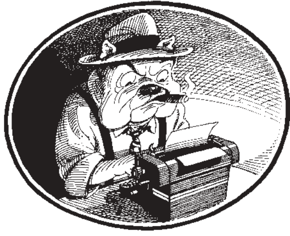

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SCHIFF'S

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The Long Black Cloud is Comin' Down

Insurance in the Crosshairs

This too shall pass. But not soon. The insurance industry is under siege, and, sadly, it has no one but itself to blame for the spectacle that's already reached epic proportions. It has been one week since New York State Attorney General Eliot Spitzer unveiled the charges against Marsh & McLennan, AIG, and ACE that set in motion a chain reaction of investigations, allegations, regulations, insurance-stock declines, class-action lawsuits, credit-rating downgrades, subpoenas, and guilty pleas.

The allegations of corruption are broad, ranging from the long-established practice of contingent commissions to kickbacks, bid-rigging, price-fixing, and breaching fiduciary responsibilities. Although the industry—which is pretty much despised to begin with—has been criticized often for many of these same practices, the criticisms never created such commotion before. Why is it different this time?

The film *The Cincinnati Kid* reaches its climax with a marathon five-card-stud poker game in which Edward G. Robinson, through a stroke of luck, cleans out the title character, Steve McQueen. After picking up the money in the pot, Robinson, the old master, provides The Kid with this bit of enlightenment: "Gets down to what it's all about, doesn't it? Making the wrong move at the right time."

So it goes for the insurance industry. Practices that look bad in the light of day—but would not otherwise have made headlines—turned into the perfect storm due to an unlikely confluence of events. If the attorney general bringing the charges weren't a nationally-renowned reformer named Spitzer, and if the trio of companies at the center of the scandal were not run by Hank Greenberg, Jeff Greenberg, and Evan Greenberg, this story would have had a hard time breaking out of the trade publications. If the news had broken in the pre-Enron era of the Imperial CEO, this whole mess would have been settled in the usual manner—with some consent decrees and token fines.

Grant's Interest Rate Observer, in a cover story entitled "Goodbye to All That" (invoking Robert Graves' pungent memoir of post-World War I disillusionment), writes the following: "When Armando Falcon [the regulator who oversees Fannie Mae and Freddie Mac] and Eliot Spitzer begin to outshine the chief executives of the companies they regulate, one may surmise that the end is near. But the end of what?...In the world we knew, the share prices of banks, insurance companies and federally chartered mortgage behemoths tended to go up. In the world we are slowly getting to know, the same stocks will tend to go in the other direction. It is hard to exaggerate the importance of the shift. Never before have financial stocks contributed so much to the S&P 500—either in terms of earnings or market capitalization—as they have since the millennium."

The insurance industry is, ostensibly, in the business of managing risk. Yet in many ways it was blind to the regulatory risks it exposed itself to through hubris, negligence, and greed. Spitzer's assertions, together with guilty pleas and incriminating emails, have rocked the industry. "The damages are vast; the corruption is remarkable," says Spitzer. Of course, the charges of pervasive fraud, restraint of trade, conspiracy, and deception have not yet been proved. But the insurance industry, caught with its guard down, is ill-positioned to wage a public war with the law. Spitzer's roundhouse blow has awakened the somnambulistic state-insurance regulators who, like the villagers of Brigadoon, seem to materialize once every hundred years. And what can these ersatz enforcers do now but admit that they're shocked, shocked to discover that fraud was taking place—then swing into action?

On Wednesday, California commissioner John Garamendi proposed new regulations (http://www.insurance.ca.gov/docs/FS-PRS084-04.htm) and declared that his "*ongoing investigation* [emphasis added] will expose these under-the-table kickbacks that are not in the best interest of consumers." His regulations would make it a violation of the insurance code if a broker does any of the following: "(1) Fails to provide the client with the proposal of a best available insurer; (2) Advises a client to select an insurer other than a best available insurer; (3) Advises a client not to select a best available insurer from among multiple insurers suggested to the client; (4) Fails to take reasonable measures to obtain a quote from an insurer that might be a best available insurer." The problem with this regulation is that the definition of "best available insurers" is vague: "the most suitable insurers for

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the client based on coverage, service, financial security and price...." Naturally, the regulation doesn't tell brokers *how* to figure out which insurance company is the "most suitable."

The insurance brokerage business has been a good business for a long time. So good that the brokers got cocky and complacent. They will pay dearly for this. Litigation and investigations will be a continuing burden. The days of insureds using only one broker will probably be gone for awhile. Margins will be under severe pressure. And Marsh & McLennan's board will have to address the question of whether Jeff Greenberg must go. The scandals happened under his watch—it's that simple—and unless the board determines that the behavior was the work of a few isolated rogues, we don't see how it can retain him as CEO in light of the mounting public pressure and weakened financial outlook.

Contingent commissions are not inherently evil; nor are they, in Spitzer's words, an "improper incentive." Certainly, any commission creates a conflict of interest. But conflicts of interest aren't always irreconcilable. Disclosure can alleviate some conflicts. But perhaps the times are such that the mere concept of commissions will be too much for clients to stomach. Brokers provide an essential service, and they can earn a good return going forward on a fee basis.

In April 1907, Cornelius DuBois of the insurance brokerage firm of Frank & DuBois, delivered a report about the history of the insurance-brokerage industry to an association of insurance brokers. He closed by saying the following: "I know of no other business that is capable of producing such satisfactory results—in return for such a small investment of money...The risks of losing money are slight...The [insurance] companies remunerate you for bringing them the business originally, and they keep on remunerating you for not taking it away."

Times have changed.

David Schiff bought Marsh & McLennan stock at $25.53.

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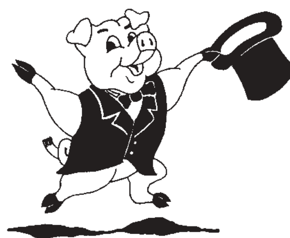

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