Compensation Conundrum

The current producer compensation system encourages sales but discourages persistency. Regulators could help revamp the system so agents receive an even stream of compensation over the life of the policy.

by Anthony Steuer and Barry Vokes

It is time for a fundamental change in producer compensation; the current system is badly in need of repair. Something more realistic is needed: a way of compensating producers commensurate with their vital role in keeping business on the books.

The current compensation system invites replacement and poor persistency. It fails to align the interests of producers and life companies.

Consider the producer's perspective: Selling life insurance is a tough job. Few consumers seek out life insurance or annuities; the producer must persuade a prospect to buy. Prospecting for business is hard, unpleasant work. Successful producers understandably feel deserving of their financial rewards.

On the other side, life companies must write enough business and keep it in force long enough to make a profit. Since a career agency force is almost prohibitively expensive, most companies are forced to compete for independent producers. This intense competition creates enormous pressure to pay the highest possible commissions. But unrestricted competition does not always serve the public interest.

The present agent compensation system is based upon the fact that life products are hard to sell. The more difficult the sale, the higher the commission--and the more inefficient the product is from a consumer standpoint.

Regulatory Solutions

Regulatory help is needed to facilitate a new compensation model that serves the agents as well as the industry.

High, or "heaped," first-year commissions are common throughout the industry. Producers then receive smaller commissions each year as long as a policy is in force. This model, however, encourages sales but discourages persistency. While the need for change has been apparent for several years, insurers cannot afford to act unilaterally, and antitrust implications prevent them from acting in concert.

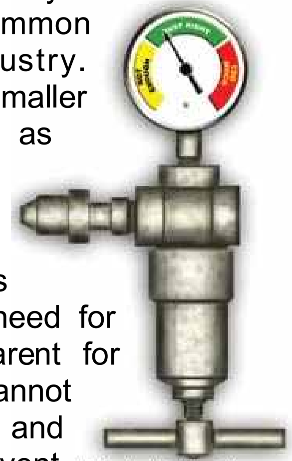

Illustration by William Waggoner

Surely, here is an opportunity for state insurance regulators. Life companies should support a coordinated state regulatory initiative limiting up-front producer compensation. There is no need, however, to limit the ultimate commission payout. Let competition take care of that.

Split Fee

Specifically, producer compensation should be split into a selling fee and a service fee. The selling fee would be whatever amount an insurer deems appropriate, but it would have a ceiling on how much is payable within the first year the policy is in force. For example, a selling fee may be payable over five years, contingent on the policy staying in force and with up-to-date premium payments. A service

fee, on the other hand, would be paid to the agent who services the policy, and this may not necessarily be the selling agent.

Regulators also could exercise control over the commission structure by limiting product approvals. Companies must design products attractive to the consumer while satisfying producer commission demands. This virtually impossible task produces a competitive landscape in which products are studiously differentiated. Companies go to great lengths to differentiate their products, because without product differentiation, products quickly become commodities, destroying profit margins.

Too Much Choice

But excessive life and annuity product differentiation is the enemy of competition. It makes direct product comparison by consumers very difficult.

Equity-indexed annuities are a textbook example of product differentiation carried to its extreme. No two such products are exactly alike, and many have multiple moving parts. Some equity-indexed annuities create consumer expectations that cannot possibly be met, setting the stage for class-action litigation that threatens to further weaken the public image of an already battered industry.

One Product Per Market

By limiting product approvals, regulators can stave off the proliferation of confusing products. The standard could be to allow one product per company per target market. For example, an annuity writer might be allowed one flexible-premium annuity and one single-premium annuity in each marketplace--e.g., 403(b). This would not preclude companies from seeking additional product approvals, but they would be required to justify the need for additional products. This, in turn, would help keep commission levels at bay, because companies wouldn't be able to create higher-commission products just for the sake of attracting producers.

Involving the Producers

Good product design and pricing lead to persistency--and ultimately, profitability. It is unrealistic, however, to link producer compensation with profitability. The producer does not control these factors. Producers shouldn't be pen- alized for home office management failures.

Companies, however, can tap producers to help encourage persistency. For example, producers could be required to meet with each policyowner at least once a year or forfeit their right to ongoing compensation. Producers who have an assured interest in their in-force business will strive to maximize their compensation by encouraging persistency.

Life insurers should enter good-faith, profit-sharing agreements with their producers. If insurers expect producers to forgo heaped first-year commissions, they must be confident of a long-term financial reward commensurate with their contribution and commitment. Permanent life insurance is profitable for companies achieving sufficient sales volume. The same is true for annuities. Producers can make or break persistency; therefore, companies have an incentive to compensate agents based on persistency.

A Starting Point

So where do insurance companies begin in aligning their interests with those of their producers? An excellent starting point is mandatory commission disclosure at the point of sale. Making producer compensation and overall marketing allowances transparent to the buyer would help bring about lower first-year commissions and more emphasis on long-term relationships.

It is not that difficult to design a viable commission-disclosure standard. Commission

disclosure can and should be made as simple as possible. For example, the producer's first-year compensation should be disclosed as a dollar amount and as a percentage of the first-year premium. Renewal commissions should be disclosed in like manner. All other marketing costs, such as general agent allowances and other selling expenses, should be disclosed to the consumer at the point of sale. If it is administratively difficult to provide these disclosures at the point of sale, they should be mailed to the applicant by the home office. The applicant should then be given the opportunity to ask questions or cancel the application.

Developing a much-needed new producer compensation model will require a cooperative effort between the industry and its regulators. Producers and companies will adapt accordingly, consumers will be better served and this will enhance the industry's public image.

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