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Profit Commissions – One for You, Three for Me

Introduction

For both the payer and the recipient, profit commission can be a double-edged sword. Properly used, profit commission is a useful way of sharing the profits and risks of an insurance portfolio between the risk carrier and the producer, better aligning the interests of each and cementing a stable and profitable partnership. However, a poorly constructed or administered arrangement can leave one or both parties feeling at best aggrieved and at worst severely out of pocket.

This article aims to summarise the issues to be considered in establishing or reviewing a profit commission arrangement.

Although there are some similarities, this article does not extend to a discussion of profit-sharing or experience rating arrangements in general; for example premium rebates, burning cost insurance or profit-sharing for the parties to a joint venture or underwriting pool.

Profit commission – a description

Profit commissions are a type of contingent commission whereby the commission paid from the risk carrier or underwriter (typically a reinsurer, insurer or underwriting agency) to the producer/distributor (typically an insurer, underwriting agency, broker or agency) depends on the defined “profitability” of a specific book of business over a fixed period of time.

Profit commission may also be known as profit-sharing commission, bonus commission or variable commission. In contrast with straightforward flat commissions, which are based on the premium collected on the sale or renewal of a single policy, profit commission is calculated based on the financial outcomes of a group of policies.

Other types of contingent commissions might make use of measures other than profitability such as business volumes or the persistency of a book of business.

Examples where profit commissions might be used include:

- A reinsurer paying profit commission to an insurer based on the profitability of business ceded under a treaty.
- An insurer paying profit commission to an underwriting agency based on the profitability of the business written under the underwriting agency agreement.
- An insurer or underwriting agency paying profit commission to a broker or agency based on the profitability of the business written under a broker or agency agreement.

Why would a profit commission be used?

As stated above, a profit commission arrangement can create a better alignment of interests and risk/return balance between the acceptor and producer of risks, thus cementing an insurance relationship.

Some specific examples of reasons for paying profit commission include:

- Where the producer (distribution) has some control over the nature and quality of risks being submitted to the acceptor in an insurance arrangement – for example via the preliminary handling of risks by a broker, an underwriting agency setting terms and conditions and premium rates, or the management of risks by an insurer under a reinsurance treaty. A properly defined profit commission provides an incentive to good risk management behaviour by the producer. The greater the input of the producer to the overall risk management and profitability of the portfolio, the greater the weight that should be placed on the profitability rather than the volume of business submitted.
- Where the acceptor and producer are entering into a new relationship or market there could be uncertainty about the potential profitability of the venture. A properly defined profit commission may allow a better sharing of the business risks and profits of each party. For example, the addition of profit commission may be useful in getting a producer to accept a more conservative rating structure as it gives potentially higher compensation for the greater effort required.

- Where the profit commission goes hand-in-hand with reduced levels of flat commissions, a profit commission can reduce the financial strain for the acceptor of risks.

The balance of market power between the acceptor and producer of the risks may mean that the producer can demand, or the acceptor can refuse to offer, a profit commission.

Some issues to consider in the definition of a profit commission arrangement

Each profit commission arrangement will be a customised arrangement of some of the items below.

- The parties to the arrangement.
- The scope of business – what products, distribution channels, territories or currencies are included/excluded. Will there be a single pool or several sub-pools.
- What is the duration of the agreement.
- When will the profit commission be calculated and paid.
- Will the profit commission be paid in a single instalment or in several payments.
- Will there be a minimum portfolio size or profitability threshold before profit commission payments commence.
- Will losses be carried forward to be offset against future profit commissions – if so for how long.
- Termination terms and profit commission payments after the termination of the relationship.
- Arbitration arrangements.
- Profit commission formula.

There can be many variations on the profit commission formula – there is no single best or correct definition. What is best will depend on the objectives of the arrangement.

General formula: X% * (P – C – E).

- X% - fraction of "profits" payable to the recipient of profit commission (X% can be contingent or vary).
- P - earned premiums.
- C - incurred claims (i.e. includes allowance for claims provisions).
- E - expenses (could include all expense types, taxes, capital charges etc.).

More complex formulae include explicit allowances for:

- A minimum threshold of profitability for the acceptor.
- Interest earned on reserves held (more relevant for longer tail business).
- Reinsurance.

In order to reduce the volatility of payments, an averaging process may be used whereby payments depend on more than one period's profits.

Where the form of the profit commission arrangement is not dictated by market practice, each party should carefully explore the possible impact of the profit commission, on their business relationship and finances. It is also worthwhile to investigate the possible outcomes from the other party's perspective. For the payer of profit commission this is best achieved by treating the profit commission as just another expense in any financial modelling. For the receiver of profit commission, it should be treated as just another source of revenue, albeit a potentially volatile one.

As profit is typically the difference between two large numbers it can be volatile, so an exploration of the range of likely outcomes is worthwhile – perhaps via the use of a Monte Carlo model. Where the claims experience is volatile, simple good luck in claims outcomes can mean that at times profit commission is payable from an inherently unprofitable book of business and vice versa.

In particular, the producer needs to have a clear picture of the range of outcomes from a profit commission arrangement where it is expected to be a significant fraction of the firm's revenues. Finally, both parties need to be satisfied with the administrative practicality and costs of the arrangement.

Possible "fish hooks" in profit commission arrangements

- Regulatory considerations, such as the treatment of profit commission in commission disclosures (consider the charges brought by New York Attorney General Eliot Spitzer and the forthcoming changes in disclosures for NZ financial advisers) and the accounting and prudential reserving treatment of profit commissions.

- The impact of profit commission on overall profitability (for either party) is not always obvious. Careful financial modelling can help prevent disappointment.
- Where one party has discretion in defining components of the profit commission formula – expenses or claims provisions are good examples – this can lead to disagreements.
- Allowance for claims provisions can lead to problems where there is substantial IBNR or longer tailed claims for which there is a degree of uncertainty about the final payouts.
- All else being equal, the producer generally benefits from having several profit commission subpools rather than a single pool arrangement because poor results in one pool do not endanger profit commissions from better performing pools. The converse applies for the risk carrier.
- Administration delays, arguments over definitions or delays in profit commission payments from further up the chain (where several parties are involved) can cause delays in the payment of profit commission which can cause financial stresses for recipients with more limited financial resources.
- Changes in market conditions, unforeseen issues or just plain bad luck can lead to unintended outcomes, for example a lot less profit commission than was expected.
- Typically there is no “loss sharing” – where profitability has been poor the producer can terminate and go elsewhere, and may be inclined to do so where losses are carried forward.

To summarise, in order for a profit commission to be a success, or at least not a failure, there is a need for both parties to be clear about what the objectives, terms, benefits and likely financial outcomes of the arrangement will be for both of them

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