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# A Pending Revolution

## Follow the Dotted Lines

There has been a lot of attention paid to agent and broker compensation — thanks, in part, largely to the investigations spear-headed by former New York Attorney General (and now New York Governor) Eliot Spitzer and others. As an industry, what do we make of all this — and is there a solution?

While it's impossible to say just where it is going to end, it's pretty clear that it started with bid rigging and contingent compensation. The real issue is bid rigging in conjunction with contingent compensation — not just contingent compensation. What is a problem is a producer from one company colluding with representatives of another company to submit an artificially high bid that advantages another firm. That action is taken with the understanding that the colluding producer will then get a favorable position on another opportunity, which leads opportunity that leads to higher compensation. That practice is harmful to the consumer and must be addressed.

What is of great concern is the continued focus on contingent compensation and not on bid rigging. After all, contingent compensation is all around us. Virtually everyone who is paid incentive — as well as sales compensation — receives contingent compensation. The basic principle of “if you deliver more, we will pay you more” — however more is defined — is

a basic operating principle of American-style capitalism. Unfortunately, it is not yet clear that all the regulators looking through reams of paper in search of a smoking gun understand that the bid rigging is the issue, not contingent compensation.

Certainly bonuses tied to volume can make sales unprofitable to a company, but it is collusion leading to unearned payments that is the issue, not the structure of the bonus. Disclosing that you get a bonus by selling a lot should not be a surprise to individual customers.

### **Will Public Disclosure Solve the Problem?**

There seems to be a growing consensus that the industry should move to disclose compensation. Will public disclosure of compensation solve the problem? If the problem is bid rigging, that seems unlikely. Bid rigging is done behind the scenes to generate compensation that is allowed within the standard compensation plan. It is not the compensation that is wrong, just the bid rigging. Regardless of the reasoning that leads to it, if disclosing compensation does get mandated, it could well have a long list of unintended consequences but no impact on bid rigging.

It is difficult to forecast the impact without

knowing what form it takes. If disclosure is just acknowledging that agents will be paid for the sale in relation to the amount of premium paid, that would not have much impact. It would only lengthen the sales process. If, however, companies must accurately describe their full compensation plan, it could create

variable universal life target. If the first-year rate were dropped down a notch or two, companies could move to pay the same rate on term insurance as well. Disclosure could prompt companies to take a fresh look at product-based rates as opposed to playing follow the leader.

## to the Implications of Compensation Disclosure

substantial changes. In particular, it could force simplification of sales compensation.

Complex plans requiring many pages to explain suggest you are hiding something. Short, simple plans imply that you have nothing to hide. As an industry, insurance companies have relied heavily on compensation to drive behavior, which has led to very complex plans that would be difficult to explain to consumers.

Numerous studies note that consumers think highly of their own agents. Consequently most consumers would probably sign off on the disclosure without reading it (much like they do on prospectuses and real estate contracts). Other than lengthening the sales process, that doesn't accomplish much. Still, some innovative, consumer-friendly companies might try to capitalize on disclosure by simplifying their agent compensation plans. What form might that simplification take?

I certainly don't see variable compensation going away. The public understands that you must pay salespeople to sell and that payments are generally structured as commissions. It is likely to start with eliminating minor differences in payment levels. For instance, is it appropriate to pay differently by product when the products are of a similar type such as whole life, universal life target, and

Flat commission rates are not an issue, but bonus payments tied to volume could become an issue. For instance, a substantial incentive based on total volume could be triggered by an individual sale. While the cost is spread over all the sales that helped the producer qualify for the bonus, individuals could interpret the bonus as being triggered by their purchase. In contrast to volume-based bonuses, profitability bonuses based on office, regional, or company performance would be perceived as more consumer-friendly.

### Difficulty Explaining High First-Year Compensation

Is high first-year compensation an issue if you are explaining it to a customer? It seems likely that commission rates on sizeable sales might be negotiated downward more often (much like large COLI and annuity sales are often negotiated now). It would be difficult to show a prospect that your compensation may reflect a high percentage of the first year premium paid. That does not mean that total compensation will necessarily go down, but its form might well change. Great Britain imposed compensation disclosure some years ago and their compensation levels have actually moved up since then. To give the full explanation that most insurance

policy contracts do not pay for themselves until six to seven years from the date of purchase or that companies expect high lapses to make them affordable is not likely to improve the likelihood of a sale, either.

Does that suggest that companies will convert to levelized compensation? If disclosure took the form of enumerating just first-year compensation, levelized compensation is the clear outcome — but that format would seem unlikely. Fully levelized (a flat rate paid over the life of the policy) is unlikely to be viewed favorably in an open-disclosure environment. The public is likely to contrast it with asset-based fees as paid for assets retained in mutual funds. Some combination of a level rate for three to four years plus asset-based compensation seems likely. Nonetheless, any change of that magnitude comes with difficult transition requirements.

As most readers probably know, fully levelized compensation was successfully implemented in several large Canadian companies in the early 1990s but never quite caught on in the United States despite lots of experimentation and discussion. Those companies report better retention of policies and producers than U.S. companies, but the conversion process and cost of conversion scared away all but a few small U.S. companies. Because of level compensation, Canadian companies have had to add plan elements to encourage more new sales. This has contributed to total compensation rates in Canada that significantly exceed what most career companies pay in the United States. That would not be perceived as consumer-friendly.

Some companies might look at compensation formats that have not gotten much use in insurance sales. Goal-based plans are easy to explain and common in other industries. They can be designed to encourage high volumes and profitability. In contrast to commissions and volume-based bonuses, they do

not have as direct a connection to individual sales and hence seem more favorable to consumers. Salary plans are, of course, another option but they must be linked with incentives to be successful and they require closer management than most insurance companies have deployed historically.

Suppose public disclosure of compensation does come about, what else could it lead to?

It seems likely that producers could elect to declare, or perhaps be required to declare, whether they are independent or captive, much as agents did in Great Britain. Those who are independent would have a hard time advocating plan A over plan B when plan A pays more. Consequently, I could see where companies that sell through independent agents would come to offer very similar compensation payouts.

Would it be advantageous for a company to voluntarily disclose compensation ahead of any regulations that might require it? Interesting question! A company that could explain its plan in big print within a couple of pages while including an overview of industry pay levels and formats could be a big winner, particularly if it did this in concert with a public relations effort. It would set the bar for others to follow. 🌐



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