a company to compensate its field force through the payment of either cost of mortality-based compensation or on the basis of a percentage of assets. This is primarily because of the fact that the 4228(h) renewal commission limitations are strictly defined in terms of paid premium. Thus, if no premium is paid in a policy's renewal year, and a commission is paid, the rate of commission payable is essentially infinite and in excess of the limits in the law. When Mass Mutual designed its universal life policy in late 1984, we wanted to pay the cost of mortality-based compensation on it. After all, aren't we in the business of insuring against the risk of premature death? And, shouldn't we be able to match the compensation of the agent to the risk which we are in the business to provide? Needless to say, after some discussion with the NYSID, we decided that it just wasn't the time to fight. We converted the cost of mortality-based compensation to percent of premium-based compensation in order to be able to announce our product by a certain deadline.

Many companies recover their premium-based expenses through a combination of mortality and interest loads. If we are able to pay nontraditional forms of compensation, and charge for them either in the mortality charges or in the basis point charges on the assets, wouldn't we achieve a better match between our costs and the way the product recovers those costs? It would be much more equitable for the policyholder, since each policyholder would more accurately pay his share of the expenses.

Other ways for companies to achieve a more competitive product by bettering their persistency could involve the payment of either fees for service or premium-based compensation to those agents who have been assigned to "orphan" policies. This is especially true when the agent finds himself in a replacement situation. Under today's law, we are essentially unable to compensate the "new" agent on the case. This is because of the way the insurance department administers 4228(h) in the case of prospective changes in compensation after issue of a contract. The lack of any incentive to the servicing agent may make our industry's persistency that much worse. Might not a company be willing to share a portion of the present value of future profits on an orphan policy with the servicing agent if that agent could conserve the case?

Shouldn't a company be able to provide "balloon" persistency payments to its field force in order to create the incentive for the agent to keep the policies on the books? They could not do this if the value of these payments resulted in negative 4228(h) margin.

Shouldn't the rate of agent compensation on life insurance be greatest on those forms of life insurance which have the greatest amount at risk, that is term insurance? And shouldn't the rate of compensation be lowest on those policies which are "cash rich," that is 10-pay life? The current arch grades commission margins up to 55% on whole life from 37.5% on term insurance, and then back down to a marginal rate of 20% on higher premium forms. Does this all make sense? Finally, should a company be essentially forced to open non-New York subsidiaries just to avoid the extra-territoriality impact of 4228? Wouldn't it oftentimes be better to keep all your products in the parent to take advantage of its stability, and better Best's ratings? Needless to say, Section 4228 sometimes causes companies to alter their product design or compensation plan design in order to remain compliant.

As has been previously discussed, the existence of Section 4228 can, and oftentimes does, delay a product's introduction into the marketplace. At the very least, it can cause a company a great deal of discomfort and expense in having to comply. Mass Mutual's current series universal life contract was first issued in April 1985. I remember distinctly the trip to New York which I took with our Chief Executive Officer in order to lobby for approval of our product. A great deal of time and expense finally resulted in the Insurance Department's approval of our product. A similar experience took place with Mass Mutual's desire to pay compensation to our field force for our 1982 Adjustable Loan Rate Update Program. After voluminous filings, we gained approval of our $25 fee for service to our agents.

The above experiences, as well as the general routine delays involved with the filing and approval of Regulation 49 Expense Allowance Plans, has resulted in an overall slowing of a company's ability to react to the changes in the marketplace. The combination of this and the impact of many companies being forced to sell a product through non-New York subsidiaries in order to avoid the reach of the law could affect the level of new sales, the acquisition unit expense, and ultimately the price of the product to the consumer. Clearly, for those companies who wish to remain compliant, something needs to be done about these problems. Good business judgment by

responsible companies should perhaps replace the several levels of bureaucracy created by Section 4228 and its administration. Perhaps some form of deemer provision is feasible. Hopefully, we will find a solution in the joint re-write of 4228.

WHAT PROBLEMS DOES MANAGEMENT HAVE WITH 4228?
In my view, management's biggest objection to the current expense limitation laws is that these laws take away much of the business judgment involved in the decision-making process. Shouldn't senior management be able to decide how and when to spend money in order to expand its distribution systems, that is, if it were believed that it was advantageous to acquire a sales unit from another company, for example, management should be able to decide to allocate expenses from one area of a distribution system to another. Should New York Law handcuff management's ability to do what it is paid to do, make tough business decisions? This is especially difficult to understand when a company has a proven track record of having competitive products and is financially sound. Should current law thwart the desire by management to market products through the parent company in order to avail themselves of better Best's, Moody's, and Standard and Poor's ratings, only to find that some part of a proposed compensation schedule is objectionable and is therefore unattainable?

Should the existence of current law create a compensation system which biases the sale of a particular product through various outlets in a distribution system? Mass Mutual currently cannot generate certain allowances on universal life in a portion of our distribution system. As a result, our overall sales are limited in a distribution outlet which is responsible for almost 25% of our overall business. This results in higher fixed unit expenses for that product line, resulting in a worse product for the consumer.

Should the existence of current law make us unable to create a disability income (DI) bonus structure that can compete with non-New York companies that grade an agent's DI compensation up the more business he produces? Our agents tell us that this is one of the primary reasons why they do not sell our DI product. Again, our fixed unit expenses become higher, and a worse product results for the consumer.

All of the above problems have been experienced by most if not all the companies represented here. I am sure that each of you has experienced the same degree of frustration that I have in dealing with the law which has been unable to react to the modern-day insurance environment.

Hopefully, we can all join together in the gigantic effort which is currently taking place to rewrite a law which has, historically, changed about as rapidly as a "speeding brontosaurus."

MR. DE PALO: Now, I would like to introduce Bernard Packer. Bernie is with the NYSID.

MR. BERNARD PACKER: I just found out that my learned colleagues have given me a new title. I am now going to be called Barnacle Bernie, Brontosaurus of The Bronx. That sounds very nice! If I spend all of my time responding to Joel's allegations and impressions of how NYSID misuses and abuses the life insurance industry (and I'm sure some people would agree with him), there will be no time left for the subjects that Armand assigned to me; so I will try to stick to my prepared remarks.

Recently, we all saw headlines and reports of the earthquake in San Francisco. Not a day has gone by without prominent stories in virtually every newspaper and in the other newsmedia giving us additional details about the quake. The focus of many of the reports has been a comparison of the 1989 quake with the 1906 quake.

A life insurance historian wrote of the 1906 quake: "The great San Francisco disaster of April 18-19 temporarily stole the spotlight from life insurance . . . and almost squeezed the life insurance news out of the headlines."

Coincidentally, in April 1906, the New York Legislature delivered its own seismic shock to the Life Insurance industry -- the addition to the insurance law of more than 100 pages of legislation that incorporated most of the proposals of the Armstrong Committee.

Joseph Pulitzer, publisher of *The World*, led the other newspapers and magazines in breaking the stories of corruption in the hallowed halls of high finance. A battle for the control of the

Equitable Life Assurance Society had been under way for some time, and the warring factions reached that degree of passion in which each was willing to let the public know the worst -- about each other. Pulitzer, through a series of editorials, informed the public that some of the richest men in New York were charging some of the other richest men in New York with looting the Equitable. *The World* screamed "Open the Books! Let the policyholders know what has been done in secret with the money saved for the protection of widows and orphans. Let in the light!... There should be full publicity through a legislative investigation. Investigate, gentlemen of the Legislature!"

The Legislature, in special session, appointed a committee to investigate not only the Equitable, but all the big life insurers of the day. State Senator William W. Armstrong was appointed chairman, and he in turn named Charles Evans Hughes to act as Chief Counsel.

Hughes pursued the investigation through 57 public hearings from September 6 through December 30, 1905, unraveling a tale of waste, extravagance, greed and corruption. It is important to recognize that it was not the hearings alone that brought about the resulting legislative reform, but the wide publicity generated by the hearings. Just as news of the San Francisco earthquake has dominated the news of the past week, all of the newsmedia commented on the hearings more and more, with new revelations coming out of those hearings almost on a daily basis, apprising the public of the startling abuses that permeated the insurance and banking fraternities. At the start, neither Pulitzer nor anyone else knew exactly what he was getting into.

One week after the investigation ended, the New York State Legislature met. By April 28, 1906 the legislative program which reformed the life insurance industry was completed. One part of this package was Section 97 (the predecessor of Section 213 and today's Section 4228) which dealt mainly with the limitation of commissions and other expenses.

The job of the task force to modernize Section 4228 is formidable and will require all of the participants to conduct themselves in a "statesman-like manner," focusing on both the needs of the public and those of the life insurance industry, while subordinating the perceived needs of their own companies.

The philosophy underlying Section 4228 was set forth in the preamble to Regulation 49, promulgated in June of 1966:

"In establishing the purpose of Insurance Law Section 213, that strict control should be maintained over expenses incident to the acquisition and servicing of ordinary life and annuity business, the Legislature clearly recognized that such control was essential because of the trusteeship attributes of the life insurance business and the fact that life insurance is deeply affected with public interest. Consequently, the statute prescribes the maximum compensation payable to agents and also limits the total amount that may be expended for first year expenses, total field expenses and, for some companies, total expenses."

This philosophy is a natural consequence of the abuses criticized in the Hughes report: "The most wasteful expense lies in the amount paid for new business. Every company professed to deplore this, pleading that competition rendered it unavoidable." The companies characterized such competition for new business as a "commission war." The drive for more new business led companies to pay high commissions, sometimes exceeding the first-year premium, and to give favored agents bonuses, prizes and awards of substantial value.

Since that time there have been many amendments of a detailed nature to New York's expense limitations law, but relatively few major changes or general overhauls. In 1929, 1953 and 1954, major changes were promulgated to reflect more realistically the actual incidence of expense, unforeseen product changes, and economic conditions.

Since the last major revision to Section 4228, the nation's economy and the political and social climate have changed considerably. With these changes have come a bewildering array of new "modernized" life, health and annuity products, and an upheaval in the distribution systems that deliver these products to the marketplace. As I mentioned before, during the next few years we hope to "modernize" Section 4228 with the help of a Task Force chaired by Armand De Palo. Members of the Task Force were chosen to include actuaries who represent a cross section of the life insurance industry. There are members of large companies, small companies, mutuals, stocks,

branch office systems, general agency systems, so-called personal producing general agent (PPGA) and brokerage systems, and systems using consultants and financial planners.

It is important to recognize that Section 4228 applies to and makes varying provisions for both large and small companies, for general agency and branch office companies (and those in between), for new companies and well-established ones, for fast-growing and slow-moving ones, and for stocks as well as mutuals. Some restrictions apply to each policy sold, some to each agent, some to each agency, and some to each company. Some limitations apply only to one type of policy and others cut across all product lines. The company-wide aggregate limits can be viewed as nested circles since the total expense limit includes the total field expense limit, which in turn includes the first-year field expense limit.

The first-year field expense limit includes "allowances" expressed as percentages of first-year premium, sometimes referred to as the "arch."

The arch works imperfectly, but a brief review of its origin explains why it was incorporated into the statute. The task force headed by Albert Linton, which drafted the 1929 revisions, thought that term insurance was a bad deal for policyholders. The margins for term insurance under the formula in the old statute had become very large and were available for other products. A similar situation exists today for flexible premium annuity products which generate a 30% first-year field expense allowance in Schedule Q, but which have first-year compensation no greater than 7%, 8% or 9%. Thus, we now have a situation similar to that which existed in 1929. This is one of the deficiencies in the current statute that hopefully will be corrected soon.

On its left side the arch starts at 37.5% for term premiums, less than one-half a "corresponding whole life premium." Whole life premiums qualify for the peak of the arch at 55%. Higher premiums (relative to whole life) slide down the right side to theoretically meet their asymptote at 20%. To put things in perspective, a plan premium that is exactly double the corresponding whole life premium generates a value of 37.5%. Universal Life type policies are subject to separate rules, under which guideline level premiums must be calculated before the arch can be applied. Group universal life or group universal variable life, under certain circumstances, may be treated as individual ordinary life. Schedule Q is the name of the New York State Annual Statement form where expenses are compared to the various limits.

Section 4228 is generally unambiguous. Fortunately, it allows for a great deal of flexibility, which is why changing times have not rendered it unworkable. Virtually every product is subject to its self-support provision and its prohibition of bonuses other than those related to persistency. There are several references to "life insurance" where it has been concluded that the term "life insurance" includes annuities -- but not always. Reason and logic are sometimes insufficient to determine the "intent" of a particular provision in a specific situation. Such situations arise fairly often, when companies submit proposed agents' compensation plans to us for an approval under the statute. All too often, both the drafters of amendments to the law and the drafters of proposals that require the approval of the Superintendent of Insurance suffer from the same ailments -- they mean what they say, but they fail to say what they mean.

For those of you unfamiliar with expense allowance payments or EAP, a brief discussion may be helpful. Once upon a time, companies were permitted to pay expense reimbursement allowances or ERA, but several years ago the law was changed. Expense reimbursement allowances are no longer permitted -- that term implied that vouchers had to be submitted in order for an agent to be reimbursed for expenses allowed under the former Regulation 49. Today's Regulation 49 no longer requires vouchering, we think, and we now refer to expense allowance payments. However, the statute refers to reimbursement of expenses, which means different things to different people. This is another of those ambiguities that the Department hopes to eliminate during the modernization project. There is a movement afoot (I think some of you should get involved in it) to do away with expense allowance payments completely. I am saying this in full awareness that Peter Flanagan is out there taking down every word. Should we do away with expense allowance payments completely and build them directly into the commission structure with suitable limitations for the different types of agency systems?

Consider the following example, which is drawn from a recent submission involving EAP. This case involved a universal life base policy with a long-term care rider. If the long-term care rider was considered to be a separate policy, the commission limitations in Section 4228 would not apply

to the rider. The appropriate treatment for the basic universal life policy is set forth in a 1983 Circular Letter issued by the NYSID.

Depending on the characteristics of each policy issued, part of the first-year premium may be treated as an annual premium and the balance treated as if it were a single premium, both for determining the maximum expense allowance payment and for the Schedule Q calculation of the first-year field allowance. The key element in the calculation is the guideline level premium, calculated using IRS rules. Because the long-term care rider is health insurance, there is no guideline level premium associated with it. Furthermore, there is no provision to change the guideline level premium for the base policy, when a nonqualified rider is added to it. We believed that the company's proposed treatment would have resulted in excessive compensation to the agent, after reviewing the proposal relative to the basic philosophy of the law. Therefore, we rejected the proposal and informed the company of the modifications needed for an approval.

This example illustrates the problem we have with flexible premiums. Section 4228, as now written, differentiates only between annual and single premiums. When it was last revised there was no such thing as an indeterminate premium policy, a vanishing premium policy or a universal life policy. Circular Letter No. 4 of 1983 was promulgated, on an emergency basis, to allow New York licensed companies to sell so-called Universal Life policies, which were already widely available outside New York. When Circular Letter No. 4 (1983) was being prepared, it was intended that all pertinent parts of the law would be expeditiously updated for Universal Life. Regulation No. 49 has so far resisted the needed changes. A revised Regulation No. 49 was prepared, but it was rejected because of concern that the cost of implementing its notorious Appendix 1 would have been excessive. Appendix 1 incorporated a procedure to have the company's actuary make a "guesstimate" in the first year and then to retroactively split first-year premiums into their annual premium and dump-in premium portions, by analysis of actual premium persistency over a period of three years, that is, through the fourth policy anniversary. Critics in the life insurance industry have frequently charged that Section 4228 unfairly favors the Branch Office system if they have a General Agency system, and vice versa. In recent years we have seen the development of new systems which are neither fish nor fowl. When we receive a proposal from a company, it may refer to brokers, consultants, PPGAs, financial planners, supervisors, managing general agents, etc. The statute differentiates only between branch office manager -- who is salaried, and general agent -- who is not. We have seen proposals involving three and even four levels of agents to be compensated for a single sale. It is amazing that Section 4228 has continued to work with all of the diversity that has emerged. That it continues to work at all is testimony to the fine work of the Linton Committee and their successors who have continued to creatively modify and interpret the statute through the monumental changes that have occurred in the last 60 years.

Unfortunately, most proposals dealing with agent compensation contain ambiguities or omissions which make the approval process even more time consuming. This may very occasionally result in an erroneous approval which might have to be withdrawn at a future date. The withdrawal of an approval can be a terrible process for both the company and for the regulator -- that is why we always endeavor to "get it right the first time."

The appropriate validation procedure for a proposed plan of agent compensation depends on the type of agency, the type of plan, and the various elements of first-year and renewal compensation. Different maximum renewal commission scales apply to general agency systems than to branch office systems. Different lapse rates apply to whole life than to term. Different agent survival tables apply to different types of agents. Different valuation factors apply to nonvested, partially vested, or fully vested renewal commission scales. Each type of security benefit, such as group life, group health, and retirement benefits, calls for a myriad of possible variations. Deferred compensation must be evaluated to determine if it qualifies as a security benefit or if it should be handled as renewal commissions; this becomes critical where a proposed plan has margins remaining in the portion of the maximum scale reserved for security benefits but has used up the nonreserved portion.

Section 4228 prohibits advances to agents except those made against first-year commissions. It is the Department's current opinion that the first-year commissions to which the statute refers are those which an agent may be expected to earn on business to be produced in the ensuing 12 months. Companies which have asked have been told that we expect the advances to be repaid over the subsequent 18 months. Repayments can be made from any source. The statute is silent

on the interest rate to be used in making advances. The chances are that it will not remain silent much longer. At the time the statute was written, interest rates were relatively low and the matter was not perceived as presenting a major problem. It also wasn't perceived that these advances would remain outstanding for more than a few weeks or months at the most. Granting agents no-interest loans didn't become an abuse until some companies started stretching the bounds of propriety, thus making it an abuse.

With the exception of persistency production bonuses the Law prohibits bonuses. Defining which bonuses are prohibited is sometimes extremely difficult. Can a company pay an agent a 50% first-year commission if his production is less than a specified amount, but pay 55% if he exceeds that amount? The answer is yes, because a company can adopt qualification standards that must be met to earn the 55% rate. Similarly, both the amount and number of renewal commissions can be reduced if specified qualification standards are not met. The important thing to remember is that any and all such reductions revert to the company and cannot be used to increase another agent's compensation.

Persistency production bonus arrangements must conform to a number of guidelines to secure the Department's approval. Under these arrangements, one agent can get a fairly high renewal commission while another gets nothing. What makes these arrangements particularly attractive is that only the average payment has to be used to demonstrate compliance. A number of problems have emerged over the past few years -- mainly related to the introduction of flexible premium products. The law contemplated premium persistency -- not policy, face amount or some other type of persistency. Many arrangements approved before flexible premiums came on the scene would probably be approvable today, perhaps with some minor modifications. However, an approval based on plain vanilla whole life does not automatically extend to flexible premium products. For these products the definition of persistency must be satisfactory to the Department under its current guidelines, a draft of which was recently released to the Life Insurance Council of New York (LICONY). The draft contains an example of an approvable standard.

Closely related to bonuses are the subsidies permitted under training allowance plans. New agent eligibility is defined -- if somewhat ambiguously -- in Regulation No. 50. The amounts of permitted subsidies have been published in various circular letters. The subject of subsidies to experienced agents has assumed major importance this year. Over the years a number of "plans other than commissions" were approved by the Department. For a number of years, no new plans involving subsidies to experienced agents have been approved. This has been perceived by some companies as a "grandfathering" of the older plans that creates an uneven or an unlevel playing field. There were a number of reasons why the Department did not "take arms against a sea of troubles." First, there were no complaints of proselytizing of agents accompanied by subsidies -- which was usually specifically prohibited in the approval of these older plans. Second, we did not have the manpower required to accomplish the task. This year, all of this changed when we obtained well-documented allegations of improper proselytizing. The investigation into this matter has already cost us hundreds of actuary-hours and will doubtless cost many more as the investigation continues. Because there is an ongoing review it would be improper for me to comment on specific cases.

Among the important issues I have not addressed are the following:
- o Agent-owned reinsurance companies (ARCs)
- o Asset-based renewal compensation
- o Level commissions (and the Gemma rule)
- o Securitizing future renewal commissions
- o Premium rate regulation

If any of you have proposals pending with the Department or will be submitting one in the future -- check them carefully so that we can understand exactly what is being proposed and make sure you have demonstrated compliance under the statute. You cannot assume you have an approval because you haven't heard from us.

MR. DE PALO: The core group has been appointed by the NYSID as a joint committee that also works with both the ACLI and LICONY to try to rewrite the law. The main thing that I think we all must focus on is not to take the position that we don't need a rewrite of the law and there's no real competition out there and changes are not needed. But the reality of the situation is that there's change out there. The changes are from other financial institutions and from

non-New York companies. If New York companies do not work in a statesman-like fashion to compromise and to find a solution that allows them the greatest flexibility to compete with their competitors, we will find that we can compete very well against ourselves but end up with a smaller and smaller part of the pie.

In regard to items like asset-based compensation, have any of you heard about mutual funds? Mutual funds pay trailer commissions. The banks want to get into life insurance. Do you think the banks aren't going to be in Delaware pretty soon? Citibank has bought half of southern Delaware. There are the direct marketing companies. There are the banks who are going to go to Savings Bank Life Insurance on a salaried basis. You see out of Chicago financial planners selling no-load life insurance. We can protect the barriers of New York state only to find out that there is a vast world outside that we can't compete in.

Now the critical issue, and this is where we are really going to be put to the test, is if the people who are affected by the law can compromise. Not a compromise that benefits their own company, but one that benefits the industry in general. Now, each one of you will have your own vote, your own view of what the situation is or how your company views it. But you have to look not at where you are today but at where you have to be tomorrow. The effort is ongoing. There are almost 100 actuaries and other people from companies working on these subcommittees. In addition to the core committee, there are 4 subgroups underneath it that view the subject of how much can you pay, who can you pay it to, how can you pay it, and how are you going to monitor it.

In each of those groups many of them have broken themselves into two or three subgroups. All of this must be finalized and reviewed with the department to see that it is agreeable. It is basically in lock step. We can do what we want and the department can do what it wants. If compromises are not made on both sides, there will be a stalemate. The last attempt to re-write was not 1954 but in the early 1980s.

The industry tried to re-write the law itself without getting the insurance department on board. Nothing became of that. It would be a very big shame and it would hurt all of our companies and our competitive posture in the future not to allow this effort to go through. Yes it will take five years. Why will it take five years? We are already one year into the process. I will expect it to take another one to two years to come up with the first draft of the re-write of the law. And even after that is done, it is going to be exposed to political review and pressure from all different forces to see if it can survive the political process. But it is not a question of is this law needed. It is clearly needed. It is a question of will it be allowed to be born to save us as an industry. Otherwise we are not going to be able to compete.

MR. STANTON L. COLE: This is a question to Bernie and it touches on something that Dan mentioned in his talk and something that has come up, I think, in most of the subcommittees having to do with the distribution of compensation. If I understood what Dan was saying, non-New York companies tend to have a wider skewing than New York companies. What's wrong with that? Total compensation being the same, I think.

MR. PACKER: We have looked at several non-New York representative plans. It appears that non-New York companies tend to pay a little bit more in the aggregate than New York companies pay; I have heard this stated over and over again. The perception, if not the fact, is that no matter what is permitted in New York, non-New York companies will always try to pay a little bit more -- a little bit more in money and a little bit more in variety, but the compensation will not become that different. We admit many foreign companies to do business in New York, and in fact the pace has picked up quite a bit in the last few years. I am not the agents' compensation actuary for the Life Insurance companies anymore than I am the actuary who specializes in licensing or separate accounts or investment year methods or dividends, etc. Our unit handles all the actuarial work of the Bureau. Agent compensation is just one piece of the puzzle. Looking at all the pieces that come in, very few non-New York companies have very serious problems with New York's regulation.

What Dan said before, and perhaps he should provide an epilogue to all of this, is that it is hard for a company to change overnight. It's hard to go out there and tell a good agency force (if that's what your have): "the bonuses we were paying to you before can't be paid anymore." But many companies have done just that. They have managed to substitute something that was even better,

which is permitted under the New York statute. Perhaps, despite the fact that some of these potentially abusive practices are outlawed, the statute has fallen behind the times. Whether or not the task force does come up with recommendations, as Armand mentioned, there will have to be compromises on both sides.

I hate to compromise! A lot of people know that. Sure we will work together -- but perhaps compromise is the wrong word to use. There will have to be give and take, but it won't be giving away any part of the store that exists now. We are looking to realign the system of delivering compensation to agents. We are not looking to pay any more out and we are looking ultimately at the benefit to the policyholders.

The last undiscussed item that I mentioned before is the club, the ultimate club that we can wield, and that would be premium rate regulation. You may not need any regulation of agent compensation.

MR. HAROLD G. INGRAHAM, JR.: Bernie, could you share with us some of your thoughts on producer reinsurance companies and assume in this context that I am talking about a producer or reinsurance company formed by (let's say) a mutual company operating in New York state with a general agency distribution system and that producer reinsurance company is (let's say) domiciled in Arizona.

MR. PACKER: Harold, I don't know if you are aware of it, but we do have a proposed regulation in the mill. The actuaries and I believe LICONY has just about signed off on that bill. And it can be promulgated at any time. It will provide the entire mechanism for permitting exactly that kind of arrangement whether it is Arizona, Bermuda, or San Francisco which I know could use the business right now.

MR. INGRAHAM: Well it's interesting to know about that; you mentioned that this is one of the topics that you hadn't gotten to and I was just wondering if you had any unspoken procedures to take care of it.

MR. PACKER: As I mentioned, this proposed regulation has been circulated. It contains actuarial guidelines. A memorandum to be filed by the actuary will include two types of valuations. One of the valuations is an actual cost valuation of the type that every actuary does when pricing a product. We expect that this particular type of arrangement would apply to only a few products. In effect we would be using the self-support provision in the statute on a real assumption basis. The second calculation would be that of the so-called compensation actuary. It would use theoretical factors that would apply to this particular group of agents. That one should be much tougher under the current statute and under the current restrictions that we have. We would assume that all commissions are fully vested, and it would be up to the company to show that there would be some sort of termination among agents. We would also expect the business issued under this kind of arrangement to be at least Linton-A or better, since we expect that most of the agents would push away less desirable business to some other company or pass it on to another agent.

MR. DE PALO: Bernie, one question that keeps coming up in that area is how long must the agent work for the organization before any of his business can be added to the insurance company?

MR. PACKER: The last time I saw the draft was about a year ago. And at that time, I believe it said three years, but it might be down to two. That's open for discussion when the regulation is actually put up for public hearing.

MR. ROBERT B. LIKINS: I have a comment for Harold's benefit. One of the reasons that the industry actuaries aren't pushing to see the regulation come out in final form is probably indicated by Bernie's earlier comment about his "willingness" to compromise about these things, if you recollect what that was. My question is this Bernie. Last spring and fall, I understand that going through the New York legislature was a proposal to substantially increase fines that could be levied on insurance companies for certain types of violations. I also understand that it has not passed. And I wonder if you can tell us a little bit about the department's interest and willingness to levy fines these days on companies for violations of certain types.

MR. PACKER: No matter how I answer you Bob, I'm going to get into trouble, but I will try to answer you anyway. We had nothing to do with the bill that went to the Legislature; in fact, I never looked at it and I never read it. There has been pressure on my particular section to increase the level of its fines. If you look at the Monthly Bulletin, what you will find is that the property and casualty end of the Department has been really lacing into the companies for what might appear to be not that great offenses. Now, the various Bureau Chiefs that I've served under (there have been three) and I have always agreed that we are not in the business of raising money; we just want to see good plans approved by the state. We want to see companies conforming with the important parts of the statute. So we really have never set out to fine companies.

What has happened is some companies have almost begged to be fined. There are a number of companies in New York or licensed in New York who are up for fines right now, some of them know it, some of them don't know it. I'll tell you who is up for a fine right now. Any company that exceeded either of the new business limits and didn't come to us in a timely fashion will be fined. This is often just a case of exasperation, where we spend so much time, and waste so much time and energy in following up on these companies that the fines are really for willful violations. It's almost like talking about a child being willful. We are just exasperated by companies that blithely assume we don't want to know about these things -- that we don't consider them important!

We went through LICONY and other industry groups with the revision of Section 4227 only a few years ago. We changed the limits drastically to make it much more liberal, to permit companies to grow at astounding rates if they are writing either life insurance only or a good mix of life insurance and annuities. What the statute now provides was not the intent back in 1906. In 1906 the Legislature wanted to control how much business a company could write. We don't want to control how much business is written by the big companies -- we just want to make sure a company doesn't have its backside handed to it, and that the industry doesn't over-extend itself with junk bonds, or promise much more than it can deliver. So all we have here is a vehicle for companies who produce most of their business in annuities having to come back to us several times a year. Sure it's a pain in the neck -- but we haven't had any insolvencies of life insurance companies. We don't want them. The first one would be one too many and I think you will all agree that every company will be tarnished when the first or even the second goes down. I have been amazed at what the chief practitioners of the companies buying junk bonds have done. They are amazing. They have outperformed virtually every other company around in investment performance. It's not for me, and it's not for you unless you're with one of those few companies. It doesn't mean it's bad if one wants to speculate. I think if you are with a stock company or the owner of the stock company, risk what you will, but inform your Board. Do you have a right to drive your company down the tubes? Sure you do! But make sure you don't cost other companies money, either from guarantee funds or their reputations. Reputation is worth something; many companies consider it their biggest asset.

MR. MCCARTHY: I want to make an observation about the ultimate weapon that Bernie said could be wielded as an alternative to compensation regulation, and that is rate regulation. I would like to point out that for the two products on which forms of compensation are perhaps most at issue today, Universal Life and Flexible Premium Deferred Annuities, rate regulation exists today. That is to say within New York, not extra-territorial to be sure, but within New York, the law prescribes for annuities and for standard issues of life insurance every element that can be used to go into the premium and limits every element. So I would say that we not only have the ultimate weapon, we also have all the other weapons that we have been talking about. I just want to point out that rate regulation is maybe or maybe not the specter it is sometimes held out to be, but we have rate regulation and compensation regulation.