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

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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

- Premium: \( P_A < \{P_B, P_C, P_D\} \)
- Other coverage terms also considered, so low bidder does not necessarily win but buyer has full information on bids.
Brokerage Distribution: How It Really Worked

- **Premium**: $P_A^* < \{P_B^*, P_C^*, P_D^*\}$
- $P_A^* = \text{inflated price quote} = P_A + C$
- $C = \text{contingent commission}$
- **Fake price quotes** $\{P_B^*, P_C^*, P_D^*\} > P_A^*$

**Why Did Other Insurers Give 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.

Buyer: Corporation X

Broker: Recommends A even though $P_B < P_A$

Premium $P_A$

Insurer A: Wholly or Partially Owned by Broker

Insurer B: Independent of Broker

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
### World’s Largest Insurance Brokers: Global Business

<table>
<thead>
<tr>
<th>Broker</th>
<th>Country</th>
<th>Revenues</th>
<th>Employees</th>
<th>Offices</th>
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</tbody>
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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

![Graph showing ROE (%) from 1994 to 2003 for PC Insurers, Public Brokers, and All US Industries]
Top Brokers: Contingent Commissions as % of Revenues, 2003

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

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

Effective competition

Small brokers and agents
Regional brokers
Global brokers

# of potential competitors

Size of risk
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”

- **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