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Third Party Distribution Delivery and Service Strategies

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Introduction

Distribution costs are a significant business expense – often over 25% of premium. Many Australian manufacturers choose to outsource some or all of their distribution functions to third parties. Choosing the appropriate channel, service level and commission is a critical area of expenditure and value creation for an underwriter

This paper summarises certain high level results/findings from a recent Tillinghast survey on services and commission rates for third party distribution of general insurance products in the Australian market. The detailed survey report is confidential to the survey participants.

Information was collected from a series of interviews, including 8 out of Australia's largest 10 manufacturers. Findings showed:

- There is a variety of third party channels available
- Different channel alternatives provide varying service levels
- There is a strong connection between service and commissions
- A variety of other incentives are used
- The market reports a number of potential drivers of commission rates

Survey Approach

Participants

More than 25 company groups were interviewed for the study. Most company groups reported more than one manufacturer-distributor arrangement. We aimed to collect market negotiated commission based distribution arrangements. The type of organistions included:

- Insurance Manufacturers
- Financial Institutions
- Health Funds
- Brokers
- Cluster Groups
- Underwriting Agencies

Information Collected

Commission based distribution arrangements for:

- Personal Motor and Home
- Commercial Motor, Rural and Small to Medium Enterprise pack products
- Channel, state and policy type
- Commission rates and some key characteristics of each arrangement (eg.on-line / EDI enabled, volumes, exclusivity, brand, commission claw-back, duration, credit terms)
- Services levels provided for those arrangements

Service framework

Delivery services were identified for each arrangement. Insurance distribution was broken into a series of generic services - applicable regardless of the distribution arrangement. This ‘delivery chain’ included both:

- *Delivery Services* - Services involved in bringing a product to market
- *Support Services* - Key support services for product delivery (eg. staff training and IT systems)

Services were broken further in to sub-services. For example Product Development was broken down into the seven categories listed in the accompanying diagram. Participants specified which sub-services were performed for each commission arrangement. Sub-services were clearly defined and supporting examples used to determine whether performance was at a ‘none’, ‘low’, ‘medium’ or ‘high’ level.

Services and Sub-services Framework

Product Development	Marketing	Sales	Acceptance	Policy Processing	Policyholder Service	Claims
Market Feedback & Research	Market Tracking & Approach	Sales Tracking & Approach	Risk Acceptance	Issuing Policy Records	Customer Service	Claims Management
Competitor Monitoring	Product Campaign Development	Sales Enquires & Advice	Underwriting Compliance	Printing Documents	Customer Retention	
Product Concept Development	Product Campaign Materials	Premium Quote		Customer Liaison		
Product Feasibility	Product Campaign Delivery	Renewal Sales Instigation		Policy Maintenance		
Product Design	Distributor Brand Strength	Competitive Pricing		Policy Cancellation		
Product Pricing				Premium Payment Processing		
Product Management						

There is a Variety of Third Party Channels Available

Alliance: An agreement with a trade association, industry body, financial institution or small business group to provide leads or sales to their membership base. In our survey we captured mainly financial institutions and industry member groups.

Tied Agents: Intermediary acting on behalf of the manufacturer (insurer). They are agents of one manufacturer and were predominantly financial institutions, some financial planners and motor clubs in our survey.

Multi Agents: Intermediary acting on behalf of the manufacturer (insurer). They are agents for more than one manufacturer. In our survey predominantly Small Businesses, some Financial Institutions.

Brokers: Intermediary acting on behalf of the customer (ie. the insured). That is, they are independent of the manufacturer. Can occasionally be on a binder to the manufacturer and act as a tied agent.

Cluster Group: Groups of brokers who have, or develop, a specific product - generally improved or favorable policy wordings. They then invite one or more insurers (referred to as a panel) to underwrite that product and negotiate favorable commissions for their membership base (but with no requirement to use the facility)

Underwriting Agency: Organisation to which a manufacturer (insurer) delegates some or all of its underwriting and claims management. Usually in a very specific or niche product market for which the agency is a specialist. Underwriting agencies can also handle distribution or contract out the distribution.

Personal Lines use mostly tied agents to distribute business (36%).

Commercial Lines use mostly brokers either directly or through cluster groups (50%).

Survey Responses (% of total)

CHANNEL TYPE	Industry Group	Health Fund	Motor Club	Financial Institution	Financial Planners	Small Business	Independent of manufacturer	Total	Personal	Commercial
Alliance	5	-	1	5	-	2	-	12	8	18
Tied Agents	1	2	5	12	5	1	1	26	36	14
Multi Agents	1	-	-	4	2	9	-	15	20	9
Brokers	-	-	-	-	-	-	24	24	16	33
Cluster Groups	-	-	-	-	-	-	15	15	13	17
UW Agencies	-	-	-	-	-	-	8	8	7	10
Total	6	2	6	21	6	11	48	100	100	100

Delivery Services Models

Five distribution models were apparent in the markets we surveyed, and they are ranked from least to most amounts of services offered. . Each commission arrangement was assigned a model after consideration of its main services and similarity to services performed by others in the same group.

- *Spot and refer:* Distributors in these arrangements usually target their existing membership base to 'spot' potential opportunities for an insurance sale that they then 'refer' onto the manufacturer for conversion and fulfillment. They accounted for 14% of responses in our survey mainly from financial institutions and industry member groups.

- *Attract and sell*: Distributors attract and convert a new business inquiry to a sale, but don't provide ongoing policyholder service. They accounted for relatively few of personal lines responses in our survey (7% in total) and were mainly from financial institutions and small businesses.

- *Attract, sell and serve:* Distributors attract and convert a new business inquiry to a sale and also provide customer servicing and liaison in lieu of the service being provided by the manufacturer. By far the most common response for both personal lines (57%) and commercial lines (49%). They were represented by all channel types except cluster groups and UW agencies.

- *Develop plus* (includes attract, sell and serve): Distributor also provides highly structured market feedback and monitoring and has a significant input and impact on the development or maintenance of a product. They accounted for 22% of responses in our survey. Mainly from cluster groups and UW agencies.

- *Full service* (Develop, attract, sell, service and claims): Only done by some underwriting agencies and accounted for 3% of responses.

Delivery Model and Survey Responses (% of total)

DELIVERY MODEL	Product Development	Marketing	Sales	Acceptance	Policy Processing	Policyholder Service	Claims	Personal %	Commercial %	Total%
Spot & refer		✓	✓					8	21	14
Attract & sell		✓	✓	✓	✓			13	-	7
Attract, sell & serve		✓	✓	✓	✓	✓		57	49	53
Develop plus	✓	✓	✓	✓	✓	✓		19	27	23
Full service	✓	✓	✓	✓	✓	✓	✓	3	3	3
								100	100	100

Commissions Vary by Product and Service Level

Motor products have lower commission rates than other products in both personal and commercial lines.

- Personal home commission rates are approximately 10% higher than motor commission rates.
- Commercial motor commission rates are very similar to personal motor commission rates.
- Rural and SME commission rates are approximately 10% higher than motor commission rates.

Higher service levels are associated with higher commission. The commissions for the five distribution models generally go from lower to higher, based on the services offered.

- *Spot and refer:* Cannot give advice and provide the lowest level of services so are paid the least commission.
- *Attract and sell:* Relatively few responses and only in personal lines.
- *Attract and serve:* The most common model receives around 10% for motor lines and 18% for home and commercial package products.
- *Develop plus:* the extra services of products develop add between 1% to 4% depending on the product.
- *Full service:* This service model has the least transaction costs for the manufacturer, includes most of the claims management functions and attracted the highest commission rates.

Commission Rates (% net premium)

DELIVERY MODEL	Personal Motor	Personal Home	Commercial Motor	Commercial Rural	Commercial SME
Spot & refer	7.3	11.6	7.6	12.4	12.6
Attract & sell	8.7	15.7	–	–	–
Attract, sell & serve	9.8	17.6	11.0	18.3	19.2
Develop plus	12.9	22.1	12.1	22.6	22.2
Full service	25.3	36.3	25.0	37.5	37.5

Override Commissions Form Part of the Rate

Override commissions were identifiable as rewards for some operational services or for market pull. These overrides are included in the channel commissions where they form part of the delivery service.

Almost 30% of responses specified a base percent plus an override versus those defined as incentive-based.

Services Provided	Overrides (% net premium)
• UW agency services	6% - 20%
• Channel management & training	5%
• Motor premium funding	2% - 5%
• Brand use	1% - 2%
• Product development / sourcing	0.5% - 2%
• Independent agent	1%
• Electronic data interchange (EDI)	1% - 3%

- *Underwriting agency services:* Where underwriting agencies provided product underwriting, claims management and sales agent administration a total overrider between 6% to 20% is paid.
- *Channel management and training:* Where the manufacturer's product 'pitch', sales and training relationship was outsourced to the distributor, a 5% override is paid on personal lines for new business only.
- *Premium funding:* 2% - 5% commission reimbursement for providing motor premium finance in personal lines.
- *Brand/badge use:* Where a well known distributor was paid only for the use of their brand (ie. they provided no other service), overriders ranged from 1% to 2% in personal lines.
- *Product development / sourcing:* Where favorable policy wording and commission rates were negotiated (often by cluster groups on behalf of their broker membership base), an override of between 0.5% to 2% is paid for both personal and commercial lines. Other product development service examples where an override of this size is paid include significant input into the development or maintenance of a product.
- *Independent agents:* Some companies paid an override of 1% to independent multi-agents to sell their product.
- *Electronic data interchange (EDI):* Where both on-line and off-line distributors were paid commissions by a manufacturer, it is not unusual to see the on-line channels receive an override of between 1% to 3% as a reward for EDI use. EDI connections reduce the operational costs for the manufacturer. Most distributors paid their desktop hardware costs. However, agents were generally supplied IT software and links by the manufacturer whereas brokers generally paid some cost toward the IT software or a linkage fee.

Commissions are Supplemented by Other Incentives

Included here are annual payments (eg. marketing) or rewards for past performance. Specific commission amounts for the following factors have not been added into commissions as they were either not able to be made explicit, not converted to a % of net premium or they varied depending on performance. However, they provide a significant source of additional reward or incentive for distributors.

Profit sharing • 25% - 50% UW profit share under target composite loss ratio • "Significant" UW profit share by line of business • Varies by loss ratio of the business • Annual 0% - 4% more total commission depending on loss ratio	**Volume** • Premium plus policy count hurdles • Premium based volume hurdles
Equity • Distributor gets a 50% dividend • Distributor charges manufacturer shared services overhead fee • Equity share in the Manufacturer. Get 50% of the marketing budget from manufacturer	**Marketing or sponsorship** • 1% - 2% of premium sponsorship to local branches • 1% - 3% of premium marketing allowance

- *Profit sharing:* Many agents or brokers in 'binder' based arrangements had performance hurdles (loss ratio, underwriting profit after expenses, retention rates). This measure is often combined over a number of products. There were instances where there was only an upside to earning potential and others where the full commission amount was determined by the performance. Profit sharing has specific targets and is paid as a percent of premium, of underwriting profit or in some instances can determine the total base commission rate.

- *Premium volume:* Most cluster group and high volume channel commissions were at the high end of any base commission ranges. Some extra remuneration incentives were based on volume hurdles for agents or brokers in 'binder' relationships. Volume hurdle incentives fell into two classes.

- *Equity:* Some arrangements that were not purely arm's length had both positive and negative effects on distributor remuneration. Positive effects included support service sharing (eg. marketing, human resources, information technology), no commission claw-back, feedback into product development and access to equity profit streams. Negative effects involved the negotiation weakness of captive distribution channels and the influence of other strategic agendas.

- *Marketing or sponsorship:* Takes the form of sponsorship dollars or activities or a marketing budget allowance:

  - *Access to target customers:* Where a distribution channel had a membership base seen as aligned with the manufacturer's strategy, commissions can be more generous (eg. access to rural based members for a manufacturer identifying as a rural brand) - and marketing allowance or sponsorships paid.
  - *Market segment expansion and growth potential:* Where a manufacturer wants to develop a market presence, they may be prepared to either buy market share by paying higher commissions or by providing marketing allowances to channels able to access the target market. Alternatively they may help develop a new distribution arm by paying higher commissions to cover the costs of establishment. For example, some commissions paid in one state were well above other states' market rates.

Drivers of Commission Rates

These drivers were offered by participants during the interviews, and they represent the participants' views:

Line of Business: explained in differences by included:

- Customer price sensitivity of 'commodity' type motor products.
- Higher technical competency and distribution services required for home, commercial rural and SME versus 'commodity' motor products.
- Historic levels of line of business commissions.
- Motor: more work and a less profitable product for the manufacturer (eg. higher claims frequency and volatility).

Other drivers of commission rates can be broadly classified into two categories:

A. Industry Wide Factors – factors affecting the whole industry.

- *Market standards:* Most participants commented that market standard rates tend to dictate what an individual manufacturer pays to its distributors. Often a leader in the market sets the standard, and the rest follow suit. The commissions market seems to be quite sticky, ie. it is hard to change the rates once they are set and market standards have not changed significantly in the last 10 years.
- *Reinsurance costs:* Pressures on reinsurance costs in the future (reinsurer collapses, hardening reinsurance market and impact of terrorism) may squeeze insurers' margins. Insurers may not be able to absorb full increases and will be reluctant to pass it into premiums in the price-sensitive personal lines products. Consequently, there may be downward pressure on commission rates depending on the reinsurance market.
- *Financial services reform act (FSRA):* The training and compliance costs of FSRA can exert pressure on distributors to negotiate for more commissions, as well as on the manufacturers to cut expenses and reduce commissions. Under the new regime, innovative remuneration methods (based on equity, profit and volume sharing) will be permitted for independent distributors and are likely to appear.

B. Arrangement Specific Factors – factors unique in each arrangement.

- *Business arrangements*. Particular business arrangements can give one party bargaining power in commission negotiations. Examples include business partnerships in other lines of business and the ownership of customers.
- *Length of relationship:* Many base commission levels of long term relationship had not been adjusted for many years (incentives focus instead).

- *Performance:*
  - *Product profitability:* The more underwriting profit the more commission a manufacturer would be willing to pay eg. some travel insurance arrangements have 50% commission rates. Many paid a performance incentive on profit versus loading it into the base commission.
  - *Retention rate:* Higher retention rates are an extra benefit for both manufacturers and distributors - and can affect commissions.
  - *Service quality:* Generally the party who owns the customers who imposes service level KPIs or measures. On the whole, however, there were very few service level agreements with penalty clauses for non-compliance. The main driver of providing service quality was the risk of damage to either the distributor's or manufacturer's reputation and loss of relationship - rather than any specific dollar penalties.
- *Responsibility:* The more responsibilities a distributor has, the higher commissions it can command, eg. manufacturers are usually responsible for the actions of their agents while brokers are responsible for their own actions.
- *Competition for risks:* The number of providers willing to underwrite the policy or risk will drive commissions paid. Hard to place risks / unique coverage and manufacturing monopolies may mean less commissions.
- *Access to customer groups:* A manufacturer may be willing to pay for access to a difficult to reach / niche customer market.

In Conclusion

We found:

- a variety of third party channels providing differing service levels,
- a range of different reward and incentive strategies.

Cost-to-serve was a strong driver of commission rates, as well as the effects of:

- line of business drivers,
- industry wide factors,
- and arrangement specific factors.