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OVERSIGHT HEARING ON INSURANCE BROKERAGE PRACTICES, INCLUDING POTENTIAL CONFLICTS OF INTEREST AND THE ADEQUACY OF THE CURRENT REGULATORY FRAMEWORK

HEARING

BEFORE THE

FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

NOVEMBER 16, 2004

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OVERSIGHT HEARING ON INSURANCE BROKERAGE PRACTICES, INCLUDING POTENTIAL CONFLICTS OF INTEREST AND THE ADEQUACY OF THE CURRENT REGULATORY FRAMEWORK

TUESDAY, NOVEMBER 16, 2004

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL MANAGEMENT,
THE BUDGET, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:32 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Peter G. Fitzgerald, Chairman of the Subcommittee, presiding.

Present: Senators Fitzgerald, Akaka, and Carper.

OPENING STATEMENT OF SENATOR FITZGERALD

Senator FITZGERALD. This meeting will come to order. I would like to advise the panelists and the audience that the Democratic Senate Caucus has just called a meeting at 10:30 and so Senator Akaka will be somewhat delayed, but he intends to come here later.

Today, I conduct my final oversight hearing as a U.S. Senator and the hearing is on the growing controversy surrounding insurance brokerage practices and the impact of these practices on the consumer. I would like to welcome the distinguished witnesses we have with us today and thank them for taking the time out of their busy schedules to share their perspectives.

Today, we consider allegations that some insurance brokers hired and paid by their clients to represent them in procuring insurance suited to their needs have instead steered their clients to the insurers who are paying so-called contingent commissions, that is, commissions above and beyond their direct commissions that are based on volume or profitability of insurance business. In some cases, according to Attorney General Eliot Spitzer's lawsuit and the guilty pleas of certain broker executives, some broker employees have apparently even engaged in criminal bid rigging and price fixing. Everyone inside and outside the insurance industry condemns the criminal conduct and calls for its vigorous prosecution and punishment.

This oversight hearing breaks no new or interesting ground with respect to criminal bid rigging or price fixing. We do, however, critically examine the compensation structure of insurance broker-

age and we ask whether that structure poses unacceptable conflicts of interest and whether our current regulatory system is equipped to tackle that question with due regard for both free and fair markets.

My study of this insurance brokerage controversy convinces me that there is a Federal role, the time-honored Federal role that guarantees competition and fights the mischief of undue market concentration.

Contingent commission arrangements have been common and legal for decades. I believe it is no coincidence that the controversy of these compensation arrangements tracks the increasing consolidation of the brokerage market, especially the market for large corporate buyers. I believe it is no coincidence that Attorney General Spitzer first sued the largest market player in insurance brokerage, and I believe it is no coincidence that when Attorney General Spitzer first investigated contingent commissions pursuant to his powers under New York's Donnelly and Martin Acts, he appears to have discovered anti-competitive and even criminal abuses orchestrated not just by any random insurance broker, but by an insurance broker that controlled 40 percent of its target market.

By itself, an ordinary contingent commission seems unlikely to harm consumers or competition. Indeed, a broker who favored an inferior insurer merely because that insurer paid contingent commissions would quickly find itself swamped by competitors eager to provide a superior service to the broker's ill-served clients.

But that, of course, presupposes competition. What if insurance buyers with global insurance needs had little choice in selecting a broker? And what if insurers seeking global expansion of their business had little choice in accommodating a broker? In short, what if one or two global insurance brokers constituted a market bottleneck?

On the face of it, contingent commissions raise the specter of a conflict of interest. In any given instance of advising a client to purchase insurance from a particular insurer, has the broker provided that advice because it is in the best interest of its client or because the broker will be better compensated by this particular insurer under a contingent commission arrangement?

I believe it is mistaken, however, to look at contingent commission agreements in the abstract and draw sweeping conclusions from what first appears to be a misdirected incentive. Sales forces in many healthy, competitive industries enjoy incentive compensation or some form of profit sharing. The operative question should not be, could an unscrupulous broker theoretically steer business to an insurer despite the interest of its client and based on self-interest alone? The operative question should be, could a broker or a dominant group of brokers consistently get away with steering business to an insurer despite the interest of its client and based on self-interest alone?

If we answer the former question yes, then we have a breach of contract or perhaps a tort claim. If we answer the latter question yes, then we have a failure of competition. For failures of competition, our soundest antidote is antitrust law.

For nearly 60 years, since enactment of the McCarran-Ferguson Act of 1945, regulation of the business of insurance has been dele-

gated entirely to the States. The system of State regulation has worked well for many purposes, but State regulation purporting to govern global conduct may not always perfectly detect the abuses of daunting market power.

I believe it is time for Congress to revisit the antitrust exemption of the McCarran-Ferguson Act with respect to insurance brokerage and to make clear that vigorous Federal antitrust enforcement can and will reach the kind of anti-competitive conduct on the part of insurance brokers alleged in Attorney General Spitzer's lawsuit.

Furthermore, I see no continuing reason to shackle the Federal Trade Commission with an antiquated prohibition on even the mere study of the insurance industry. Until 1980, the Federal Trade Commission was empowered to study the industry and make policy recommendations. That year, Congress took away even that modest authority. The FTC enforces antitrust laws, among other charges. Declaring the FTC categorically unsuited even to peer at the insurance industry ignores the reality of national, indeed global, insurance markets, increasing consolidation in some market segments, and surges of centralized coercion that may not readily appear on the regulatory radar of any single State.

If we profess to favor free markets and robust competition, then we must equally favor their civilizing predicates, antitrust law and transparency. Healthy markets thrive on sunshine, and it has certainly been said of these contingent commission arrangements in insurance brokerage that disclosure is woefully inadequate.

We hear numerous calls for better disclosure of these compensation arrangements. But I will be especially interested in hearing from the witnesses exactly what form they propose for this better disclosure, and more fundamentally, whether disclosure alone is adequate to counter market concentration. Put another way, for those witnesses who promote greater disclosure as an adequate fix for this brokerage controversy, would you likewise support vigorous enforcement of Federal antitrust law to counter the leveraging of market domination?

I believe that transparency is an important and salutary measure. Depending on its form and content, it may be more than we need in markets that are competitive. But in markets that are not competitive, mere disclosure of a practice that a dominant company can demand may not be enough.

This oversight hearing occurs at an interesting time, not only because certain insurance brokerage practices have come under fire, but because Congress is increasingly focused on insurance reform. I will be interested in hearing the views of the witnesses as to whether they believe that this brokerage controversy lends more or less support to the optional Federal charter proposal, which would put insurance companies on a footing similar to banks in the ability to choose either State or Federal regulation.

And I will be interested in hearing the views of the witnesses as to whether this brokerage controversy lends more or less support to the proposal developed by the leadership of the House Financial Services Committee, the State Modernization and Regulatory Transparency Act, or SMART Act, a draft of which has been circulated by Chairman Oxley and Capital Markets Subcommittee Chairman Baker. The House Financial Services Committee has

conducted 16 hearings on insurance reform since the Committee's organization in January 2001 and I applaud the hard work of Chairman Oxley and Congressman Baker in this area.

At this point, I will save my introduction of Senator Akaka for later when he arrives and I would like to proceed directly to our first panel of witnesses.

Our first witness is the Hon. Eliot L. Spitzer, the 63rd Attorney General for the State of New York. Mr. Spitzer testified previously before this Subcommittee on mutual fund reform and we welcome you back here today. By the way, after you testified here, some of the larger mutual fund complexes, as you may have noticed, lowered their fees, at least on indexed funds, sometimes by four to five times, so congratulations. I think you had a significant effect that went well beyond your complaints.

On October 14, 2004, Attorney General Spitzer filed a civil suit against Marsh and McLennan Companies for alleged violation of State law regarding the companies' compensation arrangements. That same day, he also filed criminal actions against specific individuals in the insurance brokerage industry. Last Friday, November 12, Attorney General Spitzer filed a second civil suit against a California broker, Universal Life Resources, alleging that Universal accepted so-called override fees from insurers to steer business to them.

Our second witness is the Hon. Richard Blumenthal, Attorney General for the State of Connecticut. Attorney General Blumenthal has launched an investigation into insurance broker commissions and is seeking new State laws in this area. He was first elected to serve as Connecticut's 23rd Attorney General in 1990 and is currently serving an unprecedented fourth term. Prior to being elected Attorney General, Mr. Blumenthal served in both the Connecticut State Senate and the House of Representatives. Mr. Blumenthal also served as U.S. Attorney for Connecticut from 1977 to 1981.

Our third witness is the Hon. Gregory Serio, Superintendent of Insurance for the State of New York. He is here today to represent the National Association of Insurance Commissioners, known as NAIC. As New York Superintendent of Insurance, Mr. Serio is responsible for the monitoring and regulation of more than 1,000 insurance companies, with total assets exceeding $2 trillion. Mr. Serio previously served as First Deputy Superintendent and General Counsel of the New York Insurance Department and is Chief Counsel to the New York Senate Standing Committee on Insurance.

Our fourth witness is the Hon. John Garamendi, Insurance Commissioner for the State of California. Mr. Garamendi was first elected as Insurance Commissioner in 1991. He successfully implemented Proposition 103, which put into place a major reform of the auto and homeowners' insurance industry in California. In 1995, President Clinton appointed Mr. Garamendi as Deputy Secretary at the U.S. Department of the Interior. He was elected to a second term—I guess you came back and were elected to a second term as California's Insurance Commissioner in 2003, and last month, he proposed regulations that would require disclosure of certain financial incentives received by insurance agents and brokers.

Again, I would like to thank you for being here to testify. Mr. Garamendi traveled for 5 hours to get here, all the way from the Golden State, and we know it takes a lot of time to come to Washington to testify. We appreciate it.

In the interest of time, we will include your full statements in the record and we would appreciate it if you could limit your opening remarks to 5 minutes. We will have a light that is at your table that will kind of keep track of the time.

Attorney General Spitzer, welcome again to the Subcommittee. We really appreciate your help and I compliment you on the outstanding job you have been doing. You have been breaking new ground in many different areas and I admire your courage and tenacity. So thank you for coming before us.

TESTIMONY OF HON. ELIOT L. SPITZER,[1] ATTORNEY GENERAL, STATE OF NEW YORK

Mr. SPITZER. Mr. Chairman, thank you very much for your kind words, and in particular, thank you for your leadership on these issues. They have not always been easy issues, but you have played a unique role in leading Senate inquiries into critically important areas in the financial services sector and I am tempted just to adopt your statement as my statement and then leave it at that. It was right on point, in particular your statements about McCarran-Ferguson, the FTC, and the need for Congressional inquiry. I will get there in a moment.

To quote but amend Yogi Berra, this is deja vu all over again one more time. This is the third time we have seen the same story. We saw it with analysts at the investment banks. We saw it with mutual funds. Now we see it with the insurance industry. There are common elements to each of these three stories and I will very quickly run through them.

In each instance, we have seen the financial services sector incapable of resisting a conflict of interest. In every instance, it has capitalized on that to the detriment of those to whom it owed a duty of care. Indeed, at one point, we all know the famous comment from one Wall Street analyst who said what used to be viewed as a conflict of interest is now viewed as a synergy and they simply do not understand the difference.

Second, in each instance, each of these three story lines, there has been an abject failure of self-regulation. Nobody came forward to say there is a problem, there is an issue with respect to steering, bid rigging, conflict of interest that run deep in the industry, just as nobody came forward with analysts or mutual fund scandals.

Third, there has been a failure of the regulatory entities that are supposed to oversee the sector. They failed to ask even obvious questions that would have revealed deep-seated problems.

Fourth, we have had continuing claims of purity and excessive regulation, and indeed claims of intense competition from industry leaders up until the point that the allegations were leveled.

And finally, we had dramatic mea culpas only once they were caught.

[1] The prepared statement of Mr. Spitzer appears in the Appendix on page 55.

This is a story line which would be tiresome and grow wearisome over time. Indeed, we have seen it in other sectors, as well, most notably the pharmaceutical sector, but since we are here to discuss financial services, I will not verge into that.

Let me describe very quickly the sequence of our—the progression of our inquiry, and it began with simply a letter which notified us that there were PSAs, MSAs, contingent fees which are, as you said, Mr. Chairman, not in and of themselves improper. But given the magnitude of these fees, we simply made an open-ended inquiry to Marsh and McLennan and asked them, how do you ensure that these fees do not taint the decisionmaking that you endeavor to make on behalf of your clients?

We were told two things. First, there is adequate disclosure. And second, there is no information flow within the company such that the front-line brokers who were making the decisions about what products to recommend don't even know what the contingent fees are, and therefore, we were told, they cannot be influenced.

We learned very quickly that the claim of adequate disclosure was simply false. The disclosures that are made are not only grossly inadequate, they are often misleading, and indeed the companies, and I say that plural, intentionally make it difficult for their clients to find out what MSAs, PSAs, or overrides are paid because they do not want that information to be made available.

We went back to the company and said, give us more information. They said, well, nonetheless, even if the disclosure is not adequate, there is no information flow, and, of course, we found out very quickly not only was it impossible to cabin information relating to an $800 million revenue flow within the company, but there were specific instructions to the brokers to steer business based upon the magnitude and the relative value of the override payments and contingencies.

We dug even further and we were told by the company in response, well, maybe there is steering, but there is no steering to detriment, a comment that seems blatantly contradictory on its face. If you are steering, it is necessarily steering to detriment. We then said to them, how can that be, and they said, well, only if there are identical proposals for an individual client would we choose based upon the MSA, and we said that is somewhat ridiculous, and indeed it is.

We then dug further, asking the last logical question, because, of course, if I have a fiduciary duty to a client, I don't want that client to see different bids in the file and to have the client see that I am not picking the best bid. So necessarily, then, you begin to act in a way to ensure that only the bids you want end up in the file. And so we inquired of the carriers, do you have any information for us that would indicate bid rigging in the system? Forty-eight hours after we served that interrogatory on the carriers, lo and behold, our phone started ringing and we were the recipients of remarkable information about the bid rigging scandal that we have seen as a consequence.

There is liability that extends to brokers. There is liability that extends to carriers, civil and criminal. As you said, there have been criminal pleas entered. There will be more criminal pleas entered very shortly, perhaps as early as today, from another carrier. That

is ongoing as we speak. And we are finding undisclosed relationships that clients simply would be appalled to understand if they had ever been told.

The impact on our markets is enormous. The insurance sector is vast. The numbers are laid out in my testimony. And it has indeed become part of our political discourse over the past few years that the impact of rising premiums has been a tremendous drain and disincentive for the creativity of our capital markets and businesses in general.

Unfortunately, we have not heard that one of the reasons the premiums have been rising has been the collusive behavior, illegal behavior, of brokers and carriers, behavior that they understood that they simply refused to detail to the public.

Let me say, Mr. Chairman, I think there are four discrete areas where Congressional inquiry would be terribly useful, inquiry that is necessary for Congress to undertake, because frankly, I think only Congress has the capacity to reach the subpoena power to really delve fully into the breadth and scope of the issues before us. With all due respect to my fellow regulators at the State level who have done, in many ways, a very good job, these are issues that Congress must begin to inquire into.

The first area relates to the massive insurance capital flow to offshore vendors. Why is it that suddenly Bermuda is the home to so many insurance carriers, reinsurance carriers, brokers? Why have we seen such massive capital outflow from the United States, where there is regulatory authority for the States to exercise, to venues where the insurance carriers, the reinsurance carriers, and the brokers intentionally secrete themselves in ways and in areas that we cannot inquire into? There is, I would suspect, a Pandora's box that should be opened so we can understand what is going on in these offshore venues. It will not be a pretty picture.

Second, we need to scrutinize the wide-ranging interlocking relationships that have been revealed just from our superficial inquiry among brokers, insurance carriers, reinsurance carriers, reinsurance brokers. There is a multi-layered stream of income that flows to these companies, often with common ownership, that is simply not understood, that is not revealed, that has every indication of being corrupt and anti-competitive. It is an ugly picture.

Third, how are premiums being set? We hear much that is said about their huge losses. We see premiums spike. But I don't think we really understand the true finances of these companies. Part of the reason is they have secreted assets overseas. They have hidden them offshore. It is about time that we get accountability. The only way is to delve into, in a much more serious way than has ever been done, the way they set their fees.

Finally and fourth, I would suggest that there should be a fundamental inquiry into the ethics of an industry that needs to be fundamentally scrutinized. Just as has been the case with every other scandal that has come before us, the failure of this industry at any point to put up its hand and say, we have a problem, their willing, rapid descent to the lowest common denominator of behavior that is criminal, violates common decency, is appalling. This is an industry that has for years claimed purity. Once again, we are seeing

that the more profound their claims of purity, the more profound the heinous behavior we find. Thank you very much.

Senator FITZGERALD. Thank you, Mr. Spitzer. Mr. Blumenthal.

TESTIMONY OF HON. RICHARD BLUMENTHAL,[1] ATTORNEY GENERAL, STATE OF CONNECTICUT

Mr. BLUMENTHAL. Thank you, Mr. Chairman. I would like to join General Spitzer in thanking you for your leadership, your courage, and your tenacity as a leader of this Subcommittee and I am chagrined to hear that we are at your last hearing, but I hope it is a meaningful one and I know that your leadership will be much appreciated in this body.

I would like to thank my fellow panelists, most particularly General Spitzer for his leadership in this area. Each of them has played a role and I am honored to be with them on this panel.

In Connecticut, we have an investigation that is separate and distinct, has involved some 43 subpoenas beginning in October. Even earlier, we issued letters of inquiry. The scale and magnitude of corrupt practices and unethical conduct continue to mount. Increasing evidence of those practices certainly means that fundamental reform is necessary, more than simply disclosure, as you quite rightly suggest.

The evidence of illegal and harmful conduct, harmful not just to individual consumers but to our entire economy, mandates that we act decisively and dramatically to restore the credibility and trust in this industry and in the regulators who have a responsibility to oversee and scrutinize it. What we have seen in our investigation is evidence of bid rigging, fraudulent concealed commissions, secret payoffs, and conflicts of interest, all stifling competition and inflating the cost to consumers as well as businesses.

There will be a barrage of well-aimed, powerful State enforcement actions. They will involve more than one State. We are now seeing a multi-State response to this crisis, and even as we speak, there is communication and growing cooperation among those States to address this problem.

Our aim is to pursue these actions promptly and aggressively, not to be diverted by any voluntary changes on the part of the industry, but uncover all the wrongdoing and recover ill-gotten gains for consumers. Restitution is a vital objective.

But reform is also an important goal and I want to be very straightforward with this Subcommittee. I welcome the idea of changing Federal antitrust laws so as to enable and encourage Federal enforcers to play a greater role and I welcome the inquiry that the Congress may make in regard to the areas that have been concealed. But I would strongly resist, indeed, the States will fiercely fight, any effort to preempt them or supplant them or prevent them from protecting their consumers. Antitrust has been traditionally a strong and vital role for the States. Consumer protection in the insurance industry has been traditionally and historically a State responsibility. And so while we may fervently hope for cooperation, we would fiercely fight any preemption.

[1] The prepared statement of Mr. Blumenthal appears in the Appendix on page 72.

On the other hand, while federalizing the problem is not a solution, States must reform their own houses and stronger State laws are necessary. I want to commend Insurance Commissioner Garamendi for his leadership in this area, and my testimony sets forth some very specific proposals that go beyond disclosure, although they focus also on disclosure, full and complete disclosure, when a broker, for example, is compensated by both the insured and the insurer.

I believe there must be consumer choice to have a broker represent him exclusively. There must be a code of ethics that is binding. There must be other reforms that mandate better practices, forbid conflicts of interest and provide the policing and resource authority that is necessary.

So I think that State insurance laws must be reinvigorated and reinvented so that they are real agents of reform and insurance commissioners cease to be captives of the industry as they have been all too often in the history of insurance regulation.

Federalizing the problem may not be a solution, but the States must do a better job in protecting consumers. I welcome this opportunity and hope that it is the beginning of a constructive dialogue between the States and the Congress on this subject. Thank you very much.

Senator FITZGERALD. Thank you, Mr. Blumenthal. Mr. Serio.

TESTIMONY OF HON. GREGORY V. SERIO,[1] SUPERINTENDENT OF INSURANCE, STATE OF NEW YORK, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. SERIO. Mr. Chairman, thank you. The events of the past month have shone a bright and rather unflattering light upon the insurance industry. Compensation arrangements that smack of bid rigging, of steering, of favoritism are wrong and they have always been wrong. The industry has tried to split legal hairs to say that alternative compensation arrangements are lawful, but they seem to miss the point when they do that. There are serious endemic problems inside the industry that have only now been uncovered.

The use of PSAs, MSAs, and other contingency arrangements and how they have been used in insurance brokering for overtly or implicitly influencing basic insurance transactions for the benefits of the broker and/or the insurer and to the detriment of the insured is wrong and has always been wrong. Failing to disclose these arrangements to commercial buyers only makes that matter that much worse.

For brokers and carriers, the test was and always is a straightforward one. Have they acted in the best interest of the consumer, or could their acts be seen to constitute a conflict of interest? Frankly, putting it more bluntly, we would ask, would the consumer of the insurance product object to the fees and the additional costs if they knew about them, and would they object if they knew that the compensation arrangement figured prominently into the recommendation to make a certain placement?

This test, applicable to virtually every broker-driven insurance transaction, is particularly crucial to the integrity of the insurance

[1] The prepared statement of Mr. Serio appears in the Appendix on page 77.

transactions that take place at supposedly sophisticated levels where by law there has been minimal regulatory authority or legal standards defining the four corners of the transaction. Yet time and again, brokers and carriers both ignored the test, thereby ignoring the best interests of the insurance buyer.

The insidious nature of the transgressions, together with an apparent "go along to get along" attitude on the part of the carriers and even some buyers has turned the legal actions taken so far into a rocket fuel for changing the course of public policy. Brokers and insurers are even racing to disavow PSAs. At this point in time, though, we are not satisfied with simply undoing the inappropriate behavior. We want to take the opportunity to effectuate real and meaningful change and improve the integrity of the market and better protect all consumers at all levels of sophistication.

This industry has earned a sweeping reform, whether through legal and regulatory action taken so far or future legislative action. And frankly, the professional insurance buyers have also earned some of the reforms that will be coming down the road.

The NAIC, which has spearheaded a multi-year effort to uniformize rules for the licensing and regulating of brokers, proposed a new rule for the disclosure of all compensation the producer receives from an insurer in the placing of business. Furthermore, to make certain that insurance buyers are indeed active participants in the insurance transaction, the NAIC proposed that buyers provide written consent for the producer to receive any contingent compensation. The NAIC is also coordinating a nationwide information network for people to provide online tips to the insurance commissioners around the country to register complaints regarding broker activities.

The NAIC's member insurance departments discipline brokers and agents every day for violating the respective duties they owe to their clients. The regulatory actions are taken after investigations, are usually started with a complaint, are usually from insured or from information gained from tips or from information gained during other regulatory activities.

The specific actions taken in New York over the past month by the Insurance Department relating specifically to broker compensation, the citing of 15 separate Marsh entities and the flagging of all licenses associated with Marsh, the citing of ULR and its principal, and the expected increase in regulatory activity over the coming weeks arose out of the collaborative efforts between the New York Insurance Department and the New York Attorney General. This matter originated with a single and specified complaint to the Department by a carrier and accelerated into the investigation it is today through the filing of very specific complaints by others with the Attorney General.

In fact, I have to agree with the Attorney General that the industry has not been forthcoming on providing specific information about these problems. Indeed, we had to take what would be called the slow road to our examination, our early examination into the use of PSAs because the very complainant who brought an initial complaint to us, a competitor in the marketplace, failed to provide the Department with the kind of information that would have led us down this path.

It has been because of the Attorney General's powers as the chief law enforcement officer of the State as the appropriate lead agency on this matter, given his broader legal powers, his greater investigative resources, and frankly, his tireless pursuit of cases of this nature, and the Department has been in every respect a full collaborator on this and on many other matters that we have undertaken jointly over the past several years.

The State regulatory system, insurance regulators and law enforcement together, have worked to reveal these problems in the marketplace. Though people will still be tempted to declare this a crisis of regulation or to declare an acute need for wholesale Federal intervention in the regulation of insurance, these should be avoided as the only responses for these reasons.

The insurance industry, as the preceding speakers have said, more than regulation itself, needs modernization. An industry that does not provide a written contract at the time risks are bound needs to be modernized. An industry whose executives are afraid to sign certifications stating that their regulatory filings comply with the law needs to be modernized. An industry that has sought Federal legislation as much to escape regulation as to improve its own efficiency and efficacy needs to be modernized. And certainly an industry that finds itself facing questions of fundamental fairness in its treatment of customers needs to be modernized, no matter how small or compartmentalized the problem may seem to be. I agree with Attorney General Spitzer that it is not a small or compartmentalized problem at all.

The modernization will come from the legal and regulatory actions now being taken. It will come from the NAIC. It will come from Commissioner Garamendi and our colleagues at the NAIC. And the Congress' own deliberations on SMART, which has been moving, to provide uniformity of rules across State lines will also be an important component of this.

The Congress' recent work in the area of military sales of life insurance could well provide a workable model of joint Federal-State regulation. Federal declarations of the authority of State insurance departments to regulate insurance sales, together with oversight, is a good way to go about this.

Much of the modernization, though, will still have to come from the industry itself. I noted to the Senate Banking Committee back in September that Federal regulation has not been the missing link in the efforts to modernize insurance. Rather, the absence of an industry-wide self-regulating mechanism promoting the highest and best standards on corporate governance, market conduct, and financial safety and soundness represents a significant hole in the insurance regulatory construct.

Creation of an industry compliance model is a priority. Taking the steps within property casualty that were taken by the life industry after the illustration scandals of the early 1990's is an imperative. Joining in a property casualty industry-wide organization is overdue. Acceptance of a 21st Century regulatory structure allowing State regulators to peer beyond the four corners of regulated entities into the 21st Century corporate structures that own or control these regulated entities will be the first measure of good faith that the industry can exercise to let us know that they are

serious about putting the current matter behind them and taking some personal responsibility for how they operate as corporate citizens in the months and years ahead.

I look forward to your questions.

Senator FITZGERALD. Thank you very much. Mr. Garamendi.

TESTIMONY OF HON. JOHN GARAMENDI,[1] INSURANCE COMMISSIONER, STATE OF CALIFORNIA

Mr. GARAMENDI. Thank you very much, Mr. Chairman, for the invitation to appear. This hearing is extremely important. You have my written testimony. I will summarize it and add a few additional comments.

There has been much discussion in recent weeks, particularly since the election, about values, about morality. It is rather narrowly defined. Unfortunately, we are faced with a situation here of values. We are faced with a situation of ethics. And above all else, just flat out greed. It has to be addressed.

This issue is not new, as Attorney General Spitzer pointed out in his opening remarks. It is found pervasively throughout corporate America. This country, this economy will not prosper and will not move forward if there is no trust in the basic systems that we must have. So we must go further.

I don't know where this is going to end up. We are in the opening pages of a very long and sordid chapter in America's corporate life and we have to change it. We absolutely must. Otherwise, we are going to have a series of problems. We simply cannot have economic growth without a sound, viable, readily available, competitive and fair insurance system. It is one of the fundamental building blocks of economic systems and particularly the American system.

We will, in California, continue our investigations, both with the Department of Insurance effort of investigating. We will be bringing lawsuits against numerous brokers as well as insurance companies. Those are underway. Those will be coordinated with other States. We are already coordinating with the New York Department as well as Attorney General Spitzer and we will see much more coordination among many departments of insurance across the Nation as well as Attorney Generals.

You will have over 100 investigative agencies on this issue. All the various departments of insurance, 50 of them, plus a couple of districts—one district and some territories will be engaged, and Attorney Generals. That is a very formidable enforcement action that will take place, and I suppose that eventually the Federal agencies will wake up and get at it, also.

In California, beyond the investigation, we have the lawsuits that we will be pursuing. We are also pursuing a very vigorous effort to rewrite our regulations. This is not going to require new law. The laws have been in place for a long time. They basically say that a broker owes its allegiance to the consumer, to the customer, whether that be mom and pop on the corner or in the home or a major corporation. It is that breach of fiduciary responsibility that is at the heart of this problem.

[1] The prepared statement of Mr. Garamendi appears in the Appendix on page 92.

To better illuminate and to provide a bright line, in California, we are writing new regulations to do just that, to illuminate and to clarify, and I will very briefly go through that for your use here at the Federal level. This particular regulation is becoming the starting point for the National Association of Insurance Commissioners to develop a draft model law or regulation as may be required by the various States, and that process is moving along very swiftly and I would expect it to be completed at the December meeting of the NAIC.

So here is what we propose to do in the regulatory process. The intent of it, and the language follows along, is to require disclosure of all compensation a broker receives from any party, including an insurer, in connection with the placement of insurance on behalf of a client. Pretty simple, should have been done, hasn't been done.

Second, to prohibit a broker from putting his own financial interests ahead of a client's by, for example, failing to obtain quotes for insurance from a reasonable number of insurers able to meet the client's needs because the broker has an agreement to receive compensation from other insurance or from a specific insurer.

Third, failing to present an offer for an insurer to be able to meet the client's needs because the broker has an agreement, MSA or a contingency commission. And fourth, recommending that a client accept an offer from an insurer because a broker has an agreement to receive compensation from that insurer when another insurer has made a superior offer.

It would seem to be that these would be uncontroversial and should not be imposed by anybody. It is simply a matter of fairness, competition, and open markets. As I have said, I believe that there has been a need to clarify. Yet, you are going to hear from the industry objections and I want to respond to those objections right here and tell them they are going to have a big fight.

First, the objections are these. With respect to the disclosure of the amount of commissions, brokers and agents will ask, well, why should we have to disclose the amount of the commissions? Most salespeople in other industries, they don't say what their commissions are, and they don't say where they are getting their money. The answer is this. Buying insurance isn't like buying groceries. It is not like buying a car. Security brokers and real estate brokers are required to disclose the sources and insurance salespersons and brokers should, also.

Second, you are going to hear, why do these only apply to brokers? Why not to agents? The answer is fairly simple. Agents have a specific—they work for the insurance company. They don't work for the customer.

Third, you are going to hear that how could we disclose the amount when we really don't know what it is going to be, because, after all, these are contingencies. Well, make a good guess to fully disclose everything you know. Even though it may not be totally accurate, at least the customer will know where you are getting your money.

And finally, and this is probably going to be the biggest fight that we are going to have, brokers and agents will complain, oh my, you are imposing an impossible obligation on us. You are asking us to tell the customer what is suitable or what is the best

available option and there are too many factors for us to do that. These are supposed to be professionals. These are supposed to be people that know the market. And to simply be able to apply their judgment, their best judgment, is not an impossible task and they are not going to face any more lawsuits in this area than they would in some—and that they already might, and certainly by not disclosing and by steering, they are facing some very serious lawsuits.

We are not holding the broker to an obligation to find the very best policy, but rather it is the broker's duty to take all reasonable steps to determine the client's needs, to use its expertise in the best manner possible, and to make a recommendation based upon their experience and knowledge, and to keep their finger off the scale. That is what this is all about. It is about ethics and it is about fiduciary responsibilities.

Thank you, Mr. Chairman.

Senator FITZGERALD. Well, thank you all very much. I want to begin by following up with Mr. Garamendi's discussion of fiduciary responsibilities. Isn't one of the problems here that under the laws in most States, insurance brokers aren't actually treated as fiduciaries? In fact, my understanding of New York law is that they are not fiduciaries typically and that the courts, New York courts, have held that insurance brokers are actually—they are not even professionals, they are mere order takers and it is only when they engage in certain types of conduct where they can rise to the level of fiduciaries and owe their clients fiduciary duties.

I think Mr. Spitzer's complaint in the *Marsh vs. McLennan* case is careful to cite all the advertising that Marsh and McLennan had done in which they are advertising how they are going to serve the client and they are going to try and get the best deal for the client, and you find the duty arising out of some of their statements. I believe they probably did develop a fiduciary duty with those statements that they make.

But shouldn't consumers around the country be on guard that their insurance agent is not like their lawyer, who owes them a fiduciary duty? It is not like the trustee or the trust department at the local bank, which has a duty to avoid conflicts and has a duty to avoid self-dealing and to treat their clients' money as they would their own, or with a higher degree of care than their own, even. Insurance agents typically aren't fiduciaries and you have to be very careful dealing with them.

Mr. GARAMENDI. Mr. Chairman, if I might, in California, we do have a dual law that allows a person to be both a broker and an agent, but there is a very clear distinction. In our proposed regulations, we make it clear what that distinction is. It is not a new distinction. It is based in our law as well as in the various court decisions that have come down over the decades, and that is that a broker—a salesperson becomes a broker when they offer their services on behalf of the client. That is, they work for the client, the customer, the individual——

Senator FITZGERALD. And you are proposing making them fiduciaries in that instance, is that correct?

Mr. GARAMENDI. They already are fiduciaries——

Senator FITZGERALD. They already are.

Mr. GARAMENDI [continuing]. In that instance, both under California law and under the various numerous court cases in California. We are not changing it, we are simply clarifying, making it clear that that is the situation. So when they offer their services to the customer on behalf of the customer, on the other hand, an agent is working for the insurance company. There is a clear distinction, at least in the California situation.

Mr. BLUMENTHAL. You are correct, though, Senator, that in most States, including Connecticut, there really is no unequivocal explicit fiduciary duty and that is one of the problems in the State laws and the lack of definition as well as the blurring of lines between agents and brokers in many States' laws. Under the model act that the insurance commissioners themselves devised in past years, the Model Insurance Act, the Insurance Producers Act, in effect contributed to the blurring of lines between agents and brokers and to the evaporation or the lack of——

Senator FITZGERALD. So that model act is a problem because it blurs the line. How many States have adopted the model act?

Mr. BLUMENTHAL. Exactly, and the kinds of reforms that are being suggested by Commissioner Garamendi will help, I think, lead us out of that morass.

Senator FITZGERALD. But they need to be adopted not just in California and Connecticut. We need to see it changed around the country. Mr. Serio, do you care to comment?

Mr. SERIO. I think that it does need to be changed around the country, but I think that defining the fiduciary duty and making it binding has to be one central objective.

Senator FITZGERALD. But making these brokers fiduciaries imposes a lot of new duties and there are a lot of brokers—real estate agents, they are probably not fiduciary duties. I would imagine the average person out there, if you are going to get a real estate lease and say you are a small company and you go to some real estate brokerage firm, they could well be steering you to a building where the building owner is giving them a kickback for steering you into that building. You don't know who they represent.

Mr. SERIO. Let us back up a little bit. We don't want to get caught up in the idea of whether the threshold is to be a fiduciary duty or not. They are licensed entities, these brokers, and in New York, we do have a bifurcation between agents and brokers and they do hold separate licenses, so it is a little bit clearer in our jurisdiction as to what banner they are flying under. It doesn't dissolve the overall question of compensation, but it does at least make it a little bit clearer.

But here is the thing. We take regulatory action against brokers every day. We suspend licenses, we revoke licenses, we fine them, not because they have violated any fiduciary duty but because they have violated the standard of trustworthiness——

Senator FITZGERALD. What is the standard of trustworthiness for a broker?

Mr. SERIO. That they did not act in the best interest of their customer, that they have not operated in the body of law that we have and the fact patterns that are presented to us——

Senator FITZGERALD. So if they are steering their customers to carriers who offer them, the brokers, a bigger commission, they are violating their duty to their——

Mr. SERIO. That would be accurate.

Senator FITZGERALD. In all cases?

Mr. SERIO. And this is the concern that we have had with this entire situation, is that no customer complaints ever came in on this issue. The carriers did not come forward to tell us about this. And frankly, inside, I am told certain people went to the Attorney General's office. We did not even get an inside view from anybody as to how these were operating. But in your normal mom and pop operation, when somebody is not happy with the way that their broker treated them, they make a complaint to the Insurance Department——

Senator FITZGERALD. Now, you said that on November 5, you made a statement that for some reason, the customers of insurance brokers were mute on this. Why do you think they are mute?

Mr. SERIO. Not only have they been mute, but they are still mute on this issue.

Senator FITZGERALD. Are they terrified of Marsh and McLennan and AON?

Mr. SERIO. We have been given some off-the-record conversations with individuals who said some of the buyers are embarrassed that they didn't see this happening, that they didn't say something about it when they did see it happening. There are buyers who were told about contingency fees or were told they were not going to be provided information on contingency fees and they did not——

Senator FITZGERALD. So they were embarrassed they were snookered.

Mr. SERIO. And that they didn't do anything about it.

Senator FITZGERALD. OK. Mr. Spitzer.

Mr. SPITZER. Mr. Chairman, you are correct. Additional clarity about the precise contours of fiduciary duty and when it is triggered would certainly be helpful. Obviously, as you pointed out, in our complaint we allege that a fiduciary duty existed based upon representations that were made by Marsh individuals to their clients, and therefore the client could suppose and legitimately rely upon the Marsh individuals to act in a fiduciary capacity.

I would add this other point, however, and I think this is to a certain extent what Greg was hinting at. The nature of the violations that we are alleging and that have been plead to and have been confessed to by individuals in court do not depend upon there being a fiduciary relationship. In other words, this is common law fraud. This is a violation of more common law, traditional responsibilities that are incurred even if they do not rise to the level of fiduciary. That is why the issue of steering and bid rigging and the undisclosed payments are so surprising and appalling to all of us. Even in the absence of the fiduciary duty, those would constitute violations.

One last point with respect to the mutinous of those who were allegedly the victims. I do think that we are now seeing behavior in the marketplace, and this, I think, proves the point that we all agree upon. Where this behavior is disclosed, where there is ade-

quate opportunity and information flow for the purchasers of insurance to make informed judgments, they will do so. I have heard and have reliable information that there is now a very significant push back against the brokers by the major purchasers in various lines of insurance to ensure that they not only get full information, but that they eliminate the type of behavior that is injurious to the consumer.

And so while we may not have seen and did not see—and Greg certainly is right about this—consumers running to regulators complaining, we are now seeing them act in their economic self-interest, which is exactly what we want to permit them to do by mandating disclosure and prohibiting certain types of relationships.

Senator FITZGERALD. Now, following up on the nature of the allegations in your complaint, some commentators have made light of your complaint and said, well, the only thing you found that was illegal is bid rigging and everybody agrees it is illegal. So what? But when I read your complaint, I found that you have six counts, I believe, and you found a whole lot more than bid rigging. Maybe you would want to elaborate on that.

Mr. SPITZER. Absolutely. Bid rigging is perhaps the most egregious and the most immediately violative area where we found behavior because it is so clearly corrosive to the marketplace. Steering is in and of itself a violation of law, because when the companies steer, they are making a judgment that is not in the interest of their client and they are making it for the improper purpose that they are receiving undisclosed additional compensation.

I have not heard, and maybe you will hear it today from witnesses for the industry, I have not heard a single industry voice say steering is OK. Steering is wrong. Steering should not be permitted. We have senior executives under oath. When they see the E-mails—E-mails relating only to steering, where they say they are appalled, it should not happen, it should not be permitted. Strip out the bid rigging component of that. That was really the third layer of the onion. Steering is the second layer of the onion, and it is sufficient to say these companies have violated their duty. This behavior cannot be permitted to continue.

Senator FITZGERALD. Very analogous to the revenue sharing we saw with the mutual fund industry.

Mr. SPITZER. Absolutely correct.

Senator FITZGERALD. And you found instances in which Marsh and McLennan actually took existing clients who were already placed with a given insurer and you had Marsh and McLennan pressuring their clients to move their existing policies to some other company that was going to pay them a higher contingent commission, is that correct?

Mr. SPITZER. Yes, sir. And, in fact, the most—that is correct. We saw oversteering predicated solely upon the overrides that were being paid, and we also saw Marsh indicating to certain carriers that they should increase their bids so as to eliminate the possibility that the coverage would go to a carrier which was not going to pay them as much. I mean, the E-mails where they say, please increase your bid because we want the business to stay here or move, there is appalling stuff, and yet that is what we were finding.

Senator FITZGERALD. And you also state a count for securities law violations.

Mr. SPITZER. Absolutely.

Senator FITZGERALD. Do you want to go into that and explain how you arrived at that?

Mr. SPITZER. Sure, because there are disclosure violations. There is a duty to disclose to investors what the basis of the revenue stream is. Here you had a company that was deriving $854—I think that is the right number—$854 million in revenue from contingent fees, the basis of which was not disclosed and the inherent illegality which was not disclosed.

Senator FITZGERALD. And in fact, when they were asked about it by analysts on conference calls when explaining their quarterly earnings, they refused to go into it, isn't that correct?

Mr. SPITZER. They not only refused to break out the revenue that they derived, but they claimed that it was too murky and impossible to break out the distinct revenues that flowed from the contingencies when, in fact, internal to the company they had a very careful accounting that defined precisely where the contingencies came from, how to maximize them, and were acting as one would expect, in a way to increase the revenue that was generated.

Senator FITZGERALD. And this was very relevant information for investors and the analyst community because I think just a few months before, a J.P. Morgan—I believe it was a J.P. Morgan analyst—had written a whole thing about the dependency of the insurance brokerage market on contingent commissions and this analyst questioned whether contingent commissions would still be allowed after we were just uncovering similar conflicts in the mutual fund industry. And still, Marsh and McLennan was refusing to answer questions about——

Mr. SPITZER. That is correct, and just to show that I can say favorable things about that analyst, that indeed was a very prescient report where the analyst not only focused on this issue, raised the regulatory risk that Marsh was facing, but also quite accurately predicted where the stock would move in the event that there was any regulatory effort to disallow the revenue streams that he was talking about.

Senator FITZGERALD. Now, do you think that these sorts of abuses could have occurred if Marsh and McLennan only had, say, 8 percent of the market as opposed to 40 percent of the market? You have an extremely concentrated insurance brokerage industry in America. There were a lot of acquisitions during the 1980's and 1990's whereby the bigger players got bigger and bigger, Marsh and McLennan and AON being the two largest. They bought up a lot of smaller brokerage firms. Today, those two have about 70 percent, I am told, an estimated 70 percent of the commercial insurance brokerage market for large companies. I guess that would be Fortune 1,000 companies they are referring to.

For some reason, Fortune 1,000 companies, why don't they go to a smaller insurance brokerage agency? Why do they feel compelled to use the biggest?

Mr. SPITZER. Let me make one observation, Mr. Chairman. I think you are exactly correct. Certainly, the market power that Marsh had in certain cities and in the market writ large contrib-

uted to its capacity to extract the overrides. Having said that, there are much smaller companies that receive a larger percentage of their revenue when you look at their total revenue and look at the overrides that they receive, a larger percentage of their revenue in the overrides.

I do not agree with you, however, that Marsh would have been in a position to structure the illicit relationships that it had absent market power. The steering, and then the bid rigging, were dependent upon its capacity to foreclose clients from seeking other brokers who might have provided access to the insurance they needed. So I believe that it is market strength that was a necessary prerequisite to the structure that we have seen.

Mr. SERIO. And that market strength came, not just from the brokering of insurance business, but from the related services and the related organizations that the Marsh entity had acquired over the years to make it essentially a one-stop shopping opportunity for a lot of large companies.

Senator FITZGERALD. And those other entities are Putnam mutual funds——

Mr. SERIO. Mercer, risk services, and all these other entities that don't fall underneath any one regulatory umbrella. You were speaking a moment ago about the financials of the large brokerage and whether this would have been revealed at some point earlier if the financials of Marsh or of other large brokerages are actually examined on a periodic basis the way company financials are examined on a regular basis.

Brokers are not inside that regulatory paradigm, however, and they largely operate, save for their market conduct activities and their relationship to their clients, there really are no other regulatory nexes between the brokers and the insurance regulators around the country. Perhaps if they were on a regular schedule of financial examinations, those glaring deficiencies in explaining where so much of their revenue source was coming from may at least have been identified earlier, if not acted upon earlier, if the brokers were under the same regulatory regimen that the companies are under.

Mr. SPITZER. Can I add one last thought——

Senator FITZGERALD. Yes.

Mr. SPITZER [continuing]. Because I think this interlocking set of relationships really is at the essence of it and it is not only across a horizontal line to Mercer and to perhaps mutual funds, but really even within the insurance sector you have brokerage, you have investments that are made by the companies themselves and underlying carriers. You have investments in reinsurance brokerage and you have investments in the reinsurers themselves.

And so you have these four pieces that all fit together with common ownership that we just don't understand, and I think it is not only market strength in terms of the 40 percent you cited in terms of the brokerage business, but also what market strength do they garner by virtue of the vertical relationships to insurers, reinsurance brokerage, and then reinsurers themselves. I think that dynamic is one that needs to be——

Senator FITZGERALD. Yes. Does anybody care to comment on the reinsurance business? Apparently, both Marsh and McLennan and

AON set up reinsurers, offshore, I believe, in the case of AON, in Bermuda, and——

Mr. BLUMENTHAL. I would like to add a thought on this, what is fundamentally an antitrust issue, before we move on. I think it ties directly to the point you were raising and the reason that we are here today. The remedy here has to be stronger antitrust enforcement. If nothing else emerges, and a great deal will besides this point, the scrutiny has to be to the size, dominance, market power of these companies, and it has to be an ongoing——

Senator FITZGERALD. Of the brokers? Or are you saying of the insurers, as well?

Mr. BLUMENTHAL. Both. And the interlocking relationships at various levels. That is why ongoing scrutiny is so important, and that may be where the Federal Government ought to have a role.

Senator FITZGERALD. Well, let us talk about that for a second. The McCarran-Ferguson Act of 1945 exempts the business of insurance from antitrust regulation with a few distinct exceptions, such as boycotts and a couple other things. It is not clear to me whether the McCarran-Ferguson Act exempts insurance brokers from Federal antitrust regulation. The language is the business of insurance, and clearly it covers carriers.

Would it make sense to amend the McCarran-Ferguson Act—it would be very hard to ever repeal the antitrust exemption with respect to insurance carriers. If you see all the insurance industry people in this room, you would understand why, and there are other good reasons, actually, to allow companies to share underwriting information with each other, losses, age groups with buying cars or driving cars. But let us just focus on insurance brokers.

Is there a reason to have the insurance brokerage industry exempt from antitrust laws? Shouldn't McCarran-Ferguson be amended to make it clear that exemption from antitrust laws only applies to the carriers, not to the brokers?

Mr. BLUMENTHAL. If it is not clear now, it should be made clear so that there can be more robust and effective Federal antitrust enforcement in this area. But the States certainly should pursue strong and effective remedies, and perhaps as a result of these court actions, there will be.

Senator FITZGERALD. Now, I want to add that in reading Attorney General Spitzer's complaint, I got the impression that only a company that had a strongly dominant market position could get away with the kind of rogue behavior that is outlined in that complaint. I have to believe that Marsh's humongous market share is what enables them, in part, to engage in that kind of rogue behavior.

Mr. SPITZER. I agree with the following caveat. There is also, to use Mr. Grogan's word, a synergy that benefits both of the carriers and the broker when they pay the overrides. One can very well view the override payments as an access fee, access to the cartel. In other words, if, in fact, Marsh is playing the role of organizing a bid rigging scheme that drives premiums up for everybody and allocates business among the carriers, the fee that is being paid by the carriers to Marsh for entry into that system is the overriding set of payments.

Therefore, even without enormous market power, this is really a negotiation between the two sides of the transaction, a divvying up of the gains that result from the cartel behavior, and I think that is a theory that we will be pursuing in terms of damages that arise, because obviously the bid rigging drove the entire supply curve to a point where premiums were going up and we were all paying that in the form of premiums and the division of that gain was reflected by the override payments. So even theoretically, without the enormous market power that Marsh had, that relationship could have emerged.

Mr. GARAMENDI. I don't want to leave the impression that this is only a result of market concentration. It may very well be that the market concentration created the atmosphere where this kind of steering and these kinds of compensations became the norm within the industry. But it is clear from our investigations that you don't have to be real large to be engaged in practices that are every bit as illegal as what Mr. Spitzer has found with Marsh. We believe this goes way down into the smaller reaches of this industry.

Now, with regard to changing the McCarran law, what we have, it seems to me, with Marsh is a synergy in which the company was able to use its various pieces, whether it was the reinsurance business or the access to capital and the movement of capital from one place to the other or the brokerage, to create opportunities for itself, to tie, if you will, one part of its business to another part of its business. Tying happens to be illegal in most States, and it may very well be as these investigations, as we move to the various pages ahead of us in our investigations, that we are going to find tying and other State antitrust activities, or State laws, antitrust laws, being breached. I would be surprised not to find that.

Clearly, however, you are onto something very important, and that is concentration within the economic systems of this Nation, not only with insurance, but in many other economic sectors of the Nation. The concentration is an anathema to a competitive market.

Senator FITZGERALD. Now, what do you all think about, in 1980, Congress passed a law that forbade the Federal Trade Commission, which enforces our antitrust laws, from even doing studies of the insurance industry? Do you care to comment on that?

Mr. GARAMENDI. Is that the only mistake Congress has made in the intervening 24 years?

Senator FITZGERALD. It looks like it, yes, but what do you think of that?

Mr. SERIO. Whether it is the FTC or it is the GAO or any other arm of the Federal Government, the opportunity to study insurance and to make recommendations is not a bad thing, and the Congress has been doing this more and more. The Congress has become a regular partner in insurance, certainly in insurance policy making, given the discussions we have been having on SMART, the discussions we had on the Fair Credit Reporting Act, where the NAIC and the commissioners endorsed the preemption of the Fair Credit Reporting Act and the study of the FTC on the use of Fair Credit Reporting standards and creating a uniform standard across the spectrum.

That would not necessarily—I obviously haven't spoken to my colleagues in the commissioner's rank on this, but I don't think

that would necessarily be an invasive step into State regulation. In fact, if it can help to earmark and identify those areas where either stronger regulation is needed or that trade-off between McCarran antitrust protection versus greater regulation, because that really was the trade-off in McCarran, is that they were given certain antitrust exemptions because there was a body of State regulation, and that was, as you said, Mr. Chairman, really focused on the companies, not on the other players in the insurance marketplace.

And now we need to reevaluate that trade-off and if they are subject to McCarran, make it so, or to antitrust rules, make it so. Or if you still, and you clarify the rule that they are exempt from antitrust through McCarran, then there has to be a coordinated or consequent improvement in the State regulatory tools that we have at our disposal to better regulate the broker community.

The size, as Commissioner Garamendi said, is not really the important part of this. In New York, people have gone to prison, State and Federal prison, because of the inappropriate use of brokerages and the influencing, controlling, tying, whatever you may call it of the insurance business between the broker operation and the insurance or the underwriting operation that they controlled jointly.

Frank B. Hall is a name that we all knew in the 1980's, where you had a broker control problem. The issue was addressed by the States in that case. There have been, perhaps, new ways found to coordinate, as Attorney General Spitzer said, to interlock the various parts of the insurance process. But the fact of the matter is that we really are dealing with a lot of the same issue here, and whether the size became a controlling issue or just the ownership became a control issue between the broker side and the insurance or the reinsurance operations.

Senator FITZGERALD. In a moment here, I am going to allow Senator Akaka to give his opening statement. I do want to ask Attorney General Spitzer, you have said that you favor a greater Federal role here, but are you sure that is the best way when, after all, it was you, not the Federal Government, that uncovered the conflicts in the securities analyst world? It was you, not the Federal Government, that discovered and put a spotlight on the problems in the mutual fund industry. And now it is you, a State Attorney General, who has shaken the insurance brokerage world.

Are you sure—what if the Federal Government came in—this is the Federal Government that has tied its hands with respect to even studying the insurance industry—what if they pass something that preempts people like you from identifying a real problem and acting vigorously?

Mr. SPITZER. First, I would much prefer the Federal Government do it. It would make my life much easier. I would have an easier time getting out of this room. [Laughter.]

Obviously, I do not support a preemption amendment that would preclude the capacity of State inquiry into these various areas. Having said that, I certainly think we need the additional scrutiny that can be provided by the FTC, by Congress in the areas that I laid out, because your investigative powers are enormous. The areas where we have seen interlocking relationships that are injurious to competition, to a certain extent have a nexus offshore precisely because it is very often harder for State entities to inquire

with respect to those jurisdictions. Congress, on the other hand, has a greater capacity to do so. The FTC does.

So we would welcome your joining us in this effort. I certainly am not guarding with such loyalty our exclusive jurisdiction. I would love to see other entities join this investigation, join in the legislative effort, because although the State entities have had some success recently, I would hope that dynamic would change and that we would see vigorous efforts at the Federal level, as well.

Mr. BLUMENTHAL. And I would just add, if I may, Senator, because I think that the sentiments that Attorney General Spitzer has just articulated are common to most attorneys general, that preemption is the anathema here. We have very cooperative relationships, particularly in antitrust enforcement, with the Federal Government already and a lot of what we are discussing here really constitutes per se violations of our antitrust laws. Collusion, tying, price fixing, bid rigging are simply against the law, end of sentence. To ask the questions that you asked really, in many ways, is to answer them, that we need a stronger Federal role in these areas where in other industries that role would be a given and we would be working together.

All of that said, if there is a Federal role, it ought to be a constructive and helpful one, and in so many other areas, unfortunately, in recent years, we have seen a lack of Federal activism, a laxity, and even an attempt to inhibit State action. The environmental area is the best example, but there are others.

Senator FITZGERALD. I am not sure all of that is going to change anytime soon.

At this point, I will allow Mr. Garamendi, if you have something, to join in.

Mr. GARAMENDI. My good friend, Senator Akaka, please take the floor. I will be happy to follow you.

Senator FITZGERALD. Let me just say I would like to recognize the Subcommittee's Ranking Member, Senator Akaka. We have worked closely together the last few years. In fact, I am told that we held 13 hearings together in the 108th Congress. We have worked together on many financial issues, such as the mutual funds, insurance now, and also financial management bills that have installed better audits and chief financial officers in some of the Federal agencies, such as Homeland Security and the National Intelligence Director CFO.

It may surprise you, but until about 15 years ago, none of the Federal agencies were ever audited. Then they started requiring audits of the largest departments, and when I came in, the Agriculture Department was missing $5 billion. It was just missing. They couldn't find it—in cash. They later worked that difference down to only $200 million, but that is a lot of money. If we complain about Enron having bad accounting, sometimes the Federal Government needs to look in the mirror.

But we have worked very hard to extend audit requirements to all Federal agencies. We are now having audited any agency that spends more than $25 million a year, and it has been a pleasure working with Senator Akaka these years and I want to thank him for allowing me to have such a collegial and productive working relationship with him these years. And he kindly every once in a

while sends me some macademia nuts from Hawaii, which are very good—— [Laughter.]

So I want to thank you for that, too. Thank you, Senator Akaka.

OPENING STATEMENT OF SENATOR AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman, for calling this hearing today. I want to take a moment to pay tribute to our Chairman.

This is the Chairman's final hearing as Chairman of the Subcommittee on Financial Management, the Budget, and International Security. Mr. Chairman, I want you to know that I really appreciated working with you. You have done a great job here. Your leadership has been impeccable, and you have been very productive. We have done so many things together and I attribute that to your leadership and your focus on the concerns and issues of this whole industry. As you mentioned, some of this goes back years. With your leadership, we are changing some of that which will really help our country in its accountability.

I want you to know, Mr. Chairman, that I have enjoyed working with you on a number of important issues relating to financial management and transparency, and I want you to know also that I will miss you and you will be missed by the full Committee, as well.

Mr. Chairman, with that, I have a lengthy statement that I ask to submit for the record.

Senator FITZGERALD. Thank you. We will make your statement a part of the record.

[The prepared statement of Senator Akaka follows:]

PREPARED STATEMENT OF SENATOR AKAKA

Thank you, Mr. Chairman, for calling today's hearing. This is your final hearing as chair of this Subcommittee and I want you to know how much I appreciate the work you have done as Chair of this Subcommittee. I have enjoyed working wit you on a number of important issues relating to financial management and transparency. You will be missed.

Mr. Chairman, today, we focus our attention on another scandal—this one involving alleged bid rigging and secret commissions in the insurance industry. This issue has been brought to light by the actions of a group of State attorneys general and insurance commissioners.

I realize that investigations are still pending, but I am interested in learning how widespread the abuse is in the industry. I am also interested in learning more about how the insurance industry operates and, in particular, whether certain types of compensation agreements are a potential conflict of interest for brokers because if these agreements are a potential conflict of interest, we need to know if enough is being done to protect insurance buyers.

Insurance buyers trust their brokers to search the market for the policy that best suits their needs. Brokers should be required to not only disclose the total cost of coverage, and also to disclose all compensation received from an insurance company. This disclosure must be in plain language so that buyers can make informed decisions. I am troubled that, in the New York lawsuit, it appears that even knowledgeable, corporate, buyers of insurance have been taken advantage of and presented with policies that best suited the needs of the broker. Today's heari8ng will explore options to make the process more transparent.

I also want to know whether the deceptive and questionable practices found in commercial property and casualty insurance are also found in other lines of insurance, such as health insurance, where premiums continue to rise.

Employer-sponsored health insurance premiums increased an average of 11.2 percent in 2004 according to the Kaiser Family Foundation and Health Research and Educational Trust. For many working families, these increase have made it more difficult for them to make ends meet and to retain their health insurance coverage.

If a portion of the increase in premiums for health insurance may be attributed to deceptive and opaque practices among insurance brokers, steps must be taken to make sure that families are not overpaying for their current coverage due to the questionable activities of some insurance brokers.

Mr. chairman, another area we will examine is the ability of the states to provide defective oversight for the insurance industry. We need to determine whether the Federal Government should be more involved in the regulation of insurance activities which are now regulated at the state level. I expect some of our witnesses will discuss various legislative proposals including the optional Federal insurance charter and the so-called SMART Act (State Modernization and Regulatory Transparency). There are also suggestions that the Federal Trade Commission be empowered to investigate unfair and deceptive practices within the insurance industry.

I want to thank all our witnesses for coming today and I look forward to their testimony. Mr. Chairman, thank you again for holding this timely hearing. I have truly enjoyed working with you during the 108th Congress.

Senator FITZGERALD. We have been joined by Delaware Senator Tom Carper, and Senator Carper, we appreciate your being here.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. Thanks, Mr. Chairman. I apologize for not being here earlier. As Senator Akaka may have explained, the Democratic Senate Caucus has met this morning to elect our new leadership to begin the next Congress and to put the elections of 2004 behind us. So I apologize.

Mr. Spitzer, I understand you have testified already, is that correct, and I apologize for having missed your testimony. We are delighted that you are here and we thank you for the input you have provided for us here today and, frankly, on a number of other occasions, as well.

I want to thank our Chairman as he prepares to ride off—sometimes when people leave here, they ride off into the sunset. I think when Peter Fitzgerald rides off, he will ride off into the sunrise because he is still among the youngest members of the U.S. Senate. It has been a privilege for me to have served with you for these last 4 years. As Senator Akaka has said, we wish you only good things in the years to follow. We will miss your intellect and we will miss your determination just to figure out what is the right thing to do and to do it. We will miss your fairness and your even-handedness in approaching the issues with a real open-mindedness.

The investigations by, I think, two of the attorneys general that are here today have revealed some disturbing information about current practices, both legal and illegal practices, that have been occurring in the insurance industry. They have caught none less an observer than 14-year-old Ben Carper, my son, who is in a stock market course at his high school, the Charter High School of Wilmington in Wilmington, Delaware, and every morning, one morning every week, usually Monday mornings, they present from the previous week's news a story that has a real bearing or implication, a significance to the stock market. The issue that you have been testifying to today, the issue about which this Subcommittee is holding this hearing, has not just caught the eye of this Subcommittee and its Chairman and Ranking Member, but also our youngest son. We have had some interesting conversations. I don't know what everyone else has been talking about around their dining room table in recent weeks, but we have been talking a bit about these matters.

I would just say these revelations raise questions about the roles of brokers and agents. They raise questions about the protections that exist for consumers, or don't exist for consumers, and the general regulatory framework for insurance itself. As we delve into these issues, they are going to lead to bigger questions and bigger issues for us to address in the next Congress.

So, again, we welcome all of you today. To our Chairman, we wish you, as you say in the Navy—I am an old Navy guy—as you say in the Navy, fair winds and a following sea. God bless. Thanks.

Senator FITZGERALD. Thank you very much.

I have two final questions before we allow you to have a break and invite the second panel up here. I want to know whether there is any information that consumers of residential insurance policies or automobile policies, if they need to be concerned here. Have either of the attorneys general or the insurance commissioner from California found any problems with agents or brokers or personal lines of insurance, steering their clients to carriers who give them, I don't know, free trips to Hawaii?

My own insurance agent came out here with his daughter from Elk Grove, Illinois, and he has assured me that he has never accepted those forms of compensation that are sometimes offered by the carriers, maybe free trips to Hawaii, for example, if you place a number of your policies with a specific carrier. Have any of you done any work in this regard?

Mr. GARAMENDI. Mr. Chairman, indeed, it is probable that there will be and do exist problems in the personal line insurance sector. We see this in—the potential to be there. These additional compensations, whether they are called contingency commissions or the like, in all probability exist in the personal lines area. We are looking into this in California. We have concerns about it.

The way we are going about it is two-fold. First, with the regulations that we want to put in place to provide clarity that all fees, whenever an individual is acting in a broker's capacity, as distinct from an agent capacity, but in a broker's capacity, that all fees be fully disclosed and then to draw a bright line about what the proper activity of a person acting as a broker could engage in.

Senator FITZGERALD. Are there greater disclosure requirements for the individual lines of insurance, typically?

Mr. GARAMENDI. When a producer, a licensed person, whether that person is an agent or a broker—as I said, in California, it is a dual license. You can be either, and you may be one in one circumstance, as an agent, and in a different circumstance, acting as a broker. But there is clarity in at least California when a person begins to act as a broker. That is, they offer themselves as representing the interest of the consumer as opposed to an agent who is offering themselves to represent the interest of an insurance company. So there is a very clear distinction.

We want to further clarify that with the language of the regulations and also to make it clear what activities would fall within or without the appropriate fiduciary responsibilities of a person acting as a broker. So we want to do that. That is the reason for the regulations.

As I said, we are now engaged with other insurance commissioners around the Nation through the National Association of In-

surance Commissioners to propose a model, which could be a law in certain States that don't have that clarity in their law, or a regulation for those that have a legal foundation to write a regulation. So that is underway. Investigations are also underway and will undoubtedly play themselves out.

Now, we are being assisted by private attorneys who are bringing suits on behalf of individuals, companies, corporations who have been wronged by this entire practice which is being discussed here. We will, in California, undoubtedly join with some of those private attorneys. We will also join with our Attorney General in looking into all of these matters and probably bringing suit in various areas. We consider it to be a very serious problem.

I know you are on this question, but before I leave this panel, I would like to comment on the proposed SMART legislation if you intend to come to that.

Senator FITZGERALD. Well, we will be interested—Senator Akaka has some questions and I would like to allow him and Senator Carper, if he has questions, too.

Senator AKAKA. Thank you very much, Mr. Chairman. I would like to ask two questions.

One is to Attorney General Spitzer. My constituents are increasingly concerned about the rising costs of their health insurance, and it is not only Hawaii but across the country. My question is, are the deceptive and questionable practices found in property casualty insurance also found in other lines of insurance, such as health, and what impact have these practices had on the rising costs of health insurance?

Mr. SPITZER. Senator, it is a little question. I would be a little cryptic, only because I don't like to state conclusions until we have completed an investigation and filed a litigation, but suffice it to say we are finding the types of practices that are laid out in both the Marsh and the ULR complaints and the various civil and criminal complaints, as well, in other lines of business, as well. The various form of the overrides, the forms of the incentives may differ, but the underlying economic impact is ordinarily the same. It is both to create misincentive, distortive incentive, and then to drive the cost of premiums up.

I would just say in response to the Chairman's question about how does this manifest itself in other lines of the insurance sales marketplace, we have found not only trips as an incentive, but also loans and offers of stock that are made to individual brokers or agents and repayment for either the loan or the stock is contingent upon the magnitude of commissions that are generated for the company or sales or the volume——

Senator FITZGERALD. Stock in the insurance company being offered back to the agency?

Mr. SPITZER. That is correct, and often, whether or not there is required repayment——

Senator FITZGERALD. Stock or stock options?

Mr. SPITZER. It can be both. But as I say, we are just beginning to delve into some of these areas, and sometimes it is loans outright, loans of cash, capital, and again, repayment schedules and obligations are contingent upon how much business is generated in terms of the volume of product of the underlying carrier that is

sold. So this manifests itself in many different ways. But as I said, we have only begun and we have limited personnel, so we are delving into this now and we will get into it in due course.

Mr. GARAMENDI. Just very briefly, we have reason to believe that this issue spills over into employee benefits, and that would be health care plus other kinds of employee benefits, disability and the like.

Mr. BLUMENTHAL. And in answer to your question, Senator, these kinds of arrangements directly raise the cost of insurance to your constituents because they add a level of private gain that goes into somebody else's pockets. The corrosive, corrupting effect on the entire health care system cannot be underestimated. I would agree with both of my colleagues here that we will see evidence of the same kinds of practices in other lines, not just employee benefits, but health care and automobile insurance, as well.

Mr. SERIO. If I may, Mr. Chairman and Senator Akaka, one of the distinctions, though, for some States on health insurance as compared to property casualty, or even other forms of employee benefits, such as in New York, we have specific statutes with respect to how much commission can be paid on certain health insurance products. There are caps. It is generally about 4 percent.

So that gives us at least a bright line standard that you don't have that has complicated some of these other issues about what is an appropriate compensation level, and that has created a statutory model. We put that model into place, first, because of the concern over the high price of health insurance, and second, because of the large number of not-for-profit health insurers in the marketplace. And so we have actually been regulating commission structures in the health insurance field for a very long time that we do not do in other areas.

Senator AKAKA. Thank you for those comments.

Mr. Serio, I understand that NAIC is doing much to modernize State insurance regulations through efforts such as an Interstate Insurance Product Regulation Compact. I am pleased that Hawaii is one of nine States, I understand, that have enacted this compact legislation. What are the biggest challenges to reaching the goal of regulatory uniformity?

Mr. SERIO. I think one of the biggest challenges to achieving regulatory uniformity has been the push-back by a number of interests in the industry who have been looking for regulatory uniformity as a way to get to less regulation.

We have had an interest. In fact, we have had good conversations, both here in the Senate and over in the House, on what the commissioners need in terms of creating a better and a more modern regulatory structure. In fact, we were very pleased that Chairman Oxley over in the House put many of the things that appeared in what we called the NAIC road map into the first SMART bill draft, including greater financial surveillance, including greater oversight in receiverships and things of that nature, because those are things that we have identified to the Congress, shortcomings in the current State legislative structure for powers to the regulators.

This is actually very relevant to the conversation we are having here today because a lot of these problems that have come up in the past have usually found themselves in the forms of insolven-

cies, that people had been untowardly using the insurance process to drive a company into insolvency. In the 1980's, it was broker control that led to insolvencies of insurance companies. In the early 1990's, we had the same problem.

This situation is a little different, but as I said earlier, I think broadening out the financial surveillance powers of the insurance departments as is being proposed in the SMART bill will give us a great leg up from where we currently stand with respect to being able to modernize State regulation.

Senator AKAKA. Thank you very much, Mr. Chairman.

Senator FITZGERALD. Thank you very much, and I want to thank this panel. I think you have been terrific. It strikes me as I listen to the testimony that there could possibly be no end to the amounts of conflicts that you might find, especially the attorneys general, in other industries, as well. I was thinking about the real estate brokerage area, areas where people aren't necessarily fiduciaries.

I even thought of another one that you may not think of very often, but in the media. Last week, I was at the *St. Louis Post Dispatch* at an editorial board interview and they reminded me that in 1949, the *St. Louis Post Dispatch,* together with a now-defunct paper, the *Chicago Daily News,* won a Pulitzer prize for uncovering that 32 newspaper editors and publishers in Illinois were on the then-Governor Dwight Green's State payroll, typically for $10,000 a year, which in 1949, that is like $100,000 today, and they won a Pulitzer prize for that.

So the possibilities of conflicts are almost endless here and you give us a lot of food for thought and I think that it has been very helpful hearing the testimony from you both for Congress and for consumers nationwide. So thank you all very much for being here.

At this point, I would like to take about a 2-minute break and then we will reconvene with the second panel.

[Recess.]

Senator FITZGERALD. I would like to reconvene this hearing, if we could have order in the hearing room.

I now call on our witnesses for panel two. Our first witness is Albert Counselman, President and CEO of Riggs, Counselman, Michaels and Downes in Baltimore, and I guess you go by Skip, is that right?

Mr. COUNSELMAN. That is right, Mr. Chairman.

Senator FITZGERALD. Mr. Counselman is appearing today on behalf of the Council of Insurance Agents and Brokers, which represents the largest of all commercial insurance agencies and brokerage firms. Mr. Counselman is a former Chairman of the Council. His other insurance industry affiliations include Vice President and Director of Professional Agencies Reinsurance, Limited, former Chairman and Director of Assurance Global, and Director of the American Institute for Chartered Property Casualty Underwriters.

Our second witness is Alex Soto, President of InSource, Inc., of Miami, Florida. Mr. Soto is representing the Independent Insurance Agents and Brokers of America, known as the "Big I," for which he currently serves as Vice President. Mr. Soto was elected to the organization's Executive Committee in 2001 and has served as Chairman of its Communications Committee and the Branding Task Force and Natural Disaster Committee. He also served as

Chairman and State National Director of the Florida Association of Insurance Agents.

Our third witness is Ernie Csiszar, the President and CEO of Property Casualty Insurers Association of America, which is headquartered in my home State, in Des Plaines, Illinois, not too far from my home. Mr. Csiszar previously served as President of the National Association of Insurance Commissioners and as South Carolina's Director of Insurance. Originally from Romania, Mr. Csiszar has an extensive background in business and investment banking.

Our fourth witness is Janice Ochenkowski—I hope I pronounced that right?

Ms. OCHENKOWSKI. You did.

Senator FITZGERALD [continuing]. Who serves as Vice President for External Affairs for the Risk and Insurance Management Society, known as RIMS. She currently is Senior Vice President and National Director of Risk Management at Jones Lang LaSalle, Incorporated, a global real estate services company that is headquartered in Chicago. Ms. Ochenkowski has been responsible for risk management at Jones Lang LaSalle and its predecessor companies since 1980.

Our fifth and final witness on this panel is J. Robert Hunter, Director of Insurance at the Consumer Federation of America. Mr. Hunter has served as Texas Insurance Commissioner and as the Federal Insurance Administrator, which handles the flood insurance program, I believe?

Mr. HUNTER. It was then, but yes, it does now. It was at HUD when I was——

Senator FITZGERALD. Oh, OK. You were in that position as Federal Insurance Administrator under Presidents Ford and Carter. Mr. Hunter is an actuary and he is well known as a long-time consumer advocate. They could use you to solve our pension problems, too. We need some actuarial help on Capitol Hill.

Again, I would like to thank our distinguished witnesses for being here today to testify. In the interest of time, your full statements will be included in the record and we ask that you limit your opening remarks to 5 minutes. Please watch the light. Since we have such a large panel, we will adhere to the 5-minute rule to ensure that there is sufficient time for questions.

Mr. Counselman, you may begin.

TESTIMONY OF ALBERT R. COUNSELMAN,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, RIGGS, COUNSELMAN, MICHAELS AND DOWNES, INC., ON BEHALF OF THE COUNCIL OF INSURANCE AGENTS AND BROKERS

Mr. COUNSELMAN. Thank you, Mr. Chairman. As you stated, I am representing the Council of Insurance Agents and Brokers today. The CIAB member firms employ more than 120,000 people and annually place more than 80 percent of all of the U.S. commercial property casualty insurance products.

Insurance brokerage is highly competitive and it is built and relies on trust, trust between the broker and the client, trust between

[1] The prepared statement of Mr. Counselman appears in the Appendix on page 96.

the broker and the carrier, and ultimately through those two relationships, trust between the carrier and the client. The ultimate trust between carrier and the client is essential because the insurance business is one of promises, including the promise of the clients to detail the nature and the extent of its risk exposures and the promise of the carrier to cover those exposures in case of trouble, accident, or tragedy.

At the outset, we are deeply troubled by the charges of bid rigging and fraud brought by Attorney General Spitzer. Such activity is not only outrageous, but it is illegal and it has no place in an industry that is based on trust. These individuals have not only severely damaged their own brokerage firm, but they also have cast an undeserved pall on an entire industry. They besmirch the reputations of honest brokers throughout the country and they have undermined the trust on which our industry was built.

While bad actors created a corrupt scheme to limit real choices for some customers, the role of contingent commissions in this evil equation has been irresponsibly represented. Contingent commission payments were not central to the alleged fraud despite the connections that some have claimed. Contingent commissions are legal and proper methods of compensation that have been used throughout the industry for decades. Although they are not a significant source of income in most firms, they are nonetheless well understood and accepted by the commercial marketplace.

It is lack of effective disclosure, in some cases combined with the intent to defraud, that is at issue, not a systematic industry-wide failure to disclose fees or a failure of the entire business model, as has been suggested.

Even so, we realize that there is increased concern and confusion in the marketplace and we support clear disclosure of this income. The Council had such a policy in place since October 1998, recommending precisely such disclosure.

It is most important that the solution to these examples of fraud and this chance to improve disclosure be developed in the legislative and in the regulatory cycle and not in the news cycle. Contrary to recent news stories, isolated examples of abuse should not be equated with an industry-wide system of "secret payoffs and conflicts of interest." While such overheated charges create good headlines and produce new class actions for lawyers, they do not represent grounds for a stampede to judgment on a wrong-headed solution. Solutions should be based on facts and on deliberation, not headlines.

We don't believe that the fraud Attorney General Spitzer uncovered resulted from a failure of the State-based insurance regulatory system. The toughest of regulations or laws will not stop an individual intent on malfeasance. That said, we also believe that regulatory reform is essential for the industry's long-term viability because of the inherent inefficiency and the confusion stemming from a vast array of overlapping and sometimes conflicting regulatory requirements imposed from State to State.

As public policy objectives are pursued, we believe lawmakers and regulators must be mindful that the development of a relationship between broker and carrier is essential to enable brokers to provide the best possible products and services to their clients. A

strong relationship with the carrier gives the broker clout that benefits the customers for lower premiums, better coverages, specialized coverages, and quicker service and claims payment.

This is why the characterization of the client-carrier relationship as adversarial is misguided. At the end of the day, the carrier partners with the client through the broker intermediary, not as opponents but in a cooperative way to ensure that the risks that a client presents are properly covered.

All the compensation paid to a broker is funded by a client, either through direct payments or through the client's premium payments. Contingency arrangements established by insurers have been a feature of the compensation landscape for decades and generally have been well understood and accepted by the commercial client base. They replace a portion of the up-front commissions previously paid to producers and on average contribute approximately 4 to 5 percent of a brokerage firm's income. On average, for most firms, this represents 1 percent of premium volume. Again, we support and encourage client disclosure of such commissions.

To conclude, let me say I am deeply troubled by the evidence of egregious conduct uncovered by Attorney General Spitzer. Bad actors should be prosecuted to the fullest extent of the law and this pattern of behavior must never be repeated. But contingent commission arrangements, when properly constructed, disclosed, and utilized, fulfill a need in the industry to help foster a cooperative insurance environment that works to benefit all participants, the commercial client, the carriers, and the producers. We strongly support improved disclosure and heightened transparency in these arrangements in order to remove any potential specter of conflict.

As I said at the outset, this industry is based on and committed to trust, trust between broker and client, broker and carrier, and ultimately carrier and client. We stand ready to work with the appropriate committee of jurisdiction in the Congress and the States to find solutions to the issues raised at this hearing to ensure that this trust is maintained and the important work of the insurance industry, which is protecting people and the economy, continues.

Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you, Mr. Counselman. Mr. Soto.

TESTIMONY OF ALEX SOTO,[1] PRESIDENT, INSOURCE, INC., ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Mr. SOTO. Chairman Fitzgerald, I am delighted to be here. As you already stated, I am Alex Soto. I represent the Independent Insurance Agents and Brokers of America. I am a volunteer leader within that organization. We have more than 300,000 independent agents and employees that work and are located in practically every town throughout America.

The way I make my living is as an independent agent in Miami, Florida. As you stated earlier, I am president of an agency called InSource, Inc. We are primarily a property casualty agency, where we sell commercial insurance products as well as personal insurance products to customers in our general area.

[1] The prepared statement of Mr. Soto appears in the Appendix on page 107.

I echo the comments made by Mr. Counselman in that our organization obviously deplores the activities that you have uncovered and that Mr. Spitzer has uncovered, issues such as bid rigging and market manipulation. Unfortunately, not only are they illegal, but they have given all of us, brokers and agents and everyone in the industry, a black eye.

I also concur with the fact that those who are proven guilty should be punished swiftly, and again to the full extent of the law. And quite frankly, we applaud the efforts of the regulators and the attorneys general.

Senator my world is completely different from that which you were describing earlier today of the mega-brokers that have the ability and the power to influence and manipulate the marketplace. My world, and I want to take a moment to share it with you, is one of extreme and high competition.

You know, in the State of Florida, there are more than 50,000 licensed agents and solicitors. In my county, Miami-Dade, we have 5,000 licensed agents and solicitors who I compete with every day. On top of that, I am in competition with the direct sellers of insurance, those mechanisms that do not use an agent. I am in competition with the Internet, everyone that is putting wares on the Internet. I am in competition with affinity groups, such as the AARP. I am even in competition with credit unions that have tie-ins with insurance companies.

And on top of that, one of my major insurance companies informs me that more than half of all the business that they write in my State, in the State of Florida, is written by brokers and agents outside of the State of Florida. So I am not only competing with the people in my State, but elsewhere.

Every day, I must prove myself and the people in my office, not only with our prospects, but we must prove ourselves with our current customers. When a client invites us to bid on their insurance, that is precisely what we are doing. We get no up-front fee. We get no payment from that client. We simply are given an opportunity to do a great deal of work to prove ourselves, that there is more value in doing business with me and with InSource than their current relationship.

They define value in being the best price, the coverage that they are looking for, the best coverage, the quality of the insurance company that is being offered, and the services that I provide, my agency will provide to them. If I do not prove myself to be a better value in those terms to that prospect, I will not be selected. If I am not selected, I do not get paid by the client or anyone else and my expense is one that I have to eat.

If I do get paid, obviously, I get paid a commission by the insurance company that we place the business with. The competitive marketplace keeps agencies responsive and accountable, and I think you hit it on the head. More competition is better for the consumer. It is the best. What I have found over my years in the business are the checks and balances.

We do support, where the brokers are concerned, we do support transparency. It goes without saying that those people that are paid by the clients and also paid by the insurance companies need to make sure that all parties clearly understand where the money

is, what the money is, and where it is coming from, and clearly, those must be agreements that must be reduced to writing and approved by both the client and the broker. The client obviously can dispute them and simply decide to do business with somebody else.

We do support and we use them, independent agents throughout America, contingencies. Contingency is agreement. I cannot comment on PSAs or MSAs because I do not receive those, and candidly, I am almost embarrassed to admit to you that until this all emerged, I really had practically no familiarity with even those terms.

But contingency agreements are legal. They reward excellence, as they do in every other transaction, promotional transaction in the United States. They are good business practices and they do serve a legitimate purpose. It creates an incentive for the agent to be a good front-line underwriter in the selections of risk and it also incents the agent to be a good risk manager in helping the client to put in place measures that will help them reduce their losses. When that occurs, everybody wins. The client wins, because on an ongoing basis, fewer losses will translate into less expensive premiums in the future. The insurance company pays less claims and they share a little bit of that profit if, indeed, the lower losses are there.

Finally, we believe in State regulation. It has been my experience that regulation closer to home is the best regulation. Insurance commissioners in my State have taken numerous steps to protect the citizens of the State of Florida after the four hurricanes that we had, and I saw it firsthand after Hurricane Andrew. However, the system needs modernization and uniformity, and thus we support the SMART Act. In concept, it is a good venue because it will leave regulation at the State level, but there will be a certain amount of uniformity and modernization. Now, I underscore that this is a draft proposal so it needs to be worked on. This will provide targeted Federal tools with uniform standards to keep State regulations. Thank you, Mr. Chairman.

Senator FITZGERALD. Thank you very much, Mr. Soto. Mr. Csiszar.

TESTIMONY OF ERNST N. CSISZAR,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

Mr. CSISZAR. Mr. Chairman, thank you for the invitation to appear today. I am so sorry that this is your last session. I would have been delighted to serve as one of your constituents. I am a new resident of Chicago, the proud owner of a new mortgage in Chicago, so——

Senator FITZGERALD. Are you registered to vote?

Mr. CSISZAR. Yes, absolutely. [Laughter.]

Absolutely, so I am so very sorry to see you go because I think your leadership role on this Subcommittee in terms of the investigation that you have carried on, whether it be with respect to Enron, whether it be with respect to the bond market, with respect to the investment banking industry in which I had a few years' ex-

[1] The prepared statement of Mr. Csiszar appears in the Appendix on page 115.

perience a few years ago, I think they have been very valuable and have been of extreme usefulness, I believe, in bringing abuses to light that otherwise might not have been done so.

I will tell you that, speaking on behalf of over 1,100 members of the PCI, we welcome your oversight. In fact, we encourage your oversight because I, like all the panelists that I have heard this morning, I, too, am here to condemn in the strongest of terms any criminal—and I will go beyond criminal—any criminal, any deceptive, any anti-competitive conduct on the part of any member of a market.

We truly have a large market in the insurance industry and it is a market that is based on trust, public trust in particular. Any activity that impedes on that public trust is activity that must be condemned and it must be stopped.

In addition to that, any activity such as criminal, deceptive, anti-competitive activity also impedes on that free flow of information, that free flow of accurate information that is the very foundation of an efficient market, if you will.

So we really think that these allegations, and I think they certainly look like they are going to be proven, are allegations that point to conduct that is absolutely deplorable. As I said, my 1,100 members welcome this.

Having said that, I also want to make a few comments about the industry itself, because I have heard you and others this morning speak about this cartel arrangement and so on. To some extent, I think there is a good deal of truth in that. But what I would like to draw the Subcommittee's attention, and Mr. Chairman, you in particular, your attention to is the fact that there are over 2,700 companies that compete in this business. There are over 1.9 million people who are involved directly in the distribution of insurance products. It is a highly fragmented industry when you look at it overall.

Now, in this particular segment of the market, of course, the brokerage market, it is very true that three players, from what I understand, controlled 80 percent-plus of the market. So it is very highly concentrated. But overall, the market is very fragmented and the returns in that market prove it. If you look at insurance returns over the long term, they tend to be in single digits. In fact, some would argue that there is an inverse risk relationship at work when it comes to the insurance market, too much risk for too little return, if you will.

So it is a market that is very competitive, not just from a distribution standpoint but from a carrier standpoint as well as a reinsurer carrier. There are any number of reinsurers in the United States. There are a number of reinsurers in Bermuda. The Lloyd's market is also very active in this. The London market, in general, is active. So overall, it is a very broad industry. It tends to be a highly competitive industry and our point very simply is that what we are seeing here emanates in a very specific and a very narrow segment, albeit a very profitable segment of the insurance industry.

As regards contingency fees, our view is, first of all, one of the problems with these agreements is I swear they shouldn't even be called contingency fees because they are taking the contingency out

of it. In fact, if anything, there was a good deal of certainty attached to some of these agreements that the commissions would be payable. There was very little about them to be contingent.

A true contingency agreement, however, such as the one described by Mr. Soto here, truly addresses a maybe, a perhaps. It is not tied to a specific policy. It is not tied to the placement of a specific policy. It is tied to overall volume, and quite often it is also tied to overall profitability, and oftentimes that profitability doesn't emerge until years later. Workers' compensation, for instance, it is a long tail line. So whether it is profitable or not sometimes takes years to determine.

So it is not as simple as Mr. Spitzer would like it to be, perhaps, and quite frankly, we see contingent commissions as nothing more than mutual instruments. They can be used and they can be abused, as they were in this case, I believe. There is no reason to ban contingent commissions. What we suggest, of course, is that we take a true transparency, a true disclosure route to this, and that, in fact, we take one that is relatively uniform.

One of the problems with State regulation, and I believe, having been a regulator, I wholeheartedly agree with the need to modernize State regulation. The fact of the matter is, a uniform approach in terms of good, solid transparency and disclosure, we believe would solve the problem.

My time has run out and I will leave it at that. Thank you.

Senator FITZGERALD. Thank you very much. Ms. Ochenkowski, thank you for being here.

TESTIMONY OF JANICE OCHENKOWSKI,[1] SENIOR VICE PRESIDENT, RISK MANAGEMENT, JONES LANG LASALLE, AND VICE PRESIDENT FOR EXTERNAL AFFAIRS, RISK AND INSURANCE MANAGEMENT SOCIETY

Ms. OCHENKOWSKI. Good afternoon, Mr. Chairman. As a lifelong Illinoisan, I, too, would like to thank you for your efforts on this Subcommittee and the work that you have done to restore integrity into the governmental process. We all appreciate it.

I am here representing the Risk and Insurance Management Society, which is the largest professional organization for the risk management community. We appreciate the opportunity to be heard on this issue.

Our member companies, which number over 4,000, are commercial insurance consumers and we are directly affected by the issue of broker compensation and placement practices. Our membership spans the country and consists of entities in all different industries and sizes, including 84 percent of the Fortune 500 companies as well as approximately 950 small businesses, which we define as those with fewer than 500 employees. Many of our member companies have full-time risk management departments, while some rely solely on brokers for services.

RIMS has always believed that the relationship between brokers and insurance consumers should be governed by the principle of complete transparency. We emphasized this position initially in

[1] The prepared statement of Ms. Ochenkowski with an attachment appears in the Appendix on page 123.

1999 and again in a statement issued in August of this year that provides that broker compensation and placement agreements should be transparent, with all sources of compensation, direct and indirect, disclosed without client request prior to the placement of business and annually by line of coverage. A complete copy of that statement is attached to my testimony.

RIMS is shocked by the recent allegations of illegal activities by certain brokers and insurance companies in the placement of insurance contracts. We have been particularly distressed by the findings and allegations of New York Attorney General Spitzer that insurance brokers have violated their position as trusted advisor to their clients by steering clients to favor the insurance company and engaging in bid rigging schemes. Such activities undermine the trust and confidence that are at the heart of the customer-broker relationship. Our President, Nancy Chambers, issued a statement addressing this issue on October 22, a copy of which is attached to my testimony.[1]

Insurance brokers are an integral part of the insurance placement system. Brokers serve as intermediaries between commercial customers and insurers. Traditionally, brokers represent their customers while insurance agents represent insurance companies. Commercial insurance transactions are often very complex and brokers are essential to finding available insurance coverage to meet their customers' needs.

RIMS, itself, is not a standard setting body for the insurance industry. RIMS does, however, place great emphasis on educating and advising its members about current issues and providing them with useful tools to deal with these issues, and this is the approach taken by RIMS with respect to contingent fees.

As the use of placement service agreements and contingency arrangements became popular with some insurance brokers and insurance companies in the 1990's, RIMS advised its members of these practices. In 1999, RIMS issued a disclosure statement whereby brokers would disclose insurers with which they had contingency fee agreements upon the clients' request. Brokers and insurance companies declared at that time that contingent fees represented only a small part of total fees, and as such, our approach seemed appropriate.

RIMS followed up on that 1999 statement through institution of a quality improvement process in 2000, which is a comprehensive program designed to guide and facilitate quality improvement for risk managers. We use these guidelines to improve communication, develop performance expectation agreements, and to evaluate broker performance under these agreements. This agreement states that all remuneration for services should be disclosed to the client while complying with local insurance laws.

Further, in representing the interest of risk managers, RIMS provides workshops, discussion groups, and other educational programs that address the most pressing issues of the day. In fact, for the past 3 years, at its annual conference, RIMS has explored the many facets of the client-broker relationship through a series of sessions. We believe that by educating our members, they will be

[1] Exhibit A and B appears in the Appendix on page 128.

fully equipped to evaluate potential conflicts of interest in the placement of insurance policies.

As the facts are becoming known and the investigation into placement service agreements continues, in an effort to address the potential conflict of interest issue, RIMS would support a prohibition on the use of placement service agreements by insurers and brokers. Three of the largest brokers have publicly stated they will no longer enter into placement service agreement or accept contingent fees. Such actions, coupled with compensation disclosure, should bring greater transparency to the broker-client relationship and help to restore trust and confidence.

Whatever actions legislators and regulators decide are appropriate to address the issues of placement service agreements and contingency compensation, the interests of insurance consumers must be considered. Consumers should not have to pay higher costs for insurance because of abusive actions that may have been taken by some brokers and some insurers. And hopefully, any remedial action will result in lower costs for insurance for consumers by eliminating improper actions that might have increased these costs. The recent allegations against several insurance brokers in New York have been very troubling. These allegations have not only undermined the broker-client relationship, but they have wider implications for the industry as a whole. And any penalties that may ultimately be levied against these companies involved should be used to offset consumer losses that have resulted from these deceptive practices.

We understand that the NAIC is preparing to address the broker compensation issue and that one approach in their agenda is the adoption of a model law on disclosure of broker compensation arrangements. RIMS believes that a national uniform approach should be taken to address this issue. Regulatory clarity and uniformity are needed, not 51 different approaches.

Thank you for this opportunity to testify on this important issue. RIMS looks forward to working with you and your Subcommittee and with Congress to address this issue and we appreciate your time and interest and leadership. Thank you.

Senator FITZGERALD. Thank you very much. Mr. Hunter.

TESTIMONY OF J. ROBERT HUNTER,[1] DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Mr. Chairman, on behalf of CFA's 50,000 Americans, we would like to thank you for what you have done in your tenure. It has been terrific. You are one of our heroes and we would like to publicly say that.

Senator FITZGERALD. Thank you.

Mr. HUNTER. There are four major issues that we see from the Spitzer investigations.

First, and of greatest importance, the investigation reveals how easily sophisticated buyers of insurance can be duped by brokers, agents, and insurers. Imagine the potential for abuse with small businesses and individuals as they try to manipulate the insurance marketplace. It is a highly complex marketplace. They are buying

[1] The prepared statement of Mr. Hunter appears in the Appendix on page 130.

legal documents they don't understand. They need help, so they go to people and say, take me. Help me. They are vulnerable.

They have to not only find out whether they are comparing like policies, they have to look at the solidity of the insurer, they have to look at the service record because they can't kick the tires. They may not have a claim for years. They have to go through the underwriting process. And then they have the complex pricing systems, credit scoring, where you live, all these things, many determining price.

This complexity causes weak competition at all levels of this business, not just for large businesses. CFA review of rates charged, for example, show that it is easy for the exact same insured to pay two to three times within the market. A competitive market should have a narrow range, not a range like that. In Hawaii, for example—I wanted to use Illinois, but they don't produce this information—in Hawaii, a clean auto risk, buying liability coverage, can pay $397 from USAA or $993 from Geico Casualty—same exact risk. Figure that out.

In 2003, the property casualty insurance industry paid contingency commission kickbacks of $4.2 billion.

Second, the findings of bid rigging are a reflection of the deeply rooted anti-competitive culture that exists in the insurance industry. The culture derives from what you pointed out, the antitrust exemption in McCarran. We still see cartel rating organizations setting large parts of insurance rates for many companies, determining what future costs will be, and the FTC is handcuffed.

Thus, in November 2003, industry executives could freely meet to discuss pricing. "Let us not get pulled into a soft market. We are not ready for a soft market. We can't afford one. We need several more years of profitability," said James Schiro, CEO of Zurich Financial. Responding, Maurice Greenberg, Chairman and CEO of AIG, said, "As an industry, we saw much further to go to even get to a marginally acceptable return. We absolutely need to hold the line on pricing and not give in to competition." That is the industry.

Third, the Spitzer complaint shows that insurance regulators have utterly failed to protect consumers and to properly regulate insurers and brokers in a number of key aspects. To make matters worse, many of these regulators recently collaborated with insurance interests to deregulate particularly commercial insurance and especially the so-called sophisticated lines that we are now seeing were abused.

Finally, the Spitzer investigation makes clear that consumer protection standards must be raised, not lowered as the industry is pushing for.

There are five steps we would ask you to consider, three of which you mentioned, so I am going to go short on those.

One, you should do no harm. Congress should do no harm. You should stop consideration of bills that would weaken consumer protections. We urge Congress not to enact optional Federal charters that would result in concentration, as it did in banking, or create a rush to the bottom as regulators compete to get share.

We also urge that Congress stop consideration of the so-called SMART Act. The SMART Act actually goes so far as to completely

deregulate the cartel rating organizations but leave the Federal antitrust exemption intact. That is crazy, but that is what is in it.

Senator FITZGERALD. If I can interject, what are the rating organizations——

Mr. HUNTER. The rating organizations are like the Insurance Services Office and the National Council on Compensation Insurance. They establish loss costs, the major part of the rate. They do it jointly. They project the future for what are the costs going to be next year. They get together and do this. It would be like building contractors getting together and agreeing on the price of bricks for next year and labor. It is clearly, if you look at the House Judiciary Committee hearings, it clearly would violate antitrust law if the antitrust law were applied, but it is not.

The insurers do need to have some joint historic data, but all the testimony was that you don't need the antitrust exemption for that. As long as you truly use historic data and don't manipulate it, you can have that. But the manipulation of data is where the problem lies.

Second, we suggest considering a Federal minimum standards bill for States to enforce. States have been gutting consumer protections in recent years in an attempt to hold off the Federal interest. They have been trying to keep the insurers on their side by saying, look, we can go even lower than those guys are willing to go, and they have been gutting regulations. It has been interesting since Spitzer's investigation to see them sort of get almost a stiff neck as they try to turn around to go back and say, we are trying to regulate.

They have market conduct studies. They should have caught this. They go in with these market conduct and financial investigation studies and they catch nothing. The same thing happened with life insurance abuses a few years ago, when Prudential and all ended up having to pay billions because of lawsuits. They don't catch anything.

If there is to be a Federal standards approach, the standards need to be high. I list some in my testimony. I hasten to say, even with high standards, a Federal approach is fraught with risk since the Federal regulatory expertise and—there is a strong possibility that any Federal regulator would be subject to regulatory capture just as the States have been. Therefore, there needs to be well-funded approaches so that there can be a consumer advocate representing consumer interests.

Third, unleash the FTC. I am not going to say any more about that. You have already talked about that.

Fourth, repeal the antitrust exemption. I am not going to talk any more about that. I just think it is obvious that this industry has an anti-competitive history and it still functions that way.

Fifth, require transparency. For over 20 years, consumer advocates have called for disclosure similar to an energy efficiency ranking you see when you shop for a refrigerator. We suggest that Congress would require a point-of-sale disclosure of the insurance policy value. The disclosure would show the expected payout per dollar of premium—how much you are going to pay out in claims, commissions, contingency commissions, overhead, profit, etc., and

the actuaries know the figures because that is the way they set the rates.

Right next to it, you would display the same information for this product for the overall industry. Consumers could focus on, for example, the part of the premium expected to be paid out in losses. If the consumer was considering a policy that would pay out 50 cents per dollar but the industry average was 70 cents, the consumer would know this is a bad deal and ought to drop it.

I am way over my time. Sorry.

Senator FITZGERALD. Thank you very much.

All of you have had great testimony, all a little bit different angles, and all of you represent different constituencies. Just for the sake of our audience and people who may be watching this on C–SPAN at home, Mr. Counselman, you represent the Council of Insurance Agents and Brokers. Essentially, you represent the larger brokers——

Mr. COUNSELMAN. We include in our membership the larger brokers, but our members include small brokers, as well. But our distinctive character is commercial insurance.

Senator FITZGERALD. But Marsh and McLennan and AON——

Mr. COUNSELMAN. They are also members.

Senator FITZGERALD. Mr. Soto, you represent the Independent Insurance Agents and Brokers of America, the smaller agents, is that correct?

Mr. SOTO. That is correct. The average size of our membership is probably 10 to 12 employees.

Senator FITZGERALD. Are Marsh and McLennan and AON, are they also members of your association?

Mr. SOTO. Some of their branch offices have joined our State organizations. On a national basis, they are not a member, the parent companies. Neither are those large brokers.

Senator FITZGERALD. OK. Mr. Csiszar, you represent the Property Casualty Insurers Association of America. You represent the carriers as distinct from the brokers, correct?

Mr. CSISZAR. Yes.

Senator FITZGERALD. Now, Ms. Ochenkowski, you represent the Risk and Insurance Management Society, which is, you said, 80 percent of Fortune 500 companies. These are the purchasers of large corporate insurance policies, and so you are representing clients of insurance brokerage firms and underlying carriers.

Mr. Hunter, you represent the Consumer Federation of America, which represents the little guy, the ordinary consumer. So I just wanted to have that straight for all our audience members.

Mr. Counselman, you defended the contingent commissions.

Ms. Ochenkowski, you said you would be happy to see the elimination of the placement service agreement, which is the form of contingent commission agreement or arrangement that Marsh and McLennan specifically had. You weren't as clear about whether you support—you didn't say, if I listened carefully, that you support prohibiting contingent commissions. You said you support prohibiting placement services agreements. Do you still think contingent commissions should be allowed?

Ms. OCHENKOWSKI. To be clear, we would support the prohibition of all of those forms of the contingent commission as well as the

placement agreements. We have found through the information that has been provided in recent weeks that all forms of this compensation seem to put people in the position of behaving differently than they would if these agreements didn't exist. And as has been pointed out, the existence of contingent agreements in theory has not been illegal and we have not supported their abolition. But when we look at this entire issue, we think that—our position has evolved over time and we are in support of abolishing all of——

Senator FITZGERALD. And you would like your members, these big companies that are trying to get insurance now, you think you want the brokers to clearly be working on their behalf, not be also accepting compensation from the insurers, is that accurate?

Ms. OCHENKOWSKI. Yes.

Senator FITZGERALD. Now, Mr. Counselman, what do you say to your customers? They don't want you getting payments from the insurance carriers as well as from the buyers of the policies.

Mr. COUNSELMAN. Mr. Chairman, you raise a good point. My concern is that there is an understanding of what a contingent commission is versus a placement service agreement which could be called a form of contingent compensation. But the contingent compensation that I am focusing on in particular in my testimony is loss ratio driven. It is provided by the insurer as part of the commission compensation package.

Senator FITZGERALD. OK. Let me stop you right there. There are different types of contingencies. Typically, you can get paid for bringing in business to the insurance carrier that has a low loss ratio. In other words, the carrier is trying to incentivize you to go out and bring them good customers who aren't going to run up the losses.

Mr. COUNSELMAN. Correct.

Senator FITZGERALD. There are other types of contingent agreements that just pay you for bringing more policies from wherever it comes, revenue.

Mr. COUNSELMAN. Correct.

Senator FITZGERALD. Now, you run an insurance brokerage, correct? What is the name of it?

Mr. COUNSELMAN. Riggs, Counselman, Michaels, and Downes in Baltimore.

Senator FITZGERALD. OK. Do you accept contingent commissions?

Mr. COUNSELMAN. Yes, we do.

Senator FITZGERALD. And how are they based?

Mr. COUNSELMAN. They are based—there are many, because the companies present them to us, so we have many from many different companies. The majority, more than 50 percent, are loss ratio based. They are not all loss ratio based——

Senator FITZGERALD. Do you deal with any carriers who don't pay you a contingent commission?

Mr. COUNSELMAN. Some carriers do not. The majority of the major carriers do——

Senator FITZGERALD. And do you steer many of your clients to those? Do you put many of your clients into the carriers who don't pay you a contingent commission?

Mr. COUNSELMAN. Absolutely, because the primary concern, and this would be true for all agents and brokers, the primary concern

is to place the proper client in the proper insurer for their situation. The secondary concern for all agents and brokers is what is the compensation. But as has been pointed out, disclosure and transparency are what allow that to happen.

Senator FITZGERALD. Do you disclose your arrangements to your customers?

Mr. COUNSELMAN. Yes, Mr. Chairman, we do, and we——

Senator FITZGERALD. You are not required to, though, unless they ask, is that correct?

Mr. COUNSELMAN. That is correct, but we think it is a good practice to do so.

Senator FITZGERALD. Do you even if they don't ask?

Mr. COUNSELMAN. If they don't ask, we still think it is a good practice to do so.

Senator FITZGERALD. But do you?

Mr. COUNSELMAN. We do on the majority—many of our commercial presentations. We do not typically on small commercial, meaning very small clients who don't seem to have interest in that. But if they did, we would be pleased to provide that information, and we don't on personal lines.

Senator FITZGERALD. But you always put your clients in the policies with the carriers that are best for them. You don't let the extra payments from the carriers influence or cloud your judgment?

Mr. COUNSELMAN. If we didn't do the latter, if we didn't always put clients in the best insurer for their circumstance, we would not be in business for very long because our environment is—it is a competitive environment and it is the right thing to do. I mean, if I were a client, I want to be treated that way.

Senator FITZGERALD. I tend to agree with it with respect to the smaller commercial clients. Now, do you have any Fortune 500 clients?

Mr. COUNSELMAN. We do have a handful, but not very many.

Senator FITZGERALD. OK.

Mr. COUNSELMAN. We do have some, however.

Senator FITZGERALD. OK. But below the Fortune 500 or the Fortune 1,000 companies, there is a lot of competition amongst insurance brokers and I would have to say that my conclusion would probably be that contingent commissions, if there is a firm consistently steering their clients to poor policies in consideration of the contingent fees that they are receiving, they are not going to do very well for very long as an insurance brokerage, and——

Mr. COUNSELMAN. There is also the distinction of contingents are different in different lines of business. In some lines of business, they are paid. In other lines of business, they are not paid.

Senator FITZGERALD. Where are they paid and where are they not paid?

Mr. COUNSELMAN. They are, for example, typically paid for property insurance, automobile, general liability. They are typically not paid for what are considered the higher risk, less predictable lines of coverage, like umbrella excess liability, the high limits of excess exposure or umbrella liability exposure. They are not paid typically in professional liability lines of business, directors and officers——

Senator FITZGERALD. How about health insurance?

Mr. COUNSELMAN. Health insurance, they are quite often paid and they are quite often—they are more often in health insurance related to premium volume and not to loss ratio.

Senator FITZGERALD. OK.

Mr. COUNSELMAN. So that is why I say that more than 50 percent in the business are loss rated, but there are many that are not.

Senator FITZGERALD. OK. Continuing my thought, I think there is, for the smaller companies and for individuals, there is plenty of competition, but with respect to the largest companies, the Fortune 500 companies, it appears two insurance brokerage firms, Marsh and McLennan and AON, have 70 percent of the business. So companies in RIMS, Ms. Ochenkowski's association, you are typically going to have a choice of just a handful of insurance brokers and they have an awful lot of leverage with you. Why is it that your members don't go to other smaller firms? Or why is it that they stick with Marsh and McLennan or AON?

Ms. OCHENKOWSKI. Well, Mr. Chairman, we have not done a study of this, but my own observations would be that most of the larger companies have much more complex insurance placements and so they have more sophisticated advisory needs. It has been perceived, rightly or wrongly, that the larger insurance brokers are capable of delivering that more sophisticated analysis. They have additional ancillary services such as loss control services, actuarial services, etc., that are available to commercial insurance buyers and those have been helpful in assessing the underlying risks.

Senator FITZGERALD. So your biggest members of your association feel they have to go to one of these really big, behemoth insurance brokerage firms like Marsh, AON, or Willis in order to get the services they need? That doesn't give you many options, does it?

Ms. OCHENKOWSKI. It does not.

Senator FITZGERALD. Are you worried about the concentration amongst the large insurance brokers?

Ms. OCHENKOWSKI. We certainly are becoming more concerned about it. However, as we have seen competition and we have felt that in terms of risk management and the quality process that we have, in terms of the way in which risk managers have evaluated the bids that have been placed with them, the procedures that we have used internally, until the recent Spitzer allegations, we felt that those practices were sufficient to steer us in the proper direction.

Quite frankly, I think that is still truly the case except for those extraordinary incidences of fraud, where there is price steering and bid rigging. We are very closely watching the investigations that are going on so that we can better understand what the implications are for us as a whole.

Senator FITZGERALD. Now, Mr. Csiszar, you represent the insurance carriers themselves. Aren't you worried about the concentration at the insurance brokerage level for large-dollar corporate policies? Isn't there a danger for some of your association members who refuse to play ball with a Marsh and McLennan or an AON, that they could simply move the whole swath of customers away from you and put them with another insurer who pays them a higher commission?

Mr. CSISZAR. Let me make it clear, Mr. Chairman, that in the case of our members, and I think this applies to the industry in general, we deal with agents as well as brokers and the brokers are but one small part of that business. I don't have the numbers, but my estimate would be that, by far, the largest amount of business comes in either through your employees as agents or captive agents. By far, the largest volume of business would come from either a Geico-style operation, where your own employees are agents, or you have captive agents, or you have independent agents. The brokerage business is but one part, a separate part, of what the carriers do.

To the extent that you would have anti-competitive behavior of whatever kind going on in that segment of the market, yes, indeed, we would be very concerned about that.

Senator FITZGERALD. How many of you have read the Spitzer complaint against Marsh and McLennan? Have you all read it?

Mr. SOTO. Parts of it.

Senator FITZGERALD. Parts of it. There is a section in there in which the New York Attorney General's Office describes how Marsh and McLennan ordered their people to yank policies from carriers who weren't giving them much in the way of contingent commissions and move it over to carriers who were paying them more of a commission. That is pretty incredible, isn't it?

Mr. CSISZAR. Very much so. Very arrogant behavior, I would say—beyond arrogance.

Senator FITZGERALD. Now, it seems to me that this kind of rogue behavior would not succeed for very long in a very competitive market, but where you have two big brokerage firms with 70 percent of the market and the top three maybe 80 percent of the market, they can behave in this kind of abusive way. Do you agree with——

Mr. COUNSELMAN. Mr. Chairman, I don't agree that is a prevalent practice, what has been described. I don't disagree that it occurred and I don't disagree that it is a problem. But Marsh and AON have a large percentage of the market—I have heard 80 percent said several times today—of a certain segment of the business. That may be 80 percent of the Fortune 1,000 business. It may be 80 percent of the Fortune 500 business. I don't know which it is.

But in many markets, our members, the Council of Insurance Agents and Brokers members, are the dominant or the largest in their market. There are some cities where Marsh or AON are the largest. There are many cities where they are the largest. But there are many other cities where they are not dominant. That may mean there is different behavior that we observe in different cities.

Senator FITZGERALD. How about where you are in Baltimore?

Mr. COUNSELMAN. They are not the dominant——

Senator FITZGERALD. Are you dominant?

Mr. COUNSELMAN. We are dominant in our market.

Senator FITZGERALD. What market share do you have in Baltimore?

Mr. COUNSELMAN. I don't even know, but it would be probably well less than 10 percent. It is probably less than 5 percent, if even—it is probably less than 1 percent. I don't know the numbers,

because it is the kind of market that Mr. Soto described, where there are thousands of agents who are competing every day.

The Washington, DC market, which is not very far from where I live, is a different market and that market tends to be more dominated by a few small brokers. So the market is different.

My point is that in the whole commercial marketplace, Marsh and AON are significant because they are so large, but so are all of the others collectively. And so whatever rules or laws may need to be amended, we also need to understand what is the impact on the rest of that market, which may be as large as 50 percent. It is not that Marsh and AON have 80 percent of the total market. They may have 80 percent of their target market.

Senator FITZGERALD. Now, you defend the contingent commissions and you don't believe that it led to the bid rigging, but in the Spitzer complaint, he talks about the added fees as being a big incentive, and it is clear if you read the complaint that the added fees they could get from contingent commissions were one of the reasons they tried to rig bids in certain circumstances so that they could place the insurance with a carrier who would give them more of a kickback.

Let me just read one paragraph from the Spitzer complaint. This is paragraph 35 on page 12. "Marsh executives have issued directions about specific companies, as well. For example, in April 2001, a global brokering managing director in the excess casualty group in New York wrote to the heads of regional offices. She asked for, 1,920 accounts that you can move from an incumbent insurance company to a company that had just extended its contingent commission agreement.' She warned, however, 'You must make sure that you are not moving business from key contingent commission companies." So she is saying, just move it from the companies that aren't paying us big contingent commissions. Highlighting the incentive represented by her directive, she concluded, "This could mean a fantastic increase in our revenue."

Mr. Counselman, you don't believe this is a conflict of interest when the broker is accepting payments from the carriers to steer business to them?

Mr. COUNSELMAN. What you just described to me is a conflict of interest. But Marsh and AON—I presume AON. I don't know if AON has global brokering like Marsh did as described in Attorney General Spitzer's suit. But what is described in Attorney General Spitzer's suit is the centralization of the marketing or placement of the business in conjunction with these placement service agreements. What goes on in the majority of our members' offices is placements in different companies, insurance companies, are done in those individual offices throughout the country where the client is located.

Senator FITZGERALD. Each office may have their own contingent commission agreement. And Marsh used to be that way and then they centralized it in New York and then they sent out directives from New York to all the branch offices that are here, are the ones who are paying us the most nationwide and you need to steer your customers to buy their insurance from these carriers.

Mr. COUNSELMAN. That is what I have read and that is what is quite different from what we experience day to day in the market-

place, which is why I am urging caution, because we are in numbers more firms and more individuals and a very significant part of the insurance marketplace and how insurance is placed in individual offices close to the client with individual agreements.

Senator FITZGERALD. Mr. Soto, in the small insurance market—you represent the smaller agents—does your office in Miami, do you accept contingent payments from insurers?

Mr. SOTO. Yes, we do, Senator.

Senator FITZGERALD. Would you accept them on, say, an individual coming in to place automobile insurance with you?

Mr. SOTO. We have insurance companies that pay us contingency commissions in commercial lines as well as in personal lines.

Senator FITZGERALD. So should consumers of personal insurance around the country be worried that their small broker is getting a contingent fee from the insurance carrier?

Mr. SOTO. Excellent question. In theory, yes. In actual practice, that marketplace dictates that I have got to come up with the very best or I will lose it. If you look at the history——

Senator FITZGERALD. Because you have lots of competition.

Mr. SOTO. Yes, and if you look at the history of what has happened in personal lines in the United States, about 30 years ago, the independent agency system actually dominated personal lines, and then a number of direct writers and captive agents created a model which was very competitive. They drove down the cost not only in terms of the overhead, but loss control, and over time, because of competition, because insureds over the years found that that model was very attractive, books of business shifted over to the point that we now control about 30 percent of the marketplace. The companies that we do business with have reacted to that and become more competitive, more aggressive, and I can give you a couple of examples.

For example, there is one company that sells directly to the clients and pays no commission and has no contingency arrangement, but we can beat and love to compete against that particular company because those expenses have not disappeared. They have internalized them and they spend a substantial amount of the premium dollar in advertising, which is not an arena that we are talking about here.

The companies that I do business with, the model that they have created is one where I go out and get the client. I do some individual advertising in my community, in the churches, in the Kiwanis and all of that and I attract business and I can compete very well with those individuals. But at the end of the day, if I don't bring more value, they will not change their insurance to me so it is hari kari, economic hari kari for my office to not look at the bottom value.

Senator FITZGERALD. Mr. Hunter, what about that? If we eliminated or prohibited contingent commissions, do you think consumers would really wind up saving money, and are you sure they wouldn't suffer by not having as good of services on the part of their agent or on the part of their broker?

Mr. HUNTER. There is no doubt they save money because, first of all, the individual and small business market is not a sophisticated market and it frequently doesn't do much shopping. It goes

to an agent and the agent says, I represent ten companies. They think the agent will shop. There are no suitability requirements. If they have a captive person, they can put them in the higher-price company. That is why you have rates so incredibly wide apart.

I had a dean of a law school call me. He was furious because he was in AllState and he thought he had a good rate but he was in the AllState. He was not in insurance, he was in indemnity and he had been in there for 10 years, but he always qualified for the low rate. He was paying twice as much. He only found out by chance. He brought a lawsuit and he got his money back. But that is a sophisticated consumer who thinks they are doing well. This is a complex thing, a lot of same-name companies and all that.

But even more concerning than the sales incentives are the profitability contingent commissions, and I think we are going to see something about that. Lots of people have been told not to file small claims lately by insurance agents and brokers, particularly in the last few years. So you can easily devise a hypothetical where someone coming in late in the year might be the—that $1,000 fender bender might lose the contingency for that loss ratio profitability. It is a danger. It is a temptation. I don't know of anybody doing it, but I didn't know what was going on with Marsh and McLennan, either.

Senator FITZGERALD. Perhaps we should be more concerned about the contingent fees being charged of ordinary consumers than we are concerned about contingent fees being charged of the large Fortune 500 or 1,000 companies. Should Congress really care if Marsh and McLennan or AON skin IBM or Caterpillar? Should we care about that?

Mr. HUNTER. Absolutely, from a consumer point of view, because they are going to pass through the cost to us.

Senator FITZGERALD. They are going to pass it on to us, OK. But certainly we should be concerned about it in the case of ordinary consumers getting their homeowners' or automobile policies. Mr. Csiszar.

Mr. CSISZAR. Mr. Chairman, I think—I keep coming back to the fact that let us not mix apples and oranges here. Mr. Hunter talks very broadly about contingent commissions. I think it is important to distinguish between agents and brokers and make it very clear that the agent represents a company and there is a contract between the company and the agent and the best cure for the consumer—do you know when I was a regulator what I would tell my consumer? When I had 225 companies writing automobile insurance in little old South Carolina? I told them to go shopping around because by shopping around, they got the best rate, and there were plenty of places to go for shopping. So if the law dean has a problem, the answer is go shop around and you will find out that you will have more than one choice.

Senator FITZGERALD. Isn't that right, Mr. Hunter? If you are going to a State Farm agent, you know they are selling State Farm policies and probably everybody recognizes that is the only thing you can get there and they are trying to get more business for State Farm. They work for State Farm.

Mr. HUNTER. There is no State that doesn't have an Unfair Claims Practices Act. If an agent or a broker—it doesn't matter in

this example—if an agent or broker delays my claim to get it past the reporting period so that they can keep their override contingent commission on profitability, or tells me not to submit it because it is not covered when it is, or tells me not to submit it because my rate will go up when you shouldn't tell me that, that is illegal in every State for agents as well as brokers.

Senator FITZGERALD. Mr. Soto.

Mr. SOTO. May I comment on the issue of the claims reporting? First of all, it is, and I almost hate to use the term, ludicrous, and if you notice, Mr. Hunter indicated that he has not heard of any single incidence, but in theory, something could happen at the very end of a year. Somebody might not report a claim if you are on December 31. And yes, in theory, that can happen.

In actual practice, the reality is that part of my process of proving myself every day is one where the moment that a claim occurs, that client is looking to me to be prompt about reporting, to explain the process, to be an ombudsman if the claims adjustor is not calling them, and it is difficult to envision that if you have a kitchen fire, I am going to delay 2 weeks in reporting it and either win brownie points with you or get away with it. It is almost impossible to imagine on a Workers' Compensation claim that every State has a responsibility and a law under penalty that it must be reported within 24 hours. And you can go on and on with every line of insurance. It just really in actual practice doesn't happen.

Could you find one or two examples of somebody who may have done that? I suppose you could, but I think that you set the standard early on when you said, are some of these problems individualized or are they systemic and do we need to make radical changes in the system because we have uncovered a few malfeasances? I think that is an excellent standard to look at this. Could that happen? Yes, it could happen. Does it happen in real life? I would suggest to you that practically never happens.

Mr. HUNTER. I would suggest to you I would expect that practically it was impossible for Marsh to bid rig, but there was an incentive and they did. If the agent or a broker has an incentive not to file a claim, they might do it.

Senator FITZGERALD. Now, on the bid rigging—I have found in these Senate hearings that for every villain, there tends to be a hero. There were some insurance carriers that refused to go along and I believe one of them was CNA, is that correct?

Mr. CSISZAR. Yes.

Senator FITZGERALD. CNA wouldn't touch that. Were there others, Mr. Csiszar? Who were they?

Mr. CSISZAR. There were others who are members of our association.

Senator FITZGERALD. Would you like to name them, because it is in a positive light.

Mr. CSISZAR. I would rather not because there have been subpoenas issued——

Senator FITZGERALD. OK, but CNA Insurance, I recall, was one that refused to go along with the charade.

Now, wouldn't the insurance carriers like to get rid of the whole contingent commission arrangement? Isn't it kind of a shakedown of the insurance carriers when Marsh and McLennan comes to you

and says, hey, if you don't play ball with us and give me part of your revenue, kick it back to us, we are going to move insurance business?

Mr. CSISZAR. Again, I would like to distinguish between agents and brokers. For a company to pay contingency fees to an agent is a way to incentivize the agent. That is something—that is what you see with the car salesmen. That is what you see with a food broker, for instance. That is what you see in other industries, where you are incentivizing your own agent, independent or otherwise.

On the brokerage side, I will give you an example. I just bought that famous house in Chicago and it so turns out that after looking at 50 homes, I kept coming back to the same house and it had only been listed the day before or 2 days before. Well, as we are looking at that house, my agent informs me that she is also the listing agent on that house. Did I object to that? No. She had done a tremendous job taking us through 50 or 100 different homes. She was very clear in disclosing it to me. And, in fact, I appreciated the fact that she disclosed it and I don't mind her double-dipping on the commission because she has actually done a good job.

I keep coming back to that on the brokerage side, it is the disclosure issue that is the real problem, true enforced disclosure. And, in fact, we have enough laws on the books to force that disclosure now. If the SMART Act were to pass, for instance, we would have even more tools in our hands. We would homogenize and make it uniform, make it the same disclosure everywhere.

So I think we have got the tools to do this work and what happened is the enforcement process fell apart and you had a few arrogant players in the market who took advantage of it and had the market power to do it.

Senator FITZGERALD. OK. So we have greater disclosure, but you still have two large brokerage firms with 70 percent of the large corporate market. That is enough leverage to exact other types of payment probably out of the insurance carriers. Are you worried about the concentration in the insurance brokerage industry?

Mr. CSISZAR. I think that even the large clients will discover that there are other brokers out there who could do as good a job as the large brokers. Do I know the tie-ins? Oftentimes, they stem from the fact that an AON or a Marsh can do catastrophe modeling for you. They can do financial modeling for you. They have other value-added services.

I think that if General Motors wants to shop around, they can actually shop around and find another broker to deal with, because while there is concentration, I think that competition will break that concentration.

Senator FITZGERALD. What do you think about that, Ms. Ochenkowski? He is saying that General Motors, IBM, or Microsoft, they can probably go ahead and use a smaller insurance broker who can provide the same services. Is there maybe an attitude in the largest corporations in America, the Fortune 500 companies, for example, whoever is the risk manager, just in order to cover himself or herself, feels safer going to a larger insurance brokerage firm? I had better use Marsh and McLennan so nobody else ques-

tions me when I am in the—is there that kind of mentality, do you think, going on?

Ms. OCHENKOWSKI. There may be some of that, and I think there are also true services. If you are global or multinational or even a national company, it is helpful to deal with a national or multinational broker so that there are service offices in the various cities in which a client also has operations. And that is one area in which——

Senator FITZGERALD. Does anybody besides Marsh and McLennan and Willis have international reach, or global——

Mr. COUNSELMAN. Mr. Chairman, yes——

Ms. OCHENKOWSKI. Some do, yes.

Senator FITZGERALD. You do?

Mr. COUNSELMAN. Yes, many of our members do go through other members who are members of networks that operate in other countries.

Senator FITZGERALD. So you could help somebody in London?

Mr. COUNSELMAN. Absolutely.

Mr. SOTO. And you can contract for the service. You know, I am dying to slide one of my business cards to her—— [Laughter.]

Senator FITZGERALD. There you go.

Mr. SOTO. The reality is that as I have read this material, I have been flabbergasted by the fact that you have that kind of power to control large segments of business, and I am trying to raise my hand—I am talking about the mega-brokers—and I am trying to raise my hand and say, the reality is that we can either directly through alliance or through contracting, you can contract services such as loss control analysis and all of that. It doesn't really have to all be housed in-house.

Senator FITZGERALD. Well, it is——

Ms. OCHENKOWSKI. Perhaps there ought to be better marketing, too, from the smaller regional agencies to larger insurance consumers. They don't think that sophisticated insurance buyers would choose to close the door on any viable options, although part of what you suggested in your question may be true, and that is that the senior management of our firms as well as shareholders sometimes respect the placement of coverage with other well-known names because there is a feeling of competence that comes from a household name.

Senator FITZGERALD. Ms. Ochenkowski, your members are not exempt from Federal antitrust laws.

Ms. OCHENKOWSKI. That is correct.

Senator FITZGERALD. Do you think insurance brokerage firms should be exempt from Federal antitrust laws?

Ms. OCHENKOWSKI. Well, that is something you raised earlier and it is not something that RIMS as an organization has considered. It is a very interesting question and I think we would like to think about it a little bit and come back to you with our response.

Senator FITZGERALD. I am not suggesting the repeal of McCarran-Ferguson with respect to insurance carriers. That is a totally different thing, but specifically with respect to brokers. It is not clear to me whether the McCarran-Ferguson Act, which pro-

vides an immunity from antitrust for the business of insurance, meant to apply to insurance brokerage services.

Mr. COUNSELMAN. We believe that brokers are subject to antitrust laws——

Senator FITZGERALD. You do?

Mr. COUNSELMAN. Yes, and that the insurance—the McCarran-Ferguson Act protects or provides, has provisions for certain activities of insurance which allows rate making, for example, collecting data.

Senator FITZGERALD. So you think the Justice Department could bring an antitrust lawsuit against Marsh and McLennan or AON just as the State of New York has brought an antitrust lawsuit against Marsh and McLennan?

Mr. COUNSELMAN. I think that is conceivable.

Senator FITZGERALD. You do? Mr. Csiszar, would you care to comment on that? It wasn't clear to me by reading the McCarran-Ferguson Act.

Mr. CSISZAR. It is not clear, though certainly—and there has been no court case that I know decides it, either. But I think the thrust of McCarran-Ferguson had to do with the risk taking side of the business, not the insurance side.

Senator FITZGERALD. By the carriers, not the brokers, correct?

Mr. CSISZAR. Right.

Senator FITZGERALD. And so we are sitting here where there are two companies with 70 percent of the large corporate market and some of the panelists are suggesting that the McCarran-Ferguson Act was not meant to provide immunity from antitrust to insurance brokers. Maybe this is something the Justice Department should take a look at, because I don't believe these kind of abuses could have gone on successfully or had much of an effect in driving up prices if there were more competition at the very large level.

I don't think the contingent commissions that smaller brokerages, like Mr. Soto's firm, may be accepting at the end of the day, because there is so much competition in the marketplace, people can just move to any other brokerage firm, are going to drive up prices all that much. But where you have two players with 70 percent of the market, it definitely could.

Mr. COUNSELMAN. Mr. Chairman, I think that contingent commissions also drive down prices when they are applied properly because they incent lower loss ratios. They incent my firm and individuals at member firms of the council to go out and find those insureds, those clients, prospective clients, who are interested in controlling their losses and will take the steps, the known steps that a client can take to reduce their losses. So when used properly, they incent positive behavior. Now, obviously, what has been described earlier today was not incenting positive behavior.

Senator FITZGERALD. Mr. Hunter, do you believe they incent positive behavior, the contingent commissions?

Mr. HUNTER. It is possible that they could incent going out and finding some better business, but it is also possible it could incent holding down claims when they hand it in, so it has both incentives.

Senator FITZGERALD. Should politicians be raising the issue of conflict of interest with anyone when, after all, politicians who run

for office are taking campaign contributions from the very same people that they are regulating and passing laws on, correct? [Laughter.]

Mr. COUNSELMAN. We are speechless. [Laughter.]

Mr. HUNTER. You need to have a hearing on that next. [Laughter.]

Senator FITZGERALD. We have covered lots of ground. I would finally—we raised the antitrust issue. What about allowing, Mr. Csiszar, and I know this is sensitive, what about just allowing the FTC to study the insurance industry?

Mr. CSISZAR. In fact, they are doing a study now, I believe. They are doing a study on credit scoring. So they have got their foot in the door. I am not sure how they got it in, but——

Senator FITZGERALD. Now, there was a prohibition from 1980. Do you think they should be allowed—we should repeal the prohibition enacted in 1980 that forbade the FTC not just from enforcement actions with respect to the insurance industry, but from even studying the insurance industry?

Mr. CSISZAR. I think anybody ought to be able to study it. I know that as a regulator, I dealt constantly with GAO on studies. So from my standpoint, studying the industry is something that is of value.

Senator FITZGERALD. Does anybody else care to jump in on the FTC?

Mr. HUNTER. The credit scoring study was specifically authorized under FCRA. That is why it is an exception to the rule. They can't do anything else. In fact, I sat at a table with the chairman of the FTC testifying like this and the chairman was asked about insurance and he said, Mr. Chairman, if I knew the answer to that, I would have broken the law, and that is the problem.

Senator FITZGERALD. Well, listen, you all have been terrific witnesses. I appreciate your candor and your willingness to speak your positions very forcefully.

The record will stay open for 1 week, until the close of business next Tuesday, November 23, in case any of my colleagues have any written questions they may want to give to you or you have any further information that you would like to provide the Subcommittee.

Thank you all again for being here. I appreciate your patience for this long hearing. The hearing is adjourned.

[Whereupon, at 1:32 p.m., the Subcommittee was adjourned.]

APPENDIX

STATE OF NEW YORK
OFFICE OF THE ATTORNEY GENERAL
120 BROADWAY
NEW YORK, NY 10271

ELIOT SPITZER
Attorney General

(212) 416-8050

UNITED STATES SENATE

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

ELIOT SPITZER

Washington, D.C.
Tuesday, November 16, 2004

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. **Marsh & mclennan**

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.

TESTIMONY OF
ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE SENATE GOVERNMENTAL AFFAIRS SUBCOMMITTEE ON
FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY
NOVEMBER 16, 2004

I appreciate the opportunity to speak about insurance brokerage practices, including potential violations of law and conflicts of interest and necessary reforms of the current regulatory system.

I am grateful to the subcommittee members for seizing the initiative on this subject, and I appreciate the historic leadership by New York Attorney General Eliot Spitzer and his office.

My investigation, which began last spring, has expanded significantly in size and scope -- and continues to broaden and escalate.

I am encouraged by the active interest of other states, which we are enlisting and organizing into a strong multi-state response to these serious and disturbing improprieties.

The scale and magnitude of corrupt practices and unethical conduct continue to mount. Increasing evidence of such practices, as we are finding in documents and through other sources, means that much more remains to be done. Our pace will depend on the degree of cooperation or resistance, which has varied. But even at this point, early as it may seem, we have seen evidence of illegal and improper anti-consumer conduct, ranging from bid-rigging to fraudulent, concealed commissions and secret payoffs to flagrant conflicts of interest -- all stifling competition and inflating insurance costs to consumers.

Make no mistake: there will be a barrage of well-aimed, powerful state enforcement actions. They will be pursued promptly -- and aggressively. They will not be diverted by voluntary industry changes in business practices. They will aim to uncover wrongdoing and recover ill-gotten gains for consumers -- and also reform state regulation with new tighter laws and tougher enforcement.

This state enforcement and reform effort cannot be derailed or delayed by federal intervention and intrusion. We have a right and responsibility to enforce state antitrust laws. We will seek strong sanctions and scrutiny. I say with great respect to the United States Congress, and particularly to the distinguished members of this panel: we fervently hope for cooperation and will fiercely fight preemption.

State laxity and inaction will invite federal intervention. State insurance commissioners must heed the call for reform and act quickly to restore consumer confidence. Too many have been industry captives. Some insurance commissioners have aggressively responded to the crisis, but many have not. State insurance regulators may redeem credibility and restore public trust only if they join the fight for reform.

Federalizing this problem is unnecessary and unwise. The United States Department of Justice already has authority to bring antitrust actions and seek criminal and civil penalties for bid rigging and other anti-competitive practices. All too often, federal regulators have favored business over consumers, private gain over public good. The Office of Comptroller of the Currency is seeking to completely gut state banking consumer protection laws. The Federal Energy Regulatory Commission aids big oil and electricity producers without concern for state efforts to protect consumers or the environment. The Department of Transportation preempts state regulation of interstate moving companies -- allowing fraudulent movers to cheat consumers with impunity. Federal law has left the television cable companies virtually completely free from state regulation and oversight.

Rather than rely on federal regulation, state insurance laws should be reinvigorated and reinvented-- made robust and real agents of reform. They should establish an unequivocal, explicit fiduciary duty between the insurance broker and the consumer, require clear and conspicuous disclosure of fees and duties owed to consumers, enable consumers to pay for broker advice that is truly independent of insurance company compensation, and mandate transparent bid systems according consumers informed choices free from insurance company influence.

Congress should examine whether any federal agency has used brokers or agents to purchase insurance and whether any illegal steering or bid rigging occurred in these federal transactions.

I commend and thank California Insurance Commissioner John Garamendi for his thoughtful proposed regulation establishing an explicit insurance broker duty to disclose all information concerning insurance company payments and to prohibit brokers from favoring their interests over consumers.

Commissioner Garamendi's proposal is a solid step but must be more specific and inclusive. Based on the information received pursuant to my subpoenas and other information, I am recommending that Connecticut insurance laws be strengthened to:

(1) establish a code of professional responsibility for insurance agents and brokers, including a broker fiduciary duty to consumers, with clear disclosure of that duty prior to any transaction;

(2) require insurance agents to clearly and conspicuously acknowledge that an agent is acting on behalf of the insurer, not the consumer, and that the agent is paid by the insurer based on sales of the insurer's product to the consumer;

(3) require insurance brokers paid solely by insurers to reveal details regarding such compensation;

(4) provide consumers with the choice of paying a broker directly for the broker's services -- and, if the consumer makes such choice, prohibit the broker from receiving any compensation from the insurer in connection with that business;

(5) mandate that both brokers and agents disclose all insurance quotes to the consumer and record in writing the reasons why a particular insurer is being recommended and the nature of any insurer compensation, e.g. straight line fee or a fee contingent on amount of business booked.

These recommendations are the result of months of extensive review and investigation. After my office became aware of potentially illegal practices in certain aspects of the industry, I initiated and the Insurance Commissioner joined me in issuing 135 letters of inquiry to industry companies.

Since mid-October 2004, I have issued a series of antitrust subpoenas to 29 insurers and 14 insurance brokers seeking information concerning contingent commission agreements, placement service agreements, bonus or incentive agreements and arrangements and related business practices between insurers and insurance brokers. More subpoenas will follow in light of evidence indicating illegal and unethical practices concerning a broad range of insurance products.

The initial information reviewed by my staff reveals business practices at the national large broker level that are riddled with ethical conflicts and the potential for serious abuse. Suspect, corrupt, or fraudulent arrangements are by no means limited to the cases publicized so far. Incentive payments, contingent commissions, placement service agreements, overrides, and outright payoffs appear to be common industry practice, enabling and even encouraging improper and illegal activity.

One insurer, for example, had arranged with a broker to pay a six-figure bonus for meeting a sales goal. The insurer paid the broker the bonus even though the broker failed to meet the sales goal. This six-figure payment seems simply to be a bribe intended to steer future business to that insurer. Any consumer who selects that broker should legitimately be concerned about how that prepaid "bonus" affects the broker's ability to provide a fair, balanced assessment of insurance options.

I have written to chief elected officials of all 169 cities and towns in Connecticut asking for information concerning their use of insurance brokers to purchase municipal health, worker's compensation and local property casualty insurance. I also asked about any contingent commission arrangements. Some town officials have indicated that they were aware of the contingent commission practice, but felt powerless to challenge or change it. The smaller towns were helpless in the face of such predominant industry-wide practices.

We are carefully and closely examining state contracts with insurance brokers and insurers to determine whether illegal conduct has directly harmed state taxpayers.

Despite receiving many boxes of documents, some of our most useful information comes from people in the industry. We welcome such information and are determined to protect confidential sources.

My investigation is active and ongoing. I anticipate bringing lawsuits against entities who have broken antitrust and other state laws. The punishment will be severe.

But equally important is the agenda for statutory reform.

Noteworthy for this subcommittee --as well as our state legislature -- is that we are enforcing and relying on antitrust and consumer protection statutes because the state insurance laws do not adequately prohibit such obvious conflict of interest situations.

Until 2001, Connecticut issued separate licenses for insurance brokers and agents. This distinction reflected the theory that brokers worked for the consumer -- whether a small or large business, an individual or a government agency -- while the insurance agent represented insurance companies.

In response to Congressional pressure to streamline state licensing procedures, the National Association of Insurance Commissioners created a model insurance producers act adopted by virtually all states, including Connecticut.

Simply stated, the model act for registering insurance producers is designed to facilitate the interstate growth of insurance brokerage and agent business, often to the detriment of consumers.

The model act eliminated the distinction between insurance brokers and insurance agents, making them both "insurance producers". Although the designation "insurance agent" survived, the clear legal distinction between the two forms of insurance sellers was eliminated. The model act contemplates brokers receiving fees and commissions from insurers in exchange for consumer business, but it fails to recognize the potential for conflict of interest and to require disclosure of such fees, much less afford other protections for consumers.

The model act needs significant and substantive change to restore consumer faith in the insurance industry.

Specifically, consumers must know upfront whose interests the insurance seller represents. This information should be provided in writing to prevent consumer confusion and ensure compliance with the disclosure requirement. For example, the insurance broker must disclose that the broker has a fiduciary duty to act in the consumer's best financial interest, regardless of who is paying for the broker's services. The insurance agent should clearly indicate that the agent works on behalf of the insurer. This requirement is not new or unprecedented. Connecticut real estate brokers who represent both sides of a transaction must

›btain consumer consent through a statutorily required form explaining the duties of the agent t› ›oth the buyer and the seller.

State law should establish a binding, enforceable code of ethics for both insurance ›rokers and agents. This code should prohibit an agent or a broker from basing an insurance ecommendation on potential compensation from the insurer. It should also require an agent to lisclose in writing that the agent works for the insurance company rather than the consumer. 3oth agents and brokers should disclose to the consumer any compensation from insurers elating to the consumer's insurance purchases.

The code of ethics should impose a fiduciary duty on the broker to obtain the best deal 'or the consumer irrespective of broker self-interest.

Recognizing the potentially corrosive and coercive effect of either contingent or straight ›ommissions on the insurance agent's or broker's recommendation to the consumer, state law hould require full disclosure by the agent or broker of the various insurance options for the ›onsumer. If the agent or broker recommends one insurance product over another, the agent or ›roker must articulate in writing the reasons for the recommendation. This information will ;uarantee the consumer is fully aware of the options and create a paper trail for regulators to nsure that the agent or broker is not making recommendations based solely on the agent's or ›roker's financial interest.

Finally, if a consumer is willing to pay a fee for a broker's services, the broker should be ›rohibited from receiving commissions from the insurance companies concerning that consume: 'he payment of a fee raises in the consumer's mind the clear expectation that the consumer is ›urchasing a service from a person who will work solely in the consumer's best interests. 'herefore, the brokers should not be allowed to take money from both parties in this type of ransaction.

I appreciate the committee's review of this important topic.

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Financial Management, the Budget, and
International Security

Committee on Governmental Affairs
United States Senate

Regarding:
Oversight Hearing on Insurance Brokerage Practices,
Including Potential Conflicts of Interest and the Adequacy
of the Current Regulatory Framework

Tuesday, November 16, 2004

Gregory Serio
New York Superintendent of Insurance
Chair, Government Affairs Task Force
National Association of Insurance Commissioners

Testimony of Gregory Serio
Chair, Government Affairs Task Force
National Association of Insurance Commissioners

Introduction

Good morning, my name is Greg Serio. I am the Superintendent of Insurance in New York. This year I am also serving as Chair of the Government Affairs Task Force of the National Association of Insurance Commissioners (NAIC). I am pleased to be here on behalf of the NAIC and its members to provide the Subcommittee on Financial Management, the Budget, and International Security with an update on actions taken by the nation's state-based system of insurance regulation to supervise brokers, as well as an overview of our efforts to modernize state insurance supervision to meet the demands of the 21st Century.

Today, I would like to make three basic points:

- First, the state system is working well to address known problems and potential conflicts of interest by insurance brokers. The attorneys general in several states are undertaking law enforcement actions and investigations working together with their state insurance departments At the same time, state insurance commissioners are working collectively through the NAIC to develop and implement a three-prong program to protect consumers by adopting a new model law on broker disclosure of compensation, coordinating multi-state information requests and analyses of certain business practices by brokers and insurers, and launching an online system that will allow anonymous filing of "tips" to alert state regulators about unlawful or unscrupulous business practices.

- Second, insurance is a complex commercial product that is very much different from banking and securities. Consequently, the process for regulating insurance products must also be different. Insurance policies are financial guarantees that

are necessarily rooted in the contractual and tort laws of each state to provide protection against unexpected or unavoidable losses that can cripple the lives of individuals, families, and businesses. In doing so, insurance products inevitably touch a host of important and often controversial social issues that are addressed by specific statutory code language in every state. Recent natural disasters, including hurricanes along the eastern coast and fires in California, highlight the advantages of state insurance oversight. State officials are in the best position to respond quickly, and to fashion remedies that are responsive to local conditions. We are directly accountable to consumers who live in our communities, and can more effectively police claims-handling, underwriting, rating, and marketing practices. In addition, residual market mechanisms – which become important as markets harden after catastrophic losses – are more appropriately designed and administered by state officials who are familiar with the insurance carriers and demographics of their region.

- Third, we strongly believe an effective system of national regulation does not mean federal regulation. Involving the federal government will not simplify the complexity of insurance issues, nor diminish their number, nor smooth the process of regulation. Instead, federal intervention in supervising insurance will simply add additional layers of uncertainty, confusion, and cost for policyholders regarding "who is in charge" of regulating claims payments when disasters and personal losses occur. Any federal legislation dealing with insurance regulation carries the risk of undermining state consumer protections through unintended or unnecessary preemption of state laws and regulations. Creating an optional federal charter and its related regulatory apparatus would have a serious negative impact on the state regulatory system, including our efforts to make improvements in areas sought by proponents of a federal charter. Ultimately, a federal regulator would adversely affect state premium taxes and other revenues, which totaled $12.3 billion in 2002.

Two-Tier Action on Broker Issues: Law Enforcement and Regulatory Initiatives

The state response to illegal actions and questionable business practices by brokers and insurers is being handled at two levels. State attorneys general are investigating possible violations of civil and criminal law using their law enforcement powers to obtain information from industry sources by subpoena, file civil lawsuits, and seek criminal indictments and convictions. Due to the very serious consequences associated with charges of illegality and wrongdoing made by law enforcement officials – as well as the severity of potential penalties for persons and firms found guilty – the actions of attorneys general in states such as New York and Connecticut have attracted a great deal of media attention. Complicated business transactions, arcane accounting, and undisclosed compensation arrangements are normally consigned to the business pages of newspapers, but these same practices can become front-page news when allegations of far-reaching criminal fraud and corporate malfeasance affecting billions of dollars are involved.

State insurance regulators are playing a critical role by working jointly with state law enforcement investigations, by developing the facts, and by sharing the information and expertise we have gained through supervising daily aspects of the insurance business. We also recognize that our primary responsibility is to protect the stability of insurance products and markets in our home states by monitoring the solvency of insurers and assuring that consumers are treated fairly when they purchase life, health, and property-casualty insurance for their families, homes, and automobiles. As a result, state regulators routinely monitor aspects of the insurance business that do not attract media attention, but which can have an enormous impact on the two major obligations insurers owe to their customers – issuing sound policies and paying claims on time.

Although the important work done by state regulators to assure that consumers are offered a variety of useful insurance products in a healthy marketplace is not the subject of news headlines, we take pride in the fact that our system has worked very well for over 100 years to provide Americans with confidence that the basic obligations set forth in

their insurance policies will be met. Insurance products can be difficult for many people to understand, and they expect state governments to have appropriate market safeguards and an effective local response if problems arise. "No news is good news" for insurance regulators because it means the marketplace is functioning without significant problems and that our corrective efforts, when necessary, are working behind the scenes to keep insurance markets stable.

Everyone wants to see "bad guys" punished for illegal and unscrupulous activities. State insurance regulators are working with our state attorneys general in the pursuit of these investigations. Our primary responsibility is "to protect the innocent" who have bought insurance products to protect them from financial losses or who have been treated unfairly in an insurance transaction. The general rule of financial markets is that ill-informed actions by business institutions, government officials, and consumers can cause a "run on the bank" that undermines or destroys the very products that people want to save. We are committed to obtaining the facts and acting quickly in response to any findings.

Using our authority to issue licenses and supervise the financial condition of insurance providers, state regulators are reviewing industry business practices and implementing changes that will enhance public confidence in insurance markets going forward. As always, our regulatory purpose is to promote stability in insurance markets so that the highest expectation of consumers – getting their insurance claims paid on time – will continue to be the reality they experience. We achieve such stability through solvency monitoring, market conduct examinations, consumer assistance, and rate and form analysis.

Collective Regulatory Action Through the NAIC

State regulators are moving quickly to strengthen the system for supervising the business activities of brokers and other producers. Three weeks ago, the NAIC created a new Executive Task Force on Broker Activities to address alleged violations of insurance laws

and regulations. This thirteen-member task force includes most states with ongoing investigations of broker activities, as well as a cross-section of insurance markets in the United States. Task Force members include California, Connecticut, Georgia, Illinois, Maine, Missouri, Montana, New Jersey, New York, Oregon, Pennsylvania, South Carolina, and Texas.

Collective state action through the NAIC on broker issues is important for two reasons. First, the brokers and insurers who are the primary subjects of law enforcement complaints operate across the nation and throughout the world. Business practices in one state may be directly connected to problems being identified in other states. Working together, we are gathering the relevant facts to determine the scope and extent of violations and, where appropriate, to share that information with law enforcement authorities.

Second, state regulators are coordinating their inquiries to insurers and brokerage firms in order to expedite the process of receiving the information regulators need. We also want to avoid duplicative and excessive data requests that could delay the responses from the brokerage and insurance industry. Insurance brokers provide a vital service for many customers, and we will not help those customers if the regulatory process unduly hampers the ability of brokers to function efficiently.

The NAIC's Executive Task Force on Broker Activities is pursuing a three-pronged action plan to coordinate multi-state inquiries, leverage state resources, and engage consumers:

1. Greater Transparency on Broker Compensation: The Task Force has developed a draft model act for broker's disclosure of compensation.

2. Full Inquiry and Coordination: The Task Force has developed and will coordinate implementation of a uniform inquiry "template" for states to use in querying their significant domestic insurers and top brokers.

3. Fraud Reporting: As an immediate means to empower consumers, the NAIC will launch an online fraud reporting mechanism that will allow for anonymous "tips" to report unscrupulous business practices for states to investigate.

Industry Must Do Its Part to Report Bad Business Practices

State insurance departments are not law enforcement agencies, but we do supervise market activities as part of our statutory mandate to assure that insurers are solvent and treat the public fairly. Regulators have an array of administrative powers related to licensing that provides a strong incentive for insurers, brokers, and agents to follow state requirements if they wish to remain in the insurance business. A financial regulatory system – state or federal – cannot function effectively to maintain stable and fair markets if it treats all business participants as potential crooks. The vast majority of insurance industry participants provide sound products that are sold honestly in a highly competitive marketplace. What they need from regulators is clear guidance regarding solvency and market conduct requirements, combined with a system of checks and balances that can spot significant problems before they threaten the ability of an insurer to pay policyholder claims.

State insurance regulators supervise the market conduct of industry participants through a dual system of reviewing basic business operations during periodic examinations and investigating specific complaints. A recent example of a coordinated market conduct review is the investigation of race based premiums by state insurance departments. The broker compensation issues being investigated by state attorneys general are an anomaly because they have not resulted in complaints to state regulators. When consumers have complaints about homeowners, health, automobile, and life insurance, they are not shy about contacting their state insurance departments to let us know. In the current situation, commercial insurance buyers have not made complaints that would trigger state corrective action. Participants in the commercial insurance market argue they should be exempt from state regulatory supervision of their business activities because the

commercial market is populated with knowledgeable professionals who are fully able to protect themselves. Some of the most visible participants in the current broker cases are the most vocal supporters of federal legislation that would preempt state authority to regulate rates and sales of insurance.

The NAIC and its members believe industry participants must accept their responsibility for maintaining adequate internal controls and reporting to state regulators business practices which appear to be harmful, anti-competitive, or unethical. Preventing and correcting market conduct problems requires that regulators and responsible business participants work together toward a common goal of strengthening stability and fairness in the marketplace for all consumers.

State Regulatory Modernization: On Time and On Target

During the current broker investigations, some people have asked whether action or involvement by the federal government is needed. State regulators believe the answer to that question is "no". The state regulatory system is inherently strong when it comes to protecting consumers because we understand local needs and market conditions. However, we recognize a need to make the system more uniform, reciprocal, and efficient. Consequently, state regulators have agreed upon a specific modernization plan that is now being implemented across the nation.

In March 2000, insurance commissioners committed to modernizing the state system by unanimously endorsing an action plan entitled *Statement of Intent – The Future of Insurance Regulation*. This important document sets forth a common vision of our response to the Gramm-Leach-Bliley Act and how a state-based system of national regulation should develop in each area where modernization is needed. In September 2003, state regulators took the next step in the modernization process by setting specific program targets and a common schedule for implementing them through adoption of the *Reinforced Commitment: Insurance Regulatory Action Plan*. This landmark document –

the result of lengthy discussions and negotiations – puts the states on a track to reach all key modernization goals at scheduled dates within the next few years.

Working in our individual states and collectively through the NAIC, we have made tremendous progress in achieving an efficient regulatory system for the business of insurance. Significantly, our specific regulatory program targets were developed with extensive input from industry and consumer representatives who are active in the NAIC's open committee process. We strongly believe our regulatory action plan satisfies every legitimate complaint regarding inefficiency and redundancy in the state system. Even if an alternative federal regulatory system were set up tomorrow, there is no way it could achieve these improvements on a schedule that comes close to the aggressive timetable that state regulators have adopted voluntarily.

Insurance is a Complex Financial Product that Demands Local Regulation

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure – often required by law or business practice – is typically much higher for families with several members, more than one car, or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure insurers keep the promises they make.

Protecting insurance consumers in a world of hybrid institutions and products must start with a basic understanding that insurance is a different business than banking and securities. Banks make loans based upon a straight-forward analysis of a customer's collateral and ability to pay, whereas securities can be bought by anyone having sufficient funds at a price set by open markets. In contrast, insurance is a commercial product that offers consumers a financial guarantee that takes into account each customer's potential claims for losses (depending on variable circumstances), financial situation, place of

residence, type of business, "risk management" preparations, or lifestyle choices such as smoking, exercise, education, and travel.

Insurance is thus based upon a series of individual subjective business decisions such as these: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy terms? All of these subjective business decisions add up to one absolute certainty: Insurance products can generate a high level of consumer backlash and customer dissatisfaction that requires a higher level of regulatory resources and responsiveness.

As regulators of insurance, state governments are responsible for making sure the expectations of American consumers – including those who are elderly or low-income – are met regarding financial safety and fair treatment by insurers. Nationwide in 2002, state insurance departments employed more than 13,000 regulatory personnel and spent $947 million to be the watchful eyes and helping hands on insurance problems. We helped consumers collect tens of millions of dollars in claims payments.

The states also maintain a system of financial guaranty funds that cover personal losses of consumers in the event of an insurer insolvency. It is important for Congress to note that the entire state insurance system is authorized, funded, and operated at absolutely no cost to the federal government.

There have been charges from some industry groups that the state regulatory system is inefficient and burdensome, and that a single federal regulator would be better. However, the NAIC and its members do not believe the consumers we serve each day think we are inefficient or burdensome when compared to the agencies and departments of the federal government. During 2002, we handled approximately 4.2 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents. Many of those calls were resolved successfully at little or no cost to the consumer.

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each state. There is no way the federal government could possibly replicate the specific expertise of state legislatures, regulators, and courts to successfully interpret the contractual and tort laws of 50 states and the District of Columbia. Moreover, there is no reason for the federal government to do so when the states have a specific modernization plan and timetable to get the job done.

Congress Must Not Undermine State Modernization Efforts

The NAIC and its members believe Congress must be very careful in considering potential federal legislation to achieve modernization of insurance regulation in the United States. Even well-intended and seemingly benign federal legislation can have a substantial adverse impact on existing state laws and regulations designed to protect insurance consumers. Because federal law preempts conflicting state laws under the United States Constitution, hastily drafted or vague federal laws can easily undermine or negate important state legal protections for American consumers.

When Congress passed the Gramm-Leach-Bliley Act (GLBA) in 1999, it acknowledged once again that states should regulate the business of insurance in the United States, as set forth originally in the McCarran-Ferguson Act. There was a careful statutory balancing of regulatory responsibilities among federal banking and securities agencies and state insurance departments, with the result that federal agencies would not be involved in making regulatory determinations about insurance matters.

Even though Congress tried very hard in GLBA to craft language that would not unnecessarily preempt state laws, there have already been disagreements about the extent to which federally-chartered banks may conduct insurance-related activities without complying with state laws. Under GLBA, no state law may "prevent or significantly interfere" with the ability of a federally-chartered bank to conduct insurance-related business permitted by GLBA. Federally-chartered banks have aggressively asserted their

perceived rights under GLBA to conduct non-banking business unhindered by state laws. As a result, the entry of federally-chartered banks into insurance has become a source of uncertainty and dispute despite the best efforts of Congress to avoid this very result.

We fully expect federally-chartered insurers would insist that state laws involving solvency and market conduct cannot "prevent or significantly interfere" with their federally-granted powers to conduct insurance business anywhere in the United States. A federal insurance charter with its associated laws, regulations, and bureaucracy must necessarily parallel every aspect of existing state laws and regulations, meaning potential conflicts between state and federal laws will likely occur across the board. The result would be years of protracted, costly litigation, as well as market and regulatory confusion that will benefit the legal community rather than insurance providers and consumers.

One of the great strengths of state insurance regulation is the fact it is rooted in other state laws that apply when insurable events occur. The NAIC urges Congress to avoid undercutting state authority in considering any federal legislation that would preempt important consumer protections or create a federal insurance charter. Federal laws that appear simple on their face can have devastating consequences for state insurance departments working to protect the public.

The Impact of Federal Chartering on State Regulation Will Not Be "Optional"

Some industry representatives have said a federal charter merely adds an optional choice to the insurance regulatory system in the United States, and that it would not seriously affect the existing state system. State regulators disagree with this assertion. A federal charter may be optional for an insurer choosing it, but the negative impact of federally-regulated insurers will not be optional for consumers, producers, state-chartered insurers, state governments, and local taxpayers who are affected, even though they have little or no say in the choice of a federal charter.

Let's be clear about the impact of a federal insurance regulator upon state regulation and our ability to protect consumers: The federal government is not an equal regulatory partner because it can preempt state laws and regulations. This simple fact contradicts the very foundation of insurance in the United States; because insurance products are uniquely intertwined and dependent upon state law for everything from underwriting standards, to pricing, to claims procedures, to legal resolution of disputes. There is no logical or practical way to divorce insurance regulation from the state laws that give rise to consumer insurance products.

Despite our different sizes, geography, and market needs, states work together through the NAIC as legal equals under the present system. We find solutions as a peer group through extensive discussion and debate, give-and-take and mutual respect, knowing that no single state can force its own will over the valid concerns and objections of other states. Keeping in mind the original purpose of regulation is to protect all consumers, we believe this participatory democracy and state decision-making, based upon the political and business realities of local markets, is a major strength of the state-based system for protecting consumers and regulating insurers and agents.

Ultimately, a federal charter and its regulatory system would result in at least two separate insurance systems operating in each state. One would be the current department of insurance established and operated under state law and government supervision. This system will continue responding directly to state voters and taxpayers, including the statewide election of the insurance commissioner in twelve states.

A second system would be a new federal regulator with zero experience or grounding in the local state laws that control the content of insurance policies, claims procedures, contracts, and legal rights of citizens in tort litigation. Nonetheless, this new federal regulator would undoubtedly have the power to preempt state laws and authorities that disagree with the laws that govern policyholders and claimants of state-chartered insurers. At the very least, this situation will lead to consumer, market and regulatory overlap and confusion. At worst, it will lead to varying levels of consumer protection,

perhaps even a "race to the bottom" to lower consumer protection standards, based upon whether an insurer is chartered by federal or state government.

Granting a government charter for an insurer means taking full responsibility for the consequences, including the costs of insolvencies and consumer complaints. The states have fully accepted these responsibilities by covering all facets of insurance licensing, solvency monitoring, market conduct, and handling of insolvent insurers. The NAIC does not believe Congress will have the luxury of granting insurer business licenses without also being drawn into the full range of responsibilities and hard-hitting criticism -- fair and unfair – that go hand-in-hand with a government charter to underwrite and sell insurance. Furthermore, we doubt states will be willing to accept responsibility for the mistakes or inaction of a federal regulator by including federal insurers under state guaranty funds and other important, proven consumer protection laws.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand commercial insurance markets have changed, and that modernization of state insurance standards and procedures is needed to facilitate less costly and less burdensome regulatory compliance for insurers and producers.

The current investigations and law enforcement actions concerning broker practices proves once again that states are the best protectors of consumers and marketplace stability. State insurance regulators are working aggressively to identify and correct business practices that are harmful to policyholders and the public. We expect prompt action at all levels to restore full confidence in the insurance marketplace.

In addition, we respectfully request that Congress, consumers, and insurance industry participants work with us to implement the specific improvements set forth in the NAIC's *Insurance Regulatory Modernization Action Plan* through the state legislative system.

This is the only practical, workable way to achieve necessary changes quickly in a manner that preserves the state consumer protections consumers demand. The state-based regulatory reform approach far exceeds having an "insurance czar" in Washington, D.C., along with the huge, costly, isolated federal bureaucracy that will accompany it. It also gives citizens in each state control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

The NAIC and its member states have fully cooperated over the years with important inquiries by Congress into the adequacy of the state regulatory system. We believe these inquiries have been productive, and have clearly demonstrated why local and regional state regulation of insurance is the very best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation, while at the same time preserving our longstanding proven and successful dedication to protecting American consumers.

TESTIMONY OF INSURANCE COMMISSIONER JOHN GARAMENDI
CALIFORNIA DEPARTMENT OF INSURANCE

November 16, 2004

As presented to the
Subcommittee on Financial Management,
the Budget, and International Security
Committee on Governmental Affairs
United States Senate

Insurance is essential for virtually every economic activity of modern life, whether to assure the availability of health care, to buy a home, to drive a car, to own and operate a business, or to care for injured workers. The insurance industry is based on trust.

Buying a policy is not as simple as going to a supermarket for a loaf of bread or a gallon of milk. Most consumers, and even most businesses, don't have the knowledge to evaluate different brands and types of policies, then determine with certainty that what they choose is the best policy at the best price. They more often than not need assistance to make wise insurance decisions.

Because of the complicated nature of insurance, and because most insurance is not purchased directly from an insurer, consumers and businesses often rely on insurance brokers and agents to help them navigate the complex array of choices. During this process, the broker is duty bound to act on behalf of the client, ascertaining his or her needs, and then using its knowledge and expertise to identify which products are available and suitable. After obtaining quotes and offers from a number of insurers offering such products, the broker then advises the client on which option best meets the client's needs. It then negotiates with the insurer to obtain the best price and other terms for the client.

This process is complicated, but it can be compared to other, more transparent industries. Most of you have purchased a home at some point, and many of you did so in new and unfamiliar communities. To help make a wise choice, you more likely than not retained a broker. You told the broker what kind of home you needed, and the broker searched available homes and suggested suitable possibilities that matched your needs. The broker advised you on the price and helped in the negotiations. Finally, once you had found a home you wanted to buy, the broker would help you with the paperwork needed to complete the purchase.

The difference between broker practices in insurance and in real estate is what has caused a national outcry for more transparency. [Virtually] Every state requires a real estate broker to disclose to its client who it is representing and how it is being paid. As a home buyer, you know that your broker will be paid a percentage of the purchase price of the home, and that therefore the broker will be paid more if you pay a higher price for your home. Nevertheless, you trust your broker to give you independent, disinterested advice concerning what best meets your needs.

But in insurance, that's not the reality. You might be shocked and feel that your trust had been betrayed if you learned that your broker had a secret agreement with a particular real estate developer that provided that the broker would get paid more money, in addition to its commission, if it sold a certain number of houses in that developer's subdivision. In fact, any broker that accepted such secret compensation from a home seller would violate the laws in [virtually] every state.

Yet that is precisely the way insurance brokers have routinely violated the trust of the clients they represent -- by entering into agreements -- whether they are called PSAs, MSA's, contingent commission agreements or the like -- which secretly paid them hundreds of millions of dollars in additional compensation from the insurance companies that they recommended to their clients and which sold insurance to their clients. In addition, insurers secretly provided brokers and agents with lavish trips and other incentives based on the amount of business the broker placed with them.

This conduct is against the law in the State of California, and I expect in most or all of the other states as well. Yet somehow all of the major insurance brokerage firms in the country have engaged in this practice under the mistaken belief that it is a longstanding, common industry practice.

Let me be clear. I am not saying that the acceptance of a commission or a contingent commission from an insurer is, by itself, a violation of the law. Although some states prohibit an insurance broker who is acting on behalf of a client from accepting any compensation from an insurer, California, like most states, does not. It is true that if a broker stands to receive more money by placing a client with one particular insurer as opposed to another, that action creates a potential conflict of interest because it gives the broker an incentive to favor that insurer. Whether this should be made illegal is something that I am certain state legislatures will be considering as a result of this scandal.

But there should be no question that accepting such compensation in secret, or providing a disclosure that does not clearly tell the client what compensation the broker is receiving and from whom, is a violation of the broker's duty to its client. And deciding to recommend that a client buy insurance from a particular insurer, not because that insurer offers the best product for the client but because the broker will receive additional compensation, is illegal.

Yet we know that this is in fact what has happened. In fact, we know that it has been endemic, at least with respect to commercial lines of insurance. I will not catalogue all of the

evidence that has come to light as a result of the excellent work of New York Attorney General Eliot Spitzer, who has been working with Commissioner Greg Serio and his staff at the New York Department of Insurance. I would like to describe what we in California have been doing, and what we plan to do, as well as relate some information that may be unique to California.

As soon as information regarding these practices began coming to our attention, we began an informal investigation. At the same time, it was apparent to me that existing law would need to be made clearer and more specific, since such a large segment of the industry apparently was not clear about what the law requires and forbids. We therefore issued proposed regulations and began the process of accepting public comment that is required before they can become law. We are also working with the NAIC Task Force that has been formed to draft a model law to address these issues.

The language of the regulations may change, but the basic intent is this:

(1) To require disclosure of all compensation a broker receives from any party, including any insurer, in connection with the placement of insurance on behalf of a client.

(2) To prohibit the broker from putting its own financial interest ahead of its client's by, for example:

a. Failing to obtain quotes for insurance from a reasonable number of insurers able to meet the client's needs, because the broker has an agreement to receive compensation from some insurers, but not others;

b. Failing to present an offer from an insurer able to meet the clients' needs because the broker has an agreement to receive compensation from some other insurer;

c. Recommending that a client accept an offer from an insurer because the broker has an agreement to receive compensation from that insurer, when another insurer has made a superior offer that better meets the client's needs.

These obligations should be absolutely uncontroversial and should not be opposed by anyone interested in a fair, competitive, open market for insurance. As I have said, I believe that they merely clarify and make more specific what the law now requires. Yet you will hear objections from some in the industry. Let me respond to some of the objections I think you will hear.

(1) With respect to disclosure of the amount of commissions, brokers and agents will ask, "Why should we have to disclose the amount of our commissions? Most salesmen sell on commission, yet they are not required to disclose the source and amount of the compensation they receive."

The answer is, as I have said before, that buying insurance is not like buying groceries. Securities brokers and real estate brokers are required to disclose the source and amount of their commissions, and so should insurance brokers and agents.

(2) You will be asked, "Who do these obligations apply to? Only to brokers? Or to brokers and agents?"

In California, we have one license that permits a person to act as a broker or an agent. There are different requirements in different states. Our definition of who these obligations apply to is simple: anyone who represents more than one insurer, or anyone who holds him or herself out as acting on behalf of the prospective insured, must abide by these requirements.

(3) You will be told, "How can we disclose the amount of contingent commissions when we don't know at the time of the transaction whether we will or will not earn the contingent commission?"

That's easy -- you can disclose the fact that there is an agreement for a contingent commission, and the method by which the entitlement to the commission will be determined and calculated. You can provide a reasonable estimate (for example, based on previous years' experience) of what the amount of contingent commission is likely to be.

(4) Brokers and agents will complain, "You are imposing an obligation to find the most suitable or best available insurance for a client. But there are many factors, not just price, that go into determining what is best for the client; this is an inherently subjective determination made by the client."

We are not holding the broker to an obligation to find the best available insurance. The broker's duty is to take reasonable steps to determine the client's needs; to use its expertise to find options in the market place that meet those needs; to present those options to the client; and to make a recommendation, based on its expertise, of the best available option. These proposed regulations simply say that in carrying out that duty, the broker may not put its own interests ahead of its client's. No one who is unwilling to accept that obligation should be doing business as a licensed broker in the State of California, and we will do everything necessary to make sure that they are not.

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Statement of

Albert R. Counselman, CPCU

President & CEO, Riggs, Counselman, Michaels & Downes, Inc.

Past Chairman, The Council of Insurance Agents + Brokers

Chairman Fitzgerald, Ranking Member Akaka and members of the Subcommittee, I'm Skip Counselman. I'm President and CEO of Riggs, Counselman, Michaels and Downes in Baltimore, MD, Maryland's largest independent insurance agency and brokerage. I'm also past Chairman of The Council of Insurance Agents & Brokers ("The Council"). Thank you for giving me the opportunity to testify before the Subcommittee today.

The Council represents the nation's largest, most productive and most profitable commercial property and casualty insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place more than 80 percent of all U.S. commercial insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

Riggs, Counselman, Michaels and Downes (RCM&D) is the largest independent agency/brokerage firm in Maryland, with more than 250 employees. We are headquartered in Baltimore, with offices in Washington and Richmond. Based on information reported by Business Insurance in its annual survey of firms, RCM&D is the 75th largest insurance/risk management agency in the United States. Our clients range from large, multi-state employers in the Fortune 1000, to large and small hospitals, to mid-size and small businesses and individuals. We provide risk management, including risk control and claim management programs, commercial and personal insurance, self-

insurance and employee benefit programs. We represent most of the largest and best known insurers operating in the United States and many that are based overseas. We have been in business since 1885 and continue to be privately owned by individuals active in the operation of the business. Through our involvement in organizations such as Assurex Global and the Worldwide Brokerage Network, we service clients domestically and around the globe.

Introduction

Insurance brokerage is a highly competitive business that is built on and relies on trust – trust between broker and client; trust between broker and carrier; and ultimately – through those two relationships – trust between carrier and client. The ultimate trust between carrier and client is essential because the insurance business is one of promises, including the promise of the client to detail the nature and extent of its risk exposures and the promise of the carrier to cover those exposures in case of trouble, accident or tragedy.

At the outset, I must make clear that, like you, we are deeply troubled by the serious charges of bid rigging and fraud brought by New York Attorney General Eliot Spitzer. Such activity is not only wrong but illegal, and it has no place in an industry that is based on trust. No one is more concerned about this activity than our brokerage community as we pride ourselves on earning the trust of our customers everyday. We intend to keep it. If these allegations are true, the wrongdoers should be prosecuted to the fullest extent of the law. These individuals have not only severely damaged their own brokerage firm, but they also have cast an undeserved pall over an entire industry, besmirched the reputations of honest brokers throughout the country and undermined the trust on which our industry is built.

While isolated bad actors created a corrupt scheme to limit real choices for some customers, the role of contingent commissions in this evil equation has been irresponsibly hyped and misrepresented. Contingent commission payments were not central to the alleged fraud, despite the connections that some have claimed. Contingent commissions are legal and proper methods of compensation that have been used throughout the

industry for decades. Although they are not a significant source of income in most firms, they are, nonetheless, well understood and widely accepted by the sophisticated commercial marketplace. It is the lack of effective disclosure in some cases, combined with the intent to defraud (in isolated cases), that is at issue here, not a systematic industry-wide failure to disclose fees or a failure of the entire business model, as some have suggested.

Even so, we realize that there is increased concern and confusion in the marketplace, and we support clear disclosure of this income. A basic tenet of any competitive marketplace is access to good information to enable informed decision-making; transparency therefore enables better decision-making. We also believe that any conflict or appearance of conflict is avoided if there is transparency in the compensation arrangements which enables each client to decide what is in its own best interests. The Council has had a toughly worded policy in place since October 1998 recommending precisely such disclosure.

To the extent that you are seeking guidance on potential public policy responses, we offer some observations. First, it is most important that the solution to these isolated examples of fraud and this chance to improve disclosure be developed in the legislative and regulatory cycle, not the news cycle. Contrary to recent news stories, isolated examples of abuse should not be equated with an industry-wide system of "secret payoffs and conflicts of interest." While such baseless and over-heated charges create good headlines and produce new class actions for trial lawyers, they do not represent grounds for a stampede to judgment on a wrong-headed solution that will cost more to consumers than it saves. Solutions should be based on facts and deliberation, not headlines and court settlements.

Second, we do not believe that the fraud Attorney General Spitzer uncovered resulted from a failure of the state-based insurance regulatory system. The toughest of regulations or laws will not stop an individual intent on malfeasance. There have always been bad actors in all industries – not just insurance – and there always will be. That

said, we also believe that regulatory reform is essential for the industry's long-term viability because of the inherent inefficiency and confusion stemming from the vast array of overlapping and sometimes conflicting regulatory requirements imposed from state to state.

In recent years, there has been a focus on the potential creation of an optional federal charter for insurance companies. The Council has been a strong advocate of such legislation for a number of years, but realistically, we understand that it could take several years for optional federal charter legislation to be enacted. It is a major undertaking with a great number of issues to be resolved. Political reality dictates that it will not be an easy process, nor will it be quick.

Between now and then, however, insurance regulation is in desperate need of reform. In order to better serve our policyholders and clients, we need practical solutions to real marketplace problems. To that end, The Council has been an early and ardent supporter of the proposed "State Modernization and Regulatory Transparency Act" (the "SMART Act") discussion draft that Congressmen Mike Oxley (R-OH), the chair of the House Financial Services Committee, and Richard Baker (R-LA), the chair of that panel's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, have been working toward for the last two years. The SMART Act is intended to help create a more uniform and harmonious insurance regulatory system. It includes specific provisions that would require the states to develop and implement a uniform consumer disclosure regime that would include transparency of contingent commission arrangements. I have attached for the record a copy of testimony I presented on behalf of the Council to the Senate Banking Committee at a hearing in September on insurance regulatory reform.

The balance of my testimony today will focus on the role of the insurance broker, the manner in which the broker is compensated for fulfilling that role, and the benefits of contingency arrangements to carriers, to producers and, most importantly, to clients.

1. The Role of the Broker

The importance of insurance in American life and its value to the American economy is unquestioned and has been recognized since the earliest days of our nation. The Supreme Court, for example, has, on several occasions, recognized the central role of insurance to the well-being of individuals and industry alike. "Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States."[1] Indeed, insurance "is practically a necessity to business activity and enterprise."[2] But insurance also serves a broad public interest far beyond its role in business affairs and its protection of a large part of the country's wealth. It is the essential means by which the "disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired."[3]

Within this great enterprise, a broker has two primary responsibilities – to help sophisticated commercial clients minimize and manage their risk and to help such clients design, find and implement comprehensive insurance programs that meet their needs and adequately insure the remaining exposures. The risk management part of the process is essential both to limit the potential risk exposure of the client and to contain the client's cost of insuring its outstanding exposures. The insurance component may encompass, for example, assisting the client with the negotiation of traditional insurance contracts with state licensed carriers; accessing alternative insurance markets to insure more specialized risks; identifying specialized insurance programs or risk pools in which the client can participate; and/or assisting the client with the development of a self-insurance program through the use of one or more self-insurance tools.

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1 *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 540 (1944).

2 *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 415 (1914).

3 *Id.* at 413.

As a technical matter, almost all Council members will sometimes act as an "agent" and at other times act as a "broker" when assisting a commercial client with insuring its risk exposures through an insurance contract with a traditional carrier. As a practical matter, however, regardless of the legal role in which they are acting, the manner in which they approach all such placements for their commercial clients is as an intermediary – working on behalf of their clients to facilitate the consummation of insurance contracts with carriers that have the ability and the capacity to properly insure their risks.

To achieve that end, the agent or broker – or "producer" as both agents and brokers now are jointly defined under the licensure laws of almost every state – cannot simply do an internet search of all of the available off-the-shelf insurance policies and their costs because commercial insurance products are not commodities. They are customized risk-transfer tools, the price and terms of which almost always must be negotiated on a case-by-case basis. Commercial clients rely on their insurance producer to fully understand and appreciate their insurance coverage needs and to work with the carriers that the producer believes are best situated to address those needs.

To give you one example of this, one of my firm's specialized areas of expertise is in the health care sector. A typical hospital requires 142 separate layers of coverage to fully insure its risk exposures. We usually must work with a number of carriers to assemble a complete coverage package for these clients. Some of our other clients may present a more homogenous range of risk exposures, but their risk level may be too high for any one company to bear all of the exposure for any one type of risk. For the World Trade Center, for example, a number of carriers collectively participated in insuring the building, and all of those carriers ultimately contributed to the millions of dollars in payments necessitated by the terrorist attacks of September 11, 2001.

The key questions are – how do we identify the best carrier(s) for any given client? and how do we obtain the "best value" for our client from that carrier or those carriers? Over the course of the last several weeks, some have suggested that the

broker's job is to canvass every available product from each and every carrier to identify the "best" carrier for that particular client and to then zealously represent the client in an adversarial negotiation process against that carrier. The claim is that only through this adversarial process will the client receive the broadest coverage at the cheapest possible price from the "best" carrier.

In the real world, however, it is neither practical nor desirable to evaluate each and every carrier for each and every client. There are literally thousands of insurance carriers, from large national carriers that offer a broad range of insurance coverages to small regional carriers that may specialize in a single product line. At one level, all these carriers offer the same promise – to compensate the insured for a loss. But to make that promise meaningful, the carrier must have the ability to properly understand and evaluate the risk presented and – this is critical – the capacity and financial solvency required to pay any claims that may result from that risk, as well as a reputation that suggests a willingness to make good on that promise.

It is not as if you can simply scan a list of product offerings to determine which carrier offers the most tailored product at the best price. For most clients, coverage terms must be solicited from and negotiated with the carriers on a case-by-case basis, and that simply cannot be done with every carrier in the marketplace that has the capacity to insure a given exposure. And clients do not expect that. They instead expect – indeed demand – that their broker have expertise with the risk profile presented by their business and the savvy to go to the right place for the right coverage for that risk profile. Clients rely on their brokers to know a universe of carriers that are well-situated to address their needs and to negotiate with a handful of those companies to obtain the best overall insurance value for them. As is true in so many facets of life, the best broker for a given client often is the broker that knows that client – or that type of client – best.

The best way for a producer to evaluate a carrier's ability to insure a risk and its capacity to pay claims is by working with that carrier over time. Conversely, a carrier will be in a much better position to understand and evaluate the risk presented if it

understands and trusts the producer presenting the risk to be insured. Quality of business is important to all insurers for a number of reasons including profitability, regulatory compliance, and, indeed, their financial survival. Insurance companies need to make sure the risks they cover are insurable – and spread these risks appropriately – so they are not susceptible to catastrophic losses. As one of the principle insurance distribution channels, brokers help carriers spread the risks in their portfolios according to industry, geography, volume, line of insurance and other factors, and help minimize risks through risk management. As noted previously, brokers provide risk management services to help their clients improve their risk profiles and reduce the likelihood that an insurance event will occur. Brokers also provide claims management, advising policyholders as to how, when and where to file claims. Risk management helps reduce the probability that a policyholder will file an avoidable claim, and claims management helps to ensure that policyholders receive the appropriate payments for any losses that result in a claim.

Thus, the development of a relationship between broker and carrier is essential to enable brokers to provide the best possible products and services to their clients. A strong relationship with the carrier gives the broker clout that can be to the customer's benefit for lower premiums, better coverages, specialized coverages and quicker service and claims payment. This is why the characterization of the client-carrier relationship as adversarial is misguided; at the end of the day, the carrier partners with the client – through the broker-intermediary – not as opponents but in a cooperative way to insure the risks that client presents.

2. Compensation Arrangements and Their Benefits

There are three primary compensation mechanisms to compensate all producers for their services: a fee basis, under which the client directly pays for the services provided; a commission basis, under which the producer is paid a percentage of the premium for the placement services that have been provided based upon the producer's agreement with the carrier; and a contingency basis, under which the carrier provides compensation to the producer, generally at the end of the fiscal year, based on various

compensation formulas that look to the aggregate book of business the broker has placed with that carrier, **not** on any specific transaction or client.

At one level, all of the compensation paid to a broker is funded by the client either through direct payments or through the client's premium payments. The only type of broker compensation paid by the client directly, however, is fees. But the vast majority of clients do not pay fees, and the vast majority of broker compensation – in excess of 90 to 95 percent for most agencies/brokerage firms – is paid by the carriers under agreements between the carriers and the brokers. Forty states require a broker to make an affirmative disclosure to a client if the client is paying the producer a fee and that producer also is receiving compensation from a carrier. The majority of those states require that disclosure to be in writing and agreed to by the client.

Contingency arrangements have been a feature of the compensation landscape for decades, and they generally have been well understood and accepted by the sophisticated commercial client base. They replace a portion of the up-front commissions previously paid to producers, and, on average, contribute approximately 4-5 percent of a brokerage firm's revenue. In my firm, this represents less than one percent of premium volume, which approximates the norm across the industry.

Payments to producers under most contingency compensation arrangements are dependent upon a variety of factors that generally cannot be evaluated at the time any one piece of business is placed, such as overall volume of business with the carrier and the profitability of the business placed with the carrier. These arrangements are based on the overall relationship between a broker and a carrier and on specific services the broker provides to the carrier. Those services include efforts to provide detailed information to assist in underwriting and smooth submissions; work to help research and develop new insurance and risk management products; collection of risk-specific or general information for the insurer to assist in marketplace competitiveness; feedback on quality, service and cooperation in the underwriting and client-service processes; technical services related to claims, risk control, engineering and actuarial skills; assistance in

policy documentation; and analysis of the business submitted to the insurer for underwriting consideration.

Contingency arrangements became controversial in the late 1990s when a new type of compensation arrangement, called a "Placement Service Agreement" ("PSA") (later renamed "Market Service Agreements"), emerged that was not well understood by commercial insureds. Indeed, those commercial clients responded through their trade association – the Risk and Insurance Management Society ("RIMS") – by petitioning the New York Superintendent of Insurance to review the use of such arrangements. That review resulted in the issuance of New York Insurance Department Circular Letter Number 22 in August of 1998. In that letter, the New York Superintendent found nothing illegal or impermissible about contingency compensation agreements but found that the use of PSAs and other contingency arrangements should be disclosed.

At the same time, The Council also undertook its own review. In October 1998, The Council's Board of Directors issued a policy position recommending that all intermediaries provide their clients with notice of the types of compensation arrangements they have in place to give the clients the opportunity to fully evaluate those arrangements and how they affect their interests. This policy position was predicated in part on the recognition that contingency arrangements were put into place for specific purposes. They are to hold a producer accountable to some extent for representations of the risks they place with a carrier (the "preunderwriting" service); for the brokers' success in assisting with the risk management efforts of such clients; and to compensate the producer for the costs they bear in the placement process and the cost-savings they generate for the carrier when the producer and carrier have a more extensive relationship. In other words, contingency arrangements can play a valuable role in helping to facilitate a cooperative risk management/insurance environment from which all participants – client, carrier, producer – benefit.

Conclusion

In conclusion, let me repeat this in the strongest possible terms. The Council and its members are deeply troubled by the evidence of egregious conduct uncovered by Attorney General Spitzer. We embrace this process of review and pledge to do everything in our power to make sure that these bad actors are prosecuted to the fullest extent of the law and that this pattern of behavior is never repeated.

In addition, we sincerely believe that contingent commission arrangements – when properly constructed, disclosed and utilized – fulfill a need in the industry and help foster a cooperative insurance environment that works to the benefit of all participants – the commercial client, the carriers and the producers. Having said that, we appreciate the increased level of concern in the marketplace and, as our 1998 policy statement indicates, we strongly support improved disclosure and heightened transparency in these arrangements in order to remove any potential specter of conflict.

As I said at the outset, this industry is based on, and committed to, trust – trust between broker and client; broker and carrier; and, ultimately, carrier and client. We stand ready to work with the appropriate committees of jurisdiction in the Congress and the states to find solutions to the issues raised at this hearing to ensure that this trust is maintained and that the important work of the insurance industry – protecting people and the economy – continues.

Thank you.

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STATEMENT OF ALEX SOTO
ON BEHALF OF THE
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

BEFORE THE

SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

November 16, 2004

Good morning Chairman Fitzgerald, Ranking Member Akaka, and Members of the Subcommittee. My name is Alex Soto, and I am pleased to be here today on behalf of the Independent Insurance Agents & Brokers of America (IIABA) and to provide my association's perspective on broker compensation issues that are the focus of this hearing. I am an officer of the IIABA and have served on our national association's Executive Committee for over three years. I am also President of InSource, Inc., a Miami-based independent agency that offers a broad array of insurance products to consumers and commercial clients in South Florida and beyond.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a nationwide network of more than 300,000 agents, brokers, and employees. IIABA represents independent insurance agents and brokers who present consumers with a choice of policy options from a variety of different insurance companies. These small, medium, and large businesses offer all lines of insurance – property, casualty, life, health, employee benefit plans, and retirement products.

IIABA's Reaction to the Marsh Investigation

IIABA condemns in the strongest possible terms bid-rigging, marketplace manipulation, and other anti-competitive conduct, and we are outraged by those who have engaged in illegal practices and tarnished the image of our great industry in the process. We applaud the efforts of state insurance regulators, attorneys general, and other law enforcement officials to swiftly identify and bring to justice anyone proven guilty of these unlawful activities. No system of regulation and oversight will ever prevent all determined bad actors from breaking the laws of the land, but we are extremely pleased state officials are acting aggressively and in a coordinated manner to restore the public's trust in the insurance industry. It is our hope that all individuals who have engaged in this conduct will be punished to the fullest extent of the law.

On a personal level, I am saddened and disappointed that such a small group of my peers might lead some observers to question the commitment of our entire industry to its clients. In my own office, like countless others nationwide, we aspire to offer quality insurance products and professional service, and we seek to do so with honesty and integrity. We place great emphasis on operating with respect and fairness in our business relationships. My agency, however, is not unique in this regard. The vast majority of agents, brokers, and insurance professionals operate consistent with these same principles and morals, and these millions of individuals would not consider for an instant engaging in the type of illicit conduct alleged against a broker in New York.

The Insurance Marketplace

The insurance marketplace is highly competitive, and personal and business consumers are well-served as a result. Insurance buyers have an array of options when they buy insurance. Overall, there are approximately 3.5 million licensed insurance producers (agents and brokers) in this country authorized by state regulators to sell, solicit, or negotiate insurance. Consumers can choose to purchase insurance from captive agents (who sell the products of only one insurer), from insurers that sell insurance directly to consumers, or from one of the nearly 40,000 independent agencies in the country that have access to the products of multiple companies.

The independent agency system plays an especially important role in the marketplace. This system is unique from the other distribution channels in that such agencies maintain relationships with multiple insurers and can offer more choice to customers. In fact, on average nationally, they offer policies from eight personal lines and seven commercial lines carriers per agency. Independent insurance agents and brokers invest substantial effort to identify consumers' wants and needs; understand the complex terms of policies available; assess the products available and present choices to the consumer about coverage, price, service, and financial strength of carriers; and remain available to assist with any questions and changes as needed. Independent agents are not locked into one company's policies or products; since they can access multiple companies, they can help consumers locate coverage that is tailored to fit specific needs and desires.

As an independent agent who sells both business and personal insurance, I witness the effects of this intense competition on the ground floor of the marketplace every day. My current customers are approached and solicited regularly by my competitors in the area, and I also do my best to compete effectively against them to grow more business. Such competition keeps agencies responsive and accountable, and helps ensure that consumers are well-served. If an insurance provider ultimately offers a buyer insurance terms that are below par, prices that are inexplicably higher than others, or service that does not create a value proposition for the purchaser, that buyer will move its business to another agent or channel of distribution.

Regulatory oversight and law enforcement help reduce the possibility of bid-rigging and similar criminal misconduct taking place, but vibrant competition in the marketplace also plays an important role. In nearly every aspect of the insurance marketplace and certainly in main street America, the existence of effective competition serves as a check and a balance to deter the type of illegal conduct alleged against a New York broker. In fact, there are only a handful of large multi-national brokers with the economic position and leverage in the marketplace sufficient

enough to even potentially convince insurers to submit fake or excessive bids, and strong enforcement can address those few instances if they arise.

Insurance Producers and Their Compensation

When most Americans seek insurance coverage for their homes, automobiles, or businesses, they are working with an insurance agent, and not with a broker. The distinction between agents and brokers is important. Insurance agents typically do not get paid by the insurance purchaser, and it is commonly understood that the agent receives compensation from the insurer with which the business ultimately is placed. The compensation generally takes the form of a commission, which is disclosed by insurers to state insurance regulators as part of insurers' rate filings. Agents have written contracts with the insurance companies they can place business with and sometimes possess the ability to "bind" coverage for those insurers. These formal contractual relationships are disclosed to state insurance regulators in the form of appointment filings or via the submission to the states of a list of appointed agents. Agents rarely receive compensation directly from consumers, especially in the personal insurance context, and the acceptance of fees by agents is stringently regulated in those jurisdictions where it occurs.

An insurance broker offers advice directly to a client and solely represents that client in the pursuit and purchase of an insurance policy from an insurer. Brokers do this pursuant to buyer-service agreements with their business customers. These insurance experts locate, customize and secure complex insurance packages to address the interests and particular needs of their clients, and almost exclusively interact with professional risk managers and sophisticated commercial enterprises. A broker, because of his or her unique relationship with buyers, is more likely to be compensated directly by the client in the form of a fee. Given the sophistication of buyers who typically utilize a broker, the nature of the fee and the scope of the services provided are the result of negotiation between the buyer and the broker. In some instances, the broker also receives commission from the carrier for placement of a policy.

There are also insurance producers who operate as brokers when the companies they place business for as agents are unable or unwilling to insure an account of a potential purchaser (i.e. there is no market for the risk in the agency); and, again, this typically occurs with commercial purchasers. In such instances, the producer may act as a broker and attempt to locate insurance through a company or other source with which that producer does not have a contractual appointment. The agent's fee may be paid by the insured or, in some instances, by the intermediary or carrier, and the agent does not typically receive what is known as incentive compensation for this type of work.

In addition to the above mentioned compensation that agents and brokers receive, some producers may also qualify for incentive compensation from insurers when certain specified objectives are met. Sales incentive programs are a legal and legitimate tool used in nearly every industry to reward performance, including those that also rely on commission payments. From refrigerators to cars, and homes to business equipment, compensation that rewards a sales force for excellence is sound business practice. There is nothing inherently wrong with such payments that reward performance excellence. Performance excellence is compensated in virtually every industry, sales or otherwise, whether measured by the amount or quality of business produced,

administrative savings generated, speed or quality of customer service, or other criteria. Unlike some other industries, however, the existence and amount of incentive compensation paid to insurance producers is not based upon a particular insured or particular purchase of insurance but is paid based on the overall relationship between a producer and an insurer.

It is important to note that not all incentive compensation agreements are the same. Placement service agreements (which were at the heart of some of the most egregious market manipulation allegations) and contingent commission agreements are entirely different compensation tools. Unfortunately, the two terms have been used in the media as if they are interchangeable. Placement service agreements (PSAs), which are a relatively new phenomenon, are payments to some brokers for the placement of business with specified carriers based on volume, and are not based on year-end calculations that account for profitability, loss experience or other factors. These agreements are negotiated individually by each broker and carrier that have them. In contrast, contingent commissions, which have been used for decades, are based on year-end calculations that typically consider profitability, loss experience, and other factors. These agreements are based on form agreements between agents/brokers and carriers.

Put simply, PSAs compensate brokers up front for the placement of business, whereas contingent commissions are "contingent" on a number of factors and paid on the back end. Contingent commissions can be affected by a range of factors outside the control of the agency or brokerage. Because contingent commissions are not calculated until after the close of the carrier's year, an agent or broker does not even know if he or she will qualify for a contingent commission until after the year closes.

Each party involved in the insurance transaction benefits from the use of contingent commissions. They provide an incentive to agents and brokers to engage in effective underwriting and to assist customers with risk management. These fees also facilitate the appropriate matching of certain risks with risks acceptable to particular insurance companies, which can lead to greater insurance availability. In the end, by bringing efficiency to the overall marketplace, all participants (the consumer, the insurance company, and the producer) benefit.

Some have alleged that the receipt of incentive compensation by *brokers* can create a conflict of interest or the appearance of one because the broker is also paid a fee by the client and because of the broker's unique relationship with the client. Although incentive compensation agreements are legal under the laws of every state, IIABA, as I will discuss below, advocates transparency and the meaningful disclosure by brokers of all such agreements.

In one way or another, any difference in compensation available through any channel of distribution could theoretically be identified by some as creating an unlevel playing field, encouraging the sale of policies generating the highest fee, irrespective of the desirability of those policies to the insured. In fact, an insured may have a choice between a carrier offering reduced coverage at a lower premium and a carrier offering broad coverage at a higher premium. The amount of commission on these different policies could be the same if the commission rates paid by the carriers differ, or they could be different if the commission rates paid by the carriers are the same. Either way, the buyer will obtain the policy that best meets its needs, and the rate or amount of commission will not be a factor in that decision.

We would be remiss if we did not respond to certain, unfounded allegations by some special interest groups that independent agents delay or discourage consumers from filing claims in the hope of receiving contingent compensation based on the aggregate loss ratios of their business. These are irresponsible and unsubstantiated claims. A responsible agent is not going to delay the filing of a claim if his customer's house burns, car is wrecked, or property is damaged.

The reality of the highly competitive insurance marketplace dictates that retaining an insured's business by providing excellent service is far more effective to assuring profitability than attempting to do so by manipulating an incentive fee based on the timing of reporting or filing an individual claim. When an insurance consumer contacts an agent concerning a claim, this is the optimal time for the agent to show a customer that the agent brings value to the insurance transaction. Delaying or discouraging consumers from filing claims is not only reprehensible because it is unethical and improper, it would not make business sense. Such an allegation also fails to recognize that customers may choose to call claims in directly as well, as is encouraged by many carriers.

Disclosure by Brokers

IIABA believes the best way to guard against conflicts of interest or the appearance of such conflicts is through transparency and disclosure. Any insurance producer acting as a broker in a given transaction should clearly disclose to a buyer the incentive compensation arrangements that exist with the insurer providing the coverage. Disclosure of such compensation by brokers is especially important given the unique role that brokers play in the marketplace. IIABA believes that transparency is the best way to ensure that the laws are followed and that the public's confidence is earned and maintained. With proper disclosure of broker compensation practices, and absent widespread illegal and unethical practices such as bid rigging, IIABA believes that incentive compensation should not be further restricted.

Several weeks ago, the National Association of Insurance Commissioners (NAIC) established an executive-level task force to examine broker activities in the wake of the events uncovered in New York by Attorney General Spitzer and Superintendent of Insurance Greg Serio. One of the reported objectives of the new committee is to develop a national standard governing the manner in which brokers disclose the compensation agreements that exist with insurers. Although our association generally prefers marketplace solutions to outright regulatory mandates, we believe this is an area where a national regulatory standard on broker disclosures is warranted. Accordingly, we welcome the regulators' quick action in this area and believe such a model could be an excellent vehicle for restoring faith in our industry.

IIABA believes that any broker disclosure requirement should have certain key elements, including:

- The disclosure requirement should be transaction-specific and apply to any producer acting in a particular transaction as an insurance broker and acting under the terms of a buyer service agreement.

- The proposal should require brokers to disclose all incentive compensation arrangements (PSAs or contingent commissions) that are related to the transaction.

- The disclosure should be made in writing *prior* to the actual purchase of the contract of insurance.

- The disclosure requirement should be implemented by state officials, who have proven experience and expertise with insurance regulation, but it should be implemented without needless deviation or confusion from jurisdiction to jurisdiction.

Although the move toward greater transparency has already begun in earnest, we believe disclosure of broker compensation arrangements would be a significant regulatory improvement. Such action would further promote transparency, ensure that purchasers are knowledgeable of their broker's compensation agreements, and reinforce the trust between brokers and their clients. Proper disclosure also empowers insurance purchasers and enables them to make informed decisions. Most clients understand this form of compensation and its benefits, and those with concerns will have at least two options: (1) work with their broker to better understand the nature of the compensation or (2) select another broker. The insurance industry as a whole is highly competitive, and the private marketplace provides buyers with a myriad of options when they do not approve of the practices of their particular representative.

Insurance Regulation

There will undoubtedly be some who will use the investigations in New York and elsewhere to justify actions and outcomes that have no connection to the alleged illegal conduct uncovered, and such overreactions could have unintended and damaging consequences for consumers and the marketplace. For example, some observers have suggested that the establishment of federal regulation of insurance is the only way to prevent similar events from occurring in the future. As IIABA assesses the impact of this issue on the way insurance is regulated, we come to four major conclusions: (1) state officials have performed their oversight duties capably to date and they should be commended for their actions; (2) a key way to protect against illegal activity is to ensure that competition thrives and that consumers are empowered with the appropriate information and a broad array of provider options; (3) no system of regulation is perfect, and that is why the IIABA continues to support targeted federal legislation within the context of the existing state-based system; and (4) federal regulation of the insurance industry would not have prevented this criminal misconduct and is not a preferable system of oversight.

First, it would be a mistake to suggest that state insurance regulation is to blame for the actions of a small group of lawbreaking individuals. Regulation is meant to deter illegal acts, not preclude them. Individuals and corporations that violate the law are subject to prosecution after the fact, and that is what is occurring here. State officials have acted aggressively to identify and punish those engaged in improper activities, and additional intensive investigations and inquiries continue today across the country. The ongoing investigations at the state level show that the states are on the job and can be successful in ferreting out illegal activities. The alleged illegal conduct that occurred has come to light as a result of the collaborative efforts of state officials,

and we are pleased that state law enforcement authorities have worked closely with and benefited from the insurance expertise of state regulators.

One of the best ways to help prevent the occurrence of similar abuses in the future is to ensure that we have a truly vibrant and competitive marketplace based on transparency and one where consumers have many options. Anything that distorts that market, including overly burdensome regulation or illegal conduct, is not in the interest of consumers. State insurance regulation has many attributes; however, there are aspects of the system that unnecessarily restrict insurer and producer access to the marketplace and thus limit the options and choices available to consumers. State licensing obstacles make it difficult for insurers and producers to offer their services to customers in multiple states, and the adoption of reform in this area would enhance provider options in the marketplace. In addition, state product rules impose barriers that make it difficult to introduce new products and services, and the industry's ability to be responsive to consumer needs suffers as a result.

As we have for over 100 years, IIABA supports state regulation of insurance – for all participants and for all activities in the marketplace. Yet despite this historic and longstanding regulatory support, we feel that the system needs to be modernized to bring it into the 21st century. Despite our continued support for the state system, we are not confident that the states will be able to resolve all of their problems on their own. For the most part, state reforms must be made by statute, and state lawmakers inevitably face practical and political hurdles and collective action challenges in their pursuit of improvements on a national basis. That is why we feel that there is a vital legislative role for Congress to play in helping to reform the state regulatory system; however, such an effort need not replace or duplicate at the federal level what is already in place at the state level. Congress' work in this area need not jeopardize or undermine the knowledge, skills, and experience that state regulators have developed over decades or replace oversight by those closest to the marketplace. The IIABA supports targeted, federal legislation along the lines of the NARAB provisions of the Gramm-Leach-Bliley Act (GLBA) to improve the state-based system.

This is why the IIABA supports the State Modernization and Regulatory Transparency Act (SMART) discussion draft unveiled by House Financial Services Committee Chairman Mike Oxley and Subcommittee Chairman Richard Baker. The SMART draft calls for targeted federal tools with uniform standards to reform the regulatory system under the continued jurisdiction of state regulators – without creating a federal bureaucracy. The SMART bill would improve state-based regulation, which is important to note because it was, after all, an action under state law, not federal law, that brought this issue to light.

Some observers have suggested that federal regulation of insurance is the necessary response and that such a system would have prevented such abuses from occurring in the first place. The IIABA strongly disagrees with that view. Federal regulation is no panacea, and there is no reason to believe federal oversight would have caused a different result. In fact, there are numerous examples of where federal regulators, including those overseeing segments of the financial services world, have failed to adequately protect consumers. Scandals involving investment banks, mutual funds, and the savings-and-loan industry all occurred within industries subject to federal regulation, and, more recently, federal banking regulators have actively

pursued the outright preemption of many state enacted consumer protection laws. This track record does not suggest that centralized federal oversight would do a better job of protecting consumers than state regulators, who possess decades of experience and insurance expertise.

Some insurance industry participants may attempt to argue that the current investigations make the case for an "optional" federal charter. However, the creation of a system utilizing regulatory arbitrage where one regulator competes against the other in a race to the bottom is not the solution to this problem. An optional federal charter would only serve to weaken state regulation by erecting a parallel federal system with little regulatory power.

Conclusion

The IIABA is deeply troubled by the serious allegations of illegal activities such as bid-rigging raised by Attorney General Spitzer in New York. The few bad actors that may have engaged in such practices betray the public's trust and distort what is typically a highly competitive marketplace. These individuals should be prosecuted to the fullest extent of the law. However, there is a major difference between illegal activities, and long-established, legal, state-supervised business practices utilized in virtually every American industry, such as sales incentive programs.

In the insurance context, this incentive compensation benefits the entire marketplace and serves as an important tool that recognizes the value to insurance companies that agents and brokers add from a frontline underwriting perspective, as well as the value to consumers for producers' work on risk reduction. IIABA recognizes the concern expressed by some that the incentive compensation of brokers, although legal in all states, could lead to conflicts of interest or the appearance of such conflicts. IIABA believes the best way to guard against this concern is through the disclosure of all broker incentive compensation arrangements.

The IIABA also believes that state officials have performed their oversight duties capably to date and that the investigations into broker compensation practices do not suggest the inadequacy of the current regulatory framework. However, IIABA acknowledges that no system of regulation is perfect, and as a result, continues to support targeted federal legislation to improve the state-based system.

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Statement

of

Ernst Csiszar

President and CEO

Property Casualty Insurers Association of America

before the

Senate Governmental Affairs
Financial Management, the Budget and International
Security Subcommittee

November 16, 2004

My name is Ernie Csiszar and I am president and chief executive officer of the Property Casualty Insurers Association of America, an association representing over 1,000 property/casualty insurance companies that insure almost half the automobiles, four out of ten homes, and one-third of the businesses in the United States. PCI appreciates the opportunity to present its views on broker compensation issues to the subcommittee.

In the past several weeks, the news media has extensively covered allegations of improper conduct within certain sectors of the insurance industry. The most serious charges involve bid-rigging in which a few large brokers and insurers are alleged to have manipulated pricing and terms of contracts. Such activities are clearly illegal and have no place in a competitive marketplace. Individuals and companies that engage in such activities should be prosecuted to the fullest extent of civil and criminal law.

PCI members support open, fair, competitive and reasonably regulated markets that provide consumers with the greatest possible choice of products and prices. Competition based on product quality, price and customer service is the cornerstone of an efficient insurance market. We condemn any illegal, deceptive, and anti-competitive practices that distort the competitive market.

We take these charges very seriously. The industry, state law enforcement officials and state regulators are responding. However, the alleged illegal conduct identified in the investigation of the New York attorney general is limited to a scant few in the industry. We do not believe that it represents a significant failure of the regulatory system.

While the investigation focused on the blatantly illegal bid-rigging in the market for large commercial risks, some have implied that the majority of American consumers

are being damaged because agents and brokers steer business to certain insurers induced, at least in part, by incentive compensation arrangements.

PCI does not believe that incentive compensation represents an inherent or systemic conflict between agents and brokers and their clients or that it deters agents and brokers from serving the needs of insurance consumers. The integrity of an entire industry should not be called into question because of the actions of a few bad apples.

The effectiveness and efficiency of the insurance market is inherently based on the trust of consumers in their ability to fairly participate in that market. To maintain this confidence, consumers must have access to the most timely, accurate, relevant and useful information needed to make an intelligent purchasing decision. This is true whether they are responsible for protecting their home or family or a Fortune 500 corporation. Impediments to this free flow of information make the market less efficient and less competitive.

PCI believes that regulators should give careful consideration to transparency and disclosure of representation. In the case of agents, when representation is clear and consumers understand that the insurer compensates the agent, there is no conflict, real or perceived. In the case of brokers, PCI believes that trust can be enhanced by the buyer's knowledge about the broker's compensation agreements.

Industry Structure

The insurance marketplace is composed of a variety of parties, including insurers, reinsurers, agents, brokers, managing general agents and policyholders. Insurers may be stock companies, mutuals, reciprocals, Lloyd's firms, surplus lines insurers or risk retention groups. They market their products to consumers in a number of ways.

Consumers access the insurance market and shop for coverage in a variety of ways. They may use the phone to call the insurer directly, log on to the Internet for a direct response, or use an agent or broker to obtain a policy.

Some consumers often decide to hire brokers because the complexity of the coverage often requires customized insurance programs to be designed by risk management professionals. Brokers also have the ability to shop broad, global markets, help the buyer obtain the most favorable terms and conditions from the insurer, and explore alternative markets, such as self-insurance or captive insurance options, to meet their clients' insurance needs. Insurers themselves may use brokers to buy reinsurance.

Agents represent one or perhaps a few insurers. They may be employees of the insurer or independent contractors. Agents offer only the products of the company or companies they represent. Agents represent the insurer and not the buyer in any transaction. In this capacity, agents educate consumers on their insurance needs and options, work closely with companies to ensure that claims and billing questions are handled promptly and properly, and match product and price to the customer's risk profile, desired level of protection, and service requirements.

Brokers' duties to the client arise out of common and statutory law. The broker is bound to fair dealing with the buyer, and by law may not become unjustly enriched by the transaction. Representation of the buyer is the common thread with brokers, though their compensation may come from different sources. Some brokers may receive a fee from the buyer and no one else. Others may receive compensation from the seller, the insurer, and nothing from the buyer. Finally some brokers may receive payment from both the seller and the buyer.

It is important to draw a distinction between those who typically purchase insurance through an agent or directly from a company and those who more frequently use the service of brokers. It is clear from the number of insurers and the number of entities in the distribution channels that the insurance industry is for the most part a highly competitive industry. However, a few major brokers dominate the market for large commercial insurance. The three top brokers account for almost 80 percent of the commercial market placements, affording them considerable leverage with their buyers and sellers. Such concentration and leverage is not present in other segments of the market as evidenced by the 2,700 insurers and the 1.9 million resident agents and brokers licensed in the United States. Nor is it present in the reinsurance arena.

Incentive Compensation

The current controversy revolves around the value and validity of incentive compensation – bonuses paid by insurers to agents and brokers for productivity and profitability. Incentive compensation programs have been an intrinsic part of the American economy for years, broadly used and widely accepted in many industries and professions. Industries using incentive compensation include real estate, automobile sales, airplane sales, food brokerage, office equipment sales, door-to-door sales such as cosmetics, and appliance sales. In essence, any industry that relies on a professional sales force has in place some type of incentive compensation package.

In the insurance industry these incentives are referred to as "contingent commissions." What that means is that these bonuses are not certain – maybe you earn them, and maybe you don't. It is contingent upon your productivity – how many policies

an agent sells for the company or how many policies a broker places with a company – and the profitability of that business.

For the vast majority of insurance agents and brokers, these bonus programs are structured on a long-term basis so that no single transaction guarantees that either the productivity or profitability target will be reached. This structure is designed to reward agents and brokers for sales excellence, superior customer service and top-flight risk management practices over the long term. Most importantly, they also can result in the buyer being able to enjoy innovative products, and more favorable pricing, terms and conditions.

According to the allegations made by the New York attorney general, several large brokers attempted to use their leverage with insurers to make productivity bonus payments a certainty. There are very few brokers that have this type of clout in the marketplace. The key to leveling the playing field, in our view, is to ensure that consumers know whether they are purchasing coverage through an agent or a broker.

Insurance companies disclose contingent commissions on their annual statements filed with the regulators. [1] Buyers can also inquire if their insurer pays such commissions. Despite their importance to the sales force, incentive compensation represents a miniscule portion of the total price paid by buyer. As a percentage of total direct written premium, contingent commissions represented a mere 0.8 percent. By comparison, all direct commissions represented 10.5 percent of direct written premium. [2]

PCI believes that agents and brokers should be lawfully compensated for their work in marketing and risk-classification. Incentive bonuses are an important part of

[1] NAIC Property and Casualty Annual Statement, Underwriting and Expense Exhibit, part 3, lines 2.4-2.6.
[2] NAIC Annual Statement Database via National Underwriter Insurance Data Services/Highline Data

these compensation programs. Some have argued that these bonuses may harm consumers because agents may be tempted to not report claims fearing that such losses will lower their profitability and their incentive income. I can tell you that during my tenure as insurance commissioner of South Carolina I never heard one consumer complaint about such practices. Nor have I ever heard another insurance regulator raise this issue.

Several large brokers have announced that they will no longer accept contingent commissions. Some companies have announced that they will no longer pay brokers commissions based on productivity or profitability. This is a business decision – not a legislative or regulatory one. Each insurance company, agency and brokerage must decide how to handle this issue on its own.

Seeking Solutions

As we address this issue, we must keep in mind what is most important to the consumer – ensuring open and competitive markets. To ensure open and competitive markets, consumers should understand the relationship of the parties, be aware of all options in the market, and have access to accurate, unbiased and timely information.

PCI believes that transparency and disclosure are important components of open, fair, competitive, and reasonably regulated markets and believe that such efforts bear careful consideration.

We oppose overreaching or burdensome proposals that fail to deliver any real value to consumers. Public policy makers should not attempt to impose blanket prohibitions on incentive compensation programs. The terms and conditions of such agreements are best left to the private parties engaged in the contracts.

On behalf of PCI and our member companies, I appreciate the opportunity to appear before you today to address this timely and important issue. We look forward to working with Congress and state legislators and regulators to address concerns, preserve and maintain the integrity of the industry and ensure a truly competitive marketplace for the 21st century.

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SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET AND INTERNATIONAL SECURITY

OVERSIGHT HEARING ON INSURANCE BROKERAGE PRACTICES INCLUDING POTENTIAL CONFLICTS OF INTEREST AND ADEQUACY OF REGULATORY FRAMEWORK

Good morning, Mr. Chairman and members of the subcommittee. My name is Janice Ochenkowski. I am the Vice-President of External Affairs for the Risk and Insurance Management Society (RIMS), the largest professional organization for the risk management community. I am also the Senior Vice-President, Risk Management, for Jones Lang LaSalle, a multi-national real estate company based in Chicago. I appreciate the opportunity to appear before you today on behalf of RIMS on the issue of broker compensation and placement practices.

RIMS' member companies, which number over 4,000, are commercial insurance consumers and are directly affected by the issue of broker compensation and placement practices. RIMS' membership spans the country and consists of entities of all different industries and sizes, including 84 percent of the Fortune 500 companies, as well as approximately 950 "small businesses," those companies with less than 500 employees. Many member companies have full-time risk management departments to identify and manage risks, including purchasing insurance, while some rely solely upon their insurance brokers for these services.

RIMS has always believed that the relationship between brokers and insurance consumers should be governed by the principle of complete transparency. RIMS emphasized this position initially in 1999 and again in a statement issued in August of this year. In both instances, RIMS has advocated for an open and honest dialogue among all parties in an insurance transaction.

RIMS' August 2004 policy statement on industry compensation and placement practices states the following:

> Broker compensation and placement agreements should be transparent, with all sources of compensation, direct and indirect, disclosed without client request. This disclosure will ensure that the risk manager understands not only the cost of coverage, but any arrangements with specific insurance companies, or any fees obtained by the broker from markets approached on behalf of the insured. Disclosure should include compensation or fees related to the broker's overall book of business, as well as those fees related to specific offices, to individual primary and excess coverage, and to reinsurance placements. Existence of compensation arrangements should be disclosed prior to placement of business and annually by line of coverage. Failure to disclose such arrangements runs counter to the spirit of partnership that risk managers seek to achieve with their brokers, vendors, and insurers.

A copy of the statement is attached as Exhibit A.

RIMS is shocked by recent allegations of illegal activities by certain brokers and insurance companies in the placement of insurance contracts. We have been particularly distressed by the findings and allegations by New York Attorney General Spitzer that insurance brokers have violated their position as a trusted advisor to their clients by steering clients to favored insurance companies and engaging in bid-rigging schemes. Such activities undermine the trust and confidence that are at the heart of the customer/broker relationship. RIMS' President, Nancy Chambers, issued a statement addressing this issue on October 22, 2004, a copy of which is attached as Exhibit B.

Insurance brokers are an integral part of the insurance placement system. Brokers serve as intermediaries between commercial consumers and insurers. Traditionally, insurance brokers represent their customers, while insurance agents represent the insurance companies. Commercial insurance transactions often are very complex, and brokers are essential to finding available insurance coverage to meet their customers' needs. Brokers are also responsible for negotiating premiums and policy coverage terms and conditions on behalf of their customers.

RIMS is not a standard-setting body for the insurance industry. RIMS does, however, place great emphasis on educating its members about current issues and advising members on those issues and providing them with useful tools to use to deal with a particular issue. This is the approach taken by RIMS with respect to contingent fees. Members were provided information that some brokers and insurance companies had entered into contingency fee arrangements, and members were given educational tools to assess their impact on their broker relationships.

As the use of placement service agreements and contingent fee arrangements (hereinafter referred to as placement service agreements) became popular with some brokers and insurance companies in the 1990s, RIMS advised its members of such practices. In 1999, RIMS issued a disclosure statement whereby brokers would disclose insurers with which they had contingency fee agreements upon the client's request. Brokers and insurance companies declared at that time that contingent fees represented only a small part of total fees and, as such, this approach seemed appropriate. RIMS followed up on the 1999 statement through its Quality Improvement Process in 2000. RIMS' Quality Improvement Process (QIP) is a comprehensive program designed to guide and facilitate quality improvement for risk managers. Risk managers use these guidelines to improve communications, develop performance expectation agreements, and evaluate the performance under those agreements. Specifically, the QIP states that the broker should work in conjunction with its client to determine coverage needs, and to negotiate with the market to obtain the best terms and conditions at the most favorable pricing level for the client, regardless of any other compensation. Furthermore, it states that all remuneration for services should be supported and disclosed to the client while complying with local insurance laws. In representing the interests of risk managers, RIMS provides workshops, discussion groups, and other educational programs that

address the most pressing issues of the day. In fact, for the past three years, RIMS has offered sessions at its annual conference that explored the many facets of the client/broker relationship. We believe that by educating our members, they will be fully equipped to make the best decisions when they purchase insurance for the companies they represent.

RIMS believes that all compensation arrangements should be disclosed in writing. As I have said, the relationship between the broker and the commercial consumer must be based on a foundation of trust, truth, and honesty. Complete disclosure of all compensation arrangements will go a long way to promoting transparency, reestablishing the trust between the broker and the customer, and providing customers with sufficient information to evaluate any potential conflicts of interest in the placement of insurance policies.

As the facts are becoming known and the investigation into placement service agreements continues, in an effort to address the potential conflict-of-interest issue, RIMS would support a prohibition on the use of placement service agreements by insurers and brokers. Three of the largest brokers have publicly stated that they will no longer enter into placement service agreements or accept contingent fees. Such action, coupled with compensation disclosure, should bring greater transparency to the broker/client relationship and help to restore trust and confidence in the relationship.

Whatever actions legislators and regulators decide are appropriate to address the issues of placement service agreements and contingency compensation, the interests of insurance consumers must be considered. Consumers should not have to pay higher costs for insurance because of abusive actions that may have been taken by some brokers and some insurers. Hopefully, any remedial action will result in lower costs for insurance for consumers by eliminating improper actions that may have increased costs of insurance.

The recent allegations against several insurance brokers in New York have been very troubling. The notion that brokers deliberately acted unlawfully to gain additional profit at the expense of the insurance consumer is simply unacceptable. These allegations have not only undermined the broker/client relationship, but they also have wider implications for the industry as a whole. Any penalties that may ultimately be levied against the companies involved should be used to offset consumer losses that have resulted from these deceptive practices.

I understand that the National Association of Insurance Commissioners (NAIC) is preparing to address the broker compensation issue. One approach that I understand is on their agenda is adoption of a model law on disclosure of broker compensation arrangements. RIMS believes that a national, uniform approach should be taken to address this issue. Regulatory clarity and uniformity are needed, not 51 different approaches.

Thank you for this opportunity to testify on this important issue. RIMS looks forward to working with your Committee and the Congress to address the issue of insurance broker compensation and placement services. I appreciate your time, interest, and leadership, and I welcome any questions by the Subcommittee.

Exhibits (2)

Exhibit A

Policy Statement on Industry Compensation and Placement Practices
August 24, 2004

RIMS strongly supports the position that broker compensation and placement agreements should be transparent, with all sources of compensation, direct and indirect, disclosed without client request. This disclosure will ensure that the risk manager understands not only the cost of coverage, but any arrangements with specific insurance companies, or any fees obtained by the broker from markets approached on behalf of the insured. Disclosure should include compensation or fees related to the broker's overall book of business, as well as those fees related to specific offices, to individual primary and excess coverage, and to reinsurance placements. Existence of compensation arrangements should be disclosed prior to placement of business and annually by line of coverage. Failure to disclose such arrangements runs counter to the spirit of partnership that risk managers seek to achieve with their brokers, vendors, and insurers.

Because of the complex nature of insurance transactions, a special trust relationship built on a foundation of truth and honesty must exist between broker and client. Brokers are obligated to obtain the best coverage at the best price for clients. Disclosure of agreements and relationships with insurers is an important part of the integrity of this relationship. Risk managers should evaluate the impact of contingency fees on their program or marketing process based on that disclosure.

The Society has developed the Quality Improvement Process (QIP) for risk managers, including Guidelines for Performance Expectations, the Broker and Risk Manager Partnership Tool and the Underwriter and Risk Manager Partnership Tool. These tools are available to assist risk managers in working with brokers and other insurance industry providers in a professional manner. RIMS advocates for an open dialogue among all parties on all issues of compensation, as well as all other aspects of the insurance transaction. RIMS believes that broker compensation and insurer selection should be governed by the principles of complete transparency and full disclosure without client request.

Exhibit B

Message from the RIMS President
Industry Compensation and Placement Practices
October 22, 2004

RIMS is shocked by the allegations of illegal activities and their effects on our members. We are distressed by the allegations appearing daily and are disappointed in the individuals who have plead guilty to wrongdoings.

As stated in 1999 and again in our August 2004 statement, RIMS has always advocated for an open and honest dialogue among all parties in an insurance transaction. We support cleanup of any wrongdoing in the industry and hope that these are isolated incidents.

We are carefully watching as this situation unfolds and will keep you, our members, informed via RIMS Alert and other communiqués. We will shortly designate an area on the RIMS Web site for news and information regarding contingency fee issues. Visit www.rims.org to keep informed on this important issue.

A special trust relationship built on a foundation of truth and honesty must exist between broker and client. We look forward to the resolution of these issues and a positive outcome for the industry.

Nancy L. Chambers
RIMS President

Consumer Federation of America

STATEMENT OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE

BEFORE THE

SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

"OVERSIGHT HEARING ON INSURANCE BROKERAGE PRACTICES, INCLUDING POTENTIAL CONFLICTS OF INTEREST AND THE ADEQUACY OF THE CURRENT REGULATORY FRAMEWORK"

NOVEMBER 16, 2004

Chairman Fitzgerald and Ranking Member Akaka, I thank you for the invitation to discuss this important issue with you today. The Consumer Federation of America applauds this subcommittee for moving so quickly to conduct an oversight hearing about the very alarming findings of New York Attorney General Elliot Spitzer's investigation into bid rigging, kickbacks and conflicts of interest in the insurance industry. **Here is the key point I would like to make today: the Spitzer investigation reveals how easily sophisticated buyers of insurance can be duped by brokers and insurers. Imagine the potential for abuse and deceit when small businesses and individual consumers try to negotiate the insurance marketplace.**

Although some have found the results of Spitzer's investigation surprising, CFA has not. These findings are, unfortunately, a reflection of the deeply rooted anti-competitive culture that exists in the insurance industry. Only a complete assessment of the federal and state regulatory failures that have helped create and foster the growth of this culture will help Congress understand how to take effective steps to change it. On the federal side, the antitrust exemption that exists in the McCarran Ferguson Act (and that is modeled by many states) has been the most potent enabler of anticompetitive practices in the insurance industry. Congress has also handcuffed the Federal Trade Commission in prosecuting and even in investigating and studying deceptive and anticompetitive practices by insurers and brokers. On the state side, insurance regulators have utterly failed to protect consumers and to properly regulate insurers and brokers in a number of key respects. Many of these regulators, for example, collaborated with insurance interests to deregulate commercial insurance transactions, which further hampered their ability to uncover and root out the type of practices uncovered by Attorney General Spitzer.

In this testimony, I recommend a number of significant steps that Congress could take to prevent these practices and to better protect consumers. However, as you start to consider federal policy solutions to these problems, I urge you to adopt the mantra, "First, do no harm." Instead of raising the consumer protection bar by requiring a minimum, uniform level of protections in all states, insurance "reform" proposals that have been offered to date in the House would further sanction anti-competitive practices in the industry, override some of the few state protections that are still meaningful, and further encourage state regulators to compete with each other to lower standards. We strongly encourage this committee to reject the House approach outright.

Other Implications of Spitzer Investigation

Spitzer found anti-competitive schemes that harmed corporate and municipal buyers of insurance, among the most knowledgeable purchasers of all. Brokers who are supposedly only interested in getting the best deal for customers received improperly disclosed kickbacks from insurers. There was even bid-rigging complete with fake bids.

The revelations of wrongdoing are not likely to stop with commercial property-casualty insurers and brokers. The Spitzer investigation so far has centered upon brokers, who work for the customer, as opposed to agents, who represent insurers. It has also focused on the sale of commercial property/casualty insurance and not on personal lines, such as life, health, auto and

home insurance. However, because financial conflicts of interest similar to those at the center of the Spitzer investigation exist in the sales of group life and health insurance and some personal policies, similar abuses in these areas may be uncovered.

Businesses often use brokers to undertake bidding to secure "group" life and health insurance for their employees. The same bid systems and potential for abuse exist in these group sales as in the broker-secured property/casualty insurance highlighted in the Spitzer complaint. Brokers who are supposed to be representing the businesses that are buying insurance are also taking "contingent" fees from insurance companies based on the amount of insurance that is bought. This kind of conflict of interest can lead to higher prices for buyers and hurt employees. Brokers earn more from insurers if their customers pay more.

In the area of insurance that is sold individually (non-group life and health as well as auto and home insurance), most sales involve direct-to-consumer transactions, captive agents (employed by insurers) or independent agents that work for commissions and represent different companies. Compensation provided to independent agents offers the greatest potential harm for consumers. One particular type of contingency commission is especially troubling. Insurers provide agents with a kickback at the end of the year if clients file a low level of claims. If an agent's loss ratio (the percentage of claims dollars paid out in proportion to the amount of premiums paid by buyers) is better than specified levels, the agent can get more money as a year-end bonus. The lower the agent's loss ratio, the higher the bonus the agent receives. This is an obvious incentive for an agent to delay filing a legitimate claim or to improperly advise a consumer not to file it.

How Consumers are Harmed by Contingent Fee Arrangements

Consumers are hurt, directly and indirectly, by these practices. Indirect effects include higher taxes if a municipality's insurance has been made more expensive by these practices and higher prices if a corporation's insurance costs rise. Direct effects would include the delay or denial of a claim based on profitability contingency commissions or increased cost of group health insurance through higher premiums for that coverage. Even if the employer pays the premium, the higher cost would leave fewer dollars available for employees, for instance, in the form of salaries.

Marsh stated that its contingency commissions amounted to $845 million in 2003. Other brokers have indicated that they received at least $250 million in contingency commissions in that year. The bid-rigging costs are not included in these figures, but it is very likely that insurers, knowing that there was no competition, took advantage of the situation to increase their profits. When one also considers the impact of this practice on other lines of insurance such as group life and health and personal auto and home insurance, it is clear that we are talking about billions of dollars in overcharges. Indeed, according to 2003 data, industry-wide property/casualty contingent commissions were $4.2 billion.[1]

[1] Best's Averages and Averages, 2004 Edition, page 614.

The Insurance Industry's Anti-competitive Culture

To understand how these practices could flourish, one must first understand that insurance is not a fully competitive business. Attached is a fact sheet explaining why insurance is not as subject to normal competitive pressures as most other businesses. The reasons include the complexity of the product (a complicated legal document few understand), and the need to assess the financial soundness of the insurer and service quality sometimes years before a claim is filed. Insurance pricing and underwriting mechanisms are also exceedingly complex. Moreover, some consumers will stay with the same insurer, even if they know they are paying too much, for fear of having to file a claim early on with a new insurance company. Indeed, underwriting, the ability of an insurer to say "no" at the end of a long shopping effort, is an extremely unusual aspect of insurance compared to normal products.

The complexity of the insurance marketplace and the reliance of many consumers on agents or brokers as a result leaves millions vulnerable to sharp sales tactics. Many unsuitable policies are sold, such as credit insurance policies, whole life plans for children and singles who do not need the coverage, air travel life insurance, cancer insurance and other inappropriate policies.

The upshot is that many consumers pay too much for insurance. High-priced insurers often maintain significant market share, as people frequently do not shop for insurance, placing their fate in the hands of an agent or broker. Consumers we talk to have a strange combination of feelings when it comes to buying insurance: fear and boredom. Many go to a broker or agent and essentially say, "Take me, I'm yours."

For home insurance in 2003, commissions paid to agents and brokers ranged from 0 percent to over 30 percent of premium. Among the leading writers, United Services Automobile Association (USAA) had a commission of 0 percent, Farmers had a commission of 1 percent, State Farm had a commission of 13 percent and Foremost had a commission of 26 percent. Total overhead for Foremost was 35.6 percent v. 18.7 percent for Farmers. USAA had a dividend to policyholders of over 10 percent. CFA reviews of rates charged in several markets over time show that one insurer could easily charge double the price of another for coverage of the same insured. For instance, in Pennsylvania for auto insurance, full coverage rates in Berks County for Travelers are currently shown on the insurance department website as $515, while American Independent would charge $2,178 to the same insured. In Philadelphia, the rate for Progressive Halcyon is $932, but American Independent would charge $3,607. For auto insurance in Eugene, Oregon, American Family would charge a risk $281, but State Farm would price the same risk at $2,805. In Salem, Progressive Northern would charge $449 for the same risk that Mid-Century would price at $1,251. In Crawford County, Kansas for home insurance, Union Insurance would charge $781, but Allstate Indemnity would charge that risk $2,200. In Wyandotte County, Kansas, Union Insurance would ask the price of $781 for home insurance, whereas Allstate Indemnity would ask $2,805.[2] Almost every state has shopping guides. In Hawaii, clean auto risks buying liability coverage pay from as low as $397 for USAA and Tradewind Insurance Company to as high as $993 for GEICO Casualty Insurance Company.

[2] From web pages of the individual states, visited on November 3, 2004.

Unfortunately, it is impossible to assess the rate situation in Illinois, since the insurance department does not collect such data.

Abuses also occur because this is not a fully competitive industry. Insurers are not subject to federal and most state anti-trust laws. The culture of the industry that has developed over many years is one that is unfamiliar with and often hostile to vigorous competition. This is particularly true during the less competitive "hard market" phase of the underwriting cycle of the insurance industry, when insurers tend to cut back coverage and sharply raise rates. The cycle is typically a two to three year hard market followed by an eight to twelve year soft market, where prices are stable or even fall. We have just entered a new soft market after a hard period between 2000 and 2003.

This industry has grown up exempt from anti-trust enforcement and has colluded on pricing through the use of rating bureaus and advisory organizations. For decades, rating bureaus determined full rates and filed them with state regulators on behalf of many insurance companies. In the last few years, the rating organizations have not filed full rates but continue to file "loss costs." Loss costs are the part of the rate that is anticipated to be paid out in claims to victims of injury and for the costs of adjusting and/or defending such claims. The process includes taking data from the past from many insurers and jointly manipulating the data to project these costs into the future, utilizing a process known as "trending."

To get from these jointly produced loss costs to final rates, all the insurer has to do is add overhead costs and profit. It is quite a simple matter to reproduce the old rate bureau rates, since the expense data used and the profit provision of the rate bureaus is well known. Thus, at the onset of a hard market, for instance, the industry knows the approximate level of prices that the rate bureaus would have set and moves near or to that target, sharply increasing prices to non-competitive levels. Insurers have the legal right to discuss rating and they frequently signal their intent to raise rates in trade press and by other means.

For instance, "Insurance company executives lectured, scolded and even pleaded with their counterparts to hold the line on underwriting discipline and resist any temptation to prematurely soften property/casualty market prices, during an industry conference here. 'Let's not get pulled into a soft market. We are not ready for a soft market and cannot afford one…' said James Schiro, chief executive officer of Zurich Financial Services. "Let's not get in a race for marketshare,' he said, adding that 'we need several more years of profitability' … a theme emphasized again and again by CEOs speaking at the meeting.

"Mr. Schiro was hardly alone in his position. 'It's hard to understand the euphoria over the rate increases of the past couple of years, since as an industry we still have so much farther to go to get to an even marginally acceptable return-on-equity,' said Maurice Greenberg, chairman and CEO of American International Group in New York…Mr. Greenberg added that 'in a risk business like ours, the pursuit of marketshare at the expense of earnings is not a great strategy.'

"Following Mr. Greenberg's speech, William Berkley, chairman and CEO of W.R. Berkley Corp in Greenwich, CT, said during a discussion of capital strength that 'the goal of any

carrier should not just be to sell more insurance and get bigger, but to make more money on a risk-adjusted basis. That requires adequate pricing.'"[3]

"We absolutely need to hold the line on pricing and not give in to excessive competition," said Maurice Greenberg.[4]

Obviously, the Spitzer investigation has highlighted other anti-competitive practices that have occurred in the industry as well, such as contingent commissions and bid rigging. Anti-competitive state laws also abound, including laws that prohibit groups from forming to buy insurance more cheaply in some lines of insurance (so called "fictitious group" laws) and laws that prohibit agents from negotiating lower commissions with clients (so called "anti-rebate" laws).

What are the Lessons from the Spitzer Revelations?

A key lesson from this scandal is that state regulation has failed to protect consumers. Previous scandals involving life insurance market conduct abuses and insolvency issues had already shown the serious weaknesses in state regulation.[5] This raises the issue of what sort of federal role might be warranted.

Whatever the federal role, it should be to enhance, not diminish, consumer protection standards. In recent years, insurers have exploited the perceived need for regulatory "uniformity" to weaken the handful of state protections that are strong and to lay the groundwork for a weak, uniform national law. State consumer protections have been reduced over the last few years as the states geared up to fight federal encroachment into insurance by luring insurers to their camp. This has been particularly true for commercial risks.[6]

In the very area of the Spitzer findings, commercial property/casualty insurance, the NAIC has moved to gut its recommended consumer protections. Rate review by regulators has been weakened for all commercial policies. Larger, more sophisticated clients have been "freed up" from state regulatory oversight. This freeing up is now shown to be highly questionable as the supposedly sophisticated buyers were duped by anti-competitive industry practices.

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[3] National Underwriter, November 21, 2003, reporting on the Annual Executive Conference for the Property/Casualty Industry.

[4] BestWire, November 24, 2003.

[5] Many states have become classic victims of regulatory "capture". Revolving doors swing freely between regulators and regulated, as about 50 percent of commissioners come from the industry and 50 percent return to it. State legislative committees and the National Conference of Insurance Legislators are often stacked with members who are part-time legislators and full-time insurance agents, executives or employees. "Issues and Needed Improvements in State Regulation of the Insurance Business," General Accounting Office, PAD-79-72A, October 9, 1979. "State Legislators and Insurance Conflicts of Interest," Consumer Federation of America, 1995. "Many State Legislators Involved With National Insurance Organization Have Close Ties To Insurance Industry," Consumer Federation of America, July 9, 2003, http://www.consumerfed.org/0709insurance.html.

[6] "Examination and Oversight of the Condition and Regulation of the Insurance Industry," Testimony of J. Robert Hunter, Director of Insurance of the Consumer Federation of America, Senate Committee on Banking, Housing, and Urban Affairs, September 22, 2004.

Another lesson is that, if consumers are to be protected, financial conflicts of interest must be eliminated. If the scandals on Wall Street, in the mutual fund industry and now in the insurance industry have taught regulators anything, it is that consumers inevitably lose when financial conflicts exist. Most insurance agents and brokers are honest, but if the compensation system provides an incentive for bad behavior, it will inevitably occur. To weed out the abuses that have occurred, regulators must go to the root of the problem and eliminate the conflicts that fostered this unethical and illegal behavior.

What Should Congress Do?

First, Congress should stop consideration of bills that weaken consumer protections. We urge Congress not to enact proposals championed by powerful segments of the insurance industry and the leadership of the House Financial Services Committee that would deregulate insurance. The most prominent of these proposals is a "discussion draft" released earlier this year by Representative Michael Oxley, the Chair of the Financial Services Committee, and Representative Richard Baker. This proposal increases the federal role in insurance regulation while overriding many of the most important consumer protections that exist at the state level, such as the regulation of insurance rates. This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would also be helpless to stop the misuse of risk classification information (for pricing purposes), such as credit scores, territorial data and the details of consumers' prior insurance history. The draft bill goes so far as to completely deregulate cartel-like organizations such as the Insurance Services Office and the National Council on Compensation Insurance, while leaving the federal antitrust exemption fully intact.

What the draft does not do is as revealing as what it does require. It does not create a federal office to represent consumer interests, although the draft creates two positions to represent insurer interests. It takes no steps to spur increased competition in the insurance industry, such as providing assistance or information to the millions of consumers who find it extremely difficult to comparison shop for insurance, or eliminating the antitrust exemption that insurers currently enjoy under the McCarran-Ferguson Act. Insurers are not required to meet community reinvestment requirements, as banks are, to guarantee that insurance is available in underserved communities. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

The draft does not establish minimum federal consumer protections or empower a federal regulator to investigate and prosecute the kind of abuses uncovered in Attorney General Spitzer's investigation.[7] As mentioned above, the Spitzer investigation reveals that anticompetitive practices in the industry can snare even the most sophisticated buyers of insurance. By further deregulating the industry, the Oxley-Baker proposal would lead to even more anti-consumer abuses. Federal involvement should increase consumer protections, not gut them.

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[7] (For more information, see CFA's letter to Congressional leaders at: http://www.consumerfed.org/oxley-baker_proposal.pdf.)

Second, consider a federal minimum standards bill for states to enforce. If there is to be a federal standards approach, the standards must be high. (See attached list of recommended provisions for such a bill). Standards based on the best state regulation has to offer -- not the worst -- should be the focus.

An example of an effective federal approach is Senator Hollings' bill (S. 1373) to establish minimum national standards based on the California regulatory system that all insurers must meet. Research by CFA has shown that California's Proposition 103, passed by the people of the state in 1988, offers the most effective regulation in the nation. For example, since 1989, auto insurance rates are up by 30 percent nationally, but have dropped by eight percent in California. The California model has proven that tight regulation and vigorous insurance competition (California does apply its anti-trust laws to insurance) cannot only coexist but can mightily succeed. We support S. 1373's prior approval mechanism, annual market conduct exams, the creation of an office of consumer protection and the enhanced competition that enhanced consumer information and repeal of the anti-trust exemption would bring. This combination of regulatory and competitive initiatives would likely have headed off scandals of the sort Spitzer has uncovered.

However, even with good standards, a federal approach is fraught with risk, given the lack of federal insurance regulatory expertise and the strong possibility that sooner or later any federal regulator would be subject to the same kind of regulatory capture that has occurred at the state level. Thus, it is essential that any federal approach mandate strong, well-funded structures to represent the needs of consumers. One model might be the Texas Office of Public Insurance Counsel, which was formed to represent insurance consumers before the insurance department. It is a separate entity, outside of the insurance department, that appears at hearings to present the consumer view on issues. Another model would be utilities public advocates, which exist in many states. A third model is California's consumer participation program under which consumers can intervene in public policy issues and rate cases to represent the consumer interests and receive funding if they make a substantial contribution to the case's outcome.

Third, unleash the FTC. Under the McCarran Ferguson act of 1945, states are given sole authority to regulate insurance. Insurers are also granted an exemption from federal antitrust laws that prohibit anti-competitive practices, such as colluding to set rates. The FTC is forbidden from prosecuting antitrust or consumer protection violations related to the business of insurance. However, until 1981, the FTC was allowed to investigate and study problems in the insurance industry and to then make enforcement recommendations to state regulators. In response to a FTC investigation and report that was very critical of whole life insurance products, Congress prohibited FTC investigations on most insurance matters and only allowed the FTC to conduct studies of the industry if specifically requested to do so by a Congressional Committee.[8]

[8] The FTC Improvements Act of 1980 allows the FTC to study an insurance issue only upon a specific request by a majority of either the Senate or House Commerce Committees [15 USC 46(i)]. This Act also still allows the FTC to use its investigative and reporting powers to examine a minor set of issues: antitrust activities not allowed under the broad antitrust exemption granted to insurers in the McCarran Ferguson Act.

In the long run, the FTC should be allowed to prosecute unfair and deceptive practices in the insurance industry. In the short term, Congress should immediately allow the FTC to investigate and report on insurance abuses and to offer recommendations for enforcement actions to the states.

Fourth, repeal the anti-trust exemption. The question is: has the insurance industry's anti-trust exemption outlived its uselessness? The history of the insurance marketplace is replete with anti-competitive agreements and joint price-fixing arrangements. A history of the insurance anti-trust exemption and the state/federal issues involved in insurance regulation can be found in the Committee Report for legislation reported out of the House Judiciary Committee in 1994 that would have partially scaled back the antitrust exemption.[9]

As this history makes clear, insurance companies have, at times, favored state regulation of insurance and, at other times, favored federal regulation, depending upon which one was less rigorous at the moment. It is also clear that Congress intended to enact a short-term moratorium on enforcement of the antitrust laws when McCarran Ferguson was enacted in 1945, not a permanent ban. The House and Senate approved different versions of McCarran Ferguson without the benefit of committee hearings on the measure.

> Within 2 weeks of the bills *(sic)* introduction, and without holding any hearings on the new measure, the Senate had passed it... The House Judiciary Committee also approved the bill without the benefit of hearings... And it was in the conference committee that the seeds were sown for the current congressional debate over competition policy and the McCarran-Ferguson Act. The conference committee proceeded to drastically transform what had been a limited moratorium into a permanent antitrust exemption for the insurance industry... The House approved the conference report without debate. The sole expression of the Houses *(sic)* intent regarding the conference report containing the new section 2(b) proviso is the statement of House managers of the conference, which indicates the House managers intended only to provide for a moratorium, after which the antitrust laws would apply. The Senate, in contrast, debated the conference report for 2 days. After repeated assurances that the proviso was not intended to preclude application of the antitrust laws, the Senate passed the bill; and President Roosevelt signed it into law on March 9, 1945.[10]

Insurance is therefore largely exempt from federal anti-trust law application. Only a handful of state anti-trust laws apply. And even in those jurisdictions, rules allowing joint action often are in place.

Testimony before the House Judiciary Committee in 1993 makes clear that an anti-trust exemption is not required for the insurers to obtain historic data compilations.[11] But current manipulation of these data, such as trending claims into the future, would not be allowed if the exemption were removed or scaled back. Trending claims is akin to allowing all homebuilders

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[9] Insurance Competitive Pricing Act of 1994 (H.R. 9), Committee Report, October 7, 1994.
[10] Ibid, pages 23-25 in Lexis-Nexis online version (page numbers may not correspond to original).
[11] Insurance Competitive Pricing Act of 1993: Hearing on H.R. 9 before the Subcommittee on Economic and Commercial Law, House Judiciary Committee. Testimony of Assistant Attorney General Ann K. Bingaman, Consumers Union Legislative Director Linda A. Lipsen.

to get together and agree on the costs of supplies and labor in the coming year in setting prices for construction. This anti-competitive joint manipulation of data would be called price fixing in most other industries and must end.

Fifth, require transparency so consumers can compare insurance products. For 20 years, consumer advocates have called for disclosure similar to the energy efficiency ranking you see when shopping for a refrigerator. This disclosure shows, for example, that a particular unit uses 1000 BTUs, and the average for models like this is 800 BTUs. People understand right away that this is an inefficient refrigerator. CFA would suggest a point-of-sale disclosure of insurance policy value. The disclosure would show the expected payouts per dollar of premium; how much for claims, commissions, overhead, profit and so forth. Commissions could be split into regular commissions and contingent commissions. Actuaries know these figures because they are used to set rates. Right next to the various figures would be displayed the same information for the overall industry. This information is also readily available from sources such as the NAIC and A.M. Best & Co. Consumers could focus upon the part of the premium expected to be paid out in losses. This is known as the "loss ratio." So, if the policy a consumer was considering was expected to pay out 50¢ per $1.00 in claims but the industry average were 70¢, the consumer would know that it was a bad deal, an "inefficient" (costly) deal.

I would be happy to respond to your questions at the appropriate time.

WHY INSURANCE IS AN ESSENTIAL PUBLIC GOOD, NOT SOME NORMAL PRODUCT THAT CAN BE REGULATED SOLELY THROUGH COMPETITION

1. ***Complex Legal Document.*** Most products are able to be viewed, tested, "tires kicked" and so on. Insurance policies, however, are difficult for consumers to read and understand -- even more difficult than documents for most other financial products. For example, consumers often think they are buying insurance, only to find they bought a list of exclusions.

2. ***Comparison Shopping is Difficult.*** Consumers must first understand what is in the policy to compare prices.

3. ***Policy Lag Time.*** Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy's usefulness may not arise for decades, when a claim arises.

4. ***Determining Service Quality is Very Difficult.*** Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

5. ***Financial Soundness is Hard to Assess.*** Consumers must determine the financial solidity of the insurance company. One can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

6. ***Pricing is Dismayingly Complex.*** Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

7. ***Underwriting Denial.*** After all that, underwriting may result in the consumer being turned away.

8. ***Mandated Purchase.*** Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "free-market", but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.

9. ***Incentives for Rampant Adverse Selection.*** Insurer profit can be maximized by refusing to insure classes of business (e.g., redlining) or by charging regressive prices.

10. ***Antitrust Exemption***. Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it doesn't matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home or health.

Consumer Principles and Standards for Insurance Regulation

1. **Consumers should have access to timely and meaningful information about the costs, terms, risks and benefits of insurance policies.**
   - Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
   - Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
   - Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
   - Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or an independent third party.
   - Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
   - A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.
   - Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
   - Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
   - Information on claims policy and filing process should be readily available to all consumers and included in policy information.
   - Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
   - Consumer Bill of Rights, tailored for each line, should accompany every policy.
   - Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). The insurer should give the consumer notice of feedback procedure at the end of the transaction, e.g., form on-line or toll-free telephone number.

2. **Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.**

   - Disclosure requirements above apply here as well and should be included in the design of policy and in the policy form approval process.
   - Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
   - Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurance are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
   - "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
   - Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. **All consumers should have access to adequate coverage and not be subject to unfair discrimination.**

   - Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (e.g., mortgage), regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
   - Market reforms in the area of health insurance should include guaranteed issue and community rating and, where needed, subsidies to assure health care is affordable for all.
   - Information sufficient to allow public determination of unfair discrimination must be available. Zip code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authorities for review and made public.
   - Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.
   - Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
   - Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. **All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.**

   - Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
   - Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
   - Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable.)
   - In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
   - A regulatory entity, on its own or through delegation to an independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. **Consumers should have control over whether their personal information is shared with affiliates or third parties.**

   - Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
   - Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
   - Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
   - Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
   - Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.
   - Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
   - Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.**

   - Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
   - Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
   - Bad faith causes of action must be available to consumers.
   - When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be an independent, fair and neutral decision-maker.
   - Private attorney general provisions should be included in insurance laws.
   - There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. **Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.**

   - Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers:
   - The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
   - Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
   - Regulators should focus on online monitoring and certification to protect against fraudulent companies.
   - A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
     - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
     - Access to information sources should be user friendly.

  - Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database. NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., providing a rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
  - Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office

with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.

- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. **Consumers should be adequately represented in the regulatory process.**

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or "one-stop" approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have a well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., a consumer advisory committee. This is particularly true to ensure that the needs of certain populations in the state and the needs of changing technology are met.

UNITED STATES SENATE
COMMITTEE ON GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON FINANCIAL MANAGEMENT, THE BUDGET, AND INTERNATIONAL SECURITY

OVERSIGHT HEARING ON INSURANCE BROKERAGE PRACTICES, INCLUDING POTENTIAL CONFLICTS OF INTEREST AND THE ADEQUACY OF THE CURRENT REGULATORY FRAMEWORK

November 16, 2004

American Insurance Association Statement

Chairman Fitzgerald, Ranking Member Akaka, and members of the Subcommittee, this written statement is submitted by the American Insurance Association (AIA) on behalf of its member insurance companies that write all lines of property-casualty insurance in every U.S. insurance regulatory jurisdiction. AIA has a strong interest in the issues under discussion today, as many of our member companies distribute their property-casualty insurance products to consumers through insurance brokers. We also have a strong interest in a well-functioning insurance regulatory system that focuses on core regulatory functions such as financial solvency and market conduct.

In a very real and important way, a democratic, entrepreneurial society requires a vibrant insurance mechanism. We cannot have democracy without a free market economy that provides consumers with real choice. Free markets cannot exist without the ability to take risks. Risks cannot be taken without the ability to spread and protect against potential losses and costs. Insurance performs the vital task of risk sharing and provides the financial protection mechanism for individuals and commercial enterprises.

AIA and our members strongly believe that the type of illegal activity recently alleged with respect to insurance brokerage transactions is unacceptable and brings dishonor on the industry. In this context, it is important to understand that current law already proscribes bid rigging, antitrust violations and fraudulent activity.

The state insurance regulatory community has begun to mobilize to deal with issues beyond these allegations of illegality, and AIA is committed to working with regulators to ensure the adoption of appropriate new safeguards. In focusing on brokerage transactions, we believe that any new legal standards must take into account the following principles: a) compensation transparency; b) regulatory clarity; c) jurisdictional consistency; and d) business flexibility.

First, to the extent that current law does not sufficiently ensure transparency in brokerage transactions, we fully support well-considered measures to achieve such transparency. Thus, any new rules should center on transaction-based disclosure of

compensation arrangements, but without restricting insurers from compensating their producers on the basis of profitability and/or volume.

Second, new rules should be clear and unambiguous. Disclosure requirements should specifically delineate the information to be provided to insurance consumers and the manner in which such information is to be provided. It is critical that the new rules not become a litigation trap and a class action trap door. Thus, enforcement should be the exclusive province of the insurance regulator. For example, in the context of the National Association of Insurance Commissioners (NAIC) discussions, AIA would recommend acting through the NAIC Model Producer Licensing Act, which has been adopted substantively in almost every U.S. insurance regulatory jurisdiction. In this way, consumers, producers, and insurers will have a uniform understanding of what the rules are and where complaints should be directed. Consumers should not be confused as to who will enforce violations in this area.

Third, it is imperative that legal standards for broker compensation disclosure be consistent and uniform across jurisdictional lines. No one will be well-served by rules that differ and are unevenly enforced or interpreted from one state to another. Consistency and uniformity of regulation will reduce confusion among insurance consumers and facilitate a smooth compliance transition for market participants.

Fourth, legal standards in this area should make clear that various approaches to producer compensation are acceptable so long as producers meet the relevant transparency requirements. Flexibility should be emphasized, not discouraged. Legal standards should enhance, not limit, consumer choice in the insurance marketplace. Consumers receive value from insurance producers who can advise them of the spectrum of insurance products that meet their unique needs. Insurance competition will benefit from more, rather than fewer, options in the marketplace. Both fixed and variable compensation programs for producers should continue to be permitted.

AIA appreciates the opportunity to provide a statement on the important issues raised at the Subcommittee hearing today. While the recent litigation concerning the placement of commercial property-casualty insurance has caused great pain to our customers and to the industry, if we in the industry, the regulatory community and the legislature respond rapidly and with thoughtfulness, we can emerge stronger and with much greater assurance that our customers are right to place their confidence in us.

Brian K. Atchinson
Executive Director

INSURANCE MARKETPLACE STANDARDS ASSOCIATION

Committed to honesty, integrity and ethics

November 16, 2004

Senator Peter G. Fitzgerald
Chairman
Subcommittee on Financial Management, the Budget and International Security
446 Senate Hart Building
Washington, DC 20510

Re: Oversight Hearing on Insurance Brokerage Practices, Including Potential Conflicts of Interest and the Adequacy of the Current Regulatory Framework

Dear Senator Fitzgerald:

The Insurance Marketplace Standards Association (IMSA) commends the Subcommittee on Financial Management, the Budget and International Security for holding a hearing on the oversight of insurance brokerage practices. The current focus on the insurance industry makes clear the need for strict adherence to ethical market conduct standards.

IMSA's mission is to promote high ethical standards in the sale of individual life insurance, annuity and long-term care insurance products. By undergoing the rigorous assessment process to attain IMSA qualification more than 150 life insurance companies (representing nearly 60% marketshare) have committed to abide by IMSA's Principles and Code of Ethical Market Conduct to underscore the importance of ethical practices in the life insurance industry. In doing so, IMSA has become a benchmark of excellence of the individual life insurance marketplace.

To become IMSA-qualified, a life insurance company must undergo an independent third party assessment of its market conduct and compliance policies and procedures to determine whether they meet IMSA standards and promote ethical practices in the distribution of life insurance, annuities and long-term care insurance products.

Once a life insurance company becomes IMSA-qualified, it must renew its IMSA qualification every three years thereafter. Moreover, the company must maintain a system of monitoring and supervision to detect and remedy instances of noncompliance on a routine basis. Through ongoing monitoring and upgrading of its policies and procedures, an IMSA-qualified company promotes continuous improvement of its market conduct and compliance practices.

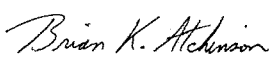
IMSA's contributions to improved market conduct practices have been noted by the National Association of Insurance Commissioners (NAIC) as well as the U.S. House of Representatives Committee on Financial Services in the development of the State Modernization and Regulatory Transparency Act (SMART Act). In its "Roadmap" for regulatory reform, the NAIC has called upon states to work collaboratively with best

practices organizations such as IMSA to promote more efficient and effective use of regulatory resources. In the SMART Act, IMSA is specifically identified as a best practices organization in key market conduct-related provisions that would establish a nationally coordinated system for periodic review of company compliance policies and procedures to incorporate market conduct practices into the NAIC state accreditation process.

While the recent instances that have focused attention upon insurance industry practices have related to activities primarily associated with property and casualty insurers, the ethical practices that underline IMSA standards can serve as a framework to promote ethical practices throughout the insurance industry. IMSA stands ready to assist the Subcommittee as it reviews these important issues to determine whether the ethical principles currently employed by IMSA-qualified companies in the life insurance industry may have further application to promote a healthy and competitive insurance marketplace and protect consumers.

Additional information about IMSA, its ethical standards and a list of our qualified companies can be found on IMSA's web site (www.IMSAethics.org). Please do not hesitate to contact me at (240) 497-2904 if IMSA can be of further assistance to the Subcommittee in its review of insurance brokerage practices and the adequacy of the current regulatory framework.

Sincerely,



Brian K. Atchinson

Two Wisconsin Circle, Suite 320, Chevy Chase, MD 20815
Tel: (240) 497-2904 Fax: (240) 497-2901
www.imsaethics.org

- The Insurance Marketplace Standards Association (IMSA) is an independent nonprofit organization based in Chevy Chase, Maryland, that promotes high ethical standards in the sale of individual life insurance, annuities and long-term care products.

- IMSA-member companies represent more than 50 percent overall market share for individually sold life insurance, annuity, and long-term care products.

- Through its Principles and Code of Ethical Market Conduct, IMSA encourages its member companies to develop, implement and maintain policies and procedures to promote sound market conduct practices.

- To become an IMSA member, a company has to adhere to a set of standards comprising six key principles that require a company to satisfy a minimum of 144 separate criteria. Companies must first submit to a self-audit and then must undergo a third-party assessment by a qualified and IMSA-approved assessor. After successfully completing both assessments, a company can join the association

- Companies can renew their membership after three years but must go through new assessments.

- Independent assessors come from various professional fields such as accounting, law, actuarial and management consulting. Each candidate for independent assessor must meet certain educational requirements, undergo a background check, complete an IMSA independent assessor training program, and attend continuing training sessions.

- IMSA's 18-member Board of Directors includes CEOs of large, medium, and small as well as individuals from outside the insurance industry.

Two Wisconsin Circle, Suite 320, Chevy Chase, MD 20815
Tel: (240) 497-2904 Fax: (240) 497-2901
www.imsaethics.org

400 North Washington Street, Alexandria, Virginia 22314

Statement of the National Association of Professional Insurance Agents
for
The Senate Government Affairs Subcommittee
on
Financial Management, the Budget and International Security

11/16/04

Founded in 1931, The National Association of Professional Insurance Agents (PIA National) is the national trade and professional association that together with our PIA-affiliated state/regional associations represent member retail insurance agency-owners and their employees in all 55 U. S. Jurisdictions.

PIA members are independent insurance agencies primarily serving the retail direct admitted marketplace for individuals' needs in the personal lines (PL) and small-to-mid-size commercial lines (CL) market for property-&-casualty (P&C) insurance. Further, PIA member-agencies comprise the usual and customary insurance producer component serving this marketplace. Over the last 15 years in particular, PIA member agencies have moved into life-&-health (L&H) insurance in response to their customers' requests, mainly for their small-to-mid-size business customers. However, this still comprises a lesser portion of their agency business at this time.

PIA agencies are local small business corporations providing insurance services for their local consumers and businesses. They are "Main Street, Not Wall Street" business-operations living in the communities that they serve and hiring community members, as well as making and investing their capital in the local economy.

PIA insurance agencies operate in the retail, admitted individual insurance sector serving individual customers for personal lines insurance (such as homeowners and auto), and their small-to-mid-sized business clients with all forms of commercial property and casualty insurance for their risk needs.

In light of recent events, a sense of urgency has developed to craft a public policy response. PIA National believes it is critical that this urgency be tempered to allow for sufficient deliberation. Significant confusion now exists regarding certain aspects that are being included in ongoing policy discussions. It is necessary to clear up this confusion first, so that successful responses to the regulatory issues at hand can be crafted.

Our position: PIA National supports a model regulation that requires disclosure of fees charged, services provided, and compensations received by a broker that is taking compensation from the insured and the insurer in the same transaction. Since the 1960's, PIA National has

worked with National Association of Insurance Commissioners (NAIC), PIA affiliates and their state departments of insurance in addressing various forms of insurance regulatory required fees and disclosure practices in both personal and commercial lines in the admitted direct insurance marketplace. Our current policy approach is an extension and expansion of those previous efforts.

Points for you to consider as you continue your deliberations:

1. **Placement Service Agreements (PSAs)** involving mega-brokers are not the same as compensation arrangements in other insurance market segments, specifically the retail admitted market. Both cannot be treated with the same regulatory disclosures.

2. **Compensation is key to the American Free Enterprise system**: The broad varieties of compensation arrangements that exist in insurance are not unique to the insurance industry. They are used throughout the U.S. economy – in both the private and public sectors – to financially reward success and productivity.

3. **Avoid unintended consequences and don't overreach:** PIA National believes that model regulation should not unwittingly overreach, or conflict with requirements already clearly established in insurance common law. These requirements provide protection for consumers and give state oversight authorities many existing tools to pursue wrongdoers.

4. **In denying critics of state regulation,** state insurance departments should look to the NAIC model regulation process and coordinate their individual efforts so that a uniform and workable solution can be achieved.

A Brief Discussion of PIA National's Policy Points:

So that the model process not confuse fee-disclosure requirements already established in a number of state insurance regulations that address different market segments and needs – PIA suggests NAIC focus in the insurance segment giving rise to this current discussion – the large Fortune 500 insurance market segment. PIA sees the following policy approach as the starting point:

In simple terms and for the large commercial insurance segment/transactions, when an insurance broker is charging fees from the insured for services they are providing for the client, ***and*** at the same time in the same insurance transaction and for the same insurer with which the insurance will be placed, the broker is receiving a compensation from that insurer – the broker is required to disclosure to their client in general terms the nature of the compensation received and services performed for the insurer. The broker is to do so in advance of the transaction being completed; with reasonable time for the insured to decide if they wish to proceed; and the insured signs the notice that they've been advised, agree to the terms, and approve the insurance transaction being completed.

NAIC should consider allowing this process to be executed by the insurance broker firm – instead of the individually licensed brokers working for the firm. Also, please consider the insurance broker firm being able to execute this on a client-basis where the broker-client insurance relationship is ongoing as opposed to a transaction-by-transaction one.

Mega-Broker Compensation Arrangements are Different:
PSAs (placement service agreements), MSAs and all the various compensation arrangements that mega-insurance brokers have with their insurers ***are unique***, individually negotiated compensation arrangements that are one-on-one developed by the mega-commercial insurance brokers with their insurers. Mega-commercial insurance brokers enjoy equity of relationship and market -size position enabling them to develop their own customized arrangements with various insurers. Each of these insurance brokerage operations manage hundreds of million of dollars in insurance placements each year.

Retail Independent Insurance Agency Compensation
PIA members, as independent insurance agencies, do not regularly receive any compensation or fees from their insureds, but receive their compensation from their carriers, costs that carriers are already required to specifically account for in the details of their rate filings and/or annual statement filings.

One part of our members' compensation is paid by the carrier to the agency in "upfront commission" earnings based upon a percentage of the gross/final price premium of the insurance sold (for new business) and business that has been serviced, updated and "sold" upon renewal.

This commission is earned per policy placement and comprises the portion of the agency's earning used to pay the day-to-day expenses of running their insurance agency. Even today and where permitted, fees charged by most PIA member agencies to their clients is a small portion of their earning and is designed to hopefully cover the full cost/exposure to the agency for providing the specified service, e.g. covering the cost of the MVR report, but competition among insurance agencies will modify such fee-structures.

The second part of the independent agency's compensation from their appointed carriers comes after the close of the calendar year-end. This portion of the compensation is referred to as a ***"contingency earning",*** and comprises the portion of earning that independent insurance agencies rely upon for their working capital to support the ongoing operations of their insurance business, payment to afford competitive employee provided benefits (to include L&H), and the balance is their margin of year-end profit to be used for employee salary increases and performance bonus awards.

How PIA member's contingency earning portion of compensation operates
In order to be able to receive it (or qualify), as well as how much the *earning will be is contingent* upon the agency successfully achieving a number of performance factors established and required by the insurer to be met that year. This compensation is developed and earned on the overall book of business the agency has produced for the insurer in that year, may be modified by previous year off-sets, and the cumulative achievement of several performance standards.

Insurers' annual oversight and evaluation of PIA member agencies' performance set against the goals and guidelines established by each carrier is an annual performance review of each independent insurance agency. Agencies that are successful their performance for the year are able to share on a pro-rated basis in an earning from the compensation pool, a finite amount of dollars available for this set by the carrier, and reported in their rate filings and annual statements.

Those that do not perform do not share in this earning, and repetitive poor performance by an agency causes the insurer to terminate the business relationship. This supports a financially successful and sound result for the insurer developed in a profitable manner by its appointed agencies based upon the expressed goals of the insurers. This benefits the stockholders, policyholders, agencies, and employees of the insurer. At the same time, it creates a financially sound insurance marketplace that is able to insure the variety of risk exposures that exist, at competitive quality and in a manner that complies with the law.

Compensation by Any Other Name

All businesses provide and use a wide variety of compensation and incentive based-earnings system to pay their sales forces, executives and employees. Whether it is incentives to sell more ties, bonuses for closing the most cases successfully with fewest state dollars spent in a state district attorney's department; executive bonus arrangements for top corporate year-end financial performance or an employee's annual performance and salary review - the vast majority of employed people in the U.S. private and public sector participate in an incentive compensation system.

How people are compensated and how a company structures that for the benefit of everyone, as well as to direct their collective achievement of the goals set and needed for the corporation to thrive is fundamental to and protected under the America Free Enterprise System. This has been proven over time to be effective for the individual, business entity, economy and the public at large.

Any compensation program (formal or informal) between two or more parties used in any business to include insurance are required to achieve the businesses' end-financial goals, and to do so complying with all applicable law related to the enterprise.

PROFESSIONAL INSURANCE AGENTS

400 North Washington Street, Alexandria, Virginia 22314

November 23, 2004

TO: Ms. Tara Baird
tara_baird@govt-aff.senate.gov

Filing Supplement Comments
To the
Statement of the National Association of Professional Insurance Agents
Filed November 15, 2004
From
The Senate Government Affairs Subcommittee
On
Financial Management, the Budget and International Security
Hearing November 16, 2004

PIA National appreciates this opportunity to provide additional comments and observations to the Committee as a result of the questions posed by Chairman Fitzgerald, and comments of panel participants.

Insurance Brokers and Fiduciary Obligations:
PIA National has sponsored an E&O insurance program for our members continuously since 1941, the oldest and longest running sponsored professional liability program in the U.S. Together with our sponsoring insurance carriers, PIA develops loss prevention programs, provides E&O and insurance compliance suggestions for our member agencies' operations, reviews legal defense team issues, and other such activities to provide a comprehensive quality program of insurance, risk management and agency legal compliance practices. Accordingly, we've developed a recognized legal expertise in this area.

PIA National can provide for your review and upon your request to us, a copy of the legal discussion we requested our counsel for PIA National Professional Liability matters (known as Errors & Omissions Insurance as applied to insurance agents and brokers) to prepare for us on the insurance common law issues raised by the California Insurance Department's initial draft regulation on insurance broker disclosure.

Several of the questions raised during the hearing emanate from the leading issues presented by the California Insurance Department draft regulation speaking to this subject. This draft attempts to ***redefine*** the definition of insurance broker; the fiduciary obligations of insurance brokers to insurance consumers; the standing of current insurance customers/insureds to potential insurance prospects; what is to be considered "income; and the placement obligations of insurance brokers by creating the term – "best insurer available."

In so doing, the draft regulation seeks to "create" these definitions, obligations and standings to be imposed by the insurance department.

However, the legal fact is that these legal terms and obligations are well established and clearly defined by and in California insurance law; and in relative uniformity among all U.S. Jurisdictions. Accordingly and perhaps unwittingly, the California Insurance Department draft effort creates material conflicts between its proposed, invented provisions to what insurance and other bodies of law that apply to these matters already hold. These other applications of currently established law respond in use matters far better and more flexibly for the insurance consumers benefit than does the California Insurance Department effort.

Insurance statutory law does not set or redefine these fiduciary obligations, but rather reflects and requires practices of insurance persons as directed by both state insurance legislation and in recognition, and in a manner not to conflict with the insurance common law established by the courts.

For example, the model defines the insurance broker as including independent insurance agents. Legal fact is that a licensed insurance agent cannot act as both an agent and a broker at the same moment in a single insurance transaction. Sometimes, independent insurance agents can act as insurance brokers, and in so doing they and the law understand that when they do so – they are an insurance broker and subject to the regulatory requirements and law expectations of an insurance broker for the nature of insurance transaction in which they are engaged.

Another example is that the model defines an insurance broker as representing the insured. If the insurance broker and insurance customer voluntarily decide to establish a signed agreement between them to that affect, i.e. the insurance consumer wants to "retain" the services of the insurance broker as their insurance broker representative in the insurance marketplace – then, true – this broker is the representative of the insurance consumer. There are other particular insurance transaction circumstances where the insurance broker may/is in fact "facilitating" for the insurance consumer, and not representing or dealing with the insurer.

However, there are just as many circumstances where an insurance broker is acting for the insurer and not for the insurance consumer, as in the case of the wholesale insurance marketplace.

Insurance brokers can obligations to both the insurers and insurance consumers. Unless there is an agreement otherwise, an insurance broker does not represent or speak with authority on behalf of the insurance consumer or the insurer.

By the same token even though an insurance agent is the appointed representative of an insurer in the insurance marketplace, and as such speaks and acts with a level of some authority on behalf of that insurer (or insurers), the law also expects the agent to know and execute their obligations to the insurance consumer.

Insurance common law makes clear that what one labels or calls oneself may not be sufficient or the case in the eyes of the court when the fact-based circumstances of the case before the court is examined. The courts use a well defined, established and common legal treaties outline to determine what obligations an insurance producer; insurer; and insurance consumer had to each other; were executing to each other; were expected to have amongst each other; or could have

reasonably relied upon among one another to decide was the producer acting or should have been acting on behalf of the insurer or consumer – and compare that to what they really did – and determine was the consumer harmed or not by the insurance producer and/or insurer – and if so what will make the consumer whole.

This flexibility is imperative for and has served well consumers' benefit, and provided clear compliance operation of insurance agents, brokers and insurers as they conduct/transaction insurance business for insurance consumers.

This is also why insurance regulations have used the most generic form of definition for insurance agent and insurance broker –

Insurance agent means any licensed insurance producer that is appointed by an insurer to act as that insurer's agent/representative.

Insurance broker means a licensed insurance producer that is not appointed by an insurer to act as that insurer's agent/representative.

Insurance regulatory definitions have and should avoid "defining/imposing" a single status, inflexible definition or obligation for either. Insurance departments have specific rules that may apply when insurance producers are acting as agent – and others that apply when an insurance producer is acting as a broker. It is the insurance producer's and insurer's responsibility to know when an insurance produce is acting in which capacity – and to be sure to comply with the correct set of insurance rules, as well as know and comply with the insurance common law expectations.

For example, specialty insurance carriers in the non-admitted insurance marketplace conduct their business with and through expert insurance brokers (called E&S Brokers). These E&S insurance wholesale brokers represent the specialty insurer, but are not appointed insurance agents of these insurers, and cannot speak or act with authority on behalf of these insurers. They can, do and are expected to act and speak with an expert level of professional knowledge about these insurers, and correctly complete the transaction of the insurance business brought to them.

E&S insurance brokers do business with retail insurance producers. Irrespective of whether the retail insurance producer most often in their retail insurance practice acts as/is an appointed insurance agent for several insurance carriers, if that "agent" can't "place" the insurance customer's insurance needs with one of their appointed insurers – and the retail insurance agent needs to place this business in the non-admitted wholesale insurance marketplace through one of these expert E&S wholesale insurance brokers – then the E&S insurance broker is representing the insurer and the "agent", now acting as a retail broker, is facilitating for the insurance customer.

Insurers, insurance agents and retail/wholesale insurance brokers are expected to know their roles, thus their obligations, as they conduct their insurance practices. Except for a few peculiar and extraordinary circumstances, there is little need for an insurance professional to state that the law is confusing or not clear.

Definition of Insurance Agents and Insurance Broker:
Insurers only "appoint" insurance agent and this should be with a written and signed agent/agency appointment agreement. *Insurers do not "appoint" insurance brokers*, but may

have a broker contract with them. The legal distinctions are material and clearly formed.

The NAIC Producer License Model Act (PLMA) provides a common single name for the professional/statutory ***license*** (and its attendant requirements for a person to be able to secure one) needed to be obtained by a person (individual or business entity) that wishes to solicit, sell, or negotiate insurance in the state. The insurance producer's ***license*** does not pre-determine what the licensed persons' business/legal obligations and actions are/must be in the insurance marketplace/transaction. The insurance state licensure process also outlines the background and pre-licensing requirements and processes that persons must submit to in order to be eligible to apply and sit for a producer license exam and secure a license.

Beyond this and contrary to some views NAIC PLMA did/does not contemplate, require or call upon state regulation to treat all "insurance producers" as one identical class and/or eliminate the use of the terms and/or attributing different rules, requirements, and/or practices to "insurance agent or broker" and treat all the same, i.e. licensed insurance producers.

One need only follow the history of the NAIC model process from its original Agent and Broker Insurance License Model to its NAIC Single License Producer Model to its current PLMA.

Such is further evidenced by the fact that the NAIC PLMA provides specific instructions to insurance departments that require appointments of insurance agents-- Section 14 Appointments, and using the term agent in this section, as well as discussing the "contrary" insurance producer to an agent. PIA National argued then and now that NAIC needs to include the terms agent and broker, because that is what the PLMA does in treatment and description.

In the mid-1980's PIA National working with the state insurance departments of Kansas and Missouri created, adopted and successfully implemented the country's first "producer" license and its process. Neither Kansas nor Missouri ever lost the subsequent regulatory differences necessary between agents and brokers or their oversight application of these. The "single" Producer License allowed PIA members to only to have to submit to one process and secure one producer license in order to demonstrate their worthiness to solicit, sell or negotiate insurance in these states. The states still recognized that the legal arrangements the "producer" made in the insurance marketplace would determine whether they were an agent or broker, and as such would need to follow additional state insurance departments' requirements accordingly.

PIA National believes confusion was introduced into this producer licensing process only when PLMA came into state insurance departments that had previously considered themselves - from an insurance regulation standpoint only – "agent-only" states – and desired to maintain that regulatory approach (again not contemplated by PLMA).

This "agent-only" regulatory view was developed in some states despite the fact that in all of these states' insurance common law clearly, consistently, uniformly made distinct differences between when persons were acting as agents or brokers and in whatever context what the exact obligation of that "producer" person was to the insurance consumer; insurer and/or any other party involved in litigation.

It is also a view under which P&C insurance cannot operate, e.g. when insurance business must be placed into a residual insurance marketplace, the insurance producer is not "appointed" by an insurer or the residual market mechanism. There are other everyday examples that PIA National

can provide on this, but suffice to say this is why PIA National has and does oppose the imposition of an "agent-only" insurance regulatory framework.

PIA Agencies and their Insurance Customers:
PIA member agencies chose to practice their insurance business among the individual insurance consumers in their local communities comprising the retail, direct individual insurance policy marketplace. For example, they provide personal lines insurance for people's cars and home; and liability and property insurance for the small-to-mid-size commercial customers they serve.

While this sector of the marketplace does not generate the multi-billion dollars of insurance premiums controlled by the mega-insurance brokers and their Fortune 500 clients, it does represents the largest number of insurance policies sold. The average PIA agency provides insurance services to an average of 1500 insurance customers, and places most of their insurance needs among the quality insurance carriers they represent and with which they have an agency appointment.

The retail insurance marketplace is more extensively regulated by insurance departments, because individual consumers need assurance that the final price they're being asked to pay for their insurance includes all their costs for all services and obligations they'll need performed during the policy period. In this way they can more accurately and easily compare among different insurance proposals. Once purchased, the insured knows that whatever services they require and/or obligations need to be executed under the policy of insurance that they have purchased, will be accomplished by coordination between the agent and the insurer – and under the premium priced they've already paid.

This is a very different insurance marketplace in scale and needs from the mega-insurance brokerage world of Fortune 500 corporations and the billions of insurance premium dollars these few insurance clients generate.

For example, the typical PIA independent insurance agency operation generates between $5 - 10 million in annual property and casualty insurance gross premium sales for their insurers – not earnings to the agency. The sum total of these numbers do not begin to compare in scale to just the $845 million reported earned by Marsh in MSA earnings alone in FY 2003.

FTC – Insurance Studies:
1981 federal law to which some panelists spoke was actively requested and supported by NAIC, because the FTC studies at that time did not include or coordinate with NAIC and state insurance commissioners. The FTC studies also came to many assumptions and conclusions about insurance regulation and practices that were legally and factually incorrect and at direct odds with what states' laws had determined and directed.

This caused great confusion and uncertainty for the insurance sector, and confusion among Members of Congress who in the majority believed states were doing the job. The law ended FTC's study efforts which the law concluded were contrary to what Congress had directed when they adopted McCarran-Ferguson (Public Law 15).

Please feel free to contact us for further information,

Len Brevik
CEO and Executive Vice President

Patricia A. Borowski
Senior Vice President
patbo@pianet.org
703-518-1360

Peter Bizzozero
Assistatn Vice President, Federal Affairs
peterbi@pianet.org

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