UNIVERSITY of SOPRON | ALEXANDRE LAMFALUSSY FACULTY OF ECONOMICS

Thesis Booklet

Eliminating the Conflict of Interest within the Insurance Distribution by introducing a customer-centric Remuneration Approach

Intended academic degree:

Doctor of Philosophy (PhD)

Author: Victoria Petsch, MA

Supervisor: Dr. Tamás Kovács PhD.

January 8th, 2022

1. Concept

The Insurance Distribution Directive (IDD) is the starting point and the backbone for this empirical research. The IDD is the latest insurance distribution regulation and is a significant milestone in strengthening consumer protection in the insurance sector (Veris & Goddet, 2018, p. 4). The IDD lays the foundation of a true customer centric insurance distribution approach. Before introducing the IDD, the customer interests have never been regulated in a European directive nor transposed into national law in a similar intensity. This strong first-time approach of customer interest in a regulatory framework is the purpose of making the customer interest the central item of this research work.

The IDD brings together the customer interest and the topic of inducements. The directive states that remunerating and incentivizing the insurance distributors should not in any way reduce the quality of servicing for the customer. Especially the remuneration based on sales targets should not provide an incentive to recommend a particular product to the customer (Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, 2016b). The member states are responsible for introducing a remuneration model that is fully aligned with the interests of the customer. The insurance distributor should develop, adopt, and regularly review policies and procedures relating to conflicts of interest. The target is to avoid any negative impact on the quality of the relevant service to the customer (Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, 2016b). The member states shall ensure that insurance distributors are not remunerated in a way that conflicts with their duty to act in the best interests of their customers. In particular, an insurance distributor shall not create remuneration systems and sales targets that could provide an incentive to recommend a particular insurance product to a customer when the insurance distributor could offer a different insurance product which would better meet the customer’s needs (Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution, 2016b).

Not only the European law emphasizes the change of the remuneration system, also acknowledged researchers in the field. Regan and Tennyson (2000) investigate the optimal design of a remuneration model for sales agents. The assumption is that sales agents are self-interested and therefore need to be externally motivated to act in the interest of the insurance company (Regan & Tennyson, 2000, p. 736).

It has been argued that compensating an intermediary with commissions does not prevent and may even encourage the conflict of interests between the intermediary and the customer. An agent might recommend a product because it generates a higher commission for him or herself rather than the best possible product for the customer. This is the reason why the effects of commission compensation for sales intermediaries are criticized heavily (Regan & Tennyson, 2000, p. 738). Cummins and Doherty (2006) state that especially the compensation models support anti-competitive practices which lead to negative results for the customer (Cummins & Doherty, 2006, p. 360). Howe et al. (1994) state that agents with a higher customer orientation (and a lower sales orientation) have higher ethical standards in their sales practices. If commission compensation encourages a higher sales orientation, then the link to unethical sales practices could be drawn (Howe et al., 1994, p. 505). Cupach and Carson (2002) investigate that the commission compensation system aligns the intermediary's interest more closely to the interest of the insurance company rather than the customer. The behavior of the intermediary will therefore favor the interest of the insurer over the interest of the customer. The agent will sell products that bring the maximum benefit to the insurer rather than to the customer (Cupach & Carson, 2002, p. 169). The researchers see a big limitation in the overall empirical evidence, because the studies solely focused on base compensation schemes. The bonus income after receiving targets over a longer time horizon plays a significant role and was not represented in the studies (Cupach & Carson, 2002, p. 173).

The third area of the research performed is about the contradictory incentivization, which is also addressed in the IDD. The principal agent theory is well-known within the insurance context and seen as one explanation for the unethical behavior of the intermediary (Laffont & Martimort, 2002, p. 2). Within the insurance context, the principal (insurance company) hires and agent (intermediary) to act on behalf of the principal. This situation faces a specific problem, when the goal of the principal and the agent are not fully aligned (Ma et al., 2014, p. 63). The dilemma can be seen even more complex because intermediaries perform tasks on behalf of both, the policyholder, and the insurance companies. The attempted solution for this problem is designing an incentive-based compensation model that is fully aligned with the interests of the principle and therefore also the interests of the agent (Cummins & Doherty, 2006, p. 383). The insurance distribution situation faces a complex agency principal dilemma, where the principal (insurance company) hires the agent (intermediary) to act on behalf of the principal but simultaneously acts in the interest of a third party (customer). The purpose of this research is to identify if a remuneration system can align the interest of the intermediary, the customer, and the insurance company and therefore eliminate the conflict of interest.

The central purposes of this research work are the customer interest, intermediaries' remuneration and the conflict of interest. These three research items are the purpose of the empirical study, but the context still needs to be defined.

This doctoral thesis follows three main research objectives. First, the research aims to identify which underlying KPIs are used in the bonus schemes for agents after the implementation of the IDD into national law. Moreover, the research identifies the importance of certain KPIs within the bonus agreement. After completing the research work, an overview of the current bonus landscape in insurance companies is available.

Second, the research examines the insurance agents' attitude towards a customer-centric remuneration approach. The agent's mindset and motivation are identified. It also provides transparency which groups of agents share which attitude towards a more customer-oriented concept, looking into years of experience, area of occupation and performance level.

Third, the outcome of this research work can help insurance companies in shaping high performing bonus agreements, which simultaneously reduce the conflict of interest and increase the customer satisfaction. The findings can be used in addition to the legal framework and suggestions from the IDD.

2. Research Questions and Hypotheses

Having the guidelines of the IDD and the scientific literature in mind, there is a huge potential to challenge the current remuneration approach. Insurance agents in Austria and Hungary have commission schemes and bonus agreements based on sales targets and sales plans. These targets and plans are based on key performance indicators (KPI) such as the amount of premium, or the number of policies sold. Different products have different commission rates and contribute a different portion to a yearly bonus. These KPIs are chosen by the insurance company to serve its own interest of maximizing the profit. It is assumed that agents are self-interested and act in their own benefit. Therefore, agents will sell the products that maximize their own commission and bonus earned. The insurance company supports such a remuneration system because their own interest is to sell as much as possible. This situation describes the classic principal agent theory, ignoring the interest of the customer. Scientific research tends to blame the remuneration system itself for this unbalanced situation, where the agent acts in his or her own interest and not on behalf of the customer. When the guidelines from the IDD are taken into consideration, the customer interest needs to be put in the center to avoid the conflict of interest in the insurance distribution process.

What if adapting the remuneration system is not necessary, but changing the underlying performance KPIs? What if customer interest and customer satisfaction were the required KPIs to reach a bonus and receive extra commission? What if a customer centric sales approach would simultaneously increase the profit of the insurance company? Would agents with a customer centric sales target achieve the same sales result as with top-line targets? How would they self-assess their own sales performance with customer satisfaction as a sales metric? Will there be differences between Austrian and Hungarian agents?

The guiding questions above can be summarized to the following research questions:

- Can the conflict of interest within the insurance distribution process be eliminated, changing the underlying KPI from a top-line performance approach (like sum of premium or number of policies) to a customer centric approach (like customer satisfaction)?

- How will agents accept and appreciate a customer centric remuneration approach?
- How will agents estimate their own or the companies' sales performance, introducing a customer centric remuneration approach?
- How will the results differentiate between Austria and Hungary, rural and city, high and low performing agents?

Considering the information received from the literature review and the assumptions made, the following hypotheses can be stated:

H1: Tied agents favor the customer centric remuneration approach over top-line performance driven remuneration.

H2: Tied agents estimate a positive change in their own sales performance (= sum of premium sold) and simultaneously a positive change in the customer satisfaction, when introducing a customer centric remuneration approach.

H3: Tied agents, who identify themselves as high performer, estimate a positive change in bonus payments, when introducing a customer centric remuneration approach.

H4: Austria's tied agents have a higher acceptance of a customer centric remuneration approach than Hungary's tied agents.

3. Methodology

For this empirical research, the online study is chosen as the appropriate research method. A list-based sample frame is used. This is the case, when a sample frame exist and individual invitations can be sent to selected participants (Fielding et al., 2017, pp. 148–149). As already stated above, the sample was purposely defined. Employed and self-employed single-tied agents, who work exclusively for the top insurance companies in Austria and Hungary are in scope.

Due to confidentiality agreements with the insurance companies, the names of the companies cannot be mentioned in this work, but the respective market can be analyzed. Looking at the sum of premium of the insurance market, the participant from Austria work for insurance companies, which cover 63,08% of the entire Austrian insurance market in 2019 (statista, 2020). This is representative for the Austrian insurance market. In Hungary, the participants work for insurance companies, which cover more than 66,15% of the overall insurance market in 2017 (statista, 2019). This share is representative for the Hungarian insurance market. In total 525 valid replies came back from participants in the period from 2nd of November 2020 to 13th of January 2021. In average the completion of the survey took five minutes. The survey link to the online questionnaire, consisting of 17 questions, is shared via email. The survey is available in German, English, and Hungarian language. The study asks exclusive sales agents for their opinion and estimation of a customer centric bonus concept, where the only underlying KPI to receive a bonus is the customer satisfaction (e.g., 5-star rating).

After the data is collected, the data needs to be cleaned before it can be analyzed. This exercise focuses on proofreading the responses, tidying up the data set and cleaning responses with missing elements or unclear answers (Punch, 2010, p. 45). The data cleaning for this research work included the deletion of incomplete replies, identifying the comments in the section “Others” and allocating to the correct answers. After the cleaning, 523 valid replies were identified.

The data derived from the online survey tool was downloaded as an Excel sheet and uploaded into Microsoft Power Business Intelligence (BI) for the analysis. Microsoft Power BI was chosen as the analysis tool because it is an analytics platform with built-in Artificial Intelligence (AI) capabilities, tight Excel integration and hundreds of data visualizations (Microsoft).

4. Conclusion and Discussion

The big question of this research work is, if customer interest can be the underlying indicator to eliminate conflict of interest. This discussion started looking at the IDD. This regulatory framework was officially implemented into national law in 2018. But how does the reality look like and what findings can be seen from the research work?

523 tied agents from Austria and Hungary filled out which KPIs are relevant to receive a bonus or incentive payment. The top three KPIs within the ranking are “sum of premium sold”, “number of policies sold” and “specific lines of business”. All three KPIs are top-line performance driven KPIs and together cover 66% of all bonus KPIs. This means that two-thirds of all bonuses motivate the tied agents to sell a higher sum of premium, sell more policies and sell a specific type of product. The bottom three KPIs within the ranking, of potential 10 different KPIs to choose from, are “customer satisfaction”, “number of customers”, “customer appointments per week”. Those three KPIs together cover 10% of all bonuses and are identified as customer oriented KPIs. Only every tenth bonus agreement motivates the tied agents to visit their customers regularly, increases the number of customer and satisfies their customers’ needs. Reading the IDD requirements and analyzing the answers from 523 agents, a gap can be

identified. The current bonus schemes are still designed focusing on top-line performance and de-prioritizing the customer interest.

The research work for this dissertation reveals that agents who rate themselves as low performers and agents who did not receive a bonus in 2019 prefer a customer centric bonus model significantly more than agents who rate themselves as high performers and agents who received a bonus in 2019. So, agents with a good sales result do not prefer customer orientation as much as agents with bad sales results. This finding shows the divergence between sales and customer orientation described by Howe et al. (1994).

When introducing a customer-oriented bonus model, agents who rate themselves as high performers estimate a lower change in their own bonus payment than agents who rate themselves as low performers. The same applies for agents, who received a bonus payment in 2019. Those group of agents estimate a lower change in their own bonus payment, when a customer-oriented bonus payment is introduced. This means, that agents who are strong performers on sales results see a lower benefit in introducing a customer centric approach. More high performing agents want to keep the top-line performance driven bonus approach. This result confirms the statements from Cupach and Carson (2002).

The purpose of this empirical research is to identify if a remuneration system can align the interest of the intermediary, the customer, and the insurance company and therefore eliminate the conflict of interest. The theoretical scenario is that customer satisfaction can be the only underlying KPI for an intermediary to receive a bonus. All three involved parties in the complex principal agent situation have the same goal. The customer wants to receive the best guidance and the most suitable product (which will be shown in a high customer satisfaction). The intermediary wants to do a good job and receive a bonus (which can be achieved by increasing the customer satisfaction). The company wants to make sustainable profit and have loyal customers (which can be potentially achieved by making the customer satisfaction the central item for their intermediaries).

In the survey the agents were asked to evaluate a scenario, where the one and only underlying KPI to reach a bonus will be customer satisfaction. The entire bonus budget will be distributed among the agents solely based on the satisfaction of their customer. As an example, the classic 5-star rating (as known from hotel bookings, restaurant visits or Amazon products shopping) is introduced. After the customer centric scenario was presented to the agents, they are asked to estimate a potential change after implementing such an approach.

The participants estimate the average change in their own sales performance after implementing a customer centric bonus approach with +18%. This means that the goal of the insurance company is achieves by increasing the profits. Furthermore, the participants estimate the average change in the customer satisfaction after implementing a customer centric bonus approach with +31%. This means that the goal of the customer is also achieved by increasing their own satisfaction. On a final note, the participants estimate the average change in their own bonus payments after implementing a customer centric bonus approach with +22%. This means that the goal of the intermediaries is also met by increasing their bonus. The results show that the theory from Ma et al. (2014) and Cummins and Doherty (2006) can be confirmed. Aligning the goal reduces the conflict of interest and simultaneously increasing the performance of all involved parties.

Asking the agents to rate the customer centric bonus scenario, they need to evaluate the statement “I like the scenario”. Participants located in Hungary rate above average and participants located in Austria below average. Evaluating if this scenario could work in the respective insurance company, agents from Hungary again rated very positive, whereas agents from Austria only rated neutral. Austria’s tied agents have no acceptance (a neutral opinion) of a customer centric remuneration approach. Hungary’s tied agents have a positive acceptance of this approach and think that the new customer centric model can work in their company. When asking the participants how the customer satisfaction would change, when implementing such a customer-oriented remuneration concept, Hungary estimated a change above average and Austria below average. The difference between the estimated of the two countries is big with 19%. Therefore, the assumption can be verified that a significant difference exists. Even tough, Austria implemented the IDD in a stricter manner focusing on the remuneration of intermediaries to protect the interest of the customer, Austrian agents see a potential customer centric bonus model far more negative than the Hungarian agents.

The assumption made in this dissertation is that adapting the remuneration system is not necessary, when the underlying performance KPIs are changed. The idea is that the customer interest and customer satisfaction are the required KPIs to reach a bonus and receive extra commission. Therefore, a customer centric sales approach would simultaneously increase the profit of the insurance company. The questions that need to be answered are if this scenario could work if agents perceive a change in their performance and how they assess the development of the company's sales results and customer satisfaction with such a concept.

The following four hypotheses are stated:

H1: Tied agents favor the customer centric remuneration approach over top-line performance driven remuneration.

The majority, with 55% of all participants, agreed to the statement “I prefer a customer centric bonus concept over a top-line performance driven one”. Only 21% disagree with the statements and 24% are neutral, which can be seen in the figure below. The average value is a positive assessment. Therefore, H1 can be confirmed.

H2: Tied agents estimate a positive change in their own sales performance (= sum of premium sold) and simultaneously a positive change in the customer satisfaction, when introducing a customer centric remuneration approach.

The results show a significant positive correlation of the estimated change in the own sales performance and the estimated change of the customer satisfaction, when introducing a customer centric remuneration approach. On average the participants estimate the change in their own sales performance after implementing a customer centric bonus approach with +18%. The average change of the customer satisfaction is estimated with +31%. Therefore, H2 can be confirmed.

H3: Tied agents, who identify themselves as high performer, estimate a positive change in bonus payments, when introducing a customer centric remuneration approach.

On average the participants estimate a change in bonus or incentive payments with the new customer centric approach of +22%. Participants, who rate themselves as high performers estimate a positive change in bonus with +19%, but still below average. Participants, who rate themselves as low performers estimate a change in bonus with +26%. Therefore, H3 can be confirmed but needs to be specified. The results show that agents, who identify themselves as low performers, estimate an even more positive change in bonus payments, than high performing agents.

H4: Austria's tied agents have a higher acceptance of a customer centric remuneration approach than Hungary's tied agents.

Participants from Hungary evaluate that the scenario can work above average. Participants from Austria achieve a neutral value. Therefore, H4 needs to be falsified. Austria's tied agents have no acceptance (a neutral opinion) of a customer centric remuneration approach. Hungary's tied agents have a positive acceptance of this approach and think that the new customer centric model can work in their company.

The results from the empirical study confirm that the conflict of interest within the insurance distribution process could be eliminated or at least reduced, changing the underlying KPI from a top-line performance approach (like sum of premium or number of policies) to a customer centric approach (like customer satisfaction). Tied Agents from Austria and Hungary estimate a positive change in sales results and simultaneously a positive change in customer satisfaction, when introducing a customer centric remuneration model.

5. List of Author's publication

Petsch, V. (2018). Analyse der Anforderungen im Risikomanagement in österr. Banken. Die Darstellung praxisrelevanter Anforderungen an Absolventen und Absolventinnen eines Finanzmarktstudiums. Akademikerverlag, Vienna. ISBN: 978-620-2-21062-1

Petsch, V. (2018). An Analysis of Requirements in Risk Management in Austrian Banks for Academic Application: A Mixed Methods Study. *Journal of Economy & Society*, 2017/3-4, 33-50, DOI: 10.21637.

Petsch, V. (2022). The IDD as the starting point for a customer-centric Remuneration Approach in Insurance Sales. Gazdaság és Társadalom (Journal of Economy & Society), ISSN: 0865-7823

Petsch, V. (2018). AN ANALYSIS OF CHANGING REQUIREMENTS IN RISK MANAGEMENT IN AUSTRIAN BANKS: A MIXED METHODS STUDY, 4th International Scientific Conference for Doctoral Students and early-stage Researcher Proceedings, 199-216, ISBN: 978-3-9519937-0-6

Petsch, V. (2019). The Necessity for Regulating the Insurance Market considering the Implementation of the IDD, 5th International Scientific Conference for Doctoral Students and early-stage Researcher Proceedings, 229-242, ISBN: 978-3-9519937-0-6

Petsch, V. (2019). The Necessity of Regulating the Insurance Market Considering the Implementation of the IDD. 2019 ENTRENOVA - ENTerprise REsearch InNOVAtion Conference Proceedings. IRENET. 97. ISSN 1849-7969

Petsch, V. (2019). The customer-centric Remuneration Approach in Insurance Sales. 6th International Scientific Conference for Doctoral Students and early-stage Researcher Proceedings, 149-168, ISBN: 978-3-9519937-2-0