TRANSACTIONS OF SOCIETY OF ACTUARIES
1956 VOL. 8 NO. 22

A NEW LOOK AT THE NEW YORK EXPENSE LIMITATION LAW

ALLEN L. MAYERSON

THE New York expense limitation law, now section 213, was enacted in 1906. The intent of this law was to secure reasonable economy in the operation of life insurance companies and to protect policyholders against extravagant expenditures.

Since that time the expense limitation law has been one of the keystones of insurance supervision in New York State. It has been bitterly attacked by some and staunchly defended by others, often discussed and frequently amended. It has been the subject of two papers in the *Transactions* of the Actuarial Society of America. Mr. M. A. Linton, in "Section 97—New York Law, Revision of 1929," *TASA* XXX, 109, discussed the amendments to the law which were made in 1929, and Mr. Daniel J. Lyons discussed the 1948 amendments to section 213, and some of the weaknesses in the law as it then stood, in "Expense Limitations in Section 213 of the New York Insurance Law," *TASA* XLIX, 27.

It seems appropriate, 50 years after its enactment, to review the history and philosophy of the New York expense limitation law and its effect on the life insurance business. This paper summarizes the experience I have gained while helping to administer this law and also discusses various interpretations and rulings of the New York Insurance Department arising from it. Of course this paper does not purport to reflect the official views of the insurance department, and any opinions expressed are those of the author.

HISTORY

At the time of the Armstrong investigation insurance supervision was considerably less comprehensive than it is today. The first New York Superintendent of Insurance had been appointed in 1860, and within the next 10 years most of the other states developed some sort of regulation. The first general insurance law in New York State was enacted in 1892. However, the law related primarily to licensing requirements, restrictions on investments, rules of procedure to be followed by the Superintendent, and taxing power. Although the Superintendent had the authority to examine companies, there was no requirement that

he do so at regular intervals and many companies were not examined for long periods of time. There were few legal provisions to protect policyholders—no effective control over policy forms, no requirement for cash values or an annual distribution of surplus, and no restrictions on the expenditures of life insurance companies.

As a result of the conditions uncovered by the 1905 Armstrong investigation, a broad system of insurance regulation was established in 1906. In addition to various laws relating to company solvency, regular examinations and more complete annual financial statements, four important laws were enacted which directly affected the disposition of the policyholder's premium dollar: a limitation on new business, a limitation on the maximum surplus of a company, a requirement of annual distribution of surplus to participating policies, and a limitation on expenses. The way in which these laws interact will be discussed later.

Section 97, the New York expense limitation law, became effective on January 1, 1907. Although its designation was changed in 1940 to section 213 and its provisions were almost completely revised by the 1929 and later amendments, the philosophy and basic principles of the original law remain unchanged.

The method applied originally by section 97 was to limit expenses to the amounts available for expenses in the premium. Thus acquisition expenses were limited to the loading on first year premiums plus the present value of select mortality gains for the first five policy years. Total company expenses (excluding taxes and investment expense) were limited to the loading on all premiums plus select mortality savings.

Because of the development of nonmedical insurance, substandard business, and supplementary benefits such as disability and double indemnity coverage, as well as the growth of term insurance and the considerable improvement in mortality, this method of limiting expenses ceased to work well. A committee of six actuaries, representing companies of various sizes as well as the New York Insurance Department, studied the situation and recommended changes in the law. The 1929 revision of the law and the reasons for the changes are ably discussed by Mr. Linton, chairman of the committee, in his paper in *TASA* XXX.

Certain amendments were made after that time, but it was not until the postwar inflation that another major revision of section 213 became necessary. In 1948 the expense limits were increased to take account of inflationary conditions and this increase was made temporary for five years in order to provide time for a thorough study of the law.

In December 1948, at the request of the New York State legislature, the Life Insurance Association of America and the American Life Con-

vention appointed a joint committee to make a study of section 213 and prepare whatever amendments or changes were deemed necessary. More than 25 actuaries as well as many other insurance executives participated in the work of this committee. At one time or another the actuary of practically every company doing business in New York State has been involved in the work of this and subsequent committees.

The report of this 1948 committee recommended a complete revision of the New York expense limitation law which would have changed not only its form but also, to some extent, its philosophy. There was, however, a feeling within the New York Insurance Department as well as among some company people that it would be possible, as well as desirable, to keep the basic philosophy as well as the form and most of the language of the present law, and make the necessary changes by amendments to the statute. This latter view prevailed and a new committee began work in 1952 to prepare amendments to section 213 which would eliminate its deficiencies and make it fit present-day needs. These amendments, passed by the Legislature in 1953 and 1954, together constitute a major overhaul of the law.

PHILOSOPHY AND PURPOSE OF SECTION 213

The New York expense limitation law has done more than almost any other element to stabilize the life insurance business. Although the law is on the books of only one state, its influence is felt throughout the country, since it applies to all the business, wherever done, of any company operating in New York State. This means that the protection of the New York expense limitation law is available to policyholders of other states who hold policies with companies licensed in New York.

Actually its influence is even more widespread, since many companies not licensed in New York have been guided by the commission patterns of companies operating in New York State. Therefore, section 213 may properly be said to have influenced the over-all pattern of agents' compensation and to have affected the level of expenditures even of companies not doing business in New York.

The over-all purpose of the New York expense limitation law is to keep the expense element of the cost of life insurance from reaching an unreasonable level. Furthermore, it tries to do this with the minimum of interference with management. The responsibility for efficiency and low expenses is primarily that of management. The function of the state should merely be to lay the ground rules and the boundaries within which management shall exercise its discretion.

While we all know that the New York expense limitation law is an outgrowth of abuses found in company operations (and particularly

in their agency operations) by the 1905 Armstrong investigation, one may well ask whether the law is still necessary today. Conditions have changed considerably since 1905. Company management is more enlightened and responsible, and a tradition of economical, efficient company administration has developed. One might prefer to leave the entire question of expense control to the judgment of individual companies, depending on the forces of competition to regulate expenses.

The opposition to expense limitation becomes even more vocal because of the erroneous impression in some circles that the purpose of the law is to regulate agents' compensation. Viewed in this light, the law is deemed by some to be improper and contrary to the practice in other industries, where wages are a matter of determination by the employer or of collective bargaining between the employer and his employees.

It must, therefore, be emphasized that the purpose of section 213 is not to limit agents' compensation but to control the expenses of life insurance companies. The reason that so much of the law applies to commissions and other selling expenses is that these are major expenses of an insurance company. As a result of mechanization and streamlining of procedures, home office expenses have been of decreasing importance in company expenditures. Here competition and efficient management have indeed operated to reduce costs.

The sales function, however, is still an individual matter; it must be performed by men, working at human speeds and having human needs and desires, rather than by machines. It is for this reason that the sales function bulks so large in insurance company expenses and that the tendency of sales expenses, in the absence of some control, would be to rise rather than to diminish. Furthermore, the effect of competition is to reduce administrative expenses but to increase sales expense.

The importance of sales costs, including agents' compensation, in the life insurance expense picture is thus a basic feature of the business, and the many references in section 213 to agency expenses, agents' commissions, etc., is a result rather than a cause of this fact. A law which attempts to regulate the expenses of a life insurance company must of necessity limit, directly or indirectly, agency expenses, because they comprise such an important part of a company's total expenditures. A law which was silent in regard to commissions and other agency expenses would be ineffective in controlling expenses.

However, the law does not, as is so often claimed, limit the compensation of an agent. This can easily be seen from the data of one large company which indicate that, while the median earnings of its nearly 4,000 agents was approximately $5,200, 8% of them earned more than $15,000 and 10% earned less than $2,000. Another large company reported median

earnings of slightly more than $4,000, with 12% earning more than $10,000, and 7% earning less than $2,000. (It should be noted that those agents earning less than $2,000 are probably either semiretired or part-time agents.)

The tremendous variation in these earnings would seem to indicate that an agent's compensation is determined, not by section 213 or any other law, but by his efficiency and the number and type of sales that he makes. The law merely sets a ceiling on the commission rates which may be paid on an individual policy, as a part of its control over all company expenses, with the object of putting a limit on the cost to the policyholder of his insurance protection.

Why, however, should it be necessary to control life insurance company expenses when the expenses of other companies are not limited? Why should the public be protected against the cost of life insurance becoming excessive when there is no similar control over the cost of other items it buys—shoes, refrigerators, automobiles, etc.?

There are four reasons for this:

1. Insurance is vested with a public interest and because of its importance and complexity requires that the general public be protected to a greater extent than is necessary in many other fields.
2. The ultimate cost of life insurance is not immediately determinable, as is the case with most products, but depends upon the future performance of the company.
3. Indirect expense control, through rate regulation, does exist in many other industries.
4. Expense limitation is one of the cornerstones of life insurance regulation—minimum reserve standards, nonforfeiture value requirements, surplus limitation and annual distribution of dividends are among the other principal protections for the policyholder.

Insurance, in contrast to most commercial ventures, is vested with a public interest. Whether the insurance company is stock or mutual, it is in the business of collecting and disbursing other people's money. For this reason, if for no other, closer governmental regulation of insurance is necessary than is the case in almost any other business.

Furthermore, the life insurance business is complex. The profusion of plans of insurance (with new ones constantly being devised), the existence of both stock and mutual companies and of participating and nonparticipating insurance, the fact that not only premiums but also dividends, surrender values and settlement options differ between companies, all tend to confuse the layman. The life insurance policy he buys is not a tangible object like an automobile or a suit of clothes that he

can look at, touch, try on, and choose for himself. His life insurance policy is merely a piece of paper—a promise to pay whose worth he must largely accept on faith. He relies, of course, upon the agent who advises him and upon the reputation of the company. However, the existence of state insurance laws and a state insurance department contribute substantially to the policyholder's faith in life insurance.

Nearly 70% of the insurance in force in United States life insurance companies is participating. The ultimate cost of participating insurance cannot be determined at issue of a policy but depends upon the future experience of the company with regard to mortality, interest, capital gains or losses, and expenses. If a company is imprudent in its underwriting or investments, or is extravagant in its expenditures, a policyholder cannot easily transfer to another company. He may be uninsurable; but even if he could obtain coverage from another company, he would almost inevitably sustain a loss through having to pay the acquisition expenses for a second time.

While some of the items which influence the ultimate cost of life insurance are uncontrollable, it is surely the responsibility of state insurance laws to regulate those elements which can be controlled in order to ensure that policyholders receive their insurance protection at a reasonable cost.

Certain other industries such as railroads, public utilities and fire and casualty insurance are also vested with a public interest. Why is there no law regulating the expenses of companies engaged in these fields, as there is for life insurance?

In the case of railroads and public utility companies, as well as fire and casualty insurance companies, indirect expense control exists through rate regulation. In general, all these companies must file their rates with some governmental body which reviews them for adequacy and reasonableness. Since the amount of money which a company can spend is obviously related to its income, and since it must justify to the governmental authority any increase in rates, it is clear that rate regulation is in effect a form of expense limitation.

The relationship between rate regulation and expense limitation is very important. Rate regulation for most lines of fire and casualty insurance in New York State dates from 1911. In 1922 the Superintendent of Insurance was given the power to order adjustments in rates which he deemed excessive or inadequate. The law was further strengthened in 1948, in view of the determination by the United States Supreme Court that insurance was commerce. It should also be noted that life insurance rate regulation exists in many foreign countries, and that the state of Wisconsin sets maximum life insurance premium rates.

I believe that the existence of the New York expense limitation law is one of the major factors which prevent a demand for rate regulation of life insurance. It is this law, section 213, together with the minimum reserve standards, the minimum and maximum surplus limitations and the requirement for annual distribution of dividends, which protects the policyholder against premium rates that are excessive or inadequate and therefore makes rate regulation unnecessary.

Inadequate premiums would result in inability to meet the minimum reserve standards and in depletion of surplus. To ensure that inadequate premiums will be immediately reflected in a company's liabilities, deficiency reserves are required if the gross premium is less than the net premium needed to maintain the valuation standard used by the company. A further safeguard against inadequate premiums is furnished by subsection 10 of section 213, which provides that no company may issue a life insurance or annuity contract which does not appear to be self-supporting on reasonable assumptions as to interest, mortality and expense.

Excessive premiums are prevented, as a practical matter, by the competition which exists among life insurance companies. In any event, the limitation on surplus, coupled with the expense limitation law, would make it impossible for a company with high premiums to retain or spend an excessive part of them. Since the expenses of a company writing participating insurance are limited by section 213, any excessive premium would have to be used to support an ultraconservative reserve basis or to increase surplus. If the reserve standard were unduly conservative, the true earnings might be concealed for a time, but would ultimately emerge as surplus. Since the maximum surplus of a domestic company writing participating insurance is limited by section 207 to 10% of its policy reserves and liabilities, any excess earnings would have to be paid to policyholders in the form of dividends. Section 216 of the New York insurance law provides for an annual distribution of divisible surplus and requires that dividends be distributed equitably, thus ensuring that earnings are returned to those policyholders who have contributed to them.

While companies writing nonparticipating insurance exclusively are exempt from the 10% surplus limitation and from the total expense limit of section 213, the fact that the vast majority of companies must comply tends to set the standard; the premiums of nonparticipating companies must be competitive with the net cost of companies writing participating insurance. Although foreign companies are not, strictly speaking, subject to the 10% surplus limitation, the provision of section 42 of the New York law requiring substantial compliance by foreign

companies with the laws relating to domestic companies would be applicable.

Something should also be said about the extraterritorial effect of the New York expense limitation law. This feature has often been attacked on the grounds that a company domiciled in, say, Massachusetts, should not be governed by New York law in regard to the expenses it incurs in, say, Kansas or California. However, since companies charge the same premiums and pay the same dividends nationwide, and since many of their expenses cannot be segregated by state, the only way to control the cost of insurance to New York policyholders is to control all the expenses of a company, wherever incurred. It is for this reason that the New York expense limitation law, in order to be effective, must control the over-all expenses of all companies doing business in New York.

It should be noted that expense limitation laws also exist in Illinois and Wisconsin, though they are less strict than the New York law. Perhaps if the New York expense limitation law did not apply extraterritorially, other states which now have no expense limitation law would adopt one.

OVER-ALL VIEW

Section 213 has the reputation of being very complex. Indeed, this reputation has kept many people from examining the law and has prevented a wide understanding of its fundamentals. However, the complexity of section 213 arises from its detailed provisions and the mechanics of its operation. Its basic principles are relatively simple and can easily be explained.

Stripped of its legal verbiage and technicalities, section 213 comprises four elements:

1. *A limitation on field expenses.*
   Field expenses are defined in the law and include commissions and all other payments to agents and general agents, a portion of advertising, branch managers' salaries, branch office rent, postage, telephone, etc., and all other expenses that are field, rather than home office, expenses. The limitation on these field expenses is set out in terms of percentages of premiums and dollars per thousand of new business and insurance in force.
2. *A limitation on the total expenses of a company writing participating insurance.*
   The total expense limit, as the name implies, limits the total expenses of the company except for taxes, licenses and fees, and investment expenses. This limit does not apply to a stock company writing exclusively nonparticipating business. The limit is expressed as a

formula based on the amounts of premiums collected, new business written and insurance in force.

3. *A limitation on the scale of commissions which a company may pay.*
The limitation on agents' commissions applies separately for the first year and renewal years. The first year commission on an ordinary life policy may not exceed 55% for a soliciting agent and 60% for a general agent. As a practical matter, first year commissions must be graded down for other plans of insurance, since the total amount which a company may spend for first year commissions is determined by a formula which employs such a grading.
Except for short-term endowments, the limit on renewal commissions is 7½% of the premium for the 2d to the 10th years and 5% for the 11th to the 15th years for a general agency company. For a branch office company the renewal commission limit is two-thirds of this scale. In addition, either type of company may pay a collection or service fee of 3% of the premium from the 16th year onward. An additional 1% of the 2d to 9th year premiums is also available as compensation to agents, intended principally to provide insurance and retirement benefits for them.

4. *Certain miscellaneous "qualitative" provisions.*
The miscellaneous provisions comprise such items as a prohibition against bonuses or prizes, a prohibition against paying any commission not agreed upon in advance of payment of the premium, and a requirement that every policy must be self-supporting. Other sections of the law permit a company to pay training allowances to new agents and salaries to new general agents, and provide a penalty for violation of the law.

Compliance with the field expense limit, the total expense limit, and the first year commission limit are tested by Schedule Q (reproduced as appendix A) which is filed each year by each licensed company as a part of its annual statement.

The Detailed Provisions of the Law

Section 213 applies to all companies doing business in New York, wherever domiciled. It applies extraterritorially, to all business of these companies, except that only the U.S. branches of alien companies are subject to the law. Stock companies writing only nonparticipating insurance in New York State are exempt from the total expense limit, but must comply with all other provisions.

The expense limits and the limitation on first year and renewal commissions apply only to ordinary life insurance and annuities. However, most of the "qualitative" provisions, such as the prohibition against

bonuses, prizes and rewards, the prohibition against issuing a policy which does not appear to be self-supporting, etc., apply to group insurance and group annuities as well. Since section 213-a regulates the expenses of insurance written on a monthly or weekly debit basis (including all industrial life insurance), such insurance is excluded from all of the provisions of section 213. However, section 213-a contains similar prohibitions applicable to debit insurance.

FIELD EXPENSE LIMIT

The total field expense limit in its present form dates from 1954. It is set forth in subsections 1, 2 and 3 of section 213. Subsection 1 states that no company may incur in any calendar year total field expenses in excess of the total field expense limit. Subsection 2 defines what shall constitute field expenses and subsection 3 sets forth the field expense limit.

With the possible exception of the first year field expense limit, described on page 278, the total field expense limit is perhaps the most important limit in section 213. The Armstrong Committee believed that the area in which companies were most likely to incur excessive expenses was the expenditure for obtaining new business. It was therefore thought essential to limit acquisition expenses. However, it is impossible to limit acquisition expenses directly, since nobody has been able to find a satisfactory definition of "acquisition expenses" nor a basis of allocation between first year and renewal expense that would be applicable to all types of companies. Therefore field expenses are limited instead of acquisition expenses. While it is recognized that a limitation on field expenses is not the same thing as a limitation on acquisition expenses, the vast majority of acquisition expenses are incurred in the field and the major portion of field expenses is acquisition cost. Hence the limit does substantially achieve its purpose.

Prior to 1954, the limitation on field expenses operated somewhat differently from the way it does now. The limitation used to be on "first year expenses," which were defined to be first year commissions, advances and other first year compensation to agents, 60% of advertising, and the excess, if any, of renewal commissions and branch office expenses over certain assumed renewal expense factors. The 1954 amendment dropped this rather unrealistic definition of "first year expenses" and limited total field expenses directly.

The expenses controlled by the field expense limit are:

1. First year commissions and other compensation for the acquisition of new business.
2. Advances to agents.

3. Salaries and expenses of persons on the home office staff spending more than one-third of their time in the field in connection with production of new business or agency supervision.
4. Renewal commissions, collection and service fees, training allowances.
5. All branch office salaries, rent and other expenses, and all expenses for agency supervision except those incurred by members of the home office staff.
6. 60% of advertising.

This list includes all field expenses, whether incurred for the acquisition of new business or not, and effectively prevents the transference of functions from the field to the home office in order to escape the limitation. Thus the provision that the salaries and expenses of home office employees who spend more than one-third of their time in the field shall be considered field expense, prevents a company from evading the limitation by placing its branch office managers and supervisors on the home office payroll. This provision has been interpreted to include company executives as well as employees, if they spend more than one-third of their time in the field.

The cost of medical examinations and the inspection of applicants for insurance is specifically excluded, since these are home office underwriting functions and should not be included with field expenses, even though a company might perform these functions in the field.

The 60% of advertising is an empirical percentage which has no particular scientific basis. The amount of advertising done to attract new policyholders varies widely among companies. However, the 60% figure has been in the law since 1929 and appears to be satisfactory for most companies. Home office as well as field advertising must be included, but advertising of a completely institutional character such as that supported by contributions to the Institute of Life Insurance may be excluded.

It should be noted that net advances to agents must be included even though most advances contemplate repayment and are not really compensation. However, they are included in order to prevent evading the law by making advances without expectation of repayment, as well as to discourage a company from making advances to agents larger than their production would warrant. It should be noted that another provision of section 213, in subsection 9, prohibits advances other than those made against first year commissions.

Expense Limit Factors

The field expense limit is composed of factors expressed as a percentage of premium and per thousand dollars of new business and of insurance in force, as follows:

1. A graded first year commission allowance which is expressed as a percentage of first year life insurance premiums. For policies with an annual premium not less than that for a whole life policy, the limit is 20% of the gross premium plus 35% of the corresponding ordinary life premium. For other types of policies the limit is 37½% of the gross premium plus 35% of any excess of the gross premium over one-half of the corresponding ordinary life premium.
2. 3½% of single premiums.
3. 30% of first year annuity premiums.
4. $1 per thousand dollars of insurance paid for during the year plus $1 per thousand dollars of such insurance still in force at the end of the year.
5. 15% of items 1, 2 and 3 above.
6. $2 per thousand dollars of new insurance paid for during the year.
7. 3% of first year premiums received during the previous five years.
8. 75¢ per thousand dollars of insurance paid for during the previous two years.
9. 2½% of renewal premiums.
10. 50¢ per thousand dollars of insurance in force plus $1 per thousand dollars of premium-paying insurance in force.
11. A graded small company allowance.
12. The excess, if any, of 2/3 of managers' salaries over the average for the past 14 years.

In items 6, 8 and 10, $100 of annual income on annuities is considered as $1,000 of life insurance, and annuity premiums as well as life insurance premiums are included in items 2, 7 and 9.

While the formula is of necessity empirical, certain factors can be roughly related to the specific expenses which are limited. Thus the first three factors are intended to cover first year agents' commissions. The fourth factor is to cover advances to agents and advertising, and to provide a margin for fluctuations in first year commissions due to a change in the distribution of business by plans or ages. The fifth item is roughly intended to cover first year overriding commissions to general agents (or a portion of branch managers' salaries) and training allowances to new soliciting agents. This factor is smaller than the sum of the maximum permissible first year general agent's overriding commission and the maximum amount permitted for training allowances. A company that wishes to spend the maximum in both these areas must therefore use some of the margins otherwise available for other field expenses. Thus the company has considerable flexibility in the types of agency expenses it can incur, while the over-all total is kept to a reasonable maximum.

The seventh, eighth and ninth items and a part of the tenth are

roughly intended to cover renewal commissions. The sixth and the balance of the tenth factor are available for all other field expenses. Item eleven, the additional allowance for smaller companies, will be discussed later.

Item 12 is intended to provide additional limits for a company which is in the process of changing from a general agency to a branch office method of operation. Under a branch office operation, the manager is paid currently for his work. A general agent, on the other hand, receives a small first year overriding commission, plus the right to certain renewal commissions to be paid in the future, on each policy sold through his agency. This provision is intended to grant relief to a company which, during a transitional period, must pay current salaries to its managers plus vested renewal commissions to general agents on business written in previous years. The 14-year period was chosen to coincide with the 14 years for which a renewal commission schedule is specified by subsection 8.

During an inflationary period such as we have experienced since the war, this provision also serves to provide additional margin for a rapidly expanding branch office company which, because of its expanding situation, incurs managerial salaries greatly in excess of those it formerly incurred. However, this relief is only temporary, since it will cease when inflationary conditions lessen and the company's managerial salaries begin to level out.

Schedule Q

The graded first year commission allowance (item 1) is obtained by a preliminary calculation made on page 2 of Schedule Q (see appendix A). Policies are divided into three groups, (*a*) those with premiums greater than ordinary life, (*b*) those with premiums less than ordinary life but greater than 50% of the ordinary life premium, and (*c*) those with premiums less than half ordinary life. The commission allowance for policies in group (*a*) is $20\%P' + 35\% L$, those in group (*b*) $37\frac{1}{2}\%P' + 35\% (P' - \frac{1}{2} L)$, and in group (*c*) $37\frac{1}{2}\%P'$ (where P' is the gross premium and L the gross premium on a corresponding ordinary life policy).

This calculation is made for all policies dated and paid for during the year and still in force at the end of the year. Single premiums and extra premiums are excluded. The ratio of the commission allowances obtained by these calculations to the gross premiums on these same policies is then obtained. This percentage is applied to all first year premiums, including extra premiums but excluding single premiums, after deducting premiums for reinsurance assumed and adding premiums for reinsurance ceded, to obtain item 1 of the company's field expense limit.

It should be noted that the premiums on which the calculation is made will differ somewhat from the premiums to which the ratio is finally applied, since the ratio is calculated on the basis of annual premiums but is applied to collected premiums. Also extra premiums on substandard business, disability and double indemnity extra premiums, premiums on policies dated in previous years but paid for in the current year, and term policies issued for less than one year are not used in determining the ratio but are included in obtaining item 1 of the expense limit. Thus, in calculating the field expense limit, the same average rate of commission is allowed on substandard, disability and double indemnity extra premiums as on the basic policy.

Certain plans of insurance may fall in category (*b*) for some ages and in category (*c*) for other ages. With the approval of the New York Insurance Department, the calculation may be based upon the average age within each plan, if the company wishes to avoid classifying its premiums by age as well as by plan.

Certain problems arise in calculating the field expense limit in regard to family income policies, other decreasing term policies, policies with irregular premiums, etc. The Department's circular letter of July 15, 1930 sets forth rules governing these situations.

In calculating the graded first year commission allowance on a policy with family income benefits, where the formula allows 20% of the gross premium plus 35% of the corresponding whole life premium, the 35% is calculated on a premium for a whole life policy containing the same family income benefits. The effect of this ruling is to allow the same commission on a family income rider as is allowed for the basic policy to which it is attached. The flat allowance per $1,000 of insurance is applied to the average face amount of the policy rather than the initial face amount. In the case of a whole life policy with family income benefits, the average amount is obtained by considering the term of the policy to be the life expectancy.

In calculating the commission allowance on, say, a decreasing term to 65 policy, where the allowance is 37½% of the gross premium plus 35% of the excess of the gross premium over one-half of the corresponding whole life premium, the whole life premium is calculated for a face amount equivalent to the average, rather than the initial, face amount of the decreasing term policy. The flat allowance per $1,000 is based on the average face amount of the decreasing term policy. The average face amount is determined by dividing the sum of the insurance for the various years by the term of the policy.

In assigning premiums to categories (*a*), (*b*) and (*c*), a problem arises for those companies which do not issue an ordinary life plan of insurance

or issue one with a high minimum amount or special underwriting restrictions. The Insurance Department requires that in such cases the gross premium on each plan of insurance be compared to a hypothetical ordinary life premium, calculated on the basis of the same loading formula as the plan being compared.

Rationale of Factors

Items 1 to 4 and 12 of the field expense limit have been in the law since 1929. The other limit factors were revised in 1954. Their number and apparent complexity are due to the need to devise a formula which would fit all types of companies—large and small, branch office and general agency, with varying proportions of old and new business and different types of commission scales. It was necessary to use limit factors which would provide for all reasonable and necessary expenses and permit a reasonable growth of new business while preventing extravagant or undue expansion, with its attendant high expenses.

The method followed in devising the limit factors was to endeavor to express each item of expense to be limited as a percentage of first year premiums and to choose limit factors which would provide for each item of expense, allowing insofar as possible both for its magnitude and for its incidence. Thus first year commissions to soliciting agents are covered by an allowance expressed as a percentage of first year premiums, while renewal commissions and service fees are covered by an allowance based largely on renewal premiums.

However, renewal commissions are generally higher in early renewal years than subsequently. Therefore a limit factor expressed as a flat percentage of renewal premiums (as was the case before 1954) would be insufficient for a rapidly growing company with considerable business still in the high renewal commission period. For this reason the allowance for renewal commissions was expressed in part as a flat percentage of all renewal premiums and in part as a percentage of the premiums on business written in the past 5 years. In order to avoid the necessity of segregating the premiums in force on business written in the previous years, it was decided to use first year premiums received in each of the past 5 years (easily available from previous years' records).

In addition, a part of the limit which is intended to cover renewal commissions is expressed in terms of insurance paid for during the previous two years and in terms of premium paying insurance in force. The purpose of basing part of the commission allowance on new business and insurance in force rather than on premiums was to give somewhat larger allowances on lower premium forms of insurance and somewhat lower allowances on high premium policies.

It should be noted that the field expense limit is an aggregate one, and a company has complete flexibility in shifting expenses between the various categories. The discussion above in which each type of expense is related to a specific limit factor is merely a convenient way of demonstrating the reasoning behind the expense limit formula.

The following table expresses the Schedule Q field expense limit in terms of percentages of first year premiums for three model companies.

SCHEDULE Q FIELD EXPENSE LIMIT FOR THREE MODEL COMPANIES
(Expressed as a Percentage of First Year Premiums)

	ANNUAL INCREASE IN NEW BUSINESS		
	0%	4%	8%
Field Expense Limit			
a) 55% graded first year commission allowance	48.000%	48.000%	48.000%
b) $1 per $1,000 of insurance issued during the year	3.333	3.333	3.333
c) $1 per $1,000 of new insurance in force at the end of the year (assumed to be 98% of item b)	3.266	3.266	3.266
d) 15% of 55% graded commission allowance	7.200	7.200	7.200
e) $2 per $1,000 of new insurance	6.667	6.667	6.667
f) 3% of first year premiums received during the previous five years*	15.000	13.356	11.978
g) 75¢ per $1,000 of insurance issued during the previous two years†	5.000	4.715	4.458
h) 2½% of renewal premiums	36.718	24.000	17.230
i) $1.50 per $1,000 of insurance in force	78.435	53.000	39.460
	203.619%	163.537%	141.592%
Assumed Expenses			
a) First year commissions to soliciting agents	48.000%	48.000%	48.000%
b) 5% first year overriding to general agents	5.000	5.000	5.000
c) Training allowances‡	2.567	2.567	2.567
d) Renewal commissions and collection fees§	79.085	56.957	43.901
e) Pension and insurance benefits for agents and general agents#	5.963	5.070	4.370
f) General agents' expense allowances (assumed to be $7.50 per $1,000 of new insurance)	25.000	25.000	25.000
g) Available for advertising, agency meetings, furniture and fixtures, fluctuations, etc.	38.004	20.943	12.754
	203.619%	163.537%	141.592%

* In our model office, assuming a 4% annual growth, first year premiums of the past 5 years represent $\sum_{n=1}^{5} [1/(1.04)^n]$ or 4.452 times current first year premiums. With a level amount of new business they would be 5 times current issues and with an 8% growth 3.993 times.

† Such insurance will be $1/1.04 + 1/1.04^2$ or 1.886 times current issues with a 4% annual growth, 2 times with level new business, and 1.783 times with an 8% annual increase.

‡ Assumed to be 5% of items (a) and (b) of the field expense limit.

§ Assumed to be 7½% for policies in 2d to 10th years, 5% for policies in 11th to 15th years, and 3% for older policies (per subsection 8(a) and 8(d) of section 213).

Assumed to be equivalent to 1% of premiums on policies in the 2d to 9th policy years, per subsection 8(aa) of section 213.

Each company operates on a general agency basis, has an average premium of $30 per $1,000, experiences Linton A lapse rates, and pays the same first year and renewal commission scale, which is assumed to be the maximum permitted by section 213, the same agents' training allowances, and the same expense allowances to general agents. They differ only in the annual increase in new business written and therefore in the composition of the insurance in force by policy year. The first column shows the various limit factors and the assumed expenses, all expressed as percentages of first year premiums, for a model company which has been in business for thirty years and whose present portfolio has been built up by a level amount of new business each year. The second and third columns contain comparable figures for model companies whose new business has been growing at an annual rate of 4% and 8% respectively for the last thirty years.

The table shows how the margin tends to decrease as a company's rate of growth increases. The company with a level amount of new business has 38% of first year premiums available for advertising, furniture and fixtures, other agency expenses and as a margin. The company with a 4% annual increase in new business has 21% of first year premiums remaining for these purposes, and the company which is growing at an 8% rate has a margin of only 13%. It should be noted that these calculations assume a commission scale of 7½% on business in the 2d to 10th policy years, 5% for policies 11 to 15 years old, and 3% for all policies issued 16 or more years ago. If a fast-growing company chose to "heap" its commission scale, paying larger amounts in the early policy years and smaller commissions in later years, the margins would be reduced, since it would have more business in the early policy years where higher commissions are payable.

The foregoing model office calculation indicates how the field expense limit of section 213 serves as a brake on too rapid company growth. A company which wishes to grow at a rapid rate may do so only provided its expansion is economical. It must economize and maintain a low expense rate in order to remain within the section 213 field expense limit. Thus section 213 serves to complement section 212 of the New York insurance law, which sets a direct limit on the amount of new business which a company of a given size may write.

Small Company Allowance

Since 1929, the law has contained a special provision for smaller companies. Since small companies do not have the backlog of business in force and renewal premiums to support their agency plant, they cannot be expected to operate at as low a unit expense rate as larger

companies. Also, small companies tend to grow faster, thereby incurring higher unit field expenses than larger companies. The law recognizes this by providing a graded small company allowance. The small company allowance consists of:

$1 per $1,000 of the first $100 million of premium-paying insurance in force
75¢ per $1,000 of the next $100 million of premium-paying insurance in force
50¢ per $1,000 of the next $100 million of premium-paying insurance in force
25¢ per $1,000 of the next $200 million of premium-paying insurance in force
less 25¢ per $1,000 of premium-paying insurance in excess of $1,500,000,000, but not to exceed $275,000.

This in effect provides an additional allowance of $100,000 for a company with $100 million of premium-paying insurance in force, increasing gradually to $175,000 for a company with $200 million in force, $225,000 for one with $300 million and to $275,000 for a company with $500 million in force. The extra allowance remains level at $275,000 for companies with between $½ billion and $1½ billion, then begins to run off at the rate of 25¢ per $1,000 of insurance, reducing to $150,000 for a company with $2 billion and vanishing when a company reaches $2,600,000,000 of premium-paying insurance in force. This method of grading slowly decreases the extra allowance per $1,000 as a company increases in size. It also compels the larger companies to operate at a slightly lower unit cost than smaller companies, or else to expand at a relatively less rapid rate.

The field expense limit is enforced by an annual reporting on a form known as Schedule Q, a copy of which is reproduced in appendix A. Both the limit and the field expenses are calculated on a "direct" basis. Reinsurance assumed is excluded and reinsurance ceded is not deducted in obtaining the limits. Expenses allocable to group insurance, industrial insurance, and accident and health insurance are excluded from the field expenses limited.

TOTAL EXPENSE LIMIT

The total expense limit and the expenses subject to this limit are set forth in subsection 5 of section 213. The total expenses are intended to include all insurance expenses—the only exclusions are taxes, licenses and fees, expenses on real estate and mortgage loans, and investment expenses not exceeding ¼ of 1% of mean invested assets.

The total expense limit consists of:

1. The total field expense limit.
2. $3 per $1,000 of new insurance paid for.
3. $1.75 per $1,000 on the first ten billion dollars of insurance in force and $1.50 per $1,000 in excess of ten billion dollars.
4. A small company allowance of $50,000 plus:
   $1.50 per $1,000 on the first $100,000,000 of insurance in force
   75¢ per $1,000 on the next $100,000,000 of insurance in force
   25¢ per $1,000 on the next $300,000,000 of insurance in force
   less 25¢ per $1,000 of insurance in force in excess of $1,500,000,000, but not to exceed $350,000.

The graded allowance remains level at $350,000 for companies with between $500,000,000 and $1,500,000,000 of insurance in force, then decreases by 25¢ per $1,000 until it vanishes for a company with more than $2,900,000,000.

The principle behind this small company allowance is the same as that governing the graded small company allowance in the field expense limit.

The following table shows the total expense limit and the margin for

TOTAL EXPENSE LIMITATIONS (ALL COMPANIES)
UNDER NEW YORK INSURANCE LAW

Year	Limit	Expenses	Margin	
			Amount	Percentage of Limit
1939	$ 360,989,215	$273,868,609	$ 87,120,606	24.1%
1940	368,296,125	277,921,880	90,374,245	24.5
1941	377,351,458	280,538,116	96,813,342	25.7
1942	375,434,537	278,562,431	96,872,106	25.8
1943	402,413,905	292,930,489	109,483,416	27.2
1944	436,550,737	321,577,575	114,973,162	26.3
1945	469,850,327	353,757,257	116,093,070	24.7
1946	549,544,177	451,560,975	97,983,202	17.8
1947	573,325,179	500,297,174	73,028,005	12.7
1948	629,531,517*	535,304,734	94,226,783	15.0
1949	645,475,982*	545,386,467	100,089,515	15.5
1950	688,836,695*	598,421,289	90,415,406	13.1
1951	729,932,214*	634,254,298	95,677,916	13.1
1952	787,091,389*	688,612,158	98,479,231	12.5
1953	884,964,856†	771,675,544	113,289,312	12.8
1954	932,854,094‡	743,975,909§	188,878,185	20.2
1955	1,043,413,497	821,820,329	221,593,168	21.2

* Additional 50¢ per $1,000 of insurance in force.

† Limit increased by 7½% of first year premiums.

‡ New limit formula.

§ The decrease in expenses for 1954 is due to the exclusion of expenses on debit business now included in section 213-a.

all companies doing business in New York State for each of the years from 1939 to 1955.

It can be seen that, on the whole, the total expense limit has always been more than adequate, and companies have not been unduly restricted by it. Individual companies have from time to time been pinched somewhat by the limit, but on the whole the conclusion seems justified that the total expense limit has not been as important in controlling insurance costs as the field expense limit and the limitation on first year and renewal commission rates.

It should be noted that stock companies writing exclusively nonparticipating insurance in this state are exempt from the total expense limit. Since there would be no incentive for extravagant home office expenses, and since the stockholders watch expenses closely, competition can be relied upon to ensure economy and to prevent nonparticipating premium rates from becoming excessive.

However, these companies are subject to the other provisions of section 213, including the total field expense limit. One reason for this is to make them subject to the same restraints as companies writing participating insurance, to avoid placing the latter at a competitive disadvantage. Also, as mentioned previously, competition tends to reduce administrative costs but to increase sales expense.

FIRST YEAR AGENT'S COMMISSIONS

First year commissions are subject to two limits, an individual policy limitation and an aggregate limit on the amount of first year commissions, other compensation and advances to agents which a company may pay in a calendar year. Both these limits are set forth in subsection 4 of section 213.

This subsection states that no company may pay to an agent a first year commission on any life insurance policy or annuity in excess of 55%. It also limits the commission which may be paid to a general agent to 60% on any policy, grading down if the general agent produces more than half the business of his agency. Thus a general agent who produces between 70% and 80% of the business of his agency would be limited to a maximum commission of 57%, and one who produces more than 90% of the business of his agency would be limited to 55%. This rather cumbersome-looking provision was inserted to prevent the appointment as general agents of men who in reality are soliciting agents, in order to escape the 55% commission limitation. Whether it actually succeeds in preventing this is open to question.

In determining the proportion of personal business written by a general agent, the amount of new business paid for, rather than premiums, is the measure.

Since it will not be definitely known until the end of the year what portion of a general agent's business was personal production, difficulties may arise during the year in deciding what rate of overriding commission can be paid. Three alternative methods can be used by a company wishing to pay the maximum permitted by the law:

a) Pay a 5% overriding commission only on business produced by subagents. At the end of the year additional amounts can be paid to those general agents who produced less than 90% of the business of their agencies to make their total overriding commissions equal to those permitted by subsection 4. Small amounts would have to be recovered from those general agents who produced more than 90% of the business of their agencies and therefore may not receive more than 55%, even on nonpersonal production.
b) Classify the agencies according to the previous year's results and make adjustments for overpayments or underpayments at the year-end.
c) Pay a maximum of 55% commission during the year and pay additional amounts at the end of the year to those general agents who produce personally less than 90% of the business of their agencies.

First Year Field Expense Limit

The aggregate test of first year commissions and related compensation is called the "first year field expense limit" and is reported on an annual basis in Schedule Q.

The expenses limited are: (1) first year commissions (excluding general agents' overriding commissions up to 5%), (2) other compensation for obtaining new business (excluding compensation for agency supervision and training allowances) and (3) net advances to agents.

The exclusion of general agents' first year overriding commissions, so long as they do not exceed 5%, was introduced in 1953, at the time the maximum commission payable to a general agent on an individual policy was increased from 55% to 60%. This was necessary to put general agency companies on a par with branch office companies, which could pay 55% to their soliciting agents and a salary to the manager for supervision. The change permits a general agency company to pay its general agent a first year overriding commission of 5% which, like the branch manager's salary, is not included in the first year limit. (However, both the general agent's overriding commission and the branch manager's salary are, of course, included in the expenses subject to the total field expense limit.) If the general agent's overriding exceeds 5%, the excess must be treated as though it were a soliciting agent's commission and included in the first year expense limit.

The item of compensation other than commissions is intended to include the portion of salary plans for soliciting agents allocable to new business and other first year compensation payments other than commissions. However, training allowances paid pursuant to subsection 13 (which will be discussed later) are excluded from this item.

The first year expense limit against which these expenses must be measured consists of the 55% graded first year commission allowance (previously discussed in connection with the total field expense limit) plus 3½% of single premiums and 30% of first year annuity premiums, plus 50¢ per $1,000 of new insurance issued and paid for during the year, and an additional 50¢ per $1,000 of such insurance still in force at the end of the year. This amount is then reduced by any excess of the present value of renewal commissions over the amounts permitted by the maximum renewal commission schedule set forth in subsection 8.

This reduction is designed to fit the case of a company which wishes to pay lower first year commissions and high renewal commissions. It also applies where a company wants to make a level commission scale available to an agent or broker. A company which chooses to do this must reduce its first year field expense limit by the value of the amounts deferred to renewal years.

In calculating the first year field expense limit (and the total field expense limit) the increase in premium upon attained-age conversion of a term insurance policy is considered as a first year premium.

RENEWAL COMMISSION LIMITATIONS

Since 1906 there has been a limit, on a "contract" basis, on renewal commissions; *i.e.*, an agent's contract cannot call for higher renewal commissions or equivalent compensation than is permitted by the rates specified in section 213. A limit of this type is necessary because of the impossibility of limiting renewal commissions on an annual accounting basis. Renewal commissions are contracted for in advance, and a company, once having made a contract with its agents, is obliged to pay the commissions which fall due, even though such payments would cause it to exceed the field expense limit or the total expense limit of section 213. Therefore the only workable limitation of renewal commissions, an important element of company expense, is a "contract control" on a present value basis.

The limitation on renewal commissions is 7½% of the premium for the 2d to 10th policy years (5% for an endowment policy with less than twenty premiums) plus 5% for the 11th to 15th policy years.

This limitation applies to a policy written through a general agency

and includes the compensation payable to the general agent as well as that payable to the soliciting agent. For a policy written through an agency supervised by a salaried manager, the renewal commissions are limited to two-thirds of the above schedule.

The 1954 amendments provided an "additional renewal commission schedule" of 1% of the premium for the 2d to 9th policy years. However, two-thirds of the commuted value of this amount must be reserved for security benefits, the balance being available for commissions or other compensation.

The reason for expressing the renewal commission limitation in this form must be sought in terms of conditions existing in 1906. At that time most companies operated on the general agency system, and their contracts were with the general agent. In most cases the company was not a party to the contract between the general agent and the soliciting agent and in some cases did not even know its provisions. Renewal commissions were vested in the general agent. The managerial system was used by relatively few companies. The purpose of the limit was therefore to control the company's over-all expenditure for renewal commissions, without interfering with the relationship between the company and the general agent or between the general agent and the subagent.

Expressing the limit in this form also bars, except for additional compensation to new general agents under subsection 8(f), the payment of any amounts other than commissions (except bona fide expense allowances) to general agents. If a general agent were paid a salary he would become a "local salaried representative" under the meaning of subsection 8(c), and the renewal commissions payable on all policies written in his area would be limited to two-thirds of the maximum renewal commission scale, namely nine 5%'s and five $3\frac{1}{3}$%'s instead of nine $7\frac{1}{2}$%'s and five 5%'s.

Some question has occasionally arisen as to the definition of a local salaried manager. The definition adopted by the New York Insurance Department distinguishes between a general agent and a salaried manager on the basis of the compensation he receives. A manager is deemed to be an employee of the company, paid currently for the work that he does. His compensation may be, and usually is, based on an incentive formula comprising such items as the amount of new business, the number of new agents hired and their production, etc. However, he receives nothing after termination of his service with the company—no part of his compensation is vested. A general agent on the other hand receives commissions that are vested, *i.e.*, payable to him whether or not he continues working for the company.

While general agents may receive expense allowances, the regulations of the New York Insurance Department have required that these expense allowances be supported by vouchers showing in detail the expenses for which reimbursement has been made. The Department's circular letter of August 23, 1948 specifies the types of expenses for which a company may reimburse a general agent and the types of vouchers required. The Department has always been very strict with regard to such vouchers and has looked with great disfavor upon any scheme to pay to general agents or to soliciting agents any additional compensation in the guise of expense allowances.

The provision in subsection 8(c) requiring a reduction of the maximum renewal commissions payable to two-thirds of the nine 7½%'s and five 5%'s where an agency is subject to the supervision of a "local salaried representative" has been interpreted not to apply to a salaried supervisor in the employ of a general agent. Therefore a supervisor may be paid a salary, although the general agent is receiving his overriding commissions; if the supervisor is actually performing necessary supervisory duties in the agency, his salary may be paid by the company, either directly or by reimbursing the general agent for the cost of the supervisor. However, if the supervisor's compensation depends in part on the business produced by the men he supervises, as is frequently the case, his own personal production may not be included in determining his supervisory compensation.

Today the situation is somewhat different than was the case in 1906. Many more companies use the managerial system, and in companies which operate on a general agency basis the company usually drafts the contract between the general agent and his subagents and is in most cases a party to it.

It is therefore legitimate to ask whether under today's conditions there should be a separate limit to control soliciting agents' commissions under both managerial and general agency companies apart from any limit on overriding commissions. It is argued that such a limit would maintain parity between different types of agents, would "tell the agent clearly what he can get," and would be more realistic. It would also relieve companies of the necessity of including renewal commissions in the annual accounting of the field expense limit even though they have already satisfied the renewal commission "contract control." Furthermore, it would obviate the possibility of renewal commission payments causing a company to exceed its field expense limit merely because of a change in the distribution of business. A proposed revision of section 213 along these lines was submitted to the New York Legislature in

1952 by a joint committee of the Life Insurance Association of America and the American Life Convention.

However, the logic that requires a "contract control" for renewal commissions, namely that renewal commissions, once agreed upon, must be paid according to contract, applies equally to general agents and soliciting agents. It soon became evident that the proportion of total renewal commissions paid to general agents and to soliciting agents varies very greatly between companies. Despite many attempts, it was impossible to devise satisfactory separate "contract controls" for soliciting agents' and general agents' renewal commissions without increasing substantially the total of renewal compensation payable by a general agency company. For this and other reasons, the legislature left the renewal commission limitation in the same form as it has had since the 1929 revision of the law.

Security Benefits

Subsection 8(aa), the additional renewal compensation schedule of 1% for the 2d to 9th policy years, was added in 1953 to meet the argument that security benefits, practically unknown in 1929, should be specifically provided for in the law. Since the New York Insurance Department, in line with the 1948 decision of the U.S. Supreme Court in the Inland Steel case, has ruled that security benefits constitute a part of compensation, a company which wishes to provide group insurance or pension benefits for agents and general agents must include the value of these benefits, along with the commissions it proposes to pay, in comparing the value of its compensation scale with the maximum renewal commission scale established by section 213. The requirement that two-thirds of the value of the additional renewal compensation schedule be reserved for security benefits was designed to specifically earmark an amount for the pensions and group insurance which the vast majority of companies admitted in New York now provide for their agents. A company wishing to provide security benefits with a value greater than the amount specifically earmarked for them may of course do so, provided that it includes such excess as a part of its compensation plan in determining its margins under the maximum renewal commission limitation of subsection 8(a).

Another provision of subsection 8(aa) permits the use of the amount earmarked for security benefits to provide "an equivalent average level renewal commission" after the fifteenth policy year, if no plan of security benefits is in effect. This level commission would presumably be based on a model office and would not vary by plan of insurance. It may not be commuted or redistributed. The amount would average only about 1%

of premiums in the 16th and later policy years, and in any case, since most companies provide security benefits for their agents, will probably not be widely used. To date, only one company has availed itself of this provision.

Commutation of Renewal Commissions

The law permits the redistribution of renewal commissions provided that a calculation based upon mortality, lapse and interest rates, proving that the commuted value of the proposed compensation plan does not exceed the legal maximum, is submitted to the superintendent and approved by him. However, certain restrictions are placed upon such a redistribution.

a) 1½% of the premium for each of the 2d to 15th policy years cannot be commuted but must, in a general agency company, be available each year. The fact that this provision does not apply to a branch office company indicates that its purpose is to ensure that some part of the premium is available each year to pay the expense of premium collections, a function frequently performed by the general agent. If this was its purpose, however, the legislature should probably also have required that 1½% of the premium each year could not be vested, but must be available for the collection of premiums in the event of the general agent's termination. Most companies do use a termination deduction in their general agents' contracts, as a matter of prudent business judgment.

b) Not more than 40% of the commuted value of the maximum renewal commission scale may be paid in any one policy year. This is a safeguard against excessive heaping of commissions, which might cause difficulty if the company later experienced lapse rates considerably worse than those assumed in the calculation submitted to the Insurance Department. Furthermore, a company which heaped its renewal commissions to too great an extent might have difficulty meeting the field expense limit.

Prior to 1954 the law specified that an interest rate not lower than four percent be used in calculating the value of renewal commissions, and the Department's circular letter of December 29, 1928 specified Linton A lapse rates (three times Linton A for term insurance), 4% interest and mortality based on the American Men Select Table for entry age 40. In 1954 the law was amended to lower the minimum interest rate to 3% and the Department normally requires that 3% interest, Linton A lapse rates and American Men mortality be used in commuting renewal commissions.

For a general agency company the value of the maximum renewal commission scale for policies with more than 15 premiums, discounted at 3% interest and expressed as a percentage of first year premiums, is:

Policy Years	Rate	Value
2 to 10	7½%	43.042%
11 to 15	5%	9.590
2 to 9	⅓%	1.758
		54.390%*
2 to 9	⅔%	3.515%†
Total		57.905%

* Renewal commission limit.
† Reserved for security benefits.

The corresponding limit for a branch office company is two-thirds of the value of the nine 7½%'s and five 5%'s and the full value of the eight ⅓%'s, or 36.846% of first year premiums, available for renewal commissions, plus 3.515% reserved for security benefits.

The change in 1954 of the minimum interest rate which may be used in obtaining the commuted value of renewal commissions from 4% to 3% was intended to make the interest rate more realistic and to bring it in line with current interest yields. It is a change which was long overdue, but whose effect is relatively minor. In general the change increases slightly the amount which may be paid by a company which "heaps" its renewal commissions and pays them in early policy years, and decreases slightly the amount available for a company which defers a portion of its renewal compensation.

The effect of the change from 4% to 3% interest will be shown by the following comparison of present values, expressed as a percentage of the first year's premium.

	3%	4%
Scale A		
7½% years 2–10, 5% years 11–15	52.63%	49.78%
Scale B		
20% 2d yr., 15% 3d yr., 10% 4th yr., 3% yrs. 5–15	52.31	50.50
Scale C		
7% years 2–15	53.60	50.45

Thus Scale B, providing for substantial heaping, would be less than the statutory nine 7½'s and five 5's at a 3% interest rate, but not at 4%. On the other hand Scale C, a level commission for fifteen policy years, would exceed the renewal commission limit by .97% at 3% interest but only by .67% at 4% interest.

Theoretically, some basis of mortality more modern than the American Men Table should probably be prescribed for calculating commuted values. However, the ultimate effect would be negligible, since the lapse rates and the interest rate used far outweigh the mortality rate in their effect on present values.

Collection Fees

Subsection 8(d) of section 213 permits a company to pay a collection or service fee of 3% on premiums received after the fifteenth policy year. Originally this 3% was intended as a fee for the collection of premiums and could therefore only be paid to the general agent, since a soliciting agent never collects renewal premiums. It was not until 1942 that the law was amended to permit its use as a service fee, thus allowing its payment to soliciting agents. Many companies pay part of the fee to the general agent for premium collection and part to the soliciting agent for rendering service.

The Department's view, expressed in part in its circular letter of July 27, 1928 and reaffirmed in the 1951–53 public hearings on section 213, is that these collection or service fees may not be commuted or redistributed nor may they be used to provide security benefits. The 3% of the premium is intended to "follow the policy" and to be available for premium collection and service on each individual policy. These collection and service fees may not be vested in any agent or general agent. However, they may be transferred from one general agent to another, provided the latter actually collects the premium or performs service on the policy. They may also be transferred from one soliciting agent to another, provided the policy is assigned to that agent for service and that such service is actually performed.

Nonvested Commissions and Salary Plans

The maximum renewal commission limit stated in subsection 8(a) of section 213 (nine 7½%'s and five 5%'s) is on an individual policy basis. Furthermore, the provision in subsection 8(b) permitting the commutation or redistribution of renewal commissions permits such a commutation to be based only upon mortality, lapse and interest rates. Nothing which we have so far discussed permits an aggregate view to be taken of agents'

compensation or permits any agent to receive compensation greater than that derived from commissions on the policies he has written.

However, if incentive salaries are paid to agents, it is inevitable that some agents will receive more than would be their due under a straight commission plan. Furthermore, since nonvested commissions involve the payment of less than the stated commission scale to those agents who terminate, with the savings being used to pay more to those agents who remain with the company, the commissions which a persisting agent receives will almost invariably exceed the legal maximum. Similarly, the company contribution towards a group insurance program or a retirement plan for agents is usually higher for an older agent than for a younger one. It is only the use of an aggregate test that permits the average value of nonvested commissions and the average cost of security benefits to be used in validating a compensation plan.

The last paragraph of subsection 8 of section 213 states that if a company compensates its agents in whole or in part on a plan other than commissions, the aggregate amount so paid may not exceed the limitations on renewal commissions. Any such compensation plan requires approval by the Superintendent of Insurance. It is this permission to use an aggregate test, and the Insurance Department's liberal interpretation of this clause, that makes possible most of the modern agents' compensation plans involving nonvested commissions and security benefits. A similar provision in subsection 4 permits salary plans for agents.

The New York Insurance Department has interpreted the phrase "in whole or in part, upon any other plan than commissions" very broadly. Any company which offers even a modest agents' retirement plan or group insurance benefit, or which pays a commission or service fee on a per $1,000 basis instead of as a percentage of premium, has been permitted to use an aggregate test.

This interpretation of the "aggregate test" provision of section 213, broad as it is, has some limits. A company may not, for example, provide a benefit that is available only to a small group of agents or brokers and spread its cost over a larger group, some of whom cannot ever qualify for the benefit. Thus it would not be permissible to provide a benefit only for agents or brokers in a certain part of the country, or only for those writing a high volume of insurance, and to spread its cost over the entire agency force.

Valuation of Agents' Compensation Plans

One technique that has been used in valuing agents' compensation plans under section 213 was ably discussed by Mr. Peter M. Tompa in

his paper, "Life Agents' Retirement Plans under New York State Expense Limitations," *TSA* VIII, 12.

The theoretically correct procedure in making a calculation under subsection 8(b), a redistribution of commissions on an individual policy basis, would be to make a comparison of the present value of the legal maximum renewal commission scale and of the proposed scale for each plan of insurance. Similarly, under the "aggregate test" basis permitted a company which uses, in whole or in part, a plan other than commissions, it would be theoretically proper to base the calculation on a weighted distribution of plans of insurance.

However, for most types of compensation plans a calculation based on a whole life policy is sufficient to demonstrate compliance with the maximum renewal commission limitations. If a company has a renewal commission scale which varies considerably by plan, or if its distribution of business or some feature of its agents' compensation pattern indicates that a calculation based solely on a whole life policy is not sufficiently conservative, it may be required to submit a calculation on a weighted average basis. Some companies with rather complicated compensation patterns which produce margins differing greatly by plan of insurance customarily submit calculations on a model office basis, weighted by plan of insurance. Certain other companies make a calculation for an ordinary life policy, an endowment with less than twenty premiums and a short term policy. If a calculation for each of these plans provides an adequate margin, it is usually safe to assume that the compensation plan would qualify on a model office basis.

When nonvested commissions or other payments dependent upon the agent's remaining in active service with the company are involved, the method used in making the calculation is usually that developed by Messrs. McConney and Guest in their paper "Some Basic Principles and Mathematical Tables Related to Agents' Compensation," *TASA* XLIII, 287. The method involves a model office of agents in various contract years with the company. Assumptions are made as to the relative production of persisting and terminating agents, and the production of a new agent is assumed to grade upward during his first few years in the business, remain level during his succeeding period of service with the company, and decrease gradually during the years just preceding retirement or other termination. The tables published by McConney and Guest assume certain termination rates of agents, and these assumed termination rates have generally been accepted by the New York Insurance Department for the purpose of validating a plan of nonvested commissions for full-time agents under subsection 8 of section 213.

If, however, a company receives a large proportion of its business from agents who also do a general insurance business, or if there is some other reason to believe that its agency force will experience termination rates substantially lower than those in the McConney-Guest table, somewhat more stringent assumptions may be required. Thus one company whose business derives largely from brokerage sources uses the McConney-Guest table set forward five years, thus assuming that the termination rate of its agents in their first year of service will be that shown in the McConney-Guest table for the sixth contract year. Another company uses the Hollenberg A table, published in *TASA* XLI, 42, which more nearly represents its experience than does the McConney-Guest table.

It is doubtful, however, whether a company would be permitted to use termination rates higher than those in the McConney-Guest tables, thereby being permitted to pay higher renewal commissions than other companies and reaping an advantage from its high agents' turnover.

For nonvested commissions payable to general agents, the unmodified McConney-Guest table is not appropriate, since general agents do not experience the high early termination rates shown in the table. In most cases the McConney-Guest table set forward ten years, thus assuming that the general agents will experience in their first contract year the tabular termination rate for the 11th contract year, would be acceptable, as would a table based on a large company's own experience. Tables with the McConney-Guest termination rates set forward five years and ten years are shown in Mr. Tompa's paper.

The McConney-Guest tables assume that all agents enter service at age 35, retire at 65, and experience American Men mortality rates during their active service. Some companies have recalculated the tables assuming a different (usually lower) age at entry into service, hence lower mortality during the agents' active career. However, the magnitude of agents' mortality is so small in comparison to the agents' voluntary termination rates, interest rate and policy lapse rates used, that such a change has a negligible effect on the value of nonvested renewal commissions. Thus a recalculation of the tables in order to use an agents' age at entry which accords more closely with a company's actual experience is hardly worth the trouble.

To ensure that the agents' termination rates used are sufficiently conservative, reasonable qualification requirements should normally be included in the contract.

For example, a brokerage contract involving nonvested commissions should require a substantial volume of production each year and should

provide for termination of the contract or nonpayment of the nonvested commissions if this requirement is not met. Otherwise a broker could continue to receive his nonvested commissions even though in fact he was producing little or no business for the company. In such a case actual terminations would be substantially fewer than those assumed in calculating the value of the nonvested commissions and the aggregate amount paid out in commissions would exceed that contemplated. A full-time agents' contract involving nonvested commissions could contain somewhat lower qualification requirements, but they are none the less necessary.

In calculating the value of security benefits, the model office technique of McConney and Guest will usually prove to be too complicated and difficult to compute. Therefore the value of security benefits is usually derived by the technique proposed by Mr. Hollenberg in his paper "Calculations for Benefits under Agents' Retirement Plans Which Are Subject to Legal Limitations of Renewal Commissions," *TASA* XLI, 37. Mr. Tompa's paper develops this technique for use with modern types of security benefit plans. This method uses a cohort of new agents entering their first contract year, follows them to retirement, and develops the cost of their pensions or group insurance as a percentage of the first year premiums they produce. This value, once calculated, can be added to the value of renewal commissions and other payments developed by the model office method of McConney and Guest.

Deferred First Year Commissions

Mention has previously been made of another provision of section 213 relating to renewal commissions, namely the permission to defer a portion of first year compensation to later years. Since renewal commission scales are validated on the basis of a "contract control," while first year commissions are reported annually, in Schedule Q, this requires a special calculation.

Subsection 8(e) permits a company to pay additional amounts in renewal years provided that its first year field expense limit is reduced by the present value of the excess renewal commissions incurred during any year. The calculation of this charge against the first year field expense limit must be approved by the Superintendent and must be based upon mortality and lapse rates and an interest rate not higher than four percent. Consistent with the rules for the commutation and redistribution of renewal commissions, the New York Insurance Department now requires that three percent interest be used. The method of making such a calculation is similar to that previously described and

is usually based on a weighted average of plans of insurance. It should be noted that a charge back against the first year limit usually contemplates an equivalent reduction in first year commissions. It would not, for example, be acceptable to offer standard first year and unusually high renewal commissions to a few key agents and charge the excess over the renewal limit against the first year margins of the company as a whole.

Additional Compensation to New General Agents

Agency supervision in the United States has traditionally been entrusted to two kinds of supervisors: managers and general agents. Some companies employ only managers, others only general agents, and some use both systems of agency supervision in different localities.

Managers are employees of the company and are compensated by a salary, although in some cases the salary is of the incentive type and is calculated by a formula which includes factors based upon the production of the men in the agency. The manager's salary, however calculated, is still the same type of obligation to a company as is the salary of any home office employee. The salary for any year can be increased or decreased by agreement between the company and the manager, and if the manager terminates his employment he is not entitled to any further compensation.

General agents, on the other hand, are independent contractors. While their contracts in most cases call for exclusive representation of one company, they frequently have contracts with other companies and in some cases they also sell fire and casualty insurance and occasionally even real estate. General agents are compensated by commissions which are usually vested in whole or in part. If the general agent terminates his connection with the company he may still be entitled to renewal commissions on business previously written for that company, even though such commissions fall due many years after severance of the relationship.

The New York expense limitation law was originally drafted with the general agency method of operation in mind, since that was the method used by most companies in the early 1900's. Since that time conditions have changed considerably and the branch manager system of operation has become most common among large companies while most small and medium size companies continue to use the general agency method of operation. As presently drafted, section 213 is intended to fit either method of operation and to limit the expenses of both managerial and general agency companies to the same degree without favoring either one over the other.

When a company starts a new agency under the supervision of a branch manager, it pays the manager a salary and pays all of his office expenses even though the agency has as yet no business to support its expenses. It is the company, therefore, that makes the investment in procuring new business. When a new agency on the general agency plan was established, however, the general agent traditionally received a contract granting him first year and renewal commissions on business produced by agents working under his supervision, as well as an allowance toward his office expenses. It was, however, necessary for the general agent to support himself and in some cases to pay at least part of the expenses of his agency for several years until enough business was produced so that the commission income was adequate to cover his disbursements.

It was therefore considerably cheaper, at least initially, for a company to start a new agency under a general agent, since it was the general agent rather than the company who made a substantial portion of the initial investment in the agency. This is probably one of the reasons for the continued popularity of the general agency system among small companies.

Under present conditions, however, companies have experienced more and more difficulty in finding men financially able to make the initial investment required to start a new general agency. Another factor is the present income tax situation whereby any advance from the company or money borrowed by the general agent is later repaid out of commissions at a time when he is in a relatively high income tax bracket.

Since 1929 the New York expense limitation law has contained a provision (now in subsection 6) permitting a company to pay a premium collection or policy service fee not exceeding 2% on renewal premiums collected in an agency after supervision by a salaried manager is discontinued. This provision was intended to make it possible for a company to start a new agency with a salaried manager, change his contract to that of a general agent after the agency is well established and pay him a 2% collection fee on all renewal premiums subsequently received on business written while he was a salaried manager. Many companies use this method of starting new agencies and find it quite satisfactory.

Other companies, however, prefer to start a new man directly as a general agent without a preliminary period of service as a salaried manager. To facilitate this procedure under present conditions a new subsection, 8(f), was added to section 213 in 1953. This subsection permits additional compensation to be paid to a general agent with less than five years of service as a general agent or agency manager with any life

insurance company. No limit is specified on the amount of additional compensation payable, but it is contemplated that it will be an amount which decreases as the commissions payable under the general agent's contract increase so that the total compensation which he receives will be adequate. If a new general agent has previously served for a period of less than five years as general agent or manager with another company, additional compensation may be paid to him only for the balance of the five years. Compensation paid pursuant to this subsection must be reported by the company in line 49 of Schedule Q and thereby included in field expenses.

In order to prevent a company's evading the intent of the law by paying the full general agency scale of commissions to soliciting agents while paying a salary to the general agent, it is provided that while additional compensation is being paid to a new general agent the renewal commission payable to agents under his supervision may not exceed the limit provided for agents subject to the supervision of a salaried manager (*i.e.*, two-thirds of that provided for a general agency).

The New York Insurance Department's circular letter of August 4, 1953 establishes rules for the qualification of new general agents under this provision. The circular letter provides that a general agent is considered eligible if he has less than five years' previous experience as a general agent or agency manager, either as an individual or as a member of a partnership or officer of a corporation. A general agency which is a partnership or a corporation is only eligible for additional compensation if no partner or officer has had five years' experience as a general agent or agency manager.

The contract between the company and a new general agent receiving additional compensation as well as renewal commissions must specify the maximum commissions payable to his subagents, namely two-thirds of the subsection 8(a) renewal commission limit. A copy of every contract which the new general agent makes with an agent must be filed with the home office.

The circular letter also states that prudent management would require that a deduction be made from vested renewal commissions upon termination of a new general agent's service, in order to pay collection fees to a successor general agent. Since this provision is not in the law, it constitutes a recommendation rather than a requirement.

Training Allowances

The compensation received by life insurance agents selling Ordinary insurance has traditionally been in the form of commissions on first year and renewal premiums. In comparison with other industries where a

salesman is paid a salary, a life insurance agent's income has always been small when he first enters the business, increasing as he becomes a successful producer and as renewal commissions become payable. In addition to the fact that initial production is usually considerably smaller than the production which an agent can expect after he has become established in the business, the situation is aggravated by the fact that a considerable portion of the compensation on any particular policy is deferred and paid in the form of renewal commissions, in contrast to most other industries where the entire compensation is payable at the time the sale is made. In recent years this situation has caused considerable difficulty to companies in recruiting new agents in competition with other industries.

In 1943 subsection 4 of section 213 was amended to help meet this problem. The amendment provided that a company could compensate its agents, or any of them, in whole or in part on a plan other than commissions. If such a plan of compensation is adopted, a company must allocate the compensation payable as between first year and renewal and the plan and the method of allocation must be submitted for approval to the Superintendent of Insurance. This provision permits salary plans for new agents but requires that a company remain within its over-all expense limits, both for first year expenses and for total field expenses, after charging the salaries payable against those expense limits.

As the labor shortage in the United States increased, the salary which a company could pay under this provision proved to be insufficient to attract new agents. In 1953 therefore a new section, subsection 13, was adopted permitting a company to pay training allowances to new agents, which allowances need not be considered as first year compensation. The law provides that these training allowances may be paid only during the first three years of the new agent's service with the company and that renewal commissions payable on business written while receiving these training allowances may not be vested.

The total amount of training allowances payable by a company during any calendar year is limited to 5% of the first year field expense limit (but not more than $700,000) or 30% of the first year premiums written by those agents receiving training allowances, if greater. The Department's circular letters of August 4, 1953 and January 4, 1955 set forth rules governing who shall be considered a new agent for the purpose of receiving training allowances.

The August 1953 letter states certain general principles governing the approval of training allowance plans. It states that the plan must be one designed to develop and train new agents rather than merely

to secure a larger volume of new business. It should give the new agent a stable income during his training period, hence it cannot merely increase the rates of commission that would otherwise be payable. Production requirements should be included to avoid making payments to agents who do not show promise of becoming successful producers.

The type of plan contemplated by subsection 13 is one which provides a decreasing subsidy to the new agent designed to level out his income during the training period and provide a smooth transition to a regular commission basis at the end of the three years.

Any plan of training allowances which does not qualify under subsection 13 may still be submitted as a salary plan under subsection 4. However, it is more advantageous for a company to have its plan approved under subsection 13, since subsection 4 requires that the payments be allocated between first year and renewal, with the first year portion charged in line 42 of Schedule Q and therefore included in the first year expense limit. Training allowances approved under subsection 13 are reported in line 50 of Schedule Q and included in the field expense limit.

The rules specified by the Superintendent of Insurance for determining whether an agent can qualify for training allowances are set forth in the circular letter of January 4, 1955. An agent must have been appointed after January 1, 1952 and must not have been a life insurance agent for more than a year before his appointment, nor have received training allowances from another company during the six months immediately preceding his appointment. Except for a college student, who may be considered a new agent upon graduation even though he has been an agent while in college, or someone appointed as an agent within six months after leaving the armed forces, a new agent must not have been an agent for any company for more than two of the last five years prior to his appointment.

MISCELLANEOUS QUALITATIVE PROVISIONS

Compensation Agreed upon in Advance

Subsection 6 of section 213 prohibits a company from paying to any agent or broker any commission or other compensation not agreed upon in advance of payment of the premium. This provision prohibits any retroactive payment and requires that a company and its agents agree in advance on the commissions which will be payable for writing and servicing business.

This does not mean that a company may not increase renewal commissions on business already written, and in fact this is occasionally

done. However, the liberalization may only be made effective on premiums paid in the future. Furthermore, a company desiring to make such a liberalization must calculate the margins available for renewal compensation under subsection 8(a) and 8(aa) of section 213 in two parts: margins available up to the date of change and margins available in the future. If compensation already paid on the issues of a particular year exceeds the renewal commission allowance for the policy years already elapsed, the excess commissions paid must be charged against the compensation margins in future years. However, if the commission allowance on past premiums exceeds the compensation actually paid to date, the excess may not be carried forward to increase renewal commissions on future premiums. Therefore any increase in future renewal commissions on existing business may not exceed the margins available on these future premiums less any part of these margins already spent in prior policy years.

The purpose of the prohibition against compensation not agreed upon in advance was to put an end to excessive and ex post facto rewards leading to extravagance. It has been held not to bar certain types of retroactive payment which do not violate the spirit of the law. For example, companies have been permitted to increase pensions payable to retired agents where the increase is modest and is intended to reflect the decline in the purchasing power of the agents' pensions due to inflation. However, this subsection has been held to prohibit a retroactive change in an agent's renewal commission scale from a nonvested scale including service fees to a vested commission scale without the service fees.

It should be noted that the prohibition against compensation not agreed upon in advance of payment of the premium applies to group insurance as well as to ordinary insurance, since the exemption of group insurance in subsection 11 refers only to the expense limits and not to the qualitative provisions of section 213. Thus it is a violation of section 213 for a company to make a retroactive commission payment to an agent or broker on a group insurance policy where no agreement had been entered into before the premium was paid.

Bonuses, Prizes and Rewards

Subsection 7 of section 213 forbids any bonus, prize or reward or any increased or additional compensation based upon the volume of new business or the aggregate number of new policies written. This provision is intended to prevent any circumvention of the commission limitations and reinforces the prohibition of payments not agreed upon in advance as well as the first year and renewal commission limitations. Thus a com-

pany may not agree to pay an agent who writes a substantial volume of new business an amount in excess of the standard rate of renewal commission.

A company may, however, condition the payment of any commissions upon a certain standard of service of the agent, and in fact subsection 8 specifically provides that a company may condition the allowance or payment in whole or in part of any renewal commission upon the efficiency of service of the agent or upon the amount and quality of the business renewed under his supervision. Thus a company may vary the number of renewal commissions payable on the business written by an agent during a particular year depending upon the amount of business produced. It is also permissible to require that an agent must write a certain amount of business each year in order to maintain his agency contract, and hence to receive any nonvested commissions payable thereunder.

This provision of subsection 8 is not in conflict with the subsection 7 prohibition against increased compensation based on the volume of new business, however, since it merely allows a company to reduce the number or rate of renewal commissions payable to agents who do not meet certain standards of production or efficiency. A company may not increase commissions to agents who produce an unusually large volume of business or meet other such standards of superefficiency. Subsection 7 has also been held to prohibit the payment to a district agent or supervisor of a fee based on the production of the agents supervised where the rate of compensation per $1,000 of production increases as the amount of business written by the agent increases.

Furthermore, the subsection 8 provision that the payment of any renewal commission may be conditioned upon an agent's "efficiency" is a qualitative rather than a quantitative provision in that no discount may be taken for any production requirements in measuring the value of a company's renewal commission scale against the legal maximum. A company must validate its top commission scale, calculating its present value on the assumption that all agents will satisfy the production requirements. No discount may be taken for agents who fail to qualify for the top commission scale.

Subsection 7 does not interfere with the common practice of paying a higher first year commission on policies of $5,000 or over than is paid on smaller policies since, provided that no such commission exceeds 55%, this does not constitute increased compensation based on volume but is merely a part of the agents' compensation plan.

Contests or competitions among agents are specifically permitted, and a company may award to the winners medals, pins or other tokens having small intrinsic value. However, the New York Insurance Depart-

ment has consistently maintained that such rewards must really be tokens of small intrinsic value, and must be given not as compensation but as bona fide recognition of merit. Cash awards are forbidden as are prizes of merchandise.

Expenditures by a company on behalf of an agent for items of an educational nature such as insurance periodicals are permitted, but not expenditures for items of a personal nature. The Department's circular letter of May 9, 1924 specifically allowed the payment by a company of the expenses incurred by an agent in attending a convention or agency meeting conducted primarily for business or educational purposes. However, a company may not pay an agent's expenses to a nonbusiness meeting or pleasure outing, nor may it pay the expenses of an agent's wife or family in attending an agency convention. This latter ruling forbidding the payment by a company, its managers or general agents, of the expenses incurred by agents' wives, families or guests in attending an agency convention was reaffirmed by the Department's circular letters of November 18, 1948 and October 6, 1953.

It should be noted that the prohibition against bonuses, prizes and rewards applies to a company's managers and general agents as well as to the company itself. Thus a manager or general agent may not grant any prize or reward to an agent, even though the company does not directly reimburse him for the expenditure so made. The prohibition also applies to group life insurance and annuities.

Loans and Advances

Subsection 9 prohibits a company from making any loans or advances to agents or brokers without taking adequate collateral security. Furthermore, such security may only be first year commissions to be earned by the agent and may not include renewal commissions. This provision is intended to limit plans involving advances to agents and to keep them within reasonable bounds. The permission to make advances against first year commissions means commissions on new business to be written within a reasonable period of time rather than many years in the future. While the maximum advance which a company can make under this provision cannot be determined exactly, it is contemplated that a company will use its own best judgment and will act in good faith in obeying the statute. This provision does not, of course, prevent a company which has in good faith determined the amount of an advance to an agent on the basis of the first year commissions he could reasonably be expected to produce, from applying renewal commissions, as earned, to repay the loan. The need for caution in making advances is of course due to the fact that, when an agent terminates with a debit balance of advances due the company, it is usually impossible to obtain repayment.

Self-supporting

Subsection 10 contains a very important provision which prohibits the issuance of any life insurance or annuity contract which shall not appear to be self-supporting on reasonable assumptions as to interest, mortality and expense. It is this provision which largely obviates the need for rate filings, minimum premium rates or other direct controls on the adequacy of premium rates for life insurance. Any company which issues a policy at a premium rate which appears to be inadequate would be considered to be violating this section. It should be noted that this provision applies equally to group life insurance and group annuities as well as to policies of individual insurance.

Enforcement Provisions

Subsection 12 of section 213 gives the Superintendent power to suspend the first year field expense limit, the total field expense limit or the total expense limit. This suspension may be granted upon written application of a company, provided the Superintendent is satisfied that the company has taken steps to comply with the expense limits in the future. However, such suspension may not be granted for more than two years in succession. It should be noted that a suspension of the limits is usually granted only after a careful investigation of the reason why the company exceeded the limit and of the measures taken to ensure future compliance.

Prior to 1953 the only remedy available to the Insurance Department if a company exceeded its expense limits or violated any other provision of section 213 was to suspend the company's license to do business in New York, to institute liquidation proceedings if a domestic company was involved, or to institute criminal prosecution if the offense was of a criminal nature. However in 1953 a new subsection, section 15, was added containing a penalty provision. This subsection empowers the Superintendent to impose a penalty not exceeding $1,000 upon any company violating any provision of section 213. The penalty may only be levied after an Insurance Department hearing has found the company guilty of willfully violating a provision of section 213. The action of the Superintendent is subject to judicial review.

The penalty provision should prove to be very effective in controlling minor offenses which, though intentional, are not sufficiently serious to justify the revocation of a company's license or the bringing of criminal proceedings.

CONCLUSION

It is hoped that this paper will convey to those who read it the author's conviction that the New York expense limitation law is a rather impressive achievement, considering the many different types of operation it encompasses. The law regulates large and small companies, branch office and general agency companies, rapidly growing and slow-growing companies. All of these must be provided for, and it is the inherent difficulty of limiting the expenses of so many divergent types of companies that leads to many of the complexities of the law.

Perhaps this paper has also demonstrated that the basic principles underlying the expense limitation law are relatively simple and require only a little study to be thoroughly understood.

Finally, it is hoped that the paper will be helpful to students and to others who wish to learn either the broad principles or the detailed provisions of the law, and that it will aid company actuaries in complying with the spirit as well as the letter of the law.

APPENDIX A

STATE OF NEW YORK
INSURANCE DEPARTMENT

SCHEDULE Q—LIFE

TO BE FILED WITH

19__ ANNUAL STATEMENT

OF THE

____ Insurance Company

AS REQUIRED BY

Sections 212 and 213 New York Insurance Law

PRESCRIBING
LIMITATIONS OF NEW BUSINESS

AND

LIMITATIONS OF EXPENSES

General Interrogatories — To be answered by ALL companies

1. Have any advances to agents been made during current year except compensation for the first year of insurance? Answer..........
   If so, give full information..........
   ....

2. Has the Company, or any person, firm, or corporation on its behalf or under any agreement with it, paid or allowed during the current year to any agent, broker or other person, firm or corporation *for procuring any application for life insurance, for collecting any premium thereon or for any other service performed in connection therewith any compensation greater than that determined in advance?* Answer..........

3. *Has the Company during the current year allowed any bonuses, prizes or rewards, or any increased or additional commissions or compensation of any sort based* upon the volume of any new or renewed business or the aggregate of policies written or paid for? Answer..........

4. Has the Company during the current year paid any compensation upon policies issued after the year 1906 in excess of the amounts allowed for this purpose by Section 213 of the New York Insurance Law? Answer..........

5. Has the Company instituted procedures in order to ascertain that compensation to soliciting agents is confined to compensation stated in written agreements, and that no compensation is paid in excess of the amount stated in such agreements? Answer..........

6. Does the Company make reimbursements or allowances for expenses to general agents? Answer..........
   If answer is "Yes", furnish following information and answer interrogatories a-d, inclusive, below:
   Average premium per $1000 of new insurance paid for in current year*.......... $..........
   Average expense allowance per $1000 of new insurance paid for in current year*.......... $..........

* Ordinary business only, excluding group business, paid-up additions, single premium business, reinsurance assumed, and branch office business. Expenses directly paid by Company for general agents, such as rent, salaries, etc., should be treated as expense allowances.

   a. Does the Company hold in its home office supporting vouchers from agents and others, which can be verified, showing in detail expenses incurred in the transaction of the Company's business *for which reimbursement or allowance is made to general agents?* Answer..........
   b. *Has the Company reported in Item 42 of Schedule Q, as compensation for new business, all agency expense reimbursements or expense allowances made or* paid by it to general agents in excess of expenses actually incurred by general agents on behalf of the Company and which are vouchered for in accordance with the requirements of the circular letter of August 23, 1948 re: Reimbursements for Office and Other Agency Expenses? Answer..........
   (Amount thereof.......... $..........)
   c. Does the Company *maintain a continuous systematic home office audit of agency expense reimbursements or expense allowances made or paid by it to* general agents? Answer..........
   d. Does the Company make periodic systematic field audits of agency expense reimbursements or expense allowances made or paid by it to general agents? Answer..........

7. Has the Company followed the instructions at the top of pages 2-4 for completing Schedule Q? Answer..........

NOTE.—Foreign corporations issuing both participating and non-participating policies shall make a separate statement of profits and losses, expense limits and expenses, as aforesaid, with reference to each of said kinds of business, and also showing the manner in which any general outlays of the company have been apportioned to each of such kinds of business.—(New York Insurance Law, section 217, Subdivision 7.)
—Alien companies which transact in this state no business other than reinsurance are not required to file this schedule.

Instructions—Exclude figures for Industrial Insurance. Exclude accident and health. Exclude from the amounts of insurance the amounts payable under accidental death benefits incorporated in life policies. Omit cents—use nearest dollar. Exclude reinsurance assumed, group insurance and group annuities but include reinsurance ceded. Commissions and expenses should be reported on an incurred basis.

SCHEDULE Q—PART I

of the ______________________________ Insurance Company

Covering ______________________________ business

(Insert "participating" or "non-participating". See note following Interrogatory 7.)

Showing Premiums, Commissions, Expense Limit and Expenses for the First Year of Insurance — Also Renewal Premiums and Commissions

(See New York Insurance Law, Section 213 as amended, and Section 217, subdivision 7.)

Supplement to Gain and Loss Exhibit, pages 5 and 6 of Annual Statement for 19____

	FIRST YEAR		RENEWAL	
	(1) Insurance	(2) Annuities	(3) Insurance	(4) Annuities
(A) Premiums (Accrual basis)				
1. Premiums per items 9 and 19, Exhibit 1, columns 3-6, of current year's annual statement	$	$	$	$
2.				
3. Deduct premiums for reinsurance assumed				
4.				
5. Add premiums for reinsurance ceded				
6. Total premiums, other than single premiums, as specified in Section 213				
(B) Commissions (Incurred basis)				
7. Commissions per items 26, 27 and 28, Exhibit 1, columns 3-6 of current year's annual statement				
8. Deduct commissions on reinsurance assumed				
9.				
10. Add commissions on reinsurance ceded				
11.				
12. Deduct commissions on due, unreported or deferred premiums December 31, previous year				
13.				
14. Add commissions on due, unreported or deferred premiums December 31, current year				
15. Total commissions as specified in §213				

(C) Calculation of Percentage of First Year's Premiums on New Insurance for use in Determining the First Year Expense Limit as Specified in Section 213

†16. Gross annual premiums (excluding single premiums and extra or additional premiums) current at the end of the year on the following policies dated and paid for during the year and in force at the end of the year:
- (a) Policies on which the gross premium rates are not less than those for a whole life policy with level premiums payable during life .... $
- (b) Policies on which the gross premium rates are less than 100% but greater than 50% of those for a whole life policy with level premiums payable during life
- (c) Other policies (excluding term policies issued for less than one year)
- (d) Total, sum of items (a), (b) and (c) above .... $

†17. What the gross annual premiums would have amounted to had the policies in items 16 (a) and (b) above been issued on the whole life plan with level premiums payable during life as specified in Section 213, items (a) (1) and (2) of paragraph 3:
- (a) Policies on which gross premium rates are not less than those for a whole life policy with level premiums payable during life
- (b) Policies on which the gross premium rates are less than 100% but greater than 50% of those for a whole life policy with level premiums payable during life
- (c) 50% of item 17 (b) above

†18. Excess of item 16 (b) above over item 17 (c) above

†19. 20% of item 16 (a) above

†20. 35% of item 17 (a) above

†21. 37½% of item 16 (b) above

†22. 37½% of item 16 (c) above

†23. 35% of item 18 above

†24. Total, sum of items 19 to 23, inclusive, above .... $

†25. Ratio per cent of item 24 to item 16 (d) above .... %

†Items 16—25 need not be filled in if a company desires to determine the ratio of item 25 in some other manner, provided a statement is furnished as to how such ratio is obtained.

Note.—Calculation (C) may with the approval of this Department be computed on a basis of the average age within each plan of insurance rather than on a basis of individual ages.

SCHEDULE Q—PART I (continued)

Instructions—Exclude figures for Industrial Insurance. Exclude accident and health. Exclude from the amount of insurance the amounts payable under accidental death benefits incorporated in life policies. Omit cents—use nearest dollar. Exclude reinsurance assumed, group insurance and group annuities but include reinsurance ceded. Commissions and expenses should be reported on an incurred basis.

(D) Total Field Expense Limit

26. ....% (per item 25 above) of first year's premiums on new insurance (including extra or additional premiums but excluding single premiums), per item 6 (column 1) above ..... $
27. 3½% of single premiums on new insurance and annuities, per item 10 (columns 3-6 inclusive), Exhibit 1, less $........ dividends applied to purchase paid up additions and annuities
28. 30% of first year premiums (including extra or additional premiums) on new annuities (other than single premium annuities), per item 6 (column 2) above
29. $1 for each $1,000 of all new insurance (excluding dividend additions and term insurance for less than one year) paid for during the current year
30. $1 for each $1,000 of all such new insurance paid for during the current year and in force at the end of the year
31. 15% of the sum of items 26, 27 and 28 above
32. $2 for each $1,000 of new life insurance (other than term insurance for less than one year) and for each $100 of annual income under new annuities, paid for during such year
33. 3% of first year's premiums on new life insurance and annuities (including extra or additional but excluding single premiums) received during the preceding five calendar years
34. $.75 for each $1,000 of new life insurance (other than term insurance for less than one year and single premium insurance) and for each $100 of annual income under new annuities (other than single payment annuities), paid for during the preceding two calendar years
35. 2½% of renewal premiums on life insurance and annuities (including extra or additional premiums) received during the year
36. $.50 for each $1,000 of life insurance and for each $100 of annual income under annuities, in force at the end of the year
37. $1 for each $1,000 of premium-paying life insurance in force (each $100 of annual income under annuities other than paid-up annuities to be considered as $1,000 of premium-paying life insurance)
38. Additional graded allowance
    - a. $1 per $1,000 of the first $100 million of premium-paying insurance in force ..... $
    - b. $.75 per $1,000 of the next $100 million of such insurance ..... $
    - c. $.50 per $1,000 of the next $100 million of such insurance ..... $
    - d. $.25 per $1,000 of the next $200 million of such insurance ..... $
    - e. $.25 per $1,000 of such insurance in excess of $1,500,000,000 (not to exceed $275,000) ..... $
    - f. Total of a-d above less e
39. The amount by which two-thirds of the total salaries of managers, assistant managers, and other local agency supervisors exceeds the average of such salaries for the next preceding fourteen years
40. Total Field Expense Limit (Sum of items 26-39)

(E) Total Field Expenses as specified in subsection 2 of Section 213

41. Commissions on first year's premiums for insurance and annuities per item 15 (columns 1 and 2) less $........ for agency supervision subject to the limitations in subsections 2 and 4 ..... $
42. Compensation other than commissions for services, other than supervision and other than training allowances paid pursuant to subsection 13, in obtaining new insurance and annuities (excluding cost of medical examinations and inspections of proposed risks) (Item A, Exhibit 5)
43. Net advances to agents including agents balances charged off during the year
44. Salaries and expenses of persons on the home office staff, other than those engaged in the medical examination and inspection of proposed risks, who spend more than one-third of their time in the field in connection with the production of new business and/or agency supervision (Number of persons........)
45. Renewal commissions and premium collection and policy service fees per item 15 (columns 3 and 4) above
46. Compensation other than commissions incurred under a plan pursuant to subsection 4 and not included in item 42 above
47. Amount for maintaining current service benefits under agents retirement plan
48. Commissions for agency supervision deducted in item 41, above
49. Compensation to general agents pursuant to subsection 8(f)
50. Training allowances incurred pursuant to subsection 13 [representing (a) ....% of item 63, and (b) ....% of first year's premiums (excluding single premiums) incurred during the current calendar year on business written by agents receiving such training allowances]. See footnote
51. Salaries and expenses for agency supervision (excluding salaries and expenses of persons on the home office staff) per item B, Exhibit 5
52. Branch office salaries and expenses (excluding advertising) per item C, Exhibit 5
53. Reimbursement or allowances for expenses to general agents, including expenses directly paid by Company for general agents, such as rent, salaries, etc.
54. Other expenses of or on account of branch offices, agencies or other local offices, including expenses of agents' conventions, not included in items 51, 52 and 53 above
55. Increase (or decrease) in cost of collection and other expenses to be paid or to become due on uncollected and deferred renewal premiums (excluding commissions thereon) of current over previous year's annual statement
56. 60% of the expense of advertising
57. Additional First Year Expenses coming under any of the above headings made or incurred by any person, firm or corporation on behalf of the company or under any agreement with it
58. Total Field Expenses (Sum of items 41-57)
59. Excess of Total Field Expense Limit over Total Field Expenses (item 40 less item 58)

(F) First Year Field Expense Limit

60. Sum of items 26, 27 and 28 and 50% of items 29 and 30 above ..... $
61. Aggregate present value of obligations incurred during current year under Paragraph (c) of subsection 6
62. First Year Field Expense Limit (item 60 less item 61)
63. First Year Field Expenses (sum of items 41, 42 and 43 above)
64. Excess of First Year Field Expense Limit over First Year Field Expenses, item 62 less item 63

FOOTNOTE *Companies should show figures for both items (a) and (b), even though item (a) may be clearly larger than item (b).

SCHEDULE Q—PART II

Showing Expense Limit and Expenses for the Company's Total Business

(Not required of stock corporations issuing or delivering in this State non-participating policies exclusively)

Instructions—Exclude figures for Industrial Insurance. Exclude accident and health. Exclude from the amounts of insurance the amounts payable under accidental death benefits incorporated in life policies. Omit cents—use nearest dollar. Exclude reinsurance assumed, group insurance and group annuities but include reinsurance ceded. Commissions and expenses should be reported on an incurred basis

(G) Total Expense Limit as Specified in subsection 3 of Section 213			
65. Total Field Expense Limit (item 40)	$		
66. Three dollars for each $1,000 of new life insurance paid for during the year and for each $100 of annual income under new annuities and new supplementary contracts			
67. Fifty thousand dollars, plus $1.75 for each $1,000 of life insurance in force (each one hundred dollars of annual income under annuities and supplementary contracts in force and each fifteen dollars of disability benefits paid, including premiums waived, during the year to be considered as $1,000 of life insurance)			
68. Additional graded allowances			
a. $1.50 per $1,000 of the first $100,000,000 of insurance in force .... $			
b. $.75 per $1,000 of the next $100,000,000 of such insurance .... $			
c. $.25 per $1,000 of the next $300,000,000 of such insurance .... $			
d. $.25 per $1,000 of such insurance in excess of $1,500,000,000 (not to exceed $350,000) .... $			
e. Total of a, b and c above less d	$		
69. Total of items 65-68			
70. $.25 for each $1,000 of insurance included in item 67 in excess of ten billion dollars			
71. Total Expense Limit (item 69 less item 70)			

(H) Total Expenses as Specified in subsection 5 of Section 213			
72. Total expenses incurred during the current year per items 21-23, columns 3-7, page 5 of current year's annual statement	$		
73. a. Investment expenses per exhibit 5, column 3 line 13 less line 9.1 and less commissions on mortgage loans .... $			
b. ¼ of 1% of mean invested assets .... $			
c. Excess, if any, of a over b			
74. Increase (or decrease) in cost of collection on uncollected and deferred premiums (covered by the loading on the total premiums and not reported in item 16, page 3) of current over previous year's annual statement			
75. Additional expense made or incurred on behalf of the Company or under any agreement with it			
76. Total expense (total of 72-75 above)			
77. Excess of total expense limit over total expense (item 71 less 76)			

LIMITATIONS ON NEW ORDINARY BUSINESS—SECTION 212—NEW YORK INSURANCE LAW

1. Business in force on December 31st of Preceding Year	$		
2. Less (a) Dividend Additions $........; (b) Reinsurance Assumed $........; (c) Group Life $........; (d) Debit Life $........;	$		
3. Difference (1) — (2)	$		
4. Maximum Amount of Ordinary Insurance permitted to be written during year consistent with (3) above	$		
5. New Insurance Written during the year	$		
6. Less (a) Dividend Additions $........; (b) Reinsurance Assumed $........; (c) Group Life $........; (d) Debit Life $........;	$		
7. Difference (5) — (6)	$		
8. Excess of Maximum Amount of Ordinary Business permitted to be written over Ordinary Business written during the year (4) — (7)	$		

DISCUSSION OF PRECEDING PAPER

DANIEL J. LYONS:

It is timely to have another paper on section 213 of the New York Insurance Law, particularly since the amendments of 1953 and 1954. We are indebted to Mr. Mayerson for the fine job which he has done in reviewing the law as it stands today.

The amendments of 1953 and 1954 resulted from studies by two Committees of the Life Insurance Association and the American Life Convention from 1948 through 1954. The first Committee attempted a thorough overhaul of the law but finally was limited to such amendments as the New York Superintendent indicated that he would approve. In 1953 the Superintendent approved an amendment for training allowances to new agents and salaries to new general agents and in 1954 a change in the formulas for total company expenses and field expenses to place more weight on new business and less on old business. Other changes of less importance were made in both the form and the substance of the statute.

The amendments accomplished some worth-while results but complicated further an already complex statute. Mr. Mayerson states that the "philosophy and basic principles of the original law remain unchanged." The original section 97 took barely more than two pages in the statute book. It limited first year compensation in the aggregate to first year loadings plus assumed mortality savings for the first five years. It limited renewal commissions by contract. It limited total expenses to total loadings plus assumed mortality savings for the first five years. It concerned itself with limiting extravagance in the aggregate with a minimum of interference with the functions of management. Following are some of the provisions of the present law not found in the original:

1. Limit on first year commission rates for agents and general agents.
2. Limitation of commissions on personal business of general agent.
3. Specification that part of renewals, if used at all, must be for security benefits.
4. Inside limits on compensation plans other than commissions.
5. Limitation on additional payments to general agents.
6. Limitation on training allowance.
7. Inside limit on agency office expenses.

In addition there have been rulings of the Department on vouchers, training allowance and other matters which have the force of law.

Mr. Mayerson's statement that the Joint Committee proposal would

have changed the original philosophy of the statute overlooks the fact that the philosophy of section 97 bears little similarity to the philosophy of the present section 213 if we judge this by the provisions of the two acts. The inside limits and detailed controls go far beyond the matter of extravagance which was the concern of the original law. Mr. Mayerson justifies limits on field expenses and agents' compensation on the ground that they are major expenses which, without controls, would rise rather than diminish. He says also that the effect of competition is to reduce administration expenses but to increase sales expenses. The effect of competition must be to bring pressure for a reduction in all expenses because this is the obvious way to reduce the net cost of insurance. We have only to look at the area of greatest competition, special policies, and note that many of them carry reduced commissions and reduced expense allowances. The argument that a large item of expense must be separately controlled by an inside limit does not stand up, since the larger the item, the more it is affected by the total expense limit. In the ultimate, it is completely controlled.

Mr. Mayerson has referred to the recommendation in 1952 of the Joint Committees of the Life Insurance Association of America and the American Life Convention for a contract control on soliciting agents' commissions. He states that despite many attempts, it was impossible to devise a satisfactory separate contract control for the general agents' and soliciting agents' renewal commissions without increasing substantially the renewal compensation payable by general agency companies. He has oversimplified the case for a contract control on agents' commissions and the reason why the legislature did not adopt the Joint Committee's recommendation. For a full account of the reasons for a contract control, the reader is referred to the report of the Joint Committee dated September 18, 1950.

The separate control on soliciting agents' commissions would have greatly simplified the statute and would have answered the agents' argument that if their commissions must be limited, they should know what the limit is. As for general agents, the Committee felt that the general agency companies were entitled to as much freedom in compensating their general agents as the branch office companies have in compensating their salaried managers.

Mr. Mayerson indicates that field expenses were limited directly by the Armstrong Committee. Actually, the original law limited only total expenses and commissions. No attempt was made to split out and separately limit field expenses. An inside limit on field expenses such as we have today cannot be equitable between companies, since it makes no provision

for functions performed in the field by one company and in the home office by another company. It is one of the unnecessary complications of the statute.

Reference is made to the provision for a reduction in the 60% maximum commission rate when a general agent produces personally more than 50% of the business of his agency. This provision affects only forms with a first year commission rate in excess of 55%. Because of its limited application, it accomplishes next to nothing. It unnecessarily complicates the statute. It is aimed at small companies and is not worth the cost of administration.

Mr. Mayerson has referred to the voucher problem. This is another inside limitation where the statute invades an area which should be reserved to management. Under the law, a general agent can spend his formula expense allowance on extravagant agency furnishings but cannot profit personally from an economical agency operation. The voucher problem arises because the law not only limits the amount which may be spent but also places limitations on how it shall be spent.

Mr. Mayerson has stated that 1½% of the premium for each of policy years two to fifteen cannot be commuted but must be maintained to insure that some part of the premium is available each year to pay for collecting the premium. He then quite properly points out that this purpose may be in doubt, since the statute does not require that the 1½% of the premium be nonvested. This is another example of confusion in the statute. Furthermore, it overlooks the fact that many companies collect premiums at the home office or in regional collection offices rather than in the agency office.

Mr. Mayerson notes that subsection 8(e) permits a company to pay additional commissions in renewal years provided that the first year field expense limit is reduced by the present value of the excess renewal commissions incurred during the year. It is a shortcoming of the statute that no provision is made for an increase in the field expense limit when the increased renewal commissions become payable.

Mr. Mayerson concludes that his 46-page paper has demonstrated that the basic principles underlying section 213 are relatively simple and require only a little study to be fully understood. The law not only is complex but because of its complexity is very vague in places. Thus many interpretations are required by the New York Insurance Department. Mr. Mayerson has pointed out one place where the New York Department has interpreted a phrase very broadly and another where it has been very strict in its interpretation. Thus a company must look beyond the language of the statute and be guided by the attitude of the Department

which may be broad or strict, depending on the Superintendent in office at the time of interpretation. While recourse to the courts is possible, it is out of the question as a practical matter to expect the courts to overrule the Superintendent in the interpretation of such a technical and complicated statute as section 213.

It is to be hoped that at some future date there may be a complete revision of section 213. Revisions over the years have added greatly to the statute's complexity. The difficulty of understanding it in its present form and the need for interpretations by the Department make a complete rewriting and simplification desirable. Before this can be done, however, it will be necessary to reach agreement on the purpose of such a law. Section 213 is not necessary to assure the solvency or to control the growth of life insurance companies. There are other laws already on the books which accomplish these two objectives. To me it has seemed that the purpose should be to control the expense element of the cost of insurance for the New York policyholders of all companies authorized to do business in New York. It should do this as simply as possible and include only such provisions as are necessary to accomplish this purpose.

How would one expect a law to control the expense element of the cost of life insurance? Obviously this control should be effected through one over-all limit on total expenses. The formula for this limit should be fair and equitable for all companies. It is not easy to produce such a formula, but it can probably be done, at least well enough to be generally acceptable.

Those who argue for inside limits say that these are required to save the companies from themselves. They contend that commissions must be limited within the total limit because otherwise commission wars will result. They say that, except for the inside limits, money will be spent unwisely to the detriment of the policyholders. They recall some of the abuses prevailing in the business from 1875 to 1900 when there were no limits in the law. They do not seem to realize that, with a total limit, excess spending in one category must be offset by savings in another. They completely overlook the fact that all business operates in a different climate today than in that era of great industrial expansion.

Mr. Mayerson pointed out that renewal commissions must be limited separately because otherwise a company may adopt such a scale that it will exceed ultimately its field expense limit. The fact is that a very large part of field expenses results from the expense of new business and that if the situation which Mr. Mayerson fears should arise, a company could limit its new business activity and remain within the total field expense limit. This would be such a painful step that company management could

be trusted to avoid adoption of an excessive renewal commission scale—particularly, the vesting element of such a scale.

While in theory only a total limit is needed to control the expense element in the cost of life insurance, we have to recognize the fact that life insurance companies have been operating with inside commission limits for a great many years. The removal of these limits might, for a time at least, create problems as between companies. It may be, therefore, that some limit on vested agents' and general agents' commissions should be continued within the total limit. If this is done, the agents certainly are right in demanding that the limit be clearly stated so that there will be no question as to what it is.

GEORGE H. DAVIS:

New York's section 213 is one of the most important of the many state laws that regulate life insurance. It is of interest and concern to all actuaries, even though only a minority may be directly concerned with the problem of compliance with the law. Mr. Mayerson has performed a great service in contributing to our *Transactions* a comprehensive description and analysis of the law. This provides a source of information on the present law corresponding to that provided for the old statute by Mr. Linton in his 1929 paper.

Section 213 has been at times a very controversial law; and the paper, although it covers the general philosophy and the background and purposes of specific provisions, is intended to be descriptive and touches only lightly on the controversial aspects of the law. I do not intend to deal with any of the controversial points in particular, but I should like to examine briefly what the law is intended to accomplish and some of the effects which it seems to have upon the life insurance business.

It might be said that the purpose of section 213 is to keep down life insurance expenses. Mr. Mayerson correctly states the purpose more precisely as being "to keep the expense element of the cost of life insurance from reaching an unreasonable level." This means that the purpose is to set a reasonable ceiling upon life insurance expenses, but the law is not intended to force the reduction of expenses to a level at which life insurance could not have full development so that its benefits may be enjoyed by the greatest number of American people and may be adapted to best serve the varying needs of all kinds of people.

One thing that occasioned the development of the 1953–54 amendments was a fairly widely held belief that a situation had developed in which some companies were not able to spend enough, particularly on commissions, to permit efficient development and expansion of their business. The

amendments were intended to eliminate these restrictive effects of the statute without endangering the fundamental purpose of prohibiting expenses from reaching an unreasonable level. It is possibly too early to form a final judgment as to whether the purpose of the revision has been achieved; but I believe, and I think that it is the considered opinion generally of the many others who have given close attention to the amendments, that they permit increases in commission rates and other expenses to a desirable extent and still serve to fulfill the fundamental purpose of the law.

The question may be asked whether the law is needed at all. It might be felt that competition would prevent the expense element of the cost of life insurance from reaching an unreasonable level without statutory limitation of expenses. I think that it has to be admitted that this was not the case immediately before the law was first passed in 1906 and that the law did serve to bring unreasonable expenses down when it was first enacted. However, it may be argued that the other important reforms of the Armstrong legislation and merely the publicity given to the undesirable practices which prevailed also played a large part in reducing expenses and that under present circumstances expenses would not become unreasonable if the law were to be taken off the statute books. Whether this is true or not has to be largely a matter for speculation.

Probably a great many actuaries concerned with the problem of compliance with section 213 have at times asked themselves the question whether the institution of life insurance would not really be better off if the law were repealed. This is, of course, a hypothetical question since the possibility of its repeal in the foreseeable future is negligible. However, I believe that most of them conclude that repeal would be undesirable. This must mean that they believe that there is at least some danger that expenses would be higher if they were not limited by statute. I think myself that this is correct. I doubt that there is any possibility of excesses paralleling those which preceded the Armstrong investigation, but I think that some tendency for expenses to rise would be likely, and I think that it would be difficult to defend a level appreciably higher than the present as being reasonable.

Another effect of the law cited by Mr. Mayerson is that it helps to prevent a demand for rate regulation of life insurance. This naturally follows if we conclude that the law effectively accomplishes its purpose of preventing an unreasonable level of expense.

The law does more than affect the over-all level of expenses. It also plays a part in determining the pattern of expenses. For instance, it has an effect upon the pattern of commission scales. I do not think, however,

that it can be considered as imposing a harmful degree of rigidity upon commission scales. It is designed to follow the pattern of commissions which have seemed to serve the business best, and it has several provisions which are intended to provide flexibility and to permit considerable variation in the compensation patterns of different companies. Some of these provisions have been added to permit new developments in compensation systems, such as heaping of renewals and salary plans.

Section 213 may also affect companies' methods of agency operation, although this is an unintended result. One of the reasons for the 1953 amendments was that there was a general feeling that the law before 1953 made general agency operation difficult, particularly for small companies, and that it thus tended to foster branch office rather than general agency systems. There seems reason to hope that the amendments have successfully eliminated this undesirable effect of the law.

Section 213 may still have some undesirable effects. The necessity for keeping fairly elaborate records in connection with the requirements for vouchering expenses under the law creates extra expense for companies. If some of this record-keeping expense could be eliminated without creating the possibility of permitting expenses beyond those intended by the law, it would be a desirable result. This was a problem to which no solution was found when the 1953–54 amendments were being developed, and it may merit further consideration. It is possible for ridiculous situations to be produced by the provisions of the law which require the vouchering procedure. For instance, a general agent may be induced to undertake an unwarranted expense because only by so doing can he obtain amounts under his expense reimbursement formula which can be paid under the law only if the money is actually spent and not if it is retained by him as compensation.

The wide variety of agents' compensation systems and patterns of other expenses that exist under the law attest to the fact that section 213 is reasonably effective in achieving its purpose of preventing unreasonable expense without interfering unduly with management's prerogative of choosing the methods by which its business will be carried on. It is largely to achieve this flexibility that the law is required to be so complex. It has had to be changed over the years to take account of new situations, and the changes usually have made it more complex rather than more simple. The changes, however, have been made to accomplish specific results, and those directly concerned with the law know what the provisions mean and how they have come to be interpreted, even though they may seem obscure and confusing to one who has had no experience with the law. The different approach of the revision recommended by the 1948 committee

was rejected, I believe, not so much because it was considered definitely inferior to that of the existing law, but because its adoption would have created a considerable area of uncertainty. The various provisions of the existing law had come to have fairly definite meanings, which provisions of a different law could acquire only after regulations had been developed and interpretations worked out to apply to specific situations.

One questionable effect of the law is that it keeps at a low level the number of companies admitted to do business in New York. This is, I think, an undesirable effect in itself, but it probably has to be accepted as an inevitable effect of the statute if it is to accomplish its intended purpose. As long as companies admitted to New York write a substantial portion of total United States business, this effect cannot be regarded with too serious concern. However, of total ordinary insurance in force in United States companies, the proportion in companies admitted to New York has declined from 80% to 73% in the last ten years. No foreign company writing principally ordinary insurance has entered New York in the past ten years, and there have been only four in the past twenty years. If this tendency continues, it is something that merits future close examination. One objective sought by the 1953–54 amendments was to make it easier for foreign companies to enter New York. Whether entry of new companies has been greatly encouraged is, I think, doubtful, but it is to be hoped that additional companies will decide to seek admission.

CHARLES F. B. RICHARDSON:

Mr. Mayerson has performed a real service to the profession in this very clear exposition of the New York expense limitation law. The paper is so well written that it is rather difficult to find anything to criticize, but there is one feature of this law not specifically covered by Mr. Mayerson which I should like to discuss.

The author deals briefly with the extraterritorial effect of this law but he restricts his discussion to the application of the law to business written in other states of the union. He does not deal with the situation in regard to business written in foreign countries. As to U.S. business he points out that since companies charge the same premiums and pay the same dividends nationwide, and since many of their expenses cannot be segregated by state, the New York Department feels that the only way to control the cost of insurance to New York policyholders is to control all the expenses of the company. These arguments do not apply to business written in a foreign country. Generally, the premium rates are different, the dividends may certainly be different and the expenses incurred in the foreign country can certainly be segregated. There is an old saying: "When in

Rome, do as the Romans do." If a U.S. company desires to transact business in a foreign country, it must conform to local practices. In many countries the maximum agent's compensation permitted to a New York company would make it impossible to compete with local companies in recruiting a sales force or in securing general agents. It seems to me, therefore, that the requirement that a company operating in New York must observe New York expense limitations in connection with business in foreign countries effectively prevents New York companies from operating abroad. In fact, this is no doubt the reason why no company operating in New York today writes business in any foreign country except Canada. Even in Canada, where practices are rather similar to those in the U.S., the New York agents' compensation limits place the U.S. companies at a serious disadvantage. It ought to be possible to permit the transaction of foreign business on the terms that are appropriate in each of the countries concerned. It should be feasible for the New York Department to require a company to prove that its foreign operations are self-supporting so that they are not detrimental to the interests of policyholders in New York State. This, of course, would require consideration of the level of premium rates, interest earnings, dividends and expenses in each country. While this would be a complicated matter, it should not be impossible of accomplishment.

There is one other point which I do not understand. The author suggests that in computing the first year field expense limit, only the increase in premium on attained age term conversions is considered as a first year premium. It had always been my impression that the entire premium should be treated as a first year premium. Certainly it is the prevalent practice to pay full first year commissions on the entire premium. If a company attempted to pay less than the full commissions, there would be an obvious temptation to the agent to place the business in another company.

In conclusion, I should like to congratulate Mr. Mayerson on an exceedingly able piece of work.

(AUTHOR'S REVIEW OF DISCUSSION)

ALLEN L. MAYERSON:

I should like to thank Messrs. Lyons, Richardson, and Davis for their discussions of my paper. All three of them were involved, as was I, in the studies leading to the 1953 and 1954 amendments to section 213.

Mr. Lyons feels that these amendments did not go far enough and that a complete overhaul of the law is necessary. He points out the com-

plexities of the present law as compared with the original expense limitation law enacted in 1906, after the Armstrong investigation. He also emphasizes the necessity for interpretation of the law's provisions by the Insurance Department and seems to believe that this is a defect in the law.

In my opinion, any law which tries to control expenses will necessarily be complex, if it is to do its job effectively, because the insurance business itself is complex and growing more so every year. True simplicity could be achieved only by "watering down" the law to a point where its value might be substantially reduced.

Furthermore, any law of this nature will require Insurance Department interpretation of its provisions. If an entirely new expense limitation law were drawn up along the lines suggested by Mr. Lyons, it would probably be only a matter of time before it, too, had built up a substantial body of interpretations and decisions. The present law has at least the merit that its interpretations are widely understood and that even its defects are known. The defects of a new law might be some time in appearing.

I agree with Mr. Lyons that the provision of subsection four of section 213, requiring the reduction of the 60% maximum general agent's commission when the general agent is largely a personal producer, accomplishes very little and could be discarded. Certain other provisions might also be simplified with no loss in effective supervision. However, to go further and adopt Mr. Lyons' approach to expense limitation might result in substantially weakening the law. It is much easier to discard controls than it would be to reimpose them if it developed that the changes were not in the best interest of policyholders.

Mr. Richardson's discussion of the effect of the expense limitation law on operations in foreign countries is an interesting one. His proposal that a company be permitted to exclude its foreign operations from the scope of the law, provided they were self-supporting, might solve the problem, though I am not completely convinced that it would be feasible. I doubt, however, that section 213 is the principal reason why New York admitted companies do not operate in foreign countries other than Canada.

Mr. Richardson also points out an error in the paper pertaining to the treatment of attained age term conversions. He correctly states that the full premium, rather than the increase in premium, is considered as first year premium in calculating the field expense limit.

It has also been pointed out to me that the statement: "the same commission (is allowed) on a family income rider as is allowed for the basic policy to which it is attached" does not agree with the interpretation of the New York Insurance Department. According to the Department's July 15, 1930, circular letter, this is true for a whole life policy only if

level premiums are payable for the entire policy period. If premiums are not level, a theoretical level premium must be substituted and an average commission allowance derived.

Mr. Davis' excellent analysis of the effects of the expense limitation law on the life insurance business is a valuable addition to the paper. I agree with him that many of the law's complexities are necessary to keep it flexible. I believe that this flexibility is very important, and that, so long as the general principles and major provisions of the law are widely understood, some complexity in detail is not necessarily deplorable. After all, many things that actuaries deal with are complex. The same can be said for lawyers. Hence a subject with both actuarial and legal implications, such as an expense limitation law, can hardly be completely lacking in intricacies.

I also agree with Mr. Davis that the vouchering procedure may produce some undesirable effects. Unfortunately, however, nobody has yet suggested a satisfactory way to eliminate the vouchering requirement and still keep the control on expenses which it provides. If someone knows of a way to do this, I believe it will be eagerly welcomed by all concerned.

It is unfortunate, as Mr. Davis says, that section 213 is one of the reasons why many good out-of-state companies have not sought admission to New York. However, I do not think the law should be changed solely on this account. If the standards established by the law are sound, it should rather be hoped that companies will accommodate themselves to these standards. If, however, other patterns of operation than those contemplated by the law prove to be equally as economical and satisfactory from the standpoint of the policyholders, the law can and should be amended to permit companies using these methods to operate in New York. In the past the New York legislature has always been willing to make such amendments when they were clearly in the policyholders' interest.