Profit Sharing Contracts Course

October 28, 2015

Greg Thompson

Senior Managing Executive - Programs

MARKEL®

Key Points on Profit Sharing

- Can easily represent a substantial percentage of a PA's bottom line
- But frequently the last item negotiated … If at all
- When offered … It is rarely questioned by P.A.

Outline of presentation

- Identify Types of Profit Sharing Plans
- Review definitions
- How to compare the various plans
- Special features that will appear in some plans ex: caps
- Noteworthy Plan Terms and Conditions ex: Minimum Premiums

Types of Profit Sharing Plans

- Standard Profit Sharing Plan
- Permissible Profit Sharing Plan
- Policy Year (London) Profit Sharing Plan
- "One and Done" Profit Sharing Plan
- Sliding Scale Profit Sharing Plans

Definitions:

- Accident Year Data

  -Losses assigned to the year in which the loss occurred regardless of when they are posted or the reserve changes (Example)

- Calendar Year Data

  -Losses assigned to the year in which the loss was posted or the reserve increased (Example)

- Policy year Data

  -All Losses and Premiums are captured in the same year in which the policy is effective. (Example)

MARKEL®

Data Year Examples

<u>Accident Year</u>

- Policy issued 12/01/14 for $1200
- $100 premium earned in 2014
- Claim occurs 12/31/14
- Not reported until 2015
- Claim is assigned to 2014 Accident Year

MARKEL®

Data Year Examples (cont'd)

Calendar Year

- Policy issued 12/01/14 for $1200
- 100 premium earned in 2014
- Claim occurs 12/31/14
- Reported in 2015: Assigned to 2015 calendar year

Data Year Examples (cont'd)

Policy Year

- Policy issued 12/01/14 for $1200
- Claim occurs 12/31/14
- Policy premiums not earned
- Instead policy written premium of $1200 reported in 2014 policy year
- All claims associated with that policy reported in 2014 policy year

Definitions:

- Incurred Loss Ratio (ILR)

  -Loss ratio excluding incurred but not reported (IBNR) losses (i.e. paid and case reserves only)

- Ultimate Loss Ratio (ULR)

  - What the loss ratio is expected to eventually become after all claims are paid

- Allocated Loss Adjustment Expense (ALAE)

  -Out of pocket (vs internal) loss adjustment costs - legal, independent adjuster, etc.

Standard Profit Sharing Plan (Vanilla Version)

- Premium
- Less: Commission
- Less: Company Expenses, Taxes and Assessments
- Less: ULR and ALAE (Accident year)

- $ Carrier Profit
- X Percentage of Profit to PA

- Equals: Profit Sharing Due

- Next: By using the standard formula and inserting standard factors: Base of Comparison

Testing Your Profit Sharing Plan Vs. Industry Standard

- Estimate: Premium you will write
- Subtract: Commission you will earn
- Subtract: 20% Company expenses, taxes and assessments
- Subtract: Estimate fully developed Loss Ratio and ALAE
- Multiply: 25% x Estimated Net Profit

Testing Your Profit Sharing Plan Vs. Industry Standard (cont'd)

Example:

$5,000,000 Premium

(1,000,000) Less: 20% Commission

(1,000,000) Less: 20% Company Expenses

(2,500,000) Less: Developed L/R + ALAE (50% assumed)

500,000 Profit

x 25% = $125,000

NOTE: Try other possible premium and L/R variables to get full range of outcomes

Permissible Profit Sharing Plan

- Very similar to Standard
- A "permissible" ULR is set below which profit sharing is offered
- Permissible may vary by line of business (Property vs Liability)
- PA gets a share of every point the actual loss ratio is below the permissible

Comparing Your "permissible" Plan Vs. Industry Standard

- 50% Permissible Ultimate Loss Ratio
- Every 1% below that: Agent gets 50% or .5%
- Assume: 50% ULR + ALAE in standard plan
- Results: 2.5% x 5,000,000 = $<u>125,000</u> in standard plan
- But: 50% ULR = <u>no payout</u> in permissible plan
- However: 20% ULR + ALAE:

  Agent gets 15% of premium or $<u>750,000</u> in permissible
- Industry standard plan: 20% ULR + ALAE: Agents get 10% of premium or $<u>500,000</u>.
- IMPORTANT: Sometimes high percent profit plans offset that with higher Company Expenses.

Common Features of Standard and Permissible

- Almost always on an accident Year basis
- Sometimes IBNR at Company discretion; sometimes scheduled (Example)
- First calculation usually 12 months after end of profit year
- Accident Year recalculated annually for 3 to 5 years (LOB)
- Vesting schedule over 2 to 5 years (LOB) (Example)
- Percentage of Profit Shared may increase the lower the loss ratio

MARKEL®

Sample of Company Scheduled IBNR Factors

Time from Inception of Accident Year	IBNR load multiplier times ILR + ALAE
12 months	2.75
24 months	2.25
36 months	1.25
48 months	1.15
60 months	1.10

Typical Vesting Plan

Time from Inception of Accident Year	Percent Vested
12 months	-0-
24 months	25%
36 months	50%
48 months	75%
60 months	100%

MARKEL®

Policy Year (London) Profit Sharing Plan

- Percentage of Profit Paid after all policies have expired and all claims have been paid and closed
- Typical Formula:

  Gross Written Premiums for all Policies in a Policy Year

  Less: 25% commissions including London broker

  Less: Taxes if any

  Less: 25% Company Expenses

  Less: Actual Claims plus Allocated Loss Adjustment Expense

  Company Profit

  X .25

  Profit Commission paid upon payment of all claims

One and Done Profit Sharing Plan

- More common on retail producer contracts
- One time payment occurs between 45 and 90 days after the end of Profit year
- Frequently on a Calendar Year basis - positive impact year 1
- Payout based on ILR vs ULR, i.e. no IBNR
- Table specifies profit commission based on ILR

Comparing Your One and Done Plan vs Industry Standard

Incurred Loss Ratio + ALAE				
	40-44.99%	35-39.99%	30-34.99%	29.99 or less
Profit Commission	.5%	3.0%	4.5%	6%

Estimate: You will produce 50% Ultimate L/R or 30% incurred loss ratio.

Standard plan: 2.5% x 5,000.000=$125,000
"One and Done": 4.5% x 5,000,000=$225,000

-OR-

Comparing Your One and Done Plan vs Industry Standard (cont'd)

Estimate: You will produce 40% Ultimate L/R or 35% incurred loss ratio

Standard Plan: 5% x 5,000,000=$250,000

One and Done: 3% x 5,000,000=$150,000

Sliding Scale Profit Sharing

- Used to ensure P.A. has "skin in the game"
- Provisional Commission vs Minimum and Maximum
- Ex: 22.5% vs 20% vs 25%
- Start with Permissible ULR or ILR
- Each ULR or ILR point above or below permissible results in return commission (above) or in additional commission (below)
- Typically: Each point above or below split 50/50
- Typically: Policy year calculations over a certain number of years or until all claims are paid

Sliding Scale: Escrow vs Collateral

- Typically: Carrier requires secure funds to guarantee potential return commission will be paid
- Escrow: Potential return commission held in bank account
- Collateral: Irrevocable and Unconditional Letter of Credit
- Either one or other required until final calculation

Can be seen in all Profit Sharing Contracts

- Caps: expense vs benefit (Actuary)
- Incentive Factors:

  -Premium Growth

  -Premium Retention

  -Mix of Business

- Minimum Premium to Qualify
- Maximum payout limit for contract or company
- Carry Forward or Carry Back Provisions

Samples of Incentive Factors

Renewal Retention %	Modifier
90-100%	1.20
80-90%	1.10
Under 80%	1.00

Premium Growth	Modifier
1.50 +	1.25
1.25-1.49	1.15
1.10-1.24	1.10
.90-1.9	1.00
.75-.89	.75
Under .75	.50

Conditions and Limitations

- No past due amounts or other contract violations
- Exclude certain classes of business: typically WC and umbrella
- Termination Provisions:

  -Typically: Profit Sharing Contract/Addendum subject to cancellation on short notice but … The real issue is profit sharing run off

  -Company Prefers: All payments cease effective date of contract termination or suspension

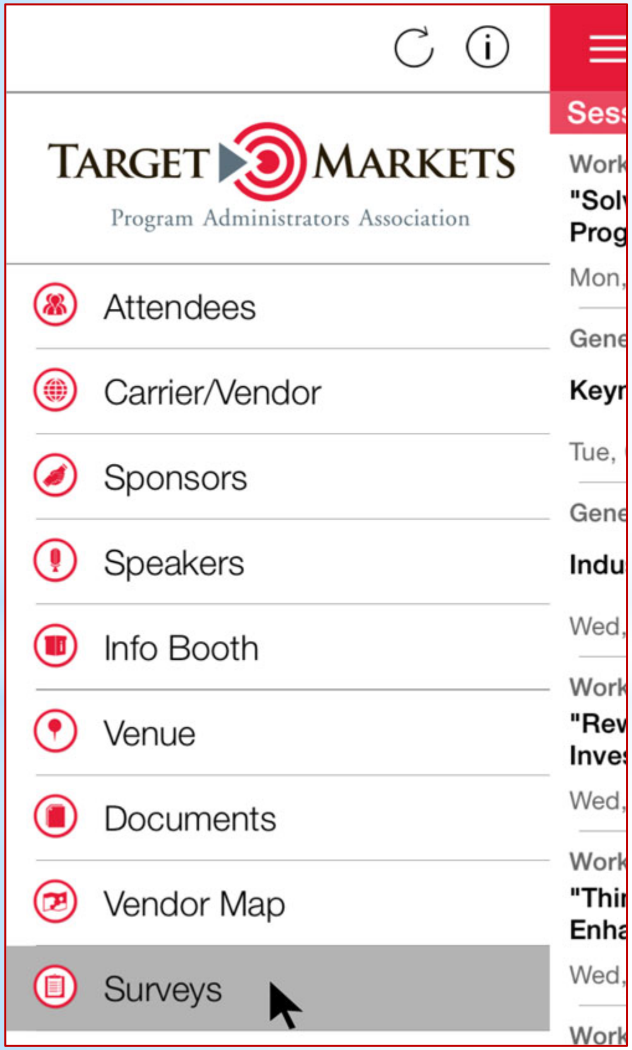
  -PA Prefers: All payments continue on all eligible business written prior to contract termination

  -Carrier will Insist: If PA contract canceled for cause, all payments cease

Wrap Up

- Request Profit Sharing terms early in process!
- If carrier profit sharing is not standard, run data though their formula and compare to standard
- Carefully review profit sharing termination terms, especially contracts with delayed payments and vesting provisions
- Enlist actuary to assist in analysis of carrier IBNR factors and cap charges.

Q & A



* **Please take one minute to complete the survey for this session in your mobile app.**

Click on “Surveys” .... Select your workshop and provide your feedback.

Thank you!