

Commission War and Profitability

Over the last two years, several life offices have increased new business commission on life and disability insurance.

Higher commission will not have an immediate impact on Margin on Services profit, because the extra cost is rolled-up into the deferred acquisition cost.

Ultimately, the extra cost will need to be recovered from policyholders or shareholders.

The typical premium rate charged in the market has not increased. Thus, it seems the burden of higher acquisition costs will be borne by shareholders.

Initial Commission

Introductory commission terms vary. New premium may include or exclude GST, policy fees and CPI increments. Commission write-back scale for early lapses differs.

Typically, commission will be a multiple of the first year premium (inclusive of pre-set negotiated bonus) plus indirect remuneration (including holidays), variable bonuses and dealer group over-riders.

Two years ago, initial commission ranged from 160% to 200% of the first year premium. Now, the range is 180% to 240%, an increase of roughly 30%.

There are higher headline numbers (e.g. 240% plus 30% dealer group over-rider), but those require exceptional persistency &/or production.

A lot of offices have increased their commission terms in response to falling sales as advisers shift their allegiance to companies that pay higher commission. Ultimately, all life offices end up paying more in a commission war.

Although many companies link some of the bonus component of commission packages to high persistency, this may not work over the medium run if an adviser builds up a book over several years before shifting that book after receiving bonuses.

Twisting

My paper to the 2004 NZSA conference identified high commission and transfer terms as incentives for advisers to churn business every two to four years.

On current terms, if new business with high up-front commission stays on the books for less than seven years, initial commission will not be recouped. The break-even period is now about a year longer than two years ago.

Recent increases in initial commission increases the financial incentive for advisers to shift existing policies.

Spread commission

Most companies encourage deferring initial commission into future years. However, many advisers have high overheads, so there is low demand for fully spread commission.

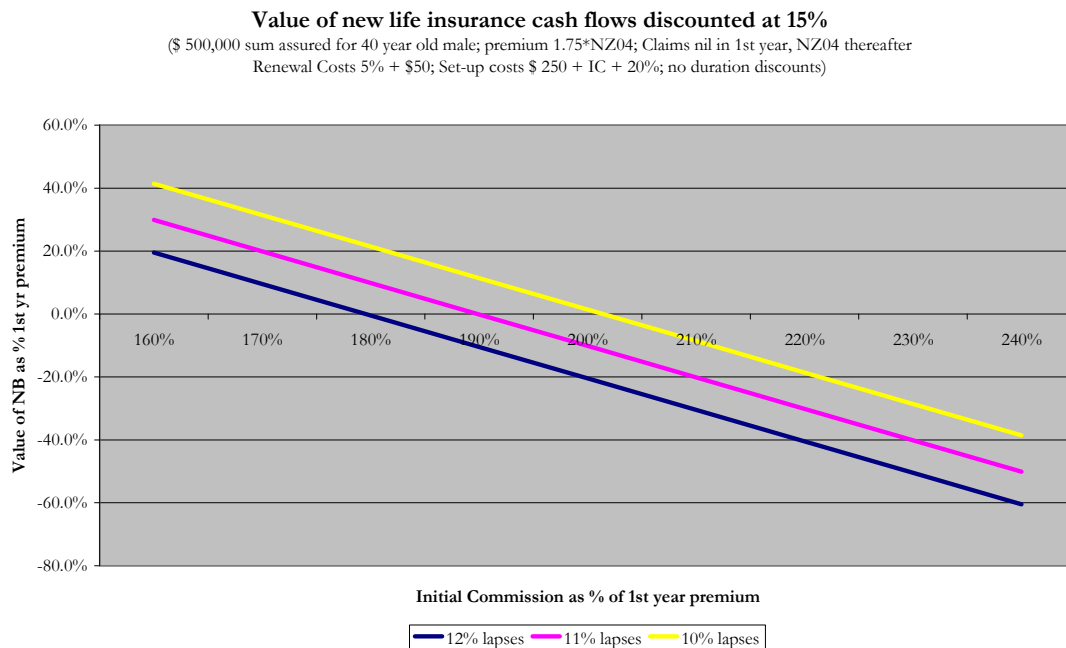
Nevertheless, there has been an increasing take-up of hybrid terms where some initial commission is exchanged for a higher renewal commission.

Hybrid commission is less capital intensive, but less profitable than up-front commission for business that stays on the books. However, it is more profitable than up-front for business that does not stick around.

Value of new business

The value of new business will depend on several factors including claims, persistency and pricing structure.

The following graph shows an example of the impact of higher initial commission on the value of new business:



The amount of initial commission that can be paid to achieve a positive net present value for new business increases as persistency improves. It is uncertain whether persistency bonuses will help improve persistency after the commission responsibility period is over.

For the parameters in this example using a risk discount rate of 15% and ignoring tax, the current level of initial commission is break-even at best.

Using a lower risk discount rate will improve the profitability of new business.

Reserving for new business

The policy reserve under Margin on Services (MoS) is calculated using a risk free rate of return with a profit margin to allow profits to emerge over the lifetime of a contract.

The magnitude of the initial negative reserve must not exceed first year claims and expenses less first year's premium. Otherwise, the value of future cash-flow would exceed the initial outgo causing a profit to emerge before future premiums are received.

Planned profit margin, claims and expenses are offset against future premiums to derive cash-flows used in a prospective MoS valuation. The size of the planned margin is calibrated so that the initial policy reserve equals the deferred acquisition cost.

This means that even though a new policy may be break-even at an economic valuation rate (e.g. 15% or 12%), a significant planned profit margin will emerge every year at a valuation rate (e.g. 5% or 6%).

For example, a 12.5% profit margin associated with 210% up-front commission would mask a 30% shortfall using a risk discount rate of 15% (see Appendix).

Taxation

Under the old tax regime, renewable term life would generate a taxable loss. For many companies, tax losses could be utilised through subvention payments.

It might be feasible to justify slightly higher commission if the benefit of tax losses are included in discounted cash flows. However, this logic would not apply to critical illness or income protection.

Under the new tax regime, term life will generate a taxable profit. This is expected to be an additional strain on emerging cash flows on new business written after 1 April 2009 and existing business from 1 April 2014.

Conclusion

The commission war has reduced product profitability.

Unless commission is reduced, the risk of distributors churning existing business will remain elevated.

Premium rate increases are likely as shareholders seek to achieve their target rate of return on capital.

John Smith
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Appendix

Assumptions used for projections of Discounted Cash Flows

Y.R.T.		Costs as % of Premium		Subsequent	Discount Rate 15%
			1st year	years	
Gender	M	Commission	210%	4%	
Age	40	Mktg/admin	20%	1%	
			230%	5%	
Sum Assured	\$ 500,000				Lapses 12%

Year	Premium as % of NZ04	Claims as % of Premium	Costs as % of Premium	Costs per policy \$	Year	Survival
1	175%	0%	230%	250.00	1	100.000%
2	175%	100%	5%	50.00	2	87.918%
3	175%	100%	5%	51.25	3	77.292%
4	175%	100%	5%	52.53	4	67.946%
5	175%	100%	5%	53.84	5	59.726%
6	175%	100%	5%	55.19	6	52.496%
7	175%	100%	5%	56.57	7	46.137%
8	175%	100%	5%	57.98	8	40.544%
9	175%	100%	5%	59.43	9	35.624%
10	175%	100%	5%	60.92	10	31.297%
11	175%	100%	5%	62.44	11	27.490%
12	175%	100%	5%	64.00	12	24.142%
13	175%	100%	5%	65.60	13	21.197%
14	175%	100%	5%	67.24	14	18.606%
15	175%	100%	5%	68.92	15	16.327%
16	175%	100%	5%	70.64	16	14.323%
17	175%	100%	5%	72.41	17	12.559%
18	175%	100%	5%	74.22	18	11.008%
19	175%	100%	5%	76.08	19	9.643%
20	175%	100%	5%	77.98	20	8.443%
21	175%	100%	5%	79.93	21	7.387%
22	175%	100%	5%	81.93	22	6.458%
23	175%	100%	5%	83.98	23	5.642%
24	175%	100%	5%	86.08	24	4.923%
25	175%	100%	5%	88.23	25	4.292%

An economic valuation of the cash flows using a risk discount rate of 15% will show an expected loss over the lifetime of the contract.

Worked example of DCF for New Business (ignoring tax)

Year	Premium	Claims	Expenses	P - C - E	E(P-C-E)	D.C.F.
1	718.38	-	1,902.27	(1,183.89)	(1,183.89)	(1,232.38)
2	756.88	432.50	87.84	236.54	207.96	168.63
3	802.38	458.50	91.37	252.51	195.17	137.62
4	855.75	489.00	95.32	271.43	184.43	113.08
5	918.75	525.00	99.78	293.97	175.58	93.61
6	991.38	566.50	104.76	320.12	168.05	77.91
7	1,076.25	615.00	110.38	350.87	161.88	65.26
8	1,175.13	671.50	116.74	386.89	156.86	54.99
9	1,288.00	736.00	123.83	428.17	152.53	46.50
10	1,419.25	811.00	131.88	476.37	149.09	39.52
11	1,569.75	897.00	140.93	531.82	146.20	33.70
12	1,743.00	996.00	151.15	595.85	143.85	28.83
13	1,942.50	1,110.00	162.73	669.77	141.97	24.74
14	2,170.88	1,240.50	175.78	754.60	140.40	21.28
15	2,433.38	1,390.50	190.59	852.29	139.16	18.34
16	2,733.50	1,562.00	207.32	964.18	138.10	15.83
17	3,077.38	1,758.50	226.28	1,092.60	137.22	13.67
18	3,470.25	1,983.00	247.73	1,239.52	136.45	11.82
19	3,918.25	2,239.00	271.99	1,407.26	135.71	10.23
20	4,428.38	2,530.50	299.40	1,598.48	134.96	8.84
21	5,008.50	2,862.00	330.36	1,816.14	134.16	7.64
22	5,667.38	3,238.50	365.30	2,063.58	133.27	6.60
23	6,413.75	3,665.00	404.67	2,344.08	132.24	5.70
24	7,258.13	4,147.50	448.99	2,661.64	131.04	4.91
25	8,211.00	4,692.00	498.78	3,020.22	129.61	4.22

V(NB) as % of 1st year Premium -30.5%

V(NB) (218.90)

If a valuation interest rate of 6% is used and planned profit margin established so that the value of new business at inception is zero, the profit margin equals 12.5% of the premiums from year 2 onwards.