

The Economics of Insurance Intermediaries: Should Contingent Commissions Be Illegal?

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Based in part on:

The Economics of Insurance Intermediaries

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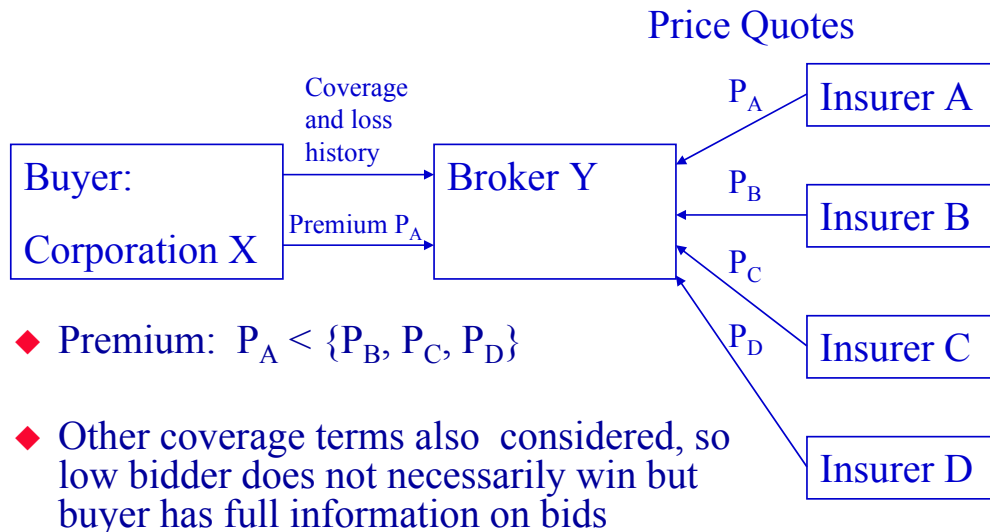
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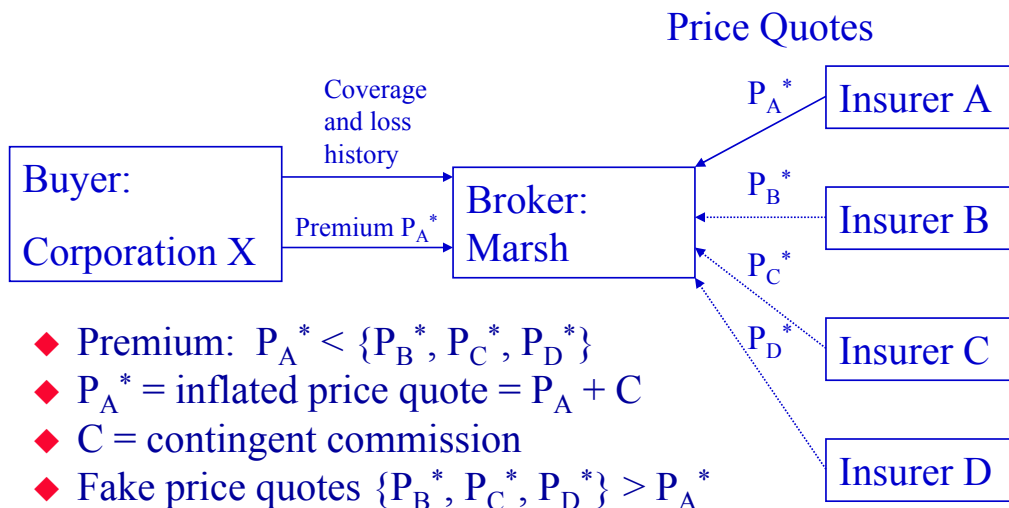
Marsh & McLennan's Market Manipulation

- ◆ On October 14, 2004, New York Attorney General Eliot Spitzer filed suit against Marsh & McLennan alleging that the insurance broker engaged in bid rigging and received widespread kickbacks from insurance companies
- ◆ The suit alleged that insurers paid Marsh more than \$1 billion in contingent commissions to steer them business and shield them from competition
 - So called “Market Services Agreements”
- ◆ Marsh also allegedly engaged in bid-rigging that increased the cost of insurance to buyers

Brokerage Distribution: How It Should Work



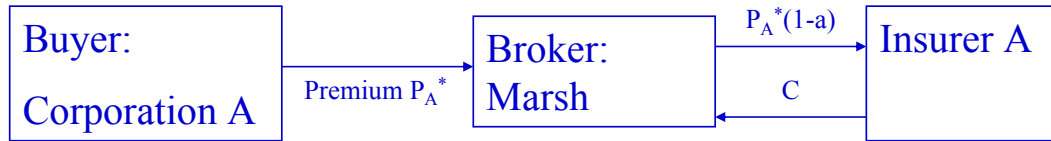
Brokerage Distribution: How It Really Worked



Why Did Other Insurers Gave Fake Quotes?

- ◆ Each insurer playing the contingent commission game had certain “favored” business it was to receive in exchange for contingent commissions
- ◆ Favored business would be forthcoming only if the insurer was willing to provide fake quotes for other insurers’ favored business
- ◆ Insurers were often told to quote “no less than” some specified amount higher than the premium Marsh had in mind for the favored company

Brokerage Distribution: How It Really Worked



- ◆ Marsh deducts its normal commission = a P_A^*
- ◆ Marsh also receives the contingent commission, C.
- ◆ In effect, Marsh is paid twice for the transaction.
- ◆ The buyer is hit twice
 - Does not benefit from competitive bidding
 - Has to pay the contingent commission

Marsh's Actions: Major Conflict of Interest

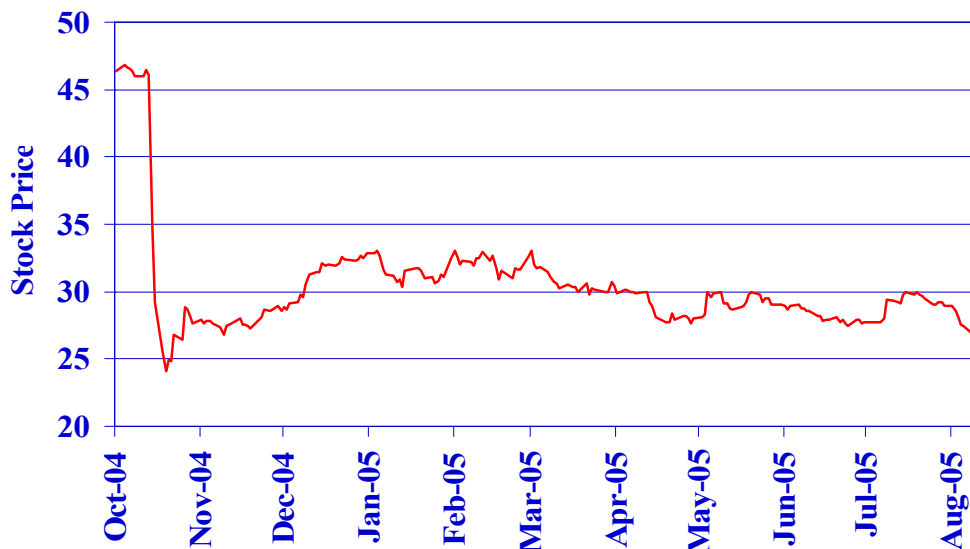
- ◆ Marsh sales literature: “Our guiding principle is to consider our client’s best interest in all placements. We are our clients’ advocates, and we represent them in negotiations. We don’t represent the [insurance companies]”
- ◆ Internal Marsh memo: The size of the contingent commission determines “who [we] are steering business to and who we are steering business from.”
- ◆ In 2003 alone, \$800M of Marsh’s \$1.5B in net income came from contingent commissions

What Determines Contingent Commissions?

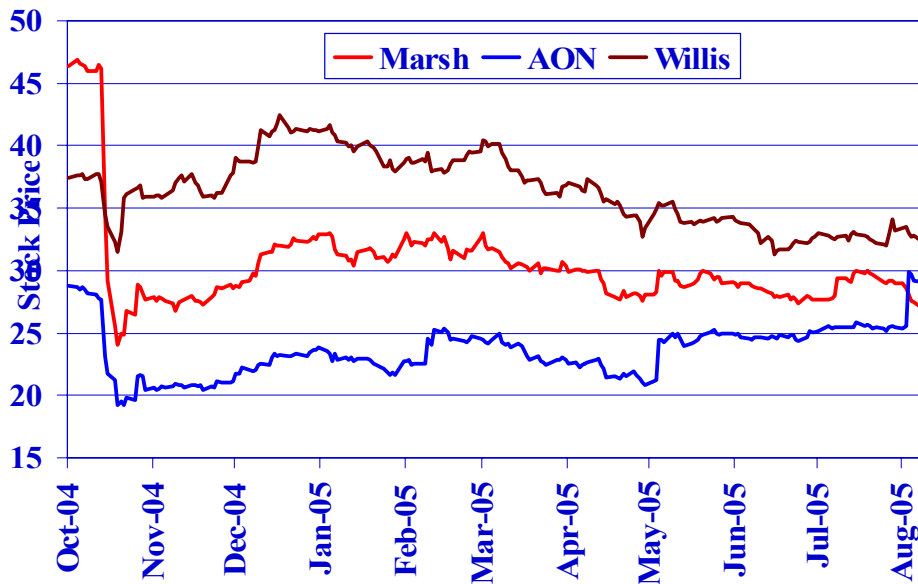
- ◆ Contingent commissions may depend on one or all of the following
 - The profitability of business placed with the insurer
 - Volume of business placed by the broker with the insurer
 - Percentage of clients who renew policies with the insurer, the renewal or retention rate

- ◆ Are contingent commissions ever legitimate?
 - Contingent commissions have a legitimate role to play in making markets work efficiently – discussed below

Market Reaction: Marsh's Stock Price



Market Reaction: Contagion Effect



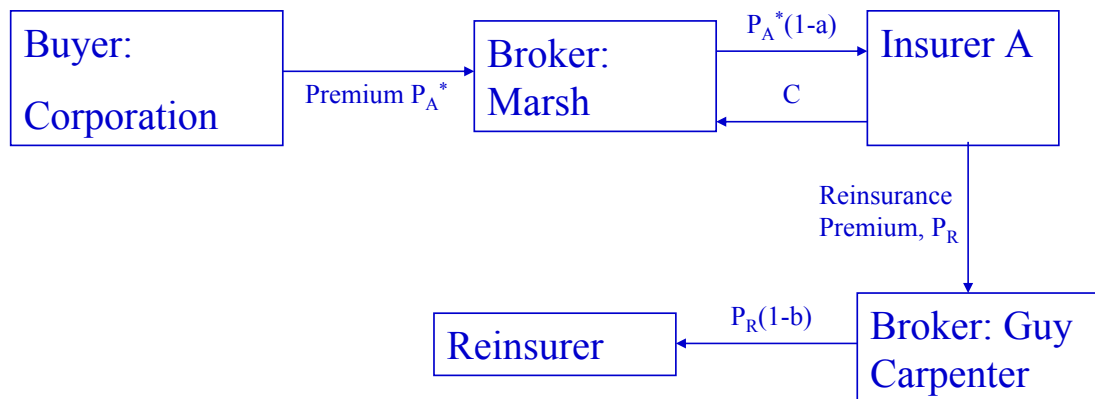
Marsh Case: Partial Resolution

- ◆ On January 31, 2005, Marsh agreed to pay \$850 million in restitution to buyers as part of an agreement to settle the suit.
- ◆ Lawsuits still in progress
 - Class action against Marsh
 - Actions against other large brokers
 - Actions against insurers who participated in bid rigging

Other Potential Problems: Tying

- ◆ To receive brokerage business from Marsh, Marsh allegedly required them to channel their reinsurance business through Guy Carpenter, a Marsh subsidiary and world's largest reinsurance broker
- ◆ Dealing with insurers for both primary market and reinsurance market business is inherently a conflict of interest that should be prohibited
- ◆ Tying is a per se violation of antitrust law in most industries

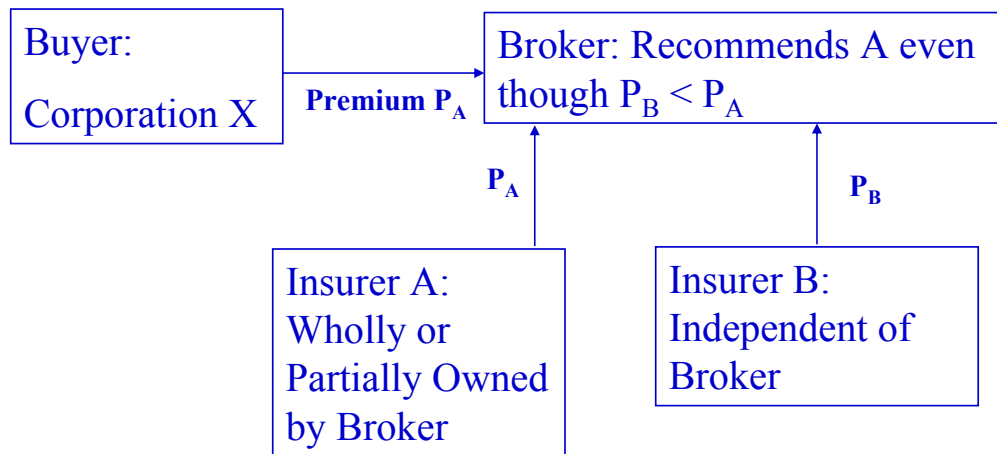
Brokerage Distribution: Tying



- ◆ Insurer A also has to deal with Marsh in buying reinsurance (b = reinsurance commission)
- ◆ Otherwise, it risks loss of brokerage business from client companies.
- ◆ Potential for bid rigging in reinsurance transaction also???

Related Party Transactions

- ◆ **Potential conflicts of interest in placing business with insurers wholly or partially by brokers.**



Why Did It Happen, What Should Be Done?

- ◆ The consolidation of the brokerage industry through M&As during the 1990s led to Marsh's scale
- ◆ The brokerage market is too concentrated at the top
 - Too much market power leads to abuses
- ◆ The insurance intermediary market is highly competitive below the top end of the market
- ◆ Therefore, the solution is to reduce the market power of the largest brokers by breaking them up into smaller divisions
 - Divestiture of Guy Carpenter, etc.

Why Divestiture Benefits Shareholders?

- ◆ The “Diversification discount” – much research has shown that diversified firms trade at a discount in comparison with more focused firms
 - Divestiture often increases the overall value of the firm to shareholders
- ◆ Therefore, reducing firm size by divestiture would
 - Add value for Marsh shareholders
 - Improve confidence in and efficiency of insurance markets

Should Contingent Commissions Be Illegal?

- ◆ Contingent commissions are only one of several mechanisms through which market power was utilized to earn excess profits
- ◆ Contingent commissions play a valuable role in the operation of efficient insurance markets
- ◆ The solution is to control abuses of market power, not to eliminate contingent commissions
 - However, more justification exists for profit based rather than volume based contingent commissions

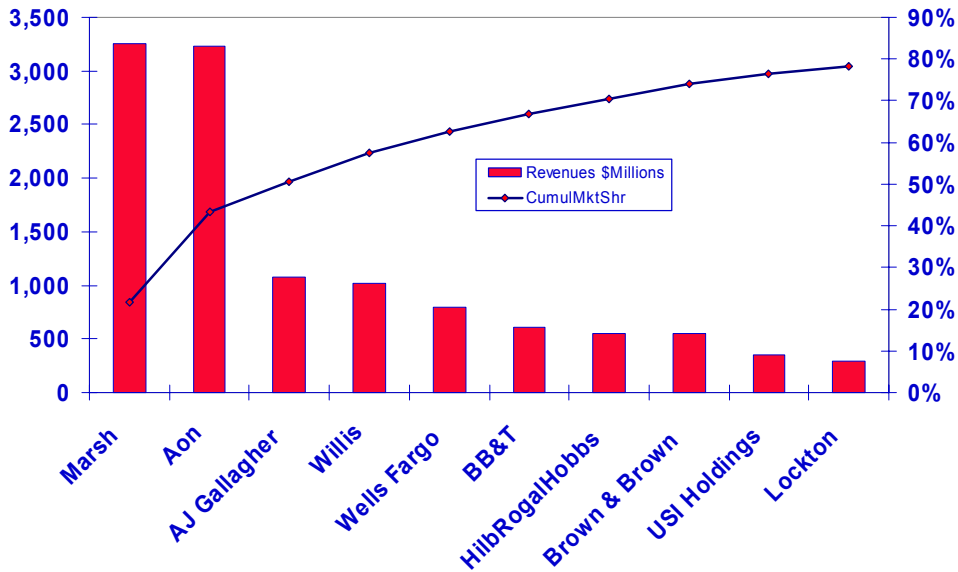
Insurance Intermediaries: Market Structure and Performance

World's Largest Insurance Brokers: Global Business

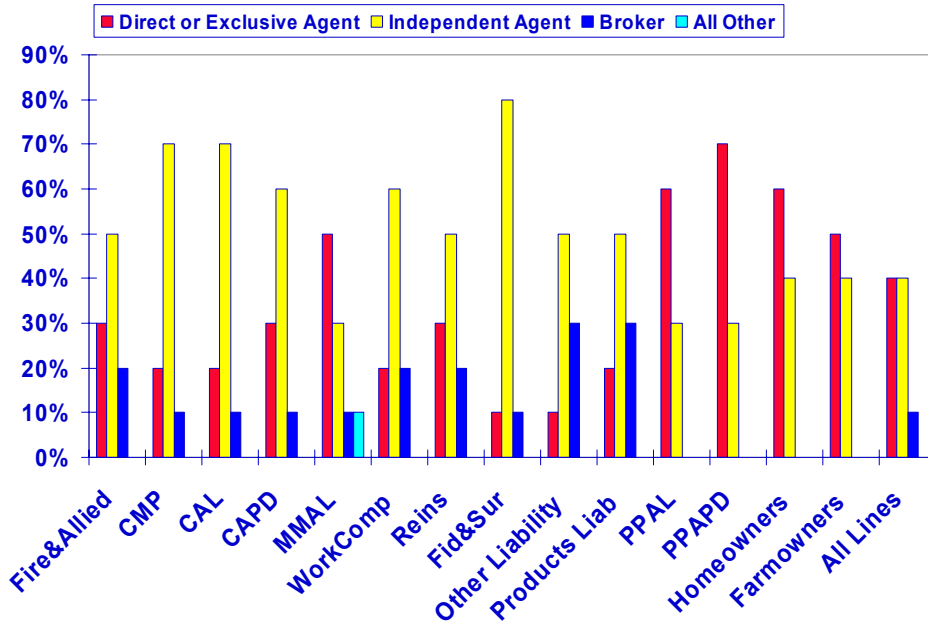
| Broker | Country | Revenues | Employees | Offices |
|-------------------------------|-------------------|-----------------|------------------|----------------|
| Marsh & MCLennan | US | 9376 | 54500 | 675 |
| AON | US | 6734 | 44500 | 600 |
| Willis | UK | 2004 | 11119 | 165 |
| Gallagher | US | 1202 | 7206 | 110 |
| Well Fargo | US | 801 | 5593 | 155 |
| Jardine-Lloyd-Thompson | UK | 701 | 4617 | 44 |
| BB&T | US | 605 | 3009 | 84 |
| Hilb,Rogal,Hobbs | US | 556 | 3300 | 108 |
| Brown&Brown | US | 545 | 3517 | 117 |
| Alexander Forbes | So. Africa | 537 | 5075 | 54 |

Source: Business Insurance, July 19, 2004.

Top 10 Brokers: US Business



Distribution Systems Market Share By Line

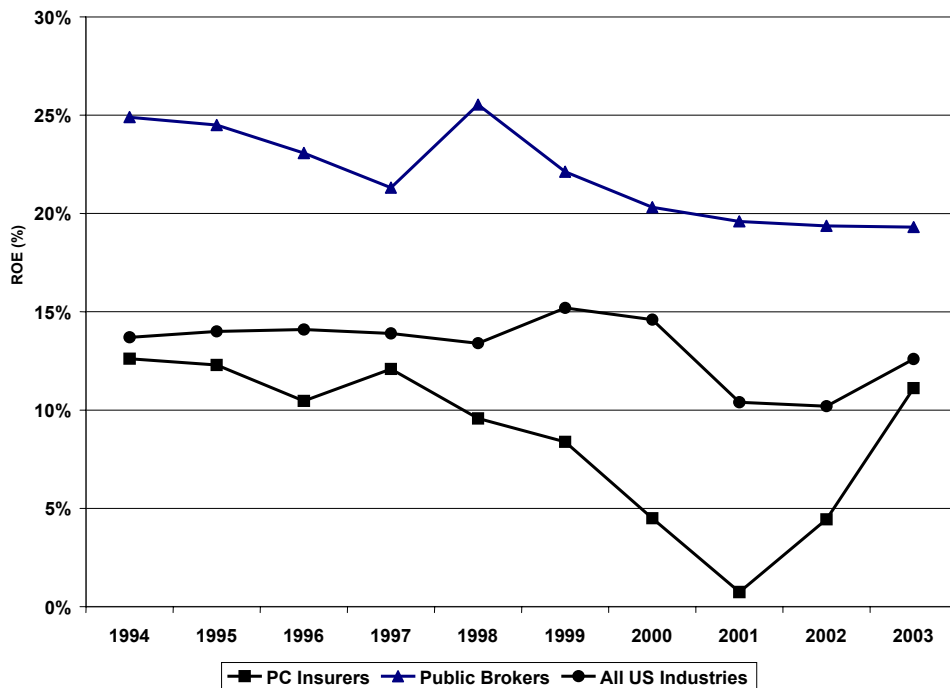


Note: Top 10 firms for which contingent commission data were available. Source: Business Insurance.

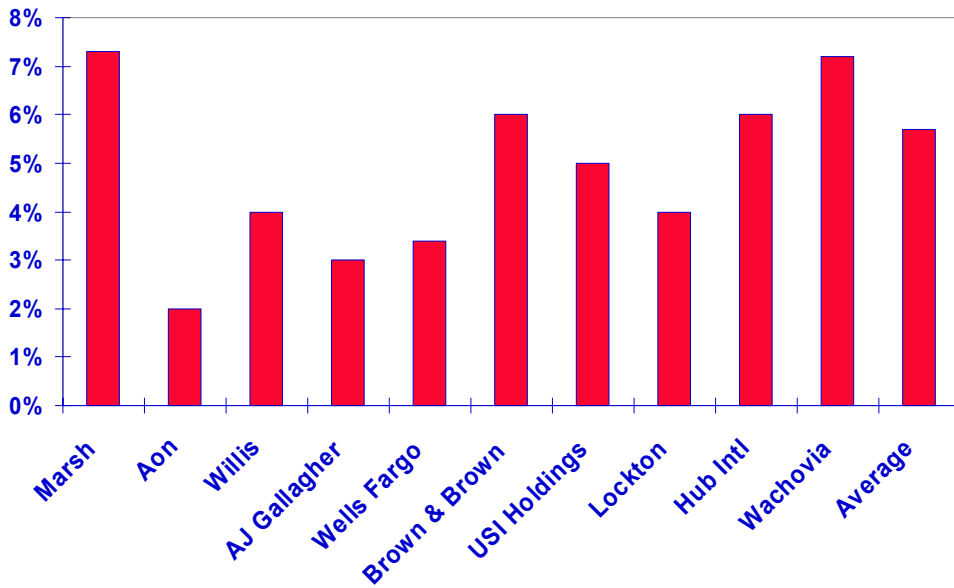
Market Shares By Line

- ◆ Overall brokers have only about 10% of property-liability market
 - However, they are mostly concentrated in the commercial lines – have at least 20% in 5 commercial lines
 - Brokers have a much larger share of the large national and international commercial lines market
- ◆ Large numbers of brokers and independent agents split up the small and regional commercial market – indicative of highly competitive market

Public Brokers & P-L Insurers: ROE

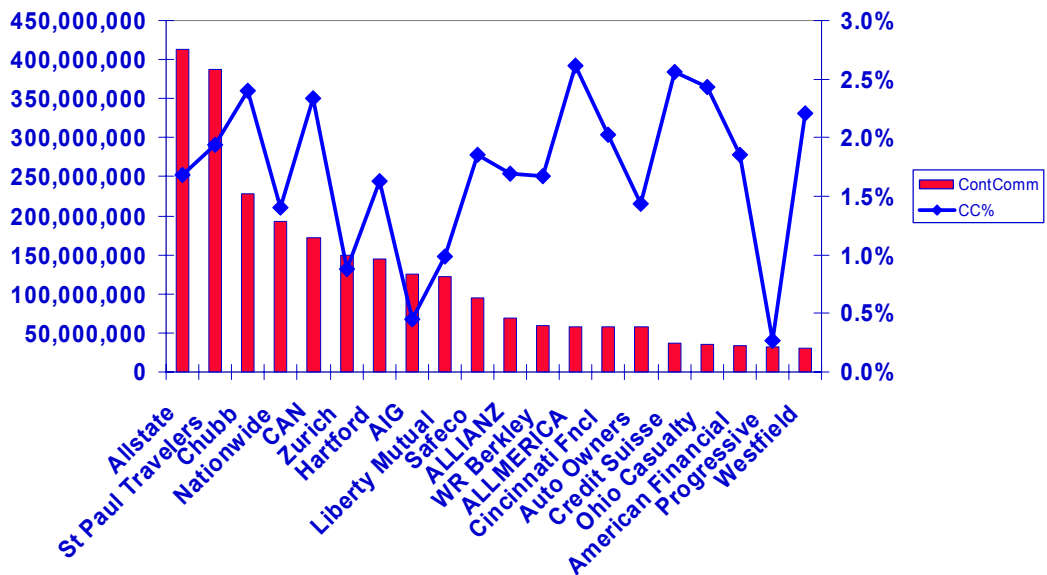


Top Brokers: Contingent Commissions as % of Revenues, 2003

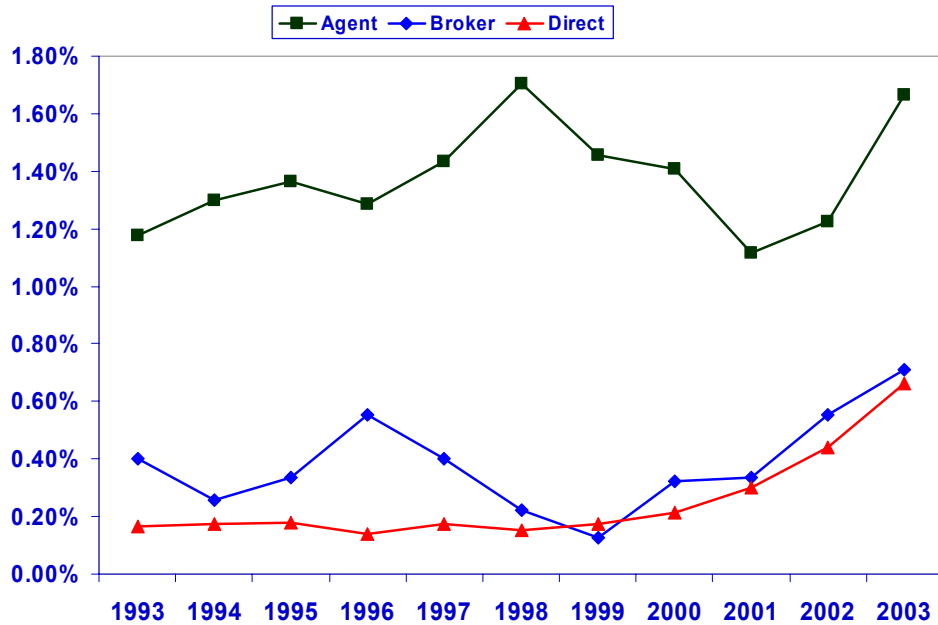


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Top Payers of Contingent Commissions

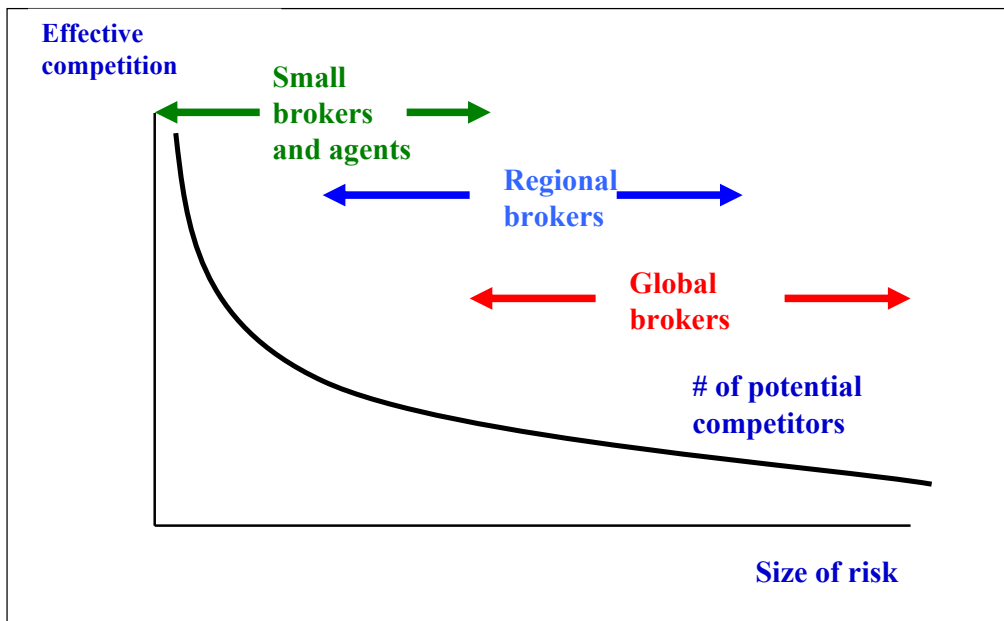


Contingent Commissions: % of Premiums



Note: Top 10 firms for which contingent commission data were available. Source: Business Insurance.

Competition Among Intermediaries



Competition Among Intermediaries

- ◆ Top of the market – mega-broker market is too concentrated giving brokers excessive market power
- ◆ Middle market – intensive competition among local and regional brokers and agents
- ◆ Small business market – intensive competition among brokers, agents, and direct writers (for some lines)

Should Contingent Commissions Be Banned?

- ◆ Contingent commissions play a valuable role in aligning incentives among market participants
 - Buyers of insurance
 - Intermediaries
 - Insurers
- ◆ Contingent commissions enhance insurance market efficiency
 - Enhance services provided to buyers
 - Reduce information asymmetries and enhance market stability

Role of Contingent Commissions

- ◆ Profit based commissions
 - Incentives to place business with insurers that have the appetite for specific type of risk
 - Appropriate placement reduces
 - Search costs
 - Switching costs
- ◆ Persistency-based commissions
 - Encourage longer-term relationships between buyers and insurers, reducing information asymmetries
 - Reduce transactions costs due to “churning”

Role of Contingent Commissions

- ◆ Volume-based commissions
 - Help insurers achieve maximal risk diversification
 - Enable insurers to realize scale economies due to fixed costs of establishing and maintaining agency relationships

Insurance: Multidimensional Transaction

- ◆ Placement of commercial insurance involves more than just price
 - Insurer reputation for service
 - Insurer reputation for claims settlement
 - Insurer reputation for financial strength
- ◆ Role of the intermediary is complex
 - Coverage design and risk management
 - Loss mitigation and control
 - Assistance with claims settlement
 - Market knowledge of price and availability

Multidimensional Transaction: Brokers

- ◆ Intermediaries play a critical role in the multidimensional commercial insurance placement
 - Shop the market for best price and coverage
 - Play a syndication role for placement of large and complex risks
 - Assist in designing risk management programs
 - Intervene with insurer in the settlement of claims
 - Reduce informational asymmetries between insurers and buyers, providing valuable information to both buyers and sellers

Policy Recommendations

- ◆ Brokerage market is too concentrated at the top – the largest brokers should be broken up
 - Small-middle markets are highly competitive
- ◆ Brokers should not be permitted to both as primary and reinsurance intermediaries
- ◆ Contingent commissions are not the problem and should not be restricted
 - However, commissions should be disclosed to buyers
- ◆ Vigorous antitrust surveillance needed to prevent future abuses