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Trends in Agent Compensation

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Summary: Competition from other providers of financial instruments, market conduct concerns, and increased pressures on profitability are some of the reasons companies are looking at alternatives in compensation of their agency forces. We discuss alternatives that companies are considering in the compensation area including levelized commissions. Discussion includes considerations of:

- *financial implication of moving to levelized compensation,*
- *product design implications,*
- *actual reduction in commission expenses versus equivalent present value of compensation,*
- *implementation of revised commission basis for all issues versus for replacement sales only,*
- *presentation to and acceptance of field force to change,*
- *relative impact for established agents versus new agents, and*
- *other reasons besides cost savings for alternative compensation arrangements.*

Mr. David M. Brown: I will give a theoretical overview concerning distribution and where I think it's going. Doug Brooks, from Mutual Life of Canada, will discuss how Mutual Life of Canada moved to levelized commissions in 1989, and the companys motives and successes. Tom Guay from Northwestern Mutual is going to

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counter Doug and talk to us about why staying with front-ended commissions may still make sense.

You can't think of compensation in isolation. It's only when you've imagined how your salesmen are selling, that you can start thinking about compensation. I'm going to consider the things that may change the distribution process which will then change compensation moving forward.

DISTRIBUTION STRATEGY FRAMEWORK

A simple framework was devised by a couple of U.K. actuaries who were trying to explain what was going to happen when banks and other financial services started competing with insurance companies, to try and help people understand which structures would be successful.

The basic idea is that you need to have your distribution structure aligned with the complexity of the consumer needs and the complexity of the products you're trying to sell.

Hence, when you have simple financial products like bank accounts and loans, you can use passive distribution channels, such as the bricks and mortar of the bank. As you move into more complicated financial products, perhaps term insurance, annuities, or property and casualty insurance, you start to need a more active sales process to make those sales. Then, you move into complex products, perhaps cash value life insurance and health products, and you need an active distribution channel. As you move into the more active distribution channels, distribution costs are higher. You need to load higher margins into the products to support the distribution channel, and the product value to the consumer is lower.

Two things happen as we move along the spectrum from simple to complex financial products. The importance of the relationship increases, and beyond a certain point "sales pressure" is needed.

The relationship is necessary to build the trust which is necessary to overcome the barriers due to the intangible nature of the product and consumers' lack of understanding of the product. Obviously, lack of understanding increases with product complexity but also the risk of significant financial loss increases, both of which lead to the need for the relationship. Beyond a certain level of product complexity, the need for what I will call sales pressure also increases. It's not enough with complex products just to present or to make the consumer aware of a product. Typically the salesperson has to drive through the sale. This is what is behind the old adage that life insurance has to be sold, not bought. That's because of the perceived need for sales pressure.

Let us investigate this framework by considering what has happened and what may happen when there's misalignment between the complexity of consumer needs, the complexity of product value, and the value added by the distribution channel. For example, 10–20 years ago the consumer's need of investment, which isn't particularly complex, was being met by a complex product, cash value life insurance. This resulted in the substitute product, which was mutual funds, taking a large share of that market.

The misalignment of product complexity and value added by the distribution channel can help explain why it's difficult for active distribution channels selling complex products to also sell simple products like mutual funds and annuities. The culture of the organization supports high rewards, not frequent small amounts. You can think of it the other way as well where property/casualty sales forces have problems selling life insurance. The culture doesn't support the rejection and the high pressure that's needed to sell life insurance.

Aligning the complexity of consumer needs with the value added by distribution may become increasingly important. Face-to-face contact with a professional is not cheap and should only be used where the professional can add value. Otherwise the competitiveness of a product, which has to support the cost, will suffer needlessly. Moving sales to cheaper distribution channels allows higher product values, which will benefit insurance companies as well as consumers. Increasing consumer sophistication and product disclosures may lead to an increase in direct sales. Banks and mutual funds will use existing relationships to sell at lower costs than traditional sales forces can. There may be a trend to fee-based work which will tend to cost less than commission as those who buy do not need to subsidize those that don't. All of this means that the existing ways of selling insurance, which are already being strained because of a lack of inefficiency, may not be sustainable.

DRIVERS OF CHANGE IN DISTRIBUTION

Changes in the distribution process will be driven by several factors: deregulation, regulation, use of relationships, and profitability.

Due to deregulation, it will be easier for banks to move into insurance (and for insurance companies to move into banking, if they want). Because of their customer base and their ability to share costs with the banking operation, they will clearly be in a strong position to distribute life insurance at low cost. Clearly any organization will look long and hard at the way it does business when confronted by new entrants with significant cost advantages.

I think we've already seen with the model regulation on life insurance illustrations a move to try and improve the quality of information that's available to allow

consumers understanding to improve. Consider increased disclosure together with consumerism and technology. Even if individual policyholders are not able to use the information, the pressure groups and consumerists will try to use it to improve the product value that's available. In the U.K., there is full expense disclosure which means that the customer must see a table which has policy duration, premiums, premiums accumulated with interest, and cash value. The difference between accumulated premiums with interest and the cash value is expressed as the effect of total charges by the company. Because it's accumulated with interest, it's a frighteningly large number.

You also have full commission disclosure, which is the total distribution costs to your organization essentially divided by production to come up with commission per unit of production. So, if this is 1.5 and if you have a $1,000 premium sale, then you show to the consumer a $1,500 cost of distribution, and he may perceive that as the agent getting $1,500.

The regulators in the U.K. make all this information publicly available. They produce league tables to rank generic products. They'll show commission, cash values at five years, and cash values at 20 years. They produce graphs showing the correlation between value and the level of commission. It's all publicly available in one document. When you combine this with consumerism and technology, I think you can start to see the risks of being uncompetitive and, hence, having your products singled out.

Marketing and branding, or the use of existing relationships and reputations to sell the products, will become increasingly important, whether using existing insurance relationships, financial service relationships, or even relationships totally outside financial services.

Many companies are struggling to make adequate rates of return (profitability) on new business. Companies are wanting to internally change and are looking to try to improve the efficiency of the process. Another aspect of profitability is mutual funds. Mutual funds have enjoyed significant growth over the past years. But, their market is now starting to mature. Mutual funds are going to be looking to expand outside their traditional markets to find other avenues of growth.

I just briefly touched on banks and insurance. It's often said that banks will only be able to succeed in insurance selling simple products. Banks are what might be called marketing led organizations. That is, traditionally their products are sold using the direct relationship between the consumer and the organizations. There is no salesperson in the middle as there is in insurance, which gives them a high level of control over distribution. However, the typical insurance sales force and sales

management would conflict with the cultures of the traditional bank, leading to problems. Having one set of employees on salary and one set of employees on commission will be difficult.

In the U.K. and Europe, they have tried to introduce lower pressure sales forces with, for example, salary plus bonuses rather than commission. If you're trying to have a sales force which works with less sales pressure, then they work best with simpler products. They make sales of simpler products, based on existing relationships, using relatively low pressure sales forces, at relatively low cost. The big question is, what proportion of the products in the U.S. market can be classed as simpler, less complex products.

FUTURE DISTRIBUTION MODEL

In the future, we can expect some increase in direct sales, when consumer needs will be met with no sales pressure. This may be through direct response, perhaps the Internet. We will also see, perhaps, work site marketing affinity groups, banks, and/or mutual funds that are going to be trying to sell simpler products with limited sales pressure. That is, a portion of the market will be served at much lower cost than current traditional channels. What do existing or traditional distribution channels need to do to compete? One option is to provide high value-added services, dealing only with complex consumer needs. While this may be the preferred option, the market is unlikely to support all the existing competitors. The other option is to try to reduce the cost of meeting main market consumer needs. To do this companies need to simplify the whole process of buying life insurance and become much more consumer focused to simplify consumer needs. That essentially allows sales to be made with less sales pressure and, hence, at less cost. At the same time, they need to try to reduce the cost of developing relationships. For the banks and mutual funds, the cost to develop that relationship is very low. Insurance companies need to find ways of producing relationships at an equivalent cost.

I said earlier that the key thing about compensation is that you don't think about compensation first. You need to understand the roles that your agents are going to be filling and how they're going to operate. What skills are needed? Once you have a vision of how your sales force is going to operate, then compensation just fits in. If moving forward we're going to be using agents in different ways, then clearly compensation needs to change as well. The main challenges that will impact agent compensation are: leveraging existing relationships, increasing structure and control of the sales force, and simplifying consumer needs.

Complex products need some form of relationship and obtaining the relationship currently leads to significant costs. Reducing the costs of obtaining relationships

and increasing the structure and control will allow companies to compete with, for example, other financial service companies. Simplifying consumer needs will allow us to further reduce the costs involved in selling.

We currently have a few agents who are very successful and do very well under the current situation. We also have a lot of agents who struggle to succeed. If we can succeed in the above challenges, then we will have made it easier to sell life insurance. All agents will be more productive, but we will pay them less per sale, which gives us a much flatter distribution of agents' income.

LEVERAGING EXISTING RELATIONSHIP

Let us consider some of the roles an agent can carry out. There's client acquisition, which has historically been the major determiner of success and the focus for current agent compensation. The agents also need to be client relationship developers, which allows them to start gathering information, which allows them to move into the sales process. This allows agents to apply specialist knowledge, which allows the agent to apply sales pressure to close the sale. Hopefully, he or she then continues to develop the relationship after the original sale, which allows him or her to re-enter the sales process later on.

What I think is going to happen is, essentially, the focus of an agent's role will have less concentration on client acquisition. Currently, the whole focus is on client acquisition. We need to find ways to focus the agent on developing the client relationship.

If, for example, we imagine a bank, it's quite possible that somebody outside the insurance area is going to be responsible for the client relationship. That person is going to identify the need for insurance. That person may then pass the warm lead across to the insurance agent. The insurance agent will only be responsible for applying specialist knowledge and applying some sales pressure. The compensation for people in those sort of situations must be significantly different than the compensation for traditional agents.

Insurance companies need to become better at leveraging existing relationships, not just lead generation. I think of lead generation as being something that as soon as you stop working on it, the leads dry up. Leveraging existing relationships is putting into place a relationship; e.g., with a bank, where the bank is continually getting new clients, which gives you a continual stream of leads. If the insurance companies can put into place a way of getting relationships, allowing us to move the focus of agent pay and activities away from client acquisition, we can move into a completely different environment.

To obtain relationships, we can use banks, mutual funds, work site marketing, affinity groups, or existing policyholders. As an industry, we've been very bad in utilizing existing policyholders as an available asset area.

If the focus is on leveraging relationships with existing policyholders, then the current form of compensation, which focuses on client acquisition, must change. For example, levelized commission, to me, is an attempt to maximize the use of your existing policyholders, which therefore, allows you to reduce the significance of client acquisition. Assets under management focuses on the relationship. Assets under management obviously link agent compensation with company objectives and are simple, but I'm not sure whether it's linked to consumer needs or to the roles that the agents carry out.

Financial service organizations, e.g., banks and mutual funds, have databases of relatively financially sophisticated clients with existing financial products. Due to the warm leads and the relative ease of turning these into sales, many people argue that the appropriate way to compensate these people is by salary plus bonus. The main point is that the result is significantly lower costs per sale.

Nonfinancial service relationships may also be used to generate insurance leads. In the U.K. a couple of new entrants into the market were trying to use their relationships gained from outside financial services, to sell within financial services. Virgin, and you may have heard of Richard Branson, had a very strong reputation for being consumer oriented. He started by selling simple, no frills, mutual funds direct with the lowest charges in the market and he sold significant amounts. He's now selling term insurance direct. That is, he is using relationships based on a strong brand image based outside financial services to sell financial services.

Marks & Spencers is a retailer that has an incredible reputation for value and quality. You can now go into the corner of their stores and there are brochures on a whole array of life insurance product. Essentially you pick one up and they use very soft language that if you have a need, this product may be appropriate for you, but there again, it may not be. If you're interested, call this 800 number and we'll send you a more detailed brochure. But, there's no contact at any stage with an insurance agent. Many in the life insurance industry are saying, "No, life insurance needs to be sold. It's not going to be bought. They're going to flop. They're not going to have any success." Well, if you talk to Marks & Spencers, they believe that they are very consumer oriented. They understand the consumer. They don't think it's going to be easy to sell this way, but they believe they're building up knowledge and experience of how to sell with limited or no sales pressure. They may need to change, to introduce some form of sales pressure to make the sales, but they believe that the knowledge they've built up in going through this route will allow them to

ultimately apply a lot less sales pressure and to understand the consumer a lot more than the current industry, which they believe has little ideas about being consumer focused.

INCREASING STRUCTURE AND CONTROL

The challenge to insurance companies with traditional distribution channels is to try and improve their efficiency. One potential way to improve efficiency is by increasing the level of control over the agents' operations but, at the same time, retaining the entrepreneurial spirit. Instead of operating a sales force as groups of small individuals, we can become more efficient by bringing certain functions under central control.

Information management can clearly improve to increase the efficiency of the sales process. There are many companies who still can't tell you, for an individual client, how many different policies that client has. We need to improve our use of information which then feeds back into lead generation.

Currently, all agents are supposed to be able to apply specialist knowledge. Would it be more efficient to use agents more as client relationship managers? Could a company have a smaller number of people within the sales force who are responsible for applying specialist knowledge in certain circumstances? The skills of the standard agent would then be very different. He or she would no longer be responsible for client acquisition or for applying specialist knowledge. He or she would thus be recruited and trained for client relationship skills. His or her responsibility would be to develop and maximize the value associated with individual clients.

Other opportunities are where we have agents working in the same market segments, such as with long-term care and survivorship. Different groups of agents will be trying to make sales to the same individuals. Clearly there are opportunities for them to exchange clients to improve the efficiency of the whole process.

SIMPLIFYING CONSUMER NEEDS

Companies need to become much more consumer oriented. This is going to allow consumers to understand the products more, which will make the sales easier, which allows us to pay agents less per sale. I think we need to try to improve the quality of information. If you ask your friends from outside the insurance industry what insurance products they have, ask them to explain why they have those products. See how many can give you anything more than very vague answers. Then, read the material the insurance companies are giving these people. See how many paragraphs you have to read over three or four times to understand what the

product is and how it works. What chance does your average consumer have of understanding these products?

Many life insurance products are sold to meet a savings need. But what information is provided to allow a consumer to understand what element of his or her premium meets his or her protection needs, which can then be compared with term product costs, and what element meets his or her savings needs? For the savings element, how can we show which returns will compare well with alternate forms of investment?

The way to simplify the whole process is to make the product closely fit the consumer need. Consumers, I think, broadly understand their own needs. They understand their needs for protection. They understand their need to save for retirement, but they don't understand insurance products. As soon as the product doesn't closely fit with the consumer's need, then I think the focus turns to the products. If you can keep the two closely matched, then that allows the sales process to focus on the consumer needs which makes it a much easier sale. Part of this is product flexibility. Imagine an agent in the sales process and a consumer asks, "What happens if?" If the agent can say, "Yes, my product copes with that." Then, I think that simplifies the whole process. The consumer then no longer has to worry about it. Any other type of flexibility is detrimental to the whole sales process and the ease of selling insurance, as it just complicates the process by increasing the number of meaningless decisions and the length of the material available.

Clearly being consumer oriented and simplifying the insurance product are not straight forward tasks. However, for companies that succeed, agents' ability to sell will be increased, which allows the average compensation to fall.

The consumer pays premiums and we get interest on those premiums. Essentially, that's the pie which needs to be split up three ways. The agent needs a piece, the company needs a piece, and the consumer needs to get the rest. If you try to give any of those three parties more, then the two other parties need to receive less. What we're trying to do is not just split up the pie differently. We're trying to increase the size of the pie. We're trying to increase persistency by focusing on relationships and by making the products fit consumer needs better. We're focusing on maximizing the value of the relationship with the client. At the same time, we're also cutting down the slice of the agent by making him or her more productive. Hence, agents as a group, will benefit. Their job will be easier and there will be fewer failures. Consumers will benefit through higher product values and through fewer inappropriate purchases. Companies too will benefit by increasing their ability to compete in an increasingly competitive marketplace.

You need to focus on distribution strategy first. Then, once you've worked out the model of how your agents are going to work, compensation strategy fits in alongside. Clearly, we need to move to higher agent productivity, which allows lower costs per sale. Being more structured in the way we try to use our sales forces and by trying to be more consumer focused to simplify the consumer needs will help. This will allow agent's income to be distributed more evenly among agents and, therefore, have more successful agents. That income will be focused on client-focused activities. It may still be up-front commission. The way you use your agents should determine the pattern of payments. This, hopefully, allows us to get into a virtuous circle as opposed to the vicious circle where we may be now.

Mr. Douglas W. Brooks: I'm going to discuss level commissions and, specifically, our experience at Mutual Life of Canada with the level commission concept. We moved to a level commission basis eight years ago, and have certainly learned a great deal from the experience. We have made some changes to our original concept as we moved along. But, it certainly has been an overall success from our point of view.

I'm would like to explain our objectives in moving to the level commissions system. We had a very successful distribution system at the time. Certainly, a logical question to ask, and what some people at the company, the board, and so on did ask, is why take such an expensive and potentially risky step potentially endangering an asset that we had in terms of our distribution system?

Second, I'm going to give you some background on our distribution system and an overview of our level commission system. Our distribution system has some unique characteristics which gave us some unique advantages in moving to a level basis. Therefore, it's important to understand our system in that context. But, I think some of the lessons that we've learned and some of the things that we've changed are generally illustrated as opposed to our specific type of compensation system.

Third, I'm going to talk about some of the results that we've had and some things we've learned. As I said before, while we are quite satisfied with our level commission system, it has had some tinkering over the years as a result of some problems that we've had and other things that we've learned as we've gone along. Finally, I'll touch on a few other issues which come into play.

We had a number of objectives in mind when we moved to our current level remuneration system. There's not a whole lot new in these objectives. They're fairly familiar ones. But, I'd like to go through them anyway as it will also give a basis for assessing the success of our system. The basic thrust of our level commis-

sion approach is to align the interests of all parties involved: the customer, the agent, and the company. David was just talking about the three slices of the pie. Although, in Canada, there's a fourth slice of the pie that's increasing and that's what the government wants to take from it. In terms of the primary slices, the customer, the agent and the company, it's important to keep those objectives in the same direction. We believed then and continue to believe now that an approach which puts the best interests of the customer at the center is the most sustainable approach and that anything which puts consumers' interests in opposition to the interests of either the company or agents won't be sustainable in the long run.

The level commission provides an orientation towards customer service on an ongoing basis. Our previous heaped commission scale often entailed a bit of a financial sacrifice for agents to the extent that they got very little compensation for conserving an existing policy. However, agents may also miss repeat sales as a result of lack of service. These sales may often be easier sales than to new clients. So, there are advantages from client persistency beyond just the retaining of the existing client and the commission that goes with that particular policy.

Obviously, one of the hopes of a level commission system is that it will result in lower rates of policy termination as a result of improved customer service. This, in turn, will result in unit cost improvements as the size of the enforced block increases. Level commissions also result in lower pricing risks. As early policy terminations do not result in significant losses, pricing becomes relatively insensitive to policy terminations at all durations, provided the cash values follow the pattern of asset shares.

We expected the agent retention would improve as a result of moving to a level commission basis given the longer term values that a level commission system would provide. Agents would see the value of their business increasing on an ongoing basis. Finally, as a result of improved retention, both of policies and agents, we anticipated improved competitive position as a result of lower costs and greater productivity.

While talking about our objectives, I'll also just touch on a few things that this particular system was not specifically intended to accomplish. First, in 1989, when we moved to this basis, we had no intention of lowering the overall compensation costs. We expected the overall impact on pricing to be neutral and, in fact, that's the way in which we came up with the particular level commission rates. Obviously, this neutrality was true in aggregate and there were some differences for specific products, ages, etc. Of course, there was a redistribution of income among agents, to some extent. Specifically, agents with high rates of policy termination, tended to have incomes drop. Agents with very good persistency had increases in

income. Second, although we were certainly aware of the fact that disclosure might become more common, we didn't view disclosure as one of the specific reasons in moving to the level commission basis that we did. We did, however, want to be able to say that our remuneration had the interest of customers in mind.

Finally, we looked at the impact on policy design. For example, tendency towards higher early cash values was not a factor in our decision. In fact, higher early cash values don't seem to do much for potential clients. Generally, the higher duration values tend to be a bit less because of the ongoing commission. Those are the cash values which often receive more attention than the early ones.

As I mentioned earlier, it's important to put our move to a level commission system in the context of our distribution system. I'll briefly run through some of the key points of our distribution system. We have a career agency system with agents who sell life insurance products and other retail insurance products exclusively for us. Similarly, we do not sell through any other channels. This is true of our Canadian operation. This isn't the case for our group products, which can be sold by other agents or brokers. Similarly, our agents may sell group cases for other companies. In discussing our level system commission, I'll be dealing with our system for individual life insurance and other retail insurance products. What I mean by that is products like critical and long-term care.

Our branch managers are employees of the company and they don't sell products. They're there to recruit, train, and motivate the agents in their agencies. Currently, we have about 2,000 agents and managers located across Canada. We moved to our current remuneration system in July 1989. At that time, we had about 1,400 agents and managers.

Our system has a number of components. Again, I'm just going to touch on these. The most basic is a level commission paid for the lifetime of the contract, assuming that the contract has lifetime premiums. The rate of commission varies, but is 15% for our most popular permanent product and is lower for term insurance and some other products. Also, it generally grades down at higher amounts and at higher ages. This commission is paid at the time each premium is billed. The commission frequency is the same as the premiums frequency.

The second component is called growth commission. It's intended to provide incentive for agents to increase the size of their block and is also quite important to new agents. It pays three times the increase in an agent annualized commission in force from one month to the next. For example, if an agent had $40,000 of annualized commission in force at one month end and increased this during that month by $500–40,500, a growth commission of $1,500 would be paid. Agents with large

blocks, obviously, have to make up for policies going off the books, while for new agents, virtually all sales operate to increase the block. Some new agents get a lot of their income from this growth commission.

The third component of our system is what we call business commission. That's an override of 20% on other basic insurance commissions. It's intended to enable agents to cover expenses of doing business, such as rent, secretarial assistance, furniture, equipment, and so on. When we began in 1989, those were the three basic components of our system. We have added one more since then. It's called policy commission. It pays an agent either $500 or $250 for six new sales in a month. By new sales, what I mean is sales that aren't replacements of existing mutual life policies. The amount, the $500 or $250, depends on length of service as an agent. Agents with four years or less of service, get the higher amount. That's done partly to maintain their incomes at appropriate levels and also to encourage them to get off on the right foot. For policies in excess of six per month, there's a per policy commission of $100 or $50 per policy paid.

The other main feature of our system is the value an agent builds up in their block of business which we call commissions or, rather (CORE). CORE represents the present value of future commissions, a percentage of the future. In our system, the company always acts as the intermediary between agents. We provide effectively, a guaranteed price to an agent who is retiring, terminating, or giving up a portion of their block of business. The agent who is, for example, retiring, receives a payout over ten years based on the present value of future level commissions. This payout is level and does not depend on the termination experience of the block of business that they are giving up. The agent who acquires this business has their commission reduced over the next ten years by this same amount. So, the net effect to the company then, except for some minor timing differences, is neutral. The present value of commissions is determined using both mortality and policy termination as well as interest, of course. This same mechanism is used when business moves from one agent to another as a result of clients moving or occasionally just deciding to move their business to a new agent.

One of the concerns when implementing a level commission system is how to make it attractive to new agents who do not have a large block of existing business. I talked about our growth commission, which is a significant portion of new agents' income. We also provide a financing plan with a monthly payment, which we call a development commission. The payment of this commission depends on meeting minimum sales results. I also mentioned the increased policy commission paid to new agents. When we started the development commission, it was higher than it is now. At the time we implemented the policy commission, we reduced the development commission. The concern was that too many new agents were collecting the

development commission and not selling. So, we reduced that and put in the policy commission. The subsidy that we pay now to newer agents is higher than we paid when we had a heaped commission scale. To make up for this from a cost point of view, the CORE, the value of future commissions, does not immediately vest for new agents. In fact, if an agent terminates within the first three years, no CORE payout is made. An agent acquiring business given up by an agent terminating within the first three years, though, does have their commission reduced by the appropriate amount, as if the agent was fully vested. CORE then starts to vest after year three and vests evenly over the following five years.

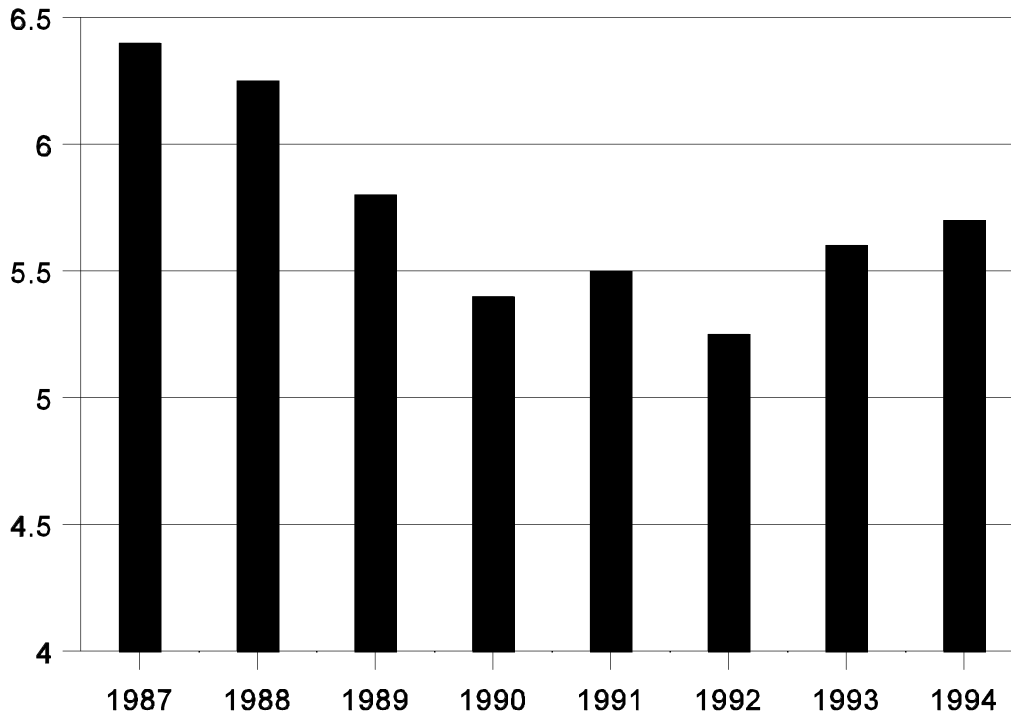
One alternative for helping new agents is to provide them with blocks of business from retiring or terminating agents. However, we have found that this has to be handled with a lot of care because the clients and agents may not necessarily be compatible. This is particularly true if the former agent was a long-term, older retiring agent and the new agent is a younger person. Matching the block of business with the agent is very important.

In retrospect, we see that one of the areas that we didn't spend enough time on initially was in determining appropriate compensation for our branch managers. We assumed that we could add overrides to the level commission system for agents, use similar concepts, and it would provide appropriate incentives. In fact, we've made a number of changes to our managers remuneration program. In particular, we've increased and added incentives that encourage agent retention. One of our fears, initially, when we went into the level commission system, was that managers might find it difficult to recruit and attract new agents to a level commission system. The initial manager remuneration system that we had was oriented to provide a lot of incentive for recruiting and, of course, we got lots of recruits. Unfortunately, the balance between quantity and quality needed adjusting. It's worth noting, however, that the level commission system has not been a negative factor in recruiting new agents. In fact, it is viewed as a positive by our managers in recruiting new agents.

What have some of our results been? Have we met the targets, the objectives that I talked about earlier? The most noticeable and immediate impact was on rates of policy termination. There was literally an overnight improvement. Much of this was related to orphaned policies. We had approximately 30% of our block where the original agent was no longer with us at the time we moved to level commissions. These policies, typically, had overall termination rates several percentage points higher than the rest of the block. Improved policy retention has been a factor, as well, in reducing our unit costs. Internal replacement activity was also dramatically decreased. We believe that appropriate activity still occurs, some term conversions and that type of thing. However the transactions that were not necessarily in the best interests of customers have significantly decreased.

Chart 1 shows the extent of the improvement in policy terminations. The years prior to the level commissions were 1987–88, The transition year was 1989. The years 1990–94, were under the level commission system.

CHART 1
LEVEL COMMISSIONS: RESULTS



In fact, if I were to split 1989 into two pieces, the first half of the year was quite similar to 1988 while the second half of the year, immediately after the move to level commissions, dropped to a lower level, approximately where the 1990 bar is. Personally, I found that result really stunning. I expected to see an improvement, but certainly didn't expect to see it as quickly and dramatically. In fact, looking at the chart, I suppose I could have made it a little bit better looking by leaving off 1993–94. The overall terminations have increased a little bit since 1992, but I believe those are not related to the level commission system, but due to other factors of relatively poor Canadian economy at that time and decrease in dividend scales.

A few other results were not as positive and required some adjustment. Some of our senior agents with a substantial block of business had relatively little incentive to sell. We've made some changes there, both in additional incentive such as the policy commission that I've talked about and also through introducing minimum

requirements. Life sales requirements also apply to qualifications for company conventions and other forms of recognition.

Agent retention improved more initially, as we had hoped. A big part of the reason for this was the manager remuneration incentives that I talked about earlier. There was also a minor shake out with the implementation of the level commission system. A few agents, and really relatively very few agents in the overall scheme of things, left for what they perceived as greener pastures. Typically, these were agents who were off to fast starts who didn't have large blocks of business in force and tended to be the ones with the high policy termination rates. At this point in 1997, our agent retention is improving and our four-year retention rate will be well in excess of 30% this year. While this is certainly very good by industry standards, it actually is more or less comparable to the agent retention rates that we had prior to the introduction of the level commission system.

There are a couple of other issues that come into play when introducing a level commissions system. If it is necessary to re-commission the existing block, which is quite likely if agent income is to be maintained at a reasonable level. There's a significant cost associated with this. This cost was applied primarily to the nonorphaned block of business, and agents did not receive commissions over again on orphaned business for free. They had to acquire that business. The cost was also reduced, to some extent, because of the growth commission which, on existing business, is effectively a recovery. Rates of agent termination have an impact on the recoverability of growth commissions as well. There are some situations, even with active agents, where we don't fully recover growth commissions for business going off the books since we never charge if that growth commission calculation is negative. Despite these offsets, though, the cost of moving to the level commission system, both in terms of the additional commissions and also the cost of developing the new system, were substantial. While the impact on pricing initially was relatively neutral, level commissions do result in pricing being more sensitive to interest rates, as the present value of level commissions varies far more than the present value of heaped commissions. With declining interesting rates since 1989, our level commissions have effectively become more costly in our pricing.

Mr. Thomas C. Guay: I'm taking the opposite end of the spectrum on whether level versus heaped compensation is right. I work at Northwestern Mutual Life. I'm an actuary, but I work right now out of our Field Financial Services Department, which deals with agent compensation issues and financial counseling and the like. You just heard Doug describe a very interesting levelized compensation plan that Mutual Canada has used for nearly a decade. What I want to do is discuss the merits of the traditional heaped compensation package.

I want to discuss why I feel companies are starting to look at heaped—or level compensation. I don't think very many companies have moved, as yet. Generally, I feel heaped compensation continues to be the better approach when comparing it to the levelized option. Afterwards I do want to explain some general trends in agent compensation. But, I want to talk a little bit about the Section 4228 modernization effort that has heated up recently.

Before I start talking about heaped compensation, let's take a look at what a traditional heaped schedule looks like. You've seen Doug's schedule to be roughly 15% in every policy year. For companies licensed to do business in the state of New York, the effect of the New York Insurance Department Section 4228 is that most permanent life insurance pays 55% in the first year, with 5–6% renewals in years two to ten, and 2% in years 11 and later, with bonuses and expense allowances paid on top. I should say that most of my comments, like Doug's, are primary talking about life insurance, although, the comments could be easily translated into long-term care or individual disability income.

The heaped structure is really quite simple. Some commissions, on top of expenses allowances, can be substantial. Commissions may comprise 25-35% of the first-year premium for some companies. Bonuses are often based on productivity and persistency. A lot of what we're seeing is a direct function of what's allowed in New York's law. But, as you well know, many companies don't operate in the state of New York and many other New York companies have gone to the great expense to form non-New York subsidiaries, often with the primary goal to avoid these compensation restrictions. This creates issues for companies like Northwestern Mutual since we're competing with companies that are paying first-year commissions of up to 100% of first-year premium and more.

You've heard Doug talk a little bit about the forces that led his company to levelized compensation. In the U.S., there are companies moving in that direction. Companies with familiar names like John Hancock and Prudential have begun moving into that area on a limited basis. There are other smaller companies that have moved full force like Acacia. Why? Each company obviously had its own reasons and it's unlikely that any two sets of reasons are identical. They're looking for ways to improve agent retention and persistency and looking at compensation structure to do that. The bottom line goal is to improve overall unit cost. The size of companies' orphan policyholder block continues to grow. The typical heaped schedule, with its nontransferable renewal commissions, it's argued, does little to incent agents to follow up with orphans. In general, companies feel that their agents will provide better service with a heaped schedule and that they will be more likely to be around to provide that service. At the same time, there is

heightened awareness on improper sales practices and the feeling that today's heaped schedule may be contributing to the problem.

Commission disclosure is already in place in Australia and the U.K. A recent survey in a *National Underwriter* article on April 28, 1996, showed that some 60% of the surveyed agents feel that commission disclosure is no more than three years away.

Other common arguments are that levelized compensation will stabilize the agent's income, reduce surplus strain to the company, and provide increased early policy value. Companies may feel that they have a better likelihood to attract high-quality people who are afraid of the feast or famine nature of heaped compensation. They also see a higher likelihood in succession planning, and success in that area. The veteran agent with the concept that Doug described can pass along a block of business to a new agent. Doug described the heart of what they did to align the interests of the insurance company, the client, and the agent.

I want to start with my defending heaped compensation top ten list. I hope to address all of those valid reasons and convince you that heaped compensation is still the better way to go. Perhaps the best place to start is to consider the unique nature of the life insurance product and how different it is from other products that have been shown to be successful with the heaped schedule like, for example, property/casualty insurance. As Jack Bobo so eloquently stated in a *Best's Review* article back in 1988, if the demand for life insurance products were such that agents could just sit around in their offices and transact business over the phone, and if selling insurance didn't entail the kind of detailed analysis and service that it does require, well, then level commissions might be best. But, as long as it's part of human nature to resist the notion of talking about death and disability, making prospecting for sales difficult at best, we'll continue to need a powerful incentive and rewards system to provide proper motivation.

It's also good to remember that people seldom buy a policy. Instead they're buying some sort of plan. They buy enough life insurance to fund a college education or to fulfill an estate plan. The policy is simply a funding mechanism for the plan that is being devised by the agent. Therefore, I feel it's not unreasonable to lump most of the commission for this effort up front, because that's when most of the planning is taking place. For example, at Northwestern Mutual, like many companies, we provide our agents with a detailed planning package, which allows them to provide a major value added service to their clients. We call it our personal planning analysis (PPA). The agent sits down with their client, gathers facts about what their needs are, about what the future holds in their lives, and enters all of these into their PPA package. Then, the agent spends significant time with the client, sitting down and going over the results of the PPA, which, depending upon the needs of the

client, may determine the amount of insurance that they need or monthly premium they need to put away to ensure education or retirement goals are met. The Northwestern Mutual Life (NML) agent provides this service as a normal part of the sales process. To me, this makes a strong case for heaped compensation since there is intensive effort put forth up front, even before any life insurance product is discussed.

Not only is the matching of service, effort, and compensation important in the first policy year, but it is important in renewal years, as well. One could argue that high level commissions and renewal years essentially leads to overpayment, given the amount of effort that is required in those years. None of these comments should suggest that I don't feel service is important. But, without the up front effort that's required to close a case, there will be nothing there to service.

Another intended effect of levelized compensation is to improve performance factors like persistency, agent retention, and to improve overall service. Let's start with service. In my company's experience, service is really a function of home office and agency manager training, not the particular compensation structure. Perhaps an even more important thing to say is that good service and good relationship building is really not an option for the successful agent. If the new agent is to survive and if the experienced agent expects to continue to hit their income goals, they must provide high-quality service to their existing clients. Not only to keep their current business on the books, but to generate future business from those clients and to generate referrals from those clients.

I was amazed when I first saw the number, which might be similar to your companies numbers, that over 50% of NMLs policies are written to clients with existing NML insurance. It would seem that I would want to pay some attention to my existing clients. In addition, between 75% and 85% of business written by our established agents comes from referred leads. In other words, 75–85% of our business is the result of our existing clients, who are presumably happy with the products they are getting and the service they're receiving who recommend their NML agent to their friends. Again, it seems that service is not an option. A particularly difficult challenge is incenting agents to service orphaned policyholders. Succession planning happens when a veteran agent works with a new agent. That would prevent many policyholders from ever becoming orphaned. Many companies, like NML, have been successful in passing clients from one generation of agents to another. One could argue that we could look at orphan policyholders as a gold mine of future possible sales for the agent.

Let's move off of service and talk about persistency and agent retention. I hold out to you that persistency is not a function of compensation structure, but rather is a

function of proper needs-based selling and consistent quality service. NML and many other companies have successfully achieved very low lapse rates while paying a heaped compensation. I feel the two concepts can work together. As for agent retention, no company I feel should expect a compensation structure to dramatically improve agent retention. Certainly, for a veteran agent with a large established block of business, the introduction of level compensation will keep them in the fold. The result of levelized compensation for this group of agents can be a substantial increase in compensation for the same or less effort. Who wouldn't stay on board?

The real goal, and one that's a struggle for all of us, is proving the retention of new agents. It's amazing to people outside the insurance industry when they hear that for every 100 agents that are recruited today, only about 15 will be around, on average, four years from now. Doug's number of 30 is very impressive. There's no question that anyone who figures out a way to continue to improve that number will be a hero. Improving retention gets at the whole heart of the process of finding and developing agents. If you asked an NML general agent how they would go about improving their agent retention, I don't think they would mention compensation structure. They'd be much more likely to say that good retention gets good recruiting, if possible, of candidates, effective selection among those candidates, superior up front and ongoing training, and effective supervision.

One serious concern with level compensation is the ability to support new agents and help them survive in a way that's cost effective to the company. The incidence of income with level commissions, at least on the surface, makes it appear that the new agent just won't be able to survive without a huge life insurance cost through training allowance plan. Now you've seen that Doug's approach has taken in supplementing the tap plan that they have with an interest in a retired or terminated agent's renewals. My feeling is that regardless of an arrangement similar to that core concept, one of two things will happen. Either the company will be forced to significantly increase costs in training allowance plan dollars or they will have a challenge on their hands. In finding recruits who are willing to wait even longer than on the traditional heaped structure to see the fruits of their labor. If the reality is that tap costs may increase, one must question whether any company savings that you might see in areas of persistency or agent retention might be more than wiped out.

Perhaps most important, is that I feel level commissions will make entering the career of life insurance sales very difficult, robbing the industry and the public of new blood at the very time when we're hitting a recruiting crisis. The trend in industry recruiting is a sobering picture. Life Insurance Marketing and Research Association (LIMRA), has discovered that as an industry, we have gone from 55,000

recruits in 1975 to 25,000 recruits in 1995. We must make the career and the prospects for financial success attractive, particularly for the types of candidates who have been shown to make it in the business.

I read the statement that the industry may be scaring away agents who are afraid of that feast or famine nature of heaped compensation. This is not the type of agent that we're looking for. Rather, we need to find entrepreneurial type of agents who aren't afraid to take risks in a career that will have some bumps along the way early on, but the pot at the end of the rainbow is limitless.

The need to attract quality recruits gets at the desire for probably all of our companies for premium growth. Even with the heaped compensation structure which pays fully for the sales effort, I feel companies will continue to find it difficult to grow in premium and maintain unit costs. It will be even more difficult with level commissions. Consider that veteran agents, obviously a huge source of potential future premium, will be much more likely to coast with a level commission structure when so much of their income is coming from renewals.
As has been mentioned, one of the major driving forces in the move to level compensation is the issue of improper sales practices, particularly improper replacements. The many completely honest and reputable agents who have been making large numbers of life insurance sales over the years with the heaped structure, are witness to the fact that the compensation method itself does not control the presence or absence of bad sales practices. I feel that compensation design is being wrongly seen as a quick fix for abusive sales practices. Again, if an agent has recruited and trained high quality people and instilled in those agents a strong culture and a sense of pride for the value that they bring to their clients' lives, then compensation structure at best becomes a minor issue in this area. Certainly no one would disagree that inappropriate replacement activity is an extremely serious problem that the industry must and is dealing with. Compensation change, though, is not necessarily the answer. In any company, only the smallest fraction of agents present problems in the area of inappropriate replacements and through monitoring and subsequent training, these agents can be re-focused on the type of selling that our companies want.

Perhaps I should have talked about product value much earlier on because I hope that you'll all agree that permanent life insurance is purchased to meet long-term needs and is most properly sold with an emphasis on long-term value. Much can be said about how early cash value can be superior with the levelized approach. I won't argue with that a bit. The point I would make is that the client, who is most concerned about short-term product value, is not necessarily the client that's going to stay on-board long-term. Let's take a simple example comparing our heaped compensation schedule to a couple of level and levelized schedules. The heaped

schedule being 55% in the first year, 6% in years 2–10, and then 2% in years 11 and later. A level schedule is 12% in all years. These schedules are consistent with some of the schedules that exist today in the U.S. and Canada.

I know this is an oversimplification, but let's just accumulate the commissions on the heaped basis compared to each of those levelized options. When you see a positive number, the levelized, at that point in time, has paid more. We're looking at $1,000 of a premium paid every year, accumulated at 8% comparing level to heaped. What you'll see is that by the 11th policy year or so, the heaped schedule gets out of the hole, I guess, against all options. The heaped product value advantage continues to grow and by the time we reach policy year 20, arguably the beginning point when you should start looking at comparing product value, the additional value from the heaped schedule is substantial and continues to grow.

I'm sure each of you could take a little different angle on this. I introduced, persistency and agent turnover in addition to interest and I got to the same result. I'm confident that where you'll end up if you do this kind of thing is that the heaped compensation structure will provide the better long-term value to your customers.

Proponents of level compensation consistently say that it provides a more predictable and smooth income flow to the agent. Like many companies, NML allows its agents to defer income and to smooth their renewal commissions, effectively giving them the option to levelize their commissions at their own discretion. It is significant, however, to note that most of the agents who are deferring their income are those that are getting towards the end of their careers (they are thinking about retirement and winding down), not those at the beginning or at the heart of their careers.

In a recent survey of agents from the April 28 *National Underwriter* article, the respondents overwhelmingly preferred the front-end loaded option. Nearly all of the "low commission agents" in the survey felt like it was critical for them to survive. Ninety percent of the high-commission agents in that survey said they preferred the heaped schedule. I'm certain that an element of this enthusiasm is the immediate feedback that's somewhat unique to the life insurance salesperson. If you or I do a terrific job in our home office roles, at least where I come from, you might see a 5% bump in salary. If things go well, you'll get promoted every so often. But, the life insurance agent in a heaped commission structure, who sets some aggressive goals for him or herself and acts upon those goals, can see some immediate and significant gratification for their work. That's my top ten list.

As I mentioned, nearly 60% of agents in that survey thought commission disclosure is coming. Dave Brown told me that after Great Britain introduced commission

disclosure, there has not been a mass exodus away from heaped to level commissions. In other words, companies and their agents in the U.K. have found a way to make heaped commissions work in a full disclosure environment. Perhaps we can all take some comfort in that fact.

Companies should not be forced to follow any particular compensation approach. There was a time in recent years when an idea was being floated, that perhaps regulators should require levelized commissions for life insurance replacement business. In fact, some of you may know that in the long-term care market at least five states require that on long-term care replacement business, the first-year commission cannot exceed the renewal commission on the policy. I feel this is a dangerous step in the area of over-regulation. Levelized compensation makes a lot of sense in a particular market or product. For example, in the executive benefits market, the first-year cash value is extremely important since the corporation must report any difference between premium and cash value as a hit to earnings. Third, each company considering a move to levelized compensation will have unique objectives and that's why we're seeing such a wide variety of levelized schedules so far. For example, companies putting the highest emphasis on policyholder service, as Doug's has, will move to a true level schedule with the same commission rate in all years. Others who are more concerned mainly with the perception of heaped commissions and a full-disclosure environment may have just slightly lower first-year commission—say 30%—with a slightly higher renewal.

Finally, any move to a levelized schedule will be slow and painful. Companies will fear being the first one to move and possibly losing some agents. Depending upon how the companies approach it and the philosophy they take towards protecting their existing agents, the transition cost can be enormous. Expect more companies to move to levelized, over a period of 10–20 years, where new recruits are given no choice but to take a levelized commission. Their existing agents, given the choice, will stay with heaped for the rest of their career.

I'll jump back up to heaped compensation soapbox and talk about a few general trends. A good place to start is the New York 4228 modernization effort. I stumbled across a letter; actually Bill Kanig, the chief actuary at NML, made me aware of it. The letter was from former chief actuary Percy Evans, who wrote a letter to one of his buddies on the East Coast saying how excited he was that the industry and the New York Department were finally getting together and modernizing the commission restrictions that were put in place in 1906 after the Armstrong investigation. I'm happy to announce that some 50 years later, it appears that Mr. Evan's wishes are going to come true.

The biggest driving force is for the modernization. Many of you are very aware of these. First of all, the industry's desire for more flexibility and compensation design with the levelized approach and asset-based compensation are the most common examples mentioned. Additionally, it's generally agreed that the current law has unneeded complexity in its rules. There are significant delays in plan approval, compensation plan approval, and a desire for file and use concept. Certainly, the sales practices in replacement issues facing our industry have helped to turn up the heat on the modernization process.

You may have heard that the original draft of the new law which was introduced into the legislature in New York in 1996, eliminated all inside limits. This would have meant no 55% first-year commission limit and no renewal commission limits. It also called for no limits on bonuses, prizes, training or allowance plans subject to an overall tighter aggregate limit. It was felt by many, me included, that this draft was potentially dangerous in a sense that it would add to the free agent mentality that may already be out there where companies are doing whatever it takes to keep the big hitters happy. Career companies like NML who invest heavily in finding and training new agents, would have lots to lose. But it was argued that the real losers would be either the policyholder through worse product value or the lower-to-medium producer who might have to take a pay cut to support the big hitters.

After the bill was reintroduced in 1997, New York's concerns on marketing abuse had heightened. It was felt that having no lid on first-year commissions, would just enhance the industry's market conduct problems. The industry was asked to make revisions to its draft, and hired consulting actuary Dan McCarthy to help, and developed a proposal that would meet everyone's needs. The new inside limits in McCarthy's proposal would apply only to business written in New York state. The position was that for rules that deal primarily with market practice, that no extra territorial rules would be needed. Thus for New York business only, first-year commissions in the draft would be limited at 55%, but to avoid companies from paying big time renewals to get around the first year limit, of course, we have to add more limits. First there would be a limit on renewal commissions in policy years two to four. Asset-based compensation on life insurance would be allowed, with some limits. There would be limits on training allowance payments, but additional flexibility compared to today's rules on designing tap plans. I must emphasize, again, and this is something I continue to have to get used to. That these inside limits, if passed, would apply only to business written in New York.

Any aspects that primarily affect companies' solvency, including aggregate limits, the concept of self-support, and the file-and-use concept, would continue to be extraterritorial in nature, applying wherever the company was licensed to do business. This proposal has received some positive feedback from all parties

involved, including the industry, the New York Department, the governor's office, and the legislature. It's currently being studied by the staff of the Assembly and the Senate in New York. There is real hope that we'll be looking at a new law sometime in late 1997.

You may have heard that New York actually began moving in the area of modernization in 1996 with its circular letter seven, which allows asset-based compensation on annuities. In a nutshell, the circular allows an asset-based compensation rate of 14 basis points for every 1% you would normally pay at the time of deposit, subject to an overall maximum of 100 basis points. Companies could certainly pay nonlevel amounts if it's less on a present value basis than what's in the circular letter. It's fair to say that companies have begun moving into asset-based compensation on annuities and more will continue to do so. My opinion on asset-based compensation is that it's obvious that it's payment for preserving assets and keeping assets under management, particularly, in the accumulation markets. Nevertheless, if you buy into my argument about matching compensation to effort, I suspect that a level percentage that's applied to an ever increasing account value, leads to later year compensation that is excessive relative to the effort that's required in those years.

Now I will share some general trends on products that are having some impact and will continue to have impact on agent compensation. For life insurance sales there is a sharp trend away from permanent to term insurance. Term's share of the industry's ordinary life sales have increased on a face-amount basis from 26% to 40% of ordinary life sales. On a policy term basis, life sales have increased from 18% to 27% from the period 1985–95. When you consider that the average term premium is a fraction—maybe one-third to one-fifth of the average permanent and that the typical term commission rate, at least for New York companies, is 35%, not the typical 55% on permanent, you get a sense for how devastating this trend could be to agents that are hoping to survive in the business. If you look at the distribution of premium sales by product type over the last ten years, you can see a sharp upward turn in variable life sales. Certainly, this is partly due to the upturn in the stock market in recent years, but it also shows a greater willingness, I think, to take risk in the life insurance purchase process. Relative to whole life insurance, the typical variable life first-year commission can be as much as 25% less than what would be paid on a regular traditional permanent policy for the same influx of premium which is another alarming fact for the agent. Note also the big increase in the low-commission annuity marketplace. Very few agents can consistently put food on the table by acting solely in that market.

Without picking on a particular product or market, look at the general downward trend in overall commission rates on permanent life insurance. This is, again,

courtesy of a LIMRA survey that showed that the average first-year commission for New York companies, moved from 55% down to 50% in 1990. For non-New York companies, it moved from 95% to 80%. That same survey showed that the typical 5–6% renewal commission on traditional business was more likely to be 3% on the very hot universal life products. So it's fair to say, we are continuing to see pressure—downward pressure—on commissions and on overall distribution costs. Companies will continue to move to a lower base compensation approach, with more money put into contingent bonuses on top. Not only does this have the potential to lower overall distribution costs, but it can provide some significant dollars to those top producers, providing them what they need to stay with you.

The most prevalent trend that I see in field management compensation is a shift to an even greater emphasis on compensation for recruiting and retaining agents. More than ever, companies are realizing that without growth and manpower, growth in premium is almost impossible to achieve. As a result, many companies have begun or have actually implemented new management compensation packages that, when compared to their old general agent or branch manager compensation paid much more on business written by agents in their early years and much less on veteran agent business.

Another realization is that growth in an agency force is most effectively accomplished through multipliers or additional and somewhat smaller management units. More management units creates the need for more management talent and more management candidates. Many companies have designed formal programs that identify potential management candidates early on in their careers and take them through a series of steps that, ultimately for some of them, leads to them being general agents or branch managers some day. As with any successful team, the goal is for deep and quality bench strength.