RECORD, Volume 23, No. 2*

Montreal Spring Meeting
June 19–20, 1997

Session 72OF
Trends in Agent Compensation

Track: Product Development
Key words: Compensation, Expenses

Moderator: ALBERT E. EASTON
Panelists: DOUGLAS W. BROOKS
JOHN WELLBORN†

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 the compensation of their agency forces. We discuss alternatives that companies are considering in the compensation area, including levelized commissions. Discussion includes consideration of:

- *financial implication of moving to levelized compensation,*
- *product design implications,*
- *actual reduction in commission expenses versus equivalent present value of compensation,*
- *implementation of a revised commission basis for all issues versus only replacement sales,*
- *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. Albert E. Easton: My role here is to set the stage and explain why the trend in compensation that we are going to explore, namely that of levelized commissions, exists. There are several reasons why you might choose to adopt a levelized commission approach to agent compensation.

---

*Copyright © 1998, Society of Actuaries

†Mr. Wellborn, not a member of the sponsoring organizations, is principal in the Decision Resource Group of Life Insurance Marketing and Research Association (LIMRA) International in Windsor, CT.

They are all really interrelated. The first, and perhaps the most obvious one, is to improve cash flow. If you are paying less up front, your company cash flow will improve. It also may improve company financials. In particular, if you are using GAAP financials, it may have a neutral or perhaps even a negative effect on company financials. It will probably improve persistency, which is something that should help you keep more business in force. And that, in the long run, should improve your financial status. Finally, it will give you an opportunity to improve the product and provide a better value for the consumer. That has been an incentive, particularly in areas where there is some thought that there will be commission disclosure. There is a real desire to have a commission scale that will look attractive to the consumer.

However, there are several reasons why you may not want to have a levelized commission scale. Maybe the number one reason is problems with the acceptance by the field force. Remember that if there is someone who feels his or her compensation will be better under a levelized arrangement, there is someone else who feels it will be worse. There will be a negative reaction from some agents. Also, there will be a few agents who will argue that levelized commissions will not produce the results you want; they will not give the incentive to sales that is needed to keep a strong insurance base in existence.

The second problem is that there is a problem for new agents. New agents will have a tougher time surviving on a lower first-year commission than on a high first-year commission. This means that you have got to have a stronger training allowance program or perhaps a salary arrangement for new agents; a way to bring new agents in that does not rely quite as much on first-year commissions.

Finally, for those companies that operate in the U.S., particularly companies that have any operations in New York, there have been major regulatory problems in New York. New York has limits on both first-year and renewal commissions. You can redistribute commissions from first year to renewal, but if you do so, you can only do so on a so-called "actuarial equivalent" basis. The actuarial equivalence is at a very low interest rate and a very low lapse rate, with no recognition of agent persistency. In other words, it is not really an equivalent basis. This situation may be relieved somewhat if some changes that are now being considered in the New York insurance laws take place. The changes could happen as early as this year. They will most likely happen in the next year or two.

Actuaries usually like to look at what has happened in the past to describe what will happen in the future. Fortunately, in Canada, there are two very large and effective companies that have done a considerable amount of work with levelized commissions, and they have had plans in effect for several years. You will be

hearing from one of them, Doug Brooks, who is from Mutual Life of Canada. He will be describing what his company does. Great West is the other Canadian company that has actively done this. There also is a Scottish company whose Canadian branch is on a modified levelized commission basis. I understand, also, that there are one or two other Canadian companies that are seriously considering changes, possibly based on the successful results that Mutual and Great West have had.

In the U.S., the experiments are a little bit more limited, partly because you cannot do this effectively in New York. Acacia does not operate in New York. Paul Schneider, from Acacia, was going to be with us, but unfortunately, he is not able to attend. I hope that John Wellborn, who has talked with Paul, will be able to describe some of what Acacia has done. John Hancock, in order to introduce a levelized plan, was forced to do it through John Hancock Variable Life, its non-New York subsidiary, and it does it only on a test group of agents that operate through John Hancock Variable Life. State Farm has done it on a somewhat more limited basis in New York than it has been able to do in other parts of the country. Its levelizing is not quite as level in New York as it is in the other states, but it does it through its main company. I understand that there is one other company, Met Life, that is doing some test cases on a salary plus bonus basis, which is a form of levelized commission.

Now, I am going to let Doug Brooks tell you, in more detail, exactly what Mutual Life's experience has been.

Mr. Douglas W. Brooks: We implemented it about eight years ago. We have had, certainly, some successes from it. There has also been some areas where we have learned through experience and have had to make some changes. I want to share some of those aspects with you. I am going to talk from the perspective of our levelized commission system because that is what I know, and that is what we have learned from and through.

I am going to start by talking about some of the objectives that we had when we moved to a levelized commission system. We had always viewed, and still continue to view, our exclusive career sales force as one of our primary assets. So one of the questions might be, why would we risk what we consider one of our most valuable assets with a move to a levelized commission system, at a time when, while there was discussion about levelized commissions, there were not many other companies that were moving in that direction? We did anticipate that there would be a little more movement in that direction than actually turned out to be the case. But we did take a risk in moving to a levelized commission system, and I want to talk about the reasons why we did that. I also want to give you some background

on our distribution system. Because of the type of distribution that we have, we had some unique advantages in moving to a levelized commission system, and I want to explain those so you are viewing our experience in the right context. I will also talk a bit about our levelized commission system: what it is, how it works, what are the different components, and so on. I will talk about some of the results that we have had, both some of the successes that we have experienced quickly, early in the process, and also some of the things that did not go so well and led us to make modifications. I would say, at this point, we are very happy with the results that we have achieved through our levelized commission system. This is speaking eight years after the initial change. We have made a number of modifications through those eight years, but we, at this point, feel that the system is working quite well and effectively. And I also just want to touch on a couple of general issues on levelized commissions.

In terms of our objectives in moving to a levelized commission basis, the primary objective was to align the interests of all parties involved: the customer, the agent, and the company. Our belief was, and still is, that any system that does not align the interests of the different parties is not ultimately going to be sustainable. If the customer is working in opposition to the interests of the agent or the company, we do not believe that is an effective, long-term method of distribution, and our remuneration system was primarily intended to bring the interest of each party in line. I will talk a little bit more about that as I describe our system.

The levelized commission system, obviously, has an orientation towards providing good customer service. There is an incentive for the agent to make sure that policies are well serviced so that they stay on the books. The previous system that we had, our heaped scale, up until 1989, effectively required a financial sacrifice, in some cases, for agents to keep existing policies on the books, and if it took effort to do that, that would often be at the expense of being able to go out and make a new sale with substantially higher commissions. So we wanted to create the right balance. Obviously, we still needed to have an incentive for sales, but at the same time, we wanted to ensure that there was an orientation towards providing good customer service. One of the spin-off benefits, though, of providing better service is that can often lead to repeat sales. If the agents were strictly looking at new opportunities, they may not have discovered possibilities within their own block of clients, particularly as customers needs, situations, circumstances changed over time. If agents are not in regular contact with their customers, they may miss opportunities for sales. So one thing we have discovered is that there are more opportunities being discovered and taken for repeat sales.

One of the objectives is increased persistency, which is obviously tied directly to providing better customer service. That ultimately results in lower costs to the

customer through reduced unit cost. I should say that virtually all of our life insurance business is participating. So the customer would ultimately share in the lowering costs through improved dividends down the road. Improved persistency and the lower cost were obviously a large factor in the motivation to move to a levelized commission system. There are also lower pricing risks, generally speaking, with a levelized commission system. The early policy durations do not give rise to the same kind of losses. In fact, for most of our business, there is no significant termination risk because of the levelized commission system. Pricing becomes relatively insensitive to policy terminations, provided that the cash values are reasonably consistent with the asset shares.

We also expected, or hoped, that agent retention would improve as a result of levelized commissions because of the longer term financial interest that the agents have in the company and in the business that they have on the books. We expected that agents would see the value of their business increasing. That is, the future value of all the commissions would increase over time, and the agents, therefore, would have greater motivation for staying with us. As a result of these factors (the combination of better persistency and better agent retention), we anticipated an improved competitive position as a result of lower costs and greater profitability.

There are a couple of things that I want to mention that were not particularly factors in our decision to move to levelized commissions. One of the advantages of being a Canadian company is that we do not have to deal with the New York State regulations. Also, it was not about lowering commissions in terms of the total value of commissions. We did want to redistribute commissions among agents. Obviously, agents with good persistency, and particularly longer-term agents, will tend to do better. Agents with poorer persistency of business will do worse. That was fine, but we did not have the objective of lowering the overall compensation being paid to agents as a result of moving to levelized commissions. That neutrality, in terms of the way we set our levelized commission rates and the way we priced the products, is to an aggregate. There would be some differences for specific products, specific ages, and that type of thing in the pricing. But, in aggregate, the value of the levelized commission system that we implemented was, essentially, the same as the value of the heaped commission system that it replaced.

The issue of potential disclosure of commissions was not a primary factor in our decision. We did anticipate that at some stage disclosure might become an issue. As I said, one of our key objectives was to align the interests of the customer, the agent, and the company, and we wanted to be able to say that publicly. We had a system that was designed to make sure that everybody's interests were in the same direction. But we did not view disclosure as one of the primary motivations for moving to the levelized commission system. Also, Al mentioned that product

design might be a motivation. That was not one of our key drivers, either. We did make some slight product changes as a result of moving to levelized commissions, but that was not one of our key motivators.

I want to give just a little bit of background on our distribution system, to put it in context, so you can understand some of the particular reasons that we did things, some of the particular results that we got, and so on. We have a career agency system. We have about 2,000 agents at this point across Canada. Agents sell life insurance products exclusively for us. We also market savings and retirement products, some of which are exclusive, some of which, such as pay-out annuities, agents can sell through other companies and vice versa. Other companies, agents, and brokers can sell some of our retirement products. However, on the life insurance side, which is the focus of what I am going to talk about on our levelized commission system, it's an exclusive career-agency system. While I am going to talk primarily about life insurance, that also extends to other products we refer to as retail insurance products: critical illness products and long-term care. We are just developing some of those products, but we feel that the same principles will apply to any product where there is a significant amount of initial prospecting and advice given through an agent. We feel that is the case with these retail insurance products, more so than with some of the savings products which do not require the same level of prospecting and advice.

Another point is that our branch managers are employees of the company (our agents are independent contractors), and the managers do not sell. The branch managers, for the most part, come from a sales background, but their role is to recruit, train, and motivate agents and not to sell. That will help to put some of this in context. I mentioned that we currently have about 2,000 agents and managers. When we moved to our current system in July 1989 we had about 1,400. There is obviously a large growth there, but a good part of that was through the acquisition of another company which brought about 450 agents and managers with it. But, apart from that, we still have increased the sales force with the levelized commission system.

We have a number of basic components in our levelized commission system. The most basic of these is a levelized commission that is paid for the lifetime of the contract. The commission rate varies depending on product, and for our most popular, or most common, permanent product, that rate is 15%. It is a little lower for term insurance, and it grades down by volume for term insurance. We also have some other products that either have a little lower commission rate or grade down at the higher amounts. This commission is paid at the same time that a premium comes due and is paid, so if it is a monthly premium policy, commissions of 15% are paid on a monthly basis. It is actually paid out as the premium is billed, and

then if the premium ultimately is not paid, it is reversed. It ties directly into the payment of the premiums.

The second component of our commission system is called growth commission. This commission has two motivations. One is to give an incentive to agents to increase the size of their block of business. It is also very important for newer agents who do not have a block of business on which they are collecting 15% commissions. The way the growth commission works is that it pays three times the increase in an agent's annualized commission. So if, for example, at the beginning of one month an agent had $40,000 of annualized commission in force, and he or she increased that to $41,000 during that month, the agent would get $3,000 paid in growth commission. The growth commission is paid on an annualized basis, not on the month-to-month basis that I talked about on the levelized commission. Agents with large blocks of business, obviously, have business going off the books, so they would have to replace anything that is going off before they would be eligible for the growth commission. We do not, in those situations where an agent may take a holiday for a month and have some policies go off the books, charge the growth commission, but they do have to make that up before getting the positive growth commission down the road. Obviously, you can see the importance of this for new agents because most of those sales would be additions to their block of business, so they would get three times it.

The third component we call business commission. It is an override of 20% on the other forms of commission that I talked about. We do this explicitly rather than just increase the commission rate by 20%, so that agents have an indication of the sort of level of expenses that they might anticipate. The business commission essentially is there to cover the agents' expenses of operation (things like rent, secretarial assistance, computer equipment, furniture, and so on). Until 1989, when we moved to this basis, we provided many of those things to agents, depending on their level of production. When we moved to this system, we started charging agents explicitly for those things and paid them this business commission to help cover the expense.

When we started in 1989, these three were the components. However, one of the things that we found was that newer agents had a tough time, just from an income point of view. Also, some older agents had a tendency to just sit on their blocks of business to some extent and we needed further incentive. So we added what we call a policy commission. It pays either $500 or $250 each month to agents who sell six new life insurance policies. The $500 level is paid to agents with four years of experience or less. The $250 level is paid to agents with over four years of experience. We do not include in the calculation policies that are internal

replacements of existing Mutual Life policies. In order to get that bonus, agents have to either sell to new clients or sell new coverage.

The other main feature of our system is the value of the future levelized commissions. We refer to this as CORE. The company acts as an intermediary in all of the situations where an agent is retiring or terminating or giving up a block of business. If an agent is retiring and another agent wants to pick up the block, we give the first agent a payout of the value of that business. I will describe how we determine that value in more detail. The new agent that picks up the block of business (and, in some cases, that could be multiple agents if the block is divided into segments) has his or her commissions reduced by an equivalent amount over the ten-year payout that we give to the retiring or terminating agent. The new agent that picks up the block has his or her commissions reduced by that fixed amount for ten years. A calculation of the value of the future level commission is done which involves contingencies—mortality being the primary one because it is a life insurance policy that we are dealing with—policy terminations, as well as interest. We calculate the present value of the future levelized commissions. We then pay the terminating agent a value based on that value over ten years, then the new agent acquires that business. The new agent has the full policy termination risk, in that the agent's commissions will be reduced over that ten-year period by a set amount. The agents have the full risk of maintaining that block, except that we give them a little bit of a window initially in case there is a run on the business.

One of the obvious challenges in moving to a levelized commission system is how to ensure that newer agents will be able to earn adequate incomes. We increased the levelized of the financing that we provide to new agents when we moved to the levelized commission system. We also have what we call a development commission, which is paid monthly to new agents, as long as they are meeting minimum sales standards, and also the increased policy commission that I talked about. When we first moved to the levelized commission system in 1989 we did not have the policy commission. We actually reduced the development commission that we paid to new agents at the time that we brought in the policy commission, so that we distribute our total financing dollars more effectively to agents who are actually selling, rather than giving everybody the same amount. In 1992, when we added the policy commission, we reduced the development commission, and it has certainly been effective in increasing the productivity of the newer agents.

While we are paying out more on a year-to-year basis, in terms of financing dollars, we obviously did not want to increase the total cost of the program. Therefore, we have a reduced vesting of the CORE that applies to new agents. If agents terminate within the first three years, they get nothing in terms of the value of future

commissions from the block of business that they sold. That increases to 100% of the value over the next five years. In order to realize the full value of their block of business, agents have to be with us for eight years. We had a five-year transition when we began in 1989 for existing agents. They did not realize the full value in their block of business if they terminated before 1994.

One of the areas that we did not handle so well when we first moved to levelized commissions was the way in which we dealt with our branch managers. We assumed as we went along and developed a levelized commission system for the agents (which is what we focused on and did extensive modeling of on an agent-by-agent basis) that we could sort of add on some overrides for managers at the end and that it would work fine. In fact, it did not work fine. We had, as it turned out, quite a bit of incentive effectively built into the system for branch managers to recruit new agents, but not significant enough incentive for them to retain those agents.

Naturally, we got many recruits, and just as naturally many left quickly thereafter. Therefore, we did make some modifications to the system for branch managers over the years. In particular, we increased and added incentives to try to ensure agent retention. Also, another type of incentive, although not a financial one, is that many of the recognition programs for branch mangers now require a certain level of retention as well. Although we have been pleased recently with our retention of agents, in fact, we have not significantly improved agent retention over what we had before the levelized commission system, in spite of the fact that this was one of our motivations.

We have, however, improved retention quite a bit from where it was five or six years ago, initially, when we brought the system in. As I said, we had problems with it in terms of agent retention. We have improved it, but effectively we are at a level similar to what we were at in the late 1980s. We have always had a quite good agent retention: four-year retention rate in 1987, 1988 was in the 35% or 36% range. We had hoped to increase that to over 40%; in fact, if you look at our current block of agents and exclude the agents who came as part of the acquisition of Prudential of England's Canadian business, we are in that same ballpark now. So we have maintained a good level of agent retention, but that is one area where we have been somewhat disappointed in not being able to make more improvements.

I mentioned that one of the other objectives that we had was to improve policy terminations. That was probably the most immediate and most dramatic area in which we noticed a difference. The improvement was literally overnight. We moved to the levelized commission system on July 1, 1989, and if you look at June's policy terminations and compared them to July's, there was a very significant

difference. The total termination rate for our overall block of life insurance business in 1987 and 1988 was about 6.25% for both of those years. Our overall policy termination rate improved from something on the order of 6.25% to a little under 5.5% overnight in mid-1989. Much of that was related to business which, until that point, had been orphaned business. We had approximately 30% of our total business for which the original agent was no longer with us. While agents were assigned to that business, they did not have a large financial incentive until we started paying them levelized commissions. That business had a dramatic improvement in persistency. We have, as a result, talked about lower unit charges for our life insurance administration. We have achieved that, partly through other initiatives, but also partly as a result of having a larger block of business because of improved persistency.

Another area where there was a fairly significant change was internal replacement of policies. Again, there was an immediate improvement. This is an area where we wanted to make sure that agents still proceeded with transactions that were in the best interest of the customer, but transactions that were not necessarily in the best interest of the customer were reduced. We certainly feel that has been the case as a result of the move to the levelized commission system. There is no additional incentive for replacing a policy internally. If you are replacing $1,000 of premium with another $1,000 of premium, the levelized commission is unchanged; there is no growth commission impact because you have an on and an off, and we do not pay the policy commission except for a new sale. So it is only transactions that are required for the customer's best interest that agents are tending to do; examples would be increases in business, action that is needed in order to conserve business, and that sort of thing.

Sales results is an area where, obviously, there can be some concern, particularly among senior agents who have a large block of in force and are therefore collecting a quite healthy level of commission. We did have some senior agents who slowed down. We effectively gave them a bit of a paid holiday and they took advantage of it. At the time when we moved to the levelized commission system in 1989 we did not have many other requirements in terms of minimum sales. We did not make dramatic changes in our recognition programs, which were essentially around total income, and, as a result, agents who had a large block still got recognized because they still had substantial incomes. We did not have minimum requirements so they were not forced to sell in order to keep their contracts.

We changed both of those things over the last five or six years. We have added some additional incentives such as the policy commission that I talked about, which applies to senior agents. We have changed our recognition programs: in order to qualify for our sales conventions, an agent has to sell a certain minimum number of

policies over the two-year qualification period, and we have implemented requirements that, in order to keep their contract, they have to sell a minimum number of policies as well (18 this year). We made those changes in order to ensure that we get the sales results from all of the categories of agents, whether they are new agents, middle duration agents, or more senior agents. I have already talked about the agent retention situation, the realignment that we did of managers' compensation to put more emphasis on the retention of agents, and also the recognition of managers who are doing a good job of retaining agents.

Just to sum up, here are a couple of other issues that come into play in deciding whether to move into a levelized commission basis. It is costly if you recommission the existing block of business, which we did. Agents did not get the orphaned business for free, they had to acquire that in the same way they would acquire a block of business from a terminating agent. So for that 30% of the business that was orphaned, they had to acquire that, and their commissions were paid on a reduced basis for that business. But on the other 70% of the business that was agent owned or agent-controlled, we did recommission that block of business, and that had a significant cost associated with it. In terms of pricing, there was really relatively little immediate impact. In doing our pricing, we did not anticipate policy persistency improvements. We expected that they would emerge over time and, in fact, they actually did emerge, but we did not anticipate that at the time in our pricing. So there was relatively little impact on pricing other than some changes by age and duration because of the nature and value in place in the levelized commissions.

One consequence of moving to a levelized commission basis is that pricing is much more sensitive to changes in interest rates. When we set our levelized commission scale in 1989, we were in a higher interest rate environment. As interest rates come down, the value of levelized commissions increases more rapidly than the value of a heaped commission. We did make some allowance at the time for that, but, effectively, our levelized commission system has become a little higher value than the heaped commission scale would be based on today's interest rates.

Mr. John Wellborn: We're going to talk about levelized commissions but before we do so, it is important that we set the stage properly for that discussion. Leveling the commissions is one of several innovative sales compensation approaches that is being discussed widely. It is important that we recognize that whether we are talking about levelized commissions, salary plans, or other nontraditional compensation approaches, there are no magic bullets, and there are no easy answers. In determining the best sales compensation system for a given company, there are many variables that need be accommodated. As we look at the broad issue of sales compensation, it is important to ask the question, "What is driving

change?" After all, we are an industry that has generally been compensating people in the same way for almost 100 years. Why are we changing now?

One key reason for change is that the insurance industry for the past several years has been flat in terms of new sales premium. Insurance companies are searching for answers in terms of developing consistent profitable growth. If traditional compensation approaches are not working, are there potential better alternatives?

Another factor is the broadening of the competitive base to include financial service organizations that are not traditional insurance distributors. Banks, stock brokerage firms, and other distribution companies are not tied to traditional compensation patterns as is the insurance industry. Because they also represent a competitive threat, the insurance industry wants to be sure that they are not gaining an advantage through new and different types of sales compensation approaches.

The competitive environment has also spawned a reevaluation as to the role of sales compensation. In the traditional model, sales compensation is almost exclusively focused on developing new business. In the broader competitive arena, sales compensation, in many cases, is being redefined as a function of relationship management. In this context, holding on to customer assets and maintaining regular new deposits is increasingly considered part of the sales function.

The third major environmental factor is the potential for regulatory change and its first cousin legal action against insurance companies for agent malfeasance. Regulatory change comes in two varieties. First is the fear of new regulation as it relates to topics like commission disclosure and appropriate advice. However, the pervasive existing regulation as it concerns U.S. companies is New York State regulation, which, in effect, controls the entire insurance industry from a compensation design standpoint. This regulation is explicit in terms of establishing commission and expense limits for the largest companies. This regulation is expected to undergo a dramatic change within the next year or so. The effect of New York regulation cannot be understated because it has provided the overall industry compensation blueprint and it was initially implemented at the beginning of this century. If there is significant change of these regulations, the effect will be to eliminate the sales compensation blueprint, which has been the basis of compensation for the industry.

So those are the three key areas that you should keep in mind when thinking about changing the sales compensation structure for your company. Another factor driving sales compensation change is the pressure on distribution margin. As companies seek to become more competitive, these margins or marketing allowances are reducing. In an environment where distribution costs are shrinking,

it is not sufficient to allocate the distribution resources in exactly the same ratio as a company's history suggests. In other words, if a company's marketing allowance moves from $1.50 of first-year premium to $1, the allocation of that reduced resource availability also needs a reevaluation. Simply maintaining a traditional resource allocation pattern in a declining resource availability environment cannot be expected to provide the best sales compensation system. In order to solve for the appropriate allocation of resource issue an important concept to embrace is one of determining your primary distribution client. Sales compensation systems that solve for the primary distribution client can be expected to be much more effective than those that remain ambiguous on this point.

As a point of reference, it helps to look at traditional compensation approaches in order to understand the primary distributor concept. For general agency-based systems, the primary distributor is the general agent. This is true whether it is a personal-producing general agent approach, a traditional career general agent distribution strategy, or an independent marketing organization. On the other hand, career managerial distribution generally is characterized by the producing agent being designated as the primary distributor. This is exemplified by the prevailing trend towards driving expense allowances and support accountability down to the agent level. In the home service distribution model, the primary distribution client is the territory. Maintaining a successful debit, regardless of the individual, is the driver.

Another concept that helps us develop direction in this changing world of sales compensation is to understand the overall distribution resource allocation relationships. I have had the opportunity over the past few years to work with organizations in the broader financial services industry that are not life insurance based. What I have found, in terms of resource allocation, is that career producer distribution channels, whether they be life insurance company based or securities industry based, tend to exhibit a similar rationing of distribution resource. That is, career distribution tends to spend 30–50% of its available distribution resource on direct compensation to its agents or brokers. This figure excludes the value of the benefits and other support. As the distribution moves towards the independent producer model, the allocation of resources focused on direct compensation increases. At the other end of the spectrum, the independent producer, whether it be an insurance broker or an independent financial planner, generally demands and receives an allocation of available distribution dollars that approaches 80% or more of the amount available. In designing a sales compensation recommendation it is helpful to understand the relative relationship of resource allocation, which is dependent upon the broad distribution model in which the compensation system is designed to serve.

Relationship management is a topic that very much relates to the issue of sales compensation. In order to compete effectively, companies are seeking to "get their arms" around their customer base in as many ways as possible. This includes discounts to the customer for multiple purchases and, increasingly, to the sales compensation structure. Compensating the field force on maintaining relationships, i.e., assets, and continuing deposits is gaining popularity among insurance and other financial service providers.

The relationship approach to sales compensation is also consistent with the industry concern on compliance. The basis of the relationship compensation model is the matching of consumer needs with the appropriate product, as evidenced by the willingness of the consumer to maintain his or her relationship with the company over time. Compliance issues, as they relate to compensation, are fundamentally focused on whether or not the salesperson did a proper job in evaluating the customer's needs and provided the right product or service to meet those needs.

With this background in mind—i.e., relationship management, sales defined as maintaining customers, their assets, and premium flow, and compliance in terms of matching customer needs with the appropriate products and services—let us now turn to the subject of levelized life insurance commissions.

Levelized commissions are defined as a significant deviation from the historical sales compensation pattern of paying 55% in the first year and 5% renewal commissions in policy years two through ten. Within that general context, there are two significantly different compensation models. These are the commission deferral approach and the integrated levelized commission system, which is a part of the customer relationship distribution model.

The fundamental difference between the two approaches is that the commission deferral system seeks to maintain the traditional philosophy of paying primarily for the sale, albeit deferring the compensation for that sale over some number of future years, versus the integrated approach which embraces the customer relationship model of distribution.

Under the commission deferral concept, the producer income pattern is significantly changed. Total compensation at the sale is greatly reduced. Under this model, renewal commissions are paid from a philosophical perspective of deferred sales commissions. Should the producer leave, the deferred sales commissions are attributed to that individual. In other words, maintaining customer relationships is not part of the philosophical foundation of this approach.

The motivation for the commission deferral approach is reduced acquisition costs, the potential of enhanced early product values for the consumer and product persistency.

The integrated levelized commission model is a more far-reaching compensation philosophy. Under this approach, the sales compensation philosophy shifts from product sales to customer acquisition and growth. In its purest form, the producer should be able to replace policies as often as the customer demands it. The concept is you need a growing premium base, a growing asset base, and a growing customer base. If you're doing that, you are providing a good service.

Asset-based compensation is the first cousin of levelized compensation. It acts similarly in many ways. Asset-based compensation is appropriate for high premium/deposit low commission-rate products. It also better accommodates single or indeterminate premium/deposit products. As with levelized compensation, asset-based compensation can be developed on a product stand-alone basis, i.e., the commission deferral approach or as part of an integrated system that espouses the customer relationship distribution model. Consistent with the customer relationship distribution model is the concept of cross-selling compensation. Explicit with the concept is that the companies will do better by managing the profitability per customer, i.e., as measured by the number of needs that a company can meet per customer. The theory is, the more needs met per customer the greater the profitability of that customer in terms of both total premiums and deposits by the customer and the greater likelihood that that customer will continue his or her relationship with the company. Cross-selling compensation is consistent with a levelized or asset-based system. It does not tend to work well with a high front-end sales commission approach.

Probably the biggest issue affecting life insurance compensation in the U.S. is not the relationship model, but rather the fear factor. It is the fear of the class-action lawsuit for agent malfeasance. It seems that not many months go by without reading of a new scandal affecting one of our major companies. In these press reports, and usually within the first one or two paragraphs of the article, something is said about compensation. The strong perception that agents are driven to take actions not in their customer's best interest, is a considerable driving force for major compensation system change.

Another significant factor that we can expect to influence life insurance compensation design is the practices of the securities industry. LIMRA studies indicate that in many companies, regardless of distribution channel, a significant portion of the total income derived by life insurance agents is from single premium wealth accumulation products. This is primarily annuities and mutual funds.

Furthermore, the growth in these products has been fueled by variable products, i.e., products funded by underlying securities.

In the securities industry there is a compensation concept that has been widely implemented which is referred to as "best advice." Under this concept, the producer is compensated the same for like products regardless of manufacturer. For example, a securities broker who presents various mutual fund products to his or her customer cannot be influenced in the recommendation by a compensation differential. In other words, while it may be in the sponsoring company's best interest to promote its own products and services, the broker is treated neutrally from his or her compensation package and recognition program so as to provide an unbiased best advice. This concept can be expected to be extended to the life insurance industry as well. One of the insurance industry fears in evolving regulation is commission disclosure. Commission disclosure is secondary to the related subjects of overall cost disclosure and underlying product value. To the extent that high front-end commission structures detract from early cash values, the disclosure issue is real; however, commissions make up only a portion of distribution costs. Companies with overall high costs will be expected to be disadvantaged by any disclosure regulation, whereas low-cost, high-product-value companies will be favored regardless of compensation style.

Another compensation concept associated with the securities industry is producer compensation as a function of gross marketing allowance or broker/dealer margin. For life insurance distribution this is an exciting concept from two perspectives. First is the concept of a clear marketing allowance.

The life insurance industry, from a historical perspective, does not think in terms of gross marketing allowance but rather its subcomponents. The amount necessary for first-year and renewal commissions, management compensation, operating expense allowances, and benefits are typically thought of in their separate components. To be competitive in today's environment, a more cogent method is to think in terms of the gross amount available to distribute the product. This concept is embodied in the broker/dealer concession approach in the securities industry. In addition to its obvious advantage of clearly identifying the resource available for distribution, the explicit marketing-allowance approach provides companies with the ability to manage multiple distribution channels on a consistent product-pricing basis. Under this concept, a manufacturer who wishes to distribute through multiple distribution channels provides a similar margin to each of its distributors; however, the distributor determines how to allocate that margin according to its own specific distribution needs. This idea strips away much of the mystery surrounding product pricing and can generally be expected to better accommodate the consumer environment as we move forward.

A second concept of sales compensation in the securities industry, which may have increasing relevance for insurance distribution, is defining producer compensation in terms of the percentage of the gross distribution allowance or broker/dealer concession. The interesting aspect of this basis of compensation is that it moves the discussion of producer compensation from an industry standard of a set percentage of premium or deposit to a consistent allocation of the marketing allowance to producer compensation. In other words, under the percentage of marketing allowance concept, all products sold by an individual producer, regardless of manufacturer, drive consistent compensation in terms of the amount available for distribution. This assures that, regardless of product mix, the resource allocation to support the other distribution functions, such as management, overhead, support, etc., are maintained in harmony. From a pure distribution perspective, this is clearly a superior methodology than dealing with producer commission rates on historical percentage-of-premium basis.

To summarize, there are a number of underlying trends that are reshaping the sales compensation environment. The major ones include the lack of growth of the industry over the past number of years, the broadening of competition to include nontraditional distributors, and the marketing environment as it regards regulations affecting compensation and the class-action lawsuits based on agents' recommendations not in the best interest of the policyholder.

As a result of a changing environment, new sales compensation philosophies are emerging. This is a positive development; however, successful sales compensation within any particular company or distribution system will be defined by the needs most important to the particular circumstances of that organization. In the short run, at least there will not be one dominant pattern that emerges, but rather numerous variations that attempt to best meet the competing needs of product manufacturing, distribution, and ultimately the customer.

From the Floor: Can you give some information about your first-year lapse rate before and after the move to levelized commissions?

Mr. Brooks: There was not a major impact on the first-year lapse rate, either up or down, as a result of moving to levelized commissions. The improvement that we noticed was primarily at the higher durations, and largely associated with the orphan business. So there was very little impact on the first-year lapse rate.

Mr. Thomas A. Phillips: Did you have an abrupt change from one compensation system to the other, so that on June 30 there was a high first-year commission and lower renewals and then on July 1 all of the agents moved to levelized commissions, or was there some sort of a transition system in place?

Mr. Brooks: Basically, it was an abrupt change with the only exception being that for policies sold on a heaped basis, we paid the second half of the first-year heaped commission six months later, and we continued to do that through the remainder of that period. But other than that, it was an abrupt change.

Mr. Lawrence S. Carson: In theory, at least, the levelized commissions should inspire agents to write better quality business. Have you seen any evidence of better mortality under a levelized commission system?

Mr. Brooks: I would not say that there has been a noticeable change in mortality. We have had some ups and downs in our mortality periods, but nothing that I would tie to the level of compensation, particularly. There is probably a little too much noise in the data to really be able to tell whether that is the case.

Mr. David Remstad: You mentioned the cost of recommissioning an in-force block, and I see you took that out of surplus rather than lowering dividends. If that was the case, did you have a noticeable decline in your surplus ratio? Or did that take place over time?

Mr. Brooks: We did take it out of surplus. It did not affect policyholder dividends. We did not charge that cost through dividends. It was significant enough of a cost that it had a major impact on the surplus ratio, but not what we considered significant.

Mr. Bill A. MacMillan: Do you think that levelized commission systems would work with an MGA distribution system? I was with Great West Life and that was kind of a pseudo-captive distribution system. I know Mutual provides a lot of training. It just seems to me that it would never work with an MGA distribution system because agents would have a choice and they would always go with the higher commission until levelized commissions were mandated, or until there was some big change in the industry that caused everyone to go level.

Mr. Brooks: Certainly, I think that is probably the case. John talked about the importance of consistency. Just looking at your own company, to have one product at a phase level and one that stays heaped would not make much sense, and this is similar to a situation where the distributor has the option of getting heaped or being level. I would not think it would fit well. Our subsidiary in the U.S. actually has a different distribution system. We do not have a levelized commission system there.

Mr. Wellborn: I was supposed to mention some points about Acacia for Paul Schneider. I talked with him this week and was not surprised to find out that his field force was growing and that he has more agents than he had four years before.

I was surprised to find that Acacia primarily recruits experienced agents. What you are finding is that in this continuum of distributors who are very much involved in the wealth accumulation and the financial planning business, levelized commissions are fitting right in with the way they do business. As a matter of fact, the high/low is a bit disruptive to the way they do business, because their theme is, "I am here for you. I get paid as long as I am satisfying your needs." Levelized commissions fit very well within that theme.