Analysis of P&C Policy Acquisition Expenses

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Dave Crozier's article on Broker M&A Activity included in this issue of the MSA Quarterly Outlook contains a number of references to commission multiples used as a valuation proxy for brokerage purchase and sale transactions, including references to both gross and net of contingent commissions calculations. He has used a series of children's games analogies to punctuate his thoughts in that article. Carrying on with his playful games approach, I thought that our readers might enjoy joining in a game of Seek & Find with the Policy Acquisition Expenses ("PAE") reported by Canadian P&C insurers, and available for analysis in the MSA P&C Researcher software. I will focus on the broader term "Policy Acquisition Expenses" rather than just "Commissions" in recognition of the changing composition of the costs of acquiring policies as direct and alternative channels gain market share. I will also ignore premium taxes in this article as they are a regulated variable cost applicable to all insurers, and not generally subject to management action.

The first screen we will apply focuses on the primary distribution channels utilized by the groups of insurers examined. The three MSA Benchmarks used are:

B13 – Broker Writers (excluding Lloyds, ICBC and SAF)

B14 – Agency and Direct Writers, and

B38 – Group and Affinity Writers

Note that there is some overlap in the groupings given the multiple distribution models used.

Exhibit 1 - Gross Acquisition Expenses Analysis by Distribution Channel

	Gross	Non-commission	Gross Commissions
Benchmark Group	Commissions /	Acquisition	and Acquisition
	Gross Earned	Expenses / Gross	Expenses / Gross
	Premiums	Earned Premiums	Earned Premiums
B12 - Brokers (excl. Lloyds)	17.06%	3.52%	20.58%
B14 - Agency and Direct	11.40%	5.47%	16.87%
B38 - Group and Affinity	16.02%	2.34%	18.36%

The analysis has highlighted a number of interesting unexpected results arising from the operating structures adopted by the insurers in the groupings. For example, several of the direct and affinity writers such as TD and Unifund show relatively high gross commission expenses due to commission charges from affiliated brokers or managing agents. In several other cases such as Northbridge, Zurich and FCT, significant acquisition costs in the form of management fees are reflected in Exhibit 80.20 (the source of the middle column in the analysis above). Companies such as Allstate, Co-operators and RBC, not surprisingly, reflect significant "Agency" acquisition expenses on Exhibit 8020 while most of the other large insurers use this exhibit to allocate salary and occupancy costs to acquisition expense. Close to 100, mostly very small and relatively inactive companies reported no acquisition costs at all on Exhibit 8020. Given the recent expansion in insurer owned brokerages, it is increasingly difficult to differentiate between third party commission expenses and non-arm's length commission charges in the regulatory filings.

The second screen we have used to analyze commissions looked at net commissions (excluding contingent commissions, other commissions and other acquisition costs) by major class of insurance.

We looked at the results for the industry as a whole (including Lloyds and the provincial auto insurers) and then using Benchmark B34 – Commercial Lines Predominating and Benchmark B35 – Auto Writers.

Exhbit 2 - Net Commissions Analysis by Class of Insurance

	Property Net	Auto Net	Liability Net	Marine Net	Total Pure	Total All
	Commission /	Commission /	Commission /	Commission /	Commission /	Commission /
	NEP	NEP	NEP	NEP	NEP	NEP
Total Canadian Property Casualty Industry	16.65%	9.91%	16.49%	22.02%	12.89%	14.18%
Commercial Lines Predominating	12.88%	9.72%	11.40%	20.99%	12.11%	13.46%
Auto Writers	17.58%	9.98%	15.72%	27.63%	12.08%	13.40%

Again this produced some slightly surprising results. The insurers with predominantly Commercial or Auto books had very similar total net commission expenses, albeit with significant differences by class of insurance. Removing the government auto insurers from the total industry line would increase the Auto and Total percentages by about 1%.

It is important to understand the role of contingent commissions in the industry when assessing broker M&A and retention strategies. Based on industry wide data, approximately 8% of gross commissions were paid based on contingent formulas in 2011. Drilling down further into this data, however, we discover that the industry is divided between those who use this compensation tool extensively, and those who have very limited use. Those reporting contingent commission expense were typically in the 12% to 20% of gross commissions range in 2011 while many show no expense at all. Two companies paid over 30% of their gross commissions on a contingent basis in 2011. When planning this article, I hoped to run a multi-year comparison of contingent commission payouts to underwriting results, a perhaps technically feasible analysis, but in all likelihood relatively meaningless given the huge variety of contingent plans in existence and the fact that many are based on multi-year results. Undaunted, I did try, but gave up after several different approaches produced virtually no correlation between insurance return and contingent payouts.

A wealth of information about insurer distribution and producer compensation strategy is available within the regulatory data filed by P&C insurers, but it takes a dedicated seeker to find the nuggets. The wide variety of different types of policy acquisition compensation agreements, particularly among sister companies, make it a challenge to assess the underlying results of individual entities. Another time, perhaps, I'll tackle the thorny issue, currently of great interest to the tax department, of deferred policy acquisition costs.

Where to Find Acquisition Expenses in the Regulatory Returns Using MSA Researcher Software:

Policy acquisition costs are reported in a number of different exhibits in the statutory P&C-1 and P&C-2 returns filed quarterly by companies and branches. Which exhibit to use depends upon the level of detail or drill down sought.

High level historical analysis:

The Statement of Income (Exhibit 20.30) contains current and prior year data for four fields:

- Gross commissions (row 66)
- Ceded commissions (row 68)
- Premium taxes (row 12)
- Other acquisition expenses (row 14)

Show Expired Fields:

There is no PAE subtotal on the exhibit but one can easily be calculated. Note that prior to 2011, the data in rows 66 & 68 were combined in a net commissions row 10. If you are performing a multiple year analysis, you will need to click on "show expired fields" when creating your Field Group.

Detailed Commission Breakdown:

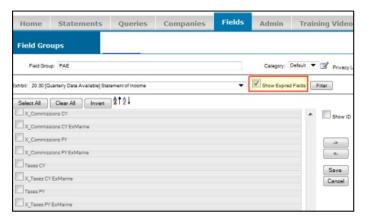
Exhibit 80.10 – Commissions summarizes commission detail by high level business class and also reports a breakdown of current period and opening and closing deferred commissions. Also included is a summary of Contingent Commission expense and Other Non-deferrable Commissions on a gross and ceded basis, though this data is not broken out by class of insurance. As in the case of the Statement of Income, in 2011 this exhibit was amended to expand the three commission categories to gross and ceded portions, making multi-year comparisons a little trickier.

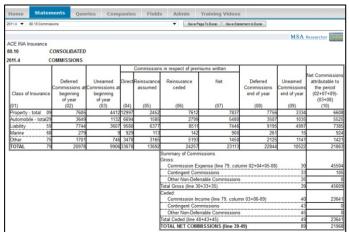
Other Acquisition Cost Detail:

Exhibit 80.20 – Expenses - Insurance Operations contains a column each for current period and deferred other acquisition expenses as well as columns for General and Internal Adjustment expenses. Costs are allocated among thirteen categories, not all of which are likely to be applicable to acquisition activities. Exhibit 80.20 is not filed quarterly.

Screenshots sourced from MSA Researcher Software

60.20	Net Claims and Adjustment Expenses	10	151440	14414
[Acquisition Expenses			
80.10	Gross Commissions	66	45609	4316
80.10	Ceded Commissions	68	23641	2360
1	Taxes	12	9624	978
80.20	Other	14	12231	1108
80.20	General Expenses	16	12608	1460
	Total Claims and Expenses	19	207871	19918
1	Premium Deficiency Adjustments	20	0	
1	Underwriting Income (Loss)	29	129	1319





	Acquisition	Expenses		Net Internal Adjustment Expenses (06)	
Expense Classification	Deferred at End of Year (01)	Attributable to the Year (02)	General Expenses (04)		
Salaries and employee benefits 5	0 0	10408	11101	1433	
Directors remuneration 5	2 0	0	42	(
Agency (excluding commissions) 5	4 0	0	0	(
Management fees 6	0	-815	-215	(
	2 0	139	847	(
Occupancy 7	0 0	1830	2797	25	
	2 0	2219	1503	(
	4 0	83	209	(
Bureaus and Associations 7	6 786	961	491	(
Home Office overhead 7	8 0	4	1088		
Allowance 8	0 0	0	2275		
Regulatory assessments 8	2 0	0	0		
	8 0	-2598	-7530	5042	
	9 786	12231	12608	650	