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Emerging Compensation Alternatives

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Summary: This session focuses on emerging compensation plans in the life insurance industry and addresses:

- *Levelized commissions*
- *Potential changes in New York regulations*
- *Compensation methods used by alternative channels*
- *Salaried agents*
- *Innovative programs*

Mr. A. Micheal McMahon: I have an easy task of introducing a very knowledgeable panel of speakers on this subject: Tom Beresford, Armand de Palo, and Roger Heath.

Tom is chief actuary at Prudential Select Life Insurance Company. Tom started his career at Penn Mutual, where his roles included a heavy dose of product management. Prior to joining Pru Select, Tom was also a senior vice president and chief actuary at Covenant Life. At Pru Select, he is responsible for managing all actuarial functions of the company including product development. Tom will talk to us about his company's experience with field compensation plans.

Mr. Thomas E. Beresford: I was asked to cover the first issue on the outline, which is level compensation, particularly as it relates to some recent experiences that Prudential has had in this area. The debate about levelized commissions and how

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they will save the industry has been around for a number of years; both have been discussed privately and publicly. I can remember actuaries talking about levelized commissions probably more than five years ago. You've probably heard that levelized commissions will solve the profit and churning issues.

An article appeared late last year in *Best's Review* "Level Commissions: The Question Isn't If, But When." Another article appeared in *The National Underwriter* earlier this year, "Study Successful Agents Favor Levelized Commissions." But for the most part, until recently, the discussion has been more of a theoretical debate than a practical one.

However, last fall, Prudential started getting a fair amount of publicity about a new company it had started up. This article appeared in *The National Underwriter* in, I believe, October: "Pru Starts Level Commission UL Company." In fact, there were numerous articles in trade publications about this new venture.

I don't want to take credit nor do I think Prudential should take credit for being the first to enter the level commission arena. In fact, it wasn't. Acacia has a level or a more levelized commission concept. A number of the Canadian companies are using level commissions. It just seems that Prudential attracts a great deal of attention no matter what it does.

Before I talk about our experience, I think it would be helpful to give you a little background to help put this in the right context. If I just got up here and told you about level commissions and what we did without putting it in the right context, I think that would be misleading, or it could be misleading to you. I want to share with you some background about Pru Select Life.

Pru Select Life (PSL) Insurance Company of America is the official title of the company that was created to do this venture. It was created and used to enter the high-end flexible premium universal-life marketplace on a levelized commission basis. PSL is a Minnesota domicile company wholly owned by Prudential. It's licensed to do business in 46 states, but not in New York, and that was by choice.

PSL developed a series of single-life and multiple-life flexible premium universal life (UL) contracts that focused on the high-end market. Generally, the minimum face amount for our product is $1 million. Our main distribution system is up-scale brokers, although the products are available through the Prudential Career Distribution Systems. Prudential really has three distribution systems; two are career agents, and one is a brokerage distribution system, and PSL was intended to focus primarily on this brokerage distribution system.

You can see that this is very focused and very much a niche. It's out of the mainstream of the Prudential bread and butter. In fact, Prudential had shied away from UL as a product for a number of years. One of the things that is fairly important to mention is that the original intent was to sell minority ownership shares of the company to a select number of producers. For a number of business reasons, that concept has gone away, but I think the elimination of that ownership has had a significant impact on the results of PSL.

We have four reasons to go to a level commission approach. First, the high-income market requires ongoing service. This is definitely the case when you talk about $1 million policies, possibly with premiums of $20,000, $30,000, or $40,000 a year. People want their hands held. They want to get comfortable and know what's going on. We felt a need to pay higher commissions in renewal years, and of course, there's only one place that can come from.

Second, in the high-income market there is a great deal of commission disclosure that goes on, and so we felt that this could address that need as well. Third, there's the proverbial capital constraints. The company was funded to a certain level and needed a large volume of business to grow. While it had Prudential's backing, they didn't want to have to put any additional capital in, so, of course, one of the ways to get around that was to come up with a commission structure that spread those commissions out over a number of years.

The fourth point is that brokers in the high-income market appear receptive to the level commission concept. A survey was done by Prince & Associates. For producers with annual incomes of $5,000 or less, the number in favor of levelized commissions is less than 2%, but as you work your way up to producers with annual incomes of $100,000 or more, you're above 60% in favor of levelized commissions. I want to emphasize that, because responding to a survey is a little different than making the actual decision as to how you're going to take your compensation in a particular case.

What exactly did we do? The structure of the commission scale that we put together is basically a 14.5% level of commissions for years one through ten with a 5.5% expense allowance in the first year. Those commissions are vested. Obviously, they'd have to be. These are UL products so this is the amount of commission that's paid up to the target premium. You may have another name for it. I don't know. Four percent is paid on the excess.

There are other people involved in the process, with overrides to the others that are in the "food chain," if you will. The first-year total commission payout was about 35%, and 17% in renewal years 2 through 10. We tried to provide a great deal of information to the producers demonstrating the value of level commissions. We showed them graphs that compared the total commission payout for a level commission scale, more traditional type commission scales, and the crossover point is at about seven years.

Actuaries like numbers, so we try to provide them with many numbers. Adding up commissions, we transferred that into the percentage of one year's premium. We did the present value calculations at 6%. The present value was greater than the present value of the commissions that are paid out on a heaped basis. Six percent may sound a little low and it probably is. In this market, what we found is there is a pretty high persistency, so a lower interest rate could be used than would be traditionally used. The other thing is I did these calculations at 10%, and they pretty much level each other out, so we decided not to share that with anybody.

We also tried to put together a pro and con list of level commissions versus more heaped commissions. On the pro side:

1. There's a potential for higher cumulative commissions over that ten-year period.

2. It aligns renewal commissions with realistic servicing costs that we feel people should be providing in this market.

3. There are higher annual commissions for the majority of the sales commission period.

4. It allows for better PSL policy pricing and longer-term values. PSL used a heap commission structure. We didn't try to put early values in the contract to compensate for the level of commissions. We do believe that there's more long-term value in the policies as a result of their being level commissions.

5. It may be viewed more favorably by consumer advocates and clients. You probably can take the words "may" and "be" out. I don't know that there are too many consumer advocates who would not like to see the industry go to level commissions.

6. Certainly, there's a lower first-year payout. Premiums must be paid each year. We're dealing with flexible premium contracts here, so that really did become an issue with us.

7. There are lower cumulative commissions on a one-year plan premium case. If you got a case that has a 1035 exchange, they're putting a large amount of

money in upfront. They, for some reason, want to prefund the case. The way we structure became somewhat of a problem.

How have we done so far? I guess that's probably what you want to know. We certainly haven't had overwhelming success, but I don't think, at this point, we consider this a failure.

We have had some success with this approach. There are a number of brokers who have bought into a levelized commission contract or concept. There are also a number of people who seem to be going to levelized commissions in the high-income market. One of the things you find is that oftentimes a sale is split between two or three carriers. People seem to be willing to take a part of their sale and put it with Pru Select Life, and that will take levelized commissions; but they don't want to necessarily put the whole sale with Pru Select Life.

There are four issues that have certainly contributed to a lack of success:

1. There is a lack of PSL exposure in the brokerage market, and this has nothing to do with levelized commissions. It takes a while to get in to see many brokers, particularly when you have a product that has a $1 million minimum face amount.

   Several brokers that claimed to be in the upscale market don't necessarily work there every day and aren't necessarily selling $1 million policies. It's sort of like a manufacturer trying to get space on a grocery shelf. It's been tough for us to get in and get attention and get people to pay attention when they know going in that they can only sell our products in a portion of their market.

2. The second factor that has contributed is interest rates. We are a UL company with a new money rate. Last year, 1995, couldn't have been a worse year to try to introduce these products in the market. I think Treasury rates dropped about 200 basis points during the year. UL rates dropped around 35 or 40 basis points. We didn't have a portfolio of assets that we could, in any way, use to back up our rates, so we wound up having to come out with some rates that were not necessarily the most competitive rates on the market.

3. The third thing is the perception that level is less. I talked to one broker and he said: "I agree with you. I think level commissions is the way we're going to go. I think it's right for the industry. I think we must do it, but that guy

over there is selling the heaped commissions, so I'm going to go over there." There's still a fair amount of that out there, which is hard to overcome.

I think there is a threshold there. I don't know where it is, but there's some kind of a threshold out there, and if you paid level commissions at a high level, you would get their attention. Unfortunately, I think that threshold is probably higher than the company can afford. It may be 20% or 30%, but that's what it's going to take to get many people over the concept that level is not less.

4. The fourth thing is that cash values in our products are not perceived to give back to the policyholder what the agent is perceiving to get in terms of a heaped commission. You get into the question of why should the agent give out commissions if there's no early return to the policyholder?

What do we do? After eight months of experience, we're going through an evaluation phase to see what it is we can do differently within the context of the products, and we'll try to address these issues. They all need to be addressed in order to turn this around to make it more successful. I'm not sure where that's going to lead us, but that's where we are right at the moment.

If you're thinking about entering the level commission market, I have a list of issues that you might want to consider.

- Distribution system structure. We focused on a market where 60% of the people said they were interested in or in favor of level commissions. If you're in a market where your producers are not making $50,000 a year and you have a 1% acceptance rate, you're going to have to think real hard about where you want to pay levelized commissions.

- "The level is less" issue. I think that's a problem out there that we still need to deal with somehow.

- Older age insured. We sell contracts to people up to age 85. It's tough to convince an agent that the business is going to be around for ten years and still paying premiums. Most companies grade off their commissions at the older age anyway, but that's something that has come up a couple of times. What are you going to do? Am I going to get the rest of my commissions if this person dies?

- Older age producers are something of a problem, too. Even though they vest their commissions, if they're not out there actively maintaining the business, we are concerned that the business is going to walk. They have some concerns about that.

- Premium requirements. If you have a flexible contract, you may want to consider what you do if there's a great deal of money paid in upfront or if premiums aren't paid in some renewal years. If your product is a traditional whole life policy, with a paid-up additions (PUA) rider where the PUAs are used to paying for the premium that are due on the whole-life contract, you may not have as much of a problem.

- The importance of overrides. Just like the producer, the agent who gets an override is going to evaluate his or her take versus what can be done elsewhere.

What kind of future influences might there be on level commissions?

- There's New York 4228. Armand de Palo is going to shed some light on that for us.

- Compensation disclosure. I think more producers are certainly going to request levelized commissions if compensation disclosure becomes more of a feature that's asked for out in the market.

- Churning. What gets regulated concerning churning may have some significant influence on the future of level compensation.

- Fee-for-service producers. There seems to be some additional interest in fee-for-services producers and that may drive the industry more towards level commissions.

- Alternative distribution systems. Banks and discount brokers are more willing to live with the level commission structure. You might see more compensation plans designed with distribution through some of these alternative channels in mind.

Are level commissions here to stay? That's a good question. I have to agree with this: level commissions—not if, but when.

Mr. McMahon: Our next speaker is Armand de Palo. Armand is the senior vice president and chief actuary for Guardian Life Insurance Company of America. Armand has a 19-year history with Guardian and has had an active industry presence on many important issues over the years. Armand is currently chairperson of the Core Committee for Modernization of Section 4228. Armand will bring us up to date on 4228 and some of the implications.

Mr. Armand M. de Palo: Agents' compensation has been regulated by New York State since 1905 when the Armstrong investigation occurred. But most of the changes really occurred in 1929 and are known as inside limits. What was created was a law that was to protect consumers by restricting how you can pay agents. More than that, it also created a structure of what's known as a general agent company, versus a branch office company. Because of that differential, it created something that's viewed as an expense allowance that pays out 96% in the first year. The 96% was based on a 55% commission. This created structures.

Also, there was a restriction in the law on hiring agents from other companies. There were restrictions on the amount of money that could be paid as training allowance and who could get this allowance. There were restrictions in the law as to what part of the margins the law made available only for agents' benefits, and this created a situation in which career companies could supply fringe benefits. But brokerage companies, if they chose not to supply fringe benefits, could not turn the fringe benefits around into cash compensation.

What this did was it created a fertile field for large companies to bring new agents into the marketplace and have some assurance that those agents would be difficult for other companies to recruit away. We spent eight years studying the law and trying to draft regulatory changes, and in 1993 we submitted a completely revised law to the insurance department. That law retained the structure of inside limits, commission limits, and limits on who can get fringe benefits. It was designed to be more flexible because evolving law didn't change its major structure. Politics changed in New York State recently now with a Republican governor and an opportunity to take a more radical change in the law.

Out of that, we started the process of saying, now we have a governor in New York State who will be pro business. The insurance department said, "We're going to change some regulations, get rid of some others." So we had a unique opportunity for major changes not perceived as possible before this time.

Life Insurance Companies of New York (LICONY) right now is working on a two-part policy. One part is saying, let's go for the biggest change we can get, and that's what's in Albany right now. It gets rid of all the inside limits. It will cut policy limits and expense allowance limits. All that will be left, if this new law goes through, is a single aggregate selling limit, which is what the company can spend on selling. This is tighter than the current law.

The structures that existed, the underpinnings that allow the career company structure to exist or to be protected, is going away. The distinctions between a career company, a branch office company, a personal-producing general agent (PPGA) company, and a brokerage company are all going away. That means each one of them is going to get the same amount of margin in the aggregate limit that they can spend. At the same time, they can spend it in the way they want to do it.

Now, the process has changed drastically. In the past, you submitted your plan of compensation to the department, documented that it complied with the inside limits in the law, and waited for approval. Some people will use the phrase, “and waited, and waited, and waited, and waited.” It was taking some companies two years from the time that they submitted a new plan of compensation to the department to the point that the department actually approved the compensation scale.

Since product development can’t wait two years, the biggest concern any company had was, I can’t live with this compensation approval process. That’s all gone in the new law if it gets through. What the new law says is the company’s compensation actuary will certify to the department that the product is self-supporting. The certification will go to the department, which is nothing more than the actuary sending in a letter with the policy form submission that the compensation paid on the policy form is self-supporting. The department, in effect, will have 60 days to get back to the company.

If the company basically wants to go live in that 60-day period, they have to commit that if the department finds their submission unacceptable, or some problem with the product, they’ll recapture compensation. After that 60-day period, you are free to use the plan. The certification to the department, which you have to have on file in the home office, is an actuarial demonstration that the product is self-supporting. Companies will need to retain that certification for at least five years after the introduction of the product. Basically, you only have to hold it until the triennial anniversary that comes up for them to review your work, if they choose to.

This is a radically different situation. We’re going from companies submitting a plan and waiting for its approval, and having to submit your expense allowance plan separate from commission plans, to a “file and use” process. Most companies now experiencing a 6–12 month wait will have almost immediate ability to modify and introduce the compensation in the marketplace.

The old law had limitations on what could be used for fringe benefits, and the margins for fringe benefits were available only for fringe benefits. The new law uses the entire margin. It doesn’t matter if a company pays that margin for fringe benefits under the proposed law.

What does this mean for career companies? It means that they are going to have to look at what their agents can get in the brokerage marketplace separate from what they're paying. They're now going to be able to pay fringe benefits, and also have the same level of compensation that a brokerage company can have. In the past, they were protected from the brokerage companies, who were strict about compensation, and chose not to get these benefits.

That's going to be a critical issue for branch office companies, in particular, where much of the expenses are fixed and not marginal. So for the career companies to survive under this new law, the expense components that are currently fixed, the overhead components, must all be turned into a bonus, which is a radical change, and reflected to the agents so the agents know that they're getting the same value if they're placing business outside the company.

The only concession that it's in this bill to the career building companies is that there is extra margin that's given if you're bringing new agents into the industry. New agents are not agents that move from one company to another. New agents are people who are not in the industry, and you'll get an extra margin for them in years one, two and three, and you'll pay it as you want. So the world is changing radically.

This is up in Albany; it's in the hands of politics right now. What I mean by politics is that it's no longer being governed by an actuarial team drafting what we would like to see as the law. It's being governed by the political forces between Democrats and Republicans, where you have the assembly basically run by Democrats, and the senate run by Republicans, and different lobbyists come in and try to keep this bill alive.

Will it survive? We don't know. There are lobbyists in Albany right now saying it's a sure thing and it's guaranteed that this is going to be passed this summer. There are other lobbyists in Albany saying that it doesn't stand a chance and it's not going to survive. We haven't yet heard from the consumerists. Guardian's own position on the bill is that we support the overall bill. We would have liked to have also seen a first-year limit in the bill. In other words, instead of having a single aggregate limit, we would have preferred to see an aggregate first-year limit, and an aggregate total limit so that money could not be drastically front-ended.

While this bill is being proposed and if you read all the literature on it, you'll see that they're saying, "The reason we want this is to encourage levelized compensation"; this will give companies the ability to come out with levelized compensation. Companies could come out under New York State law, right now, with levelized compensation.

The problem that companies have with levelized compensation was not that the law did not allow it; it was that the law did not allow you to take first-year compensation and move it to renewal years and increase its value by interest. What happened is when you levelize the compensation, the agents who were at the maximum of the existing law when you levelized it did not get something that they perceived as of equal value.

But if you wanted to come out with a 10% level of commission scale, you could have done that and not been in violation of the law. But you needed to go to about the 15% level for the agents to consider it the same value of what they were getting as a heaped scale, and the law didn't let you get to that. All that's gone. You now can, if this law goes through, levelize your compensation, pay your compensation as a function of the face amount, pay your compensation as a function of asset-based compensation, or use any other means you want.

Because the drivers of the aggregate limit currently are all premium-based drivers, we also put into the law exchange rules. If you want to pay asset-based compensation, and you were on a premium driver for aggregate limits, you would have a problem if you would stop writing business. You still have compensation to pay, because the compensation will be going through your books, but you'd have no more margin. So what we put in the law is that you take any part of your compensation that's driven by first-year margins and convert them to level margins based on the exchange rules, so that if you were paying asset-based compensation or face-amount compensation or just per-policy compensation, you can do it and not worry, if your sales fall off, about not having the margins.

I'll go back to the issue if this bill goes through. I'd say that it has a chance of going through this summer, but only a chance. We haven't seen what's going to happen up in Albany, New York. It's supported by Ed Muhl, the insurance commissioner. But the small upstate companies are fearful that this law could cause agent proselytizing problems where their few key large agents are stolen away from them because other companies have margins and could cause agent turnover to occur.

I believe that if this law was in place, its long-term benefits would probably allow flexibility, which is good for the consumer, but it will have a short-term transitional effect until the marketplace decides where it will end up. You will see major movements of agents between companies as companies realign their compensation and try to build field forces of key high-level producers.

Since we don't know if this law is going to go through this year, we don't know if it will actually go back to the state for review the following year. I think if it doesn't go through within the two-year period, it will be dead. Dan McCarthy of Milliman

& Robertson and I have a completely separate team that's working on changes to the regulations, assuming something like the current law survives.

We've already accomplished a couple of things through this effort. We have two efforts going on at the same time. One is a complete review of the law. If the law goes away, all the regulations go away. This team doesn't have to do this work any longer. But if the law, or something like the current law, stays in place, we're changing all the regulations to make them more pro business. We already have an asset-based compensation on annuities.

We're working on a regulation that will allow asset-based compensation on life insurance, and we should have that completed this summer. We're working on a change in the training allowance formulas to go to $60,000, and make it easier to pay training allowances. If you're taking an agent from one company who hasn't used up the margins, you can pay the balance of the margins to them in your next company. We are making many changes in Regulation 60, which is the replacement rules that have ramifications on agents' compensation. All this is going through at the same time. We're also trying to get something in the line of "file and use," so you don't have to wait forever to get approval on commissions. We've already gone to UL to be at the same level of compensation as whole life, that is, both of them can pay 96% as far as first-year commissions, expense allowance, and overrides.

We have accomplished a great deal and much more is left to be done; we're in a period of uncertainty. But the point I'm trying to make is regardless of what happens, if we go down path A, which the law has radically changed, we're left with self-support only. If we go with route B, they can't change the law politically, and we will still get all the regulations changed to make the law much more palatable. As a result, the marketplace is going to change rapidly.

We're also getting in the new law, for some companies, additional margins for fringe benefits. Under the existing law, since there is a limit on fringe benefits, which is 1.25% of renewal premiums, we're getting that raised to 1.33%. Certain large branch office companies whose fringe benefit costs are basically over the limit are going to have that problem solved.

That's in this year's bill to the state assembly, and that's running independent of the complete rewrite of the law; companies who are running up against the fringe benefit margins should have it resolved this summer. There's no opposition to that part of the revision whatsoever.

Where does this all go? We're going to wake up to a new world when this law changes. New York state companies, when the current law was written, affected probably 85% of all the sales in the U.S. Today, New York-licensed companies only control 45% of the sales. Outside New York people say, New York doesn't have an effect. It does have some effect—it's constraining the compensation elsewhere. Clearly, in New York State itself, and in the northeast part of the country, it has had a big constraint. All those constraints are going away.

You will see some companies moving to levelized compensation. I definitely believe that annuity compensation is going to level out tremendously as it becomes a more consumer-driven product. Life insurance is going to go two ways. Some companies are going to pay much more upfront. Some companies are going to pay much more later. Nothing in the rewrite drives compensation down. There's enough margin in the rewrite that whatever you were paying you could continue to pay.

There's going to be a new world for companies that are relying on the law to protect them. How many companies deal with the question, "I can't pay you any more because New York State law says, I can't pay you more than 91%." That's gone. The laws will no longer say, You cannot pay an agent more than 91%. If a company has its large producing agent come in and say, "XYZ company down the street is willing to give me a persistency bonus, and I can get 135% on my production," that company is going to have to react. Now if that company says, "Well, I'm going to give you 135%," and their product was only priced for 91%, are they going to raise their pricing to include a margin to pay everyone 135%, including the lowest producing agents? It's unlikely.

What would happen? If they're under the pressure to pay more to the higher producing agents, and probably more profitable agents to their companies, they will have to then lower the compensation that they're paying to their less-productive agents. We're going to go from an environment where agents receive very similar levels of compensation, regardless of their production level, to an environment where the range of compensation between the lowest producing agent and the highest producing agent widens. It's probably going to widen drastically.

Many companies highly subsidize the fringe benefits of their field force; in particular, health insurance is a per capita expense. Companies will subsidize that by having the agents pay from 50% to 30% of the cost. That same company is now competing against the brokerage company, or PPGA company that's not giving fringe benefits. That company is now freed up to convert the margins that were being paid into cash compensation. That company is going to have to react to the issue of how to tell the agent that he has value in his fringe benefit and then make him realize what the value is.

It will make fringe benefits available for you. Yes, you're going to get health insurance, pensions and disability. But since we're paying all the money out to you as compensation, you have to pay 100% of the cost. For the less-productive agent, especially on health insurance, which is, once again, a per capita expense, it's going to be a greater share of the income. At the very time that the lower producing agent is seeing his income drop because the company is now going to refocus compensation to the higher-producing agent, the cost that the lower-producing agent was, in effect, getting for free is going to become less.

What does this all mean and where am I leading on this? The ability to bring new agents into the industry was created by a structure. The old law created a structure that was designed to finance and protect new agents in the industry. The new law no longer creates a structure that allows a company to finance and protect that company from those agents moving elsewhere. The way that the market is going to go is the amount of the money you can get through a new agent is going to reduce. It's very likely that this law is going to reduce the number of agents that this industry will bring in.

The agents groups, which are mostly larger agents, are actually in favor of the law. The National Association of Life Underwriters (NALU) or one of the other groups might say, "All my main members are successful." Those groups look at this law and say that this law is wonderful for existing membership because companies can pay out more. If you're looking at it from the point of view of new members to the industry, there's going to be a serious question that's unresolved and unknown. Will companies be interested in financing new agents into this industry if the laws that existed in the past to allow this new blood to be brought into the industry no longer exist? How are those companies going to protect themselves?

The change is coming, and it's going to come rapidly, because, once this floor is passed, its change will be based on "file and use." You just submit the plan and you do your demonstration of self-support. The self-support demonstration is on marginal expenses and not fully allocated expenses, which means it's even a loose definition of self-support.

This thing will run fast. Companies will come out with new ways of compensating. What if one company says, "We're going to compensate the higher producing agents better than the lower producing agents by a wide amount," and they might go down to the agents of the company down the street and say, "Oh, yes, by the way, you know, if you come to my company, I will basically pay you high compensation for big production." There will be a major movement of high-level agents between companies. That's the world we're moving into.

You have to realize that New York did constrain the markets outside of New York to some extent. When these limits go away, which they're very likely to do, outside New York, then whatever constraint New York companies had on the marketplace, is also going to go away. In fact, the New York companies may be the ones that are going to get very aggressive outside of New York because now they have a new game to play.

How you basically restructure your field force, the need in this new law to be marginally priced on your all expenses, becomes very real. You can't afford to get minimum production from the agents to get housing, to get fringe benefits, and let them place their business outside your company. You are going to have to rethink how you compensate people. This may drive the whole market to a much more brokerage or PPGA-type structure.

What we've known in the past of general agents (GAs) and branch offices, and I hate to use the word *exclusive* agents (no agent is totally exclusive anymore), are not going to be as exclusive as you think they are if this new law goes forward, because the ability to get more money, if they place it outside the company that's giving them housing, is going to be very real.

Something is going to happen. Will it pass in its current form? I think it's going to go through one more pass, and the consumerists haven't looked at it yet. I think that it has been presented as a means to levelize compensation. It may still end up with an aggregate first-year limit. But an aggregate first-year limit is not a 55% commission. It's not a 91% Regulation 49 rule; it's simply a companywide limit.

If this law went through, and there were rampant increases in agents' compensation, there could be a backlash, since the industry sold it to the insurance department as a means to lower compensation, and as a means to levelize compensation. If the reality became a massive amount of upfront compensation being paid, there could be a backlash of going back to strict regulation.

Don't forget—self-support is still something that the department is going to review, and they can get as much control out of self-support if they really wanted to by just saying, "Your demonstration is fictitious." The door is not completely closed for the department to get their hands into reviewing your work. Actuaries are going to have to learn how to do a self-support demonstration that's acceptable to the department.

Asset-based compensation is available right now for annuities. They're giving fast turnaround on approval of asset-based compensation. In the summer of 1996, we should have asset-based compensation for life insurance, independent of the law completely passing. The law may change this summer; if it changes, it will be effective January 1, 1997. If we don't get the law changed in 1997, it will be a January 1, 1998 change. We're looking for whatever change occurs on a January 1 basis.

Mr. McMahon: I think the theme is "change." With that, our next speaker is going to help us sort through the way we can work through some of this change. Roger Heath is a principal at the Dallas office of Tillinghast-Towers Perrin's insurance general management consulting division. Roger specializes in distribution effectiveness, corporate strategy, marketing strategy, and financial analysis in the life, health, and annuity markets.

Roger is a frequent industry speaker and a frequent industry author. He will talk to us about trends, the force driving compensation plans, and the concepts we need to pay attention to in designing those plans.

Mr. Roger R. Heath: Armand, speaking for those of us who have been outside the influence of New York field compensation, welcome to the real world.

I thought I'd try to give you some background and context for compensation plans. I will talk about some issues that you should consider so that when you put a slide up, you won't have to put up why our levelized compensation didn't succeed. Hopefully, when we finish this, you won't have to copy anyone else. You can use the concepts that come from this to develop your own.

The title of my talk is "Field Compensation: What Should You Pay For and What Should You Get?" If you've looked at industry or general press recently, there's a discussion about what employers are going through relative to the deal with their employees. Well, insurance companies, in addition to addressing how they handle and deal with employees, are seeing a changing nature in the deals they must make with the two other major constituencies they have: the consumers and the agents. There's a need by insurance companies to increasingly have that deal be attractive for both groups. While at one time, 25% to 30% of the costs of every life insurance policy that was sold went to paying the agent (something agents like), it translates into a premium or a load that the consumer has to pay (something agents don't particularly like). The problem is in matching these two issues.

Insurers must craft two good deals in a difficult environment. That is, the consumer wants a competitive product with value at a low cost that fulfills all their expectations for protection, income, health, and assets, as well as investment expertise. The agent wants a competitive product, not for its own sake, but to help make him successful. He wants good earnings potential and ease of doing business in an environment of a life insurance industry that has high costs. There are market conduct issues that are being addressed currently by the largest of our colleagues, but will soon filter down to the rest of us. There has been flat productivity for the last 25 years, and there are other pertinent field productivity issues that are hurting or constraining us.

Field compensation is an integral part to the overall distribution challenge that we all face. The compensation challenge is fundamental to that. It’s not the sum total of it, but it’s a big piece of the issue that we have for lack of productivity in our distribution. Compensation, a redefined sale, and roles and behavior should drive that compensation. Field needs should be addressed. In other words, we should not just look at what we want, but what agents need and want.

I’m going to talk about compensation design. Those issues should be approached with discipline and in the broadest context. We’re going to try to stand away from compensation, from the field compensation issues, and the numbers, and talk so that we can expand the paradigm we use to determine compensation issues.

First, distribution, especially field compensation, is the largest expense for most companies. This is taken from some work that I do with clients that show that about two-thirds to three-quarters of most of the expenses of a life insurance company is distribution in some form. Agent compensation and field management compensation is a big piece of that. Compensation, in addition to being expensive for the company, is a vital link among the four principal players. I have added three—a player to the traditional agent, buyer, and company. Also, I added field management because I consider it to be as or more important than the agent in this process. I gave the customer a larger influence because the customer is in a process in today’s environment of driving things.

All four players seek a cost-effective arrangement that ultimately has to be mutually beneficial for the entire group. Each group—customers, agents, field management, and the company—is in its own mind sort of balancing cost and benefits. The customer sees it as cost premiums, loads and charges, and personal effort in determining how to get his needs taken care of. They may not see the loads per se, but they certainly see the benefits that go with it. If the benefits of protection and investment savings, or providing a relationship is not what consumers want, or it costs too much, they will go some place else.

On the other hand, agent and field management have as their cost personal effort: "How much time and effort does it take me personally to make a sale or to manage that rogue agent that I have to deal with? And how much hassle do I have to go through to get what should be a simple policy approved by the home office?" The benefits, on the other hand, are compensation and cash, recognition, and satisfaction for a job well done.

The company sees as its cost, expenses, capital, and benefits and claims. Benefits, hopefully, will get profits and growth through satisfied customers and productive agents. Our role in compensation is to help balance some of those costs and benefits. One of the ways to deal with this is to think about it in terms of how the company touches the customer, and what is the agent's role. If you're going to try to pay an agent or increase or change their field compensation, it might be a good start to have a sense of what role you want them to play.

There's the process of customer development, for example, taking a market which is unknown to you, transferring them from being unknown to being a prospect, going from being a prospect to making a sale, then on to delivering service and subsequent sales and service. Who should look at each of those steps? Typical companies I visit recruit agents to be renaissance people to perform almost all of those steps. Is it so important? Is that the way to do it? Some think it is. Companies like IDS have decided that going from unknown to prospect, and from prospect to a good portion of the initial sale should be done at the home office.

In deciding on field compensation, we must also address business and operational issues because they're going to help define the roles and the ultimate compensation requirements that are required. In other words, we have marketing and sales strategies where we're answering questions such as: "Which customer and markets are we going after? What products are we going to sell, and what channels are we going to go through? What's the mix of channels?" We need to manage the distribution, which we'll discuss in a second. For distribution productivity, questions are: "What is the performance score card, and what are the root causes for success or, in some people's case, not much success?"

Success in our field compensation requires that all dimensions of the distribution be aligned. We shouldn't look at just compensation and rewards in isolation, but also what is the role of the field versus the home office, and what are their roles and responsibilities? How should we organize, manage, and staff the distribution function? What kind of sales and support processes do we put in place? And how do we use technology and the other issues? Each of these things should have an influence on compensation. We need to answer questions such as, "Do you want a multifaceted relationship and What role do you want the agent to play?"

One of my clients has a high percentage of households that have only one of their products. A much smaller percentage have two products, and a minuscule percentage of the households that are their customers have four or five products. Those that have four or five products represent something on the order of 25% of the products that are in force. How did they get to those, and how can we expand that? If your agents are going to play a role in that, your compensation probably needs to address that as well.

Should there be a stronger relationship, and how will you get the agents involved in this? Again, from work that I've done with clients, I started by asking them how many of your policyholders are orphaned, and they had a very narrow definition of orphaned. That is, there was no agent assigned. We started asking questions and found out that was 10% or 11%.

When you ask them how many haven't had contact in the last 6 months or 12 months with their agent, you'll find the answer was a pretty high percentage. How many of them have a mutual relationship where the only thing they do is talk about beneficiary changes periodically? Once again, the answer was a pretty high percentage. And how many of them have strong relationships? It turns out that very few really have relationships where they're customers. Should agents be participating in that? I think so. I think most of us would think that's where agents strengths are, and yet as T. S. Elliott would say, ". . . between the doing and the saying falls the shadow."

Beyond a good deal, what do agents need? Well, all people work to a certain comfort level. You work hard, but at a certain level, greed just won't do it anymore. You decide that you'd rather spend time going on vacation or spend time with your son. That's something where, at a certain point, those agents get comfortable. There's no amount of additional compensation, as a practical matter, that they're going to go for.

The next effort is that agent effort and premium, assets accumulated, profitability, or face amount may not be related. If pay were proportionate to profit, all would be well. That's what many of my clients think. But I'm here to tell you that, for agents, effort is everything. If they can have people lined up outside their door wanting annuities that pay 5%, they don't particularly care that their whole life policy, which requires them to spend hours and hours of effort, pays a 55% commission. So it's their effort as well as anything else. Total compensation, in other words, means more to them than the commission rate.

The market for independent agents, as Armand indicated, is very competitive. They can take a hike anytime they want, and have been able to since 1905 in the rest of the U.S. Agents are not a homogeneous lot, so don't generalize about them. For a sales manager, compensation is at least as important, or perhaps more so, than the entire rest of what we're talking about.

Agent needs and roles change over time. Both Tom and Armand talked about how, when going to levelized compensation, these agents who have 500 to 1,000 clients, who have a market franchise or a support staff, love having levelized commissions. They can see how it's going to be good for their business. But what about other ones? Early in an agent's career, the potential is much better than the result.

Let's put it that way. They have high turnover. If you're paying only for results, then you're going to have a hard time bringing along anyone who might be good for you later because they can't possibly produce the results that you need for them if you're just paying for results. Later, they're more average. They have a few clients. They get some referral momentum, and maybe you can handle it in those things. But the real point behind this is that, as an agent, his or her success changes the role of compensation, its economics, and the deal you have with the agents should change. It shouldn't be one price or one compensation contract fits all.

Compensation should be redesigned in the context of your overall distribution system as well. In other words, it's the distribution cycle as opposed to the sales cycle. We go through recruiting, training, management, and they begin prospecting. They get paid for productivity. Those that don't make it, turn over. Each of these is interdependent, and we add value by looking at design.

The first column of Table 1 is headed "Party Mix" and that has to do with how much of your total compensation is fixed versus how much of it is variable. The next columns are what perception the sales force has about that; what kind of control management has, and how the compensation develops a sense of urgency or getting along with things today. This comes from a great deal of experience in many industries.

As you can see, if 90% of your sales compensation is fixed and 10% is variable, the sales force is asleep. You have much control from the management perspective, but the agents don't have a great deal of urgency about getting on with their sales. The reason I bring this to your attention is because people who deal every day in sales compensation and sales management issues across many industries look at what they consider to be a sales compensation scheme, that is, a compensation system that agents perceive as for gamblers, that delivers almost no management control and a sense of urgency that is outrageous to the point of ridiculous—it's a mix of 50% fixed and 50% variable pay.

TABLE 1
IMPACT MIX ON RESULTS

Party Mix Percentage*	Sales Force Perception	Degree of Management Control	Degree of Desired Urgency
90/10	Asleep	Highest	Lowest
85/15	Nice Reminder	High	Little
80/20	Motivational	Solid	Some
75/25	Gets Attention	Good	Meaningful
70/30	Drives Behavior	Moderate	Good
65/35	Significant Risk	Only Key Things	Significant
60/40	High Risk	Weak	High
50/50	Make Quota or Quit	Minimal	Very High
50+	For Gamblers	Almost None	Outrageous

* Midpoint salary and target incentive as a percentage of target total compensation

In essence, for all of the life insurance industry, we have 100% variable pay in terms of our compensation. I guess I would challenge Armand's changes to go from fixed to variable. I think you must find a way to get more fixed and still make money.

We end where we began. Ultimately, two good deals depend upon addressing distribution and productivity challenge, and field compensation is a key element in that.

Mr. Michael J. Francescone: I have a question for Armand. Would the new law apply to compensation paid on individual disability policies?

Mr. de Palo: The new law, as it's currently written, is limited to individual life and individual annuities. It will not apply to any health line or group policy forms.

Ms. Linda M. Springer: We have been very close to the Section 4228 rewrite process, not to the extent that I would say that Armand has, but there are some other aspects to this that I think are worth pointing out. These are just comments, but you might want to make a comment on them as well.

Because the New York law in its current form has been extraterritorial; it has led to some inefficiencies and results that I think the new law in Albany will help remedy. One of these is the fact that companies have had to establish subsidiaries, either non-New York subsidiaries or subsidiaries in New York for companies that are not currently in New York. The duplication and its filing, and statement preparation, and staffing has really led to a situation that many companies are not comfortable with. But, because of the extraterritorial situation, those companies feel that to compete effectively in the other 49 states they have had to do that. One of the benefits of this new law would be to eliminate that.

Mr. de Palo: The law retains extraterritoriality; it eliminates the complexities, but the law will remain extraterritorial.

Ms. Springer: That is correct, but the first-year limits, which have been the source of the problem, will not be there. That has been the cause of having the subsidiary arrangements.

In addition, I think that because of the situation of mass agent proselytization, while we don't know, it remains to be seen what will happen there. I seem to think that's somewhat overstated. It certainly hasn't happened outside New York to the extent of companies paying 135%. I think the trade-offs there would be enormous in product, competitiveness, in the company profitability. While there might be some of it, I think that our position would be slightly overstated.

Mr. de Palo: Let me comment on that last statement. The point I was trying to make is 4228 existed and created structure, right or wrong, that constrained the market. There's no doubt when 4228 is changed, agents who were used to getting 91% are going to put greater pressure on their companies to pay higher compensation to them for higher production and better persistency.

The crisis is not to pay them that higher compensation. It's a fact that the lower, less productive agents are going to see their compensation go down. There will be a period of time when the pressure to pay more to the higher producing agent is there. The companies have not yet come to grips with having to reduce compensation to less productive agents, which is the pricing trauma, which is transitory; it will go away.

Five years down the road, we'll probably get to a better structure that higher producing agents will make more money. The less productive agents will make less money. How we bring new agents into the business is probably an open question right now. But during that transition period, for the companies that were constrained by New York State, everything is in play, and they're going to have to figure out how they're going to make that transition. The transition is what's going to be painful.

From the Floor: I have a question for Armand. You just mentioned that the new law would not cover group. I write group universal life and have a great deal of fun getting my compensation through the 4228. Any speculation on where do you think the group folks will end up since we're not going to be covered by the new law, and the old law is a real mess?

Mr. de Palo: Where I think it's going to end up is, if you're really a group contract and if there's any employer sponsorship, you're just going to be able to do what you want. There are no inside limits at all in this law. There's no concept of first-year commission or first-year expense allowance. Where this is ending up is if it's a group policy form and there's an employer sponsor, you're going to be out of that whole loop. You're just going to submit your policy forms to Albany. You're going to submit your plan of compensation to Albany just because it's a group policy form. But submit it and put it on file, and that's going to be the end of it.

Mr. McMahon: I have one question for Armand regarding asset-based compensation on in-force annuities: Is there any development in New York?

Mr. de Palo: Well, as you know, we got the circular letter through on asset-based compensation for annuities. As I mentioned earlier, we're working on the one for life insurance. Imbedded in the regulation is the ability to pay 25 basis points on in-force business if you can cost-justify that and if you can show the price is still profitable.

The department is also willing, without changing the existing law, to let you go back and look at the original annuity pricing and see what you paid out as compensation. If there is a margin you did not use, they will let you come back prospectively and pay that as asset-based compensation on in-force business. I think most companies, if they want to, are going to find that they could possibly have 25 basis-point trailers that they could pay on in-force business. So that door is not closed.

Ms. Rebecca F. Evans: Is that levelized commission going to take place on new products only? Or is there going to be repricing on existing products during a transitional period?

Mr. de Palo: New York never lets you change compensation under the current law on products that are already sold. The view has always been that compensation is defined in advance. So levelized compensation would have been an issue of new plans only, unless you can go back and show how you have unused margins, and they would let you do that. But most current compensation on life insurance, in particular, had very little unused margins that you can come back and pay anything on for in-force business.

The new law, if it goes through, would purely be a self-supported provision. You must demonstrate that, with the compensation you already paid and the compensation you're going to pay in the future, the product is still profitable to the company. There's nothing in the new law that would stop you from doing it once you made the demonstration that over the life policy, from its inception to what you would then choose to pay on the in-force, is still profitable to the company.

Ms. Evans: What are your thoughts on levelized compensation?

Mr. Heath: Well, I guess I tend to have a slightly different view than some of the rest of the panel and others in terms of levelized compensation. I don't necessarily think it's the panacea. I think you need to undertake a basic understanding of what you want the agents to do and what kind of products and services you want to deliver; then come up with a distribution approach that would be successful and find a way to incent your agents to do that.

If people pay attention to that, I think it's unlikely that levelized compensation will end up being the magic bullet that helps you do that. And you just have to think about what do you do when you get levelized compensation and somebody has a nice in-force book of business, and they're making $50,000 a year. Try to get them to sell something then. If you stop to think about that for a minute, you won't necessarily go to levelized compensation everywhere.

Mr. de Palo: I want to comment on levelized compensation. If you do go to pure levelized compensation, your ability to bring new agents into the business becomes much more difficult because you're then faced with much greater finance costs. If you don't have control over the agent, which is where the marketplace is rapidly moving, who's going to finance that agent?

New York always limited you to giving advances on loans against first-year compensation. If you levelized your scale, there's less first-year compensation. The only way I see financing agents into the business is having, in effect, self-financing, that is, having their renewal compensation advanced to them with some hooks into them. Otherwise, it's just going to be too prohibitive for companies to be financing agents into the business, only to find out that their production comes outside the company that paid for their training.

Mr. Beresford: I guess I could try to answer the question directly. I think it's very difficult if you already paid heaped commissions out on the contract to go back and levelize it. It's the best of both worlds, at least from one perspective.