

## **EDITORIAL**

### **If It Ain't Brokin' (or Regulatin'), Don't Fix It**

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In mid-October of 2004, the usually quiet world of commercial property-liability insurance was rocked by the announcement of New York Attorney General Eliot Spitzer's civil action against mega-broker Marsh & McLennan/Marsh, Inc. Specific charges included (1) "bid-rigging", in which Marsh was alleged to have guided clients through fictitious bidding processes with pre-selected insurance company "winners", and (2) the inappropriate use of "contingent commissions" paid by insurers to brokers for the placement of business. Immediate fallout from the AG's efforts included the resignation of Marsh CEO Jeffrey Greenberg, the entering of plea agreements by several brokerage and insurance company employees, and decisions by major brokers to discontinue the use of contingent commissions.

Not surprisingly, reactions to these events within the insurance community have been mixed, ranging from "It's about time!" to "This is a cheap shot by a self-promoting politician!" to "Where were the state regulators when all this was going on?" While most industry observers are clearly distressed by the alleged practice of bid-rigging, opinions on contingent commissions are more varied and nuanced. Certainly, most people agree that insurance brokers, by their very definition, must recognize the primacy of their clients' interests; however, the mere existence of contingent-commission arrangements doesn't necessarily prove that clients were losers. In fact, some would argue that the alternative to contingent commissions is simply higher brokerage fees.

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In any event, such analyses are now just so much “water under the bridge.” Contingent commissions are gone for the moment, and what is most important is to ask which – if any – remaining aspects of the commercial P-L insurance market need to be fixed.

In reading AG Spitzer’s original complaint, one cannot help being struck by the tremendous power that Marsh is supposed to have wielded in the commercial market. Although most of the accusations revolve around alleged abuses associated with contingent commissions, it is clear that Marsh could never have carried out such abuses without its large (40+ percent) market share. Thus, insurance market reforms that do not specifically address the problem of excessive concentration are unlikely to endure, and may do more harm than good.

So how should policy makers deal with the problem of market concentration? To consider this question, one must first step back and ask: How did the brokerage market become so highly concentrated in the first place?

The answer lies within the American system of state insurance regulation. Insurance brokers, like insurance companies, are exempted from federal anti-trust laws by the McCarran-Ferguson Act. Consequently, when this sector of the insurance market consolidated rapidly in the 1990s, it was up to the patchwork of individual state regulators to monitor this evolution and take action if necessary. Needless to say, no action was taken at the time. In fact, state regulators did virtually nothing until mid-October 2004, when they desperately began playing “catch-up” with the New York AG.

So what should policy makers do now to address the problem? Should they press state regulators to “break up” the commercial brokerage market? Or should they perhaps push to federalize insurance regulation, as some in Congress have suggested?

At this stage, neither of these approaches seems particularly well advised. The time for state regulators to act dramatically on brokerage market concentration may well have

passed, since the shockwave from AG Spitzer's actions appears to have given smaller brokers a window of opportunity to gain market share. While federalizing insurance regulation will always offer certain advantages (e.g., enhanced consistency in rulemaking, greater coordination of efforts, lower costs of company compliance, etc.), the regulatory system as a whole really isn't broken. We don't need to fix *state regulation* so much as we need to fix *state regulators*. Just as the insurance company solvency initiatives of the early 1990s made regulators more aware of their financial oversight responsibilities, and provided the statutory power to carry them out, we now need a new set of initiatives to make oversight of the brokerage market a real priority and possibility.

In reforming any aspect of the insurance market, it is important to remember that this is a financial services industry unlike any other, with its own particular (and sometimes quirky) institutions. Presumably, we all want to avoid "throwing the baby out with the bathwater." To this end, we must make sure that reform measures distinguish between practices that may appear dubious to some but are generally fairly innocuous (like insurance "fronting" arrangements, in which an insurer writes coverage for a risk and then reinsures most or all of the potential losses), and practices that may seem benign to some but are actually quite anti-competitive (such as "tying" arrangements, in which a broker directs primary business to insurers who place their reinsurance through the broker's affiliate). In addition, reforms must distinguish between sectors that need reform, such as commercial brokers, and sectors that do not need reform, such as commercial insurers.

Overall, reformers must keep in mind that (1) commercial P-L insurance company market shares are fairly diffuse, with numerous companies competing aggressively for business, and (2) commercial P-L policyholders (unlike personal lines policyholders) are generally well-informed and sophisticated. Thus, given a reasonably attentive regulatory

system, policyholders will quickly follow the “invisible hand” to the best brokers, or alternatively, to the best direct writers.

In short, the commercial P-L insurance market has been highly competitive in the past, and will be in the future, as long as regulators make sure that market power is not concentrated in too few hands. AG Spitzer’s charges seem to have set in motion a dynamic to help the market correct itself. It is now up to state regulators to ensure that the system reaches satisfactory equilibrium, without “fixing too much that isn’t broken” along the way.