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Study of Insurance Economics

# Études et Dossiers

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

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**J. David Cummins**

**World Risk and Insurance Economic Conference**

**August 10, 2005**

**Based in part on:**

***The Economics of Insurance Intermediaries***

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**J. David Cummins and Neil A. Doherty**

**May 2005**

**Available at:**

**<http://www.huebnergeneva.org>**

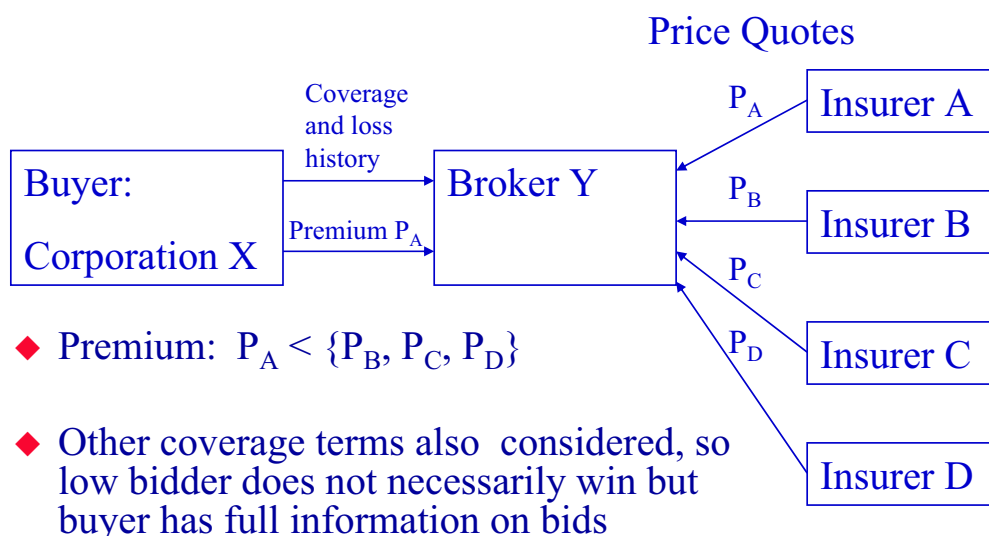
## Marsh & McLennan's Market Manipulation

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- ◆ 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

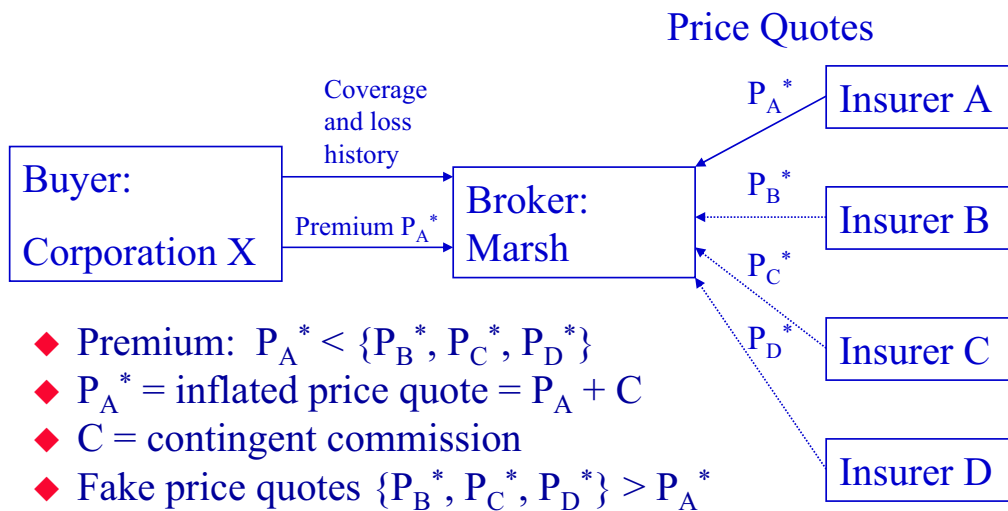
## Brokerage Distribution: How It Should Work

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## Brokerage Distribution: How It Really Worked

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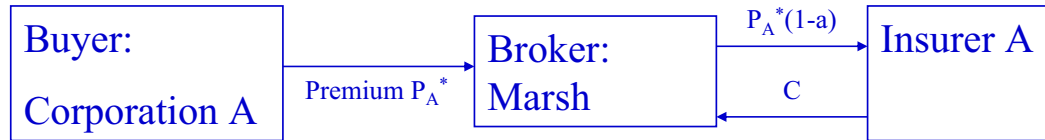
## Why Did Other Insurers Gave Fake Quotes?

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- ◆ 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

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- ◆ 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

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- ◆ 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

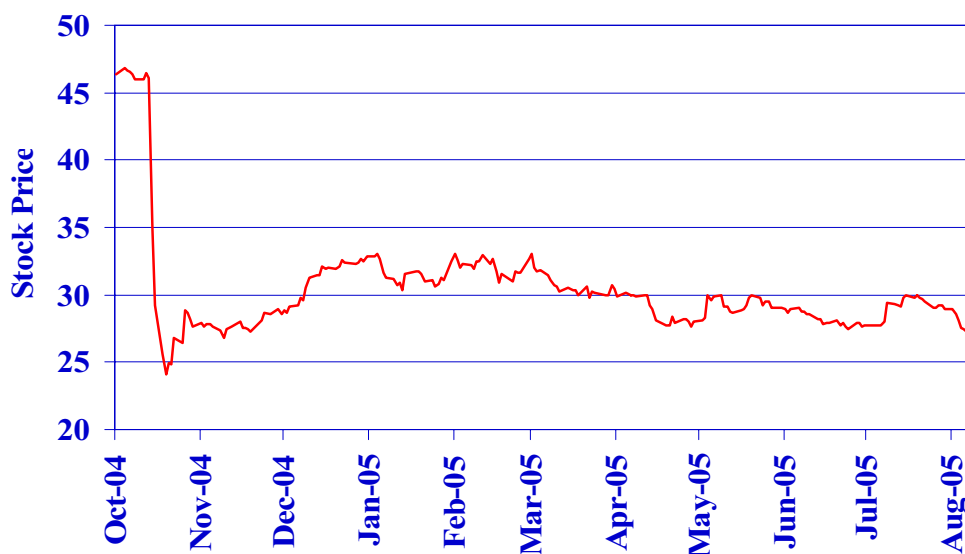
## What Determines Contingent Commissions?

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- ◆ 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

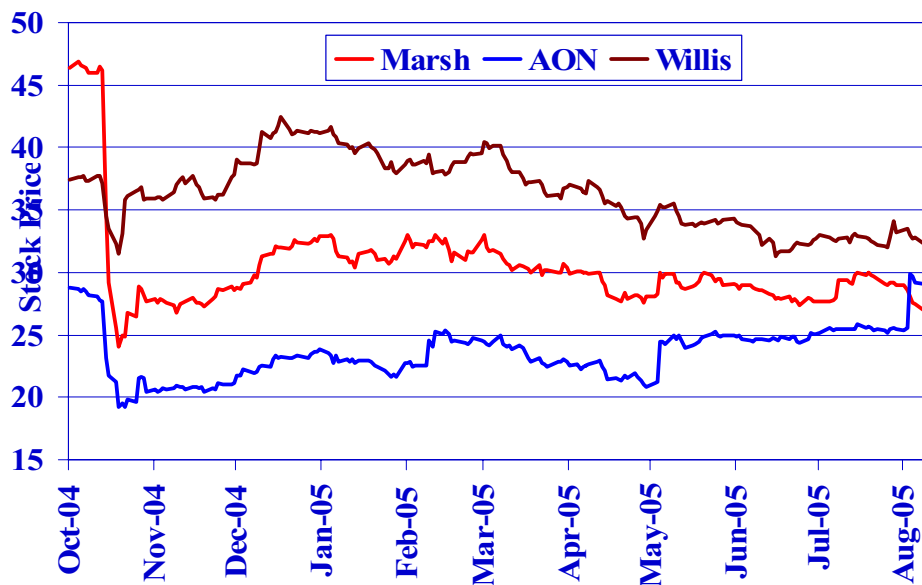
## Market Reaction: Marsh's Stock Price

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## Market Reaction: Contagion Effect

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## Marsh Case: Partial Resolution

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- ◆ 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

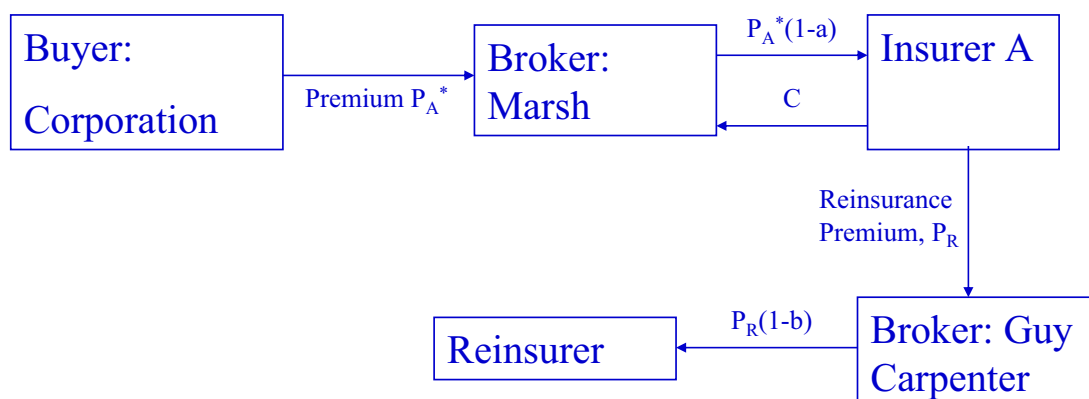
## Other Potential Problems: Tying

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- ◆ 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

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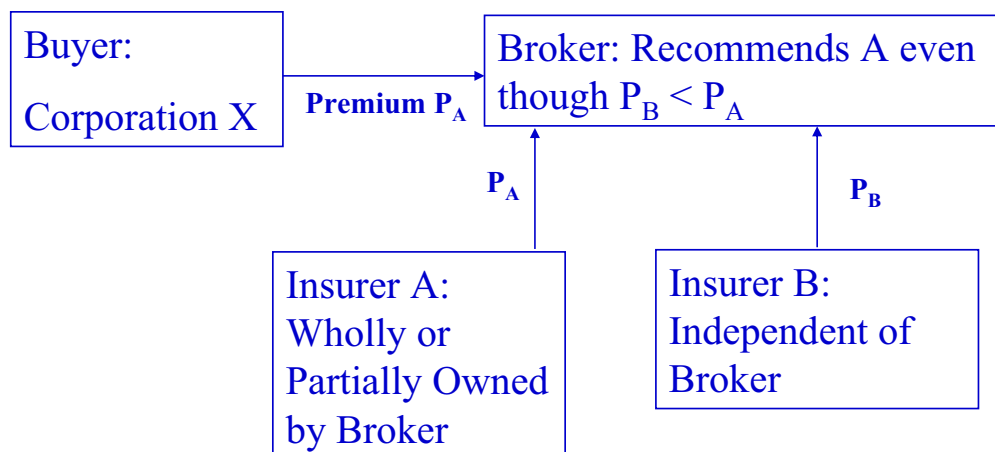


- ◆ Insurer A also has to deal with Marsh in buying reinsurance (b = reinsurance commission)
- ◆ Otherwise, it risks loss of brokerage business from client companies.
- ◆ Potential for bid rigging in reinsurance transaction also???

## Related Party Transactions

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



## Why Did It Happen, What Should Be Done?

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- ◆ 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?

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- ◆ 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?

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- ◆ 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

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## Insurance Intermediaries: Market Structure and Performance

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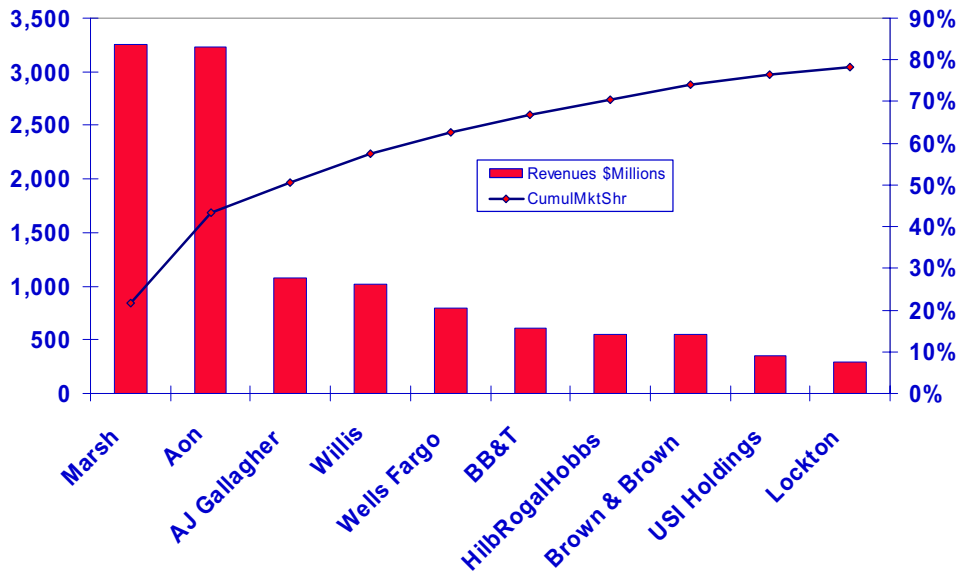
### World's Largest Insurance Brokers: Global Business

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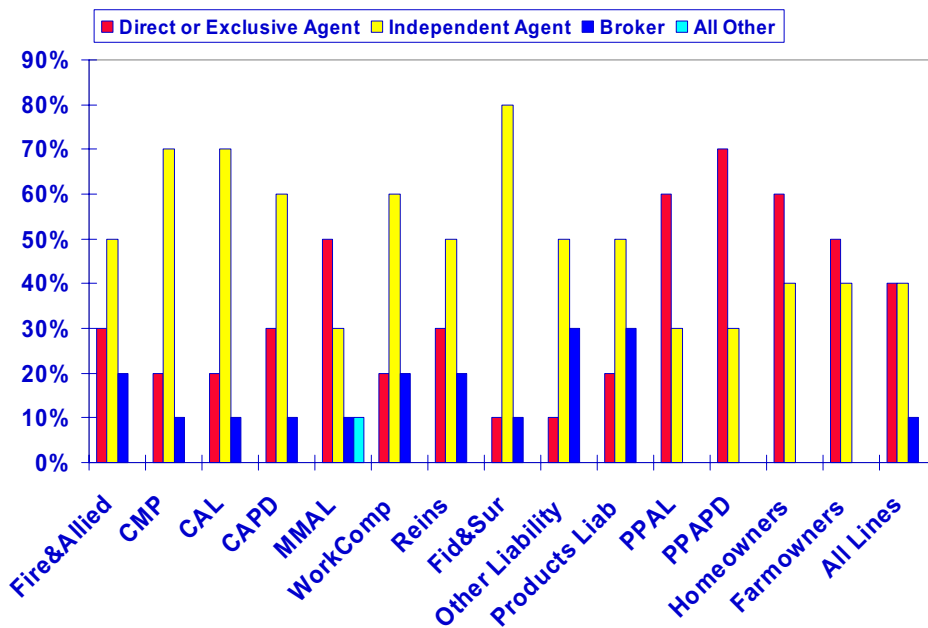
Broker	Country	Revenues	Employees	Offices
Marsh & MCLennan	US	9376	54500	675
AON	US	6734	44500	600
Willis	UK	2004	11119	165
Gallagher	US	1202	7206	110
Well Fargo	US	801	5593	155
Jardine-Lloyd-Thompson	UK	701	4617	44
BB&T	US	605	3009	84
Hilb,Rogal,Hobbs	US	556	3300	108
Brown&Brown	US	545	3517	117
Alexander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

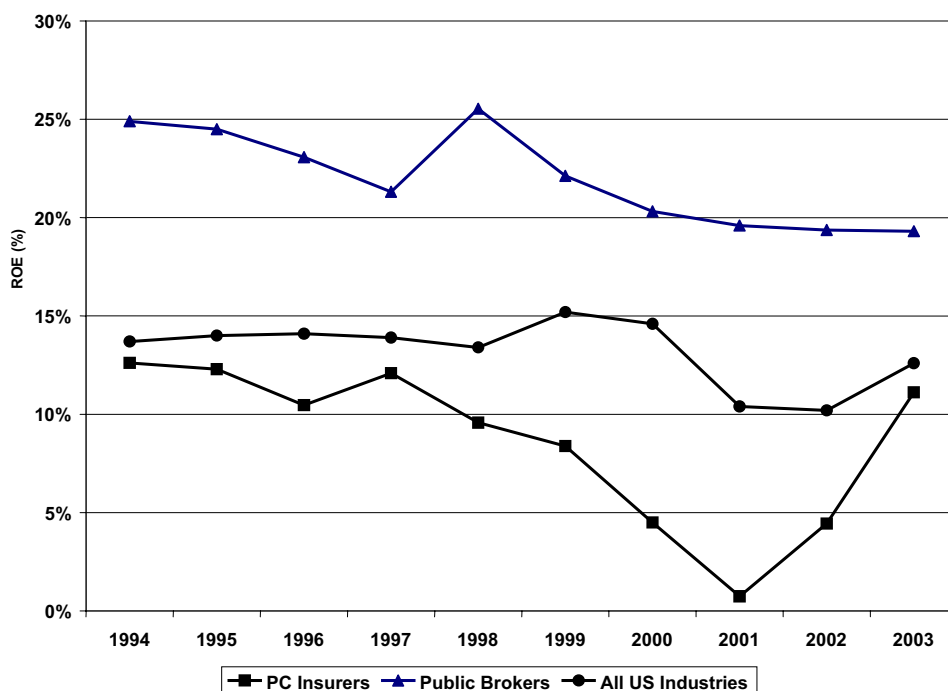
## Market Shares By Line

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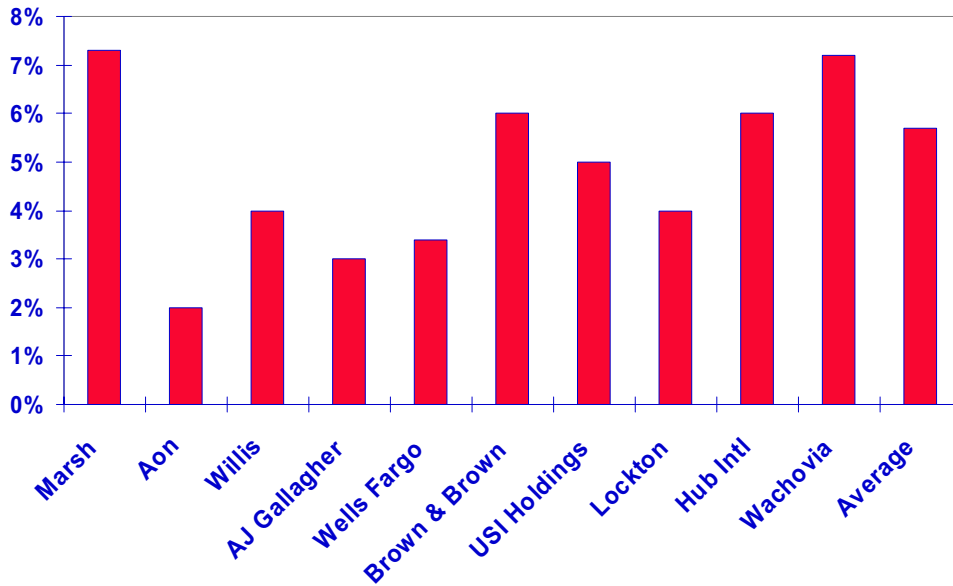
- ◆ Overall brokers have only about 10% of property-liability market
  - However, they are mostly concentrated in the commercial lines – have at least 20% in 5 commercial lines
  - Brokers have a much larger share of the large national and international commercial lines market
- ◆ Large numbers of brokers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

## Public Brokers & P-L Insurers: ROE

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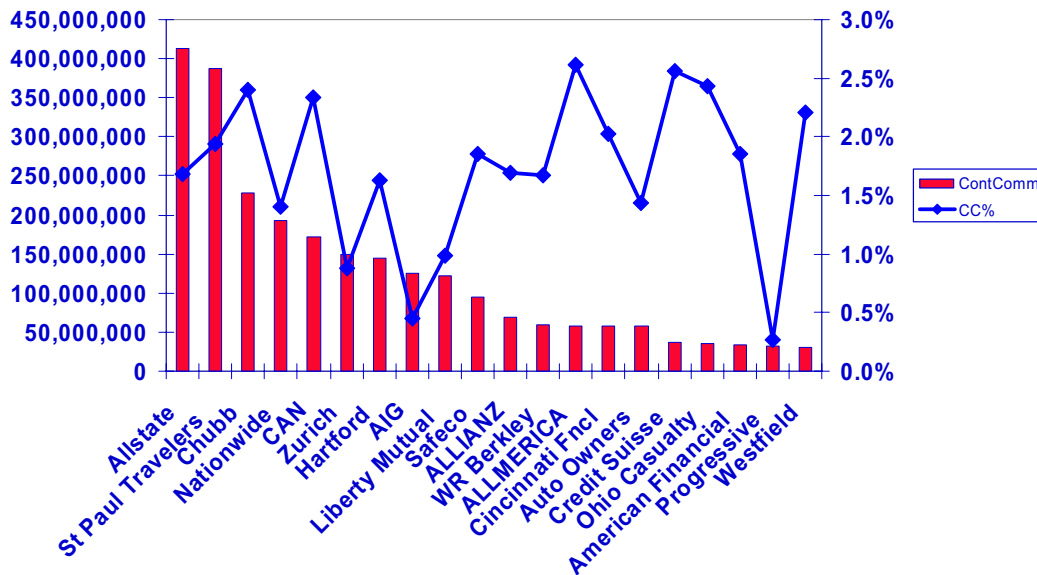


# Top Brokers: Contingent Commissions as % of Revenues, 2003

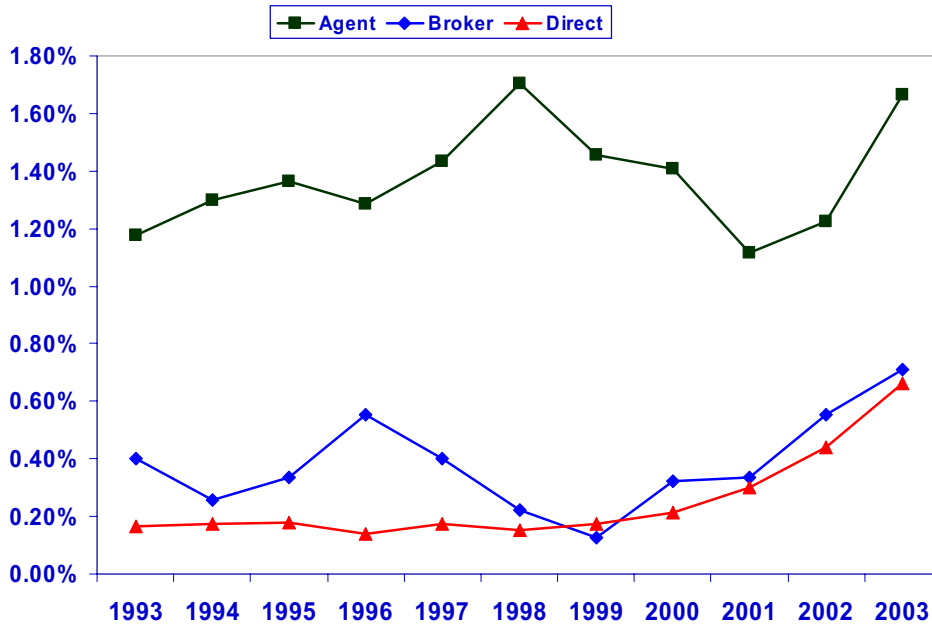


Note: Top 10 firms for which contingent commission data were available. Source: Business Insurance.

# Top Payers of Contingent Commissions

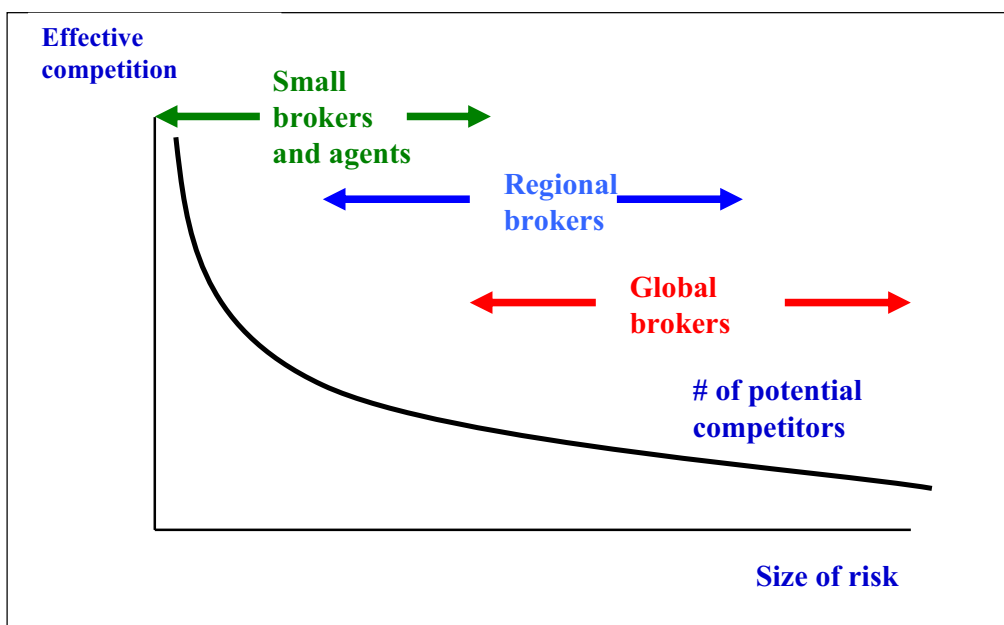


## Contingent Commissions: % of Premiums



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

## Competition Among Intermediaries



## Competition Among Intermediaries

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- ◆ 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)

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## 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

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- ◆ 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

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- ◆ 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

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- ◆ 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

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- ◆ 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

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- ◆ 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