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THE MCCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING THE INSURERS' ANTITRUST EXEMPTION

HEARING

BEFORE THE

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CONTENTS

STATEMENTS OF COMMITTEE MEMBERS

WITNESSES

QUESTIONS AND ANSWERS

SUBMISSIONS FOR THE RECORD

THE MCCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING THE INSURERS' ANTITRUST EXEMPTION

TUESDAY, JUNE 20, 2006

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senator Leahy.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. Good morning, ladies and gentlemen. The Judiciary Committee will now proceed with our hearing on the McCarran-Ferguson Act, and examine the issue as to whether there ought to be antitrust coverage for the insurance industry, whether McCarran-Ferguson ought to be repealed or modified.

The issue has been the subject of a number of legislative proposals. House bill 2401, introduced by Congressman DiFazio, would eliminate the antitrust exemption under McCarran, and is a byproduct of earlier legislation which was introduced by Congressman Brooks, then chairman of the House Judiciary Committee.

In the Senate, we have Senate bill 1525, introduced by Senator Leahy, which relates to the issue that McCarran would not apply to medical malpractice insurers who engage in any form of price fixing, bid-rigging, or market allocation, and Senate 2509, Senator Sununu, which would authorize Federal regulation for insurers who opt into the program.

The issue has been the subject of an investigation by the New York Attorney General's Office, which found that there was bid-rigging and customer allocation schemes among some major insurers, and the country's largest broker. We have a panel today of six witnesses, evenly divided: three advocating for repeal of McCarran-Ferguson and three opposing it.

This is a very important subject where there is a significant question as to whether regulation by the States is sufficient and whether there should be special status accorded to the insurance industry to be exempt from the antitrust laws, with those laws being very, very important in enforcing competition in the economy generally.

Without objection, my full statement will be made a part of the record.

We will now turn to our first witness. Our first witness is Ms. Elinor Hoffmann, Assistant Attorney General, Antitrust Bureau, in the New York Attorney General's Office.

She has had 25 years of litigation experience, including numerous antitrust cases. She is an Adjunct Professor of Law at Brooklyn Law School, Phi Beta Kappa and Magna Cum Laude from New York University, and a law degree from Brooklyn Law School, and a Master's in law from New York University.

Thank you for joining us here today, Ms. Hoffmann. We look forward to your testimony.

Ms. HOFFMANN. Good morning. On behalf of the New York State Attorney General, thank you for the opportunity to testify here today.

The antitrust laws reflect our society's belief that competition in the commercial marketplace enhances consumer welfare and promotes our economic and political freedom.

Unrestricted competition, however, may not be consistent with other significant public policies or regulatory schemes that also serve the public interest. So we exempt conduct from antitrust scrutiny to the extent necessary—but only to the extent necessary—to obtain—

Chairman SPECTER. Ms. Hoffmann, you have just begun your testimony, less than a minute in. I want to turn to you, Senator Leahy, to have your opening statement. We just adopted a new rule. If you are less than a minute into your testimony, you are subject to interruption.

[Laughter].

Chairman SPECTER. You are subject to interruption, and you will be accorded the full time when you begin again, providing your microphone is on.

Ms. HOFFMANN. Thank you, Senator.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. These are known as the Specter rules, which I want you to know, we all follow.

With respect, I did want to be here. I apologize, I started off a little late this morning. I had breakfast this morning with Cardinal McCarrick, one of the finest clerics to serve here, who is now retiring, which means they will find hundreds of other things for him to do and will have him working even harder than he does now. He is a great person, and it was a very inspirational breakfast.

As far back as 1945, the insurance industry has operated largely beyond the reach of Federal antitrust laws. The McCarran-Ferguson Act created this exemption. So long as the insurance business is regulated by the States, there is no room for Federal oversight.

The drafters may well have been well advised at the time, and perhaps it was a worthwhile policy, but the times have changed. The common refrain of tort reform proponents is "out-of-control juries and large malpractice awards drive insurance costs higher," and medical professionals, we are told, are being crushed by excessive costs.

Just recently, the Senate considered legislation to cap punitive damages in medical malpractice cases. One study found that among the 15 best-rated medical malpractice insurance providers, premiums rose dramatically between 2002 and 2005—dramatically—but the cost of the claims paid out remained flat, so it was hard to see just how, somehow, claims were pushing up the cost of premiums.

Claims are not driving the premiums. Insurance costs among competing companies are rising in lock step with each other. That was the other thing. They were not paying out any claims, but the costs were going up and they were in lock step. Maybe there were other causes.

I have introduced a bill, the Medical Malpractice Insurance Antitrust Act of 2005, along with Senators Kennedy, Durbin, Rockefeller, Boxer, Feingold, Salazar, Obama and Mikulski. It would repeal the antitrust exemption for medical malpractice insurance, and only for the most egregious cases of price fixing, bid rigging, and market allocation. It is a narrow bill.

My bill targets a particularly troublesome aspect of the problem, and I think we should look at it. If insurers around the country are operating in an honest and appropriate way, they should not object to being asked to abide by the same antitrust laws as virtually all other business.

There is no reason why they should be treated differently than other businesses. We all want to be treated alike, in an egalitarian manner, because nobody is above the law, except for insurance companies.

American consumers, from sophisticated multinational businesses to individuals shopping for personal insurance, have the right to be confident that the cost of the insurance reflects competitive market conditions, not collusive behavior.

I recognize the insurance industry's unique characteristics, including the dependence on collected claim and loss data. But I think you can combine those legitimate needs while still providing Federal regulators with the tools to investigate and prevent collusion and other anti-competitive behavior.

Individuals and businesses are compelled, sometimes by law and sometimes by prudence, to purchase many kinds of insurance. I just want to make sure they are being treated fairly and are not subject to insurance company activities that create, not better insurance packages for the individual, but higher profits for those selling them.

So, thank you, Mr. Chairman.

[The prepared statement of Senator Leahy appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Senator Leahy.

Ms. Hoffmann, we return to you with the full five minutes.

STATEMENT OF ELINOR R. HOFFMANN, ASSISTANT ATTORNEY GENERAL, ANTITRUST BUREAU, OFFICE OF THE ATTORNEY GENERAL FOR THE STATE OF NEW YORK, NEW YORK, NEW YORK

Ms. HOFFMANN. Thank you, Senator. Good morning. On behalf of the New York Attorney General, thank you for the opportunity to testify here today in favor of the repeal of the McCarran-Ferguson exemption from the antitrust laws.

The antitrust laws reflect our society's belief that competition in the commercial marketplace enhances consumer welfare and promotes our economic and political freedoms.

Unrestricted competition, however, may not be consistent with other significant public policies or regulatory schemes that also serve the public interest, so we exempt conduct from antitrust scrutiny to the extent necessary—but only to the extent necessary—to attain other important goals.

The McCarran-Ferguson exemption from the antitrust laws is an industry-specific exemption, unlike, say, the labor exemption, which is a broad-based policy exemption that crosses many sectors.

It was enacted in 1945 as part of a bill to address the concerns of the insurance industry in the States after the Supreme Court's decision holding that insurance, unquestionably, was part of interstate commerce.

The insurers wanted to continue to engage in collective conduct like rate setting and policy term agreements that they deemed necessary for solvency. McCarran preserves the power of the States to regulate and tax, but affords an exemption from the antitrust laws for the industry.

McCarran states that the Federal antitrust laws apply to the business of insurance to the extent that such business is not regulated by State law. Agreements and actions taken to boycott, coerce and intimidate are not exempt.

Thus, in some senses the exemption is narrow, but it runs very deep. It was intended to protect the industry from the chilling effect that antitrust exposure might have on joint activities designed to ensure prudent transfers of risk. But, importantly, it protects price fixing, cartel-like behavior that in most industries would be summarily condemned.

Since 1945, some participants in the insurance sector have, on occasion, engaged in anti-competitive conduct that has nothing to do with the original purpose of McCarran.

Recently, New York and other States found evidence of serious misconduct in the insurance industry. Information obtained during our investigation supports our allegations of collusion to subvert the competitive process.

More specifically, we have discovered, among other things, stark evidence of bid-rigging and customer allocation. For example, we found evidence that Marsh & McClennan, one of the world's largest insurance brokers, steered unsuspecting clients to insurers with which it had lucrative payoff arrangements based on volume or profitability of the business that Marsh brought to the insurers. These arrangements were often called contingent commissions, or overrides.

In order to make the scheme work really well, Marsh solicited fictitious bids from insurers so that business could be steered to the insurer favored by Marsh on a particular deal, that is, the insurer who would pay Marsh the most.

The customer thought it was getting the benefits of competition, but it was not. Marsh's clients may have been unaware of the scheme, but the insurers were not unaware. Marsh sometimes even circulated the favored bidder's quote and ask other bidders to protect it by submitting a higher, non-competitive quote.

As a result of our investigation, hundreds of millions of dollars in restitution will be paid to customers injured by this type of anticompetitive conduct. Twenty officers and executives have pled guilty, six companies have settled, and a total of over $3 billion in restitution and penalties has been recovered due to antitrust and other violations.

The investigations and litigation are ongoing. In addition to a pending lawsuit that we have against Liberty Mutual, Florida has sued Marsh under State laws alleging antitrust and RICO violations, and there is a pending class action before the District Court in New Jersey, where McCarran is the subject of extensively briefed Motions to Dismiss.

We brought our case against Marsh in State court and we plead State law claims, including claims under New York's Donnelly Act, New York's antitrust law. Donnelly has its own antitrust exemption for insurance. It exempts property and casualty insurers, but not brokers and not the business of insurance.

Had we prosecuted our case in Federal court under Federal antitrust law, we likely would have encountered a defense under McCarran, delaying, or maybe precluding, settlement. That is not to say we would have lost, but as enforcers we are not inclined to invite delay in reaching the merits.

This is not just New York State's problem, it is a pervasive national problem. McCarran, because it precludes Federal antitrust enforcement of serious anti-competitive conduct in the insurance sector, requires State enforcement agencies and litigants to examine each State's laws to determine whether that State exempts the business of insurance, or any part of it, from State antitrust scrutiny.

Some States follow Federal law in whole or in part, others exempt insurance from State antitrust law to some extent, and still others have no exemption at all. Remedies and outcomes may differ from State to State. Differences in State laws may pose an impediment to class certification in some instances.

The impact of McCarran is that it encourages inefficient multiple proceedings under disparate laws brought by diverse sets of public and private plaintiffs, with the clear potential for inconsistent results.

Chairman SPECTER. Ms. Hoffmann, how much more time will you need?

Ms. HOFFMANN. About two more minutes.

Chairman SPECTER. Why do you not summarize at this point?

Ms. HOFFMANN. Sure.

There are other ways, in fact, for the insurance industry to achieve its legitimate goals. Exchanges of information are permitted in other industries, consistent with the antitrust laws.

In sum, experience with McCarran indicates that there is the need to reexamine industry-specific exemptions periodically. Markets change in many cases, eliminating the need for broad exemptions. McCarran is one example of an exemption that has no apparent business justification and impedes free and open competition in a major sector of the U.S. economy.

Chairman SPECTER. Thank you very much, Ms. Hoffmann.

[The prepared statement of Ms. Hoffmann appears as a submission for the record.]

Chairman SPECTER. We turn now to Mr. Marc Racicot, president of the American Insurance Association, former Governor of Montana. He had served as Chairman of the Republican National Committee. He is a graduate of Carol College in Helena, Montana, and the University of Montana Law School.

Thank you for joining us, Governor Racicot, and we look forward to your testimony.

STATEMENT OF MARC RACICOT, FORMER GOVERNOR OF MONTANA, PRESIDENT, AMERICAN INSURANCE ASSOCIATION, WASHINGTON, DC

Mr. RACICOT. Thank you, Mr. Chairman, and good morning. I am delighted to be here this morning to speak on behalf of property and casualty insurers across the country and around the globe that are members of the American Insurance Association. We are, of course, appreciative of the opportunity to be here to discuss McCarran-Ferguson.

It is important to note that McCarran is a power-sharing statute that reflects Congress' judgment to delegate, not abdicate, authority over insurers to States that regulate the business of insurance themselves.

In doing so, McCarran provides insurers with an antitrust regime that recognizes the insurance regulatory role entrusted to the States. Because of the delicate balance of power contained in McCarran, we believe the discussion of a repeal or limitation of McCarran's antitrust provisions cannot be divorced from a corresponding discussion of the nature of State insurance regulation.

Within this framework, my testimony today will focus on two things: first, some perspective on the McCarran discussion over the years; second, the role of McCarran in today's debate over needed reform of the insurance regulatory system.

In 1944, as was mentioned, the Supreme Court held in Southeastern Underwriters that insurance was indeed a product of interstate commerce and, therefore, subject to Federal scrutiny.

As the case centered around how insurers collected and analyzed data to appropriately price risks, it necessarily focused congressional attention on several pressing questions dealing with the primacy of State regulations, State taxation of insurers, application of Federal antitrust laws, and whether, and how, insurers could collaborate on drafting uniform policy forms.

Congress responded by enacting McCarran a year later, as the committee is well aware. McCarran entrusted the States with authority to regulate and tax the business of insurance, giving them three years from enactment to implement their regulatory systems, and said no Federal law should be presumed to interfere with that authority unless clearly designated to do so.

McCarran also said that Federal antitrust laws would apply to the extent that such businesses were not regulated by State law, or in any case where insurers had engaged in, or attempted to engage in, an act of boycott, intimidation, or coercion.

Following the passage of McCarran, all States enacted unfair competition and trade practices laws directed specifically to insurers and adopted prohibitions on acts of boycott, intimidation, or coercion by insurers, as well as Sherman Act-and Clayton Act-type prohibitions on unfair restraint of trade.

When implementing these regulatory structures, the States also faced the question always raised when dealing with a regulated industry, and that is how to balance the roles of regulation and antitrust policy.

They responded by placing all collective activity by insurers under regulatory control, scrutiny and review, effectively replacing antitrust litigation with regulatory oversight of any collective activity.

Not coincidentally, the same type of balance exists for other financial services institutions and industries, such as banking and securities. Federal courts have held that this balance is critical and that antitrust scrutiny is inappropriate where activity is subject to regulation, otherwise, chaos would rule.

Private antitrust litigation constantly would battle Federal regulatory systems, creating enormous uncertainty for businesses and customers, to no one's benefit. One important distinction, from an antitrust perspective, however, is that the banking and securities industries are principally Federally regulated, while insurance is principally State regulated.

When Federal antitrust laws balance against Federal regulation for a specific industry, courts give precedence to the specific regulatory system Congress has set up for that industry over broad non-specific language of the antitrust laws.

McCarran comes under fire periodically. Whenever an affordability or availability problem arises in any line of insurance, critics in those circumstances tend to blame McCarran. Their misguided solution is to repeal McCarran.

Ironically, when the problem subsides, those who have argued that McCarran should have been repealed never credit McCarran for having cured the problem. The reality is that when insurance prices spike or availability shrinks, it is all because of some underlying problem that needs to be addressed.

To be fair to all customers and to stay in business, insurers must be able to price prices to cover policy losses. When government price controls prevent that, insurers are forced to pull back from the marketplace. Instead of looking at insurer activity under McCarran, it would always be better to examine cost driver-related problems and fix them.

In the early 1990s, as was mentioned, AIA worked with Congress to develop legislation to retain essential McCarran antitrust exemptions through specifically identified safe harbors. After the

1994 elections, congressional interest moved from amending McCarran to enacting wide-ranging insurance regulatory reform. Today, we believe that regulatory reform is the way to go.

Since McCarran only applies to the businesses of insurance regulated by the States, it obviously would not apply to pricing activities of Federally chartered insurance agencies or insurance industries operating under a national charter.

As was mentioned by the Chairman, Senate bill 2509 sets about to do just that. We think it is time for that particular issue to be entertained by the committee and by Congress.

AIA members are certainly willing to take the risks inherent in that approach recommended in that legislation because we strongly believe that a competitive marketplace is critical to being able to serve our customers in the years ahead.

Mr. Chairman, thank you for the opportunity to present. I am available, obviously, as you know, for questions.

Chairman SPECTER. Thank you very much, Governor Racicot.

[The prepared statement of Mr. Racicot appears as a submission for the record.]

Chairman SPECTER. Our next witness is Mr. Bob Hunter, Director of Insurance, Consumer Federation of America, formerly the Texas Commissioner of Insurance, and president and founder of the National Insurance Consumer Organization. He has worked both as underwriter and actuary in the insurance industry.

Thank you for coming in today, Mr. Hunter. The floor is yours.

STATEMENT OF J. ROBERT HUNTER, INSURANCE DIRECTOR, CONSUMER FEDERATION OF AMERICA, WASHINGTON, DC

Mr. HUNTER. Thank you, Mr. Chairman, Ranking Member Leahy.

Adam Smith wrote this in 1776: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public or in some contrivance to raise prices.” That is why we passed antitrust laws.

But in insurance, this is a trade enjoying an unusually broad exemption, an exemption, by the way, slipped in in the conference committee in 1945, after both Houses passes the legislation it did not have it in.

While it should not require a study to prove that collusion harms buyers, you have study after study by Federal agencies that all call for an end to the antitrust exemption. As a result of this call, in 1994 the House Judiciary Committee passed a sharp cut-back of the exemption in a bipartisan vote.

Since 1994, collusive behavior in insurance companies continues. We just heard about the bid-rigging, et cetera that New York has uncovered. Again, State regulation has failed to catch it. It was at least 20 years ago that I first warned the State regulators about the perils of the contingency commission arrangements.

Anti-competitive price and market allocation signals by insurers have exacerbated the insurance crisis in homeowners’ insurance on the Nation’s coasts. The Nation has suffered another hard market, starting in the year 2000, a period when insurers returned to the price levels established by the rate bureaus.

These cartel-like bureaus, such as the Insurance Services Office, day after day produce price guidance on 70 percent of the rate that many insurers use as the basis for their pricing. They manipulate data and project pricing into the future, using steps that legal experts told Congress, when the House was reviewing it, would be illegal absent the McCarran immunity.

Rate bureaus have cartel-like control of rate-making data. They establish price classes for people to be charged. They establish territories that are used to rate people and the data that are collected and the format they establish assure significant uniformity in the market. The antitrust exemption has been the most potent enabler of these, and many other anti-competitive practices.

Along the coast today, on May 9, 2006, ISO's CEO signaled that the market was over-exposed on the coastline of America, and days later, leading insurers announced they were dropping over 150,000 homes.

In March, another rate guidance organization, Risk Management Solutions, announced it was changing its hurricane model, causing home insurance hurricane rates to jump 40 percent on the Gulf Coast, and by up to 30 percent all the way up to Maine.

The old models were developed after Hurricane Andrew, based on long-term 10,000-year damage projections. Insurance commissioners, including me, were told that the large price jumps that we were asked to approve at that time were scientifically proper and would bring price stability.

We were assured there would be no need to raise rates after catastrophic weather events because the storms would have already been anticipated when the rates were set, even including Category 5 storms hitting Miami, nor would there be rate drops if no storms came. Insurance would bring stability rather than turmoil after large, infrequent storms, we were told.

However, the new RMS model breaks that promise, and instead of a 10,000-year projection, makes a mere 5-year projection, with higher hurricane activity expected. It is clear that the insurance companies pressured the modelers to achieve this result. The other modelers followed suit.

It is shocking and unethical that scientists at these modeling firms, under pressure from the insurers, have completely changed their minds all at the same time, after a decade of using models they assured the public were scientifically sound. Worse, the changes have nothing to do with science, but rather with collusive pressure brought by the insurance companies.

Support for ending the exemption is strong. The New York Times editorialized, "Bust the Insurance Cartel," and similar headlines in many editorials. Business Week and other leading business journals also called for the end.

Consumer groups, small business groups, AARP, the American Bar Association, the American Bankers Association, labor unions, medical groups, and others supported repeal when the House Judiciary Committee last reviewed this. Rate bureaus and insurers claim that, despite their history of rampant collusion, they have gone straight and now a modeling of competition.

A simple question can test this bold claim: does the insurance industry unconditionally support a bill that repeal's McCarran's broad antitrust immunity? A straight repeal, not tied to proposals to gut the meager consumer protections that we enjoy today?

Mr. Chairman and members of the committee, now is the time to repeal the McCarran-Ferguson Act's antitrust exemption. We estimate it would save consumers about 10 percent, or $45 billion a year.

Chairman SPECTER. Thank you very much, Mr. Hunter.

[The prepared statement of Mr. Hunter appears as a submission for the record.]

Chairman SPECTER. Our next witness is Mr. Michael McRaith, Director of the Division of Insurance for Illinois, Department of Financial and Professional Regulation. Prior to his appointment as Director, Mr. McRaith spent 15 years in private practice in Chicago.

He has a bachelor's degree from Indiana University and a law degree from Loyola University School of Law in Chicago.

We appreciate you coming in, Mr. McRaith, and we look forward to your testimony.

STATEMENT OF MICHAEL MCRAITH, ILLINOIS DIRECTOR OF INSURANCE, CHAIR, BROKER ACTIVITIES TASK FORCE, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, CHICAGO, IL

Mr. MCRAITH. Thank you, Chairman Specter and Ranking Member Leahy. I appreciate the invitation to testify this morning on behalf of the National Association of Insurance Commissioners.

I am Michael McRaith, Director of Insurance in Illinois, and an active participant in the NAIC's continued leadership on national insurance matters. I also serve as chairman of the Broker Activities Task Force for the NAIC.

As insurance commissioners, our core priority is consumer protection. Insurance is a uniquely personal and complex contract. Analogies to other financial sector products, including the banking industry, are inherently misleading. With debt or equity financial products, even with deposits, a consumer assumes the risk; with insurance, the consumer transfers the risk.

Consumers pay in advance for a benefit that may never be needed, or may be needed significantly in excess of the price paid. Insurance is a product unique to the individual or unique to the insured property, business, or community. Insurance is always local and personal, if not intimate.

Today the question of McCarran will be interpreted differently by different witnesses. Some will use this discussion to propound the need for a Federal regulator. The creation of a massive Federal bureaucracy to benefit a small segment of the largest carriers in the insurance industry at the expense of consumers is an idea that this committee and the U.S. Congress should unequivocally reject.

The reasons for rejection are so expansive, I will resist the urge today to engage in that dialogue and focus instead on the question at hand. With the limitation exemption of McCarran, State-based regulation fosters a competitive marketplace.

With more than 5,000 insurers in the United States, only 296 have more than 500 employees. These smaller insurers do not have as prominent a voice in Washington, but they serve niche markets and they provide more personalized service, or maybe a long-standing farm mutual serving a rural community in your home State.

State-based regulation affords comprehensive cradle-to-grave supervision, ensures carrier solvency, monitors market conduct of carriers and producers, and enforces unfair competition and deceptive practices statutes.

Discussion of McCarran's appeal must be considered in the broad economic context. Repeal of the exemption cannot be viewed in a legalistic vacuum. Any repeal, even with a list of permissible items, will subject regulation of the industry to years of uncertainty and stability, amounting ultimately to installation of the courts as a de factor regulator.

Moreover, the discussion of enumerated permissible practices implicitly illustrates the difference between insurance and other industries. The business of insurance exemption in McCarran authorizes insurers to engage in supervised, but cooperative, activities. These practices foster competition, consumer choice and awareness, and help maintain marketplace integrity.

But the label of an antitrust exemption is a misnomer because States extensively and actively regulate the entire industry. We closely supervise the conduct of the very organizations involved with the cooperative activity.

Price fixing, bid-rigging, tying, boycotting, other anti-competitive practices that negatively impact consumers, those are simply not allowed.

Attorney General Spitzer of New York should be commended for bringing the abusive contingent commission practices into the spotlight. NAIC members have worked on these issues with attorneys general from around the country. NAIC members have guided resolutions that have returned more than $1 billion to policyholders and imposed businesses reforms that prioritized consumer protections.

McCarran's limited exemption is intertwined with extensive State-based regulation. A repeal would not improve—not improve—the affordability, reliability, or availability of insurance to consumers.

Repealing the exemption would inject uncertainty, reduce stability and predictability, deter capital infusions, and ultimately eliminate, if not reduce, competition and raise costs. Consumer benefits and protections are enhanced with McCarran's limited exemption.

The NAIC looks forward to continued work with Federal and State officials, consumers, the large and small industry participants, and all interested parties to ensure that prevention and punishment of anti-competitive practices continues.

Thank you.

Chairman SPECTER. Thank you very much, Mr. McRaith.

[The prepared statement of Mr. McRaith appears as a submission for the record.]

Chairman SPECTER. Our next witness is Mr. Donald Klawiter, Chairman of the American Bar Association's Section of Antitrust Law, partner in the antitrust practice group of the office of Morgan, Lewis & Bockius. He has had several supervisory positions with the Antitrust Division of the Department of Justice. He has an undergraduate and law degree from the University of Pennsylvania.

With all that background, Mr. Klawiter, in ML&B, why did you come to Washington?

Mr. KLAWITER. I have always been in Washington, Mr. Chairman.

STATEMENT OF DONALD C. KLAWITER, CHAIR, SECTION OF ANTITRUST LAW, AMERICAN BAR ASSOCIATION

Mr. KLAWITER. Chairman Specter, Senator Leahy, I appreciate the opportunity to present the views of the American Bar Association on the insurance exemption from the antitrust laws in the McCarran-Ferguson Act.

Just over 60 years ago, Congress enacted the McCarran-Ferguson Act as a limited exemption from the antitrust laws for the insurance industry. It was enacted as an attempt to reaffirm the supremacy of State regulation in response to Federal criminal antitrust challenges. It was a time when many industries were regulated, either at the Federal or the State level, and enjoyed exemptions from the Federal antitrust laws.

The world is very different today. Over those 60 years, our competition policy has moved decisively from promoting the benefits of regulation and regulatory oversight to fostering the benefits of free and open competition.

In the late 1970s, the National Commission for the Review of the Antitrust Laws and Procedures, where Senators Kennedy and Hatch served with distinction as commissioners, focused enormous attention on the need to repeal and limit industry-specific antitrust exemptions, and many were repealed by the Congress after that commission's work.

The current Antitrust Modernization Commission is, today, studying the remaining exemptions that have been presented and there have been proposals to eliminate or sunset many of the exemptions, including the insurance industry exemption.

This committee should be commended for your focus on this issue today. In 60 years, we have learned that industry-specific exemptions from the antitrust laws are rarely justified, and that the antitrust laws are a flexible instrument of the law that transcends industries and special competitive circumstances.

The American Bar Association favors repeal of the McCarran-Ferguson Act. It is our strong position that the insurance industry should be subject to the same antitrust laws and rules as all other industries.

We believe, however, that the law should be replaced by a series of safe harbors to make clear that certain types of conduct by insurers that are necessary, pro-competitive, and beneficial to the American economy should be encouraged.

Safe harbors would provide the industry with an opportunity to conduct necessary pro-competitive joint activities without the chilling concerns of possible antitrust litigation.

Among the safe harbors we would propose would be the following. First, the industry should be able to collect and disseminate past loss experience data over a large number of insured. This is essential to the industry's ability to make assessments of risk. Small companies, in particular, need this base of information to compete effectively against larger companies.

Second, standardization of policy forms contributes to consumer understanding and assists in reliable data collection efforts.

Third, where the risks are too large or too uncertain for a single insurer to underwrite, the insurers traditionally have cooperated in creating pools or joint ventures, writing large risk and then sharing that risk. As in any joint venture, the parties need to agree on rates and policy language to complete the underwriting job.

Fourth, State regulators often require insurers to cooperate in underwriting residual risk, particularly in inner city areas. These cannot be insured in the voluntary market. This conduct should be allowed, as long as it is authorized and actively supervised by the States.

Fifth, we are reluctant to suggest an exclusive list of cooperative activities, and we suggest that the industry should propose other features of joint activity that would be pro-competitive. This is not intended to be an open-ended provision. Indeed, it must be very specific and unambiguous to be effective.

These safe harbors are intended to protect legitimate pro-competitive joint activity by insurers, while still subjecting the insurance industry to the antitrust rule of law. While most, if not all, of the safe harbor conduct would be permissible, or even encouraged, under current antitrust precedent, the idea of safe harbors is to remove all doubt, especially where there is no antitrust precedent or frame of reference in many of these areas because McCarran has been the law for 60 years.

Thank you for the opportunity to appear before you today and present the views of the American Bar Association. Competition is the hallmark of the American economy. The United States has very successfully spread the gospel of competition to the rest of the world, with remarkable results in international acceptance and enforcement over the years.

Special treatment of certain industries, whether more lenient treatment or stricter treatment, makes us look inconsistent or even hypocritical to those we seek to educate and influence around the world, especially the countries of Eastern Europe, which are just beginning to develop their economies.

The American Bar Association believes strongly that competition in the insurance industry can be enhanced, consistent with necessary joint activities, to the benefit of all segments of the economy.

I would be happy to answer any questions the committee may have.

Chairman SPECTER. Thank you very much, Mr. Klawiter.

[The prepared statement of Mr. Klawiter appears as a submission for the record.]

Chairman SPECTER. Our final witness is Mr. Kevin Thompson, Senior Vice President, Insurance Services Office. In that position, he is responsible for filing activities required by regulators at the States. He has 30 years of professional insurance experience. He has a bachelor's degree in mathematics and education from New York University.

We appreciate you coming in today, Mr. Thompson, and we look forward to your testimony.

STATEMENT OF KEVIN THOMPSON, SENIOR VICE PRESIDENT, INSURANCE SERVICES OFFICE, JERSEY CITY, NEW JERSEY

Mr. THOMPSON. Thank you, Mr. Chairman and Ranking Member Leahy, for the opportunity to discuss the vital role ISO plays in the property and casualty insurance industry in the United States today.

The property and casualty insurance industry today is intensely competitive and fragmented. Not only do insurers compete in the way they package and price their products, but they also compete in the way they distribute and service them.

Within the industry, ISO provides insurers with critical insurance information that promotes competition between all insurers and adds economies of scale to functions vital to each individual insurer.

Access to a broad base of reliable information and standardized coverage parts that comply with State requirements permits any insurer to enter new insurance markets and compete in existing ones that might not otherwise be possible if it had to rely solely on its own information and resources.

ISO's charter specifically states that all ISO information and services are purely advisory. That is, insurers select among any of ISO's services and use them as they choose. ISO does not develop rates. Instead, ISO provides advisory prospective cost information. Rate setting is a matter between individual insurers and their regulators.

ISO provides statistical and actuarial information and analyses, policy forums, data processing, and related services for a broad spectrum of commercial and personal lines of insurance.

ISO is actively regulated by the States as an advisory organization and performs its various functions in each of the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands.

ISO information is available to any property and casualty insurer, and insurers are free to use, modify, or not use ISO information as they determine their own strategies in the highly competitive insurance marketplace.

The pro-competitive benefits of ISO's products and services are well-documented and include, first, accurate projections of future claims payments. Pricing insurance is difficult. Unlike most businesses, insurers cannot set a price based on known costs and production and distribution. When pricing a policy, an insurer needs to project the cost of future insurance claims by examining historical data.

This method is reliable only when the insurer uses a sufficient amount of accurate data. ISO's actuaries are highly trained to compile, edit for quality, process, and combine data for many companies into statistically credible pooled databases accessible by any insurer which, along with his own data and other information, enable an insurer to independently determine its own prices and competitive strategies.

Second, economies of scale. For many States and lines of insurance, if individual insurers had to replicate the pooled databases, actuarial analyses, professional staff, and data processing provided by ISO, the costs would be so great that a number of insurers could decide to not enter, or not remain, in some markets. Insurers would incur higher expenses in replicating ISO materials, thereby making insurance more expensive.

Third, ease of market entry. Access to ISO's products and services enables insurers of all sizes to more easily enter product lines or geographic markets they might not otherwise consider worth the risk of the start-up costs.

Fourth, availability of a credible industry database. ISO's data compilations increase data quality for both insurers and regulators and facilitate research and development of new products and innovations to existing products.

ISO submits summaries of this information to insurance regulators, as required by law, to help the regulator evaluate the state of the insurance market in each jurisdiction.

In conclusion, by improving insurers' knowledge of their true costs and by introducing economies of scale, ISO confers benefits to the insuring public through lower costs.

The pall that would be cast over these essential operations by the repeal or substantial modification of the already limited antitrust exemption contained in McCarran-Ferguson could be enough to severely curtail these benefits. The result would be a disservice, not only to insurers, large and small, but also to the insuring public as a whole.

That is why, when considering any possibility of amendment or repeal of the McCarran-Ferguson Act, care must be taken to ensure access to vital advisory organization products and services it preserved and protected.

Once again, thank you for the opportunity to discuss the vital role ISO plays in the property and casualty insurance industry in the U.S. today.

Chairman SPECTER. Thank you very much, Mr. Thompson.

[The prepared statement of Mr. Thompson appears as a submission for the record.]

Chairman SPECTER. We now proceed with questions by members of the panel. Our customary rule is five minutes, and we will observe that, but there are only two of us here.

Ms. Hoffmann, what was the gravamen of the matter that you referred to? What insurance companies were involved in that Marsh matter?

Ms. HOFFMANN. Marsh? I believe it was AIG, Liberty Mutual, ACE, Zurich.

Chairman SPECTER. Liberty Mutual, AIG. Who else?

Ms. HOFFMANN. I think, Zurich and ACE.

Chairman SPECTER. Will you speak up? Who was the last one you mentioned?

Ms. HOFFMANN. ACE.

Chairman SPECTER. You say you believe. Are you sure about that, as to what companies were involved? I really do not like to identify companies unless you know they were involved.

Ms. HOFFMANN. I am basing that on the document that I read that I have attached to my written testimony.

Chairman SPECTER. Well, did you prepare your written testimony?

Ms. HOFFMANN. Yes, I did.

Chairman SPECTER. What was involved? You did not give us very much detail. You said there was a pay-off here involving Marsh. You said that there were hundreds of millions of dollars involved in restitution.

You did not mention any criminal charges in your written testimony. In the written testimony of Mr. McRaith, there is a reference to criminal prosecutions and guilty pleas. What was the case all about? Let us hear.

Ms. HOFFMANN. The Marsh case involved the existence of contingent commissions. These are commissions that were paid by insurers to Marsh based on volume or profitability of business that Marsh brought to insurers.

Chairman SPECTER. Were there criminal prosecutions brought by the State Attorney General's Office?

Ms. HOFFMANN. Yes, there were.

Chairman SPECTER. And against whom were those prosecutions brought?

Ms. HOFFMANN. Individuals. Civil cases.

Chairman SPECTER. That does not tell me very much. From what companies? What were their positions?

Ms. HOFFMANN. I do not know the exact positions of the individuals. I believe that individuals from Marsh and AIG pleaded guilty, and from Zurich.

Chairman SPECTER. The written testimony you submitted says, "Marsh moved business to the insurance companies that paid it the highest commission, and to make the scheme work, Marsh solicited fictitious or cover bids to make the incumbent insurers' rates appear competitive.

Three insurance company executives, two AIG and one from ACE, pleaded guilty to criminal charges in connection wit the scheme. Two employees from Zurich American Insurance Company also pleaded guilty to criminal charges in connection with the bid-rigging scheme."

Can you tell us a little more, by way of amplification, as to exactly what conduct was involved there?

Ms. HOFFMANN. I do not recall the specific conduct attributed to those individuals.

Chairman SPECTER. Well, could you provide that information to the committee, please?

Ms. HOFFMANN. I will.

Chairman SPECTER. Mr. McRaith, in your written statement you refer to a task force of some 15 States. The NAIC appointed a 15–State task force to develop a three-pronged national plan to coordinate multi-state action on broker commission issues.

You refer in your testimony to common law fraud, which resulted in a number of guilty pleas on criminal charges of fraud related to bid rigging. At least 17 guilty pleas and 8 indictments have been entered based on related charges.

Were any criminal charges brought by Illinois State officials?

Mr. MCRAITH. No, Mr. Chairman.

Chairman SPECTER. Why not?

Mr. MCRAITH. The criminal charges were brought by New York officials.

Chairman SPECTER. Did Marsh function in Illinois?

Mr. MCRAITH. Marsh certainly did have clients in Illinois. Yes, Mr. Chairman.

Chairman SPECTER. Did you investigate to make a determination as to whether there were criminal violations by Marsh in Illinois?

Mr. MCRAITH. Mr. Chairman, the Division of Insurance, in conjunction with the Illinois Attorney General, did review conduct by Marsh in relation to policyholders in Illinois. The criminal charges—

Chairman SPECTER. My red light is on. But with your permission, Senator Leahy, why do we not make this 10-minute rounds? Since there are only the two of us present, we will not keep anybody waiting.

Come back to the question about why Illinois did not bring criminal charges.

Mr. MCRAITH. The criminal conduct that we know of, Mr. Chairman, occurred primarily or was based in New York.

Chairman SPECTER. Primarily. But how about other than primarily? Was there any in Illinois?

Mr. MCRAITH. The impact was certainly felt in Illinois by policyholders in Illinois, Mr. Chairman.

Chairman SPECTER. Well, that gives you jurisdiction. Senator Leahy, did you not used to be a prosecutor? That gives you jurisdiction in Illinois.

Senator LEAHY. I said it was the best job I ever had.

[Laughter].

Chairman SPECTER. You mean, the only job you ever had.

[Laughter].

Well, that gives you jurisdiction. Senator Leahy and I know a little something about that.

Did you pursue it to see if there were cases of criminal conduct which impacted on Illinois citizens?

Mr. MCRAITH. I should be clear, Mr. Chairman. As the Director of Insurance, as the regulator, I do not have independent authority to prosecute criminal charges.

Chairman SPECTER. You know some of the prosecutors in Illinois, do you not?

Mr. MCRAITH. I certainly do. Yes.

Chairman SPECTER. Did you refer the matter to them?

Mr. MCRAITH. We did work with the Attorney General of Illinois, who also worked with the Attorney General of New York, to ensure that the policyholders received the restitution.

In terms of the discussion about criminal charges, we certainly were aware of the underlying conduct. I did not engage in any discussions with our Attorney General about criminal charges.

Chairman SPECTER. Well, restitution is fine, Mr. McRaith. That brings the defrauded people back to zero, or at least some of them. Customarily, not all of them, because you cannot reach all the people affected in a civil suit.

But you do not have any teeth in restitution. All you have to do is pay back the money which you should not have taken. But the teeth in governmental action comes with criminal prosecution and jail sentences, especially with white-collar crime.

Would you not have liked to have had the assistance of the U.S. Attorney? You have a pretty active U.S. Attorney in Illinois, do you not?

Mr. MCRAITH. We absolutely do, Mr. Chairman. Yes.

Chairman SPECTER. Well, would you not like to have his assistance to ferret out wrongdoing and incarcerate wrongdoers?

Mr. MCRAITH. As the insurance regulator in the State of Illinois, we had two priorities. One, is let us make sure that the consumers who have been harmed by this conduct receive the restitution that they are entitled to. Secondly, let us take any action that we need to take to ensure that this conduct does not occur again.

Chairman SPECTER. Well, would number two not squarely go to the issue of criminal prosecutions as a deterrent?

Mr. MCRAITH. From our perspective as the insurance regulator, we look at the licensing side. Are these agents licensed in Illinois who are conducting themselves in this way?

Chairman SPECTER. Well, that is all well and good. But you also have a duty to make references, referrals.

Mr. MCRAITH. Yes, sir.

Chairman SPECTER. If you do not have that duty, why would you want to keep the U.S. Government out of it on antitrust violations and keep an activist like your U.S. Attorney in Chicago out of it?

Mr. MCRAITH. Mr. Chairman, again, our Attorney General worked very closely with Attorney General Spitzer on a number of these investigations, and it was our Attorney General who would make the decision whether to prosecute criminal charges against them.

Chairman SPECTER. Well, that is all right for him. But you are taking a public policy position here today before this committee that you do not think there ought to be Federal antitrust jurisdiction.

Mr. MCRAITH. That is correct.

Chairman SPECTER. And in the context where you talk about criminal conduct which is not being prosecuted in Illinois, the big question that arises in my mind is, why would you want to keep the Feds out of it? The Feds have a pretty good record in Illinois. Was there not a guy named Capone from Illinois?

[Laughter].

Mr. MCRAITH. That is correct, Mr. Chairman. If there were criminal conduct, Mr. Chairman, that we discovered or identified that occurred in Illinois, we would refer that to our Attorney General without hesitation.

Chairman SPECTER. And did you refer it to the Attorney General?

Mr. MCRAITH. We did not identify criminal conduct by individuals based in Illinois.

Chairman SPECTER. But you have identified criminal conduct which impacted—I would like you to submit a supplement to your written testimony, if you would.

Mr. MCRAITH. Yes.

Chairman SPECTER. Governor Racicot, you say in your written testimony, "There is no lack of State antitrust authority with regard to insurers."

Do you not think it would be helpful if you had the long arm of the Federal Government to help out, when you have an impact in Illinois and no action taken in Illinois to deal with criminal conduct which impacts on their citizens?

Mr. RACICOT. Well, Senator, with all due respect, without commenting upon pending litigation, frankly, I do not know the facts about the pending litigation intimately.

Chairman SPECTER. I am not asking you about pending litigation. I am asking you about testimony which Mr. McRaith has given that there has been an impact on consumers in Illinois and there has been no criminal prosecution.

Mr. RACICOT. Well, that is a matter of record.

Chairman SPECTER. Wait a minute. Wait a minute. I am not finished with my question. They stop at restitution. You are making the statement here, "There is no lack of State antitrust authority with regard to insurers."

Do you stand by that? What factual material can you give this committee to demonstrate that there is active State antitrust action with respect to insurers?

Mr. RACICOT. I think there have been, already, attachments to the various different testimonies submitted, if I am not mistaken, from Mr. McRaith that lists the individual States and all of their various unfair trade practices legislation and statutory framework that allows for antitrust enforcement.

So, virtually every State in the United States of America has the capacity, on the basis of State law that enacted, copied, or mimicked in some fashion either Sherman, Clayton, or other unfair trade practices or laws, the ability to go forward with State antitrust actions. That is how New York went forward, apparently quite effectively in the minds of the committee, to carry on this particular prosecution.

If I might also make note of the fact, as I know the Senator knows because you were a prosecutor, as well as was I, that typically one singular case is utilized in one jurisdiction as a vehicle to make certain that you address all of the circumstances, then work restitution in other concomitant jurisdictions all across the country.

So if there is a violation, a multi-state violation that occurs, prosecution typically takes place in one venue, then the remedial part of that action is taken all across the country as it applies to individual citizens.

Chairman SPECTER. Well, Governor Racicot, I do not know that at all. When I was a prosecutor and I found an impact on the people in my jurisdiction, I brought criminal prosecutions.

But you say there has been effective action. You are the president of the American Insurance Association. Would you undertake to provide to this committee what criminal prosecutions have been brought in the 50 States?

Mr. RACICOT. I believe, Mr. Chairman, we will make every effort to do that, as exhaustively as possible, if that is what the committee desires. I would point out, as Mr. McRaith also points out in his testimony, that there are some 3.7 million complaints that are lodged with various State authorities each year, is my recollection, if I am not mistaken.

Of course, tracing virtually all of those might be a fairly monumental task, but we can certainly make the best effort at it if that is what the committee would desire.

Chairman SPECTER. No. I am not asking you to trace 3.7 million complaints. I am not asking you to trace any complaints. I am asking you to provide this committee with the prosecutions that have been brought by the States against insurance companies.

You say here that there is no lack of antitrust authority with regard to insurers. Well, I would like to know what the insurers have done. You are the president of the group, you have made this assertion. I would like to see what evidence there is.

Mr. RACICOT. Senator, with all due respect, I stand by that assertion. I just mentioned the fact that there is authority in all 50 States.

There is an actual exhibit report in the written testimony that sets forth exactly what that authority is. If you would like further information and evidence of every single State prosecution against an insurance company, we will do everything in our power to make certain that we supply that information to the committee.

Chairman SPECTER. All right. That is what we would like. It is not sufficient to say they have the authority. The question is, have they exercised it? The question is, have they brought the prosecutions? That is why you have a Federal Government which can reach into States where they do not have the resources and undertake those cases.

Senator Leahy?

Senator LEAHY. Thank you, Mr. Chairman. I see you have asked some of the questions I was thinking of asking.

But Mr. Klawiter, let me start with you. I am obviously pleased to see in your written testimony that you feel my bill, S. 1525, which removes malpractice insurance from McCarran-Ferguson protection, is a good first step in the application of antitrust laws to the insurance industry.

You also mention we could refine the bill further to ensure that we do not require a more rigorous standard than necessary. In what way, sir?

Mr. KLAWITER. Senator Leahy, I think it is simply a matter of the wording. Words like "price fixing" or "market allocation," in certain circumstances, might not, in fact, be illegal. That may be hard to appreciate and understand.

But, for example, vertical pricing issues, vertical allocation issues are very common in many industries and the courts have ruled, under the rule of reason, that they are a perfectly legitimate activity as long as there is no anti-competitive effect.

I think a simple amendment along the lines of price fixing, market allocation, et cetera that contravenes the Sherman Act, or the Sherman and Clayton Acts, would certainly take care of the issue. It is more a matter of semantics than anything else.

Senator LEAHY. Using words that are not here.

Mr. KLAWITER. Yes. Exactly. It would be really focusing it directly to the statute, to the Sherman Act. Because again, if we are going to go into areas of criminal liability, as Senator Specter noted before, the Federal antitrust laws have a great deal of punch, with 10-year prison sentences and $100 million fines, and issues that are really going to get people's attention.

Senator LEAHY. Yes. And I agree with the Chairman on that. Both of us, in our experience as prosecutors, was that they have kind of a lot of money and they happily pay a fine, and that is the end of it and they go on, business as usual. If all of a sudden you think, what, I am going to wear one of those iron suits and I am going to live where? The door clanks? You get their attention a lot more.

Also, in talking about this in your testimony, you also talked about safe harbors. You want to allow for insurance companies to compare notes on past losses and things like that. I do not have a problem with that.

Would you or your Antitrust Section be able to help us on what activity would be allowed and what would be disallowed?

Mr. KLAWITER. Well, I think the five categories that I mentioned just in my oral testimony a few minutes ago would be the beginning of the four.

The fifth, is we would certainly ask you to consult with the industry as to others that they may think would fit within the category of being, again, pro-competitive, not a violation of the antitrust laws, but again, just giving the industry the flexibility to deal with these kinds of issues, things like the risk assessment information, the joint venture activity on a very large underwriting where one company itself cannot handle it, but maybe a group or a pool can; those things, again, within the context of very strict functioning of the Federal antitrust laws would be permissible conduct. It would be like a joint venture that is otherwise cleared, and that would be good.

Senator LEAHY. We have a lot of experience, do we not, in antitrust law where major industries do cooperate. I can think of certain safety standards in the automobile industry, safety standards in others. I think most would agree, in those areas consumers would benefit.

Mr. KLAWITER. Yes. Exactly, Senator. That is true.

Senator LEAHY. So probably going back to another way of asking, what kind of behavior among insurers or between insurers and rate service organizations is most harmful to competition, and thus, consumers?

Mr. KLAWITER. If the insurance companies, the insurers, were actually getting together to set a price, certainly without any form of regulation or in contravention of a regulatory scheme—and I say that in the context that you have 50 States that regulate insurance; some do it better than others, some are much more involved, some are actively supervising, others are not.

So, there are opportunities for companies to get together and fix prices, in the sense that we would consider them to be fixed, and to tie products together: in order to buy this insurance you also have to buy this one. That, under a normal antitrust theory, would be a problem.

Those are the kinds of issues I think that the repeal of McCarran-Ferguson would get us to, and would allow for the Federal jurisdiction there that would affect this industry in very much the same way it affects all other industries.

Senator LEAHY. As we talk about Federal jurisdiction, following what Mr. McRaith was saying in his answers to Senator Specter, you said in your written testimony, as I understand it, that "the current system of State regulations work well to create a competitive marketplace. State regulators adequately supervise State insurance activities." Now, of course you have different sized States. Illinois is a different size than Vermont, Montana or Wyoming.

Ms. Hoffmann had testified about how her office uncovered widespread anti-competitive behavior in New York among some of the country's largest insurance companies, and she had a very aggressive team of investigators, auditors, accountants, and everybody else going into that.

But you also said—and this goes back to some of the questions you were being asked—had her office prosecuted that case in Federal court, companies might have had a defense under the McCarran-Ferguson Act which might mitigate against having an aggressive U.S. Attorney like they have in Illinois, or others, going in there.

Mr. McRaith, should you not have the power to use all available laws, all forms to root out behavior that is so harmful, whether it is the forum of your own State courts or Federal courts?

Mr. MCRAITH. Senator Leahy, we have the authority at this time to prohibit and to ultimately punish any of the conduct—the misconduct—just described by Mr. Klawiter. If there is that conduct that is found, in the State of Illinois or any State, it is prohibited, tying, boycotting, price fixing. I would like to add that in terms of penalties, the question is, how severe can the remedy be? Is the remedy more severe in Federal court under antitrust law? I think the New York Attorney General resolutions with AIG were over $1.5 billion. The resolution with Marsh McClennon was $850 million.

In Illinois, we have resolutions with other large brokers. We entered, as a group of regulators, working with 10 different Attorneys General, into an agreement with one company where that company is going to pay $160 million.

Senator LEAHY. But as Ms. Hoffmann pointed out, there are actions they could not have taken in Federal court because they would have been blocked by McCarran-Ferguson. Do you agree with that?

Mr. MCRAITH. I am far from able to question Ms. Hoffmann's legal analysis. As a practical matter, I would say that the penalties that have been imposed when this conduct has been found are severe, and as severe as they might have been under Federal antitrust laws.

Senator LEAHY. Thank you.

And Mr. Hunter, you have had a lot of experience with insurance issues. You were a Federal insurance commissioner, a Texas insurance commissioner, and now you are Director of Insurance for the Consumer Federation.

In your testimony, you estimate that if the McCarran-Ferguson Act is repealed, consumers would save approximately 10 percent on insurance costs each year. How do you arrive at that, and could it be more than that?

Mr. HUNTER. Yes. Well, it could be. That is at least. I do some calculations at the back. I also have other studies of the effects of imposing the California antitrust laws in the State of California when they were first imposed and a tougher regulatory regime imposed.

In 1988, California had the third-highest auto insurance rates. Now it has about average auto insurance rates, about a 20 percent savings if it had stayed at third place. So you have that, plus the calculations I made at the back of the report, and some other calculations.

I would like to comment on one thing. There were huge life insurance market conduct violations with billions of dollars paid by MET Life, Prudential and others a few years ago. I do not think there were any criminal charges brought in any of that.

I really do think that that Chairman Specter's idea of calling for what has happened in terms of actual numbers of criminal charges is very important information, and I hope the NAIC would help with that as well.

Senator LEAHY. Thank you. My time is up. I may have other questions. I want to go back and review some of this testimony, Mr. Chairman. I may have some other questions to submit for the record, if that is all right.

Chairman SPECTER. Mr. Hunter, you have written in your testimony that California's Proposition 103, eliminating the State antitrust exemption in California and imposing more active State regulation, has proved to be successful in lowering prices for consumers and stimulating competition.

Mr. HUNTER. Yes.

Chairman SPECTER. Could you amplify about that?

Mr. HUNTER. Sure. Yes. In 1988, the people of California enacted Proposition 103, which imposed the State antitrust laws on the insurance industry and also created a regulatory regime which is the toughest in the Nation. A lot of people would try to argue, there is a balance between regulation and competition.

Chairman SPECTER. Well, that is what they did.

Mr. HUNTER. They did not balance it. They said, look, why not get the best benefits of both? Why not have competition and then use regulation as a back-stop just because they both seek the same goal, that is, the lowest possible rates consistent with a fair return.

Chairman SPECTER. Mr. Hunter, come to the point from your written testimony where you said that it was "a successful formula in lowering prices for consumers and stimulating competition."

Mr. HUNTER. Yes.

Chairman SPECTER. Come to that point.

Mr. HUNTER. All right. Well, as I said earlier, when the proposition passed California had the third highest auto insurance rates in the Nation, and today they are the twentieth highest, with about an average national rate. It is about a 20 percent lowering relative to the national average. That is a very significant savings for consumers, in the tens of billions of dollars.

Chairman SPECTER. Governor Racicot, in your testimony you say, "when this committee last held McCarran hearings in 1989, the issue was the cost of commercial liability insurance." Was that the last time this committee looked at McCarran-Ferguson, was 1989, as your testimony says?

Mr. RACICOT. I believe, if I am not mistaken. I could be, Mr. Chairman. But my belief is that it was as late as 1994. If that is a reflection that it was 1989, I assumed that that was referring to the House proceedings. There certainly were considerations by Congress up through 1994.

Chairman SPECTER. The House took a look at it in 1994, but the last time the Senate Judiciary Committee took a look at it was 1989. Your assistants behind you are nodding in the affirmative, if the record may show that.

Mr. RACICOT. That is my understanding, yes. I had it in reverse.

Chairman SPECTER. The testimony submitted by Ms. Hoffmann says that "this is not just a New York State problem, it is a pervasive national problem."

Would you agree with that, Mr. Thompson?

Mr. THOMPSON. I am sorry, Mr. Chairman. You are talking about the problem that New York uncovered?

Chairman SPECTER. Well, the issue raised here about Marsh, the fraud and the criminal prosecutions, the assertions made by Ms. Hoffmann that "this is not just a New York State problem, it is a pervasive national problem."

My question to you is, do you agree with that?

Mr. THOMPSON. Well, I have not been involved in anything that has been going on with the New York prosecution, other than what was in the general press or trade press.

Chairman SPECTER. Well, your resume says, as a senior vice president for Insurance Services Office, "you are responsible for all filing activities by regulators in the various States." Are you saying you just do not have enough information to agree or disagree with Ms. Hoffmann's statement?

Mr. THOMPSON. In that particular case, yes, sir.

Chairman SPECTER. Mr. Klawiter, do you think that is an accurate statement?

Mr. KLAWITER. The pleadings in the case, I think, show more pervasive conduct that New York looked at, and other States looked at as well. I think you have got to kind of focus attention on what comes out of that record. I think if that record demonstrates that the impact was in various States, that would certainly be considered pervasive.

Chairman SPECTER. The American Bar Association, as you have testified, has taken the position—you are head of that section—that McCarran-Ferguson ought to be eliminated. Do you think there ought to be Federal antitrust enforcement in the insurance industry, like all other commerce?

Mr. KLAWITER. Absolutely.

Chairman SPECTER. What is the basis for your statement? What factual underpinning can you provide as to the inadequacy of State action and the necessity for Federal antitrust enforcement?

Mr. KLAWITER. Well, I think, number one, our position is very clearly predicated on the fact that regulation is not as good as free and open competition. If you have a regulatory scheme, it is going to be looked at differently by each of the States.

Chairman SPECTER. Can you point with any specificity, or could you supplement your testimony, to any antitrust violations that have gone unprosecuted and not pursued by the States, contrasted with the kind of vigorous antitrust enforcement that comes out of the Department of Justice, where you serve?

Mr. KLAWITER. I am not sure, Senator, that we could actually identify those. I think we could look to what the States have done, and note that some of those could well have been the subject of Federal investigation and Federal prosecution if, indeed, McCarran-Ferguson were not the law.

Chairman SPECTER. All right. If you had State action where it was insufficient, the committee would be interested in that. I mean, you say we ought to have Federal antitrust action. The committee is considering the issue. If we are to act, we need to act on hard evidence. If you have State action which was insufficient, that would be probative on the issue of bringing in the Federal Government.

If you have the failure of States to act where there were antitrust charges that ought to have been brought, that would be probative for Federal action and the repeal of McCarran-Ferguson. If you could supplement your testimony in those two areas, the committee would be appreciative.

Mr. KLAWITER. We will do that, Senator.

Chairman SPECTER. All right.

Ms. Hoffmann, you testified that there were pending investigations. Did you mention Liberty Mutual? I believe you did.

Ms. HOFFMANN. Yes. We have brought a lawsuit against Liberty Mutual, and it is pending.

Chairman SPECTER. And what is the gravamen of the lawsuit?

Ms. HOFFMANN. The gravamen of the lawsuit, I believe, is fraud, and we mentioned bid-rigging.

Chairman SPECTER. Fraud and what?

Ms. HOFFMANN. Bid-rigging.

Chairman SPECTER. Bid-rigging. With Marsh?

Ms. HOFFMANN. Yes.

Chairman SPECTER. And what court are you in?

Ms. HOFFMANN. We are in New York State court.

Chairman SPECTER. Why was the determination made to utilize a civil suit as opposed to the criminal prosecutions which you have identified in your testimony?

Ms. HOFFMANN. We brought criminal prosecutions against individuals. I do not believe we have brought any criminal prosecutions against the companies.

Chairman SPECTER. Have you brought criminal prosecutions against individuals at Liberty Mutual?

Ms. HOFFMANN. I would have to check that. I do not recall.

Chairman SPECTER. What determination do you use to decide when to prosecute the company, in addition to the individuals? You customarily cannot prosecute a company unless you have evidence against individuals. The individuals act for the company. But what are the standards that you use for deciding to prosecute individuals and not the company?

Ms. HOFFMANN. Do you mean criminally prosecute individuals?

Chairman SPECTER. That is what I am talking about.

Ms. HOFFMANN. I believe that some of the standards used were the cooperation of the company, the willingness of the company to recognize the misconduct, and to determine and make sure that such conduct does not occur in the future.

Also, the recognition that criminally prosecuting a company can sometimes cause far more harm to innocent individuals—customers, employees and a segment of the industry—than would be warranted or wise.

Chairman SPECTER. Well, thank you all for coming in. We would be interested, as I have said, in a supplement by your organization, Governor Racicot, as to the specifics as to where the States are acting; conversely, Mr. Klawiter, as to where you think the Federal Government should be in the picture.

We would be interested in a supplement, as I have indicated, Ms. Hoffmann, as to what the New York cases are all about. You are in the prosecutor's office and you are in the best position to give us a summary. We would like to get the specifics as to what actions have been brought, all the matters that are of public record.

We are not inquiring into your investigations; we understand the dependency of those. But where you have broad criminal prosecutions and gotten guilty pleas or convictions, we would like to know. We would like to have an amplification of, where you have made a judgment to prosecute individuals but not companies, what the factors were which led you to that conclusion.

Mr. McRaith, we would like the details as to what was done in Illinois, what action your agency took to inform or bring in the State Attorney General, and what the State Attorney General did, and what your reasoning was in not wanting, say, the U.S. Attorney from Chicago to come into the picture.

Mr. Hunter, to the extent you could give us any more information on California, we would appreciate it, as to what the success was there.

Thank you all very much. That concludes the hearing.

[Whereupon, at 10:54 a.m. the hearing was adjourned.]

[Questions and answers and submissions for the record follow.]

[Additional material is being retained in the Committee files.]

QUESTIONS AND ANSWERS

Supplemental Submission to the Judiciary Committee On Behalf of the Office of the Attorney General of the State of New York
July 20, 2006

At the Judiciary Committee hearing on June 20, 2006 entitled "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption," the Chairman requested that I submit additional information describing the cases brought against entities in the insurance sector by our Office, and amplifying our reasons for bringing criminal prosecutions against individuals, but not companies. Under cover of a letter dated June 29, 2006, Chairman Specter requested a written response to a specific question relating to guilty pleas by certain employees of ACE, AIG and Zurich American Insurance Company.

On behalf of the Office of the Attorney General of the State of New York, I appreciate the opportunity to make this supplemental submission responding to the Chairman's written question, and addressing other issues that arose during the hearing.

1. **Response to Written Question**

Question:

"'Your written testimony says that "Three insurance company executives, two AIG and one from ACE, pleaded guilty to criminal charges in connection with the [Marsh] scheme. Two employees from Zurich American Insurance Company also pleaded guilty to criminal charges in connection with the bid-rigging scheme.'

Please describe the conduct alleged with respect to each of the individuals referenced above, the charges brought against them, and the charge to which they pleaded guilty."

Response:

As a point of clarification, the quotation used by the Chairman is from the comments that we submitted to the Antitrust Modernization Commission, dated July 15, 2005, in connection with the AMC's consideration of the McCarran-Ferguson Act. My written testimony submitted to the Judiciary Committee on June 20, 2006 reflects more recent developments in our insurance investigation. As of the date of this supplemental submission, 21 employees of insurance brokers and insurance companies have pleaded guilty to criminal charges brought by the Attorney General of the State of New York, including the five mentioned in the Chairman's question. Several additional cases are pending, and our investigation is ongoing.

Although the customers injured by the conduct may have been different, the pattern of wrongdoing was similar. The five insurance company employees referenced above, for example, worked with brokers from Marsh & McClennan (Marsh) to place business. Each was instructed by Marsh, and sometimes others at his or her place of employment, to submit protective quotes on business where Marsh had predetermined which carrier should win the bid. Each submitted one or more protective quotes. These quotes often were called "B quotes," "alternative leads" or "backup quotes." Brokers at

Marsh sometimes provided the favored insurer's bid, a specific target, or a range in which to bid so that the "B quote," or relevant terms, would be non-competitive with the bid of Marsh's favored carrier.

There was also evidence that on several occasions, when a carrier submitted a "B quote" on the lead layer of insurance, Marsh allowed that carrier either to renew its place on the excess layer, or to gain new business.

The Criminal Proceedings chart, appended here as Exhibit A, summarizes the criminal charges brought by our office and the guilty pleas submitted to date as a result of our investigation into the insurance industry.

2. Other questions raised during the hearing

a. The Chairman requested a more detailed explanation of why our office decided not to bring criminal charges against firms, although we did bring criminal charges against a number of individuals employed by those firms. Some of the important factors that we considered were the willingness of the firms to cooperate with our investigation, their commitment to instituting rigorous controls to prevent unlawful conduct in the future, and the likelihood that criminal prosecution of the firms could injure innocent persons such as customers, employees and shareholders.

The civil settlements included the following key elements:

- A detailed description of the misconduct in question.
- Payments of significant restitution, to be returned to consumers, and/or fines.
- Issuance of public apologies (all except Willis and ULR).
- Commitments to change corporate policy and to implement controls to prevent fraud and other unlawful conduct.

In addition, several of the firms made significant changes in management.

b. The Chairman requested additional details regarding the civil and criminal litigation brought against firms and individuals as a result of our investigation into the insurance industry.

Civil Actions: The companies in the property/casualty sector with which our office has reached civil settlements to date are Marsh, AIG, ACE, Aon, Willis and Zurich. Our office also reached a settlement with Universal Life Resources, a consulting firm specializing in life, accident and disability insurance. We have filed suit against Liberty Mutual, and that lawsuit is pending in New York State Supreme Court. To date, no other firms have been the subject of a lawsuit brought by the New York State Attorney General as a result of our investigation into the insurance industry. Our investigation is ongoing.

Criminal Actions: To date, 21 individuals have pled guilty to antitrust and fraud-related charges, including present and former employees of Marsh, AIG, ACE, Liberty and Zurich. Several matters are pending, and investigations are ongoing.

In further response to the Chairman's inquiry, attached as Exhibits A and B are detailed charts summarizing each criminal and civil action brought by the Office of the New York State Attorney General as a result of its investigation of the insurance industry, including the name of the defendant, the causes of action, the date of filing, the court, and the resolution. Links to the full text of complaints and exhibits, settlements and press releases, where available, are also provided.

3. Additional issues raised during the testimony on June 20, 2006

a. We support the repeal of the McCarran-Ferguson exemption to the federal antitrust laws because full application of the federal antitrust laws to the insurance industry will benefit competition, and because the exemption is not necessary to accomplish legitimate goals of the insurance industry, as more fully explained in my written testimony dated June 20, 2006. Our support for repeal of McCarran does not result from weak state antitrust enforcement—to the contrary, state enforcement is strong and effective. But there should be dual enforcement, under state and federal law, by state and federal enforcement agencies and private litigants, in the insurance industry as there is in most other sectors of the economy. Repeal of the McCarran exemption will strengthen enforcement because it will enable public and private litigants to investigate and prosecute unlawful conduct under federal law with a predictable set of possible claims, outcomes and penalties. The ability to proceed under federal law in a federal forum will reduce the burdens of inefficient litigation on plaintiffs and defendants alike. It will enable public and private litigants to take advantage of the often broader subpoena powers available in a federal forum.

b. As I explained in the June 20th written testimony, repeal of the McCarran-Ferguson exemption from federal antitrust law would not require pre-emption of state law. Concurrent enforcement, and concurrent regulation, exists in a number of contexts, for example, with respect to securities and environmental law. All industries are subject to both state and federal antitrust law and enforcement unless, like the business of insurance, they are exempted by statute or judicial decision. Because the McCarran exemption, as written and construed, protects anticompetitive conduct, and because the legitimate concerns of the insurance industry can be addressed in a manner consistent with antitrust law and policy, we support the repeal of the exemption.

We would be pleased to answer any additional questions that the Committee may have.

Questions from Senator Specter

The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption
June 20, 2006

For Hunter (CFA):

You testified that California's reforms drastically reduced the cost of insurance for consumers over time. Please describe the regulatory and antitrust reforms implemented after the adoption of Proposition 103 and discuss how the various reforms have influenced prices.

Response:

Proposition 103 dramatically altered California's regulatory system from one with virtually no regulation that allowed rating bureaus to exercise cartel-like rate setting authority to a system with significant state antitrust restrictions and a tough regulatory regime that reinforces competition. For example, insurers must seek prior approval of insurance rates and forms from the Insurance Commissioner. As a result, California insurance prices have risen at a significantly lower rate than the national averages since Proposition 103 became law.

Proposition 103 incorporated all of the changes needed to spur meaningful, vigorous competition. For example, it imposed significant antitrust restrictions on the state insurance industry. It also allowed banks to sell insurance and permitted group sales well before other states did. Proposition 103 also spurred greater agent competition by allowing agents to offer rate rebates.

Further, unlike the weak enforcement efforts in most states that require prior rate approval, Proposition 103 requires and adequately funds full regulatory oversight. This assures that consumers are protected and that competition is effective. California regulations are exemplary – by far the most effective state insurance regulations. They are completely transparent, allowing insurers, agents, brokers and consumers to understand what is expected. These regulations disallow excessive costs, such as excessive expenses, fines, bad-faith lawsuit costs, and excessive executive salary costs. They test insurer assumptions with state standards. The required data elements assist insurers in obtaining information on competitors, which improves their ability to compete.

The strong incentives for driver safety built into Proposition 103 play a significant role in reducing the cost of insurance. Consumers with a clean driving record receive a 20 percent discount. They also have the right to buy insurance from the company of their choice through Proposition 103's "Good Driver Protections."

Proposition 103 was a shot across the bow of the insurance industry. Prior to 103, the industry saw itself as a "pass-through" operation, adding up anticipated losses and expenses, no matter how inefficient, and including desired profits on top of these costs. So long as they kept costs near their generous loss projections, they had what amounted to a "cost-plus" system. In California, that "cost-plus" approach was rejected under Proposition 103 and costs were tested by efficiency standards and other methods.

As CFA's in-depth study of regulation by the states revealed,[1] (attached) California's regulatory transformation -- to rely on both maximum regulation and competition -- has produced remarkable results for auto insurance consumers and for the insurance companies doing business there. The study reported that insurers realized very nice profits, above the national average. At the same time, consumers saw the average price for auto insurance drop from $747.97 in 1989, the year Proposition 103 was implemented, to $717.98 in 1998. Meanwhile, the average premium rose nationally from $551.95 in 1989 to $704.32 in 1998.

California's rank dropped from the third costliest state to the 20th and it has continued to maintain this position. According to the NAIC, the average annual premium in California in 2003 was $821.11 (20th in the nation) versus $820.91 for the nation. From the time California went from reliance solely on limited competition, as insurers envisioned, to full competition and regulation, the average auto rate insurance rose by 9.8 percent. Over the same time span, the national average rose by 48.7 percent. In 1989, California consumers were paying 36 percent more that the national average. By 2003, they paid premiums that were virtually the national average.

[1] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," June 6, 2000; (www.consumerfed.org.) Copy attached.

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July 27, 2006

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Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
224 Dirksen Senate Office Building
Washington, DC 20510-6275

Attn: Barr Huefner

Re: The McCarran-Ferguson Act Additional Comments

Dear Chairman Specter:

Thank you for the opportunity to provide testimony on behalf of the American Bar Association on the Committee's review of the McCarran-Ferguson Act on June 20, 2006. I am responding to the additional questions from you and Ranking Member Leahy, and I appreciate the additional time you allowed me to respond.

> *Question of Senator Arlen Specter: Please provide the Committee, to the best of your ability, with examples of cases in which states took no action to prosecute conduct by insurance companies that would have constituted a violation of the federal antitrust laws, or where their actions were limited because antitrust law could not be applied.*

After considerable review of our resources, we cannot point to specific cases that were not brought by the states that would constitute a violation of the federal antitrust laws. That would require a major survey, and, even with considerable research, would be very difficult to establish. We can, however, establish that many of the states would not pursue antitrust actions against the insurance industry for the same reason that the federal government did not pursue them – because many states also have exemptions to the antitrust laws similar or identical to McCarran-Ferguson. Several states, notably Florida and Massachusetts, incorporate all federal exemptions to the antitrust laws into their state antitrust laws. Other states, notably Illinois and New Jersey, expressly provide that their state antitrust laws are to be interpreted consistent with federal law. At least fifteen other states have express state antitrust law exemptions for the insurance industry written into their laws. A large number of states, therefore, would not bring state antitrust actions against insurance companies because they would face the same difficulty in prosecuting their cases as the federal government faces today – the anticompetitive conduct of the industry is exempt. If McCarran-Ferguson were repealed, the states that provide the same exemptions as the federal government or follow federal precedent would be able to pursue antitrust actions against insurance companies under their state law. The states with express exemptions would still maintain their exemptions unless they expressly repealed them (and there may be support for such repeal arising out of the Congressional repeal of McCarran-Ferguson).

The other issue that is relevant to this point is that the range of penalties and remedies under the federal antitrust laws is clearly broader and more potent than any state law penalty or remedy could be. While the record of prosecutions and recoveries that New York State has achieved in its recent cases, as outlined in Ms. Hoffmann's testimony to the Committee, is impressive, the antitrust claims are brought under the Donnelly Act, not the Sherman Act, and are thus limited. New York's action against Aon Corporation included settlements with Illinois, and Connecticut, but not a settlement broadly covering the United States, as would be possible under the Sherman Act. If actions for bid rigging and rate fixing were prosecuted criminally under the federal antitrust laws, the corporate maximum fine is $100 million and the maximum individual sentence is ten years in prison. These are penalties that would be substantially higher than any state antitrust penalties. Similarly, federal private damage actions under Section 4 of the Clayton Act would permit treble damage recoveries for alleged conspiracies on a national basis. The deterrent impact of federal enforcement would be substantially enhanced if the exemption were repealed.

Questions of Senator Patrick Leahy:

1. The ABA recommends repeal of the McCarran-Ferguson insurers' exemption, but also the continued regulation of insurers by the States. If Federal antitrust laws were to apply to the business of insurance, how would current State antitrust laws and any applicable State exemptions be affected?

2. Would Federal antitrust law preempt all inconsistent State antitrust law?

3. Could a Federal body of antitrust law applicable to the business of insurance coexist with 50 separate bodies of State law?

4. Do you foresee tension between Federal enforcers acting under Federal antitrust laws, and State regulators and attorneys general whose State antitrust law might contain an exemption for insurers?

5. Do you have any recommendations as to how a State regulatory system and an applicable body of Federal antitrust law could coexist?

I believe these questions can best be answered together. If the federal antitrust laws applied to the business of insurance, the federal and state antitrust laws would operate as they operate with respect to all businesses that are not subject to an exemption. In our experience, criminal prosecutions and major cases seeking injunctive relief generally are brought at the federal level. The states may sometimes join in the federal civil actions, or bring their own actions, as appropriate. Where states have existing exemptions for the business of insurance, those states with exemptions that flow from the federal law will no longer have exemptions. Those that have express state law exemptions will either maintain those exemptions or reconsider them in light of the new federal law. If they maintain them, they will simply be precluded from bringing antitrust actions under state law against insurance entities.

Honorable Arlen Specter
July 27, 2006
Page 3

On the issue of preemption, if McCarran-Ferguson were repealed and insurers were subject to the federal antitrust laws, the federal law would not preempt all inconsistent state antitrust laws. That was made clear by the U.S. Supreme Court in *California v. ARC America*, 490 U.S. 93 (1989) with respect to state indirect purchaser statutes that are at odds with the federal law. Preemption occurs only where (1) Congress expressly preempts by statute; (2) there is a congressional manifestation of the intent to "occupy the field"; and (3) an actual conflict exists between the federal and state law. *Crosby v. National Foreign Trade Council*, 530 U.S. 363 (2000). Indeed, in the antitrust world today, the indirect purchaser statutes of many different states demonstrate that federal and state antitrust laws allowing for very different damage recoveries are able to coexist.

The "safe harbors" provisions discussed in my testimony on behalf of the ABA is an effort to allow the state regulatory process to operate in areas such as the collection and dissemination of past loss experience, standardized policy forms, joint underwriting agreements and residual market mechanisms subject to the active supervision of the state commission. All other matters are subject to the federal antitrust laws. This provides a means to address necessary regulatory activity in a manner consistent with the operation of the federal antitrust laws.

A final point is that the recent proposals for federal chartering of insurance companies have proposed that federally chartered insurers would not be subject to state regulation and would be subject to the federal antitrust laws. While taking no position on these proposed bills, federal chartering raises some additional issues for consideration in this discussion.

I hope that these responses are helpful to the Committee in its continuing consideration of the repeal of McCarran-Ferguson. The American Bar Association remains available to assist the Committee on this important issue.

With best wishes,

Yours faithfully,

Donald C. Klawiter

Chair, Section of Antitrust Law

cc. Lillian Gaskin, Senior Legislative Counsel

Illinois Department of Financial and Professional Regulation

Division of Insurance

ROD R. BLAGOJEVICH
Governor

DEAN MARTINEZ
Secretary

MICHAEL T. McRAITH
Director
Division of Insurance

July 20, 2006

The Honorable Senator Arlen Specter
Chairman
United States Senate Committee on the Judiciary
Washington, D.C. 20510-6275

Re: Response to Requests for Information (The McCarran-Ferguson Act)

Dear Chairman Specter:

As you will recall, I testified before the Senate Committee on the Judiciary on June 20, 2006, as Director of Insurance for the State of Illinois and on behalf of the National Association of Insurance Commissioners. We received your letter dated June 29, 2006, in which you requested information to substantiate or supplement my written or oral testimony. Your letter contained questions posed both by Senator Leahy and by you. Sent herewith are responses to the questions, as well as materials that further support or clarify the responses.

We worked to provide answers and supplemental materials which respond directly and completely to the questions presented. However, please do not hesitate to contact me if you have additional questions or if we can be of further assistance.

Very truly yours,

Illinois Division of Insurance

Michael T. McRaith

Cc: Barr Huefner

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Responses to Questions from the Honorable Senator Arlen Specter

Following the Senate Judiciary Committee Hearing

"The McCarran-Ferguson Act: Implications of

Repealing the Insurers' Antitrust Exemption"

June 20, 2006

Submitted by Michael T. McRaith, Director of Insurance, State of Illinois,

Appearing on Behalf of the National Association of Insurance Commissioners

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1. You testified your investigations of the Marsh scheme did not identify criminal conduct by individuals based in Illinois. Did your investigation uncover criminal conduct that impacted Illinois consumers? If so, did you encourage the Illinois Attorney General to consider bringing criminal charges against those who harmed Illinois residents, or refer the results of your investigation for his consideration?

As Director of the Division of Insurance ("Division"), I work with my professional staff so that insurers and producers operating in Illinois do so in a manner consistent with State law. This duty remains fixed and constant. The authority to bring criminal actions based on State law belongs solely to the Illinois Attorney General and other local law enforcement authorities. The Division refers to the appropriate law enforcement authority any evidence of criminal behavior.

Illinois Attorney General Lisa Madigan and her professional staff have worked closely with New York Attorney General Elliot Spitzer. To the extent that Attorney General Madigan has discovered or will discover criminal conduct either based upon or independent of any Division investigation, the Division is entirely confident that she would aggressively act in the best interests of Illinois consumers.

With respect to Marsh, Inc ("Marsh"), Illinois reviewed the conduct of Marsh and the Willis Group ("Willis") in connection with consideration of the New York agreements. State regulatory authorities did not duplicate the New York Attorney General's investigation of either company. Marsh and Willis are New York-based producers and state insurance regulators generally defer to the company's domestic regulator.

In concert with our Attorney General, the Division investigated AON, Inc. ("AON") and Arthur J. Gallagher & Co. ("Gallagher"). As to AON, the Division worked closely with the Illinois and New York Attorneys General, as well as the New York Department of Insurance. The investigating parties did not find evidence of criminal conduct either at or by AON or Gallagher.

Illinois' investigations of a number of producers and insurers have uncovered conduct that may violate Illinois insurance laws, but to date we have not identified criminal conduct.

Any antitrust violations discovered by the Division would be referred to our Attorney General.

Responses to Questions from the Honorable Senator Patrick Leahy

Following the Senate Judiciary Committee Hearing

"The McCarran-Ferguson Act: Implications of

Repealing the Insurers' Antitrust Exemption"

June 20, 2006

Submitted by Michael T. McRaith, Director of Insurance, State of Illinois,

Appearing on Behalf of the National Association of Insurance Commissioners

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1. In your testimony, you expressed your belief that under the current State-based regulatory regime for the insurance industry, State Commissioners and Attorneys General are able to adequately prevent anticompetitive behavior.

Under Illinois State antitrust law, it is unlawful, among other provisions, to:

(1) Make any contract with, or engage in any combination or conspiracy with, any other person who is, or but for a prior agreement would be, a competitor of such a person:

a. for the purpose or with the effect of fixing, controlling or maintaining the price or rate charged for any commodity sold or bought by the parties thereto, or the fee charged or paid for any service performed or received by the parties thereto;

b. fixing, controlling, maintaining, limiting or discontinuing the production, manufacture, mining, sale or supply of any commodity, or the sale or supply of any service, for the purpose or with the effect stated in paragraph a. of subsection (1);

c. allocating or dividing customers, territories, supplies, sales, or markets, functional or geographical, for any commodity or service; or

(2) By contract, combination, or conspiracy with one or more other persons unreasonably restrain trade or commerce; or

(3) Establish, maintain, use, or attempt to acquire monopoly power over any substantial part of trade or commerce of this State for the purpose of excluding competition or of controlling, fixing, or maintaining prices in such trade or commerce...

The insurers' exemption from Illinois antitrust laws reads as follows:

> **No provisions of this Act shall construe to make illegal:**
>
> **the activities (including, but not limited to, the making of or participating in joint underwriting or joint reinsurance arrangement) of any insurer, insurance agent, insurance broker, independent insurance adjuster or rating organization to the extent that such activities are subject to regulation by the Director of Insurance of this State under, or are permitted or authorized by, the Insurance Code or any other law of this State...**

Please submit a list of criminal prosecutions (regardless of the outcome) of insurance companies or brokers in the State of Illinois for the last ten (10) years, which were based on Illinois antitrust laws. For each prosecution, please specify the charges that were brought, and the specific action that was the subject of the prosecution.

As Director of the Division of Insurance ("Division"), I work with my professional staff to ensure that insurers and producers operate in a manner consistent with State law. This duty is fixed and constant. The authority to bring criminal actions based on State law belongs solely to the Illinois Attorney General and other local law enforcement authorities.

While the Division does not possess the power to file criminal charges, it does possess law enforcement powers, including the power to impose discipline upon both producers and insurers. Evidence of the Division's vigorous enforcement includes:

- The Division collects certain fines and penalties from insurers and producers as a result of regulatory actions (*e.g.*, civil forfeitures, hearings, tax penalties, producer reinstatement fees, examination findings) and deposits them into the State's General Revenue Fund ("General Revenue Collections"). From 1995 to the present, the Division's General Revenue Collections total $22,681,091. In addition, from 2004 to the present, the Division collected $334,035 as a result of the Monumental Life settlement, a multi-state market conduct examination regarding race-based premium findings. These funds have been placed in a State trust fund.

- From 2001 through 2005, the Division revoked the insurance licenses of 432 insurance producers resulting from a variety of criminal behavior.[1]

- From 2001 through 2005, the Division fined 225 producers a total of $725,450.

- From 2001 through 2005, the Division conducted 137 market conduct examinations. As a result of those 137 market conduct examinations, the Division:

    - imposed 65 civil forfeitures, amounting to $2,526,295; and

    - collected $1,544,182 in premium overcharges and $246,769 in additional claims dollars (for a combined total of $1,790,950).

- Starting in 2004, the Division investigated commission and payment generation practices at large and mid-size insurers and producers. These investigations have resulted in settlements that impose sweeping, pro-consumer business reforms and, thus far, payment of more than $362 million to consumers.

[1] Considerable time and resources would be required to determine the precise nature of the conduct involved. Both the revocations and the identity of the producers are matters of public record.

2. In your testimony you state that the regulatory regime in Illinois has maintained a "vigorous and competitive marketplace," yet you provide no examples of actual benefits to consumers. Although you state the way in which the current regime allows for smaller insurance companies to enter the marketplace, I would be interested to have specific examples of this competitive environment in Illinois, and the way in which consumers benefit specifically from the Federal antitrust exemption.

Consumers do benefit from Illinois' vigorous and competitive marketplace for insurance, and my testimony intended to provide evidence of this fact. The question posed refers to one such piece of evidence – by allowing smaller insurers to enter and compete in otherwise cost-prohibitive markets, state-based regulation of anticompetitive behavior provides consumers better insurance products. As stated in my testimony, 2002 economic census data shows there were over 5,000 insurers operating in the United States with combined revenues of $1.2 trillion; only 296 of those insurers had more than 500 employees, yet they accounted for more than 90% of total revenues. Many smaller insurers exist to serve niche markets and provide more personalized service.

My testimony emphasized three additional ways in which Illinois consumers benefit from State regulatory efforts. First, the Division's strict enforcement of solvency requirements ensures that insurers are able to provide coverage for which premium has been paid. Strict scrutiny of solvency also produces other, more long-term benefits; solvent insurers produce a stable and strong insurance market, which moderates premium fluctuations and attracts additional capital. Second, the Division's market-conduct examinations help deter violations of State law. Insurers who do not comply with State law are subject to fines, penalties, and/or corrective orders articulating the precise business practices that must be followed. Revocation of an insurer's certificate of authority is also a potential regulatory remedy for misconduct. If a company violates Illinois law and fails to correct the violations and pay all assessed penalties, the Division possesses the authority to terminate that insurer's business operation. Any and all regulatory actions may be enforced in State court through the Illinois Attorney General.

Finally, in recent years, Illinois authorities, in conjunction with the National Association of Insurance Commissioners ("NAIC") and Attorney General Spitzer, have returned more than $1 billion to policyholders as a result of investigations into price-fixing, bid-rigging and other anticompetitive practices. All Illinois consumers benefit from the deterrent effect of these ongoing investigations and the resulting settlements and business reforms.

Illinois' regulatory system produces one of the most competitive insurance markets in the United States. The high level of competition results, in part, from the State's carefully considered policy choice to, where appropriate, harness pro-consumer market forces (*e.g.*, the Division does not subject most rates to prior approval). This policy allows the Division to devote more resources towards targeted, effective means of deterring and punishing violations of the Insurance Code. Today, in Illinois:

- 1,821 insurance companies are authorized to conduct business.
- 203 authorized insurance companies write premiums for homeowners' coverage. The company with the smallest market share writes premium for less than 1% of the market. The company with the largest market share writes premium for 32.34% of the market.
- 274 authorized insurance companies write premiums for auto coverage. The company with the smallest market share writes premium for less than 1% of the market. The company with the largest market share writes premium for 5.84% of the market.

- 288 authorized insurance companies write premiums for workers' compensation coverage. The company with the smallest market share writes premium for less than 1% of the market. The company with the largest market share writes premium for 6.36% of the market.

- Even very small insurance companies can compete, often by serving otherwise underserved rural areas. 82 farm mutual companies currently operate within the State. Farm mutual company surpluses, which provide a rough, imperfect indication of the size of an insurer, range from $221,472 to $3,789,826.

- Concerns regarding the availability of auto insurance are negligible. Only .06% of Illinois consumers obtain coverage through residual market plans.

- Only a very small percentage of Illinois consumers – .52% – purchase fire and homeowners' insurance through the State's FAIR Plan, a residual market mechanism.

- Many insurance companies compete to provide health coverage: 58 insurers offer individual coverage; 50 insurers offer small group coverage; 76 insurers offer large group coverage; and 27 insurers offer HMO coverage.

- The Division tracks the competitiveness of certain Illinois insurance markets on an annual basis in what is referred to as the Cost Containment Report (Exhibit A). For additional information regarding the Illinois market, see another Division publication – The 70th Annual Report to the Governor: Summary of Annual Statements (Exhibit B).

Another measure of competitiveness in the Illinois insurance market, one with more immediate relevance for the average consumer, is the relative premium costs of insurance. Premium costs are an imperfect measure. State regulators are concerned about both excessive and inadequate premiums; the former leads to consumer overcharges and the latter risks the solvency of the carrier and the overall stability of the insurance market. Nevertheless, despite extremely diverse statewide demographics, the Illinois insurance marketplace consistently generates relatively low-cost premiums:

- The average yearly expenditure for auto insurance in Illinois is $760.98. The nationwide average is $820.91.

- The average yearly premium paid for dwelling fire and homeowner-occupied policies in Illinois is $610. The nationwide average is $760.68.

The Illinois General Assembly and Governor have demonstrated a willingness to attack a non-competitive insurance market with sweeping reforms. In 2005, the Illinois medical malpractice insurance market reflected a non-competitive insurance line. Year 2003 Annual Reports indicated that a physician-run mutual company collected nearly 67% of all premiums paid by physicians and surgeons who purchased conventional insurance. The entire industry experienced significant rate increases from 2000 to 2004. With an emphasis on health care quality and availability, the General Assembly passed in 2005, and Illinois Governor Blagojevich endorsed and signed, reform legislation that included meaningful medical malpractice insurance changes. The legislation requires absolute transparency by every insurer writing medical malpractice insurance in Illinois. Any rate filing submitted by any medical malpractice insurer is now publicly available. Illinois' General Assembly and Governor adopted this approach so that rate companies can properly set premium rates for more specialties in more counties and regions of the State. This policy of absolute transparency will foster competition and provide Illinois' doctors with more coverage options.

3. The ABA has suggested repeal of McCarran-Ferguson, but with safe harbors to permit pro-competitive activities to continue. Could you comment on the ABA's proposal, and discuss whether you think such a proposal is workable, regardless of whether you think it is necessary?

If you oppose the ABA's proposal, please explain why, including why the safe harbors envisioned would not adequately meet the unique needs of the insurance industry. Please also explain, given the safe harbors in the ABA proposal, why giving Federal enforcers the tools to investigate and prosecute anticompetitive behavior would be undesirable, if that is your view.

The NAIC agrees with the ABA's support for continued state supervision of insurance. The ABA Policy is explicit: "States should retain the authority to regulate the business of insurance." *Letter from Klawiter, Chair, ABA Section of Antitrust Law, to Antitrust Modernization Commission, Apr. 10, 2006.* The ABA's fundamental affirmation of state-based regulation of insurance markets must be emphasized before responding to the ABA's "safe-harbor" proposal.

The ABA proposal would repeal the McCarran-Ferguson antitrust exemption and, in its place, establish a limited number of safe-harbor exemptions for certain forms of cooperative conduct (*e.g.*, collection and dissemination of past loss-experience data, development of standardized policy forms). At first glance, the broad outline of the ABA's proposed reform – and a broad outline is all that exists – appears superficially to strike a straightforward balance between preserving the state-based system of insurance regulation and empowering federal prosecutors. Notably, the ABA does not offer any evidence or practical reasons to contravene the many consumer-centered benefits of the exemption.

NAIC members – regulators with actual experience protecting consumers in insurance markets – understand the potentially devastating practical implications of the proposed safe-harbor reforms. For more than sixty years, the McCarran-Ferguson Act has defined the relationship between state insurance regulation and federal antitrust law. Refined by decades of case law and regulatory experience, this mature relationship produces the American insurance market – the most competitive and sophisticated in the world. While seemingly modest, safe harbor reforms would fundamentally alter the federal-state relationship, subjecting the regulation and operation of the insurance industry to years of uncertainty and costly litigation. Clearly defined margins of misconduct would be blurred as state legislative and regulatory authority would be ceded to state and federal courts. Consumers would not benefit from such unprecedented confusion.

Repealing the McCarran-Ferguson exemption would inject confusion into the current regulatory system, ultimately diminishing the strength and breadth of state expertise. State regulators provide cradle-to-grave regulation of insurance companies. Debates about reforming insurance antitrust law cannot take place in an analytical or legislative vacuum, where specific antitrust provisions are discussed without mention of the larger context. Antitrust provisions are an important part but, nonetheless, a part, of a larger set of state laws governing every facet of insurance company behavior. The safe-harbor approach would allow federal courts or regulators to dictate policy in a dual, complex, and inter-connected regulatory arena. The real solution – the solution being pursued every day by the NAIC and its members – is to further strengthen state regulation.

Finally, the NAIC cautions against unintended but inevitable consequences. With respect to regulatory uncertainty, not all insurance companies are created equal. Large insurers have the resources and expertise to weather the storm. Smaller insurers, insurers critical to the high level of competition that exists today, can least afford these expensive battles. Ironically, though intended to generate competition, safe-harbor reforms may actually cause industry consolidation, increase the market share of the largest insurers, and squelch competition from important but less resourceful carriers.

4. In your testimony, you discuss state regulation of insurance companies that "low ball" their pricing. Given that insurers are currently able to share loss data and collectively set rates through the recommendations of rate service organizations, what guarantee would a consumer have that a "low ball" premium was not actually a fair price? What would currently prevent the biggest insurance providers in a given state to collectively set rates and create the appearance of an unreasonably low rate in a smaller competing company?

To clarify the current state of law with respect to rate setting and sharing of loss cost data, an insurance company, regardless of size, is not allowed to "collectively set rates." Any attempt by an insurance company to collectively set rates would, at the very least, constitute a violation the various states' unfair trade practices law. *See, e.g.,* 215 ILCS 5/421, *et seq.* Some states also have insurance-specific laws that explicitly prohibit anticompetitive behavior, including price-fixing (see below).

Insurers are allowed participate in the joint development of trended loss-cost data (a practice conceptually and practically distinct from the collective setting of rates), but only through heavily regulated advisory organizations. In Illinois, for example, each advisory organization must be licensed by the Director. 215 ILCS 5/123A-4. In order to qualify for a license, an advisory organization must submit detailed corporate information and rules, subject to approval by the Director, that specifically prohibit anticompetitive behavior. 215 ILCS 5/123A-6. At a minimum, the rules must: 1) permit any company to become a member or withdraw without discrimination; 2) refrain from forcing members to use its statistics, forms, or underwriting rules; and 3) "neither practice nor sanction any plan or act of boycott or intimidation resulting or tending to result in the unreasonable restraint of or monopoly in the business of insurance." 215 ILCS 5/123A-7. In addition, the Code outlaws agreements between insurers and between insurers and advisory organizations that require adherence to shared statistics, forms, or underwriting rules. 215 ILCS 5/123A-11.

Designed and regulated with antitrust concerns in mind, advisory organizations exist to foster competition in insurance markets. Consolidated collection and analysis of data help smaller insurers both engage in responsible rate setting (*i.e.*, maintain solvency) and enter into or expand within markets for which independent loss data does not otherwise exist. Consumers benefit from the resulting increase in the quality and quantity of market choices.

NAIC members' focus on law enforcement promotes fair premiums in insurance markets. Existing state consumer protection, antitrust, and unfair trade practice laws provide the necessary tools to stop anticompetitive conduct. The existence and enforcement of these laws has resulted in an insurance industry far more competitive (and far less dominated by a few large companies) than the banking and securities industries, to which the full spectrum of antitrust laws applies. The NAIC has led the effort to coordinate state investigations into anticompetitive conduct (*e.g.*, price-fixing, bid-rigging, and improper steering of customers to secure contingent commissions). Individual and multi-state investigations have already produced results: criminal convictions have been secured and so, too, have settlements with some of the nation's largest insurers, resulting so far in the return of over one billion dollars to consumers.[2]

[2] This monetary relief resulted from settlement agreements with the Attorneys General and Departments of Insurance from several and various states, including Illinois. The monetary relief by specific settlement follows: AON ($190,000,000); A.J. Gallagher & Co. ($26,962,500); Marsh ($850,000,000); Willis ($50,000,000); Zurich ($151,700,000). In addition to providing monetary relief, the settlement agreements imposed business reforms.

UNITED STATE SENATE
COMMITTEE ON THE JUDICIARY
"THE MCCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING THE INSURERS' ANTITRUST EXEMPTION"
JUNE 20, 2006

RESPONSES OF THE
AMERICAN INSURANCE ASSOCIATION TO QUESTIONS POSED BY CHAIRMAN SPECTER AND RANKING MEMBER LEAHY

Question from Chairman Specter

Please provide the Committee with a detailed list of prosecutions brought against insurance companies by the states pursuant to their antitrust authority.

We have attached a one-page document that lists criminal prosecutions brought against former employees of insurance companies during the last three years by the states pursuant to state criminal antitrust statutes. The list reflects those prosecutions that we were able to uncover through a search of public materials available online and through informal contact with the state attorneys general offices. We understand that the New York Attorney General's Office may have received a similar question with respect to their activities, and we will defer to their list of criminal antitrust prosecutions, as the fully body of that information is within their control.

Questions from Ranking Member Leahy

1. ***If the McCarran-Ferguson exemption were repealed, what insurance company or rate agency activities currently in practice would no longer be permissible under Federal antitrust laws?***

Because of the relative absence of judicial decisions on the applicability of the federal antitrust laws absent the McCarran exemption, it is impossible to determine with precision what current insurance practices no longer would be permissible under those laws. In the final analysis, the federal courts would be responsible – through litigation – for determining the legality of any such conduct based on the factual circumstances and the application of federal antitrust law to those circumstances.

During 1994, the House Judiciary Committee favorably reported a version of H.R. 9 that maintained McCarran "safe harbors" in several areas of collective insurance activity. Those areas are:

- Data Collection: Joint conduct to collect, compile, classify, or disseminate historical data, including development of procedures with respect to handling of historical data, and verification of accuracy and completeness of such data.

- Loss Development: Joint conduct to determine and disseminate loss development factors or developed losses.
- Common Policy Forms: Joint conduct to develop and disseminate standard insurance policy forms, provided there was no joint agreement to adhere to the forms, and the parties developing a form made their own decisions whether or not to use them.
- Manuals: Joint conduct to develop and disseminate manuals filed with a state that provide information, explanations and instructions relating to data, statistics, losses, policy forms, or any other matter otherwise protected by McCarran, as long as there was no agreement to adhere to the manual.
- Residual Market Pooling Arrangements: Joint conduct for participation in plans designed to make insurance available to persons who would not otherwise be able to purchase it in the voluntary market.
- Historic Voluntary Pooling Arrangements: Providing insurance pursuant to one of the insurance industry's historic pooling arrangements.
- Administration of Residual Markets: Administering a state residual market, as long as authorized and supervised by the states.
- Inspection of Commercial Buildings and Fire Protection Facilities: Joint conduct to develop and participate in programs to evaluate building codes or inspect commercial buildings and fire protection facilities for the purpose of determining likelihood of loss, pursuant to state law.
- Workers' Compensation Experience Rating Programs: Participation in joint efforts to measure employer experience with respect to work-related accidents and illness against comparable experience of other employers, and to make modifications for that employer based on the comparison.
- Trending: During the 2-year transition period following enactment, joint conduct to determine and disseminate trend factors, to the extent regulated by state law. After the transition period, general antitrust principles, including the "state action" doctrine, would govern use of collective trending. In addition, independent purchase of a trend factor by an individual insurer from "a person not engaged in providing insurance" would be presumed not to be an antitrust violation.

These safe harbors were included in H.R. 9 because of an agreement that they represented necessary collective activity by insurers that might be subject to federal antitrust litigation if McCarran's antitrust exemption were simply repealed. Today, AIA believes that merely amending McCarran is not enough. Rather, AIA believes that the question of the application of federal antitrust laws can not be divorced from reform of the overall insurance regulatory system.

For this reason, AIA does not today support adoption of antitrust safe harbors within the current state system; instead, AIA supports enactment of optional federal charter legislation that relies on the market to regulate insurance rates for federally chartered insurers. As a part of the market-based system, the pricing activities of those insurers would be subject to federal antitrust law, to the extent that those activities are not regulated under state law. AIA's position on the optional federal charter is more fully explained in response to the next question.

2. In your testimony you discussed the idea of a Federal charter, and your views that such an approach would be acceptable to insurers. Given that under Senator Sununu's bill, S. 2509, federally chartered insurance companies would be subject to Federal antitrust law, can you explain why this would be preferable to a repeal of McCarran-Ferguson with continued State regulation, but with safe harbor provisions for cooperative behavior? Is there anything other than removing governmental price controls that leads you to your conclusion that companies would be willing to take the "risk" of a federally chartered system where antitrust laws would apply?

We have concluded that a market-based optional federal charter – which preserves the current state system for those companies choosing to remain there, but re-focuses regulation for those opting for federal regulatory oversight – represents the best hope for a modernized regulatory system that will work for consumers and the industry. The current state system is dysfunctional in a number of ways, and efforts to repeal McCarran's antitrust protection in part or in whole do not address that systemic dysfunction.

First, the system emphasizes government price and product controls, which place state regulators in the inappropriate position of exercising business judgment and anticipating customer needs as to the available range of product and pricing options – functions normally left to companies operating in the marketplace. The regulatory structure is not designed to respond to the wide range and evolution of consumer needs; indeed, it is hostile to innovation. As a result, the system discourages price competition, product innovation, and availability of coverage. Instead, the system promotes inflexibility, which reduces options for consumers and frustrates insurers' ability to respond quickly to customers.

Regulators have tended to use their rate review authority to artificially suppress insurance rates below that which is commensurate with the risk and would be established in a free market. Insurers need risk-based pricing in order to provide as much capacity as possible to satisfy consumer demand, and government price controls thus frustrate the efficient use of underwriting capacity. As a general matter, the result of rate regulation (government price controls) is that the number of insurers competing for business is smaller than it otherwise would be, and the size of the so-called "residual markets" (i.e., the markets of last resort for consumers unable to purchase insurance in the voluntary market) is larger that it otherwise would be or needs to be.

Second, the state regulatory system does not promote regulatory uniformity. Instead, it breeds regulatory inconsistency, imposes unnecessary and duplicative regulatory compliance costs, and raises barriers to innovation. Insurers trying to get a national product to market must navigate 51 separate regulatory structures. This process is marked by regulatory red tape and substantial delay, particularly for new or innovative products that depart in any significant way from previously reviewed and approved policy forms.

In contrast, under an optional federal charter, national insurers would be subject to singular and uniform regulation that stresses the core regulatory functions of market conduct oversight and financial solvency protection, and eliminates or substantially scales back those functions that are best regulated by consumers in the marketplace, and that have led to near-universal calls for modernization. In this system, state insurance regulation would also be largely preempted for national insurers, but several critical elements of the current state system would be preserved, including state premium taxes, the state guaranty fund system, and certain local prerogatives with respect to workers' compensation and motor vehicle insurance coverage requirements. Finally, to the extent that regulation would no longer exist at the state level, national insurers would not be eligible for McCarran's antitrust exemption.

AIA members are willing to take the risks of a federal charter not simply because the system normalizes price and product regulation for those choosing a national charter by letting the free market determine the range of price and product options, but also because the federal framework stresses strong market conduct and financial solvency oversight and applies regulation in a consistent, uniform manner. After considerable thought, we believe that this is the best and most effective way to "re-balance" regulatory and antitrust objectives to meet the modern demands of the insurance marketplace.

3. ***Mr. Hunter testified about automobile insurance rates in Philadelphia – information about which he obtained from the Pennsylvania Insurance Department – and the wide disparity between different companies' rates for the same driver. Mr. Hunter argued that this was evidence of a lack of competition in the marketplace, because "[i]n a truly competitive market, prices fall in a much narrower range around a market-clearing price at the equilibrium point of the supply/demand curve." Do you agree with Mr. Hunter's argument that such a disparity represents weak competition in the marketplace? If not, can you explain why such disparity in premiums would exist between two companies offering insurance for the same person driving the same vehicle, and how such a disparity benefits consumers?***

We disagree with Mr. Hunter and his idiosyncratic economic theories. The example Mr. Hunter cites neither provides evidence of weak competition nor leads to a conclusion that McCarran's antitrust exemption is protecting a weakly competitive market.

The same differences exist in almost every industry. For example, a recent on-line search for one-day advance round-trip airfare from Washington, DC, to Philadelphia, PA, yielded a low of $474 (a two-stop trip on US Airways/United departing from BWI) and a high of $1,628 (also, a two-stop trip on US Airways departing from BWI at the same time). Interestingly, the same search also revealed a non-stop fare on United at $573. We also looked at the hotel industry and discovered that the rates for a one-night stay in a standard room at a Philadelphia-area hotel ranged from $48/night to $319/night.

In addition, we compared the cost of a loaf of bread in Philadelphia, which most U.S. consumers believe is an essential commodity, and found prices ranging from $1.79 to $4.50 for this commodity. Thus, even for essential food items, there is a broad disparity of prices in the marketplace. This observation also applies to what is arguably Philadelphia's best-known product; the price of a "Philly Cheesesteak" sandwich ranges from under $4 at Dallesandro's to $18 at the Four Seasons Hotel.

Mr. Hunter apparently prefers a world of economic homogeneity, where products and services are undifferentiated, innovation is rare, and consumers are presumed to be unable to make decisions for themselves. We disagree with Mr. Hunter's perspective, and we suspect that most consumers do, as well.

A fundamental economic theory is that pricing is competitive in a deconcentrated market – one in which there are numerous sellers with none having market power. In such a market, collusion is highly unlikely. The Pennsylvania private passenger auto insurance market is such a deconcentrated market. Currently, there are 69 auto insurance groups, each of which writes more than $1 million in annual premiums in the state. Average annual state-wide premiums rank Pennsylvania 21st among the 50 states, even though Philadelphia (with average annual auto insurance premiums of $4,142) is the second-most expensive city for auto insurance in the nation. The Herfindahl-Hirschman Index (HHI) – a standard measure of market concentration typically used by the U.S. Department of Justice and the Federal Trade Commission – for the Pennsylvania auto insurance market is 972, which is considered "unconcentrated" and below any threshold that would raise attention from these federal antitrust regulators.

Further, Mr. Hunter's analysis ignores the fact that auto insurance is not a product where costs are known in advance. By far, the biggest component of auto insurance rates is future losses, which an insurer must predict. Those assessments can vary significantly, and therefore rates do as well.

The biggest fallacy in Mr. Hunter's testimony is to attribute any market imperfections in Pennsylvania to weak competition protected by McCarran (highly unlikely given the unconcentrated structure of the market), rather than pervasive regulation of insurance rates and policy forms. Insurers in Pennsylvania must file their private passenger auto insurance rates with the Department of Insurance and state proposed effective dates for those rates. Those rates must be on file with the department for a waiting period of 30 days before they become effective, and the waiting period may be extended for an additional 30 days. Rates filed with the department are deemed approved and effective unless the department disapproves them prior to the expiration of the waiting period. (Pa. Stat. Ann., title 40, sec. 1184).

Similarly, insurance policy forms must be filed with and approved by the department. Forms are deemed approved unless disapproved by the department within 30 days. (Pa. Stat. Ann., title 40, sec. 477b). In addition, under Pennsylvania law, automobile insurers must participate in the state's residual market plan, and use of insurance rates for the residual market is subject to prior approval by the department. (Pa. Stat. Ann., title 75, sec. 1741 *et seq.*).

Insurers must adhere to filed rates and forms, and cannot change them except by going through this approval process again.

Presumably, the premium quotes that Mr. Hunter cites, and the policy forms he references, were based on filings made by those carriers with the department according to the review and approval process just described. Thus, to the extent that the regulatory system prevents or delays the normal functioning of the private market, it is a factor in the pricing disparity that Mr. Hunter references.

4. ***As President of the American Insurance Association you presumably have a good knowledge of the various issues that face insurance companies in the various States. Please identify one instance of a criminal antitrust prosecution against an insurance company in any State, brought under State antitrust law. Please provide the details of the prosecution, including what specific State antitrust laws were at issue.***

In response to a similar question posed by Chairman Specter, we prepared the attached one-page document that lists the criminal prosecutions brought against former employees of insurance companies or the insurance companies themselves during the last three years by the states pursuant to state criminal antitrust statutes. The list reflects those prosecutions that we were able to uncover through a search of public materials available on-line and through informal contact with the state attorneys general offices.

The list also reveals that all of the criminal antitrust prosecutions we were able to locate were initiated by the New York attorney general, pursuant to the criminal provisions of the Donnelly Act (N.Y. Gen. Bus. L. sec. 340 *et seq.*; <u>see</u>, specifically, N.Y. Gen. Bus. L. sec. 347 ("Criminal prosecution")), against insurance company executives rather than the insurance companies directly, in connection with the multi-state investigation of insurance broker compensation practices. While criminal actions were initiated only against former employees, there are numerous examples of civil antitrust complaints brought by states against the insurance companies directly, some of which have been settled. Most recently, for example, the Illinois attorney general filed civil suit against Liberty Mutual, alleging violations of the Illinois antitrust law.

5. ***Based on your knowledge of the insurance industry, are there factors other than a fluctuation in claims paid from year to year that affect any given company's profit? For example, does a company's return on the investment of its premiums affect its future premiums? If yes, is it normal practice for an insurance company to pass investment losses on to a consumer through higher rates, whose premium, in theory, is based on historical and projected loss data?***

Insurance premium rates are intended to cover the cost of paying future claims and related costs, and to provide a reasonable underwriting profit. Other factors typically affect the ultimate premium, such as competitive and market forces, or a particular state's regulatory scheme. Still, setting an appropriate rate to cover claims costs and a reasonable return remains the overriding goal of insurers.

Insurance is the only product for which the true cost of the product is unknown at the time the price of the product is established. It follows that when insurers obtain later information indicating future losses will be higher, they must adjust rates, to the extent they can, to cover the increased costs of future claims. Thus, it is the increasing cost of covering insurance risks, not investment outcomes, which drives the growth in premium rates. It is important to note that all of an insurer's investments are always "on the hook," meaning that they must be used to pay policyholder claims if needed. As a result, state rules governing insurer investments are highly restrictive.

The stock market is simply one of several investment vehicles that can be used for managing the upfront cash from premium payments. In the past, when the stock market has performed especially well, investment returns have helped provide overall insurer profitability, particularly in periods when premium rates approved by state regulators have been insufficient to provide adequate underwriting profits. Insurers, however, limit their exposure to the stock market by allocating invested assets among a mixture of investment vehicles. Indeed, property-casualty insurers are historically heavily invested in bonds, and are among the largest institutional purchasers of state government bonds that go directly to the financing of public projects.

As for any connection between investment income and premiums, some, but not all, states require insurers to consider investment income in their pricing. However, even in those competitive markets in which insurers are not required to consider investment income, some insurers may elect to consider this information in their pricing models. Companies will differ in their assessments of the correct balance between underwriting and investment profit, depending on the competitive environment. This balance may vary by line of insurance, with some insurers electing to consistently make underwriting profits in every line of business they write.

As a general matter though, insurers attempt to price products so that a reasonable profit can be generated from the insurance operation itself. Despite these attempts, the property-casualty industry as a whole has had only two underwriting gains in the last 27 years. (*A.M. Best Special Report* on Industry Financials, A.M. Best Company, Oldwick, NJ, at 1 (May 2006)). Certainly, based on this statistic, one could not argue that insurance consumers were harmed during those years. At bottom, property-casualty insurance is a highly competitive business with over 1,100 major insurer groups representing nearly 4,000 companies, so insurer pricing practices differ among individual companies, jurisdictions, and lines of business.

6. The ABA has suggested repeal of McCarran-Ferguson, but with safe harbors to permit pro-competitive activities to continue. Could you comment on the ABA's proposal, and discuss whether you think such a proposal is workable, regardless of whether you think it is necessary? If you oppose the ABA's proposal, please explain why, including why the safe harbors envisioned would not adequately meet the unique needs of the insurance industry. Please also explain, given the safe harbors in the ABA proposal, why giving Federal enforcers the tools to investigate and prosecute anticompetitive behavior would be undesirable, if that is your view.

The ABA policy on the McCarran antitrust exemption describes the "safe harbor" protections as follows:

(1) Insurers should be authorized to cooperate in the collection and dissemination of past loss-experience data so long as those activities do not unreasonably restrain competition, but insurers should not be authorized to cooperate in the construction of advisory rates or the projection of loss experience into the future in such a manner as to interfere with competitive pricing.

(2) Insurers should be authorized to cooperate to develop standardized policy forms to simplify consumer understanding, enhance price competition and support data collection efforts, but state regulators should be given authority to guard against the use of standardized forms to unreasonably limit choices available in the market.

(3) Insurers should be authorized to participate in voluntary joint-underwriting agreements and, in connection with such agreements, to cooperate with each other in making rates, policy forms, and other essential insurance functions, so long as these activities do not unreasonably restrain competition.

(4) Insurers participating in residual market mechanisms should be authorized in connection with such activity to cooperate in making rates, policy forms, and other essential insurance functions so long as the residual market mechanism is approved by and subject to the active supervision of a state regulatory agency.

(5) Insurers should be authorized to engage in any other collective activities that Congress specifically finds do not unreasonably restrain competition in insurance markets.

(See Statement of Donald C. Klawiter on behalf of the American Bar Association, before the United States Senate Committee on the Judiciary, at 6 (June 20, 2006)). As we have previously noted, these are not true safe harbors. They are merely the illusion of safe harbors that may confuse those not well-versed in antitrust law. A true safe harbor protects the defined activity from litigation, as the safe harbors in H.R. 9 did when finally reported by the House Judiciary Committee in 1994. The ABA safe harbors are illusory because they do not provide protection against uncertainty and litigation. In particular, the ABA's so-called principal safe harbors for pricing, forms development and joint underwriting condition the protection on the activity not resulting in an "unreasonable restraint of competition." This is no protection at all, but, rather, a backdoor application of the antitrust laws. The "exemption" would only become available if there were first a finding that the practice would not violate the antitrust laws in the absence of an exemption. In effect, with this type of limitation, the safe harbor is merely restating antitrust litigation standards and inviting litigation over whether the activity has met those standards. In antitrust litigation, that is at the heart of the parties' dispute; specifically, whether the challenged activity is a reasonable or unreasonable restraint of competition. The ABA "safe harbors" thus would be little different from a complete repeal of McCarran protection.

Moreover, the ABA position does not account for the fact that state insurance departments exercise a great deal of rate and policy form regulation already, which substantially narrows the opportunity for the competitive market to operate. For example, ABA Safe Harbor #2 suggests that state insurance regulators be given the authority to "guard against" the use of standardized forms that can be used to limit market choices. Yet, government product controls are designed to accomplish the exact opposite: to perpetuate use of commoditized products and to discourage and delay innovation. Thus, and as more fully explained in response to question #2, more state regulatory authority is not the answer to decreased product differentiation.

In addition, in other areas such as participation in state residual markets, the safe harbors mimic the state action doctrine's "active supervision" test and therefore do not provide any additional antitrust protection than would otherwise be provided in the absence of the McCarran-Ferguson Act.

Finally, in response to the second part of this question, because the ABA safe harbors do not provide any protection for insurers, allowing federal oversight without regulatory relief in the form of an optional federal charter would guarantee that any collective activity by insurers could be open to constant, duplicative and overlapping enforcement actions.

ATTACHMENT

STATE CRIMINAL ANTITRUST PROSECUTIONS – INSURANCE INDUSTRY

Based on a review of publicly available material, it appears that, since 2003, the New York Attorney General has pursued criminal prosecutions of the following former company executives, based in part on alleged violations of the state's antitrust law (N.Y. Gen. Bus. L. sec. 340 *et seq.*). As most of the public information on these prosecutions focuses on guilty pleas rather than indictments, however, we are not able to confirm this. We do note that all of the following criminal prosecutions were in connection with the investigation of insurance broker compensation issues, which rested in part on allegations of state antitrust violations. We also have informally contacted the state attorneys general offices to request information on criminal antitrust prosecutions during the same period of time, and have not uncovered any additional instances of activity.

Based on this information, 16 former insurance company executives have pled guilty, and 6 more former employees have been indicted.

October 15, 2004: Karen Radke (AIG[1]) and Jean-Baptist Tateossian (AIG) pled guilty to criminal fraud charges arising from bid-rigging allegations.

November 16, 2004: John Keenan (Zurich American) and Edward Coughlin (Zurich American) pled guilty to misdemeanor antitrust charges arising from "bid-rigging" allegations.

January 6, 2005: Robert Stearns (Marsh) pled guilty to a fraud charge arising from "bid-rigging" allegations.

February 15, 2005: Joshua Bewlay (Marsh), John Mohs (AIG) and Carlos Coello (AIG) pled guilty to fraud charges arising from "bid-rigging" allegations.

February 27, 2005: Kathryn Winter (Marsh) pled guilty to fraud charges arising from bid-rigging allegations.

August 4, 2005: Regina Hatton, Nicole Michaels, Jason Monteforte, and Todd Murphy (all formerly of Marsh) and James Spiegel (Zurich American) pled guilty to fraud and/or attempted restraint of trade charges. Monteforte and Michaels pled guilty to a misdemeanor attempted restraint of trade charge, while the others pled guilty to fraud charges.

August 8, 2005: Kevin Bott (Liberty Mutual) pled guilty to criminal charges in connection with big-rigging conduct.

September 15, 2005: the following former Marsh executives were indicted on charges of a scheme to defraud, combination in restraint of trade and competition, and various counts of grand larceny: William Gilman; Joseph Peiser; Edward J. McNenney; Thomas T. Green Jr.; Kathleen M. Drake; William L. McBurnie; and Edward J. Keane Jr. Greg J. Doherty (ACE) was indicted as well. On October 1, 2005, Keane pled guilty to a reduced charge in exchange for his cooperation. We are unaware of the current status or disposition of the other indictments.

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[1] This indicates the companies that formerly employed the individuals that were indicted or pled guilty.

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KEVIN B. THOMPSON, F.C.A.S., M.A.A.A.
SENIOR VICE PRESIDENT
INSURANCE SERVICES DEPARTMENT

July 17, 2006

The Honorable Arlen Specter, Chairman
Committee on the Judiciary
United States Senate
Washington, DC 20510
Attn: Baer Huefner

Dear Chairman Specter:

It was my pleasure to appear at the United States Senate Judiciary Committee hearing regarding "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption" and discuss the vital role ISO plays in the Property/Casualty insurance industry in the United States.

Attached to this letter are responses to the additional questions transmitted with your June 29th letter to me.

I hope these responses are informative.

Sincerely,

Kevin B. Thompson
Senior Vice President

Attach.

Questions of Senator Patrick Leahy
Following the Senate Judiciary Committee Hearing
"The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption"
June 20, 2006

Questions for Mr. Kevin Thompson

1. When your company, Insurance Services Office, formulates its advisory information, do you take into account current and predicted future financial market conditions? If so, how do financial market conditions affect the advisory data you distribute?

Answer:
In formulating ISO's advisory information, ISO does not take into account current or predicted future conditions in the financial markets.

2. In your written testimony, you predict that if the McCarran-Ferguson insurers' exemption were repealed, insurers would experience a chilling effect, which could "deprive insurers of legitimate use of pro-competitive advisory organization products and services." If the McCarran-Ferguson insurers' exemption were repealed, could your company continue its operations consistent with Federal antitrust law? If so, would you be required to refine your services to comply with Federal antitrust laws? If so, how?

Answer:
If the McCarran-Ferguson limited antitrust exemption were to be repealed, ISO believes that all of its activities would eventually pass antitrust muster under a rule of reason analysis because they are pro-competitive and consistent with the antitrust laws. Accordingly, we do not believe that, if challenged, a court would require any refinement of our services. Yet, as is clear from the testimony of Mr. Hunter, our opinion is not shared by all.

In the wake of McCarran repeal, each insurer would have to determine for itself the risks associated with participation in ISO activities and use of its information. The cost of litigating rule of reason cases is high and the chances of prevailing in them are difficult for even the most experienced lawyers to predict. This was recognized by the GAO in its July 28, 2005 report on McCarran-Ferguson to Representative Oxley, Chairman of the House Committee on Financial Services, which stated "...because the courts have not considered which activities within the "business of insurance" might violate federal antitrust laws, it is difficult to determine which insurer activities would withstand antitrust scrutiny if the exemption were removed." As I stated in my testimony, Faced with this uncertainty, there would undoubtedly be a tendency on the part of insurers to question the wisdom of participating even in those activities that would ultimately be sustained as pro-competitive under antitrust "rule of reason" analysis. Uncertainty about the outcome would persist for years until a sufficient body of law was established on the topic.

SUBMISSIONS FOR THE RECORD

STATEMENT OF SENATOR RICHARD J. DURBIN

Before the Senate Judiciary Committee

"The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption."

Tuesday, June 20, 2006

Thank you, Chairman Specter and Ranking Member Leahy, for scheduling this hearing. This hearing is about a very important issue that deserves our committee's full attention.

I have long supported the repeal of the McCarran-Ferguson antitrust exemption that we have provided to the insurance industry for over 60 years. I know that there is a long history of litigation and legislation involved in this issue, dating back to the 1869 Supreme Court decision in Paul v. Virginia, which held that states have the right to regulate insurance.

At that time, according to the Supreme Court, insurance was considered not to involve interstate commerce, and therefore, was within the states' jurisdiction.

The Paul decision was overturned by the Supreme Court in 1944 in U.S. v South-Eastern Underwriters Association, which held that insurance was indeed interstate commerce, and therefore, eligible for federal oversight.

The South-Eastern decision, however, was quickly undone by Congress in 1945 through the McCarran-Ferguson Act. That monumental law, overturning a Supreme Court decision, was passed by both chambers of Congress without a single hearing on the bill or any serious debate. That was a mistake.

While academicians and others continue to debate whether or not Congress should have enacted McCarran-Ferguson exemption in 1945, several federal officials, agencies and commissions that have looked into the issue all have urged its repeal. In 1994, the House of Representatives took steps toward such repeal through a bill that the House Judiciary Committee reported out in a bipartisan vote.

Most recently, in the last two Congresses, I joined with Senators Leahy, Kennedy and others in introducing the "Medical Malpractice Insurance Antitrust Act," which would prohibit anti-competitive behavior in the medical malpractice insurance market through a narrow repeal of the McCarran-Ferguson Act. Our bill would allow for federal prosecution of the most pernicious antitrust offenses, such as price fixing, bid rigging, and market allocations.

I have also introduced a bill with my Republican Colleague, Senator Graham, in the 108th Congress, entitled, "Better Health Act," which had included a provision to repeal McCarran-Ferguson as an effort to rein in the rise in medical malpractice premiums that may be attributed to collusion among insurers.

Examples of recent prosecutions convince me that this reform is needed. The American International Group (AIG) is one of the largest medical malpractice insurers in the country. Its former head, Hank Greenberg, was ousted by its board after the company was sued by New York Attorney General Eliot Spitzer under state laws for fraudulent transactions aimed at manipulating the insurer's financial statements and for deceiving regulators and investors.

Therefore, at least in the context of medical malpractice insurance, I am for reforming this area of federal antitrust law. I now look forward to learning more from our expert witnesses as to whether such repeal is necessary for the rest of the insurance industry.

One of our witnesses today is Michael T. McRaith, the Director of the Division of Insurance from my home state of Illinois. Our Governor, Rod Blagojevich, made an excellent choice in selecting Mike McRaith for this very important position. Director McRaith is a seasoned attorney who has practiced insurance law for over 15 years prior to his appointment as state insurance commissioner.

Immediately upon taking office last year, Director McRaith confronted the challenge of rising medical malpractice insurance premiums, by working with our state's General Assembly to develop a new medical malpractice rate regulatory scheme. He also led the first public hearing on the proposed medical malpractice premium rate changes. As a result of Director McRaith's leadership, our state has stabilized the medical malpractice problems we faced only a few short years ago.

Director McRaith has also worked closely with our state Attorney General, Lisa Madigan, in investigating abuses among insurance brokers, similar to action taken by Attorney General Spitzer in New York.

These cases have resulted in remarkable recovery for residents of Illinois, such as $190 million settlement with Aon, the second largest insurance broker in the nation, and a $151 million settlement agreement with Zurich, which required Zurich to pay back $88 million to policyholders. This last settlement also included Zurich's agreement to pay $65 million in penalties and payments, including $12 million transferred to Illinois Comprehensive Health Insurance Plan (CHIP) to benefit uninsured or low-income Illinoisans.

Director McRaith is here today representing the National Association of Insurance Commissioners. NAIC has long maintained its position that McCarran-Ferguson should not be repealed. I look forward to listening to arguments from both sides of this debate today.

Again, I thank Chairman Specter and Ranking Member Leahy for holding this hearing.

# # #

Testimony of Assistant Attorney General Elinor R. Hoffmann, on behalf of the Office of the Attorney General of the State of New York

Submitted June 20, 2006

On behalf of the Attorney General of the State of New York, I appreciate the opportunity to present testimony to the Judiciary Committee in connection with the Committee's consideration of the McCarran-Ferguson exemption from the federal antitrust laws. In the paragraphs below, I describe the principles that should govern an accommodation between the antitrust laws and other public policies or regulatory schemes; I conclude that the McCarran-Ferguson exemption for the business of insurance does not have continuing vitality in light of those principles and market developments; and I suggest some factors important to an evaluation of exemptions like McCarran.[1]

SUMMARY

The antitrust laws reflect our society's belief that competition in the commercial marketplace enhances consumer welfare and promotes our economic and political freedoms. Unrestricted competition, however, may not be consistent with other significant public policies or regulatory schemes that also serve the public interest. Thus, we exempt conduct from antitrust scrutiny to the extent necessary to attain other important goals. When considering an exemption, Congress should take into account the commercial sector that it affects most directly, examine carefully the public policy to be advanced, craft a limited exemption to achieve identified goals, and periodically reexamine industry-specific exemptions in light of changing market conditions.

The McCarran-Ferguson exemption to the federal antitrust laws for the business of insurance illustrates an industry-specific exemption that is ripe for reexamination, and, in our view, repeal. The exemption has interfered with the ability of public and private enforcers to use readily the full panoply of federal antitrust remedies to correct, deter and obtain compensation for abuses in the insurance sector. A uniform federal antitrust

[1] The Office of the Attorney General of the State of New York submitted similar comments on McCarran-Ferguson to the Antitrust Modernization Commission in July 2005 in connection with its consideration of exemptions and immunities from the antitrust laws. Those comments may be found at http://www.amc.gov/public_studies_fr28902/immunities_exemptions_pdf/Office_of_NY_AG_revd.pdf My testimony is also consistent with the Principles of Antitrust Enforcement adopted by the National Association of Attorneys General ("NAAG") (including New York's Attorney General) in March 2005. There, the Attorneys General emphasized that NAAG "consistently has opposed legislation that weakens antitrust standards for specific industries because there is no evidence that any such exemptions would either promote competition or serve the public interest" and that NAAG would continue to do so. The NAAG Resolution is available at http://naag.org/issues/pdf/2005.Spring.Antitrust.Resolution.Final.pdf

standard would facilitate antitrust enforcement and benefit plaintiffs and defendants alike, in contrast to disparate actions, under different laws, that may yield inconsistent results.

Further, repeal of the exemption should not require preemption of state regulatory systems, which comprehend far more than antitrust policy, and are consistent with a preference for competition in this critical sector of the nation's economy.

I. RELATIONSHIP BETWEEN EXEMPTIONS AND IMMUNITIES AND THE ANTITRUST LAWS

Antitrust policy and other strong public policies sometimes appear to be inconsistent with one another, but the ultimate goal is the same: to promote our economic, political and social well-being. Congress and the courts have created exemptions and immunities to address unavoidable tensions between the antitrust laws and other significant public policies or regulatory systems. In some cases, the courts shield conduct from antitrust scrutiny in the face of potential conflicts with constitutional mandates.[2] In other cases, Congress has enacted explicit exemptions to further industry-specific goals.[3] And, in still other cases, courts have created implied immunities when faced with a plain repugnancy between the antitrust laws and a pervasive regulatory scheme.[4]

Although complete harmony may not be possible, Congress may adjust the degree of dissonance as contexts change over time. In the case of industry-specific exemptions, reevaluation of purpose and effect may often be appropriate in the light of current market conditions.

A. What Balance Should be Struck Between the Antitrust Laws and Competing Policies?

The courts apply a set of general principles in construing the scope of immunities and exemptions, whether express or implied. Likewise, Congress has taken into account the significance of the antitrust laws to our economy in evaluating the need for statutory

[2] *See, e.g.*, Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 127 (1961); United Mine Workers v. Pennington, 381 U.S. 657 (1965) (antitrust immunity for petitioning the government, regardless of anticompetitive motive).

[3] *E.g.*, Capper-Volstead Act, 7 U.S.C. §§ 291-292 (agricultural producers' cooperatives); Agricultural Marketing Agreement Act, 7 U.S.C. §§ 608(b), 608(c) (agricultural marketing agreements sanctioned by Secretary of Agriculture); non-profit agricultural cooperatives' exemption (not for profit agricultural producers' cooperatives); 15 U.S.C. § 17; Fishermen's Collective Marketing Act, 15 U.S.C. §§ 521-522 (fishermen's collective action); McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (business of insurance); Shipping Act, 46 U.S.C. app. § 1701 et seq. (shipping conferences).

[4] *E.g.*, Gordon v. New York Stock Exchange, 422 U.S. 659 (1975) (agreements subject to the jurisdiction of the SEC). See generally, II AMERICAN BAR ASSOCIATION SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS (FIFTH) at 1238-42 (2002) (hereinafter cited as ALD(5)).

exemptions. But beyond generally applicable principles, Congress has not applied, and should not apply, a uniform standard for creating an exemption. Each statutory exemption must be customized: narrowly drawn to serve an identified public interest.

B. General Principles, Market-Specific Inquiries

Judicial opinions from different philosophical wings of the Supreme Court consistently have made clear that fostering competition in the business world is a critical national policy.[5] Exemptions and immunities from the antitrust laws are disfavored,[6] but a narrowly tailored exemption or immunity may be appropriate to make a regulatory scheme work, or to achieve an important public policy objective. Antitrust should be fully applicable, though, when those entitled to the benefits of an exemption or immunity exceed the limits of the exemption.

Despite the applicability of these general principles, regulatory schemes differ from one another, and public policy goals even more so. It would be unwise to cast all exemptions from one mold, or even to adhere to a single set of evaluative criteria.

A broad, express immunity is appropriate in some situations. In creating a statutory exemption for unilateral labor conduct, for example, Congress wrote a sweeping exemption to protect the formation and operation of labor unions from antitrust attack.[7] Its purpose was to preclude antitrust litigation against nascent labor organizations, because, as Congress declared, "[t]he labor of a human being is not a commodity or article of commerce."[8] The statutory labor exemption was enacted because anything less than a broad immunity from antitrust prosecution might chill cooperation among members of labor organizations, and create imbalances in collective bargaining relationships, interfering with our national labor policy.

In some other contexts, Congress has limited the risk of exposure under the antitrust laws to create incentives to engage in behavior deemed pro-competitive. Under the National Cooperative Research and Production Act (the "Act"), a research joint venture that meets the Act's criteria is subject to antitrust review under the rule of reason, and joint venture defendants may recover attorneys' fees if they substantially prevail in

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[5] "Antitrust laws in general, and the Sherman Act in particular, are the Magna Carta of free enterprise." United States v. Topco Associates, Inc., 405 U.S. 596, 610 (1972) (opinion by Justice Marshall), *quoted in* Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko LLP, 540 U.S. 398, 415 (2004) ("The Sherman Act is indeed the 'Magna Carta of free enterprise'") (opinion by Justice Scalia).

[6] Southern Motor Carriers Rate Conf. v. United States, 471 U.S. 48, 67 (1985).

[7] 15 U.S.C. § 17.

[8] The statute continues: "Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor . . . organizations, . . . or to forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the antitrust laws." *Id.*

antitrust litigation that is frivolous or unfounded. Further, a joint venture that notifies the enforcement agencies of its formation and activities is protected from treble damage liability under federal and state antitrust law.[9] The Act was amended in 2004 to extend its protections to standard-setting organizations.[10] Unlike the broad immunity granted by the statutory labor exemption, the Act simply mitigates risk for joint ventures that are perceived to be pro-competitive and that have been notified to the enforcement agencies; it does not insulate conduct from antitrust scrutiny. The Act, designed to further antitrust policy, would not be an appropriate model for a broad labor exemption; and the statutory labor exemption, designed to further labor policy, would not be an appropriate model for a qualified immunity for research joint ventures.

From time to time, industry groups have persuaded Congress to exempt collective conduct within a market sector to circumvent the effects of a recent judicial decision, or to preempt interference with customary industry practices that may not pass antitrust muster.[11] In each instance, the key question that Congress must address is whether the exemption only benefits a special interest group, or whether the benefit to the public is such that it makes sense to tolerate economic favoritism. Further, because these exemptions are market-specific, and markets evolve, periodic review of such exemptions would be appropriate. Sunset provisions are likely to be a good tool for prompting periodic legislative review.

II. SPECIFIC IMMUNITIES AND EXEMPTIONS: MCCARRAN-FERGUSON

The McCarran-Ferguson Act[12] is an industry-specific exemption, intended to protect state regulation and taxation of the insurance industry as well as the customary practices of insurers. But insurers have, from time to time, engaged in anticompetitive conduct that does not serve any discernible public interest. A decade after a comprehensive reform of the liability insurance industry flowing from antitrust litigation prosecuted by the states (including New York),[13] the New York State Attorney General is investigating conduct by participants in the insurance sector and has discovered new and pervasive instances of abuse.

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[9] 15 U.S.C. §§ 4301-4306.

[10] U.S. Dep't of Justice, Antitrust Division, Press Release, *Justice Department Implements the Standards Development Organization Advancement Act of 2004* (June 24, 2004), available at www.usdoj.gov.atr/public/press_releases/2004/204345.htm.

[11] *E.g.*, Medical resident matching program exemption, 15 U.S.C. § 37b (prior to enactment, matching program attacked as price-fixing); Soft Drink Interbrand Competition Act, 15 U.S.C. §§ 3501-3503 (prior to enactment, soft drink industry attacked under antitrust laws for establishing exclusive territories for distributors); Health Care Quality Improvement Act, 42 U.S.C. §§ 11101-11152 (protects those engaged in peer review from antitrust damages provided the peer review meets certain due process criteria; no insulation from injunctive relief).

[12] 15 U.S.C. §§ 1011-1015.

[13] *See* Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993), discussed below.

A. History of the McCarran-Ferguson Exemption

The 19th century witnessed the growth of the insurance business, primarily fire insurance. States reaped solid revenues from taxing fire insurance companies and charging out-of-state insurers fees to do business within state borders. Insurance companies began to pool loss experience data to facilitate the insurance of prudent risks and to guard against insolvencies. States built administrative systems to regulate the industry. After the Civil War, the insurers challenged pervasive state regulation, but the Supreme Court upheld the states' right to regulate, stating in dictum in *Paul v. Virginia*[14] that an insurance contract was not interstate commerce. In 1944, the Court effectively overruled *Paul* in *United States v. South-Eastern Underwriters Ass'n*, finding that the business of insurance was indeed interstate commerce, and noting the explosive growth of the marine and fire insurance business nationwide since *Paul* had been decided.[15]

The states and the insurance industry alike were disappointed with the result in *South-Eastern Underwriters*. The states feared that the Court's ruling threatened their power to tax insurance companies, especially out-of-state insurance companies. And the insurers wanted to continue to engage in collective conduct that might be questioned under the federal antitrust law. Congress enacted the McCarran-Ferguson Act in 1945 as a compromise between those who advocated a blanket exemption for the business of insurance and those who favored no exemption from antitrust scrutiny.[16] McCarran-Ferguson thus preserves the power of the states to regulate and tax insurers, but provides only a limited exemption from the antitrust laws.[17]

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[14] 75 U.S. (8 Wall.) 168 (1869). For a general description of the historical background of the insurance industry, *see* United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 545-47 (1944).

[15] United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944). In *South-Eastern Underwriters*, the government had indicted members of an insurance association for violating the Sherman Act by fixing rates and monopolizing insurance in six states.

[16] Alan M. Anderson, *Insurance and Antitrust Law: The McCarran-Ferguson Act and Beyond*, 25 WM. & MARY L. REV. 81, 85-86 (1983).

[17] The McCarran-Ferguson Act provides, in pertinent part:

> (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
>
> (b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, That . . . the Sherman Act, . . . Clayton Act, and . . . Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

15 U.S.C. § 1012.

B. Scope of the Exemption: How Applied

The McCarran-Ferguson exemption is phrased in the negative: it states that the federal antitrust laws apply to the "business of insurance" to the extent such business is not regulated by state law. Agreements and actions taken to boycott, coerce, and intimidate are not exempt. [18]

1. The Business of Insurance

Consistent with precedent that antitrust exemptions should be narrowly construed, the Supreme Court has narrowly defined the "business of insurance," distinguishing between practices that constitute the business of insurance and entities that engage in the business of insurance. The exemption applies to the former, but not to all of the activities of the latter. For a practice to be part of the "business of insurance," it must have "the effect of transferring or spreading a policyholder's risk; [be] an integral part of the policy relationship between the insurer and the insured; and [be] limited to entities within the insurance industry."[19] Thus, an agreement between an insurance company and pharmacies on reimbursement rates is not the business of insurance, because it meets none of the above criteria;[20] nor is a peer review arrangement between an insurer and a professional association used to determine the reasonableness of practitioners' charges.[21] On the other hand, collaboration among insurers involving the setting of rates has been deemed the business of insurance.[22]

2. Regulated by State Law

When it enacted McCarran-Ferguson, Congress explicitly provided that the business of insurance would continue to be subject to state regulation and taxation, and that the Sherman Act would only apply "to the extent that [the business of insurance] is not regulated by State law."[23] Subsequent judicial interpretation has established that the degree of state insurance regulation needed to avoid antitrust scrutiny is less than that needed for the doctrine of state action immunity to apply.[24] A state administrative

[18] 15 U.S.C. § 1013(b) provides that "[n]othing contained in this Act shall render the . . . Sherman Act inapplicable to any agreement to boycott, coerce or intimidate, or act of boycott, coercion or intimidation." *See also* Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993).

[19] Union Labor Life Ins Co. v. Pireno, 458 U.S. 119 (1982); Group Life & Health Ins. Co. v. Royal Drug Co, 440 U.S. 205 (1979).

[20] Group Life & Health Ins Co. v. Royal Drug Co, 440 U.S. 205 (1979).

[21] Union Labor Life Ins Co. v. Pireno, 458 U.S. 119 (1982).

[22] ALD5, *supra* note 4, at 1369-73 and cases cited therein.

[23] 15 U.S.C. § 1012 (b). Congress' declaration of policy stated "that the continued regulation and taxation by the several States of the business of insurance is in the public interest . . . ." 15 U.S.C. § 1011.

[24] The state action doctrine permits state governments, municipalities and private economic actors to defend against antitrust liability on the ground that a state regulatory regime has displaced competition

scheme is sufficient regulation to remove the business of insurance from federal antitrust scrutiny, and, unlike the more general test for state action immunity, active supervision by the state is not required.[25]

3. Exception for Boycotts, Coercion or Intimidation

That Congress intended only a limited immunity from application of federal antitrust law is reinforced by McCarran-Ferguson's exception for conduct constituting boycotts, coercion or intimidation.[26] In such cases, the antitrust laws apply with full force.[27]

State antitrust enforcers have demonstrated that when they have authority to challenge anticompetitive conduct in the insurance industry, they are able to achieve significant reforms. The case that later became known as *Hartford Fire Insurance Co. v. California* in the Supreme Court[28] began when cities, towns and counties complained to state Attorneys General that they were unable to obtain insurance for pollution and certain other risks. The states brought the matter to the attention of the Antitrust Division of the Department of Justice, which declined to pursue it, in part because of the view that "'collusion is highly unlikely' in unconcentrated industries like the property and casualty insurance industry."[29] The investigation by the state Attorneys General revealed that collusion not only was possible, but that it was present. Customers lacked coverage because of collusion among major commercial liability carriers, a trade association that issued standard forms, and reinsurers who refused to reinsure certain risks. After the Supreme Court upheld the states' claims, the case settled. The states and a group of the

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with respect to the conduct in question. Private economic actors normally must show that the challenged restraint is "one clearly articulated and affirmatively expressed as state policy" and that the policy is "actively supervised" by the state for the doctrine to apply. *See California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980).

[25] *See, e.g., In re* Workers' Compensation Ins. Antitrust Litig., 867 F.2d 1552, 1557-58 (8th Cir. 1989) (repeal of statute authorizing collective ratemaking did not make the exemption unavailable because the insurance commissioner still had general authority over rating practices); Mackey v. Nationwide Ins. Cos., 724 F.2d 419, 420-21 (4th Cir. 1984) (agent's antitrust challenge to insurer's redlining practices barred by McCarran-Ferguson Act where insurance was subject to state regulation).

[26] 15 U.S.C. §1013(b).

[27] *See* Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993) (collusion by primary and secondary insurers and trade association to preclude other insurers from covering "long-tail" risks constituted a boycott, unprotected by the McCarran-Ferguson exemption from antitrust scrutiny).

[28] *Id.* The Supreme Court opinion, arising from a dismissal of plaintiffs' case at the trial court level, defined the parameters of the boycott exception to the McCarran Ferguson exemption and held that conduct having a substantial effect on United States commerce is subject to the Sherman Act.

[29] Letter dated April 22, 1986 from Assistant Attorney General Douglas H. Ginsburg to Jay Angoff, *quoted in* Michael F. Brockmeyer, *State Antitrust Enforcement*, 57 ANTITRUST L.J. 169, 170 (1988).

defendants used some of the settlement funds to create a state and municipal database of loss experience by risk, enabling state and municipal agencies to negotiate more effectively with insurers. Another result of the settlement was that all parties jointly established the Public Entity Risk Institute ("PERI"), an organization that serves as an educational, training and general resource for private, public and non-profit entities involved in risk management.[30] The industry trade association also adopted important governance reforms.

C. How Has the McCarran-Ferguson Act Affected Antitrust Enforcement?

In the fall of 2004, the New York Attorney General's Office and Insurance Department announced a joint probe of misconduct in the insurance industry. Our investigation has disclosed, among other things, evidence of bid rigging and customer allocation. We have pursued our antitrust claims criminally and civilly under New York's antitrust law, the Donnelly Act.[31] Our civil settlement with one of the world's largest insurance brokers, Marsh & McClennan Companies and Marsh Inc. (collectively, "Marsh"), required Marsh to pay $850 million in restitution. To date, our investigation of the insurance industry has resulted in settlements with six companies, guilty pleas from 20 executives and officers, and the recovery of approximately $3 billion in restitution and penalties.

On October 14, 2004, the New York Attorney General filed suit against Marsh in state court, alleging that Marsh had steered unsuspecting clients to insurers with which it had lucrative payoff agreements, often called contingent commissions. While Marsh had disclosed the existence of contingent commission agreements since 1998, the true nature of these agreements remained secret. In fact, Marsh moved business to the insurance companies that paid it the highest commission, and, to make the scheme work, Marsh solicited fictitious or cover bids to make the incumbent insurer's rates appear competitive to the insureds.

The documents produced during the investigation support the allegations of collusion to subvert the competitive process. Marsh solicited fictitious bids from insurers so that business could be steered to the insurer that Marsh favored on a particular deal, often at a price "target" set by Marsh. Marsh's clients may have been unaware of the scheme, but the insurers were not. Marsh sometimes even circulated the favored bidder's quote and asked other bidders to "protect" it by submitting a higher quote. In one example from 2002, involving a school construction project in Greenville County, South Carolina, Marsh was determined to steer business to Zurich North America. To make the bid look competitive, Marsh solicited a non-competitive bid from another company, CNA. The Marsh executive assigned to the project wrote to his contact at CNA:

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[30] The database eventually was merged into PERI. Additional information about PERI may be found at www.riskinstitute.org

[31] N.Y. GEN. BUS. LAW § 340 et seq. (McKinney 2004).

> Per my voicemail, we need to show a CNA proposal. I will outline below the leading programs (ACE and Zurich). I want to present a CNA program that is reasonably competitive, but will not be a winner.
>
> (Ex. A attached hereto).

Another example involved efforts by a Marsh client to renew its property and casualty insurance, including excess casualty, in 2003. In email correspondence between Marsh executives that was then forwarded to Liberty Mutual, an insurer, a Marsh executive wrote: "I need a B quote [i.e., a fictitious bid] from Liberty. I finally had AIG agree to write this thing at the target [$140,000.00]. Have Liberty come in around $175,000.00." (Ex. B. attached hereto). Liberty conveyed a higher "proposal," and AIG won the coverage.

We attached these documents, and many others like them, to our complaints filed against Marsh and Liberty Mutual, respectively.[32]

On January 6, 2005, a senior executive of Marsh pled guilty to criminal charges and admitted that during a period from 2002 to 2004, he had instructed insurance companies to submit noncompetitive bids for insurance business and conveyed these bids to Marsh clients.[33] On January 30, 2005, the Attorney General and Marsh settled the lawsuit, with Marsh agreeing to pay $850 million in restitution and to institute certain business reforms.[34] Marsh also issued a public apology, stating that "the recent admissions by former employees of Marsh and other companies have made clear that certain Marsh employees unlawfully deceived their customers."[35] Contemporaneous with the settlement, Marsh released a copy of a memorandum summarizing an internal investigation by Davis Polk & Wardwell that discusses bid-rigging within a unit of Marsh.[36]

On March 4, 2005, the New York Attorney General simultaneously filed a complaint in state court and, together with the New York Department of Insurance, Illinois Department of Insurance and the Attorneys General of Connecticut and Illinois, announced a settlement agreement with Aon Corporation.[37] In April 2005 the New York

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[32] Marsh Complaint and Exhibits, available at http://www.oag.state.ny.us/press/2004/oct/oct14a_04.html; Liberty Mutual Complaint and Exhibits, available at http://www.oag.state.ny.us/press/2006/may/may05b_06.html

[33] Press Release, available at http:// www.oag.state.ny.us/press/2005/jan/jan06a_05.html

[34] Press Release and Settlement, available at http://www.oag.state.ny.us/press/2005/jan/marshsettlement_pr.pdf and http://www.oag.state.ny.us/press/2005/feb/marsh_settlement.pdf

[35] *Id.* (Settlement Agreement, Ex. 1.)

[36] Marsh Press Release and Davis Polk Memorandum from Internal Investigation, available at http://www.mmc.com/news/pressReleases_222.pdf

[37] Press Release, available at http://www.oag.state.ny.us/press/2005/mar/mar04a_05.html.

Attorney General and New York Department of Insurance announced an agreement with Willis North America, Inc.[38] The Aon and Willis settlements both resolved concerns about fraud and anticompetitive practices. Pursuant to the settlements, Aon and Willis will pay $190 million and $50 million, respectively, in restitution to policy holders harmed by anticompetitive conduct.

In February 2006, the New York Attorney General, together with the New York Department of Insurance, the U.S. Department of Justice and the SEC, announced a $1.6 billion settlement with AIG that includes a provision for $375 million to be paid as restitution to policy holders harmed by bid-rigging.[39] In the spring of 2006, the New York Attorney General, the New York Department of Insurance and the Attorneys General of Connecticut and Illinois announced a $153 million settlement with Zurich Financial Services and an $80 million settlement with ACE Ltd. The settlements require Zurich to pay $88 million, and ACE to pay $40 million, to policy holders harmed by bid- rigging.[40] In May 2006, after settlement talks broke down, the New York Attorney General filed a complaint against Liberty Mutual alleging violations of the Donnelly Act and the Insurance Law, and seeking treble damages.[41]

In short, our investigation of the insurance industry disclosed serious, well-substantiated instances of bid-rigging that resulted in artificial inflation of commercial insurance rates because of the absence of competition. Our state court suit against Marsh pleaded various state law claims, including ones under New York's Donnelly Act, which, when read together with the New York Insurance Law, does not exempt brokers from the constraints of state antitrust law. The Donnelly Act provides that state antitrust law "shall apply to licensed insurers . . . licensed insurance brokers . . . and other persons and organizations subject to the provisions of the insurance law, to the extent not regulated by provisions of article twenty-three of the insurance law."[42] Article 23 prohibits insurers, but not insurance brokers, from agreeing on rates (although it permits the exchange of statistical information).[43] The same Insurance Law provision authorizes the state to sue price-fixing insurers for injunctive relief and fines (at the maximum rate of $1,000 per occurrence), and permits injured customers to sue for treble damages.[44] Thus, New York's antitrust exemption for insurance is in some ways more favorable to insurers than McCarran-Ferguson, and in some ways less so.

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[38] Press Release, available at http://www.oag.state.ny.us/press/2005/apr/apr08b_05.html

[39] http://www.oag.state.ny.us/press/2006/feb/feb09a_06.html

[40] Press Release (Zurich), available at http://www.oag.state.ny.us/press/2006/mar/mar27b_06.html; Press Release (ACE), available at http://www.oag.state.ny.us/press/2006/apr/apr26a_06.html

[41] *Supra* note 32.

[42] N.Y. GEN. BUS. LAW § 340(2) (McKinney 2004).

[43] N.Y. INS. LAW § 2316((a)(2) (McKinney 2004).

[44] Id., § 2316(b) , § 2320(c) (McKinney 2004).

Had we prosecuted our insurance cases in federal court under federal antitrust law, we likely would have encountered a defense under the McCarran-Ferguson Act, delaying, or maybe precluding, settlement. Federal antitrust enforcers and private litigants would face the same obstacle. Indeed, in a private federal multidistrict litigation based on the facts disclosed in New York's investigation, a fully-briefed motion to dismiss on McCarran grounds is now pending before the court.[45] The *Hartford Insurance* case, discussed earlier, involved just such an objection to federal jurisdiction, producing a trip to the United States Supreme Court and years of delay before a settlement was reached.

This is not just a New York State problem: it is a pervasive national problem. As the Supreme Court found in 1944, insurance unquestionably is interstate commerce, and, but for McCarran-Ferguson, would be fully subject to federal antitrust law. Currently, the business of insurance comprises approximately 10% of the national economy in terms of premium dollars.[46] Yet the McCarran-Ferguson exemption precludes federal antitrust enforcement of serious anticompetitive conduct in the insurance sector, and requires state enforcement agencies and private litigants to examine each state's laws to determine whether that state exempts the business of insurance or any part of it from state antitrust scrutiny. Some states follow federal law in whole or in part, others exempt insurance from state antitrust law to the extent it is subject to any other state law, and still others have no exemption.[47] Remedies and outcomes may differ from state to state. Differences in state laws may pose an impediment to class certification in some instances. The impact of McCarran-Ferguson is plain. The statute tends to create inefficient multiple proceedings, under disparate laws, brought by diverse sets of public and private plaintiffs, with a clear potential for inconsistent results.

D. Does the McCarran-Ferguson Exemption Continue to Serve an Important Goal that Outweighs Any Potential Anticompetitive Effect?

The McCarran-Ferguson exemption from the antitrust laws had a general purpose and a specific purpose. The general goal, discussed below, was to reinforce the rights of

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[45] *In re* Insurance Brokerage Antitrust Litigation, 2:04-cv-05184-FSH-PS (D.N.J. filed Oct. 22, 2004) (MDL 1663).

[46] Insurance companies wrote a total of approximately $1.1 trillion in premium in 2003, or approximately 10 cents of every dollar of the $11 trillion Gross Domestic Product. Insurance Information Institute, *citing* U.S. Department of Commerce, Bureau of Economic Analysis, available at http://www.financialservicesfacts.org/financial2/chartindex/chart/ppartid.723300/

[47] *Compare, e.g.,* Cal. Ins. Code § 790 (regulates trade practices in the business of insurance "in accordance with the intent of Congress") *and* 740 Ill. Comp. Stat. § 10/5(5) (2005) (insurance-related activities are exempted from the Illinois Antitrust Act to the extent insurance activities are subject to the Insurance Code or any other law of Illinois) *with* Ohio v. Ohio Medical Indemnity, Inc. 1976 U.S. Dist. LEXIS 13206 at *9 (S. D. Ohio 1976) ("[t]he question really is whether the State of Ohio has preempted the regulation of the business of insurance by its statutory scheme. The Court holds that the State has done so, albeit by a system of non-regulation.")

the states to regulate and tax the business of insurance. The specific goal was to enable insurers to continue to exchange loss data and protect themselves in the commercial marketplace through collaborative activities. We are aware of no good reason, however, to enable insurers, as a matter of federal law, to agree on rates for insurance and thereby eliminate price competition between them. Indeed, the policy of New York State, expressed in its Insurance Law, forbids such agreements. If exchange of information, such as loss experience data, promotes prudent business practices, that information may be shared in the same manner as it is shared in many industries. It is not unusual to have unaffiliated third parties collect historical data from market participants, aggregate it, and disseminate the information in an anonymous but useful format.[48] Similarly, standards designed to enhance consumer understanding of insurance policies and practices may be jointly established in a manner that does not adversely affect commercial competition among insurers.

E. Would Application of the Federal Antitrust Laws to the Business of Insurance Require Preemption of a State Regulatory Regime?

The more general goal of McCarran-Ferguson relates to preserving state regulation of the business of insurance. New York State's regulatory regime, like that of other states, comprehends far more than antitrust considerations. It governs insurance operations, reserves, notices to policy holders, forms of policies, and other matters affecting the day-to-day business of insurance. Repeal of the McCarran-Ferguson exemption from the federal antitrust laws should not affect these aspects of state regulation. Repeal simply would permit federal enforcement agencies, as well as state enforcement agencies, to police violations of the antitrust laws, without impairing the states' overarching regulatory authority.

III. Recommendations

Application of the general principle that antitrust exemptions are disfavored requires a strong showing that an exemption will benefit the public at large, not only a special interest group or industry. Congress should examine the following matters in considering whether an exemption is warranted:

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[48] The Federal Trade Commission and Justice Department have offered guidance on this issue:

> Other things being equal, the sharing of information relating to price, output, costs, or strategic planning is more likely to raise competitive concern than the sharing of information relating to less competitively sensitive variables. Similarly, other things being equal, the sharing of information on current operating and future business plans is more likely to raise concerns than the sharing of historical information. Finally, other things being equal, the sharing of individual company data is more likely to raise concern than the sharing of aggregated data that does not permit recipients to identify individual firm data.

Federal Trade Commission and Department of Justice, Antitrust Division, Antitrust Guidelines for Collaborations Among Competitors § 3.31(b) (April 7, 2000).

- What is the relevant sector of the economy? How does it operate?
- What is the conduct proposed to be exempted from antitrust review?
- What purpose would the exemption serve? Would the exemption enhance consumer welfare?
- Is the exemption strictly tailored to achieve a defined objective?
- Is there any alternative to a statutory exemption?
- Are there inconsistent state or federal regulations applicable to the industry in question?
- If yes, should the legislation include a savings clause?
- Would a sunset provision be appropriate?

In a sunset review, Congress should consider the questions set forth above, focusing on whether the purpose for the exemption still exists, whether the exemption has achieved the goals it was designed to reach, and whether the exemption has been abused or expanded in a way that unreasonably restrains competition or otherwise impairs the public interest.

Application of the foregoing inquiries to McCarran-Ferguson supports repeal of the exemption. An important original purpose of the exemption was limited: it was to protect an exchange of information regarding loss experience and other important industry data – exchanges that should still be possible, post repeal, to the extent they do not restrain competition. Congress should examine whether a specific exemption is necessary, or whether insurance companies should be subject to the same collective exchange of information standards that have developed through case law and that are applicable to other industries.

When considering the advisability of repealing the McCarran-Ferguson exemption, Congress also should pay careful attention to the particular requirements of the insurance industry. It may be necessary, for example, to include targeted savings clauses in the legislation to enable insurers to participate in joint underwriting agreements and ancillary activities in a manner that does not restrain competition, and to cooperate in developing standards that would enhance consumer understanding of their insurance policies, such as standards for plain language and simplified forms for insurance policies. Congress should consider savings clauses for other cooperative activities by insurers, provided they would not unreasonably restrain competition, and if necessary be subject to specific authorization and active supervision by the state regulatory authorities.[49]

[49] Many of the recommendations set forth in this submission are similar to those adopted by the American Bar Association House of Delegates in 1989. *See* AMERICAN BAR ASSOCIATION, *Report of the Commission to Improve the Liability Insurance System (Report No. 107)* (February 6-7, 1989).

Finally, because state regulation of insurance is complex and reaches far beyond the concerns of antitrust law, state regulation should not be pre-empted. By the same token, state regulation should not exempt insurers from the federal antitrust laws. Rather, the state action doctrine, as it is applied generally, should be adequate to deal with the insurance industry as well.

Experience with McCarran-Ferguson indicates a need to reexamine industry-specific exemptions periodically. Markets change, in many cases eliminating the need for broad exemptions. McCarran-Ferguson is one example of an exemption that has no apparent business justification and that impedes free and open competition in a major sector of the U.S. economy.

Consumer Federation of America

TESTIMONY OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE,
CONSUMER FEDERATION OF AMERICA

BEFORE

THE COMMITTEE ON THE JUDICIARY
OF THE
UNITED STATES SENATE

REGARDING

THE MCCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING THE
INSURERS' ANTITRUST EXEMPTION

JUNE 20, 2006

Good morning, Mr. Chairman and members of the Committee. Thank you for inviting me here today to discuss the need for the antitrust exemption of the McCarran-Ferguson Act. My name is Bob Hunter. I am Director of Insurance for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. I am also an actuary, a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries.

OVERVIEW

The McCarran-Ferguson Act is a truly astounding piece of legislation. The Act takes two controversial steps:

1. it delegates the regulation of insurance entirely to the states without providing any guidelines or standards for the states to meet and without mandating any continuing oversight by GAO or other federal entities, and

2. it exempts insurance companies from antitrust law enforcement, except for acts involving intimidation, coercion and boycott.

Allowing corporations to collude in pricing and other market activities results in higher costs for buyers. Since the antitrust exemption was enacted in 1945, study after study by the federal government has called for an end to it. Both business and consumer buyers of insurance have also called for this virtually unprecedented industry-wide antitrust exemption to be revoked, as have many editorial writers. Acting on a broad consensus that the antitrust exemption was harmful, the House Judiciary Committee passed a bipartisan bill in 1994 that limits the exemption.

Since then, developments in the insurance industry have added additional urgency to the need for full repeal of the antitrust exemption:

- Anticompetitive behavior by the insurance industry has been a prime cause of the homeowners insurance crisis along America's coastlines.

- State attorneys general have had to intercede to stop anticompetitive acts in the industry, including bid-rigging, market allocation arrangements and hidden kickbacks to brokers. This development has also demonstrated that state insurance regulation again has failed to police collusive behavior and that even the most sophisticated buyers are not able to protect themselves from such acts.

- Under threat of federal intervention, the insurance industry has been pushing states to deregulate insurance.[1] This is an approach that makes no sense when collusion and cartel behavior is allowed.

[1] One segment of the industry seeks an optional federal charter for insurance. A second segment seeks federal preemption of state consumer protections. A third segment of the industry supports the status quo. Both industry-

CFA urges the Senate to repeal the antiquated, unnecessary and harmful insurance antitrust exemption for the benefit of the nation's insurance consumers. We estimate that elimination of the exemption will save insurance consumers about at least 10 percent of the current premiums, or about $45 billion a year.

BACKGROUND[2]

The history of the McCarran-Ferguson Act is replete with drama, from an industry flip-flopping on who should regulate it to skillful lobbying and manipulation of Congressional processes in order to transform the bill's short antitrust moratorium into a permanent antitrust exemption in the confines of a conference committee.

In fact, the insurance industry has long-standing anti-competitive roots. In 1819, local associations were formed to control price competition. In 1866, the National Board of Fire Underwriters was created to control price at the national level, but states enacted anti-compact legislation to control price fixing.

This increased state regulatory activity led insurers to seek a federal approach to preempt the state system. In 1866 and 1868, bills were introduced in Congress to create a national bureau of insurance, but the insurer effort was unsuccessful. Failing in Congress, the industry shifted to a judicial approach.

The case on which rode the industry's hope for court-initiated reform was Paul v. Virginia, 75 U.S. (8 Wall) 168 (1868). But the insurance industry's hopes were dashed when the Supreme Court ruled that states were not prohibited by the Commerce Clause from regulating insurance, reasoning that insurance contracts were not articles of commerce in any proper meaning of the word. Such contracts, they ruled, were not interstate transactions (though the parties may be domiciled in different states the policies did not take effect until delivered by the agent in a state, in this case Virginia). They were deemed, then, local transactions, to be governed by local law.

For the next 75 years, insurance regulation remained in the states, despite repeated insurance industry litigation seeking federal preemption. (Ironically, the industry would later adopt the Paul rationale to fend off enhanced federal scrutiny of its activities under the Sherman and Clayton Antitrust Acts.)

Until 1944, state regulation of insurance was secure, based on the rationale that insurance was not interstate commerce. But that assumption was repudiated in the 1944 Supreme Court decision United States v. South-Eastern Underwriters Association. That case brought the

sponsored proposals would accomplish something very hard to do given the overall inadequacy of consumer protection under the current state system – they would lower consumer protections. Consumer representatives do not care who regulates insurance, but about the quality of consumer protections. CFA's Principles for a solid regulatory system, be it federal or state, are attached to its testimony of October 22, 2003 before the Committee on Commerce, Science and Transportation of the U.S. Senate, available at http://www.consumerfed.org/pdfs/Insurance%20RegulationSenatetestimony10-03.pdf.

[2] Much of this material is derived from the Report of the House Judiciary Committee on the Insurance Competitive Pricing Act of 1994 (House Report 103-853) dated October 7, 1994.

insurance industry's swift return to Capitol Hill to seek exactly the opposite type of relief from what it had previously advocated for so long.

Three months after the Supreme Court denied a motion for rehearing in South-Eastern Underwriters, Senators McCarran and Ferguson introduced a bill that would become the Act bearing their names. The bill was structured to favor continued state regulation of insurance, but also, ultimately, to apply the Sherman and Clayton Antitrust Acts when state regulation was inadequate.

Within two weeks of the bill's introduction, and without holding any hearings on the new measure, the Senate had passed it and sent it to the House of Representatives. As it was sent over, the McCarran-Ferguson Act provided only a very limited moratorium during which the business of insurance would be exempt from the antitrust laws.

The House Judiciary Committee also approved the bill without holding a hearing. The House floor debate indicates that House Members believed the language of the original bill already comported perfectly with the Senate amendment's stated goal of creating a limited moratorium during which the Sherman and Clayton Acts would not apply to the business of insurance.

However, despite the clear intent of both houses not to grant a permanent antitrust exemption, the conference committee proceeded to drastically transform the limited moratorium into a permanent antitrust exemption for the insurance industry. The new language provided that after January 1, 1948, the Sherman, Clayton, and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

The House approved the conference report without debate. The sole expression of the House's intent regarding the conference report containing the new section 2(b) proviso is the statement of House managers of the conference, which indicates they intended only to provide for a moratorium, after which the antitrust laws would apply. The Senate, in contrast, debated the conference report for two days. After repeated assurances that the proviso was not intended to preclude application of the antitrust laws, the Senate passed the bill, and President Roosevelt signed it into law on March 9, 1945.

The legislative history shows that the Senate had a serious debate on the antitrust exemption, unlike the House. Senator Claude Pepper contended that the new conference language enabled the states to evade the federal antitrust laws by mere authorizing legislation. Senator O'Mahoney stated that section 2(b) of the conference report simply provided for a moratorium, after which the antitrust laws would "come to life again in the field of interstate commerce." The "state action" doctrine of Parker v. Brown would apply fully, he said, so that "no State, under the terms of the conference report, could give authority to violate the antitrust laws." Therefore, he concluded, "the apprehensions which [Senator Pepper] states with respect to the conference report are not well founded." Senator McCarran likewise reassurred Senator Pepper that "he is in error in his whole premise in this matter."

Unfortunately, the courts construing the Act did not make these inferences. When presented with the question of what Congress meant by "regulated," the courts found no standard in the text of the statute and, declining to search for one in the legislative history, reached the very conclusion that Senator Pepper had anticipated and vainly struggled to forestall.

The antitrust exemption has been studied on several occasions by federal authorities, each time with the determination that continued exemption was not warranted. For example:

- In 1977, when I was Federal Insurance Administrator under President Ford, the Justice Department concluded, "an alternative scheme of regulation, without McCarran Act antitrust protection, would be in the public interest."[3]
- In 1979, President Carter's National Commission for the Reform of Antitrust Laws and Procedures concluded, almost unanimously, that the McCarran broad antitrust immunity should be repealed.
- In 1983, then FTC Chairman James C. Miller III told the House Subcommittee on Commerce, Transportation and Tourism that he saw no legitimate reason to exempt the insurance industry from FTC jurisdiction.
- In 1994, the House Judiciary Committee issued its report calling for a sharp cutting back of the antitrust exemption and proceeded to pass bipartisan legislation to do so.

ATTORNEY GENERAL SPITZER'S FINDINGS

The nation was shocked when it learned that New York Attorney General Elliot Spitzer had uncovered remarkable levels of anticompetitive behavior involving the nation's largest insurance companies and brokers. The victims were the most sophisticated insurance consumers of all – major American corporations and other large buyers. Bid-rigging, kickbacks, hidden commissions and blatant conflicts of interest were uncovered. Attorney General Spitzer's findings are, unfortunately, a reflection of the deeply rooted anti-competitive culture that exists in the insurance industry. Only a complete assessment of the federal and state regulatory failures that have helped create and foster the growth of this culture will help Congress understand how to take effective steps to change it.

On the federal side, the antitrust exemption that exists in the McCarran-Ferguson Act (and that is modeled by many states) has been the most potent enabler of anticompetitive practices in the insurance industry. Congress has also handcuffed the Federal Trade Commission in prosecuting and even in investigating and studying deceptive and anticompetitive practices by insurers and brokers. On the state side, insurance regulators have utterly failed to protect consumers and to properly regulate insurers and brokers in a number of key respects. Many of these regulators, for example, collaborated with insurance interests to deregulate commercial insurance transactions, which further hampered their ability to uncover and root out the type of practices uncovered by Attorney General Spitzer. Deregulation coupled with an antitrust exemption inevitably leads to disastrous results for consumers.

The Spitzer investigation reveals how easily sophisticated buyers of insurance can be duped by brokers and insurers boldly acting in concert in a way to which they have become

[3] Report of the U.S. Department of Justice to the Task Group on Antitrust Immunities, 1977.

accustomed over the long history of insurance industry anticompetitive behavior. Imagine the potential for abuse and deceit when small businesses and individual consumers try to negotiate the insurance marketplace if sophisticated buyers are so easily harmed.[4]

WIDE RATE DISPARITY REVEALS WEAK COMPETITION IN INSURANCE

Consider the wide disparities in automobile insurance rate quotes that a thirty-five year old married man in Philadelphia with a clean driving record would receive.[5] Allstate would quote as much as $12,493 for this coverage; Erie Insurance Exchange (an insurer with a better service record than Allstate) would charge $2,500.[6]

Some would say this wide range in price proves a competitive market. It does not. A disparity like this, where prices for the exact same person can vary by a multiple of five, reveals very weak competition in the market. In a truly competitive market, prices fall in a much narrower range around a market-clearing price at the equilibrium point of the supply/demand curve.

There are a number of important reasons why competition is weak in insurance. Several have to do with the consumer's ability to understand insurance:

1. ***Complex Legal Documents.*** Most products are able to be viewed, tested, "tires kicked" and so on. Insurance policies, however, are difficult for consumers to read and understand -- even more difficult than documents for most other financial products. For example, consumers often think they are buying insurance, only to find they've bought a list of exclusions.

2. ***Comparison Shopping is Difficult.*** Consumers must first understand what is in the policy to compare prices.

3. ***Policy Lag Time.*** Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy's usefulness may not arise for decades, when a claim arises.

4. ***Determining Service Quality is Very Difficult.*** Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

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[4] For a complete discussion of the anticompetitive activities uncovered by Attorney General Spitzer, see Statement of J. Robert Hunter before the Senate Committee on Governmental Affairs on November 16, 2004 in the hearing entitled, "Oversight Hearing on Insurance Brokerage Practices, Including Potential Conflicts of Interest and the Adequacy of the Current Regulatory Framework."

[5] To insure a four-door, 2003 Ford Taurus SE equipped with air bags, anti-lock brakes and a passive anti-theft device for someone who drives to work five miles one way and 12,000 miles annually and seeks insurance for $50,000/$100,000/$5,000 (BI/PD limits) and comprehensive coverage with a $250 deductible.

[6] Buyers Guide for Auto Insurance. Downloaded from the Pennsylvania Insurance Department website on May 12, 2006.

5. ***Financial Soundness is Hard to Assess.*** Consumers must determine the financial solidity of the insurance company. They can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

6. ***Pricing is Dismayingly Complex.*** Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a rate quite different from what he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

7. ***Underwriting Denial.*** After all that, underwriting may result in the consumer being turned away.

Other impediments to competition rest in the market itself:

8. ***Mandated Purchase.*** Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "free-market," but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.

9. ***Producer Compensation is Unknown.*** Since many people are overwhelmed with insurance purchase decisions, they often go to an insurer or an agent and rely on them for the decision making process. Hidden commission arrangements may tempt agents to place insureds in the higher priced insurance companies. Contingency commissions may also bias an agent or broker's decision making process.

10. ***Incentives for Rampant Adverse Selection.*** Insurer profit can be maximized by refusing to insure classes of business (e.g., redlining) or by charging regressive prices. Profit can also be improved by offering kickbacks in some lines such as title and credit insurance.

11. ***Antitrust Exemption.*** Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it doesn't matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home, family or health.

There will always be a need for regulation of insurance since it requires the consumer to pay for a service today that is not delivered until later – often much later. Competition and regulation are not mutually exclusive. They seek the same ultimate goal: the lowest possible price consistent with a fair return to the provider. Competition can be greatly improved by correcting the final two market problems itemized above.

Attorney General Spitzer has begun tackling the contingent commission problem and the House Financial Services Committee has begun exploring the abuses in the title insurance industry. Today, Mr. Chairman, we address the antitrust exemption.

COMPETITION CAN BE ENHANCED BY REPEAL OF THE ANTITRUST EXEMPTION

The insurance industry, as documented by its history recounted above, arose from cartel roots. For centuries, property/casualty insurers have used so-called "rating bureaus" to make rates for several insurance companies to use. Not many years ago, these bureaus required that insurers charge rates developed by the bureaus (the last vestiges of this practice persisted into the 1990s).

In recent years, the rate bureaus have stopped requiring the use of their rates or even preparing full rates because of lawsuits by state attorneys general after the last liability crisis was caused, in great part, by insurers sharply raising their prices to return to ISO rate levels in the mid-1980s. ISO is an insurance rate bureau or advisory organization. Historically, ISO was a means of controlling competition. It still serves to restrain competition since it makes "loss costs" (the part of the rate that covers expected claims and the costs of adjusting claims) which represent about 60-70 percent of the rate. ISO also makes available expense data to which insurers can compare their costs in setting their final rates. ISO sets classes of risk that are adopted by many insurers. ISO diminishes competition significantly through all of these activities. There are other such organizations that also set pure premiums or do other activities that result in joint insurance company decisions. These include the National Council on Compensation Insurance (NCCI) and National Insurance Services Organization (NISS). Examples of ISO's many anticompetitive activities are attached as Attachment A.

Today the rate bureaus still produce joint price guidance for the large preponderance of the rate. The rating bureaus start with historic data for these costs and then actuarially manipulate the data (through processes such as "trending" and "loss development") to determine an estimate of the projected cost of claims and adjustment expenses in the future period when the costs they are calculating will be used in setting the rates for many insurers. Rate bureaus, of course, must bias their projections to the high side to be sure that the resulting rates or loss costs are high enough to cover the needs of the least efficient, worst underwriting insurer member or subscriber to the service.

Legal experts testifying before the House Judiciary Committee in 1993 concluded that, absent McCarran-Ferguson's antitrust exemption, manipulation of historic loss data to project losses into the future would be illegal (whereas the simple collection and distribution of historic data itself would be legal). This is why there are no similar rate bureaus in other industries. For instance, there is no CSO (Contractor Services Office) predicting the cost of labor and materials for construction of buildings in the construction trades for the next year (to which contractors could add a factor to cover their overhead and profit). The CSO participants would go to jail for such audacity.

Further, rate organizations like ISO file "multipliers" for insurers to convert the loss costs into final rates. The insurer merely has to tell ISO what overhead expense load and profit load they want and a multiplier will be filed. The loss cost times the multiplier is the rate the insurer will use. An insurer can, as ISO once did, use an average expense of higher cost insurers for the expense load if it so chooses plus the traditional ISO profit factor of five percent and replicate the old "bureau" rate quite readily.

It is clear that the rate bureaus[7] still have a significant anti-competitive influence on insurance prices in America.

- The rate bureaus guide pricing with their loss cost/multiplier methods.
- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust law exemption.
- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.
- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

CURRENT EXAMPLES OF THE COLLUSIVE NATURE OF INSURANCE – HOME INSURANCE AVAILABILITY AND PRICING IN THE WAKE OF HURRICANE KATRINA

As an example of coordinated behavior that would end if antitrust laws applied fully to insurers, consider the current situation along America's coastlines. Hundreds of thousands of people are having their homeowners insurance policies cancelled and prices are skyrocketing. As to the decisions to non-renew, on May 9, 2006 the ISO President and CEO Frank J. Coyne signaled that the market is overexposed along the coastline of America. In the *National Underwriter* article, "Exposures Overly Concentrated Along Storm-prone Gulf Coast" (May 15, 2006 Edition), the ISO executive "cautioned that population growth and soaring home values in vulnerable areas are boosting carrier exposures to dangerous levels." He said, "The inescapable conclusion is that the effects of exposure growth far outweigh any effects of global warming."

Insurers have started major pullbacks in the Gulf Coast in the wake of the ISO pronouncement. On May 12, 2006, Allstate announced it would drop 120,000 home and condo policies and State Farm announced it would drop 39,000 policies in the wind pool areas and increase rates more than 70 percent.[8]

Collusion appears to be involved in price increases along our nation's coastline as well. On March 23, 2006, Risk Management Solutions (RMS) announced that it was changing its hurricane model upon which homeowners and other property/ casualty insurance rates are based.

[7] By "rate bureaus" here I include the traditional bureaus (such as ISO) but also the new bureaus that have a significant impact on insurance pricing such as the catastrophe modelers (including RMS) and other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like FAIR Isaac are one example).

[8] "Insurers Set to Squeeze Even Tighter," *Miami Herald*, May 13, 2006.

RMS said that "increases to hurricane landfall frequencies in the company's U.S. hurricane model will increase modeled annualized insurance losses by 40% on average across the Gulf Coast, Florida and the Southeast, and by 25-30% in the Mid-Atlantic and Northeast coastal regions, relative to those derived using long-term 1900-2005 historical average hurricane frequencies." This means that the hurricane component of insurance rates will sharply rise, resulting in overall double-digit rate increases along America's coastline from Maine to Texas.

The RMS action interjects politics into a process that should be based solely on sound science. In the aftermath of the unexpectedly high damage caused by Hurricane Andrew, insurers turned to computer catastrophe modelers like RMS for new approaches to setting rates for catastrophe insurance coverage. The new method was a computer simulation model based on either a 1,000 or 10,000-year weather forecast. Consumers were told that the increase in rates resulting from the new computer catastrophe models would lead to greater rate stability. (I was promised this outcome personally when I was Texas Insurance Commissioner.) There would be no need to raise rates after a catastrophic weather event with the use of the new models, insurers said, because these storms would already have been anticipated when rates were set. However, the new RMS model breaks that promise to consumers and establishes rates on a five-year time horizon, which is expected to be a period of higher hurricane activity.

RMS has become the vehicle for collusive pricing. In its report on its new hurricane model, RMS states:

> In developing the new medium-term five-year view of risk, RMS has taken <u>counsel from representatives across the insurance industry</u> in determining that future model output will be for a 'medium-term' five-year risk horizon.[9]
>
> <u>To determine what should be the explicit risk horizon of an RMS Cat model, opinions were solicited among the wider insurance industry</u> from those who both use and apply the results of models <u>to find the duration over which they sought to characterize risk</u>.[10](Emphasis added)

It is clear from the release that insurance companies sought this move to higher rates. RMS's press release of March 23, 2006 states:

> 'Coming off back-to-back, extraordinarily active hurricane seasons, the market is looking for leadership. At RMS, we are taking a clear, unambiguous position that our clients should manage their risks in a manner consistent with elevated levels of hurricane activity and severity,' stated Hemant Shah, president and CEO of RMS. 'We live in a dynamic world, and there is now a critical mass of data and science that point to this being the prudent course of action.'

The "market" (the insurers) sought leadership (higher rates), so RMS was in a competitive bind. If it did not raise rates, the market would likely go to modelers who did. So RMS acted and the other modelers are following suit. According to the *National Underwriter's* Online Service (March 23, 2006): "Two other modeling vendors—Boston-based AIR Worldwide

[9] Risk Management Solutions, "U.S. and Caribbean Hurricane Activity Rates," March 2006, page 1.
[10] Risk Management Solutions, "U.S. and Caribbean Hurricane Activity Rates," March 2006, page 4.

and Oakland, Calif.-based Eqecat—are also in the process of reworking their hurricane models." It is shocking and unethical that scientists at these modeling firms, under pressure from insurers, appear to have completely changed their minds *at the same time* after over a decade of using models they assured the public were scientifically sound.

Insurers often try to position supposedly objective and independent third parties as the public decision-makers when it is insurers themselves who want to increase rates. For decades, the third parties that often performed this function were ratemaking (advisory) organizations such as ISO. At least ISO and other rating organizations were licensed by the states and subject to at least nominal regulation, because of the important impact they had on rates and other insurance tools, such as policy forms.

More recently, insurers have utilized new third party organizations (like RMS) to provide information (often from "black boxes" beyond state insurance department regulatory reach) for key insurance pricing and underwriting decisions, which helps insurers to avoid scrutiny for their actions. These organizations are not regulated by the state insurance departments and have a huge impact on rates and underwriting decisions with no state oversight. RMS is one such organization. Indeed RMS's action, since it is not a regulated entity, may be a violation of current antitrust laws.

INEFFICIENCY HARMS CONSUMERS

Because of market inefficiencies, exacerbated by the collusion allowed by the McCarran-Ferguson antitrust exemption, high expense insurers with commensurate high prices can charge whatever is needed to cover their inefficient operations or even more and, like Allstate in Philadelphia, still retain significant market share.

Inefficiency abounds in insurance, as the attached spreadsheet reveals (Attachment B). If competition was more effective, significant cost savings (savings in the double digits) could be expected. The spreadsheet contains data compiled by AM Best and Co. showing expenses as a ratio of premiums for all major insurers and aggregate expense information for the entire property/casualty insurance industry.

The first three columns of numbers are the expenses for the entire industry. The spreadsheet shows, by major line of insurance, the loss adjustment expense and the underwriting expenses and the total of these two expense ratios. The loss adjustment expense is the cost of settling claims, including defense attorney costs, adjusters' costs and other claim-related expenses. The underwriting expense includes the costs of policy writing, agent and broker costs, overhead costs and other business expenses, with the exception of loss adjustment costs.

The next three columns show similar data but for a specific efficient and large (at least one percent of the national premiums in the line of insurance shown) insurance company.

The final two columns are calculations made by CFA to show the potential savings if competition were enhanced. The first of the two columns shows the savings that would occur if the average expense ratio of all insurance companies were lowered to that ratio enjoyed by an efficient insurer. The final column on the spreadsheet shows the savings that would occur if the expense ratio of the inefficient insurer were lowered to the average expense ratio of all insurance companies.

CFA believes that application of antitrust laws to the insurance industry could result in double-digit savings for America's insurance consumers of at least ten percent. Our study shows remarkable potential benefits for consumers if the antitrust exemption is removed and states do a better job of regulating insurers.

ELIMINATING THE ANTITRUST EXEMPTION HAS HELPED CONSUMERS IN CALIFORNIA

The proof that competition and regulation can work together in a market to benefit consumers and the industry is the manner in which California regulates auto insurance under Proposition 103. Indeed, that was the intent of the drafters of Proposition 103. Before Proposition 103, Californians had experienced significant price increases under a system of "open competition." Proposition 103 sought to maximize competition by eliminating the state antitrust exemption, laws that forbade agents to compete, laws that prohibited buying groups from forming, and so on. It also imposed the best system of prior approval of insurance rates and forms in the nation, with very clear rules on how rates would be judged.

As our in-depth study of regulation by the states revealed,[11] California's regulatory transformation -- to rely on both maximum regulation and competition – has produced remarkable results for auto insurance consumers and for the insurance companies doing business there. The study reported that insurers realized very substantial profits, above the national average, while consumers saw the average price for auto insurance drop from $747.97 in 1989, the year Proposition 103 was implemented, to $717.98 in 1998. Meanwhile, the average premium rose nationally from $551.95 in 1989 to $704.32 in 1998. California's rank dropped from the third costliest state to the 20th.

I can update this information through 2003.[12] As of 2003, the average annual premium in California was $821.11 (Rank 20) vs. $820.91 for the nation. Since California went from reliance simply on competition as insurers envisioned it to full competition and regulation, the average auto rate went up by 9.8 percent while the national average rose by 48.7 percent -- a powerhouse result for consumers! [13]

Removing the antitrust exemption has been a key element in this successful transformation of California's insurance market.

BROOKS HEARINGS

I encourage you to carefully review materials from the last time Congress studied this matter: the hearings and report developed under Chairman Jack Brooks of the House Judiciary

[11] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," June 6, 2000, (www.consumerfed.org).
[12] State Average Expenditures & Premiums for Personal Automobile Insurance in 2001, NAIC, July 2005.
[13] Insurers have posted excellent profits as well. Over the decade ending in 2004, California insurers enjoyed a return on equity for private passenger auto insurance of 11.1 percent vs. 8.5 percent for the nation (Report on Profitability by Line by State 2004, NAIC).

Committee in the early to mid 1990s. You will find that a long list of organizations supported reform: from labor to business, from consumer groups to the ABA.

In 1994, the House Judiciary Committee issued its report. A compromise proposal emerged after years of negotiation that both we at CFA and the American Insurance Association (AIA) supported. It would have only controlled trending by insurers where groupings of "rivals" in bureaus like ISO cooperated in the ratemaking process to project pricing into the future. The compromise would have also prohibited joint final price fixing, allowed today. The idea was to end the situation under McCarran where a state law on the books – no matter how weak or unenforced – trumps federal antitrust enforcement. This system, which produces extremely weak consumer protection results, would be replaced by the more normal American system known as the state action doctrine, which would require active supervision by a state that wanted to allow collusive behavior in the insurance market. The bill was passed out of the House Judiciary Committee on a bipartisan vote.

That bill would have been a good step forward in 1994, so we agreed to the compromise. In the intervening years, we have had another hard market made possible by Congressional inaction on McCarran reform. We have had shocking revelations by Attorney General Spitzer of bid rigging and kickbacks, where the most sophisticated insurance buyers were duped. We have seen reverse competition, where kickbacks to intermediaries have caused extreme increases in prices of title insurance, credit insurance and other lines.

Given these new outrages, CFA believes that the compromise we agreed to in 1994 would be too little, too late in 2006. We now believe that only a complete repeal of the antitrust exemption will achieve the reforms that are necessary to end these anticompetitive abuses.

CONCLUSION

Congress should end the long history of insurance industry collusion and anticompetitive behavior. This behavior routinely costs consumers more money than a competitive market would because insurers can cooperate in price setting. The business cycle of the property/casualty insurance industry is exacerbated by the availability of pure premium and other rate guides the rate bureaus publish. These guides are not used by many insurers during the "soft" market periods but become a kind of safe harbor when the periodic hard market strikes the commercial property/casualty market.

As insurers push for more pricing freedom, I always ask them where they stand on repeal of the McCarran-Ferguson antitrust exemption. It seems pretty obvious to me that it is folly to deregulate an industry with cartel structures still in place (I happen to believe that insurance is not a good product to deregulate for reasons expressed earlier in this testimony).

Public and media support for ending this antitrust exemption has been quite strong for a very long time. Over the decades:

- *Business Week* editorialized that "The Insurance Cartel is Ripe for Busting."[14]

[14] April 11, 1988.

- *The Journal of Commerce* called for an "End to McCarran Ferguson."[15]

- *The New York Times* asked Congress to "Bust the Insurance Cartel."[16]

- *The Los Angeles Times* wanted Congress to take "New Action on an Old Proposal to End Cartel-Like Conditions."[17]

- When the House Judiciary Committee last studied eliminating or scaling back the antitrust exemption, there was much support. Consumer groups, small business groups, AARP, the American Bar Association, the American Bankers Association, labor unions, medical groups and others supported the effort. The American Insurance Association participated in lengthy discussions with the Committee staff and consumer advocates to try to determine a way to cut back the exemption.

- Every independent study of the McCarran-Ferguson Act's antitrust exemption has concluded that it should end.

It is time to heed the advice of federal study after federal study. It is time to heed the advice of business consumers and simple American consumers. It is time to heed the call of editorial writers. It is time for Congress to repeal the antitrust exemption of the McCarran-Ferguson Act!

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[15] May 25, 1988.
[16] May 4, 1991.
[17] June 12, 1991.

STATEMENT OF THE
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA, INC.
BEFORE THE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
HEARING ON

"The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption"

June 20, 2006

This statement is submitted for the hearing record by the Independent Insurance Agents and Brokers of America, Inc. (IIABA), whose members and their employees have a vital interest in subject of today's hearing. IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a nationwide network of more than 300,000 agents, brokers, and their employees. IIABA represents independent insurance agents and brokers who present consumers with a choice of policy options from a variety of different insurance companies. These small, medium, and large businesses offer all lines of insurance – property, casualty, life, health, employee benefit plans, and retirement products.

Limited Scope of the Present Exemption

The McCarran-Ferguson Act provides a limited exemption not to insurers or any particular entities, but rather to the "business of insurance" from the federal antitrust laws. The entities in the industry are not exempt in anyway for conduct that is not part of that core activity. Moreover, the Act provides that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act only apply to the business of insurance "to the extent that such business is not regulated by state law." Further, even that limited exemption from federal antitrust law does not extend to "any agreement to boycott, coerce or intimidate, or act of boycott, coercion, or intimidation," which remain subject to the Sherman Act.

The Act also declares that the business of insurance shall be subject to regulation and taxation by the states. After passage of the Act in 1945, all states adopted or retained some form of rate (and form) regulation to qualify for the exemption. Over time some of these states have enacted legislation limiting such regulatory review – particularly for commercial insurance. The practical import of the antitrust exemption has, to some extent, been eroded over the decades as courts have narrowed the definition of the "business of insurance" and broadened the definition of "boycott," and as an increasing number of states have subjected the insurance industry to state antitrust law.

Litigation regarding the scope of the federal antitrust exemption has involved the meaning of the terms "business of insurance" and "regulated by state law," and the question of what constitutes a "boycott." Supreme Court decisions regarding the scope of the phrase "the business of insurance" focus on three elements: the "spreading and underwriting of a policyholder's risk," the direct connection of the activity to the contractual relationship between the insurer and insured, and whether the allegedly anticompetitive practice is "limited to entities within the insurance industry." Regulation by the state has been held to mean regulation of the relationship between the insurance company and the policy-holder, and not regulation of other aspects of the insurer's business. (The degree of regulation required to meet this standard generally is less than the "active supervision" with "intent to displace competition" required for the state action[1] doctrine to apply.) The courts have also held that a "boycott" need not be an absolute refusal to deal on any terms, but can "be conditional, offering its target the incentive of renewed dealing if and when he mends his ways;" the boycott must extend beyond the targeted transaction, so that "unrelated transactions are used as leverage to achieve the terms desired."[2]

Several courts have held that the McCarran-Ferguson Act does not exempt mergers from antitrust review.[3] The business of insurance also remains subject to state antitrust laws.

The Insurance Marketplace

Any consideration of McCarran-Ferguson Act repeal must begin with a look at the structure and competitive state of the insurance sector. The insurance marketplace is highly competitive, and both personal and business consumers are generally well-served as a result. Insurance buyers have an array of options when they buy insurance. As of year-end 2003, there were more than 2,700 property-casualty insurers, approximately 1400 life insurers, 585 health insurers or HMO plans, and over 2,500 other county mutuals, farm mutuals, auto services companies and specialty insurers not counted in the previous categories.

According to the Insurance Services Office, Inc. (ISO), concentration in the property-casualty insurance sector barely increased in the past quarter-century from 229 in 1980 to 341 in 2004 on the Herfindahl scale, used to measure market concentration. The U.S. Department of Justice classifies any score under 1,000 as un-concentrated. A score over 1,800 means an industry is highly concentrated.

Distribution channels in the industry are evolving and multiple in form. Overall, there are approximately 3.5 million licensed insurance producers (agents and brokers) in this country authorized by state regulators to sell, solicit, or negotiate insurance. Consumers can choose to purchase insurance from captive agents (who sell the products of only one insurer), from insurers that sell insurance directly to consumers, or from one of the nearly 40,000 independent agencies in the country that have access to the products of multiple companies.

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[1] Under the state action doctrine, private action taken pursuant to a clearly articulated policy of one of the states to displace competition and subject to the active supervision of the tate is immunized from antitrust liability. This principle applies for any industry, not just insurance. The Supreme Court has held that general prohibitions against unfair practices, combined with authorized enforcement, constituted sufficient regulation under the McCarran-Ferguson Act.

[2] Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993).

[3] See, for example, American General Insurance Co. v. FTC, 359 F.Supp. 887 (S.D. Tex. 1973); Maryland Casualty Co. v. American General Insurance Co., 1964 Trade Cas. 71,188 (D.D.C. 1964).

The independent agency system plays an especially important role in the marketplace. This system is unique from the other distribution channels in that such agencies maintain relationships with multiple insurers and can offer more choice to customers. In fact, on average nationally, they offer policies from eight personal lines and seven commercial lines carriers per agency. Independent insurance agents and brokers invest substantial effort to identify consumers' wants and needs; understand the complex terms of policies available; assess the products available and present choices to the consumer about coverage, price, service, and financial strength of carriers; and remain available to assist with any questions and changes as needed. Independent agents are not locked into one company's policies or products; since they can access multiple companies, they can help consumers locate coverage that is tailored to fit specific needs and desires.

Independent agents who sell both business and personal lines insurance are in a position to witness the effects of this intense competition on the ground floor of the marketplace every day. Indeed, producers are in their own competition, with their customers being approached and solicited regularly by competitors. Such competition keeps agencies responsive and accountable, and helps ensure that consumers are well-served. If an insurance provider ultimately offers a buyer insurance terms that are below par, prices that are inexplicably higher than others, or service that does not create a value proposition for the purchaser, that buyer will move its business to another agent or channel of distribution.

The business of insurance is not unique in having a qualified exemption from full application of the federal antitrust laws, but it is perhaps unique among those industries in having a comprehensive state-level system of regulation and antitrust enforcement.

A vibrant system of state regulation of insurance exists under McCarran-Ferguson and is probably the most important factor behind (1) the level of competition within the industry and (2) the continued robust financial health of insurers even in the face of extraordinary challenges in most years (e.g., 9/11, four major hurricanes in 2004 followed by catastrophic losses in 2005 from Katrina and Rita). In fact, this state regulatory oversight, supplemented by state and federal law enforcement has produced vibrant competition in the marketplace In nearly every aspect of the insurance marketplace and certainly in main street America, the existence of effective competition serves as a check and a balance to monopolistic conduct. While there are certainly imperfections in insurance markets, particularly availability in some difficult-to-insure lines, and occasionally affordability issues in isolated sectors, there is little evidence or reason to believe that the problems and challenges confronting the industry would be lessened or improved by a wholesale change to the McCarran-Ferguson Act antitrust qualification.

Compelling Reasons Need to be Shown Before Disturbing the Current Balance

Insurers are in the business of assuming risk. Collective activities that increase information or spread risk among insurers tend to reduce the price of insurance. Collective action is important for loss forecasting and pricing accuracy.

Certain functions, such as standardizing policy forms, pooling and analyzing data, and estimating loss development and trends, have traditionally been performed by rate service organizations, such as ISO and NCCI. Obviously, the information gains from data pooling are greatest for small insurers. Even large insurers benefit from data pooling in unpredictable lines, particularly in states and lines where their own experience is relatively thin. In commercial lines there are also advantages for large buyers with multi-state operations in obtaining coverage for all their exposures in all states from a single insurer. By using ISO rates or loss costs as a benchmark, insurers can satisfy those demands at reasonable risk even in states or lines where they do not have a large market share. All of this is potentially pro-competitive.

Some cooperation on the design of policy forms is acceptable because it facilitates price comparisons for producers and consumers. Also important but less widely recognized, use of common forms is essential for meaningful pooling of data. Some risk sharing through risk pools also generally increases the availability of coverage. Congress should take care not to destroy these pro-competitive benefits.

Repeal might actually <u>reduce</u> competition, <u>increase</u> the cost of insurance, and <u>reduce</u> the availability for some high-risk coverages, because the threat of antitrust litigation could make insurers unwilling to engage in efficiency-enhancing cooperative activities.

It is possible – indeed very likely – that, in the absence of McCarran-Ferguson, reasonable joint activities including most practices in the industry today would be protected under general antitrust principles, including the above-mentioned "state action" doctrine. As stated earlier, the state action doctrine preempts federal antitrust surveillance of activities that are regulated by the individual states. However, there is considerable uncertainty as to just how detailed the state regulation must be to qualify for the exemption. Thus, one possible outcome of repeal of McCarran-Ferguson is that at least some states would adopt <u>more</u> stringent regulation. If collective activities are protected by increased state regulation, proponents of competitive insurance markets would have won the battle but lost the war.

CONCLUSION

IIABA believes that the financial condition and state of competition and consumer choice in the insurance marketplace today are quite high. A vibrant system of direct state supervision/law enforcement supplemented by a qualified application of federal antirust law/law enforcement appears to have served the industry and the consuming public well. We see little reason or evidence for making wholesale changes to the antitrust system which now applies to the insurance sector. We urge the Committee to be deliberate in its consideration of this subject and in particular and at minimum to await the report of the Antitrust Modernization Commission which Congress established less than two years ago to study a variety of antitrust issues including the multiplicity of existing exemptions and privileges of which McCarran-Ferguson is only one.

AMERICAN BAR ASSOCIATION
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STATEMENT OF DONALD C. KLAWITER

Chair, Section of Antitrust Law

On Behalf of the
AMERICAN BAR ASSOCIATION

Before the
Committee on the Judiciary
United States Senate
Concerning
THE McCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING THE INSURERS' ANTITRUST EXEMPTION

June 20, 2006

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to present the views of the American Bar Association on the subject of the insurance exemption from the antitrust laws, known as the McCarran-Ferguson Act of 1945. My name is Donald C. Klawiter, and I am the Chair of the Section of Antitrust Law of the American Bar Association and a partner in the Washington, DC office of Morgan, Lewis & Bockius LLP. I am appearing on behalf of the American Bar Association and its President, Michael Greco. My testimony today reflects the position of the American Bar Association.

I commend the Committee for its consideration of the repeal of the antitrust exemption for the insurance industry. Industry-specific exemptions from the antitrust laws are rarely justified. The antitrust law, and more specifically, the Sherman Act, has served the nation well for 115 years because it is a simple and very flexible statement of competition policy that is interpreted by the courts based on the facts and circumstances of each particular case. The interpretation of the Sherman Act certainly can apply across many industries with unique issues – and the insurance industry is certainly no exception. The benefits of antitrust exemptions almost never outweigh the potential harm imposed on society by the loss of competition. Such exemptions often are not necessary to eliminate or limit the risk of antitrust liability for procompetitive conduct, and the goals of such protection can be achieved in a manner consistent with established antitrust principles and enforcement policy.

The American Bar Association favors repeal of the McCarran-Ferguson Act, which largely exempts the insurance industry from the antitrust laws. We believe that the law should be replaced by a series of safe harbors to make clear that certain types of conduct by insurers are procompetitive and beneficial to the American economy. Other than the safe harbors, it is our strong position that insurance industry should be subject to the same antitrust rules as other industries. Congress has, in the past, eliminated exemptions for many industries with the demonstrable result that competition increased and flourished after the elimination of the exemption. The American economy, its consumers and the insurance industry will benefit in the long-run from the discipline of free and open competition among insurers.

Why do we have an antitrust exemption for the insurance industry? I believe a brief historical review is helpful. In the latter half of the 19th century, dramatic growth in the fire insurance industry led to increased interest by the states in the regulation and taxation of insurance companies. In response, insurance companies, seeking to avoid such regulation, challenged the states' authority to regulate the insurance industry, contending that such regulation constituted a violation of the Commerce Clause. However, in *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868), the United States Supreme Court rejected the insurers' position, holding that the Commerce Clause did not preclude the states from regulating insurers.

In the wake of the *Paul* decision, state regulation of insurance increased significantly. Then, in 1944, the United States Supreme Court, in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), effectively overruled *Paul,* holding that insurance was interstate commerce and should be regulated under the Commerce Clause. In response, the very next year, Congress enacted the McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq.*

The Act provides the insurance industry with a limited exemption from the federal antitrust laws. Specifically, the McCarran-Ferguson Act exempts conduct if that conduct (1) constitutes "the business of insurance" (2) is "regulated by State Law" and (3) does not amount to an "agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation." All three prongs of the McCarran-Ferguson Act must be satisfied for the exemption to attach to an insurer's conduct.

In determining whether conduct qualifies as "the business of insurance" under the McCarran-Ferguson Act's first prong, the courts have considered the following factors: (1) whether the activity has the effect of transferring or spreading a policyholder's risk; (2) whether the activity is an integral part of the policy relationship between insurer and insured; and (3) whether the activity is limited to entities within the insurance industry. *See Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119 (1982); *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979). Notably, no single factor is determinative on this issue.

As to the second prong, courts have held that an activity is regulated by state law if the insurer is subject to general state regulatory standards. In addition, the quality of the regulatory scheme, or its enforcement, does not influence the availability of the exemption. *Hartford Fire Ins. Co. v. California*, 509 U.S. 794 (1993).

Finally, with respect to the third prong, the Supreme Court in *Hartford Fire* held that a boycott occurs, thus subjecting insurer conduct to the federal antitrust laws, when a refusal to deal is designed to pursue an objective "collateral" to the terms of the transaction in which the refusal to deal occurs.

The perception is widely held that the McCarran-Ferguson exemption from the antitrust laws permits insurers to manipulate the insurance mechanism and the price of insurance coverage collusively. Many claim that the exemption produces anticompetitive results to the detriment of consumers throughout the country. Specifically, proponents of repeal have claimed that:

(1) rate service organizations facilitate collusion on prices;

(2) consumers are often forced to purchase coverage they do not want to obtain the coverage they desire. These tying arrangements can be anticompetitive because they force consumers to pay for less desirable products to get high-demand products, especially when the tying is pervasive on a market-wide basis;

(3) insurance companies are permitted to control the price at which insurance is offered to consumers, which reduces competition among agents; and

(4) insurance companies are permitted to engage in market allocations, which control the number of competitors in a market and reduces competition.

Nearly twenty years ago, the American Bar Association formed a commission to study, among other things, the important policy issues associated with the application of the U.S. antitrust laws to the business of insurance. Following two years of discussion and debate, the ABA adopted a resolution recommending the repeal of the McCarran-Ferguson exemption to the antitrust laws, to be replaced by a series of safe harbors defining certain categories of exempt conduct.

The current activities of the Antitrust Modernization Commission, which will issue its report to the Congress in 2007, provide the opportunity and impetus for the antitrust bar generally, and the Section of Antitrust Law specifically, to revisit the issues associated with the McCarran-Ferguson antitrust exemption. The Section of Antitrust Law formed a task force of many of the most respected antitrust practitioners and academics to study various issues being considered by the Antitrust Modernization Commission. The Section, through the work of the task force, prepared a variety of different comments, including comments on the area of exemptions and immunities generally and on the McCarran-Ferguson exemption specifically. Just a week ago, the Section presented a symposium on important issues under consideration by the Antitrust Modernization Commission, and a panel of distinguished practitioners and academics discussed exemptions and gave specific focus to the need to "modernize" the insurance industry exemption. The comments of the Section of Antitrust Law to the Antitrust Modernization Commission on exemptions, and its specific comments on McCarran-Ferguson, restate and reaffirm the ABA's thinking and recommendations from the late 1980s. The ABA recommendations are attached to this statement for your convenience.

It is the view of the American Bar Association that all conduct that does not fall within the specific safe harbors should be subject to the same antitrust rules that are applied to all other sectors of the American economy. The state action doctrine, which immunizes certain conduct from antitrust liability that arises from government action, should only immunize the conduct of insurance companies to the extent that conduct falls within one or more of the safe-harbors outlined in the attached ABA policy. The safe harbors are not intended to alter existing antitrust policy. They are intended merely to deter private litigation challenging conduct that, in the unique circumstances of the insurance industry, may actually promote competition.

Specifically, the ABA recommendation recognizes the benefits of safe harbors for the following conduct by insurance companies:

(1) Insurers should be authorized to cooperate in the collection and dissemination of past loss-experience data so long as those activities do not unreasonably restrain competition, but insurers should not be authorized to cooperate in the construction of advisory rates or the projection of loss experience into the future in such a manner as to interfere with competitive pricing.

(2) Insurers should be authorized to cooperate to develop standardized policy forms to simplify consumer understanding, enhance price competition and support data collection efforts, but state regulators should be given authority to guard against the use of standardized forms to unreasonably limit choices available in the market.

(3) Insurers should be authorized to participate in voluntary joint-underwriting agreements in connection with such agreements to cooperate with each other in making rates, policy forms, and other essential insurance functions, so long as these activities do not unreasonably restrain competition.

(4) Insurers participating in residual market mechanisms should be authorized in connection with such activity to cooperate in making rates, policy forms, and other essential insurance functions so long as the residual market mechanism is approved by and subject to the active supervision of a state regulatory agency.

(5) Insurers should be authorized to engage in any other collective activities that Congress specifically finds do not unreasonably restrain competition in insurance markets.

These safe harbors are intended to protect legitimate procompetitive joint activity by insurers while still subjecting the insurance industry to the antitrust rule of law. While much, if not all, of the safe harbor conduct would be permissible or even encouraged under current antitrust precedent, the idea of the safe harbors is to remove all doubt, and hence to discourage private suits challenging such procompetitive conduct.

The American Bar Association position also makes clear that the states should retain the authority to regulate the business of insurance, except in the unusual circumstances where the regulatory objective can only be accomplished through federal involvement.

While this hearing is considering the broader implications of the antitrust exemption for the business of insurance, I wish to comment briefly on S.1525, which would remove the antitrust exemption in the medical malpractice insurance area. S.1525 is an outstanding first step along the road to a sensible application of the antitrust laws to the insurance industry and seeks to ensure that the same rules of competition apply to the insurance industry as apply to all other aspects of American business. The same concerns and considerations that animate S.1525 apply with equal force to areas of the insurance industry outside of the medical malpractice context. Moreover, Section 3 of S. 1525 provides for what we have referred to as safe harbors for certain procompetitive conduct. We would urge the Congress to spell out those safe harbors more expressly in any legislation.

I would add one word of caution regarding the specific language of S. 1525. Just as the insurance industry should not be subject to an antitrust exemption, it should not be subject to a more rigorous antitrust standard than the rest of American industry, and I do not believe that the bill's intention is to impose more demanding antitrust standards on the insurance industry. The language of the bill, however, could be read to condemn activity that would be permissible under the antitrust laws. Some activities that could be labeled by some as "price fixing" or "market allocation" could have procompetitive justifications that would make them permissible under the antitrust laws. For instance, the antitrust laws generally permit manufacturers to set exclusive territories for their downstream distributors, even though such conduct could be construed as vertical "market allocation." These terms have very specific meanings in the existing case law relating to the Sherman Act and it should clearly not be the intent of this very constructive legislation to place a greater burden on the insurance industry than on other industries.

Thank you for the opportunity to appear before you today to present the views of the American Bar Association. Legislation to repeal the McCarran-Ferguson antitrust exemption and replace it with the safe harbors outlined above promises to serve consumers by promoting competition in the insurance industry. Competition is the hallmark of the American economy. The United States has very successfully spread the gospel of competition to the rest of the world – with remarkable results in international acceptance and enforcement over the past ten years. Special treatment for certain industries makes us look inconsistent or even hypocritical to those we seek to educate and influence in the rest of the world. The American Bar Association believes strongly that competition in the insurance industry can be enhanced, consistent with necessary joint activities, to the benefit of all segments of our society.

I would be happy to answer any questions you may have.

Resolution Adopted By The
American Bar Association
House of Delegates
February 1989

BE IT RESOLVED, That the American Bar Association adopts the following recommendation:

1) The current McCarran-Ferguson exemption to the antitrust laws should be repealed and replaced with legislation containing the following features:

(1) Insurers should be made subject to general antitrust laws but provided with authorization to engage in specified cooperative activity that is shown to not unreasonably restrain competition in the industry.

(2) Insurers should be authorized to cooperate in the collection and dissemination of past loss experience data so long as those activities do not unreasonably restrain competition but should not be authorized to cooperate in the construction of advisory rates or the projection of loss experience into the future in such a manner as to interfere with competitive pricing.

(3) Insurers should be authorized to cooperate to develop standardized policy forms in order to simplify consumer understanding, enhance price competition and support data collection efforts, but state regulators should be given authority to guard against the use of standardized forms to unreasonably limit choices available in the market.

(4) Insurers should be authorized to participate in voluntary joint underwriting agreements and in connection with such agreements to cooperate with each other in making rates, policy forms, and other essential insurance functions so long as these activities do not unreasonably restrain competition.

(5) Insurers participating in residual market mechanisms should be authorized in connection with such activity to cooperate in making rates, policy forms, and other essential insurance functions so long as the residual market mechanism is approved by and subject to the active supervision of a state regulatory agency.

(6) Insurers should be authorized to engage in such other collective activities that Congress specifically finds do not unreasonably restrain competition in insurance markets.

(7) State regulation of insurance rates should not exempt insurers from the antitrust laws under the state action doctrine, except as specified in Recommendation B.1(1) to B.1(6). Other non – rate regulation by a state should not exempt insurers from the antitrust laws unless that regulation satisfies the requirements of the state action doctrine and the regulation is shown to not unreasonably restrain competition.

2) States should retain the authority to regulate the business of insurance. The federal government should defer to state regulation except in those unusual circumstances where the regulatory objective can only be effectively accomplished through federal involvement.

U.S. SENATOR PATRICK LEAHY

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Statement of Senator Patrick Leahy
Ranking Member, Judiciary Committee
Hearing on "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption"
June 20, 2006

As far back as 1945, the insurance industry has operated largely beyond the reach of federal antitrust laws. The McCarran-Ferguson Act created this exemption, and so long as the insurance business is regulated by the states, there is no room for federal oversight. Perhaps this was well-advised legislation at the time, and perhaps it served worthwhile policy. But times changed.

A common refrain of tort reform proponents is that "out-of-control juries" and large malpractice awards drive insurance costs higher. Medical professionals, we are told, are being crushed by the excessive costs of insurance. Just recently, the Senate considered legislation to cap punitive damage awards in medical malpractice cases. Yet, among the 15 best-rated medical malpractice insurance providers, premiums rose dramatically between 2000 and 2005 while the cost of claims paid out remained flat. If claims are not driving premiums, but insurance costs among competing companies are rising in lockstep with each other, it is time to admit that there are other causes of this problem.

I have introduced a bill – S. 1525, The Medical Malpractice Insurance Antitrust Act of 2005 – along with Senators Kennedy, Durbin, Rockefeller, Boxer, Feingold, Salazar, Obama, and Mikulski. This bill would repeal the antitrust exemption for medical malpractice insurance, and only for the most egregious cases of price fixing, bid rigging, and market allocation. It is a narrow bill that targets a particularly troublesome aspect of the problem, but I believe that we should consider all of the effects of the exemption as we consider legislation.

If insurers around the country are operating in an honest and appropriate way, they should not object to being answerable under the same federal antitrust laws as virtually all other businesses. American consumers, from sophisticated multi-national businesses to individuals shopping for personal insurance, have the right to be confident that the cost of their insurance reflects competitive market conditions, not collusive behavior.

I recognize that the insurance industry has unique characteristics, including the dependence on collective claim and loss data, but I am confident that we can accommodate those legitimate needs while still providing Federal regulators with the tools to investigate and prevent collusion and other anticompetitive behavior. Individuals and businesses are compelled, sometimes by the law and sometimes by prudence, to purchase many kinds of insurance. We must ensure that those citizens are being treated fairly, and that the providers of the product are not stifling competition in the marketplace.

I thank our panel for their testimony today, and I also thank Chairman Specter for his efforts in convening this hearing.

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Testimony of the National Association of Insurance Commissioners

Before the
Committee on the Judiciary
United States Senate

Regarding:
State Regulation of Insurance Under
the McCarran-Ferguson Act

Tuesday, June 20, 2006

Michael McRaith
Illinois Director of Insurance
Chair, Broker Activities Task Force
National Association of Insurance Commissioners

Testimony of Michael McRaith
Chair, Broker Activities Task Force
National Association of Insurance Commissioners

Introduction

Chairman Specter, Senator Leahy, and Members of the Committee, thank you for inviting me to testify before the Committee on the McCarran-Ferguson antitrust exemption.

My name is Michael McRaith. I am the Director of Insurance in Illinois, and I serve as Chair of the Broker Activities Task Force of the National Association of Insurance Commissioners (NAIC). Prior to becoming Director of Insurance, I was personally involved for fifteen years as a private attorney with complex commercial litigation, including antitrust and insurer financial issues. I am pleased to be here today on behalf of the NAIC and its members to provide the Senate Committee on the Judiciary with our views concerning the efficacy of state regulation of insurance and the antitrust exemption for insurance activities granted by the McCarran-Ferguson Act. In addition, my testimony will highlight how the NAIC continued its tradition of collaborative leadership last year to address broker compensation practices and related misconduct.

Today, I will make four basic points:

- First, insurance is a unique, complex and personal product that is much different from other financial services, such as banking and securities. Whereas other financial products—either debt or equity—are about taking risk in order to make money, insurance is precisely the opposite. The insurance consumer seeks to protect what he or she has by transferring risk to another. A fundamental precept of financial planning is: (1) buy insurance (to protect what you have) and then (2) invest (to get more). Regulating insurance is therefore fundamentally different from regulating banking and securities products because its focus is on protecting the underlying interest of consumers—their property, their health, their businesses, and their lives. The value of these assets and the cost to protect them from risk depends greatly upon local demographics, geography, and individual needs. Although insurer solvency is our central concern, the overall purpose of insurance regulation is protecting the lives and property of consumers and businesses rather than monitoring the profits of insurers.

- Second, the NAIC believes the limited federal antitrust exemption for the "business of insurance" has worked well for decades to maintain a vigorous and competitive marketplace. Congress recognized the unique nature of insurance when it enacted the McCarran-Ferguson Act in 1945 to authorize continued state-supervised sharing of loss-related information among competing insurers. As the true cost of insurance is not known at the time the product is sold, insurers need to have collective data about loss experience and claims before they price their products. This type of data sharing, which would be illegal under the Sherman Act absent the exemption, also allows new insurers to enter markets for which they have no independent data. Ultimately, the competition fostered by the exmption benefits both individual consumers and businesses, from large multi-national corporations to small firms in every rural county.

- Third, state insurance officials and attorneys general play complementary roles in monitoring insurers, agents, and brokers to prevent and punish activities prohibited by state antitrust and unfair trade practices laws. Supervision of the "business of insurance" by state insurance departments involves careful review and regulation of solvency and policy terms to assure the public that insurers will meet their promises. It also involves monitoring and investigating anti-competitive, unfair, and deceptive trade practices—and taking enforcement action, where appropriate. State attorneys general likewise take action under state antitrust and unfair trade practices laws when evidence of insurer or agent wrongdoing arises.

- Fourth, the state system continues to operate as Congress intended when it enacted McCarran-Ferguson—it prevents and punishes anti-competitive practices. A recent example of effective state-based regulation is our effort over the past two years to address wrongdoing and potential conflicts of interest by insurance brokers and carriers. The attorneys general in several states pursued enforcement actions and investigations with assistance from their state insurance departments. At the same time, the NAIC developed and implemented a reasoned but aggressive program to better protect consumers by: (1) adopting a new model language on broker disclosure of compensation arrangements to consumers, (2) coordinating multi-state information requests, investigations, and analyses of business practices by brokers and insurers, and (3) launching an online system that permits anonymous reporting of "tips" to alert state regulators about a carrier's or agent's unlawful or unscrupulous business practices.

Insurance: A Unique Financial Product that Requires State Supervision

Paying for insurance products is one of the largest and most important consumer expenditures for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure transfers to an insurer the risk of financial loss, thereby protecting consumers' health, families, homes, and businesses. Consumers clearly have an enormous financial and personal stake in making sure that insurers keep their promises.

For state regulators, protecting consumers must start with a basic understanding that insurance is a business offering distinctly different products from banking and securities. Banks give consumers the immediate benefit of up-front loans based upon a straight-forward analysis of a customer's collateral and ability to pay, whereas securities can be bought by anyone willing to pay the price set by open markets. In contrast, insurance is a risk transfer product that consumers—either personal or commercial—buy in advance in exchange for a financial guarantee of future benefits when specified events occur. For personal lines, insurers take into account each customer's potential loss claims, depending on personal characteristics such as gender, age, financial situation, place of residence, type of business, "risk management" preparations, or lifestyle choices.

Insurance thus is based upon a series of constant but unique business analyses: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy terms? All of these considerations add up to one absolute certainty—insurance products can generate a high level of consumer confusion and dissatisfaction that require focused regulatory expertise and resources.

Every day, state insurance departments ensure that insurers meet the reasonable expectations of American consumers—including those who are elderly or low-income—with respect to financial safety and fair treatment. Nationwide in 2004, state insurance departments handled approximately 3.7 million consumer inquiries and complaints regarding the content of the policies and the treatment of consumers by insurance companies and agents. Many of those calls were resolved successfully at little or no cost to the consumer.

The states also maintain a system of financial guaranty funds that cover personal losses of consumers in the event of an insurer insolvency. The entire state insurance system is authorized, funded, and operated without cost to and without involvement by the federal government.

State Supervision of Insurer Pricing and Sales Practices Is Long-standing

Competitive forces generally produce the lowest prices and broadest array of goods and services for insurance consumers. However, Congress and state legislatures a century ago recognized that the benefits of vigorous competition are undermined by unfair market manipulation and monopolies. Federal and state antitrust laws promote fair and free competition by defining, prohibiting, and punishing unfair trade practices that corrupt the marketplace. A large body of antitrust case law has developed to further define illegal anti-competitive practices.

General antitrust law is often adequate to protect competition in the marketplace. Certain industries, however, require more direct government involvement and more specific performance standards. States proactively began regulating the business of insurance in the 1850s—decades prior to congressional enactment of federal antitrust laws—because they realized the unique commercial and personal benefits of insurance posed unique opportunities for fraud and mismanagement. In addition to the marketplace problems addressed by the Sherman and Clayton antitrust laws, state regulators learned that insurance products carried additional risks of failure due to insolvency. Customers pay for an insurance policy in exchange for a promise of benefits that may be needed months or even years later, if at all, meaning that promised benefits may not be paid if an insurer mishandles policyholder premiums entrusted to its care.

The danger of insurer insolvency and a failure to pay legitimate policyholder claims is very real for reasons distinct from other financial products. Furthermore, the ability of customers to protect themselves against unfair trade practices is complicated by the nature of insurance products and the way they are sold. First, an insurance policy is simply a written promise to pay benefits at a later date in exchange for premium money received up front. Since an insurance policy does not require a physical product, manufacturing plant, or investment in resources that can be inspected by consumers, insurance is sold on the basis of sales promises and the reputation of the insurer, making it an attractive target for fraudulent behavior and mismanagement. Second, insurance is a product whose actual cost is uncertain at the time it is sold, which means poor underwriting and low-ball pricing can lead to insurance company failures. Third, because insurers are permitted to offer policies and set prices for different customers based on a host of individual personal criteria, detecting unfair trade practices is much more difficult. Fourth, the coverage terms and conditions of insurance policies are often very difficult for consumers to understand and compare at the time of purchase, meaning that unfair trade practices may not be detected until later when insurance claims are not paid or other evidence of impropriety comes to light.

As a result of the unique challenges associated with the insurance business, every state has laws that require regulators to monitor and intervene to make insurance markets more stable and fair. These laws prohibit insurance rates that are excessive, inadequate, or unfairly discriminatory. Most people instinctively see the need for states to prohibit price-gouging and discriminatory red-lining by insurance companies, but states also must take action against low-ball pricing because prices that are unjustifiably low will cheat consumers just as much as excessively high prices if an insurer's ability to pay claims is jeopardized. State regulators understand that an insurance policy that fails to pay legitimate claims is not insurance.

As Congress considers the impact of antitrust laws and unfair trade practices on the American economy and individual consumers, NAIC members believe that state supervision and intervention in insurance markets is absolutely critical to maintaining and improving the current highly competitive market. State action to mandate certain types of coverage, maintain market stability, and protect the rights of consumers is an essential part of the American insurance market—the most vigorous, respected, and trusted in the world. The insurance regulatory system in the United States is a model for developing countries around the world. Our nation's insurance system rests on consumer confidence, and the expertise and focus of state insurance officials ensure that the confidence of the insurance-buying public is justified.

The Federal Antitrust Exemption for Insurance Has Worked Well

Since 1945, the McCarran-Ferguson Act has permitted state supervision of anti-competitive activities by insurance companies without interference from the federal government. During that time, the insurance industry in the United States has grown exponentially, while remaining financially strong and highly competitive in offering a broad array of policies to consumers. The vast majority of insurers competing in the market are relatively small and may not be directly heard or seen in Washington, D.C. Economic census data from 2002 shows there were over 5,000 insurers with combined revenues of $1.2 trillion operating in the United States. Only 296 of those insurers had more than 500 employees, yet they accounted for more than 90 percent of total revenues. Thus, the delegation of authority to states contained in McCarran-Ferguson has been both successful and well tested by time and market changes.

Congress passed the McCarran-Ferguson Act in direct response to the U.S. Supreme Court's decision in *United States v. Southeast Underwriters Association*, 322 U.S. 533 (1944). The Supreme Court held, contrary to 70 years worth of precedent, that insurance transactions constitute interstate commerce, and thus are subject to federal regulation under the Commerce Clause of the United States Constitution. Following *S.E. Underwriters*, the NAIC became concerned that state insurance rate regulation would be found to violate the Sherman Act, and therefore lobbied Congress for a limited antitrust exemption. The NAIC's fundamental concern in the 1940s, a concern that continues to define the NAIC position on antitrust reform, is that the competitive benefits of collectively developing loss costs and policy language would be jeopardized by the insertion of federal antitrust authority in the insurance markets. The jeopardized benefits include: (1) standardized risk classifications and policy form language that make data more credible; (2) consolidated collection and analysis of data improve quality and aid smaller insurers with responsible rate-setting; and (3) publication of advisory loss costs and common policy forms make it less costly for competitors to enter or expand in the market.

In recognition of the counterintuitive fact that the limited antitrust exemption promotes competition, the McCarran-Ferguson Act includes this preemption clause: "the business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business, unless such act specifically relates to the business of insurance." In addition to the regulatory responsibility assigned to the states, McCarran-Ferguson exempts certain limited insurance activities from federal antitrust laws.

This limited exemption allows insurers to share loss data, which promotes healthy insurance markets by increasing the number and competence of the competition. Advisory organizations collect statistical information from many insurers and provide compiled information on loss costs to all their members. This, in turn, makes it much easier for small and medium-sized insurers to compete. Those insurers do not generate sufficient business volume to predict the future loss costs of policies they sell. Loss costs published by advisory organizations are absolutely vital to their ability to price policies effectively; without published loss costs, many of these smaller insurers would have to limit policy offerings or even leave the business to the much larger insurers.

Additionally, the antitrust exemption is central to other cooperative functions, such as residual market mechanisms and joint underwriting associations, which provide an important "safety net" for individuals and businesses unable to secure coverage in the voluntary market. This is especially important to satisfy state mandatory insurance requirements for automobile insurance, medical malpractice insurance, and workers' compensation.

It is important to emphasize that the current federal antitrust exemption is limited. Indeed, judicial rulings confirm the applicability of antitrust laws to insurance companies. To the extent that insurance companies engage in anticompetitive conduct not related to the business of insurance, federal antitrust authorities are unrestrained. For example, an anticompetitive agreement between an insurance company and a pharmacy would not likely be protected by the exemption.

The Two Tiers of State Insurance Supervision: Regulation and Law Enforcement

State insurance departments are not law enforcement agencies, but we effectively prevent unfair trade practices as part of our proactive mission to assure that insurers are solvent and treat consumers fairly. Every state has an Unfair Trade Practices Act that gives its insurance regulator power to investigate a variety of unfair practices and to impose fines and require corrective actions if a violation is found. As an example, the Unfair Methods of Competition and Unfair and Deceptive Acts and Practices law in Illinois prohibits boycotts, coercion and intimidation, discrimination on the basis of race or other protected class, misrepresentations of policy costs and benefits, unfair claims handling procedures, and various other fraudulent practices. In Illinois, as in other states, laws specifically prohibiting unfair trade practices are enforced by the insurance commissioner through a broad array of administrative powers.

State regulators' primary responsibility is to maintain the stability of insurance markets and products for the benefit of consumers. Every day conscientious and highly skilled regulatory professionals monitor business activities related to the two major obligations insurers owe to consumers—issuing sound policies and paying claims on time.

Market conduct exams are part of the monitoring system. State insurance officials supervise the market conduct of industry participants by reviewing their business operations through market analysis, periodic examinations, and investigation of specific consumer complaints. When consumers have complaints about homeowners, health, automobile, and life insurance, they readily contact their state insurance departments. State officials earn consumer trust, in part, because they know the towns, cities and communities in which consumers live, and the nuances of the local insurance marketplace. Insurance products are difficult for many consumers to understand. Consumers expect state governments to have appropriate safeguards and an effective local response if problems arise.

Insurers, agents, and brokers also must accept responsibility for maintaining a competitive and fair marketplace by reporting business practices that appear to be harmful, anti-competitive, or unethical to state regulators. Preventing and correcting market conduct problems requires that regulators and responsible business participants work together toward a common goal of strengthening stability and fairness in the marketplace. We achieve such stability through extensive daily monitoring of solvency, review of rates and policy forms, and evaluating market behavior.

In addition to being subject to these extensive regulatory and enforcement powers, insurers are subject to state attorneys general enforcement of state antitrust laws. Some state laws contain a limited exemption for certain insurance activities. A 50-state table of antitrust insurance exemptions is attached as an appendix to this testimony.

Given their primary role in the protection of insurance consumers, state insurance commissioners take pride in the historical fact that state-based regulation works very well to provide consumers with a healthy marketplace and confidence that the basic obligations set forth in their insurance policies will be met. When the marketplace functions without significant problems, it means that we are working successfully to protect consumers by maintaining competitive and stable insurance markets.

State Action to Address Broker Compensation Abuses and Conflicts of Interest

A recent example of the state system working successfully is our effort over the past two years to address wrongdoing and potential conflicts of interest associated with broker compensation. In October 2004, New York Attorney General Eliot Spitzer filed a civil complaint against a large brokerage firm that was preceded by months of investigation by the attorney general and more than a year of analysis by the New York Insurance Department. The civil complaint, which included claims based on violations of New York antitrust law, unfair business practice law, and common law fraud, has resulted in a number of guilty pleas on criminal charges of fraud related to bid-rigging. At least 17 guilty pleas and eight indictments have been entered based on related charges.

The charges stemmed from contractual and implied arrangements between insurers and brokers in which the insurer pays extra commissions to the broker based on a number of factors, such as the loss ratio or retention of business placed through the brokerage firm. These commissions were in addition to regular sales commission, and were often based on the performance of the insurer's entire book of business with an individual broker. Although these types of contingent commissions have been commonplace for more than a century, certain brokers and carriers were alleged to have "rigged" the competition. For example, a broker would steer a particular piece of business to one insurer based on a favorable commission structure. In some cases other insurers participated by offering less-attractive prices, called "B quotes," to steer a policyholder to the pre-selected insurer. It also was alleged that brokers would freeze out insurers with less favorable commission arrangements, regardless of whether the insurers fit a customer's needs. In terms of law enforcement and insurance regulation, this conduct constitutes fraud, an unfair business practice, and a violation of state antitrust law.

The system has worked because existing state consumer protection, antitrust, and unfair trade practice laws provide the necessary tools to stop anti-competitive conduct. Without admitting or denying the allegations against them, five of the nation's top brokers entered into consent agreements with a number of attorney generals and state insurance departments. The agreements establish settlement funds ranging from $27 million to $850 million, which are available to policyholders who release the brokers from any liability associated with the settlements. The NAIC applauds these broker settlements and advises consumers to consider agreeing to their terms.

When the original allegations surfaced in October 2004, the NAIC also appointed a 15-state task force to quickly develop a three-pronged national plan to coordinate multi-state action on broker compensation issues. The first prong of the NAIC's national action plan was to amend its existing Producer Licensing Model Act to require greater transparency of producer compensation in certain circumstances. The NAIC followed an accelerated time frame, adopting the amendment in December 2004 in order to have it available for 2005 state legislative sessions.

The focus of the NAIC model disclosure amendment is consumer protection. It does not prohibit payment of contingent commissions or restrict the ability of producers to receive appropriate compensation for the services they provide. Instead, it requires insurance agents and brokers to disclose their compensation arrangements, which in turn allows consumers to fully evaluate their own options. This approach respects business realities and market-driven forces, while at the same time putting a priority on consumer protection. To date, seven states have adopted all or part of the reforms in the NAIC amendment, and others are considering them. Four more states have issued bulletins since the allegations arose. These measures are in addition to existing statutory limitations or related disclosure regulations already on the books in many states. For example, one state barred contingent commissions in the mid-1980s. Also, by virtue of numerous settlements with brokers and carriers, written disclosure is becoming an effective industry standard.

The second prong of the NAIC's national action plan was to facilitate consistent regulatory action among the states, starting with the distribution of uniform templates for states to use in investigating broker compensation issues. Based upon the findings and monetary relief produced by the New York Insurance Department's settlement with Marsh & McLennan, the nation's largest broker, the NAIC's Broker Activities Task Force coordinated a multi-state regulatory settlement that has been joined by at least 33 other insurance departments. In exchange for releasing related regulatory claims, the signatory regulators can enforce the settlement's terms locally and receive compliance reports directly from Marsh & McLennan, while maintaining their ability to continue ongoing investigations. The Task Force released a similar settlement with the nation's second largest broker, Aon Corporation, and is currently working on similar multi-state agreements with other large national brokers. In addition, regulatory staff from six states, including Illinois, together with attorneys general from 10 states reached a settlement with insurer Zurich North America arising out of bid-rigging allegations and resulting in $151 million in restitution to Zurich policyholders. The Task Force is leading the NAIC's collaborative efforts to reach settlement agreements with other brokers and commercial insurance carriers, where appropriate.

As the third prong of its national plan to improve consumer protections, the NAIC launched an online fraud reporting mechanism in January 2005. It allows consumers, employees, or others who witness wrongdoing to anonymously report their suspicions for investigation by state enforcement authorities. Collective state action through the NAIC on broker issues is important because the brokers and insurers involved operate across the nation and throughout the world. Business practices in one state may be connected directly to problems being identified in other states. Continued regulatory collaboration avoids duplicative and excessive data requests that delay responses from the brokerage and insurance industry and hinder state action.

Conclusion

The NAIC and its members ask that Congress carefully consider the unintended consequences and potential pitfalls of amending the McCarran-Ferguson Act. State regulation of the "business of insurance" under the limited federal antitrust exemption granted by the McCarran-Ferguson Act has protected consumers for over 60 years, as it did for many years preceding the Supreme Court's decision in the *Southeast Underwriters* case. We have used that time to sharpen market supervision and enforcement tools to promote a lawful and competitive marketplace for insurance companies. Although insurance products generally have been widely available and competitive throughout the United States, state regulators will continue to act when necessary to correct market imbalances by using our authority to mandate insurance coverage and appropriate rates.

The first priority of state insurance regulators is to protect consumers. We recognize that insurance is a unique financial guarantee product that is essential to protecting not just the American economy, but also the most cherished personal effects of individual consumers. It is part of the social fabric and financial safety net that enables citizens, small businesses, and global corporations to move forward each day with confidence. NAIC members look forward to continuing our work with federal and state officials, consumers, the insurance industry and other interested parties to prevent and punish anti-competitive activities within the insurance industry.

ATTACHMENT: STATE ANTITRUST LAWS AND EXEMPTIONS

5/06

STATE	CITATION	STATUTORY EXEMPTION APPLICABLE TO INSURANCE	OTHER GUIDANCE
AL	§§ 8-10-1 to 8-10-3	No	
AK	§§ 45.561 to 45.594	Activity expressly required by a state regulatory agency. Activity permitted by a state regulatory agency is not forbidden if the agency considered possible anticompetitive effects before permitting the activity and enforcement of antitrust act would disrupt regulatory scheme (§ 45-50-572)	
AZ	§§ 44-1401 to 44-1416	No	"Construed to effectuate its general purpose to make uniform the law" among states enacting similar laws. Courts "use as a guide" federal court interpretation of comparable federal statutes (§ 44-1412)
AR	§§ 4-75-201 to 4-75-211 (Unfair Practices) §§ 4-75-301 to 4-75-314 (Monopolies)	No	
CA	Bus. & Prof. §§ 16700 to 16703 (Combinations in Restraint of Trade) Bus. & Prof. §§ 17000 to 17002 (Unfair Practices)	No	
CO	§§ 6-2-105 to 6-2-117 (Unfair Practices) §§ 6-4-101 to 6-4-117 (Antitrust)	Activity exempt or immune under the state laws or federal antitrust of this state (§ 6-4-108)	Courts to "use as a guide" federal interpretation of comparable federal laws (§ 6-4-119)
CT	§§ 35-24 to 35-46	Activity specifically directed or required by state or federal statute (§ 35-31)	Courts "guided by" federal courts interpretation of federal antitrust statutes (§ 35-44b)
DE	Tit. 6 §§ 2101 to 2114 (Antitrust) Tit. 6 §§ 2531 to 2536 (Trade Practices)	Activity subject to regulation by the Insurance Commissioner or authorized by insurance code or other state law, including joint underwriting or reinsurance. Further, exempts activity required by state or federal statute and conduct or arrangement approved or required by state or federal regulatory body (Tit. 6 § 2104)	"Construed in harmony with" interpretations of comparable federal statutes (Tit. 6 § 2113)
FL	§§ 542.15 to 542.36	Activity exempt under federal law or FL common law (§ 542.20)	

STATE	CITATION	STATUTORY EXEMPTION APPLICABLE TO INSURANCE	OTHER GUIDANCE
GA	§§ 10-1-250 to 10-1-256 (Below Cost Sales Act applicable to sale of octane fuels)	No	"Great weight" given to federal courts' interpretation of Section 2, Sherman Act, as amended (§ 10-1-256)
HI	§§ 480:1 to 480:15	Transaction in the business of insurance expressly permitted by state insurance laws, except agreement to boycott, coerce, or intimidate or act of boycott, coercion, or intimidation. (§ 480.11)	
ID	§§ 48-101 to 48-118 (Antitrust) §§ 48-201 to 48-206 (Anti-Price Discrimination)	Activity required or affirmatively approved by state or federal statute or by a regulatory agency of this state (§ 48-107)	
IL	740 ILCS 10/1 to 740 ILCS 10/12	Activity of any insurer, insurance agent, insurance broker, independent insurance adjuster or rating organization to the extent subject to regulation by the Director of Insurance under, or permitted by, the Insurance Code or any other law of this State, including participating in joint underwriting or joint reinsurance arrangement (740 ILCS 10/5)	Use federal interpretation "as a guide" when this Act is identical or similar to that of a federal law (740 ILCS 10/11)
IN	§§ 24-1-1-1 to 24-1-5-7	Any powers, rights or privileges now existing or conferred by law (§ 24-1-2-1)	
IA	§§ 553.1 to 553.18 (Competition Law) §§ 551.1 to 551.12 (Unfair Discrimination)	Activity arrangements expressly approved or regulated by any state or federal regulatory body (§ 553.6)	
KS	§§ 50-101 to 50-115	No	
KY	§§ 356.020 to 356.030	No	
LA	§§ 51:121 to 51:142	No	
ME	Tit. 3 §§ 1101 to 1109	No	
MD	Comm. §§ 11-202 to 11-213	Activity of an insurer, insurance producer, public adjuster, insurance advisor, or rating organization, to the extent regulated by the Maryland Insurance Commissioner or authorized by the insurance code or any other law of the state (§ 11-203)	Courts " guided by the interpretation given by the federal courts" to similar federal statutes dealing with the same or similar matters (§ 11-202)

STATE	CITATION	STATUTORY EXEMPTION APPLICABLE TO INSURANCE	OTHER GUIDANCE
MA	§§ 93:1 to 93:12	Activity exempt from federal antitrust laws or the Federal Trade Commission Act other than by reason of the absence of a sufficient involvement of or impact upon interstate commerce; activity subject to regulation or supervision by state or federal agencies; or activity authorized or approved under federal, state or local law (§ 93:7)	
MI	§§ 445.771 to 445.788	Activity specifically authorized under state or federal law, or specifically authorized by the administration of a state or federal regulatory agency, board, or officer (§ 445.774)	To the extent act incorporates uniform state antitrust act, it shall be construed in uniformity with states enacting similar provisions (§ 445.784) "Due deference" given to federal court interpretations including per se violations and the rule of reason (§ 445.784)
MN	§§ 325D.01 to 325D.71	Activity permitted or regulated by any regulatory body acting under state or federal statutory authority exempt from finding of unreasonable restraint (§ 325D.55)	
MS	§§ 75-21-1 to 75-21-39	No	
MO	§§ 416.011 to 416.635	Activity expressly approved or regulated by any regulatory body acting under state or federal statutory authority (§ 416.041)	"Construed in harmony with" judicial interpretations of comparable federal statutes (§ 416.141)
MT	§§ 30-14-201 to 30-14-226 (Unfair Trade) §§ 30-14-901 to 30-14-906 (Price Discrimination)	No	As to price discrimination, "due consideration and weight" given to interpretations of FTC and federal courts (§ 30-14-903)
NE	§§ 59-501 to 59-508 (Discrimination in Sales & Purchases) §§ 59-801 to 59-831 (Restraint of Trade)	No	Courts "shall follow the construction" of similar federal laws by federal courts (§ 59-829)
NV	§ 598A.010 to 598A.280	Activity expressly authorized, regulated or approved by state or federal statute, ordinance or state or federal administrative agency (§ 598A.040)	"Construed in harmony with" judicial interpretations of comparable federal statutes (§ 598A.050)
NH	§ 356:1 to 356:14	Activity permitted, authorized, approved, required, or regulated by state or federal regulatory body acting under state or federal statutory scheme or otherwise actively supervised by regulatory agency (§ 356:8-a)	Courts "may be guided by interpretations" of federal antitrust laws (§ 356:14)

5/06

STATE	CITATION	STATUTORY EXEMPTION APPLICABLE TO INSURANCE	OTHER GUIDANCE
NJ	§ 56:9-1 to 56:9-19	Activity, including joint underwriting or reinsurance, of any insurer, insurance agent, insurance broker, independent insurance adjuster or rating organization to the extent subject to regulation by the Commissioner of Banking and Insurance of this State, or as permitted or authorized by the insurance code. Certain aspects of private passenger automobile insurance not exempt (§ 56:9-5)	"Construed in harmony with" judicial interpretations of comparable federal statutes and to effectuate uniformity with other states (§ 56:9-18)
NM	§§57-1-1 to 57-1-19 (Antitrust) §§57-14-1 to 57-14-9 (Price Discrimination)	No	Unless otherwise provided, construed "in harmony with" judicial interpretations of federal laws (§57-1-15)
NY	GBS 22 §§340 to 347 (Monopolies) GBS 24-A §§369-A to 369-EEE (Fair Trade Law)	Activity of licensed insurers, licensed insurance agents, licensed insurance brokers, licensed independent adjusters and others subject to insurance law, to the extent not regulated by the P/C rates article. Marine insurance not exempt (GBS 22 §340)	
NC	§§75-1 to 75.105	No	
ND	§§51-08.1-01 to 51-08.1-12 (Antitrust) §§51-09-01 to 51-09-06 (Unfair Discrimination) §§51-10-01 to 51-10-15 (Unfair Trade Practices)	No	
OH	§§1331.01 to 1331.99	No	
OK	§§15-598.1 to 15-598.11 (Unfair Sales) §§79-201 to 79-212 (Antitrust)	No	"Interpreted in a manner consistent with" federal statutes and case law (§79-212)
OR	§§646.705 to 646.836	No	Federal courts construing federal law "shall be persuasive authority" (§646.715)
PA	73 P.S. §§201-1 to 201-9.3 (Unfair Competition, Acts or Practices) 73 P.S. §§211 to 217 (Unfair Sales)	No	

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STATE	CITATION	STATUTORY EXEMPTION APPLICABLE TO INSURANCE	OTHER GUIDANCE
PR	10 L.P.R.A. §§257 to 276	No	
RI	§§6-36-1 to 6-36-26	Activity exempt from federal antitrust laws. (§6-36-8)	"Liberally construed in harmony with" comparable federal statutes, except where expressly contrary to applicable federal provisions (§6-36-2)
SC	§§39-3-10 to 39-3-510 (Trusts, Monopolies & Restraints of Trade) §§39-7-10 to 39-7-50 (Fair Trade)	No	
SD	§§37-1-1 to 37-1-33	No	Interpretation of comparable state or federal laws to be used "as a guide" (§37-1-22)
TN	§§47-25-101 to 47-25-109 (Unlawful Restraint of Trade & Discrimination) §§47-25-201 to 47-25-206 (Unfair Sales)	No	
TX	Business & Commerce Code §§15.01 to 15.52	Activities exempt from the operation of the federal antitrust laws, except McCarran-Ferguson Act does exempt activities under TX act (§15.05)	"Construed in harmony with" comparable federal statutes to the extent consistent with purpose (§15.04)
UT	§§13-5-1 to 13-5-18	No	"Shall be liberally construed" (§13-5-17)
VT	9 V.S.A. §2453	Rules and regulations shall not be inconsistent with the rules, regulations and decisions of FTC and the federal courts interpreting the FTC Act (9 V.S.A. §2453)	Courts to be "guided by" the construction of similar terms of Section 5(a)(1) of FTC Act (9 V.S.A. §2453)
VI	11 V.I.C. §§1501 to 1518	Activity, including joint underwriting or reinsurance, of any insurer, insurance agent, insurance broker, independent insurance adjuster or rating organization to the extent subject to regulation by Insurance Commissioner (11 V.I.C §1505)	Courts "shall follow" federal interpretation of same or similar federal law (11 V.I.C. §1501)
VA	§§59.1-9.1 to 59.1-9.18	Activity authorized, regulated or approved by state law or by an administrative or constitutionally established state or federal agency with jurisdiction of the subject matter and authority to consider anticompetitive effect (§59.1-9.4)	"Construed to effectuate its general purposes in harmony with" comparable federal provisions (§59.1-9.17)
WA	§§19-86-010 to19-86-920	Activity otherwise permitted, prohibited or regulated under laws administered by the insurance commissioner of this state, provided that certain statutory provisions are not exempt unless required or permitted by insurance code (§19-86-170)	Courts "guided by" federal court and FTC interpretation of same or similar federal statutes (§19-86-920)

STATE	CITATION	STATUTORY EXEMPTION APPLICABLE TO INSURANCE	OTHER GUIDANCE
WV (M/YY)	§§47-18-1 to 47-18-23	Activity regulated by state or federal agency pursuant to state or federal law, to the extent of such regulation (§47-18-5)	
WI	§§133.01 to 133.18	No	"To be interpreted in a manner that gives the most liberal construction to achieve the aim of competition" (§133.01)
WY	§§40-4-101 to 40-4-123	No	

This chart does not constitute a formal legal opinion by the NAIC staff on the provisions of state law and should not be relied upon as such. Every effort has been made to provide correct and accurate summaries to assist the reader in targeting useful information. For further details, the statutes and regulations cited should be consulted. The NAIC attempts to provide current information; however, readers should consult state law for additional adoptions.

UNITED STATE SENATE
COMMITTEE ON THE JUDICIARY
"THE MCCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING THE INSURERS' ANTITRUST EXEMPTION"
JUNE 20, 2006

MARC RACICOT
PRESIDENT
AMERICAN INSURANCE ASSOCIATION

Good morning, Mr. Chairman. My name is Marc Racicot. I am president of the American Insurance Association (AIA). AIA represents major property and casualty insurers doing business across the country and around the world. I appreciate the opportunity to be here, today, to participate in the committee's discussion of the McCarran-Ferguson Act (McCarran).

Enacted in 1945, McCarran is a power-sharing statute that reflects Congress' considered judgment to delegate – not abdicate – its authority over insurance to states that regulate the business of insurance themselves. In doing so, McCarran provides insurers with an antitrust regime that recognizes the insurance regulatory role entrusted to the states. Because of the delicate balance of power contained in McCarran, we believe that discussion of a repeal or limitation of McCarran's antitrust provisions can not be divorced from a corresponding discussion of the nature of state insurance regulation.

In this connection, we believe that congressional review of the state insurance regulatory system is long overdue, including a frank and honest examination of the economic utility of government price controls and the regulation of insurance policy forms. In addition, we note that there is a growing understanding in Congress about the very real problems associated with the current state-based regulatory regime – and that steps must be taken to improve and modernize the way insurance is regulated. The bipartisan bill (S. 2509) introduced in April by Senators Sununu and Johnson is a first major step forward in the effort to successfully address these challenges. Similarly, the House Financial Services Committee, under Chairman Oxley's and Subcommittee Chairman Baker's direction, has been undertaking its own efforts to fashion a regulatory reform measure. We have been privileged to participate in both of these efforts and are hopeful that they will ultimately result in broad reform legislation being enacted.

Within this framework, my testimony today will focus on three things:

- first, a brief historical sketch of McCarran;
- second, some perspective on the McCarran discussion over the years; and,
- third, the role of McCarran in today's debate over needed reform of the insurance regulatory system.

An Historical Introduction to the McCarran-Ferguson Act

The McCarran-Ferguson Act is the outgrowth of two U.S. Supreme Court decisions that defined the course of U.S. insurance regulation. The first was *Paul v. Virginia,* in 1869. *Paul* held that the insurance transaction was so intrinsically a local matter that Congress had no constitutional authority under the Commerce Clause to regulate it at all.

As a practical matter, the *Paul* decision ceded insurance regulation to the states. It remained the law of the land for the next 75 years, until – on the eve of the Normandy invasion in June 1944 – it was overturned by the Court in *United States v. South-Eastern Underwriters. South-Eastern Underwriters* held that insurance did, in fact, move in interstate commerce and was, therefore, subject to congressional jurisdiction.

The notion that insurance is a product in interstate commerce seems matter-of-fact today. However, at the time, that notion threatened the viability of the insurance system, particularly since *Southeastern Underwriters* was a "price fixing" case, which immediately made many necessary, collective insurance activities subject to federal antitrust laws. Over the next nine months, there was urgency in Congress to determine the impact of *South-Eastern Underwriters*. Would it mean the end of state insurance regulation, with the federal government taking it over? Would it mean that the states, which had traditionally taxed insurers, might lose that authority? Would it mean that the insurance industry would be crippled by the application of federal antitrust law, so it could no longer collect and analyze the enormous amounts of data necessary to appropriately price insurance risks? Would it mean that insurers would lose the ability to collaborate on drafting uniform policy forms for many lines of insurance?

As Congress and industry struggled with these questions in 1944, a formula ultimately emerged for dealing with them. That formula became the McCarran-Ferguson Act. McCarran addressed three important goals for the Congress: 1) delegation of authority to the states to the extent that the states regulate the business of insurance; 2) creation and maintenance of a broad insurance regulatory system; and 3) balancing regulatory objectives against antitrust policy objectives.

McCarran's enactment furthered all three congressional goals. It entrusted to the states the authority to regulate and tax "the business of insurance," and said that no federal law should be presumed to interfere with that authority, unless it was clearly designed to do so. It gave the states three years from the 1945 enactment to put their regulatory systems in place. Finally, McCarran said that the federal antitrust laws would apply to the business of insurance "to the extent that such business is not regulated by State Law," or in any case where insurers had engaged in – or attempted to engage in – an act of boycott, intimidation or coercion. (15 U.S.C. Chapter 20, §§ 1012(b), 1013(b))

During the three years between the 1945 enactment and the 1948 effective date, all states enhanced their regulatory systems by enacting state unfair competition and trade practices laws directed specifically to insurers. Those state laws included what were referred to as "little Federal Trade Commission (FTC)" statutes, because they adopted the FTC's unfair trade practices requirements and placed them on insurers directly through state law. States also adopted their own prohibitions on acts of boycott, intimidation or coercion by insurers, as well as Sherman Act and Clayton Act-type prohibitions on unfair restraints of trade.

In establishing their insurance regulatory systems and adopting unfair competition and deceptive trade practices standards, the states faced the same question that is always raised when dealing with a regulated industry: How do you balance the role of regulation against the role of antitrust policy? Their answer mirrored the one adopted for other industries. Specifically, where there is a regulatory system, antitrust laws can not be used as a way to undercut it. Conversely, where activity takes place outside the regulatory system, antitrust laws will apply. With this approach as their roadmap, the states placed all collective activity by insurers under regulatory control, scrutiny and review – effectively replacing antitrust litigation with regulatory oversight of collective activity, including activity to: 1) gather, analyze, and make predictions about data; 2) establish final prices; and, 3) create standardized insurance policy forms. Over the years, this basic approach has remained unchanged, except that state laws now overwhelmingly prohibit insurers from agreeing on final price, even under regulatory oversight.

Moreover, every organization that engages in data collection and analysis, or in the development of common policy forms, must be registered with the state and is subject to direct regulation by it. Any collective activity by insurers not done through a registered entity (generally called an "advisory organization") is subject to both the antitrust provisions in the state's insurance code and to the state's broad antitrust laws. All insurance activity is thus subject to regulatory supervision or antitrust exposure in the states—and sometimes both.

This balancing of regulatory supervision and antitrust litigation – as noted earlier – is not unique to insurance; it also takes place in other financial services industries (i.e., banks and the securities business) where federal courts have held that understanding the balance is critical and that antitrust scrutiny is inappropriate where the activity is subject to regulation. (*See, e.g.*, *Gordon v. New York Stock Exchange, Inc.*, 422 U.S. 659 (1975)).

If this were not the case, there would be nothing but chaos, with private antitrust litigation – including massive class actions – constantly at war with the federal regulatory systems established by the government. This would create enormous uncertainty for these businesses and their customers, to the benefit of neither.

The difference between banking and securities regulation, on the one hand, and insurance regulation, on the other, is that the banking and securities businesses are principally regulated by the federal government, while insurance is principally regulated by the states. This is a particularly important difference when looked at from an antitrust perspective. When federal antitrust law is balanced against federal regulation for a specific industry, the courts have a long and appropriate history of giving precedence to the specific regulatory system that Congress has set up for that industry over the broad, non-specific language of the antitrust laws that did not have that specific industry in mind.

Since insurance regulation, however, resides primarily at the state level, McCarran is necessary to provide the kind of balance of "regulation vs. antitrust" for insurance as exists for federally regulated banking and securities businesses. This central point in understanding the true role of McCarran merits special emphasis, and is worth repeating: *The McCarran-Ferguson Act balances regulation and antitrust for state-regulated insurance, just as that same type of balance has been established for the other two legs of the financial services sector, federally regulated banks and securities firms.*

If McCarran did not exist, then the balance between state insurance regulation and federal antitrust law would be quite different. It would be governed by the "state action" doctrine – an antitrust principle first adopted by the courts in the years immediately prior to McCarran taking effect.

Under the "state action" doctrine, federal antitrust laws take precedence over "state" regulation, unless that state regulation is particularly intrusive and has an essentially anti-marketplace competition orientation. Even in these circumstances, the primacy of the state regulation is dependent on whether the regulatory oversight meets an "active supervision" test, which can be determined only through litigation and which, therefore, means that there will be much litigation. Perhaps constant litigation.

Although anti-McCarran forces often assert that insurance is the only economic activity, other than baseball, with a significant antitrust exemption, that, of course, is not true. In addition to the exemptions that exist for regulated industries generally, there are exemptions – to name a few – for newspapers, joint research and production ventures, farm cooperatives, utilities and labor unions. All of these exemptions were created for important policy reasons, just like the McCarran-Ferguson Act.

So, for the member insurance companies that comprise the American Insurance Association, the issue is not whether a balance needs to exist between antitrust principles and regulation, but where that balance ought to be drawn. For the purposes of state insurance regulation, that balance would be dangerously imperiled if McCarran were repealed.

The McCarran Debate in the Public Arena

The McCarran-Ferguson Act has been periodically controversial over its 61-year life. Ironically, whenever there is an affordability/availability problem in any specific line of insurance, industry critics argue that this problem results from the alleged ability of insurers to collectively fix prices under McCarran. Their misguided "solution" is to call for the repeal of McCarran.

However, when the problem subsides in that particular line of insurance, the call for repeal generally also subsides, with those who had argued that McCarran was the cause of the problem never saying that perhaps McCarran should now be credited for curing the problem, as well. If insurer activities under McCarran were the reason that prices went up, then insurer activities under McCarran must be the reason that those very same prices went down.

When this committee last held McCarran hearings in 1989, the issue was the cost of commercial liability insurance and the limited availability of certain types of insurance; these problems long ago were resolved in the marketplace, with McCarran remaining on the books.

The reality is that insurance is like the canary in the mine. When an insurance price spikes or availability shrinks, it is because an underlying problem (e.g., a particular cost driver) needs to be addressed. To be fair to all customers – not to mention to be able to stay in business – insurers must be able to price their policies to cover their likely losses. If they can not do that, because of government price controls, they will be forced to pull back from the marketplace. This reaction is as inevitable as Newton's apple finding its way from tree to ground. Instead of looking at insurer activity under the McCarran-Ferguson Act as the issue, it would be better to look at the underlying problems and fix them.

There also seems to be a persistent misperception that McCarran provides a *blanket* exemption for insurers from federal antitrust law application, allowing insurers an unfettered right to engage in anticompetitive behavior. Perhaps a brief examination of the law will help clear up the misperception, and avoid a result that will upset the balance between regulation and antitrust policy.

Here is the law (some of which picks up themes explored above):

1. McCarran does not provide a blanket exemption from the antitrust laws for insurers. It is a *targeted* exemption that balances the goals of regulation with the goals of antitrust law. It works exactly the same way as those two goals are balanced for the two other federally regulated financial services industries, the banking and securities

industries. Congress has enacted significant antitrust exemptions for public policy reasons in a variety of other areas. So, it is simply not accurate to single out insurance, especially since the exemption is so clearly limited to those insurance activities that government regulates.

2. There is a significant body of state antitrust statutes that apply to insurers. Every state provides some form of antitrust regulation of insurers, whether through broad state laws based on the federal Sherman and Clayton Acts, antitrust provisions in their insurance codes, or language barring unfair competition in the little FTC acts. Often, states have multiple avenues to address alleged anticompetitive behavior. So there is no lack of state antitrust authority with regard to insurers.

3. Contrary to what some may say, McCarran provides no exemption from state antitrust or insurance laws for any bid-rigging behavior, which is fully subject to state law. Since bid rigging is not a state-authorized activity, it enjoys no exemption under state antitrust laws, and indeed has been prosecuted vigorously under them.

4. Private allocation of markets by insurers among themselves would be subject to state antitrust and unfair practices laws, just as bid-rigging would be. It is true that, under McCarran, the states themselves have established fallback risk-sharing mechanisms called "residual markets" to provide insurance to those who otherwise would not be able to find coverage, including with regard to medical malpractice insurance. However, we suspect that the states, not insurers, would be most troubled by attempts to change McCarran to erode (and perhaps outlaw) use of those mechanisms.

5. While measures to repeal McCarran have called for removal of so-called McCarran protection for price fixing, the truth is that states acting under McCarran do not

allow insurers to privately agree on price. Moreover, except in the limited number of jurisdictions that have state-administered pricing for discrete lines of business such as workers' compensation, today, insurers are not allowed to agree on price even under regulatory scrutiny. What the states do permit and regulate is data collection and analysis through state-approved "advisory organizations." In each case, however, this only is done within a state's regulatory law and is subject to regulatory scrutiny.

6. Repeal of McCarran might impact legitimate information gathering undertaken pursuant to state law and regulation, thus undercutting the ability of the states to decide the types of information they want to allow insurers to collect, share and analyze under state supervision.

As a result, a repeal of McCarran can not be justified as a matter of law. Nor would it be sound public policy.

The McCarran-Ferguson Act and Insurance Regulatory Reform.

Mr. Chairman, although we oppose repeal of the McCarran-Ferguson Act, AIA long has recognized that McCarran is likely to be a target from time to time for the reasons just described and refuted. Moreover, McCarran is associated with a state regulatory system that uses government price controls as its primary regulatory tool, which we believe is a mistake that both distorts the marketplace and injures consumers.

In light of these concerns, AIA worked very hard in the early 1990s to see if legislation might be developed that would retain the essential McCarran antitrust exemptions through specifically identified safe harbors, while leaving all other activity to be judged under generally applicable antitrust principles. The result of that work – from several years of negotiations with then-House Judiciary Committee Chairman Brooks –

was carefully crafted legislation supported by AIA and favorably reported by that committee.

After the 1994 mid-term elections, the McCarran issue was not revisited, and interest gradually changed from amending McCarran to enacting wide-ranging insurance regulatory reform. Today, we believe that the regulatory reform route is the way to go. This route, however, also has McCarran ramifications.

Senators Sununu and Johnson's recently introduced ground-breaking legislation, titled the National Insurance Act of 2006, would allow both life insurers and property-casualty insurers – as well as insurance agents and brokers – to opt into a federal regulatory system. S. 2509 is patterned on the current dual banking system, which provides for both federally and state-chartered banks. The new national insurance regulatory system would focus on tough financial and market conduct regulation; however, unlike the state insurance regulatory system, the national system would dispense with government price controls. Rather, the bill opts for price competition in the open market among insurers.

Since the McCarran-Ferguson Act only applies to the business of insurance regulated by the states, it obviously would not apply to pricing activities of federally-chartered insurers operating under federal law. Therefore, federal antitrust laws would apply to federally-chartered insurers under S. 2509 to the extent that the states no longer regulate their activities. AIA members are willing to take the risks inherent in this approach on the antitrust side because we so strongly believe that a competitive market, without government rate and price controls, is critical to being able to serve their customers in the years ahead. Thus, we are willing to shift McCarran's current balance between regulatory supervision and antitrust policy to one that reduces the role of regulation and returns that role to the federal government, and increases the role of the federal antitrust laws. However, we do not believe it is appropriate to repeal McCarran-Ferguson in the context of insurance pricing without initiating the paradigm shift that would result from S. 2509.

If Congress decides to take this approach, we can perhaps solve several market challenges at the same time. We look forward to working with Congress to do just that.

Mr. Chairman, thank you very much for giving us the opportunity to appear before you today. I would be pleased to answer any questions.

UNITED STATES SENATE COMMITTEE ON THE JUDICIARY
June 20, 2006 Hearing on the McCarran-Ferguson Act:
Implications of Repealing the Insurers' Antitrust Exemption
KEVIN B. THOMPSON, FCAS, MAAA
Senior Vice President, Insurance Services
Insurance Services Office, Inc., Jersey City, N.J.

Good morning Mr. Chairman, I am Kevin B. Thompson, Senior Vice President- Insurance Services of Insurance Services Office, Inc. (ISO). I am a Fellow of the Casualty Actuarial Society (CAS) and a Member of the American Academy of Actuaries. I have served in various positions in the CAS leadership, including as a member of its Board of Directors and as Vice President-Admissions. My statement describes the essential role that ISO plays in fostering the competitive marketplace that is the property/casualty insurance business in the United States.

In the course of my remarks, I briefly cover ISO's role as an advisory organization and as a statistical agent of state insurance regulators, how its activities, products and services are regulated by government and how it has evolved over the years into a for-profit corporation that is not controlled by insurers. By making it possible for more insurers to compete in the marketplace, at lower cost, these products and services help reduce prices paid by consumers; give consumers greater choice of insurers; enable consumers to more easily compare prices and coverages; and speed the claims handling process.

In a highly competitive industry characterized by tight profit margins, where an insurer often must use the aggregated data of many others as an aid in estimating the average cost of its own products, it is vital to have a relatively low-cost source of those estimates. Developing prospective cost information from the aggregated data of many insurers is an expensive process and the information's availability can be a crucial factor in an insurer's decision to enter or remain in a market. While we take no position on what laws should regulate the property/casualty insurance industry —state or federal— we believe insurers' access to vital advisory organization materials deserves to be preserved and protected. Since repeal or substantial modification of the McCarran-Ferguson Act's limited antitrust exemption is likely to create legal uncertainty and have a chilling effect on legitimate insurer use of those materials, no change should be considered without proof that it is needed and that it will help, not harm competition in the property/casualty insurance business.

ISO's role as a state-licensed advisory organization and statistical agent and how it is regulated by the states

ISO is licensed as an advisory organization[1] in all fifty states, Puerto Rico and the District of Columbia. As an advisory organization, our company provides statistical, actuarial, policy form development and related products and services to property/casualty insurers, including advisory prospective loss costs[2], other prospective cost information,[3] manual rules and policy forms. ISO also serves as an officially designated statistical agent of state insurance regulators to collect policy-writing and loss statistics of individual insurers and compile that information into reports used by the regulators.

[1] The official designations of such organizations vary under state law and include "rating organization" "rate service organization" and/or "advisory organization."
[2] Prospective loss costs are actuarially established estimates of the dollars needed to cover future loss payments and loss adjustment expenses.
[3] The term "prospective cost information" as used here includes prospective loss costs, increased limits factors, classification differentials and deductible relativities.

While the style of regulation varies from state to state, ISO's prospective loss costs, rules and policy forms are typically filed with and are subject to review and/or approval by state regulators. In addition to this state oversight of the materials ISO makes available to insurers, ISO's operations are the subject of thorough examinations conducted by state regulators. They are typically single-state examinations, but the resulting reports are made available to all states. Currently, we are being examined by New York and a Georgia examination was recently conducted.[4] ISO's operations and its products are subject to many state antitrust statutes within or outside state insurance codes, which are typically enforced by state attorneys general and/or insurance regulators.

How ISO has evolved over the years

From its beginning in 1971, ISO differed from its historical predecessors. In the early to middle twentieth century, there were insurance cartels that had mandatory membership criteria, offered indivisible services, and ran "stamping offices" that enforced adherence to the cartels' rates, rules and forms. But from the outset, ISO had a non-adherence policy and encouraged insurers to make their own decisions on the rates they would charge and the forms and rules they would use. Over the decades that followed its creation, ISO made a series of changes in its operations and structure: stopping the development of rates (1989); eliminating decision-making by insurers as to the loss costs, rules and forms ISO would develop and distribute (1994); divesting insurers of control of the organization (1994); and becoming an independent for-profit corporation (1997).

[4] The Georgia examination report has not yet been issued.

ISO's corporate structure assures independence from insurer control; insurers may only own stock in the corporation that has very restricted voting rights, primarily limited to the election of three of the eleven members of the Board of Directors, alteration of its certificate of incorporation, or substantial changes to the corporate structure (i.e., merger or dissolution). As is common in other businesses, ISO hosts user meetings and panels to help improve its services, but those attending have no decision-making powers and are prohibited from discussing the corporate policies or intentions of any insurer. Meeting participants may not discuss insurer rate levels, insurer loss cost levels, or what ISO advisory loss cost levels ought to be. To assure compliance with ISO policy and the law, ISO lawyers attend all panel meetings.

ISO encourages and facilitates insurers' independent decisions about whether and how to use its material. Its Certificate of Incorporation and By-Laws contain a non-adherence provision, which states that no insurer may be required as a condition of its participation to use any loss costs, rules, forms or anything else that ISO produces. When it distributes advisory prospective cost information, ISO actively encourages each insurer to take into account its own loss experience and to use the insurer's own actuarial judgments and procedures to determine its rates. A similar statement accompanies the distribution of ISO's manual rules and policy forms.

ISO also makes its material available in ways that permit insurer analysis, modification and adaptation in pursuit of independent business objectives. This includes distributing detailed statistics that underlie prospective loss cost information, providing ancillary services structured to facilitate insurers' analyses of risk and granting insurers the right to use policy form text in whole or in part. ISO does not publish information supplied by any individual insurance company and no insurer has access through ISO to any other insurer's data that ISO uses to develop prospective loss costs.

ISO's staff of more than 150 actuaries includes approximately 50 Fellows and Associates of the CAS. Its staff of insurance experts includes more than 120 professionals who have received the Chartered Property Casualty Underwriter (CPCU) designation, as well as members of the Insurance Data Management Association (IDMA) and many other professional societies and associations. ISO's legal and government relations staffs are current with developments in statehouses and courthouses around the country. Each year, ISO reviews thousands of regulations and laws, both proposed and actual, as well as court decisions, to evaluate their effect on ISO's offerings.

ISO's actuaries develop cost-based projections of prospective cost information at various levels of detail—state, territory and class. This information is submitted to state regulators and is made available for insurer use, but they may elect to accept, adjust, or not use any of it. ISO's actuarial analyses are produced entirely by its professional actuarial staff in accordance with the Professional Code of Conduct adopted by the CAS and the American Academy of Actuaries, using generally accepted actuarial procedures. These procedures are consistent with the "Statement of Principles Regarding Property and Casualty Insurance Ratemaking" as promulgated by the CAS and the Actuarial Standards of Practice adopted by the Actuarial Standards Board.

ISO's products and services help reduce consumer prices; give them greater choice of insurers; help them to more easily compare prices and coverages; and speed the claims handling process
ISO reduces an insurer's operating costs by providing information and services that the insurer needs to write business at relatively lower costs than would be possible using its own resources. Without the availability of ISO's materials many insurers would have to increase staffing substantially and invest in expensive equipment, significantly increasing costs. In a competitive insurance market, lower costs of doing business translate into lower prices for consumers.

Also, by enabling insurers to more reliably predict expected losses, the availability of ISO's information permits them to be more confident in making pricing decisions. This increased confidence means less margin for error can be built into rates, leading to lower premiums. Many insurers, especially smaller ones, do not generate enough of their own loss information to predict expected costs reliably. They need this information because, unlike other industries, insurers do not know the ultimate cost of the product that they sell - the insurance policy - at the time of sale. It may take months or possibly years after the policy expires before an insurer knows the policy's costs because, at the time of sale, losses under the insurance policy have not yet occurred. However, by using ISO's products and services small insurers can compete with large ones and large insurers can do business in places in which they have low premium volume or no business at all. Insurance consumers are the beneficiaries when there are many insurers competing to gain market share.

ISO's common policy form language confers several benefits; one of the most important is the facilitation of comparison shopping by policyholders and their representatives. By comparing different insurer coverage forms to common policy language developed by ISO, insurance buyers and their representatives have the means to assess competing price and coverage offerings. The common language also enables state regulators to assess comparable statistics from insurers. Lastly, common policy form language, which has been interpreted by the courts, takes on a distinct and more certain legal meaning. This legal certainty reduces the likelihood that the same issues will be litigated time and again. This speeds the claims handling process, producing cost savings which can be passed on to consumers.

ISO's policy forms enhance variety by providing language from which coverage can be tailored by insurers for the purpose of insuring unique risks and targeting specific submarkets. Insurers can and do compete in providing coverage enhancements and developing entirely unique, proprietary coverage programs.

The availability of prospective cost information based on the independently performed analyses of the combined data of many insurers is essential to the functioning of the highly competitive property/casualty insurance industry market.

There are fundamental differences between the insurance business and other industries. One of the most important differences is the lack of actual cost information about the insurance product at the time that it is offered for sale.

In exchange for a pre-determined premium, insurers provide coverage to their customers, but at the time a policy is sold, an insurer does not know to any significant degree the actual losses it will incur over a policy term. Consequently, the price charged for a policy is based on the insurer's best estimate of what those costs could turn out to be – on average. In most industries, companies are able to develop a greater proportion of the actual cost per production unit from more knowable, predictable, or controllable costs. For example, in the manufacturing sector, most businesses incur the majority of their costs before their products reach the market. As a result, a manufacturer has a great deal of the information it needs to determine a price for a product (i.e., to cover costs of acquiring raw material, manufacturing the product, and delivering it to the retail environment), as well as the profit it hopes to realize in a competitive market. Thus, at the time of sale or shortly thereafter, the manufacturer will know virtually all of its costs, both fixed and variable. In contrast, property/casualty insurers cannot know the ultimate cost or even the majority of the costs of their production units – insurance policies – at the time of sale.

The insurer is able to accept this risk of loss transferred from the insured if it can rely on the "Law of Large Numbers." The problem is that, for most lines of property/casualty insurance, few insurers have enough information of their own to allow the Law of Large Numbers to work for the purpose of evaluating the risk of loss associated with the types and classes of property/casualty insurance policies that they underwrite in every state.

If an insurer has been writing a given type of policy – a particular coverage grant, sets of exclusions/conditions, etc. – for a specific classification in a particular location for a given period of time, the insurer may have accumulated enough premium and loss data to be of some use. But if the insurer is small, has been in business for only a short time, or is large but is not a major writer for a particular line, class, or state it may not have enough reliable or credible information of its own to enter or remain in a market. It is this problem, unique to insurance, which drives such an insurer to seek from ISO advisory prospective cost information based on the aggregated data of many insurers.

The amount of information that any one insurer has for each of the thousands of individual classes and categories in a line of insurance is more limited than the data for the whole line. For example, commercial general liability insurance can be provided for more than 1,100 classes, ranging from hardware stores to coal mines. Accordingly, having a large aggregate data base available to insurers for each of these subgroups is even more crucial for reliably determining prospective loss costs for each of these classes. Depending on the line of insurance, several years of data often are needed to determine average statewide loss cost levels. But, even with a large pooled database provided by ISO, a larger volume of data is needed to provide reliable estimates of expected prospective costs for the individual classifications. Generally, multiple years of data from all jurisdictions are combined so a broader, more credible body of experience can be used to determine the loss potential for each class.

Although large quantities of data are a prerequisite to a credible database, data collection is only the first step in the process of obtaining information about the future costs of insurance coverage. Historical data can provide a good picture of past costs, but it may provide little insight into the future costs current policies are expected to cover. Additional adjustments to this historical data -- loss development, trend, and others-- are necessary. These adjustments--including trend-- are needed to place the aggregated historical data on a comparable basis and, because the purpose of the process is to estimate costs on policies yet to be issued, trend also is used to project cost estimates to the time policies will be in effect.

Collecting raw data from insurers and turning it into prospective cost information is a complex and costly process

The production of prospective cost information from a large aggregated database of statistics reported by many insurers is a complex and demanding process, as are many of the processes inherent in the production of ISO advisory information. That is why the process is so expensive. As I noted above, ISO employs a large staff of highly qualified data management and actuarial professionals who are familiar with the composition and nuances of the database. ISO actuaries, using generally accepted actuarial principles, work independently and perform analyses on the "raw data" to develop useful information for insurers, regulators, and others. They use generally accepted actuarial techniques, such as catastrophe procedures (more recently including modeling), loss development and trend to develop prospective loss costs.

Critics might say that it would not be difficult or costly for an insurer or consultant to perform the trend analyses that ISO uses to develop advisory prospective cost information. While the concept of trend is relatively simple, providing a false sense of comfort that the application of trend in the analytical process is also simple, it is not. Trend analysis is not simply a matter of applying the economists' consensus inflation forecast to last year's losses; it requires a careful examination of claim severity changes over time, claim-frequency patterns over time, and changes in exposure patterns. It requires the evaluation of deductibles, policy limits, the effects of non-recurring events, and changing societal conditions, such as the propensity to litigate. It means reviewing data over both the short term and the long term for some lines of insurance. It often means looking at data countrywide and state-by-state. The data is analyzed line by line and coverage by coverage. This process not only requires focusing on insurance cost data but also the consideration of external information.

The use of trending in the analysis of data is what makes prospective loss costs prospective, but that is not its sole function. The trending process does not merely involve a projection; it also involves a complex process under which various sets of data are brought to common point in time (past, present or future) for evaluation purposes.[5] Actuaries use trend techniques to combine and analyze multiple sets of data (for example, losses, premiums and exposures) arising from different periods of time and to estimate what experience will be generated by policies written in the future. Actuaries rely on the observed rate of change over time (trend) in the frequency and size of insured losses, and in the number of insured exposures, viewed in the context of current and future events that might affect whether that trend can be expected to continue. This enables them to estimate from the most currently available data what experience was or can be expected for that set of policies written at any different point in time. These estimations are especially dependent on a thorough knowledge of the characteristics underlying the data.

Trend is embedded in many analyses that are used to derive prospective cost information from reported losses, and therefore is calculated and/or applied thousands of times annually by ISO

[5] An example would be the combination of data from multiple years needed to develop cost estimates for individual classes. Before several years' data can be combined for analysis, each year's data must be brought to a common point in time, e.g. 2002 and 2003 data might be adjusted to the 2004 level before being combined with data from that year.

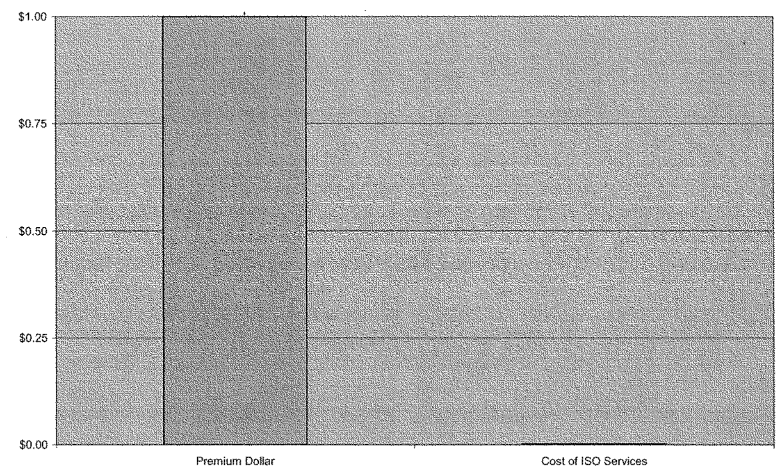
actuarics to analyze costs for the various states, coverages, deductibles and amounts of insurance for which ISO publishes information. Thousands of separate reviews are performed annually by ISO actuaries. When higher limits reviews are considered along with regional and multistate trends, as well as exposure trends, the number of analyses is even more overwhelming.

The expense of the process needed to produce prospective cost information from the data of many insurers is significant because a small increase in marginal insurer expenses can have a big impact on an insurer's ability to enter or remain in markets

In 2004, average insurer profits were 9.1% of written premium (preliminary data indicate that the 2005 profit margin will be a bit higher). But, profit margins have been variable over the years. From 2000 through 2004, average insurer profit margins ranged from a high of the 9.1% earned in 2004 to a low of a net *loss* of 2.2% in 2001.

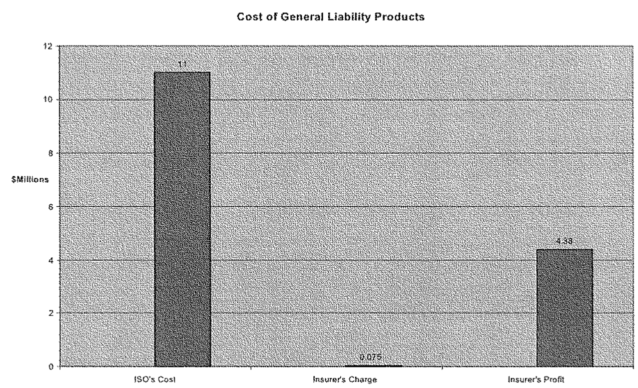
Since ISO provides information to many insurers, the relative cost to any individual insurer is low. Using commercial general liability insurance as an example, for each premium dollar written by insurers that purchase ISO's advisory prospective loss costs, rules and forms, insurers pay less than two tenths of one cent to ISO.

Cost of ISO Products and Services --- Less than Two Tenths of One Cent



If every insurer had to incur even a fraction of the total ISO cost for providing these services, it would have a significant impact on each insurer's ability to stay in or enter many markets. For example, a typical insurer operating in 25 states with an annual general liability insurance premium volume of $50,000,000 pays approximately $75,000 a year for all of ISO's general liability prospective loss costs, rules and forms – less than two tenths of one cent for every dollar of general liability premium the insurer writes. For just one line of insurance, it cost ISO more than $11 million in 2005 to produce those products. That figure represents only ongoing operating costs for this line of business; ISO has incurred significant expense over the years in developing the infrastructure, computing power, and expertise to develop these products. If this insurer achieved the average (all-lines industry-wide) profit margin for the 5 years ending 2004, it would have netted nearly $4.4 million. All that profit would have been eaten away if that average insurer incurred expenses approaching only part of ISO's costs to replicate the processes

ISO performs. It is important to note that 2004 saw the highest profit margin for the industry in the past five years, the average margin in that period was a little over half of the 2004 figure.



That is why the economies of scale offered by the availability of ISO advisory products and services are so important. In a business where all-lines industry-wide profit margins for insurers have ranged from -2.2% to 9.1% of written premium over the recent past, the benefits of the availability of essential information at low cost are obviously substantial.

Because advisory organization products and services have a beneficial effect on competition, insurers' access to them should be preserved and protected

In the late 1980s Professor Scott Harrington, then of the University of South Carolina now at the Wharton School, observed that the property liability insurance market was characterized by vigorous competition and that there was no evidence that advisory rates had increased prices or profits. (ISO had not yet fully transitioned to developing only loss costs.) Professor Patricia M. Danzon of the Wharton School wrote in the early 1990s that the availability of advisory organization services (prospective loss costs) increased rather than reduced competition. Studies by the General Accounting Office, the Federal Trade Commission and the U.S. Department of Justice in the 70s and 80s also concluded that the insurance industry of the time was structured competitively.

In 1996, in an administrative proceeding[6] before the California Insurance Commissioner, ISO retained the services of noted antitrust scholar Professor Lawrence A. Sullivan[7] to analyze evidence concerning the competitive effect of advisory organization manuals containing prospective cost information. Professor Sullivan concluded that property/casualty markets both in California and elsewhere are effectively competitive and that "...the circulation in such markets of advisory organization manuals that include prospective cost information does not in other states and would not in California adversely affect competition." Professor Sullivan stated the case for prospective loss costs quite forcefully:

> To assume that each insurer could replicate the entire prospective loss cost development and analysis process that an advisory organization undertakes to produce these data, is, on its face, unthinkable. If each insurer individually incurred costs even remotely approaching ISO's costs, all save a few of the largest insurers would be driven from the market... [I]ndividual costs could be cripplingly high even if the advisory organization provided manual data up to and including, but no further than, class level detail on reported losses for several years from all states – the point at which the trending analysis to attain prospective costs begins for General Liability classification differentials. To complete the process of producing its own prospective loss cost information, each insurer would be obliged to do for itself what the advisory organization now does in modest time with a main frame and a proprietary system developed at substantial cost. Certainly this would entail considerable cost, far more than any savings in payments to the advisory organization. These costs would be passed on to insureds. Moreover, in consequence of

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[6] *In Re Regulations Governing the Filing, Contents and Approvals or Disapprovals of Advisory Organization Manuals*, Hearing Docket #RH-346, California Department of Insurance, January 12, 1996

[7] Professor of Law at Southwestern University School of Law, Earl Warren Professor of Public Law, emeritus, Berkeley, an invited witness before the Senate Committee on the Judiciary Antitrust Subcommittee in 1995 and an appointee of President Carter to the National Commission for Review of Antitrust Laws and Procedures.

> the higher cost, some small insurers might withdraw or fail to enter when otherwise they would. Both effects belong on the negative side of the rule of reason scale.
> ...
> The most salient result from forbidding circulation in such markets is to deprive insurers of some scale efficiencies in underwriting in the interest of somewhat more widely scattered and perhaps less expert predictions about anticipated costs from certain prospective losses. In my opinion, to do that would not improve competition. Its primary effect would be increased costs and prices, to the disadvantage, primarily of smaller firms.

Our own studies of the competitive structure of the insurance industry confirm the earlier works, which concluded that the property/casualty insurance market is competitively structured and there is no evidence that the availability of advisory organization information has had an adverse affect on competition. In fact, the data suggest the opposite, that there is a high positive correlation between the use of ISO's advisory information and competition. For those lines where insurers purchasing ISO services have the highest market shares, industry concentration is the lowest. And, conversely, for those lines where insurers purchasing ISO services have lower market shares, industry concentration ratios are highest.

We believe that repeal or substantial modification of the insurance industry's limited antitrust exemption is likely to elevate the level of legal uncertainty with which insurers must cope, resulting only in reduced capacity, availability, and competition in the marketplace. Most practices would be subject to a "rule of reason" analysis, to be performed by courts, on a case-by-case basis, as the practices are challenged. "Rule of reason" cases generally entail complex presentations of statistics and expert witnesses; they are among the most difficult kinds of cases for juries (and for judges) to decide. The costs of litigating them and the chances of prevailing in them are difficult for even the most experienced lawyers to predict.

For insurance companies, there would undoubtedly be a tendency to question the wisdom of participating even in those activities that would ultimately be sustained as pro-competitive under an antitrust "rule of reason" analysis. This chilling effect is not likely to be a quick or transitory experience; the evolution of the law interpreting the boundaries of the McCarran-Ferguson Act has taught us that much. The practical effect could be to deprive insurers of legitimate use of pro-competitive advisory organization products and services.

I have described for you how the products and services that ISO provides to insurers help them operate in the competitive property/casualty insurance market. By improving insurers' knowledge of their true anticipated costs and by introducing economies of scale, ISO confers benefits to the insuring public through lower costs. The pall that could be cast over these essential operations by the repeal or substantial modification of the already limited McCarran-Ferguson exemption could be enough to severely curtail them. Such a result would be a disservice not only to insurers, large and small, but to the insuring public as a whole. That is why proponents of repeal or modification should demonstrate the need for change and that any proposed change will help, not harm competition in the property/casualty insurance business.

Thank you for giving me the opportunity to present this statement. I would be pleased to answer any questions you may have.