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DESIGNING A FIELD COMPENSATION STRUCTURE

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Panelists:	ABRAHAM HAZELCORN
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Recorder:	CAROLYN J. STONTZ

- o Balancing product and compensation
  - -- Brokerage, Wall Street
  - -- Special deals
  - -- Is it time for levelized commissions?
- o Optimizing distribution effectiveness through compensation design
  - -- 213→4228→Reality?

MS. CAROLYN J. STONTZ: During this session we will take you through the mine-field of field compensation and share with you insights from both a practical and theoretical basis.

Our first speaker is James McDonough. Jim will share his experiences from his many years of directing marketing for various financial institutions. He will present the practical aspects of balancing policyholder, producer, and manufacturer concerns.

Our next speaker will be George McKeon. George's presentation encompasses how to optimize your distribution system's effectiveness through appropriate compensation design.

Our third speaker will be Abraham Hazelcorn. Abe has been very active in the New York arena of the design or, rather, the redesign of the New York field compensation expense limitation, and he will bring us up to date on what's going on there.

He joined his present firm, then known as E.F. Hutton Life, in February 1984 as Vice President of Sales. Two years later, he moved over to E.F. Hutton & Company to become the National Director of Manpower Development. Prior to this, Mr. McDonough was President of Putnam Financial Services, a broker dealer, and Executive Vice President of Western Traveler's Life Insurance Company, both owned by Marsh & McLennan.

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Mr. McDonough graduated with honors from Fordham University, Bronx, New York, in 1958, with a Bachelor of Science in Finance.

MR. JAMES R. MCDONOUGH: As I listened to Carolyn, I wasn't sure if I had a lot of experience or a checkered career. Probably a little bit of both.

Initially, let me extend my deep appreciation for the opportunity and the honor of being a member of this panel. Rarely do I get the chance to address a group of actuaries. Normally, they are chastising me for representing, overdiligently, the field force that I oversee.

Before I go into the formal comments that I have, I think it's relevant to establish the point of view from which my comments originate. First Capital Life, which is the successor company to E.F. Hutton Life, is a universal life company. E.F. Hutton Life was the first company to introduce universal life, and we've continued to stick to our knitting over the years since 1978, remaining at the forefront of universal life. We have not deemed it necessary to go into many other areas -- even in the term insurance area we have a couple of products but they're hardly competitive. We also do quite an amount of annuity business.

Our distribution system is such that we do the majority of our life insurance business through a network of managing general agents throughout the country. This network consists of approximately 125 independent businesspeople who act as an extension of our home office in the hiring, maintaining, motivating, and training of a sales force. These 125 individuals have approximately 10,000 individual agents and general agents assigned to their particular business endeavors.

In addition, we market both life and annuities -- primarily annuities -- through various New York Stock Exchange member firms. Obviously our foremost generator of business was E.F. Hutton & Company, which became Shearson Lehman Hutton, and now actually Shearson Lehman Brothers as the name Hutton has been dropped as of the end of June 1990. We also do a substantial amount of business with PaineWebber and Prudential-Bache, as well as a series of regional member firms throughout the country.

The reason I preface my comments with a description of who we are is that the compensation package and the necessity of different compensation packages for each type of distribution system is of paramount importance. They all don't respond to the same type of compensation package. Through a compensation package our goal is to identify, attract and retain a highly experienced and professional sales force. It is not the only tool in that endeavor, but it is a very important tool to begin with.

Having had the pleasure of working with Carolyn Stontz for a lot of years, we can both speak to the point that the development of the product and the representation of the field force, if you will, have always involved a very delicate balance.

We have two product committees with field representation: a product intelligence committee and an in-house product development committee. The product intelligence committee consists of the various members of our distribution network. They help in telling us what types of products they think will work in the field. We limit them in compensation approaches and in deciding anything along that nature, or in packaging, but the very essence of the product and a lot of the origins of the ideas that ultimately lend themselves to a product formulation, come from our field. We're not going to change that.

Then we go into the product development committee which consists of our president and the senior officers from our various functional areas. Here, we have three very distinct constituents whose interests we must not only honor, but also maintain a balance among. These three constituents are the policyholder, the producer, and the manufacturer, or issuer, of the product.

Present day policyholders are much more aware and astute than in the past. They know what is going on, through periodicals that they read and consumer organizations, and most certainly through the competition. They are very, very bright. They're inquisitive, and they investigate and compare today probably more than they ever have. So we have to make certain that the benefits of the policy are suitable and acceptable to the ultimate consumer, the policyholder.

Then we have the producer. Once again, I think we're dealing with a sales force that is highly intelligent and much more informed than it has been in the past. At First Capital Life, we work with mostly experienced agents. I try not to hire a general agent unless he or she has been involved in the business at least three years, and has a sustained and proven record of success. Now, you don't always have this type of candidate and you always have exceptions, but everybody is clamoring for that same quality producer. We've been very fortunate and blessed to have attracted them.

Here, again, you're working with a group that is very perspicacious, and these producers want to be rewarded for their efforts. A lot of competitors are vying for their business and they're using compensation structures of various sorts to attract them. So now we have to make certain that a product not only primarily benefits the client, but also provides a very good form of compensation for the individual distributor of the product.

Last, and obviously very importantly, is that the manufacturer or the issuer of the product, reap a fair return on the invested capital as well as acquire a good persistent block of business. Additionally, from a very selfish point of view, the manufacturer must be able to bring in highly productive producers and retain them.

Now we get into the balance of all of these in any product definition. Quite candidly, we have made errors that have resulted in wonderful ideas sitting on a shelf and never moving. To harken back to the origin of universal life, the product was actually available in 1978. The original product, which we called Total Life just didn't attract any attention. The explanation generally accorded to that was it's a brand new idea; the first settlers will get an arrow in the chest as they come through the pass; it's revolutionary. Is it life insurance? As you know, there was a lot of press -- antiuniversal life press -- that the product was a sham of some sort.

All of these affected the apathy of our sales force at the time to market the product. But really, if you wanted to scratch below these superficial items, the main reason why the agents didn't sell it is that the compensation on the original product, vis-a-vis what they had been accustomed to selling historically, was drastically lower. The field was saying that we overcompensated for the client, the policyholder, and we were oblivious to the needs and the requirements of the producer and the marketer.

The result was that our first version -- even when we found out the name was already used by somebody else and changed the name -- didn't sell. So we had to come out with version two.

The revised version had a little bit more front-end loading, and as a result of it, in 1980-81 it finally began to attract the attention, not only of the public, but also of the individuals in the industry who wanted to be brave enough to take a new product and see where it would lead.

I submit to you that the compensation structure was very critical in delaying the launch of universal life for probably 12 months. There was a lack of compensation that hurt us very much.

We go through the negotiations in this product development committee, trying to represent all constituents. Trying to make certain that there is a very delicate balance maintained. A lot of it is logic. We all sit there and we all logically know these things, but sometimes we find that emotional issues overrule some things. Then we get into compromise. Ultimately, the president will make the decision as to what we shall do, and we then proceed with the compensation structure.

That is on an individual product. What we have to really look at as well is, what meaning do all the different forms of compensation have and what importance do they have relative to our field force?

Now the commissions, which are specific to a particular product, are very, very important. But that's only one little form of the compensation as far as I'm concerned. The difference in commission from one product to the next may cause a person to make a decision or opt for another company, but normally such differences are minuscule and they're acceptable. We have other things that we try to embrace in our compensation philosophy because the whole idea is, if we can attract those top producers whom we target, if we can get them in, then it's our obligation to keep them. We keep them through using various forms of compensation in addition to commissions.

One portion of our structure is a built-in escalation process which is on a 12-month, calendar-year basis. We do this because we not only want the good person in there, but also we want him to give us the majority of his business. At different plateaus, then, a person will bonus retroactive to dollar one, and we want him to be motivated to hit those plateaus as early as possible. What we're trying to do is to not only get him to write a piece of business a month or two pieces a month, and give us a chance, but also to say, "Well, maybe I better put it all here because my ultimate bottom line is going to be amazingly increased if I concentrate a little bit." Obviously, we have built-in renewals and "trailers" for persistency and to compensate the agent for the servicing.

We also have conventions. We just came back from three weeks in Ireland and everyone said that it topped anything we had ever done in the past. Many times this product committee that I was talking to you about says, "Why do we do this every year? Why do we have these conventions? Do you know the cost of it?" Obviously, we build in the cost. Another comment I hear every year is that the same people are on the trip every year. My response is, "Isn't it great to have those same people with us every year?" We want to maintain the level of total production. Our convention rules go up every year: the amount of production that has to be generated to qualify increases at least 20 to 25% per year. But our number of qualifiers increases, and the group that we want to maintain stays. So I think, as I said when we were discussing compensation, you have to think of all the components and what you want them to accomplish.

We also have a program we call Performance Plus. You might think of it as a frequent flier program. Under this program we use bonuses to get the majority of a producer's business. Qualification for this club is on a quarterly basis. Here, again, we are striving for continuity of effort among our people. We view this program as another form of compensation. Producers clamor to make membership each quarter. If they don't do a certain amount of production within a quarter, they fall out of the club. Then they have to requalify at an even higher standard. Even though it is complex to administer and there are a lot of questions about it, we continually find that at the beginning of each calendar quarter the field force is saying, "What do I have to do this quarter?" This program, coupled with the bonuses, gives us a sustained business volume, and we avoid the situation of getting one big case with the guy then taking a walk so that he can qualify for the ABC Company contest with his next big case. We keep them coming on with their sustained continuity of effort.

Another aspect of our compensation structure is deferred compensation for our managing general agents. The loyalty and perpetuity of this group is instrumental in keeping this ship afloat. We also have stock ownership for all our producers where they can purchase stock on a quarterly basis at a discount if they reach a certain level of production. I want them to have an equity ownership in the company that they're representing as much as possible. We also provide training, of course, and offer health plans which are reimbursable on a production level.

I feel that the overall package and the balance that we have in the package is as good as anywhere in the industry. We don't go into automobiles or any other perks like that. Periodically we might have a little promotion, but it's not in relationship to the convention. We might give some special training concurrent with the convention for the qualifiers.

So, to me, it's a combination of all these things. We've made numerous errors along the way. There was a time in 1985 when we couldn't invite general agents from different managing general agents into the same room. And the reason was the managing general agents did not want their general agents to mingle with the general agents of one of their colleagues. Why? Because the way our commissions were structured, we were giving a representative amount to the general agent and a large amount to his managing general agent. Some of these managing general agents were bonusing their general agents but others of them were miserly and kept the bonuses all for themselves and their own development. Hence, we must have had as many different commission schedules floating around our field force as we had members of our field force. So the managing general agents didn't want the general agents to be able to talk to one another. That's a tragic situation because you lose the spontaneity and exchange of ideas that agents generate. Some also used to ask for cash in lieu of going on the conventions.

These are important examples of how you can fragmentize a sales organization because of poor planning when it comes to compensation. It's extremely important that you offer the same opportunity of maximizing income to everyone. At First Capital Life, everyone has the same opportunity to participate in these promotional ideas and the Performance Plus in the life line. I find that the Performance Plus is an interesting factor in that most of the individuals are using the points they accumulate in order to get professional degrees, be it CLUs, CFP (Certified Financial Planner) and so on. They're not all using it for software that helps them in their business, and they're not using it frivolously. What is gratifying to me is they are using Performance Plus to benefit their own careers and increase their own professionalism. Compensation from that point of view is so essential to review. It can build a very strong team, or it can destroy what potentially could be something very strong.

Let's take the other distribution systems as a conclusion to my remarks. I told you that we distribute through these independent managing general agents as well as through New York Stock Exchange member firms, both of whom require different things. There is an acceptance on the part of the independents to have some of their compensation deferred along the way, to accumulate things for some future pot of gold if you will. They all need a portion of it right up front, but they don't have to have it all.

When you're dealing with New York Stock Exchange member firms, you need to recognize that they're under totally different types of pressures. Current income and current bottom line are all they're worried about. In addition, the mentality of the person selling the product is not one for continuing service. He wants his compensation all up-front and then leave the responsibility for administrative services and support to you. At times these services can be a very high cost. So our compensation is different, although it doesn't radically differ.

We do design certain specialty products for the New York Stock Exchange member firms, particularly in the variable area, and focus more on up-front compensation rather than some continued compensation. Banks probably fall more into this category and we deal with a few of them. Although we're not a pure brokerage agency, we also have a couple of brokerage operations that are successful for us -- we've had quite a few that have failed for us, too. They also have a tendency to want compensation more up-front than on a deferred basis.

Although we haven't got a captive sales force, what we've done over the years of our operations is, in essence, converted it to one because the agents are so involved in all these elements of compensation that they really don't go very far.

Last, I was asked to comment on the levelizing of commissions. We probably all would love it, from a surplus strain point of view and from the ultimate profitability point of view. Every company would love to go along with that.

Periodically, as long as I've been in the business, on about a three- or four-year interval, up comes the idea again and it gets a lot of press and attention. Recently I was reading that the 1990s might be the decade of levelizing commissions. It may well be. But I think we still have the same things to overcome as in the past. Namely, that the producers of life insurance, for the most part, always need money. I don't know why. They might be wonderful salespeople, but maybe they don't budget very well. At First Capital Life, we pay commissions daily and still receive complaints that commissions are slow. Daily we pay them. I don't know what we can do, I guess we can pay them twice a day, I don't know.

There is another issue to overcome -- and that's why I don't think it'll be accepted by a large majority. The second issue is that many marketers would ask their companies, "Why hold my money? I can make better use of my money, why should you have my money?"

Now, I do have to admit that we're working on certain things right now, which are, in a sense, levelized commissions. But the reason the commission is levelized is that of necessity. Our products have surrender charges, obviously, since we have no front-end loads. But we're utilizing one of our products and waiving the surrender charges in some specialty marketing areas, particularly with banks and in deferred compensation areas where it's required. In those cases, out of necessity, since we are waiving the surrender charges, we are levelizing the commission quite extensively so we're not exposed.

We have, in an annuity, a levelized commission. We were the first to introduce the CD annuity back in the mid-1980s. Although we have a large block of it, and we try to encourage people to keep putting money in and get 1% a year -- 1% a year allows you to build a large base in the product -- results have been spotty at best. We have a high degree of turnover each year. It looks like the product is more of a place to park money for one year and to see how the economy stabilizes or to watch the trend of interest rates, and then to move the money on to something that pays a higher commission and has maybe a longer interest crediting period.

So I haven't found, in my experience, that the levelization has been successful. I would like it to be, and we keep trying to come up with products, but we've had abysmal luck with it. Overall, I would like to see levelized commissions. But I just don't think that human nature is going to change dramatically nor that the demands on income are going to be such, that the majority of agents will opt away from receiving the money up-front.

In conclusion, I'd just like to say that a compensation structure is a very delicate balance of many things. If done properly, and if engineered properly, and if all of the components blend harmoniously, the compensation for a company can be the very tool that keeps the top professional with your organization. Knowing you have the distribution system allows you to develop products. So it doesn't work to just say, "Oh yeah, give them this, they'll take it." They don't. The total compensation package is something that has to be thought of very, very seriously when developing products.

MS. STONTZ: Our next speaker is George McKeon. Mr. McKeon provides consulting services to LIMRA (Life Insurance Marketing and Research Association) member companies on issues related to field compensation and distribution system costs. Joining LIMRA in his present position in 1988, he was previously Vice President, Capital Markets, and an NASD (National Association of Securities Dealers) registered General Securities Principal with Huggins Financial Services.

George began his career in 1969 in the actuarial training program at Penn Mutual Life Insurance Company. During his 17-year career with Penn Mutual, Mr. McKeon held the positions of Supervisor, Manager and Director of Agency Finance. He was named Assistant Vice President, Agency Finance and Administration, in 1980; Second Vice President, Marketing, Finance, and Administration in 1983; and Second Vice President, Financial Planning and Control in 1985. He is a graduate of Villanova University with a Bachelor's Degree in Mathematics.

MR. GEORGE P. MCKEON: I am part of LIMRA's Company Operations Division, and I work with member companies on issues related to Compensation and Cost Management.

My topic is "Optimizing Distribution Effectiveness Through Compensation Design." From my perspective, as we talk about compensation design, there are two key concepts: communication and consistency. During my remarks, I will keep coming back to these two items. But first, let me use an analogy to place compensation within the overall context of your marketing operation.

Think of an eight-oared rowing scull. I will be using this eight-oared rowing scull, as an analogy, to place compensation into context within the marketing operation. Initially, I am going to do some recruiting of personnel to fill out the positions in the scull. Then we can talk about how the whole package fits together.

First, and most important, in any marketing organization, is the marketing plan. It provides the overall direction to the marketing operation, and for that reason, I am going to assign it to the role of coxswain in our rowing scull.

Now, let's recruit the eight rowers that we're going to put in the scull. These rowers represent the eight different aspects of a marketing organization. First we need a product, or more typically within an insurance company marketing operation, a whole portfolio of products.

Now, we need consumers for our products. In the terminology of the marketing plan, they are often referred to as the target market.

Next, we need an organization which is going to take our product to the target market, the distribution system. For most of you, this involves salespeople, producers of one kind or another. Some of them will be called agents, or brokers, or personal-producing general agents (PPGAs). In a few cases, they will be telemarketing specialists. Whatever they are called, these are the individuals who take the product to the market.

There are also financial issues that we need to address in our approach to the marketplace. The key concept is the profitability of the product portfolio, often expressed in terms of return on equity, or the return on the investment that has been made in the product portfolio. Also falling under this heading are such things as the investment itself that has been made in the product, often referred to as surplus allocation. Expense management and tax issues also fall under this heading.

No marketing organization would be complete without some sales goals. How much product can I expect my distribution system to sell? How much do I need to sell to offset my product development costs? How much does my current surplus position allow me to sell?

Sales support is another major issue in my marketing organization. Under this heading, I am grouping all those things that I use to position my product in the marketplace. Point of sale material, product illustrations, the training of my distribution system and advertising all fit within this category.

Product delivery is the name that I am going to give to my seventh rower. I will use this category for many of the home office functions which support my marketing organization, such as underwriting, policy issue and policyholder service.

Finally, since we have only one oar left, let's make the last rower the compensation plan. How am I going to pay my distribution system for bringing my product to the target market?

The main reason for this lengthy analogy is to put compensation into context within my marketing organization. It also gives me the opportunity to talk about the need for consistency, one of the key issues I mentioned earlier. How many of you have seen an eight-oared scull with coxswain? With such things as cable TV and ESPN, I am sure that many of you are familiar with this beautiful sight. The coxswain calls the cadence and gives direction to the rowers. Each of the rowers strokes in unison. The rowing scull cuts cleanly through the water.

That is just the way it happens in your company, right? The marketing plan gives clear direction. All aspects of the marketing organization work together in unison. Great profits result. Right?

Think about what happens in the rowing scull when there is no coxswain or when one or more of the rowers decides to march to the beat of a different drum. Chaos is the result. This is what happens in many companies when one or more areas decide to go off on their own. Some companies have no marketing plan. In others, the plan is too vague to give direction. In some companies you will find people who say, "Oh yes, we have a marketing plan, but I think my way is better."

The one key issue is consistency, where compensation supports the marketing plan. The other is communication. Compensation has been called, "The most effective way to communicate your marketing strategy to your distribution system."

Let's assume for a moment that there is something I want you to do. It could be almost anything. Perhaps I want you to sit down front during my presentation. Perhaps I want you to leave your business card on the table on the way out, so that I will know who has been at the session. Or perhaps I want you to sell a financial services product to an ultimate consumer. How could I get you to do that? I could ask you to do what I want done, and some of you would do it just because I had asked you. I could tell you to do it. And, if I had any authority over you, that might get more of you to do it than just asking would. But generally speaking, the most effective way to get people to do what we want them to do is to pay them to do it. If I were to offer $5 for every business card left at the door, that would probably maximize the number of business cards that I would get. So when it comes to compensation design, we want to make sure that the plan is communicating what it is that we want people to do.

Let's look at a marketing plan. What might it tell us about what we want done? What implications might it have in the design of the compensation plan?

Perhaps it would tell us something about the product we want sold. It might be a product that is manufactured by the company, and therefore one on which there is a lot of flexibility in compensation design. Or it might be an imported product, one manufactured by some other company and just distributed through our distribution system, with a compensation program that is constrained by the limits already negotiated into the distribution agreement. There is often a distinction in compensation design between mainstream and marginal products. A mainstream product is one that is priced to carry the full load of overhead expense and one that I want to sell as much of as possible. A marginally priced product, perhaps designed to fit into a specific market niche, may not carry a full share of overhead and the amount I want to sell might be somewhat constrained. Chances are that we built some quality business assumptions into the product design, often associated with persistency, and we want the compensation plan to motivate quality sales. Or perhaps we made some assumptions about product mix (by plan, by age, by case size) when we did our product pricing, and we want the compensation plan to stimulate sales that will parallel those assumptions.

The target market where I plan to sell my products might dictate some compensation design issues. I might not be particularly concerned about sales to a primary market, but if I hope to make additional sales, in some ancillary markets, perhaps my compensation plan needs to do something special to motivate such sales. Or I may have a specialty product, being sold in a specialty market, which demands some special compensation.

What does the marketing plan tell me about the driving force behind my product? How it will be positioned in the marketplace, how it will be differentiated to the target market? What implications does that have for compensation design? I may be dealing with a product driven strategy, with a product that is positioned to sell itself. Compensation may play a minor role in such a strategy. Or perhaps my strategy is distribution driven, requiring a compensation system that must satisfy the needs of that distribution system. Or my product may be compensation driven, with sales dependent on the strength of the compensation program itself, irrespective of other product features. Generally speaking, these items are not addressed as singular issues, but rather as the balancing of factors which determine product and compensation system design.

Closely related to the concept of driving force is the issue of client focus, who it is that I am actually selling to. Is it the policyholder, the ultimate consumer? Is it the agency head, perhaps a managing general agent (MGA)? Or is it the producer? If I am trying to appeal directly to the consumer, without a sales force being involved, then a low price, low compensation approach may be in order. If I am dealing with an agency head as my consumer, a MGA for example, then I need a compensation system that will satisfy the needs of my wholesaler, knowing full well that he/she will be dealing with the retail distributor and that I may not be involved at that level. I may have a strategy that addresses the producer as the primary client, and need a compensation system that gives incentive to the producer to sell my product.

What is the marketing plan telling me about the financial environment within which my compensation plan is being designed? Do I have the flexibility to increase the amount being paid? Unfortunately, that is a bit rare these days. More often I am looking to maintain the overall payout but redistribute what I am currently paying to get more bang for my buck, to increase the reward to those who are doing the job that I want done. But as more and more organizations develop concerns about costs and profitability, the charge from management to the compensation design project is to reduce the amount being paid, perhaps in an attempt to restore the profitability of a particular product, but not upset the attractiveness of the product to the distribution system. These can be hard issues to balance.

What is the marketing plan saying about my distribution system, what behaviors do I want to stimulate, and what implications does that have for compensation design? Do I need to increase the number of producers, or their productivity? Do I want more sales offices, or larger ones? If I want larger ones, do I plan to achieve that by increasing the number of producers per office, or the production per producer, or both? Is the profitability of my sales offices a concern? Each of these goals places somewhat different design constraints on my compensation system.

Having looked at the marketing plan, we can ask the question, "Does your compensation plan pay for what you really want to accomplish?" Is it communicating the correct message to your distribution system? Is the message that it is communicating consistent with the marketing plan?

When we arrive at this point in the compensation design process, we use a technique that we call the job description to address this issue. The job descriptions that we are talking about are not the same as those that each of you has filed within the personnel area in your home office, but there are some common items. For each position that we are going to look at in the compensation design process, we look first at listing the functions that we expect to be performed. Next, we look to split those functions into the ones that we expect to compensate and the ones that, while important, we do not expect to compensate directly. For example, looking at the producer, sales is an important function, and one that is normally directly compensated. On the other hand, while prospecting is another important function, it is one that we do not normally directly compensate. Instead, we indirectly reward successful prospecting by paying for the sales that result. Once we are able to compile the list of compensable functions, we then address the issue of measuring those functions, of developing yardsticks. If we cannot measure the performance of a particular function, we cannot reward that performance.

The next step is to establish standards of performance for each function. We need these in order to evaluate the amount we are willing to pay at various levels of performance. We will normally use three or four levels of performance in defining our standards. Once defined, we use these performance standards to evaluate our revised compensation design. For example, we want to be sure that those who are performing at or above our standards are the ones who are being rewarded. The concept of weights is another way to evaluate our revised design. Those functions that are deemed most important should be the ones we are paying for.

Having listed the functions that need to be performed, the compensation design process can now deal with how to reward them. The first element that we have to work with is base compensation. In most situations this will be commissions or overrides, but occasionally, especially with management compensation, a base salary may be involved. Now that we know what the marketing plan is telling us, we can address the behaviors that we want to motivate in our compensation design. Should we vary compensation in relation to product? Generally, the industry pays more for whole life than for term, possibly due to the fact that whole life is perceived to be more profitable. Some companies are concerned about policy size, and will vary their compensation to pay less at both extremes; less on small policies because of a concern that they do not have the loads to cover it; and, less on the high end because the dollars being paid are so large that they feel they can afford to reduce the percentage in an effort to improve profitability. Some companies will vary compensation in relation to the age of the insured. Your marketing plan will tell you what you need to reflect in your compensation design.

How should we deal with the issue of the balance between new and renewal compensation? Traditional life products normally involve about a 50/50 split, new versus renewal. Level commissions, a topic on many people's minds, involves a substantial change from this pattern. From my perspective, this is an issue that will be coming in the U.S. market, probably introduced, as was universal life, by a nontraditional product manufacturer. Asset-based compensation is another nontraditional approach which has had limited success, but appears to reward the kind of behavior that companies are interested in motivating. One of the major problems with both of these approaches is the New York Insurance Law, which makes it difficult for companies to implement either of them.

The next areas we can address in compensation design are bonuses. Here we will find much more flexibility, and can structure our program more directly toward rewarding those behaviors we desire. In addition, bonuses are normally easier to change or update, to build in annual adjustments in order to keep your compensation plan in step with changes in the marketing plan. Production and persistency, or a combination of the two, are the most common types of bonus. In many companies, people would like to implement a profitability bonus. This can be very difficult, because profitability is often expressed in such technical terms that the bonus fails the communicability test. More often, companies will use an indirect approach, rewarding the various elements that make up profitable business: quality, case size, mix of business, expense management. Growth bonuses are another area, sometimes focused on growth in sales, otherwise on growth of the in-force block, which addresses both sales and persistency. Mix of business is another issue. Bonus payments can be used to motivate people to produce that mix of business, by plan, by size, by age, by whatever has been used in product pricing. Some companies look to the source of the prospect in their bonus structure, especially if their marketing plan calls for the distribution system to emphasize sales from specific areas. In some cases, this could be a new client bonus, if the marketing plan is looking to expand the pool of policyholders. Other companies, concerned that there are too many policyholders who have not made additional purchases, might choose a repeat sales bonus. It is your marketing plan that will tell you what is right for you.

Indirect compensation, like fringe benefits, conventions, etc., is another vehicle to use to motivate certain behaviors. Some companies will use fringe benefit qualification levels to address the productivity per producer issue. By including or excluding certain products, or by setting inside limits by product (no more than 25% of total credits can come from such and such a product), companies can send a mix of business message as part of their convention qualification rules. Each of these compensation design items gives the company an opportunity to use its compensation program to communicate the marketing plan.

What other issues need to be addressed? Clarity is a critical one. If it is difficult for the field force to understand the compensation plan, chances are that the company is not effectively motivating the field force to do what it wants done. Responsiveness is another issue. Timeliness is important. How long does it take the reward to follow the behavior we are trying to motivate? We consider volatility. Do we need to smooth out fluctuations in income, perhaps with some type of averaging technique? Testing the plan at the extremes falls under this heading. The last thing that any company needs is a plan that is so volatile that, as soon as the producers do a bit too much of the very things that you were trying to motivate them to do, you realize that you can no longer afford the plan. Integration at all levels is an issue to address when putting together the plan for management as well as producers. The message being communicated should be consistent, at the sales level, at the sales management level and at the regional or distribution system level. Managers should be rewarded for getting their producers to achieve the goals we have established. One way to achieve this is to pay overrides to managers on the bonus payments earned by agents. Having responsibility for a particular goal, the authority to achieve the goal and the reward for successful performance all resident in the same individual is important. How many managers' compensation programs have a business management factor, but all of the key decisions are made in the home office? Perhaps the leasing coordinator, not the branch manager, should receive the bonus for bringing the rent account in on target.

Industry trends, what the other guy is doing, often play a disproportionate role in compensation design. While it is important to know what is going on out there, just because some other company has adopted a particular compensation strategy does not automatically make it a good strategy for you. Your strategy needs to tie in to your plan. On any given day, and on almost any issue, chances are that I can find one company moving from point A to point B on that issue, while another well-managed organization, for reasons that make sense to it, is moving from point B to point A. Use your compensation plan to communicate your strategy, not someone else's strategy.

We have talked about a lot of specific pieces that go into the compensation design process. If you have been successful in addressing them during your design process, the result will be an incentive compensation system that is clear and understandable, rewards those people who are doing what you want done and is communicating your message to the distribution system.

MS. STONTZ: Our third speaker is Abraham Hazelcorn. Mr. Hazelcorn is Vice Chairman of the Board of American Mayflower Life Insurance Company of New York. American Mayflower is a subsidiary of First Colony Life. The ultimate parent of both is Ethyl Corporation of Richmond, Virginia. During his career, Mr. Hazelcorn worked for the Veterans Administration; the New York Life Insurance Company Group Department; the New York State Insurance Department as Principal Actuary; Actuary and Coordinator of Agency, Actuarial and Administration for Guardian Life Insurance Company; and Principal and Director of Actuarial Services for Coopers & Lybrand.

He formed his own company, Hazelcorn Associates, Inc., and shortly thereafter merged his company with Tillinghast, Nelson & Warren, Inc. In March 1979 he joined American Mayflower as its President and Chief Executive Officer.

Mr. Hazelcorn received his Bachelor of Arts in Mathematics from Brooklyn College in absentia since his last year was at the University of Basel. His Master's Degree in Germanic languages was received at the University of Zurich, where he continued to use his World War II educational benefits.

Mr. Hazelcorn is a Fellow of the Society of Actuaries, Member of the American Academy of Actuaries, Fellow of the Conference of Actuaries, Fellow of the Canadian Institute of Actuaries, Associate of the Institute of Actuaries, and an Enrolled Actuary.

Mr. Hazelcorn is active in Society of Actuaries' proceedings, has served on two Advisory Committees to NAIC Subcommittees and has been a frequent speaker for the AMA (American Medical Association) on insurance related subjects. In July 1988, he presented a paper at the International Congress of Actuaries in Helsinki, Finland, on statutory projections. On January 1, 1989, Mr. Hazelcorn become Chairman of the Life Insurance Council of New York, which is an honorary post for a one year term.

MR. ABRAHAM HAZELCORN: In order to give you some perspective as to my remarks, I'm going to quote something that was said about 30 years ago at an international meeting. A New York actuary was asked by a foreigner -- foreign to the United States, what regulation in the United States is about. His reply was, "In 49 states, it's the land of the free, in New York it's the home of the brave."

In New York, we are engaged in a Modernization Committee. In one of our frequent meetings with the Insurance Department, there is one actuary in particular who harks back to the Armstrong Investigation in almost any discussion. And, believe it or not, he is probably one of the youngest actuaries in the Department. We get tired of his harking back on almost every issue to the Armstrong Investigation. Yet, it's interesting that last month's ACLI *Council Review* has a three-page coverage of the Armstrong Investigation which mentions how few of the excesses were based on field activity. It also refers to the journal of the CLU and the ChFC article of November 1989 which also, in a short coverage of the Armstrong Investigation, has made 10 major findings, not one of them agency related.

I tell you that because in many ways there is a great deal of overkill in the regulation of expenses -- overkill as far as the field is concerned. This is ironic, too, because it's the people who sell the product, as Jim can tell you, who are there on the firing line, and you'd think they would be tempted more than anyone else to abuse expenses. However, most of the excesses which led to the Armstrong Investigation were home office criminal activities, and by any standard, they were damnable acts.

When Carolyn asked for a title for my presentation, I gave her a wonderfully catchy, but misleading, title. You'll notice in your booklet it says 213 to 4228 to reality. Well, there's no difference between Sections 213 and 4228. It just so happens that in 1984, the New York Insurance Department recodified its entire insurance law. There is no substantive change between Sections 213 and 4228. I don't even think there was a minor change in the expense limitation in that year. I just wanted to give you something to attract interest and it worked.

The Armstrong Investigation, which ended up, I think, in 1906 or so, resulted in a Section 97, which became Section 213 and then Section 4228. There have been some changes along the way, but strangely enough, the core of what is now Section 4228 has not changed a great deal. That has been a source of consternation to the industry and, I must say, to some extent, it's been a source of consternation to the officials. The officials cannot break their own law.

You must realize that the Insurance Department, by law, is administering a code. So, if there's something out of phase because things have changed, it can only use judgment to a certain extent. The Department cannot, however, break its own law, the law that it is being paid to enforce.

For those who don't know, the New York Department, I guess similar to the California Department, is split between two cities: the Actuarial Bureau is in Albany, and the Life Bureau, which, of course, has more actuaries than the Actuarial Bureau, is in lower Manhattan. Terry Lennon, who is Chief of the Life Bureau -- the lower Manhattan part of the Insurance Department -- is the one that who agency compensation regulation. Valuation and other matters have been handled by the Albany part of the New York State Insurance Department.

There have been previous attempts to modernize Section 4228. According to Terry Lennon, about every 30 years -- at the end of 1988 we were on the 30-year pattern --

there is an attempt. This time, I believe there is a real considered attempt. It is important to know that this is the Department's show, it's not the industry's show. This whole effort is under the direction of the people at the New York State Insurance Department. They thought they would like the help of an industry group to modernize and propose legislation so that this law will be in keeping with reality.

Now a word about LICONY (Life Insurance Council of New York). The Life Insurance Council of New York is very similar to the ACLI, but has a very special membership. These are companies which are not only authorized in New York State but also domiciled in New York State. For those who have worked in such companies, you have to know, even though Section 4228 is extraterritorial in its effect, there is quite a difference between the way it's actually enforced -- or can be as a practical matter -- when it's a foreign company, mainly an authorized company domiciled outside New York State, than for a New York State domiciled company. LICONY has used its good offices to help develop today's modernization effort. But it is not a LICONY effort, it's really an Insurance Department/industry group, composed mainly of compensation actuaries.

But there is more history to this. One of the last commissions that Governor Carey appointed before the ending of his term, was the Heimann Commission, the temporary insurance commission. This was an interesting commission, which sought to bring the life insurance regulation in New York State into the 20th century. A great deal of testimony was taken. Unfortunately, most of what came out of it, as far as my topic is concerned, came out on the investment side. The Prudent Investment Man Rule was adopted instead of the eyedropper method, there you had 1.2% of this kind of investment and so on. That was the major outcome of the Heimann Commission, named after its chairman. But much was said about what should be done about compensation. The fact that the approval of universal life in New York State took one year longer than the 49th state, New Jersey, is a fact that I attribute to the Heimann Commission. Then, Governor Cuomo appointed a Banking, Insurance and Financial Services Commission early on in his first administration. That has created a great deal of heat but not as much legislation coming out of it. One of its proposals was to allow banks to underwrite life insurance and other insurance, and vice versa, to allow insurance companies to be in the banking business.

Well, that brings us up to a current frustration. Terry Lennon has been quite flexible. I just hope he doesn't end up like President Carter in that there was much to do when President Carter first assumed office of how he was going to change things. And he found out in short order that he was a captive of the Civil Service. It turns out that most of the people who hark back to the old rules are actuaries because it is an actuarial law, of course. If you want to get an excellent background as to what happened up through 1954, you can read Allen Mayerson's paper, "A New Look at the New York Expense Limitation Law," in *TSA* VIII.

So we're brought up to the point of Terry Lennon saying, with the approval of the Superintendent of Insurance, "Let's try to do something about Section 4228." Through the help of the good offices of an IBM facilitator, in the first week of November 1988, people from the industry and from the Department identified issues concerning Section

4228 that have to be solved to achieve modernization and to have New York function in a realistic market. Additionally, out of that effort came some planning.

In the spring of 1989, a core committee was formed. That core committee, which is going to work on the modernization project, is chaired by Armand dePalo, who is the Chief Actuary of the Guardian. We have four subcommittees. We took the issues that the IBM facilitator identified, and we distributed them among the four subcommittees, leaving some for the core committee. Subcommittee One, which handles companywide limitations, seeks to answer the question, "How much does a company have available to spend and still be within appropriate limitations?" That subcommittee is cochaired by John Dinius of AETNA and Richard Ostuw of The Met. Subcommittee Two, on policy, agent and agency or other level limitations, seeks to answer the question, "What are the policy, agent and agency or other level limitations that should govern company payments?" That is cochaired by Marshall Lykins of New England Mutual and Jacob Poleyeff of MONY. The third subcommittee is on basis of payment and seeks to answer the question, "How can a company distribute what has been limited by the law?" That subcommittee is cochaired by me and Bill Koenig of Northwestern Mutual with a significant amount of work also done by Gary Peterson of Northwestern Mutual, who is Bill Koenig's alternate. And finally, the fourth subcommittee has a title of compliance issues, and seeks to answer the question, "How can what is paid be monitored and controlled?" It is cochaired by Bob Likins of Prudential and Dan McCarthy, who is representing Security Mutual as a consultant.

To bring more of the industry in, we had a session in July 1989, in the Metropolitan Auditorium. The industry and the Department participated to establish a grand design -- how we expected to go about the modernization effort. We mentioned that it would be a three- to five-year project. Now, I think whether the effort will succeed will be decided within a half a year, because we're at a crucial point as to whether there will be some give. And when I say give, again I have to hark back to the fact that the Department is administering the law and cannot break the law, but there is much in the way of regulation and Circular Letters that allows some judgment. In the LIMRA book on *Marketing for Actuaries: Individual Life and Health Insurance*, there's an interesting sentence written by Nate Jones, one of the Department actuaries. He has a sentence there which is wonderful. He mentions that, "Section 4228 is encrusted with years of technical amendments." I think that's a wonderful sentence. Of course, what has happened is, the law has not changed for many situations that were appropriate 40 or 50 years ago. But it's still in the law. The point is, how do you modernize, how do you bring New York into a competitive situation? Many New Yorkers are proud of the fact that Equity Funding would never have happened in New York; and, I have to believe that, because of their strict regulation. But the tradeoff is quite a bit of just unworkable regulation. You mentioned asset-based commissions, Jim. We can't use them in New York. We've been struggling -- we were going to put that outside the modernization effort because the Department gave us an indication that maybe we could succeed on a separate track -- but we just have been frustrated at every turn. U.S. Life uses asset-based commissions in all its out-of-state companies very successfully but cannot use it in its New York company.

Another item that fits into assets under management would be persistency bonuses. Here again, you'd like to design a persistency bonus or a bonus in general which rewards the right thing. In New York you cannot give more money based on volume. There is a special persistency bonus that was allowed but is now being revamped, and I don't think it will survive.

The Modernization Committee had an opportunity recently to make some points with the Department. The Department said to us, "Look, there's a Regulation 50 which regards training allowances for new agents. We have a problem. Two mutuals are at each other's throats, figuratively, because one has a grandfathered approved training allowance system and is being accused of unfairly using it to proselytize all the agents of another mutual." Well, Subcommittee Two did a very fine job in coming up with a proposal. But, in my opinion, because the actuaries on the Committee did not communicate with the lawyers, the proposal didn't pass at the LICONY meeting where it was discussed. So we missed an opportunity. Again, the lesson to be learned from this particular situation -- and I'm sure it's a much broader lesson, not just in regard to modernizing Section 4228 -- is that actuaries and lawyers have to communicate better with each other and I'm sure with agency people, too.

As of last week, we may have a new Superintendent of Insurance. He was not yet confirmed. Superintendent Salvatore Curiale, once he's confirmed, seems very reasonable. I would hope that once Sal becomes Superintendent we will have a willing audience in that he will use his efforts to help us truly modernize Section 4228.

MR. W. HOWELL PUGH: Fortunately, I'm not a New York company, but I would like to ask Mr. Hazelcorn, why modernization, why don't you go for repeal?

MR. HAZELCORN: Well, it's a good question and we have tried repeal for various parts of law. For example, there is Section 4227 which is a limitation on new business. We have tried year after year to repeal it completely. Instead, the best we can do is liberalize it. And I think we are in the process of succeeding. The New York Department is changing a very strange limit in regard to the writing of annuities with cash values.

MR. JOSEPH PAESANI: Mr. Hazelcorn, we've heard about some of the things the Committee's doing concerning asset-based compensation and that perhaps something will come about in the near future in New York. I got the impression from your comments that, if anything, that's still a long way off.

MR. HAZELCORN: Well, as I mentioned, we had hoped that we could get it outside the Modernization Committee work because we had received an indication that it could be treated separately. But I give it very little chance of taking that separate route. It will be thrown in with the rest of the modernization effort.

This is ironic to me; I feel that the three largest mutuals in New York understand trailer commissions as rewarding people for accumulation of money in addition to other considerations.

I feel that, certainly in New York, if you cannot adopt asset-under-management or asset-based compensation in some form, eventually it's going to contribute to losing the battle for certain insurance company products with heavy investment elements to noninsurance companies.

MR. MCKEON: I'd be interested in knowing what percentage of the audience actually operates in the New York environment, and what reactions you have to the current efforts. Let's go for a show of hands. How many New York admitted companies are in the audience?

It looks like about a quarter of the audience is from New York admitted companies.

MR. HAZELCORN: Most of them are from the land of the free.

MR. MCKEON: The thing I had heard, Abe, about the concern for the new regulations is that nothing would be proposed to the Department until all of the constituencies, as it were, had an opportunity to review and accept the proposed regulations. And when I start talking about constituencies, I talk about managerial companies versus general agency companies, domicile versus admitted companies, career versus brokerage companies, all of whom have slightly different axes to grind.

MR. HAZELCORN: There was an off-site meeting in Terrytown, New York, in February 1990. And I think that Terry Lennon is changing that.

You don't want to have a completely piecemeal approval, but if there are certain self-contained elements that can be approved, or can be a part of an early modernization effort, I think he's leaning that way now.

MR. MCKEON: That would be encouraging.