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December 2, 2004

To: Members, CSAC Excess Insurance Authority
Members, California Public Entity Insurance Authority

From: Michael Fleming, Chief Executive Officer

Re: Broker Contingent Income

Many of you are aware of the growing scandal in the insurance industry with respect to brokers' receipt and abuse of so-called contingent income agreements. The purpose of this memo is to bring you up to date on the nature and extent of the issue, to let you know that the CSAC Excess Insurance Authority takes this matter very seriously and we are actively engaged in researching how this may or may not impact the CSAC EIA, the CPEIA, and their members. Although research is continuing, we are pleased to report that at this point in time, the Executive Committee continues to have full confidence in our broker, Driver Alliant. Should our research indicate any reason to feel otherwise, we are prepared to deal with that event in an appropriate manner.

Marsh & McLennan Indictment

On October 14, 2004, the Attorney General for the State of New York filed suit against Marsh & McLennan Cos., Inc (Marsh) for alleged abuses related to contingent income agreements with certain insurance companies. The New York Attorney General indicated that other brokers are also being investigated and that this indictment is expected to be the tip of the iceberg. This scandal has rocked the insurance community and continues to develop on a day-by-day basis.

The specific allegations against Marsh stem from the abuse of their contingent income agreements (CIAs). CIAs are very commonly used by most, if not all, insurance brokers and companies. CIAs typically pay brokers additional income based upon premium volume and/or

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profitability on a broad book of business (not individual clients). CIAs are not illegal and are in fact commonly used in the industry.

In Marsh's case, they have been accused of "steering" clients to insurers that would pay Marsh the most commission. According to the indictment, Marsh set up a Global Broking division to concentrate their buying power and then leveraged this volume to force insurers to provide lucrative CIAs. Marsh then systematically identified those markets that would provide the most income for Marsh, communicated to their brokers who were the favored markets, and then maintained a system of reward and punishment for placing business with the preferred markets. The most disturbing aspect of the allegations involves "bid-rigging". Marsh is alleged to have solicited phony, artificially high quotes from certain insurers to make the "preferred" market's quote look better to the client. Insurers participated in this bid-rigging process knowing that they would be on the receiving end of this process as well. Marsh Global Broking's objective soon became to maximize income for Marsh instead of its original intent of concentrating their buying power for the benefit of their clients.

Additional Litigation / Regulatory Activity

The New York Attorney General has indicated that they are also investigating contingent income practices at other brokerages, including AON, Willis, and Kaye Insurance Associates. The indictment cites relationships Marsh had with such insurers as AIG, American Re, Ace, and Hartford. Other states have now launched their own investigations of other brokers and insurers and it is generally believed that additional indictments and litigation will ensue. California Insurance Commissioner Garamendi has already promulgated regulations requiring full disclosure of contingent income agreements.

On November 2, 2004 the County of Santa Clara filed a lawsuit on behalf of all public agencies in California naming Driver Alliant, Keenan & Associates, and Marsh as defendants. Allegations in the Santa Clara lawsuit are similar to the New York indictment of Marsh including steering and bid-rigging charges. The lawsuit also claims that because Driver and Keenan dominate the public entity market in California through the JPA community which they control, they have manipulated the insurance market for their own self-interest and against the best interests of their public entity clients. The suit also claims that the defendant brokers maintain secret income agreements that they are unwilling to disclose to their clients.

It is our understanding that plaintiff attorneys are actively seeking additional public agencies to join in the Santa Clara lawsuit. To our knowledge, the suit has not yet been served.

Driver Alliant Contingency Income Agreements

When the story on the Marsh indictment broke in mid-October, staff immediately started a dialogue with Driver to determine the status of contingent income agreements (CIAs), if any. The EIA Executive Committee has received several reports on this issue and has met on three separate occasions to discuss this matter in detail.

We have been pleased to find that Driver has been fully cooperative throughout this process. We have requested and received information relating to income Driver received from CIAs, we have requested and received copies of CIAs relating to EIA/CPEIA business, and Driver have made themselves available to openly address any questions related to this matter. It is our understanding that Driver is also organizing meetings for any and all public agency clients who may have questions regarding this issue. We have found this level of cooperation to be refreshing and essential in order for us to continue our business relationship with Driver.

Through this process we have determined that, as respects the EIA's eight major programs, there was only one relationship that Driver had where they received contingent income. This was with American Reinsurance Company (Am Re) and it spanned a period encompassing calendar years 1998-2003. It has been determined that, over this six-year period, Driver received contingent income relating to EIA business totaling \$343,415. The EIA has a contract with Driver that limits the amount of commission income that Driver can receive on account of EIA business. There are a couple of important points to note:

- The \$343,415 contingent income should be put into context. This works out to an annual average of \$57,236. The corresponding premium estimated to be placed by Driver over this same period is approximately \$258 million. The contingent income received equates to about one-tenth of one percent.
- None of the contingent income received was a direct result of EIA business. Payments were made on a broad book of business that included the EIA business. Driver has made reasonable estimates of how much is related to EIA business.
- EIA legal counsel has reviewed the contingent agreements with Am Re and has concluded that the contingent income is not subject to the contractual income limitations of the EIA/Driver agreement.

Driver has voluntarily determined that in the spirit of our agreement and for the sake of our continuing good relationship, they will consider the Am Re contingent income to be subject to our contractual limitations. Therefore, Driver will rebate a portion of the upfront commission that was earned on our account so that when contingent income is added, the contractual maximums are not exceeded. This amounts to a total rebate of

\$299,809 involving the Excess W.C. (EWC), Primary W.C. (PWC), and General Liability 1 (GL1) Programs. Details of the contingent income estimated to be received and the amount of the rebate are shown in the following tables. The first table shows the total estimated contingent income received from Am Re that is attributable to the EIA/CPEIA. The second table shows the total amount of the agreed rebate. The difference between the two is due to Driver initially taking less than the maximum commission allowed by contract in some cases.

**1998-2003 Am Re
Estimated Contingent Income Received
Relating to EIA/CPEIA Business**

	<u>EWC</u>	<u>PWC</u>	<u>GL1</u>	<u>Property</u>	<u>Total</u>
1998	\$10,000	\$10,295	\$11,000	\$1,196	\$32,491
1999	22,400	28,393	28,300	5,152	84,245
2000	35,321	35,137	27,507	828	98,793
2001	3,127	0	1,800	0	4,927
2002	0	0	0	0	0
2003	<u>99,166</u>	<u>23,793</u>	<u>0</u>	<u>0</u>	<u>122,959</u>
Total	\$170,014	\$97,618	\$68,607	\$7,176	\$343,415

Driver Agreed Rebate

	<u>EWC</u>	<u>PWC</u>	<u>GL1</u>	<u>Total</u>
1998	\$10,000	\$10,295	\$1,400	\$21,695
1999	22,400	28,393	13,820	64,613
2000	35,321	35,137	16,957	87,415
2001	3,127	0	0	3,127
2002	0	0	0	0
2003	<u>99,166</u>	<u>23,793</u>	<u>0</u>	<u>122,959</u>
Total	\$170,014	\$97,618	\$32,177	\$299,809

This activity covers all of EIA's major programs which accounts for approximately 93% of our premium dollars. The other 7% of premium goes to our Miscellaneous and Employee Benefits Programs. Driver has indicated they are committed to providing the same type of information on the Miscellaneous and Employee Benefits Programs; however, the information is not readily accessible and it will take more time to develop this information. Thus, our research continues.

Information Considered By Executive Committee

We distinguish our situation from the allegations surrounding the Marsh indictment and the other defendants (Marsh and Keenan) in the Santa Clara suit in several important ways. Unlike Marsh's Global Broking division, Driver has not had a centralized source for negotiating and tracking contingent income agreements. This is contributing to Driver's difficulties in figuring out where agreements exist and locating copies. The individuals at Driver responsible for presenting recommendations and obtaining bids are likely to be unaware of the existence of any CIAs, and even if aware of the existence, they are unlikely to understand the potential impact. In addition, Driver has no monetary interest in any insurers with which the EIA has ever done business.

The EIA has been, and continues to be a member-directed organization. We have a complex committee structure of 16 different committees staffed by representatives of member counties and CPEIA representatives. Your staff takes a very active role in the marketing of the organization to potential underwriters including face-to-face meetings. Key committee members also periodically meet with underwriters and assist with this process. Committees determine marketing strategy and give direction to staff and Driver on how to proceed with negotiations. The committee members involved in the decision-making process are extremely sophisticated, dedicated and talented individuals, including many full-time risk managers with a deep understanding and appreciation of the marketing and placement process.

At the end of the day there is no way to be absolutely certain your broker is acting in an ethical manner. It largely comes down to the level of trust we have for our broker, the environment in which we operate, and the prudent steps we take to protect ourselves. The following are significant factors contributing to our comfort level:

- We have a high level of committee involvement and expertise.
- All details of marketing efforts are presented to committees including alternatives and declinations.
- Long-term deals are negotiated at the direction of the committees so that Driver's role is often focused on getting the best deal out of the market selected by the committee.
- We continue to have a high level of trust in Driver's integrity based upon 20 years of experience and their demonstrated openness and willingness to provide information as requested.
- We operate in an extremely competitive environment. Even as we go through hard market cycles, JPAs compete with each other, as well as the ultimate competition with stand-alone self-insured programs. Everyone, including (maybe especially) the broker has an incentive to provide the absolute best, lowest cost program in the face of this competition.

Contingent Income Did Not Affect Pricing

It is important to note that the existence of the Driver/Am Re contingency agreement did not have any impact on the price that the EIA and its members paid for insurance coverage. When an underwriter sets pricing there are three major components that are included:

1. Acquisition costs. These are expenses of the underwriter associated with putting the business on the books. It includes upfront commission to brokers which is clearly defined.
2. Overhead and profit. Included are all of the operating expenses and profit for the insurer.
3. Anticipated loss and loss expense. This is the most significant component and is based on actuarial input and/or internal rates developed by the insurance company.

Notwithstanding these pricing components, the price we actually pay is also dramatically impacted by insurance market conditions.

The existence of contingency agreements would generally be factored into the overhead and profit category. These agreements are not specific to any individual clients and are not paid until after the end of the contract year, if they are paid at all. Elimination of all contingency agreements by an insurer might have an impact on the factor used for overhead assuming that it is not replaced by another mechanism to compensate brokers. More than likely there would be a replacement method of compensation put into place. Elimination of an individual broker agreement or removal of a particular client from a broker contingent agreement would have no impact on the rate setting process since no one knows at the time of pricing whether or not contingent income will be paid, and if so, how much will be paid and how much would be attributable to a particular client. This is very different from the upfront commission income that is included in the acquisition cost component. A change in the upfront commission rate generally will produce a dollar-for-dollar change in the cost of insurance.

American Re Placement Not Influenced By Self-Dealing

The decision to place coverage and continue the relationship with American Re (Am Re) was not at all influenced by Driver based upon any self-interest. Allegations similar to those made against Marsh for "bid-rigging" and "steering" simply did not occur in our situation.

Marsh was the EIA's broker of record for the Excess Liability Program for the 1985/86 program year. For the 1986/87 year, Marsh failed to find any acceptable coverage for the Liability Program due to the hard market. The EIA conducted a broker RFP during the 1986/87 year and selected Driver as the broker of record. It wasn't until April 15, 1988 that coverage was first bound with Am Re. At that time there were no other alternatives to Am Re. The EIA developed a very good relationship with Am Re over the years and elected to enter into a 5-year program from 1992-97 on the Liability Program. By 1998 (the inception of the Am Re/Driver contingency agreement) the EIA's agreement with Am Re on the Liability Program was a multi-year, non-cancelable rolling program.

In 1997 the EIA entered into a 5-year agreement with Am Re on the Primary WC program. There were no alternatives to Am Re on the Primary WC (PWC) Program and without Am Re's support, the PWC Program would not have existed. As part of that deal, Am Re insisted on writing the Excess WC (EWC) Program and matched terms and pricing of the expiring market to provide an extremely competitive product. The EWC was also written on a rolling, multi-year, non-cancelable basis.

From 1998 to 2000, Am Re participated in small layers here and there on our Property Program as an accommodation to the EIA and Driver. Pricing was at market rates based upon the layer pricing dictated by the market. This was something Am Re was willing to do, at our request, only because of the excellent relationship on other lines of coverage.

By July 1, 2002, Am Re effectively cancelled the long-term deals on EWC and Liability (because pricing was so advantageous to the EIA and they were losing money). The EIA replaced Am Re on Liability as of 7/1/03 and Am Re was replaced on EWC and PWC by the EIA on 7/1/04.

Conclusion

At their meeting on December 2, 2004, the Executive Committee determined that there is no evidence that the Am Re contingency agreement was used inappropriately by Driver. Placement of coverage with Am Re was clearly in the best interest of the EIA/CPEIA and members. The Executive Committee accepted Driver's offer to consider the contingent income received as subject to the contractual income limitations. This will result in a \$299,809 commission rebate to the EIA. Staff was directed to:

- Continue investigation of CIAs on the Miscellaneous and Employee Benefits Programs.

- Update the EIA/Driver agreement to require that EIA business be excluded from all CIAs in the future.
- Advise the EIA and CPEIA membership of EIA's position with emphasis on the fact that the EIA remains a member-directed organization and any statements or allegations made in the Santa Clara lawsuit implying that Driver in any way controls our program are wrong.

EIA Executive Committee Action

Upon proper motion and second, the following specific action was taken by the EIA Executive Committee at their meeting on December 2, 2004:

The Executive Committee acknowledges the following:

1. The use of contingency income agreements have been common practice within the insurance industry for years; however, clients may or may not have known that these types of agreements existed.
2. Contingency income agreements sparked widespread debate in the late 90's culminating in an agreement between the Risk & Insurance Management Society, Inc. (RIMS) and Marsh on disclosure of contingency income. The agreement required disclosure of estimated contingency income to any client upon request. In May, 2004, RIMS announced the formation of a task force to review this position based upon renewed concerns over the use of contingency arrangements.
3. The EIA/Driver contractual agreement limits the amount of commission income on EIA business, and did not require Driver to disclose contingency income that is received in part based upon EIA business.
4. At the request of the EIA, Driver Alliant has voluntarily disclosed its contingent income related to EIA business on all major programs going back as far as records exist (generally five years to November 1999). There appears to have been only one insurance company relationship that paid contingent income to Driver and that was with American Reinsurance Co. Driver has indicated that to the best of their recollection, there were no other contingency agreements involving EIA back to the inception of the EIA/Driver relationship in 1984. Driver has indicated that this income is not "commission income".
5. At the request of the EIA, Driver has forwarded to EIA legal counsel all contingency agreements with American Re in their possession, in which EIA business was included. This included four separate agreements – 2 draft agreements and 2 final agreements. Agreements relating to the 1999 and 2000 years can not be located at this time. EIA legal counsel has reviewed the contingent agreements with Am Re and has concluded that the contingent

income is not subject to the contractual income limitations of the EIA/Driver agreement.

6. Driver has reasonably estimated that they received \$344,415 of contingency income from American Re from 1998 to 2003 related to EIA business. If this contingency income had been determined to be subject to contractual limitations, then \$299,809 would be in excess of the EIA/Driver contractual limitations on Driver's commission income.
7. The contingent income received, in part based upon EIA business, was incentive income (bonus) paid by the insurer to the broker on a broad book of business after the closing of each year. EIA staff has determined that the payment or non-payment of the bonus did not affect the cost of coverage paid by the EIA and its members.
8. The contingent agreement is a contractual agreement between Driver and American Re. The broker agreement specifying up-front commission income is an agreement between the EIA and Driver. Even though EIA legal counsel has determined that the contingent income received from Am Re was not subject to our contractual limitations, Driver has indicated they will reduce the amount of up-front commission income taken over the 1998-2003 period by \$299,809 to avoid any perception of conflict of interest and as a gesture of good faith and good will.

The EIA Executive Committee, therefore, makes the following findings:

1. There is no evidence that the American Re contingency agreement was used inappropriately. Specifically, there is no evidence of improper conduct such as "steering" or "bid-rigging". Evidence indicates that placement of coverage with American Re was for the benefit of the EIA and its members and was clearly the best, and sometimes the only, alternative.
2. The EIA Executive Committee acknowledges and accepts Driver's written offer to reduce the amount of up-front commission income received from American Re from 1998-2003 by \$299,809, which will be rebated to the EIA in a manner mutually agreed between EIA and Driver and approved by the Executive Committee.
3. Staff is directed to follow-up with Driver to obtain details of any contingency agreements relating to miscellaneous and employee benefits programs. The results of this inquiry will be reviewed by legal counsel and reported to the Executive Committee as soon as possible.
4. Staff is directed to update/modify the EIA/Driver contract to address the issue of contingency income. Specifically, the EIA requests, to the extent possible, to be excluded from any contingency income agreements in the future. If determined not to be possible, Driver shall fully disclose the details of the contingency arrangement.

5. Staff is further directed to report the actions of the Executive Committee to the entire EIA and CPEIA membership as soon as possible. It should also be made clear to the members of EIA and CPEIA that any statements or allegations made in the Santa Clara lawsuit that Driver controls the EIA programs are not correct. Members are involved in the decision-making process and the EIA remains a member-directed risk sharing pool committed to providing superior programs and services to its members.

As new information becomes available, we will continue to keep the membership advised. In the meantime, please don't hesitate to give us a call if you have any questions. We would also encourage anyone with questions or concerns to attend one of the meetings hosted by Driver Alliant on this topic.