



TESTIMONY OF INSURANCE COMMISSIONER JOHN GARAMENDI
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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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