Published:	**Wednesday, October 20, 2004**	Edition:	**STATEWIDE**
Page:	**E1**	Type:	**COLUMN**
Section:	**BUSINESS**	Source:	**Dan *Haar***
Column:		Series:	

LITTLE CHOICE IS BIG TROUBLE

It's possible that all this laser focus on bonuses paid by insurance companies to agents and brokers will lead us to conclude the system stinks head-to-toe because it's rife with conflicts.

Maybe. It's worth examining. But for now, the hunt is obscuring a more obvious potential source of odor.

Three or four insurance sellers control the vast majority of Fortune 1000 business. The largest of them, Marsh Inc., stands accused of rigging bids to steer clients to underwriters of its choosing.

The second-largest, Aon Corp., is said to be under investigation for strong-arming insurance companies. Under that scheme, if companies wanted to sell their products through Aon, they would have to buy reinsurance -- a way of spreading their own risk -- through Aon.

It's been widely reported that Marsh and Aon control $8.5 billion of the commercial insurance market in the United States, compared with $5.2 billion for the next eight companies combined. There's no publicly available data on how many of the largest companies use Marsh and Aon, but experts say the two companies' grip on that market is at least as tight as it is in the broader industry -- tighter, by some accounts.

Oddly, investigators in attorneys general offices from Connecticut to New York to California, not to mention insurance industry officials everywhere, seem to be treating those facts as a sideline issue. They are not a sideline. Market consolidation is the main event here.

For several reasons, antitrust laws -- including the Donnelly Act that New York Attorney General Eliot Spitzer invoked in breaking open the scandal -- have failed to prevent a few firms from growing to the point where they can muscle insurance companies. That imbalance seems a more likely culprit than a payment system spread evenly among some 38,000 brokerages and agencies.

"To the extent that there is indeed abuse, the problem is Marsh as the 800-

pound gorilla and Aon as the 600-pound gorilla," one industry expert said.

A look at the brokerage system from the standpoint of mid-size players -- agencies that sell property-casualty insurance to clients of some heft, but not the largest publicly traded companies -- shows why the payment system, flawed as it may be, includes checks and balances against fraud.

That same look illustrates a shortage of competition among the biggest players.

The president of the largest insurance agency based in Connecticut -- Webster Insurance -- tells of a client, a municipality paying more than $500,000 for liability and workers' compensation coverage.

Among insurance companies offering policies to the burg, one had a contingency commission agreement with Webster. That meant it would pay Webster a bonus at the end of the year if Webster sent enough high-quality business its way. But Webster placed the municipality with another insurer.

The move, Webster Insurance president John Queirolo said, "basically blew up the entire contingency agreement with the carrier for a year."

That's OK, he said. On a smaller scale, it happens quite a lot.

"At the end of the day, you're looking for a long-term relationship with the client," said Queirolo, who joined Webster when the bank holding company bought his Westport agency.

The point is that Webster -- like any other agency -- does indeed face potential conflicts in its business, as it works for clients and is paid by the people selling products to them. But a robust marketplace of competitors, in an industry still based on personal trust, neutralizes the conflicts.

Queirolo said Webster is able to "iron out the bias" in a number of ways, including multiple bids and full disclosure.

The payment concern is, after all, similar to the sorts of ethical conflicts that arise in business every day. We in newsrooms, for example, have a duty to readers to report facts that keep stories from growing out of proportion. But we get ahead by breaking big stories -- the bigger the better. The hope is the marketplace works out the problems, although we've had a few embarrassing doozies lately.

Back to the insurance industry, there are many types of bonuses paid to brokers and agents, most of which grew in the last 25 years or so as basic, straight commissions shrank. In those decades, the industry also

consolidated to the point where most large companies turn to Marsh, Aon and, to a lesser extent, two others: Arthur J. Gallagher & co. and Willis Group.

Players the size of Webster, and even national firms that are not in the top few, say they would have no way of engineering the sort of bid-rigging that Spitzer charges occurred at Marsh, even if they wanted to. That's all the more true of the hugely competitive collection of brokerages that sell home and auto insurance to individuals.

The biggest companies, especially the first two, have much more power to extract bonuses from the likes of The Hartford -- not because of a built-in conflict, but because of their size.

That's because the insurers know that risk managers at the largest clients must turn to the biggest brokers if they want to avoid being second-guessed by the brass.

"By the fact they're the largest broker, if you make the decision to buy from Marsh, it's a no-call," said industry consultant Timothy Cunningham, principal of OPTIS Partners in Chicago.

Gerber Scientific Inc., for example, buys property insurance through local agencies, but uses Marsh and other industry giants for specialized risk such as directors and officers liability and product liability, said Gerber's senior vice president and general counsel, Bill Grickis. Companies such as Gerber -- which is publicly traded and global -- depend on the biggest brokers to sort out subtle nuances in complex policies.

"The field is equally narrow when it comes to who is carrying the insurance," Grickis said.

The problem is all the worse when companies -- clients and insurance carriers -- have only a few choices.

That leads to a possible emerging trend in all this. Smaller, national brokerage houses, Cunningham said, "have got decent capabilities and they can deliver the same thing as Marsh."

In fact, executives at some of those firms said this week they are positioning themselves to capture business that had gone largely to the biggest players.

Until then, the questions of whether Marsh actually committed fraud, and whether Aon overtly tried to squeeze the big carriers, are important, as is the payment system. But consolidation underlies all of it.

"I don't think these companies collude with each other. However, the fact that market power is so concentrated means that the insurance companies are much more dependent on them than they probably would like to be," said George Smith, an economic historian at the Stern School of Business at New York University who studies monopolies.

Smith believes the payment system is flawed because it creates conflicts. But he said, "It's a strong hypothesis here to say that the industry consolidation is causing the problem. ... Now it will be studied to death."

Published:	**Sunday, October 24, 2004**	Edition:	**STATEWIDE**
Page:	**D1**	Type:	**COLUMN**
Section:	**BUSINESS**	Source:	**Dan *Haar***
Column:		Series:	

ENDING INSURANCE BONUSES WOULD CARRY A REAL PRICE

The rolling, coast-to-coast inquiries into insurance brokerage firms over the last 10 days have amplified a rallying cry among reformers and others with political ambition.

Stop contingent commissions!

For the financial services set, at least, it has a kind of ring to it, like Whip Inflation Now -- President Ford's lasting contribution to economic policy.

But like rising prices, this newly publicized evil seems simple, but isn't, and certainly doesn't lend itself to easy answers. Anyone remember that other '70s stunt, wage and price controls?

Contingent commissions is a fancy name for bonus payouts from insurers to agents and brokers, usually at the end of a year. The bonuses, which come in many shapes and sizes, are typically based on volume and/or profitability of the business the agents send to the insurers.

The bonuses are over and above standard commissions, which have shrunk over the last few decades. No one keeps track of how many hundreds of millions of dollars the bonuses total, or what percentage of agencies' compensation they represent. But generally they are more significant for bigger agencies.

They taint the industry, the argument goes, because they represent a hidden, murky form of compensation that creates a basic conflict. An agent who knows there might be a pot of gold coming at the end of the year from a certain insurer will steer clients to that carrier, the best interests of the customer be damned.

Worse still, the bonus -- if it's based on the quality of the business, meaning the lack of claims -- gives the agent a reason to squash claims before they reach the insurer.

And worst of all, the back-door payments are said to stifle competition, and therefore have the effect of allowing insurers to maintain higher prices.

"The cleanest system would have no back-door payment," said J. Robert Hunter, director of insurance for the Consumer Federation of America, and an actuary himself. "Prices are higher because of this."

The theory of this insidious corruption seems sound, and the facts may someday bear it out. But out there in insuranceland, it looks so far like a different story. It's not at all clear that bonuses paid to brokers, when used correctly, have hurt the insurance-buying public.

In fact, they deliver some pluses along with the threat of abuse.

Chiefly, the bonuses strengthen ties between brokers and insurers, which can help clients; they let insurers efficiently target the types of policies they sell, thereby reducing overall cost; and they give brokers and agents an incentive to help their clients avoid calamities before they happen.

"It's good for society that we've got safer workplaces. It's good for society that we've got safer homes," said John Queirolo, president of Webster Insurance.

We're talking about legal, fully disclosed bonuses here. The fuss started 10 days ago when New York state Attorney General Eliot Spitzer accused four major players in the industry, including The Hartford, of manipulating the market by engaging in bid-rigging.

Spitzer made little effort to distinguish legal practices he doesn't like from illegal or clearly unethical tricks.

Since then, we've seen attorneys general and insurance commissioners in California, Connecticut and Massachusetts announce their own probes, all aimed broadly at the bonus system. We've seen a trickle of lawsuits, and we've heard from corporate risk managers asking hard questions of their

brokers.

Marsh & McLellan, the nation's largest brokerage and a target of Spitzer's charges, said it will "suspend" certain types of bonuses, although it was unclear how much it will forgo of its $800 million-plus in annual bonus revenues.

On Thursday, Willis Group Holdings Ltd., the fourth-largest, said it will not accept any type of contingent payments from insurers, which would have totaled 4 percent of global revenues, or $160 million, including $35 million in North America. That's what clients want, the Willis CEO said.

"We see tremendous marketplace opportunities," Willis spokesman Dan Prince added Friday.

They've done the math: Adding just 1 percentage point of global commercial market share would increase revenues by $200 million.

So the rush to appear cleanest may be on, despite what the facts turn up, despite what regulators and legislatures decree. And through it all, there is, so far, little or no public evidence that contingent commissions corrupt the sale of insurance.

Moreover, contingent commissions have evolved over the last two decades into a deep-seated part of the industry. If they disappeared tomorrow, something would have to replace them -- more upfront fees from customers, less service, higher standard commissions, back-end fees from insurers or some combination of the four.

Willis, for example, said it will restructure half of its $160 million in broadly defined contingent commission revenue into fully disclosed fees for services from insurers, not tied to sales.

All of those options bring their own set of sticky questions. With whom will insurers contract for services? If you're a small-business owner buying insurance, do you really want to have to negotiate fees with your broker? Would you like to pick through a menu of options, or pay your broker by the hour?

Do you really want your agent to have an anonymous, non-relationship with the insurance company? In 23 years, my agent has pleaded my case with insurers more times than I'd like to count.

Customers do want assurance, along with their insurance, that they're paying a reasonable, competitive price for the service and coverage they're buying. There's no reason to believe contingent commissions prevent true market-

pricing if -- and this is a big if -- there are plenty of agents out there competing for the same business. That has not been the case among the brokerages serving the largest corporate clients, and that lack of competition is the real problem.

Hunter, at the consumer federation, argues that higher prices artificially keep some of the nation's 38,000 agencies in business. If that's true, the best way to address it is to open up the whole commission system and encourage efficient brokers to keep a smaller percentage.

Over the decades, commissions and fees paid by commercial property-casualty insurers to brokers and agents have dropped sharply, from 20 percent of net premiums in 1955-64 to 10.8 percent in 1994-2003, according to A.M. Best figures provided by the Insurance Information Institute. So the pressure for efficiency is real.

"Over the last five years, we are expected to do more of the work that they used to do, and at the same time they are reducing compensation," said William A. Lindberg, vice president of the Lindberg & Ripple Inc. agency in Windsor, which sells life and health coverage.

In the end, it's still a handshake business, and it's still in the best interest of agents to keep their clients happy. Wherever that's not true, customers should walk -- and the best thing to come out of this crisis is, they will.

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