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COMMISSION – BASED COMPENSTION SYSTEM – THE FACTOR OF EFFECTIVENESS OR PATHOLOGY DETERMINANT

© Andrzej Janowski

Mass cancellations of life insurance policies held by clients of insurance companies, resulting from unethical practices pursued by insurance agents, identify a high probability of the pathology [1] existence in the compensation system in life insurance organisations

Keywords: agent, commission - based system, effectiveness, human performance, life insurance company

Масові скасування полісів страхування життя, проведених клієнтами страхових компаній, в результаті неетичної практики, здійснюваної страховими агентами, визначили високу ймовірність наявності патології [1] в системі компенсації по організації зі страхування життя

Ключові слова: агент, система на основі комісії, ефективність, можливості людини, компанія зі страхування життя

1. Introduction

Numerous cases of agents selling insurance products and communicating unrealistic or false assumptions concerning the features of these products lead to multi-billion losses in the whole insurance industry in the United States [2]. Unfair sale constitutes the fundamental problem faced by the insurance industry. Insurance companies developed codes of conduct with particular emphasis on the client's best interest in the sales process [3]. However, conclusions from the conducted empirical research substantiate the claim that ethical behaviour of life insurance agents is determined not only by corporate rules, but also by ethics training and recommendations of the management. Additionally, legal authorisation of insurance agents as entrepreneurs operating on behalf of insurance companies and their compensation in the form of nothing but commission for sold products are often the reason for dysfunctions in insurance organisations.

2. Legal fundamentals of insurance business in Poland**2. 1. Sources of insurance law**

The sources of insurance law are the forms in which the state's intentions concerning insurance issues is expressed and demonstrated to an entrepreneur (*a natural or legal person*). Sources of different branches of law, including one of the comprehensive branches, i.e. business insurance law, are examined and shown in such a formal context. Business insurance law, in contrast to most of the basic branches of law, is not codified. Thus, its sources are dispersed and can be found in numerous normative acts (*mainly government acts, regulations and decrees*). Among them, The Insurance Activity Act [4] and 1964 Civil Code are of special significance. Moreover, Act of 22 May 2003 on Insurance Mediation [5] describes rules for property and personal insurance mediation.

2. 2. Insurance agency

Insurance mediation consists in the performance, for remuneration, of factual or legal acts involved in the conclusion and performance of

insurance contracts. Insurance mediation is performed exclusively by insurance agents or insurance brokers, and it is a business activity within the meaning of the provisions of the Act on Economic Activity. An insurance agent is an entrepreneur who performs agency activities under an agency contract concluded with an insurance company and entered into the register of insurance agency activities may be performed exclusively by a natural person meeting statutory conditions [6].

3. Description of distribution channels in life insurance companies

Insurance companies provide services primarily focused on the sale of insurance policies, both directly and by means of insurance agency, which consists in the performance of factual or legal transactions pertaining to the execution or performance of insurance contracts exclusively by insurance agents or insurance brokers [7]. According to A. Payne [8], choosing the location and distribution channels are strategic decisions in a service organisation. Their particular importance stems from specific product features. Moreover, the "distribution", which includes the place and surroundings in which a service is provided and the way of providing it, constitutes a part of the general image which determines the assessment of the perception of values and benefits following from the purchase of a particular service. Insurance companies which pursue operational activity in Poland are obliged to use the following distribution channels: direct sales, agency sales and sales through insurance agents and sales through insurance brokers (Table 1).

A broader perspective of insure agency is presented by the so-called French concept, according to which insurance intermediaries are employees of an insurance company who perform acquisition activities on behalf on an insurer, as well as insurance agents and insurance brokers. In line with a more narrower approach to insurance agency, the so-called German concept, insurance intermediaries are only insurance agents and insurance brokers. The analysis of the proportion and types of life insurance distribution channels shows, that

the proportion of insurance agents in the distribution of insurance companies' products is very high and remains at the same level, while direct sales made by the employees of insurance companies do not reflect sales effectiveness (*Despite of employees of insurance companies, agency activities are also performed by employees of banks, travel agencies and even postmen*). It seems, however, that the people employed by insurance companies will remain the cheapest source of acquisition of insurance contracts in long run [9].

Nevertheless, in this case it is difficult to presume that this particular method of sales leads to the creation of solid bases of loyalty on the part of the clients. This is not the only distribution channel, as selling life insurance policies through banks becomes increasingly popular, which constitutes a derivative of the progressive concentration process within the scope of financial services, among which banking and insurance combinations, referred to as bancassurance, play a crucial role [10].

Table 1

Proportion and type of category 1 insurance companies distribution channels in the years 2007–2013 [%]

Specification	2007	2008	2009	2010	2011	2012	2013
Direct sale	27,3	22,9	32,4	36,8	34,6	28,8	40,2
Agent sale	66,3	72,5	62,5	52,6	55,9	63,0	56,8
Brokers sale	2,4	1,6	1,8	1,7	1,9	1,6	1,8
Other	3,9	3,0	3,3	8,9	7,7	6,6	1,1

Source: Committees of Financial Supervision [www.knv.gov.pl]

In these sectors, there is a particularly high number of common areas, hence the effectiveness of such combinations. From the point of view of banks, the biggest benefit is the extension of their deposit base, whereas insurance companies gain a new distribution channel. In some countries, this cooperation is particularly effective and the share of sales of life insurance products by banks exceeds 60 % of total sales. Another argument in favour of combining businesses, is the possibility of increasing the number of services offered, including joint insurance and banking products. In Poland, such cooperation is still very scarce. There have been attempts to sell life insurance policies on the Internet. However, this method may not fully replace the classic forms of sales, a personal contact between the parties of the contract, especially when the insurance concerns large sums and a wide scope. Even if entering into an insurance contract on the Internet is not always effective (*There is no possibility for the client to use electronic signature – lack of legal regulations*), and the insurance contract is actually signed through personal contact between the parties, it still has a strong impact on spreading general information concerning insurance, providing the clients with possibilities to familiarise themselves with particular products offered by various insurance companies. It is possible for a client to establish an opinion as to the means of securing one's needs and to make a decision concerning insurance (*The intermediary meets a client who is well-oriented and whose requirements are provisionally established*). Hence, life insurance agents and multi-agents play a fundamental part in distribution, employment establishments resort to independent intermediaries only in the case of group insurance policies. Similar conditions hold in the majority of EU countries [11], so it seems authorized to claim that the conditions in the area of insurance product distribution are similar in the whole of Europe. Life insurance companies mainly use the services of insurance agents – the dominant distribution channels, including all the consequences, even unethical issues.

4. Ethics in the process of selling life insurance policies

Research carried out among insurance agents indicated that when asked directly, they responded that during the insurance sales process they are solely concerned with their client's well-being. However, the following critical factors determining unethical practices during the life insurance policy sale process were identified: high level of complexity of life insurance (*Taking into consideration the level of complexity of insurance products, many purchasers of insurance policies do not fully understand the features of the product they bought, agents have a significant advantage over clients in terms of product intelligence. While making a purchase of an insurance, the client relies mainly on the honesty of the agent*) and "dual loyalty" resulting from the legal relationship imposed by an agency contract (*The interdependence of the agent-client relation in the sales process creates dilemmas for the agent. It follows from the definition of an agency contract that the agent is obliged to perform activities against remuneration on behalf of the insurance company*). Due to the intermediation of the agency in the relation between the client and the agent, when providing services for the client, the agent also works for the insurance company. Since the insurance company pays commission for the agent's successful sales, it is the strongest party to the insurance contract (*By applying the system of penalties and awards, the insurance company may influence the volume of sales of particular insurance products*). Therefore, short-term benefits for the insurance company may entail long-term disadvantages for the clients [12].

5. Empirical implications of the commission-based compensation system in the context of life insurance organizations effectiveness

Insurance agents, as the link between supply and demand, have been very important participants of the insurance market. Life insurance is voluntary, so the role

of an intermediary is not restricted to the conclusion of a contract in a technical sense, as it is often the case for obligatory insurance. Life insurance is a long-term contract, so the decision concerning entering into such a contract requires a thorough analysis.

It is understandable that the role of the intermediary is the most important one. The agent should be more of a client's adviser than a representative of the insurance company (e. g., following the example of *Financial Planning Advisers operating in Great Britain*). The client who entered into a contract with an agent expects professional assistance (And, hence, increasing the value of the offered product). The agent is often the only representative of the insurance company who the client can initiate direct interpersonal relations with. The nature and quality of such relations will – to the greatest extent – determine the development and consolidation of a positive image of the insurance company (*Creating long-term cooperation relations with clients is the best way to guarantee increasing income for the agent and the insurance company in the long-term perspective. Clients should have the possibility to perceive agents as their financial advisers and professionals who devote them enough time and attention and have sufficient knowledge and experience to provide them with advice and whom they can trust*) [13]. Moreover, the agent earns income only when can sell a product. Therefore, the agent has to make decisions, e. g. on the amount of time devoted to a potential purchaser of an insurance policy for the sale of which commission will be paid. In such situations, the agents are under constant pressure, as a result of which they often try to provide services only to those clients who are likely to buy an insurance policy and ignore those who are more difficult to convince [14]. Agents may even make attempts to sell clients insurance policies, which are incompatible with their needs and even detrimental, often entailing high contract costs [15]. In such a case there is a high probability that the insurance company had a product which would fulfil the needs of the client to a larger extent, but the agent sold a different one only because has got a higher commission, did not express any interest in the client's needs or had insufficient theoretical preparation (Asymmetry in widely understood insurance knowledge). In the past, insurance agents used to be sellers only. Today, clients increasingly often expect them to provide professional advisory, even though they receive commission for the insurance policies that they sell. Nevertheless, the agent does not have any statutory authorisation to play the role of an adviser (*A professional service is provided by qualified personnel with specialist knowledge. It is of advisory nature and focuses on problem-solving. A professional service stands out in that it is specialised and labelled with a specific name such as "architect" or "consultant". A professional service is a task entrusted to a service provider by a service user. Such service is independent of the provision of other goods and services*) [16]. The similar conclusion it is shown in the research conducted by K. J. A. Eastman [17] showed that the agents who took part in the survey are guided by concern for the clients and want to safeguard their best interests during the process of insurance sale (*There are two distinct approaches presented in research literature*

*on professional services to date. The first approach is narrow. According to it, professional services include certain types of services provided exclusively to entrepreneurs and institutions. The second, broader approach, includes selected services provided both to entrepreneurs and institutions, as well as individual consumers. The narrow approach includes: services which streamline producers' activities, so-called facilitating services, e. g., transport services, insurance, storage), advisory and consultative services. These comprise legal advice, accounting and financial consulting, personnel training, research, advertising, technical expertise, etc. High professional qualifications of service providers, including education, professional experience and individual predispositions in a given area, are characteristic of the group of professional services and advisory services they include. Professionals have specialist knowledge, which, in combination with the creative work they perform, allows to solve problems reported by clients). However, several factors, which are conducive to the occurrence of unethical behaviours among insurance agents, were also identified during the research. The following were considered the most important: complexity of the insurance product (*Life insurance in particular*), the problem of the agent's "dual loyalty" – it follows from the statutory definition, that the agent is a permanent representative of the insurance company while being the client's adviser at the same time. This is why an insurance company may exert stronger pressure on the activities pursued by an agent, since it rewards him or her with commission (*The higher the product's profitability for the insurance company, the higher the commission for the agent*) for the sales of insurance [18]. Focusing on short-term profits for the organisation may cause a decrease in long-term benefits for the client. Yet, irrespective of the special context of the agency contract, an exclusively commission-based compensation system creates a conflict of interest by posing a threat to the agent-client relation (*Higher commission for the agent translates into fewer benefits for the client, and slower increase of the insurance policy value, lower insurance amount, narrower scope of contract*). The commission-based system is considered as favourable to the interest of the insurance company, compromising the quality of the product for the client – the agent inclines towards selling insurance with a higher commission. Paradoxically, due to the commission-based system, whose aim is to motivate agents to sell new insurance contracts there arises a conflict of interests between the intermediary, the holder of the insurance policy and the insurance company (*First-year commission for the agent for entering into an insurance contract is several times higher than in subsequent years of the contract duration*). However, selling a product with a higher commission is not always related to unethical activities on the part of the agent. If the amount of commission constitutes the main factor according to which recommendation is given, the agent's interest does not positively correlate with the client's one.*

A significant number of authors claim that by disregarding the specificity of the agency relation, a solely commission-based compensation of insurance agents creates a conflict of interests, as the agent's fiduciary

obligations towards the client are subject to compromise (Because the commission-based compensation system makes the agent dependent on the insurance company (employer) and his activities favour potential benefits for the insurance company at the cost of the client's benefits). The agent (*as an entrepreneur*) is more interested in selling the product, that includes the highest commission [19]. Paradoxically, the system of commission-based motivation used by life insurance companies makes his interests contradictory to both the client's and life insurance company's benefits. Placing more emphasis on increasing sales of new contracts than on maintaining already signed contracts and creating long-term relations with clients determines the occurrence of pathological behaviours inside the organisation: e. g. recruiting people, who are motivated mainly by strictly economic factors, what is reflected in high sales personnel turnover and clients' withdrawals from life insurance policies (*In the years 2011–2013, some insurance companies lost over 30 % of their portfolio*).

6. Conclusions

Conclusions drawn from the conducted research imply that by using only the commission-based compensation system, insurance companies achieved a high level of efficiency in operational activity [20]. However, a high sales staff turnover ratio and the number of clients' complains concerning unethical practices used by insurance agents does not allow to perceive life insurance companies as socially efficient (*While achieving its goals, an organisation bears economic and social costs. Social costs include in particular: job dissatisfaction, unstable development opportunities, social disintegration of working teams and the entire organisation, unstable mental health of the participants of the organisation, negative interpersonal relations, alienation, lack of autonomy and self-fulfilment of individuals. Referring to the typology used in praxeology: efficiency, effectiveness and cost-effectiveness, Sz. Soltys coined the term social effectiveness of organisations which comprises of: "social cost-effectiveness of work" and "social effectiveness of work"*) [21]. Moreover, agents, as entrepreneurs, do not identify their activities with strategic assumptions of the organisation, treating the objectives established by the management in a selective manner (*According to the assumptions of the expectancy theory*) [22], so according to the quoted definition of motivation, the commission-based compensation system cannot be perceived as an effective motivation technique.

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Andrzej Janowski, PhD, The Headmaster of Banking and Insurance Faculty, Higher School of Personnel Management in Konin, Powstańców Wielkopolskich st., 16, Konin, Poland, Zip Code 62-500

E-mail: andrzej.j@poczta.fm

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ІНФОРМАЦІЙНА АСИМЕТРІЯ ТА МОРАЛЬНИЙ РИЗИК У ФІНАНСОВІЙ ДІЯЛЬНОСТІ: ПРОБЛЕМИ ТА СПОСОБИ ПОДОЛАННЯ

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У статті досліджено сутність та проблеми інформаційної асиметрії у фінансовій діяльності. Визначено вплив морального ризику на функціонування фінансових корпорацій у світі. Проаналізовано сучасні проблеми національних державних фінансів, що пов'язані з порятунком фінансових корпорацій у кризовий та посткризовий періоди. Запропоновано заходи із забезпечення прозорості фінансової діяльності

Ключові слова: інформаційна асиметрія, моральний ризик, прозорість, інформація, фінансова діяльність, фінансовий сектор

This article explores the nature and problems of information asymmetry in financial activities. The influence of moral hazard on the functioning of financial corporations in the world is determined. The current problems of national public finances related to rescue financial corporations in crisis and post-crisis periods are analyzed. The measures to ensure transparency of financial activities are proposed

Keywords: information asymmetry, moral hazard, transparency, information, financial activities, financial sector

1. Вступ

Одним із джерел трансакційних витрат є диференціація та інтеграція видів фінансової діяльності у реаліях інформаційної асиметрії агентів. Нині на

обсяги основних факторів виробництва, зокрема праці, землі та капіталу, суттєво впливають послуги та інформація. Остання відіграє важливу роль у функціонуванні фінансового сектору і зниженні трансакцій-