

**Analysis of the Consumer Federation of America
Report on Contingent Commissions**



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Introduction

An Insurance Information Institute analysis of a January 26, 2005 report by the Consumer Federation of America (CFA) on contingent commissions has found that the CFA's study:

- Grossly mischaracterizes how insurance is bought and sold.
- Relies entirely on conjecture to support its thesis that buyers of insurance are overpaying for coverage and are discouraged from filing claims.
- Ignores well-known facts regarding the cost of insurance and the competitiveness of insurance markets.¹
- Fails to recognize the service and value insurance agents bring to millions of consumers and that buyers of insurance have more shopping options than ever before.

Ironically, the net result of the CFA study is to confuse consumers and may cause them to avoid the products offered by many insurers and agents, thereby reducing the options available to them.²

CFA Conjecture that Contingent Commissions Raise Costs to Consumers is Unsupported by the Data

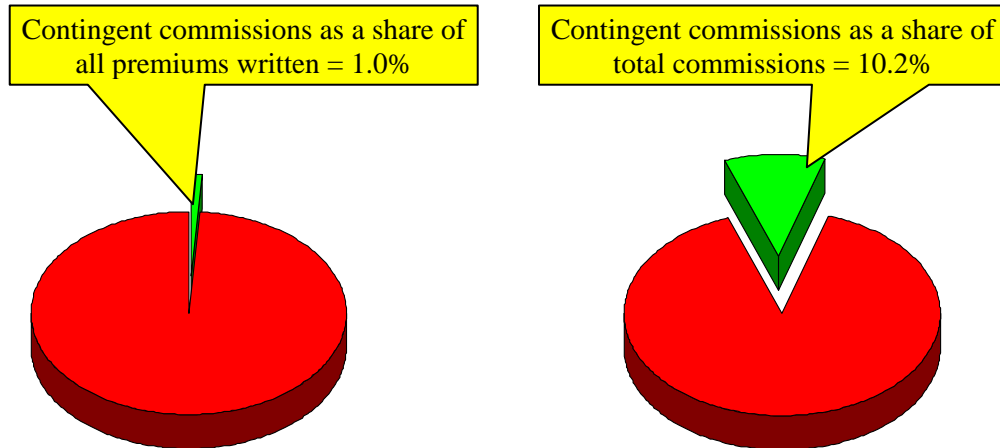
- The CFA study equates the existence of contingent commissions with an unfounded assertion that contingent commissions automatically lead to higher costs for customers. There are two fatal flaws in this argument:
 - Contingent commissions represent a tiny fraction of premiums paid. Because an agent's value is literally measured by the size of his or her renewal book of business, the agent has no incentive to jeopardize that value by shifting customers from insurer to insurer, year after year in search of a few extra dollars in commission. In fact, contingent commissions amount to just 0.14% of premiums for insurers whose primary business is auto insurance and 1.1% for companies whose business is predominantly derived from the sale of auto and homeowners insurance. These commissions account for just 6.99% and 11.28%, respectively, of the total commission received by agents selling these types of insurance. Across all lines of insurance, contingent commissions

¹ *Contingent Insurance Commissions: Implications for Consumers*, Consumer Federation of America, January 26, 2005, available at: http://www.consumerfed.org/contingent_commissions_release.PDF.

² For a more detailed discussion on insurance intermediary compensation, the reader is referred to the Insurance Information Institute paper, *Background on Insurance Intermediaries*, available at: <http://www.iii.org/media/hottopics/insurance/brokercompensation/>

amount to just 1% of premium or about 10% of total agent compensation.³ Contingent commissions as a share of premium and total producer compensation are displayed in Exhibit 1.

Exhibit 1: Contingent Commissions are a Small Part of Premiums and Total Producer Compensation, 2003



Source: A.M. Best's *Aggregates & Averages*, 2004 Edition.

- The CFA provides no evidence that contingent commissions increase costs for consumers. There is no evidence that companies that pay contingent commissions are not price competitive with companies that pay little or no such commissions. In fact, the majority of insurers selling insurance in the United States today do offer some form of contingent compensation to agents. Of the 400 leading property-casualty insurers, 66% pay contingent commissions.⁴ Presumably, if the payment of contingent commissions led to consistently higher prices for insurance, companies that pay those commissions would be driven from the market because their products would not be price competitive. Clearly companies that offer contingent commissions to their producers are price competitive.

CFA's Accusation that Contingent Commissions Discourage Legitimate Claims is Unfounded

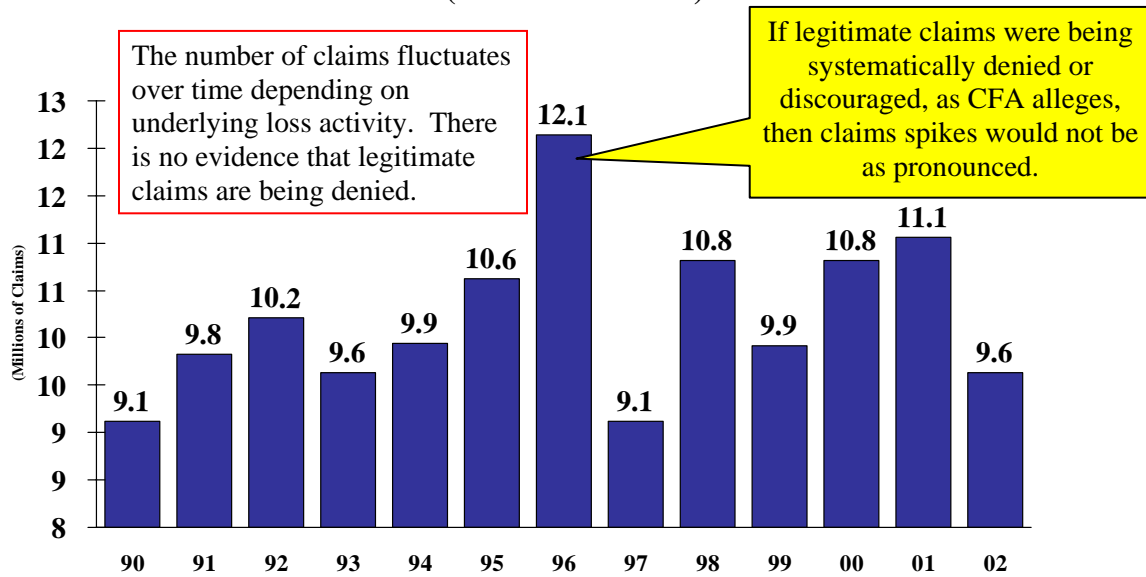
The CFA study suggests that profit-based contingent commissions give agents an incentive to delay or discourage the filing of legitimate claims. Again, CFA provides no evidence to support this charge and again the accusations are unsupported by the data. In

³ All figures on contingent commissions are from A.M. Best's *Aggregated & Averages*, 2004 edition. This is the same data source used in the CFA study.

⁴ A.M. Best *Aggregates & Averages* (2004 Edition) lists 472 "Leading Property-Casualty Groups" for 2003. Excluding the 71 companies with negative contingent commissions, 266 (66%) of the remaining 401 paid contingent commissions in 2003 while 135 (34%) did not.

reality, the number of claims filed by policyholders rises or falls each year in relation to underlying loss activity. This is demonstrated in the homeowners insurance context in Exhibit 2.

Exhibit 2: Number of Homeowners Insurance Claims, 1990-2002*
(millions of claims)

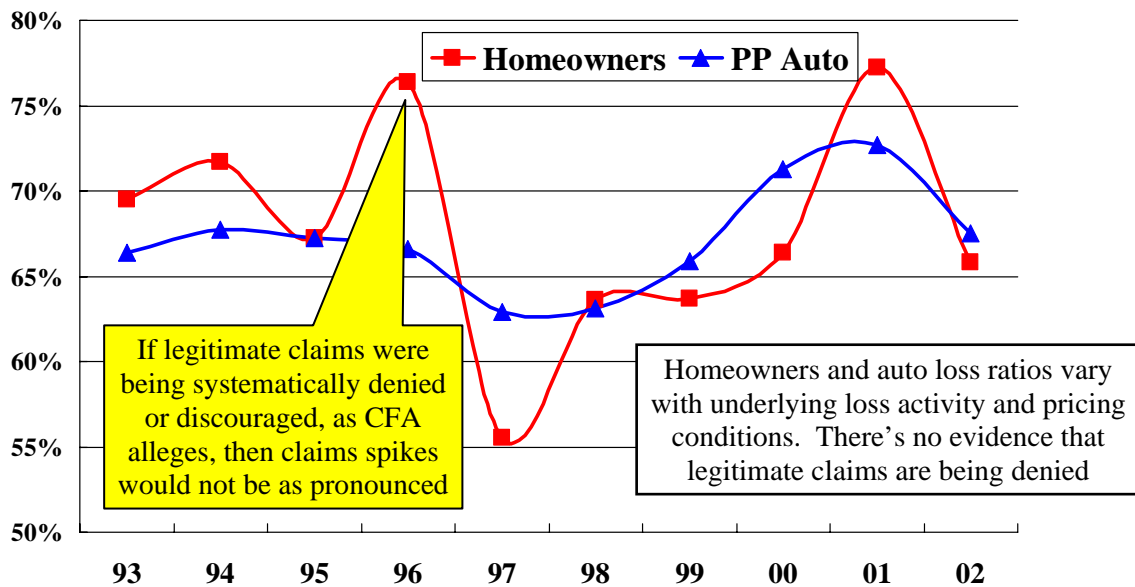


*Reported and assumed.

Source: A.M. Best's *Aggregates & Averages*, Schedule P—Part 1A (2004 Edition).

Likewise, the actual loss experience of insurers (as measured by the loss ratio) varies over time as well, as illustrated in Exhibit 3.

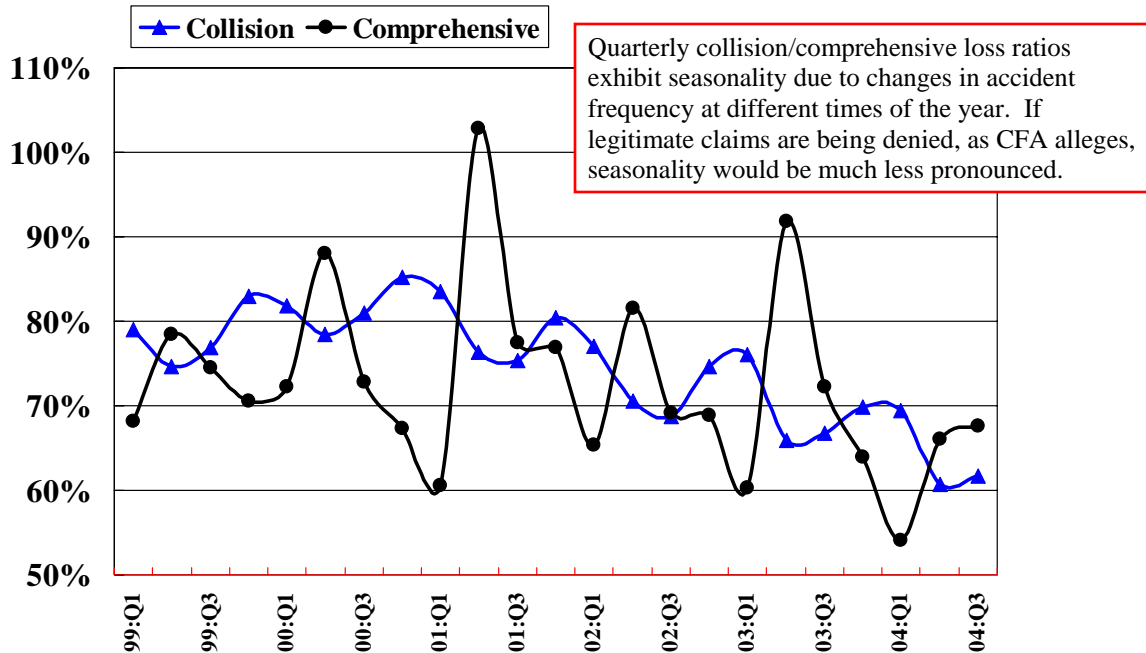
Exhibit 3: Loss Ratios: Private Passenger Auto & Homeowners, 1993-2002



Source: NAIC; Insurance Information Institute

Were agents attempting to discourage or delay claims as the CFA alleges, the observed periodic spikes in claims that occur would be much less pronounced because agents, whose profit-based contingent commissions were threatened, would actively seek to reduce the number of such claims. Variations in claim filing activity are also evident within a given year, as the seasonal fluctuations in collision and comprehensive claim filing in Exhibit 4 demonstrate.

**Exhibit 4: Private Passenger Auto:
Incurred Loss Ratios, 1999-2004:Q3**



Source: ISO Fast Track; Insurance Information Institute.

If the CFA allegations that agents routinely try to delay or discourage such claims were correct, the seasonal fluctuations would be much less pronounced and/or would be shifted to other parts of the year. This is because seasonal spikes in claims pose the greatest threat to profit-based contingent commissions. Under the CFA hypothesis, the seasonal spike in collision claims that occurs every winter—when driving conditions are poor in much of the US—would be less pronounced if claims were successfully discouraged or would be pushed into other seasons if delayed. Instead, claiming activity is consistent with expectations: the frequency of collision claims rises as driving conditions worsen in the winter and drops in the summer. Likewise, the spike in comprehensive claims during the spring and summer—a phenomenon associated with more frequent severe weather events at that time of the year such as hail storms and floods—is also consistent with expectations. The significant variability over time in both the number of claims and in loss performance—to which agent compensation is directly tied in profit-based contingent commissions—directly contradict the CFA’s allegations. There is no evidence of claim suppression or delay.

The CFA Incorrectly Characterizes the Insurance Industry as an ‘Anti-Competitive Culture’

- The CFA study states that insurance is not a “fully competitive business” and that it is not “subject to normal competitive pressures as most other businesses.” The report then argues that the complexity of insurance products forces many consumers to be reliant on agents or brokers and that this dependence leaves many consumers vulnerable to “sharp sales tactics” and “hidden commission arrangements.” Contrary to the CFA’s assertions, the facts show that insurance is actually one of the most competitive businesses in America and consumers today are empowered with more shopping options than ever. In most states, hundreds of insurers compete for the business of consumers, as shown in Exhibit 5. For example, the number of auto insurers ranged from a low of 249 in Hawaii to 634 in Illinois in 2003, according to A.M. Best.⁵ Homeowners insurance is also competitive, with 88 companies operating even in sparsely populated Alaska to a high of 334 in Illinois.

Exhibit 5: Number of Auto and Homeowners Insurers, by State (2003)

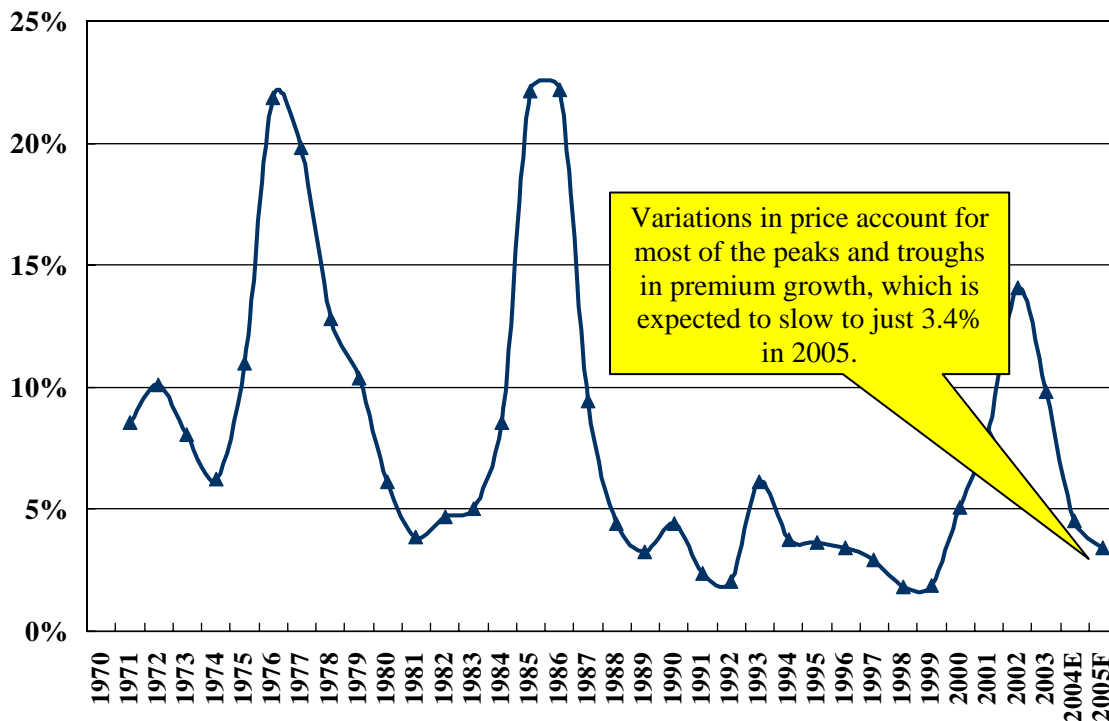
<u>State</u>	<u>No. of HO Cos.</u>	<u>No. of Auto Cos</u>	<u>State</u>	<u>No. of HO Cos.</u>	<u>No. of Auto Cos</u>
AL	193	502	MT	151	409
AK	88	307	NE	196	479
AZ	234	549	NV	177	457
AR	194	486	NH	164	334
CA	267	553	NJ	213	435
CO	222	501	NM	181	430
CT	201	412	NY	277	517
DE	165	407	NC	226	475
DC	129	356	ND	150	412
FL	291	588	OH	296	633
GA	276	603	OK	206	491
HI	89	249	OR	207	504
ID	182	435	PA	307	585
IL	334	634	RI	162	365
IN	271	620	SC	214	483
IA	220	526	SD	172	435
KS	233	493	TN	263	590
KY	226	508	TX	284	610
LA	199	492	UT	197	452
ME	161	342	VT	159	330
MD	229	504	VA	254	533
MA	216	316	WA	217	507
MI	216	471	WV	161	412
MN	230	489	WI	280	567
MS	193	497	WY	146	371
MO	247	555	Total US	1,109	1,509

Source: *Best's Review*, October and November 2004 issues.

⁵ A.M. Best, *Best's Review*, October and November 2004.

- The sheer numbers of insurers competing for business in all 50 states in most major lines of insurance directly contradicts the CFA statement that competition in insurance is “weak.” Moreover, competition in recent years has in fact intensified as the number of distribution channels for insurance has proliferated. Consumers today have more options than ever when it comes to shopping for insurance. Insurance can be purchased not only through independent and exclusive or captive agents, but also via telephone, mail and the internet.
- It is worth noting that the independent agency system itself generates significant competition. In 2002, there were more than 39,000 independent insurance agencies in the United States, according to the Independent Insurance Agents and Brokers Association. The average agency that year represented 7.0 personal lines (auto and home) insurers, 6.7 commercial insurers and 5.3 life and health insurers. This means that many agencies compete with each other for business within the same communities. These agents, combined with exclusive/captive agents in those same communities, the solicitations from direct marketers and the ease of online shopping offer the typical consumer an extraordinary array of purchase options.
- Significant variation in the price of insurance over time indicates that insurance is a very price competitive business. Exhibit 6 show the growth rate of net written premiums from 1970 through 2005 (estimate). The peaks and troughs in premium growth are principally the result of changes in price.

Exhibit 6: Strength of Recent Hard Markets by Net Written Premium Growth*

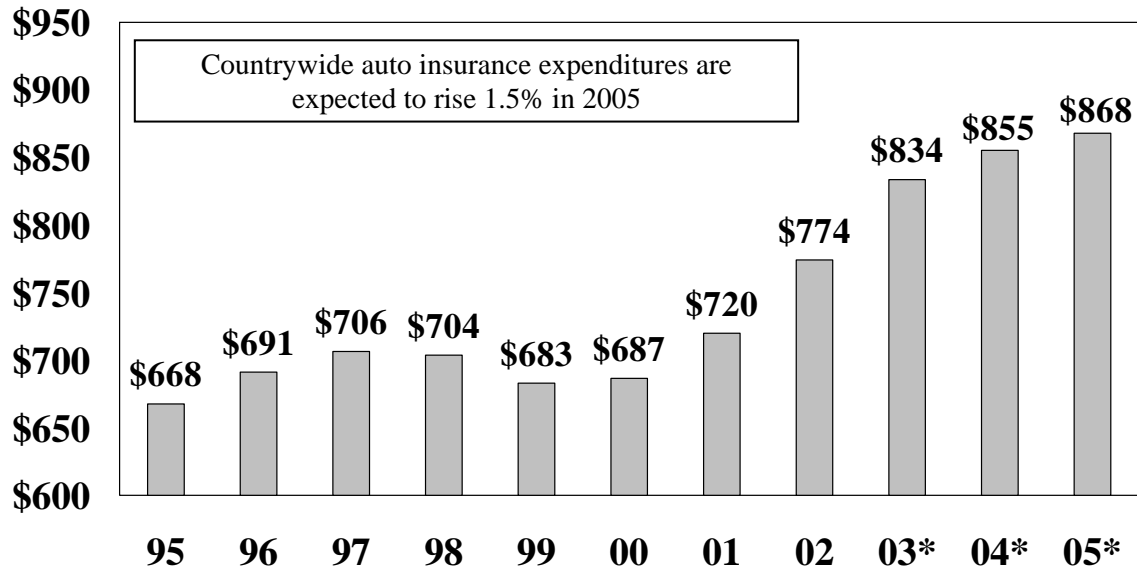


Note: Shaded areas denote hard market periods.

Source: A.M. Best; Insurance Information Institute estimate/forecast for 2004 and 2005.

The effect of changes in price is also evident in individual lines of insurance. For example, Exhibit 7 shows the average expenditure for private passenger auto insurance from 1995 through 2005 (estimate). In 1998 and 1999, the average expenditure on auto insurance fell and was essentially flat in 2000. After several years of increase brought about by adverse loss trends, the average expenditure increase in 2005 is forecast at just 1.5%. Were the CFA's assertions that insurance markets are not competitive true, no such variations in price would be observed.

Exhibit 7: Average Expenditures on Auto Insurance



*Insurance Information Institute Estimates/Forecasts
Source: NAIC. Insurance Information Institute

The CFA Study Ignores the Value Agents Bring to Consumers

- Agents bring enormous value to the insurance transaction for customers and insurers alike, a fact that is ignored in the CFA study. Customers want advice on making smart insurance buying decisions. Agents work hard to ensure that their customers get the right coverage with appropriate limits at a competitive price with a secure insurer. In general, an agent or broker who has a profit-sharing arrangement with an insurer also has a good working relationship with that insurer's underwriters, claims adjusters, premium auditors, accident prevention personnel and management team. These relationships are very important in negotiating on behalf of the client in terms of coverage, premium (rate) and claims settlement.⁶

⁶ Testimony of Sharon Emek, Ph.D., on behalf of the Independent Insurance Agents & Brokers of New York, January 7, 2005.

The CFA Study Ignores the Role Agents Play in the Underwriting Process

- Agents and brokers are not mere conduits or middlemen between insurers and customers. Aside from offering their expertise to clients, insurers rely on agents to act as field underwriters, helping the insurer identify and rate risks. If this function were not performed by agents it would have to be performed by staff in the insurer's home office, likely at greater expense. Performing this function in the field also reduces approval time (oftentimes to nearly zero in auto and homeowners insurance). To the extent that the agent partners with the insurer to produce profitable business, it is appropriate for the agent to have a stake in the outcome.

The CFA's Recommendations Could Confuse Consumers and Reduce Shopping Options

- The CFA study implies that many insurance producers are unscrupulous individuals and that consumers should be very suspicious when doing business with them. Though the CFA study offers no evidence to support its assertion, the net effect could be to discourage people from using independent agents and the companies that offer insurance products through them. Ironically, the result could be that people do not fully shop the market, have fewer choices and therefore make insurance purchase decisions based on incomplete information. With similar irony the CFA describes insurance as a "complex" product—seemingly the type of product where consumers could benefit from the services of an experienced insurance producer.

Summary

Insurance is a highly competitive business. More than 3,000 insurance companies currently operate in the United States, giving consumers scores if not hundreds of choices.

In addition to a large number of choices of insurers, consumers also have more choices than ever in terms of *how* they want to buy their insurance. Those options include direct methods such as purchases made via the telephone, mail or internet as well as through exclusive or independent agents.