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Statement of the Shadow Financial Regulatory Committee

On

Statement on the Insurance Brokerage Scandal

December 6, 2004

On October 14, 2004, New York Attorney General Eliot Spitzer filed a civil action in New York alleging that Marsh & McLennan Companies solicited rigged bids for insurance contracts through its subsidiary Marsh and illegally directed clients' insurance business based on the magnitude of commissions Marsh would receive from insurers. The complaint also named several major insurers as participants. Attorney General Spitzer filed a related suit on November 12 against Universal Life Resources, a California-based life and disability insurance broker. A few days later California Insurance Commissioner John Garamendi filed a suit against Universal that also named several insurers as defendants. The U.S. Senate Government Affairs Committee's Subcommittee on Financial Management, the Budget, and International Security held a hearing on insurance brokerage practices on November 16.

Bid rigging clearly involves illegal collusion among competitors and merits appropriate penalties and sanctions. In addition, "contingent commission" arrangements, which allow brokers to receive additional compensation from insurers based on the volume and/or profitability of business placed with a particular insurer, create a potential for and in some cases a real conflict of interest between brokers and their clients. Contingent commission agreements increase the possibility that some brokers may direct business to an insurer with the goal of increasing brokerage revenues rather than helping the client make an informed choice based on the insurer's price, coverage, service, and financial strength.

Marsh and a number of other large brokers and insurers have announced the termination of various arrangements of this kind.

At the same time, the Spitzer allegations have been followed by blanket condemnation of contingent commissions, especially by editorialists. Those condemnations fail to consider the benefits that may flow from these arrangements, which have evolved over decades. In cases where brokers disclose the arrangements to their customers, contingent commissions can and often do achieve meaningful efficiencies that benefit policyholders, brokers, and insurers.

Profit-based compensation to a broker based on the insurer's claims experience raises issues of loyalty, but it can encourage brokers to reveal information about clients' risks to insurers, which in turn helps underwriters quote more accurate prices. More accurate prices obviously benefit those clients who obtain lower prices commensurate with their lower risk of loss. More generally, increased accuracy in insurance pricing helps provide incentives for policyholders to control losses and otherwise manage risk efficiently.

Contingent commissions based on the premium volume for business placed by a broker with a particular insurer have a related function. Greater volume improves the statistical reliability of claims experience for business placed by the broker. It therefore improves the insurer's ability to monitor the quality of that business, and it facilitates the use of profit-related compensation as an incentive device. Greater volume also helps achieve some degree of scale economies between a broker and insurer and lowers business acquisition expenses. Consequently, greater volume with an insurer reduces costs and increases the broker's ability to negotiate favorable terms for its clients.

Potential conflicts of interest from contingent commissions, and whether and how brokers should disclose such arrangements to insurance buyers, have been discussed by brokers, corporate insurance buyers, and various state insurance regulators since the late 1990s. Recent events could lead to much more disclosure even without any new regulatory requirements. The Committee nonetheless regards some degree of additional mandatory disclosure as an economically sensible response to potential conflicts of interest that may arise from contingent commission arrangements.

Insurance producers should clearly disclose to prospective customers whether they represent the customer, one or more insurers, or both the customer and insurers, so that customers can consider the potential conflicts when choosing a producer. In addition, mandatory disclosure of the terms of broker compensation may be desirable for certain transactions. On December 4, the National Association of

Insurance Commissioners (NAIC) held a public hearing on a proposed amendment to its Producer Licensing Model Act. The proposed amendment would require insurance producers that receive commissions from policyholders (as is customary for brokerage arrangements for medium to large corporate insurance buyers) to disclose the amount of any compensation from the insurer, how that compensation will be calculated, and an estimate of the amount of compensation if the specific amount is not known at the time of disclosure. A second provision would require all insurance producers to disclose generally whether they will be compensated by an insurer, and, if so, that the compensation may differ depending on the product and insurer, and that the producer may receive additional compensation based on factors such as premium volume placed with the insurer or claims experience. Without endorsing the specifics of the NAIC proposal, the Committee regards this general approach as reasonable.