

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

Benchmark Group	Gross Commissions / Gross Earned Premiums	Non-commission Acquisition Expenses / Gross Earned Premiums	Gross Commissions and Acquisition Expenses / Gross 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.

Exhibit 2 - Net Commissions Analysis by Class of Insurance

	Property Net Commission / NEP	Auto Net Commission / NEP	Liability Net Commission / NEP	Marine Net Commission / NEP	Total Pure Commission / NEP	Total All Commission / 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.

Screenshots sourced from MSA Researcher Software

60.20	Net Claims and Adjustment Expenses	10	151440	144141
	Acquisition Expenses			
80.10	Gross Commissions	66	45609	43161
80.10	Ceded Commissions	68	23641	23601
	Taxes	12	9624	9781
	Other	14	12231	11081
80.20	General Expenses	16	12608	14601
	Total Claims and Expenses	19	207871	199181
	Premium Deficiency Adjustments		0	1
	Underwriting Income (Loss)	29	129	1319

Home Statements Queries Companies **Fields** Admin Training Video

Field Group: PAE Category: Default Privacy L

Exhibit: 20.30 (Quarterly Data Available) Statement of Income Show Expired Fields Filter

Select All Clear All Invert

- X_Commissions CY
- X_Commissions CY ExMarine
- X_Commissions PY
- X_Commissions PY ExMarine
- Taxes CY
- X_Taxes CY ExMarine
- Taxes PY
- X_Taxes PY ExMarine

Show ID Save Cancel

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.

Home Statements Queries Companies Fields Admin Training Videos 20

2011.4 30 Net Commissions Save Page To Excel Save Statements to Excel MSA Researcher

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80.10 COMMISSIONS

Class of Insurance	Deferred Commissions at beginning of year (02)	Unearned Commissions at beginning of year (03)	Commissions in respect of premiums written				Deferred Commissions end of year (08)	Unearned Commissions end of year (09)	Net Commissions attributable to the period (02+07+09) (03+08)	
			Direct	Reinsurance assumed (05)	Reinsurance ceded (06)	Net (07)				
Property - total	69	760	4412	12997	2452	7612	7837	7756	3334	6608
Automobile - total	29	3643	1132	6694	1584	2799	5482	3507	1039	5523
Liability	54	7744	3607	9580	6377	8511	7448	9198	4997	7389
Marine	68	278	9	929	113	142	900	261	15	924
Other	75	1701	748	3478	3162	5193	1450	2125	1141	1421
TOTAL	79	20978	9908	33678	13692	24257	23113	22844	10522	21863

Summary of Commissions

Gross		Ceded	
Commission Expense (line 79, column 02+04+05-08)	30	45504	
Contingent Commissions	33	109	
Other Non-Deferrable Commissions	35	0	
Contingent Commissions	45	0	
Total Gross (line 30+33+35)	39	45609	
Commission Income (line 79, column 03+06-09)	40	23641	
Contingent Commissions	45	0	
Other Non-Deferrable Commissions	45	0	
Contingent Commissions	49	23641	
Total Ceded (line 40+43+45)	49	23641	
TOTAL NET COMMISSIONS (line 39-49)	89	21968	

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.

Expense Classification	Acquisition Expenses		General Expenses (04)	Net Internal Adjustment Expenses (05)
	Deferred at End of Year (01)	Attributable to the Year (02)		
Salaries and employee benefits	50	0	11101	1433
Directors remuneration	52	0	42	0
Agency (excluding commissions)	54	0	0	0
Management fees	60	0	-215	0
Professional fees	62	0	847	0
Occupancy	70	0	2797	25
Information technology	72	0	1503	0
Inspections and Investigations	74	0	209	0
Bureaus and Associations	76	786	491	0
Home Office overhead	78	0	1088	0
Allowance	80	0	2275	0
Regulatory assessments	82	0	0	0
Other expenses	88	0	-7530	5042
Total	89	786	12608	6500