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COMMITTEE ON GOVERNMENTAL AFFAIRS

**SUBCOMMITTEE ON FINANCIAL MANAGEMENT,
THE BUDGET AND INTERNATIONAL SECURITY**

HEARING ON INSURANCE BROKERAGE PRACTICES

TESTIMONY OF

NEW YORK STATE ATTORNEY GENERAL

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Introduction

Over the last year, my office has undertaken an investigation into the market practices of insurance brokers. Insurance brokers serve businesses and individuals seeking to purchase insurance, and they hold strict fiduciary duties to serve the best interests of their clients. We were concerned that brokers were subject to conflicts of interest due to their receipt of contingent commissions and other hidden payments from certain insurance companies for steering client business to preferred insurers. Very quickly, our investigation found widespread evidence that brokers were receiving hidden payments, essentially kickbacks, from insurance companies.

By looking closely at these contingent commissions, we uncovered another side of the insurance industry. Not only do insurance brokers receive contingent commissions to steer business, but many brokers, with the assistance and collusion of insurance companies, engage in systematic fraud and market manipulation in order to ensure that profitable and high volume business goes to a few selected insurance companies. In other words, we found that favoritism, secrecy and conflicts rule this market, and not open competition.

This struck us as a very familiar pattern. Whether in investigating conflicts of interest between the research and investment banking arms of large wall street firms or our recent work in the mutual fund industry, we have found that the lack of transparency, combined with inadequate disclosure and regulatory oversight, often leads to market fraud and collusion. Many insurance lines, from employee benefits to property and casualty, essentially function as insiders' clubs, where those with market clout and power pay for preferential treatment. Similar to the small investor on wall street or in mutual funds, the ordinary purchaser of insurance has no idea that the broker he selects is receiving hidden payments from insurance companies, that the advice he receives from the broker may be compromised, or that the market bids he sees may be illusory. This has led to a crisis of accountability.

Industry background

the insurance industry is vast, and touches nearly every segment of the national economy. Insurance companies wrote a net total of approximately $1.1 trillion in premium in 2003, or approximately 10 cents of every dollar of the $11 trillion gross

domestic product. Even minor variations in premium pricing have dramatic consequences on the economy.

Much of this industry, however, operates in secrecy. Under the mccarran-ferguson act of 1945, 15 u.s.c. § 1011 et seq., the regulation of insurance is delegated almost entirely to the states. Disclosure laws among the states, however, vary. Furthermore, an increasing number of insurers and brokers maintain offshore operations, particularly in bermuda.

In addition, market power in the insurance brokerage market has rapidly consolidated over the last ten years. A market study conducted by swiss re found that in 2002 marsh and aon together comprised 54 percent of the global brokerage market, and willis comprises an additional 7 percent. These two or three firms also dominate reinsurance brokerage markets. With so much market power concentrated in two or three brokerage firms, the threat of collusion has become a reality. We found that a small group of brokers and insurance companies essentially control the market, having created a network of interlocking connections and secret payments which ensure that

the bulk of business goes to certain insurers and that profits remain high. The bottom line is that the consumer pays more for coverage.

1. <u>Marsh & mclennan</u>

on october 14, 2004, my office filed a complaint against marsh & mclennan companies and marsh inc., alleging widespread fraud and antitrust violations in the procurement and broking of insurance. Many of the nation's largest insurance companies were implicated in these practices, including american international group ("aig"), ace ltd., and the hartford financial services group.

Concurrent with the marsh action, my office filed two criminal complaints against executives at aig, charging a scheme to defraud in violation of new york state penal law § 190.65 and a third criminal complaint against an executive at ace, charging violation of new york state antitrust law under general business law § 340. All three executives pleaded guilty.

2. Universal life resources, inc.

Last friday, my office filed a complaint against universal life resources, inc. ("ulr"), a key consultant and broker in the employee benefits industry. Ulr advises hundreds of employers in the selection of insurance and has placed insurance for four million u.s. workers. The complaint details how ulr is retained to help employers reduce costs and procure the most appropriate benefit plans for their employees, but instead engages in massive steering of this business to a small set of insurers that have been willing to enter into side-deals with lucrative payoffs for ulr. These insurers include unum provident insurance company, metropolitan life insurance company and prudential financial corporation. It is, of course, employees who pay for these hidden costs through higher life and other group premiums.

Summary of investigation and findings

Many purchasers of insurance, whether corporations or individuals, use independent insurance brokers for assistance in sorting through the numerous insurance products available and to obtain the best available coverage at the lowest

price. Although these brokers have a fiduciary duty of loyalty to serve their clients' best interests faithfully, we found these duties are systematically betrayed by brokers with the aid of the insurance carriers.

All insurance brokers receive compensation when they obtain insurance for their clients. Typically, this compensation takes the form of a customary 10 percent commission paid by the insurance company out of the client's first premium check. However, some insurance clients forego this arrangement and pay their brokers a direct fee.

Our investigation revealed that in addition to this customary disclosed commission, many brokers also receive contingent compensation from insurance companies based on the volume and/or profitability of the business that the broker places with them. These payments are known as "contingent commissions," but go my many other names such as "overrides," or in the case of marsh, placement service agreements ("psas") or market service agreements ("msas").

We found that brokers routinely mislead their clients about the true nature of contingent commissions. Marsh's website, for instance, described msas as

“agreements that cover payment for the value brokers provide to insurance carriers.” The truth is that contingent commissions and msas provide little or no value or services to insurance carriers. They appear to be nothing more than payments for steering business to preferred insurance carriers.

We were concerned about the obvious conflicts of interest that arise when insurance intermediaries have undisclosed incentives to “steer” business to certain insurance carriers in return for additional compensation. However, we did not anticipate the sheer magnitude of this practice, or how these hidden payments drive the insurance business as a whole. We have found:

- contingent commissions plays an important role in the business models of many insurance brokers. Marsh established a separate business unit solely for the purpose of negotiating, collecting and extracting contingent commissions. Contingent commissions are highly profitable: for example, in 2003, marsh received $845 million in such payments, and because little or no service is performed for steering business to insurance carriers, this $845 million represents almost pure profit.

- smaller insurance brokers also enter into contingent commission agreements with insurance companies for the purpose of steering business.

- many of the major insurance companies have entered into contingent commission agreements with brokers, and are paying millions of dollars in additional commissions, which contributes to rising premiums.

- contingent commissions have infected practically every line of insurance business we examined, including employee benefits, medical malpractice, property, casualty, excess and surplus lines, executive risk, personal lines, marine, and aviation.

Contingent commissions also infect the reinsurance markets, which is a major cost driver for retail insurance costs and premiums. Reinsurance is insurance purchased by insurance companies to cover the risk created by the retail insurance policies they underwrite. In investigating this area, we found that the large retail insurance brokers also dominate the reinsurance brokerage market, and they have found numerous and

creative ways to get second, third and fourth bites at the undisclosed compensation apple through reinsurance.

Contingent commissions represent the first source of undisclosed or poorly disclosed income. However, in exchange for entering into contingent commissions and steering retail insurance to an insurance carrier, brokers sometimes demand that the carrier enter into a reciprocal relationship to use the broker for the carrier's reinsurance purchases, resulting in additional reinsurance commissions to the broker. This represents a second source of undisclosed income. Essentially, brokers agree to an undisclosed quid pro quo with insurers: we'll steer more retail business to the insurance carrier if the carrier uses our reinsurance brokerage services. This arrangement results in significant undisclosed income and creates new conflicts of interest for retail brokers seeking to lock-in reinsurance commissions.

If the broker places reinsurance with a reinsurance carrier, the broker receives a customary disclosed commission and may also receive additional undisclosed income as a result of maintaining a contingent commission with reinsurance companies. This constitutes a possible third bite at undisclosed earnings. Finally, some brokers manage

a fourth bite at the apple through maintaining investments in reinsurance companies to which they steer the reinsurance business.

Thus, across the entire life span of an insurable risk, brokers may receive as many as four additional streams of income in addition to receiving customary retail commissions. All of these payments, however, are undisclosed, or poorly disclosed, and place higher costs on the insurance itself, resulting in higher premium payments by consumers.

Contingent commissions and side-dealings between brokers and insurance companies also distort competition by turning insurance markets into an insiders' club, where business is steered to a select few insurance carriers who are willing to pay for these opportunities. Those carriers who enter into these agreements with brokers are usually assured that they will become a "partner" or a "favored nation," which are euphemisms for getting preferential, and sometimes criminal favoritism. Those carriers who refuse to "pay to play" are disciplined by seeing their premiums drop as brokers steer business to other carriers.

To make the system work, however, the broker has to deliver the promised volume of business to the insurance company that is paying it to steer. This pressure to deliver business leads brokers to engage in bid rigging and other forms of market manipulation. We found:

- evidence of direct bid rigging in excess casualty insurance markets where marsh arranged for the submission of fictitious or artificially inflated bids in order to create the illusion of competition among insurance carriers and mask the direct steering of insurance business to a favored insurance carrier. Criminal charges were filed against two aig employees and one ace employee in connection with this scheme.

- cases where marsh arranged for insurance carriers to refrain from bidding on certain accounts in order to limit competition and steer business to a preferred carrier.

- evidence of proposed or actual “no shopping” agreements where marsh and ulr would affirmatively undertake not to shop policies when they come up for

renewal, essentially guaranteeing that the business stayed with the incumbent insurer.

- numerous indirect examples of steering such as brokers offering favored carriers opportunities to be the lowest bidder but not offering similar opportunities to other bidders.

Significance of findings

we have identified two major adverse impacts arising from these practices. First, steering results in strong incentives for the broker to send insurance business to preferred insurance companies which means that the customer is not always getting the best coverage for its needs. Second, the interlocking network of insurance brokers and insurance carriers essentially creates a secret cartel based on hidden payments and preferential treatment. Like any cartel, however, this one results in higher prices for the public and a drag on the economy. This causes inefficiencies and ultimately higher costs in a sector amounting to 10 percent of the national economy.

Reform and the next step

my office intends to follow its investigation to its natural conclusion. We have sued marsh and ulr and are continuing our investigation of collusion and fraud between brokers and insurers. We have also begun to look at other troubling areas of the insurance industry beyond steering and bid rigging. However, there are limits to what this office can do. The problems we have uncovered in the insurance industry are profound, complicated and national in scope. We represent the interests of only one state and cannot unilaterally accomplish the systemic nationwide reform that is urgently needed.

Here are some areas warranting further investigation:

1. The trend offshore

one area that requires close attention is the extent to which insurance brokers and insurance companies have sought to evade state regulation by locating their operations in bermuda and other offshore havens. This makes the states' job of supervising these

companies far more difficult and creates numerous opportunities for secrecy and insider dealings.

Since 2001, there has been a reported huge transfer of insurance capital and underwriting activity to bermuda, and more recently the cayman islands. Many of these off-shore entities are either owned in part or operated by the insurance brokers themselves. Marsh helped to create the bermuda-based ace ltd., xl capital ltd., mid ocean re and axis, while aon has sponsored lasalle re and endurance. This sets the stage for conflicts of interest, steering and self-dealing in insurance and reinsurance markets that we are just beginning to understand. And this is not to mention the numerous and profound tax implications of permitting u.s. insurers to accrue investment earnings in favorable offshore havens.

2. Antitrust issues

second, we believe we have only scratched the surface with regard to the interlocking relationships between insurance companies and between brokers and insurance companies that affect pricing and market competition. This is an industry that has traditionally been exempted from broad areas of federal and state antitrust laws.

Broker rigging of markets is one manner in which premium costs stay high, but we believe there are other means by which brokers coordinate pricing such as setting prices through rate service organizations and trade associations, which serve as clearing houses for the setting and publishing of price information.

3. Disclosure on premiums

a third and related area for investigation is the setting of premiums themselves, which remains a mysterious function. What percent of premium actually goes toward paying claims as opposed to simply being invested for income? In 2003, property and casualty insurers netted $38.7 billion in investment income, constituting by far the largest component of earnings for the year. With investments comprising the lion's share of insurance company earnings, we need to ask ourselves to what extent are investment performance and interest rates driving premiums and what manner of disclosure is appropriate here, so that consumers of insurance understand why they are paying the rates they do?

4. Insurance culture and ethics

lastly, the brokers should be called to account for their steering activities. How has the culture of favoritism and pay-offs distorted their basic fiduciary duty to serve the customer. More importantly, how can we take steps to reform this culture by requiring appropriate disclosure to ensure the markets are operating properly?

Conclusion

from our work in this area, it is clear that the federal government's hands-off policy with regard to insurance combined with uneven state-regulation has not entirely worked. There are too many gaps in regulation across the 50 states and many state regulators have not been sufficiently aggressive in terms of supervising this industry.

The federal government should not preempt state insurance enforcement and regulation. Nonetheless, I do believe there is a role for the federal government, especially in the areas of off-shore capitalization and investment by insurance companies. At a minimum, federal involvement may be necessary to assure some basic standards of accountability on the part of insurance professionals.

Congress has acted in similar cases. Whether in investigating and implementing reforms for the oil and railroad cartels of the late 19th century, or more recent probes into the savings and loan industry, tobacco, or energy markets and enron corp., there is ample precedent for congress to investigate the insurance industry and to undertake reform. In fact, in 1991, the house energy and commerce committee examined this industry in light of a rash of insurance company insolvencies, and concluded that state law did not adequately ensure the financial integrity of insurers or punish insurers for violation of state insurance laws. I believe further congressional action would go a long way toward avoiding the type of business dysfunction and collapse that has characterized other industries in recent years, and would be a first step toward controlling soaring insurance prices for the american consumer.