Statement of

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before the

Antitrust Modernization Commission

on the

McCarran-Ferguson Act

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I. Introduction

I believe the case for repeal of the McCarran-Ferguson Act is a strong one. However, I do not want to overstate either the role that the McCarran exemption currently plays in the insurance marketplace or the effect that repeal of the exemption would be likely to have. I therefore ask that the Commission keep the following three points in mind:

A. Repeal of McCarran-Ferguson is not a panacea.

In property/casualty insurance, the absence of objective standards governing actuarial projections of future losses--which are what current rates are based on--is a more fundamental problem than the industry's antitrust exemption. In health insurance, the absence of laws enabling and requiring competition on the basis of price rather than on the basis of risk segmentation and product differentiation is a more fundamental problem than McCarran-Ferguson. Repeal of McCarran-Ferguson, without more, is unlikely to ameliorate these underlying problems of insurance markets.

B. Notwithstanding McCarran-Ferguson, by many measures competition has been flourishing in the insurance industry.

The internet, for example, has both enabled insurers to reduce their costs and enabled consumers to obtain comparative price information, both of which have resulted in downward pressure on prices despite the existence of McCarran-Ferguson.

In addition, by many measures profits in most lines in the insurance industry have not been excessive over the long run. In fact, in Illinois, the one state which has no auto insurance rating law—i.e., no law that requires insurance rates to be not "excessive, inadequate, or unfairly discriminatory"—auto insurance has yielded a 9% return on net worth over the last decade.[1] The Illinois auto insurance market is thus an example of a market in which the combination of no antitrust enforcement and no rate regulation has not resulted in supra-competitive profits.

C. The state statutes governing mergers between insurance companies contain tougher antitrust standards than those currently used by the federal antitrust agencies or enunciated by the courts.

Specifically, most state insurance holding company acts are based not on the current DOJ or FTC antitrust guidelines but rather on the 1968 DOJ Guidelines: they evaluate the competitive impact of mergers based not on the Herfindahl index but on market share, and they presume that a merger between two companies with a combined market share of as little as 8% may substantially lessen competition and thus may be disapproved. E.g., §382.095.4(2)(a), RSMo. In addition, they contain a provision enabling the commissioner to disapprove a merger if he finds that it "is likely to be hazardous or prejudicial to the insurance buying public." E.g., §382.060.1(6), RSMo. The approval of large, controversial mergers by state insurance commissioners therefore can not be blamed on the McCarran-Ferguson exemption.

Nevertheless, notwithstanding the above, I believe that the case for repealing McCarran-Ferguson is very strong, as will be set out in the remainder of this statement.

II. McCarran-Ferguson is both an exemption from federal antitrust laws and an exemption from federal consumer protection law; both exemptions have had adverse effects on consumers

A. Effects of the McCarran-Ferguson consumer protection exemption

McCarran-Ferguson exempts insurance companies from federal consumer protection laws in two ways. Specifically, the first clause of 15 U.S.C. §1012(b) provides

[1] NAIC, Report on Profitability By Line By State in 2004, at 198 (2005).

that federal laws may not supersede state insurance laws, and the second clause provides that the FTC Act—which includes the section 5 prohibition on unfair or deceptive practices as well as unfair methods of competition—is applicable to the business of insurance only if it is not regulated by state law.[2]

All states regulate the insurance industry; McCarran-Ferguson thus leaves no doubt that federal law providing a higher degree of protection than state law, or providing additional remedies or penalties than those provided by state law, does not apply to the business of insurance.

Consumers involved in disputes with insurance companies thus must look exclusively to state law for relief. Most provisions of state insurance law are based on model laws promulgated by the National Association of Insurance Commissioners. Under most state laws, the insurance commissioner has no authority to issue refunds, even if he has found that an unlawful overcharge has occurred; in virtually all states there is no private right of action under the insurance rating law, as a result of which private parties have no ability to challenge rates as excessive; and in most states there is no private right of action under the unfair insurance trade practices act, as a result of which private parties have no ability to obtain damages even when they can prove a law violation. The state regulation that McCarran has made possible thus in many cases prevents insurance policyholders from obtaining an adequate remedy. If McCarran were

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[2] 15 U.S.C. 1012(b) provides:

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 after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended [15 U.S.C. 41 et seq.], shall be applicable to the business of insurance to the extent that such business is not regulated by State Law.

repealed, and the Federal Trade Commission were thus enabled to challenge unfair or deceptive practices in the insurance industry as it does in other industries, consumer protection of insurance policyholders would be substantially enhanced.

B. Effects of the McCarran-Ferguson antitrust exemption

1. Long-term supra-competitive profits in certain lines of insurance

Based on the Annual Statements insurance companies file with state regulators, the NAIC annually calculates the rate of return yielded by each of the 14 major property/casualty lines of insurance in each state for each of the last ten years. On an all-lines basis, property/casualty insurance profitability is typically not excessive. In several lines, however, including farm owners, fire, and auto physical damage, rates and profits in many states have been excessive over the long run and remain excessive today. [3] There may well be non-McCarran factors at work that have played a role in the maintenance of these long-run excessive rates and profits. It seems unreasonable, however, to believe that such rates and profits are completely unrelated to the industry's antitrust exemption.

2. Price-fixing that is not undertaken pursuant to a clearly articulated state policy and is not actively supervised by the state

Under the state action doctrine, which would apply to insurer anticompetitive activity absent the McCarran exemption, insurers would be able to agree on price if such agreements were undertaken pursuant to a clearly articulated and affirmatively expressed state policy and were actively supervised by the state. Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 105 (1980). Under McCarran, in contrast,

[3] NAIC, Profitability By Line By State in 2004 at 101-02, 113-14, 117-18 (2005).

insurers may agree on price even if the state has expressed no policy supporting such agreements and exerts no supervision over such agreements.

While the state statutes authorizing price-fixing by insurers would arguably meet the "clearly articulated and affirmatively expressed" state policy test under the state action doctrine, they would clearly fail the "active supervision" test for state action immunity. The Missouri statute, for example, which is based on the NAIC model, provides in relevant part that "two or more insurers may act in concert with each other and with others with respect to any matters pertaining to the making of rates or rating systems…." §379.346, RSMo. Although the statute does not mandate price-fixing, it clearly permits it; there is therefore at least an argument that the first test under the state action doctrine is met. On the other hand, Missouri does not actively supervise any price-fixing among insurers. To the extent insurers may agree on price, whether on an insurer-to-insurer basis or through an insurance rating organization--defined in Missouri as an organization "which has as its primary object and purpose the making and filing of rates," §379.323.1, RSMo.--such agreements are clearly the product of private action, not state action.

The license McCarran grants to insurers to engage in price-fixing does not necessarily mean, however, that they will do so; the extent to which insurers do actually fix prices has long been a subject of dispute. On the one hand, insurance industry rating bureaus did historically both establish rates and enforce compliance with the rates they established; those are the practices that were challenged by the Justice Department and held unlawful by the Supreme Court in U.S. v. Southeastern Underwriters Ass'n, 322 U.S. 533 (1944), and which the McCarran Act has immunized. On the other hand, the industry has changed since Southeastern Underwriters; while rating bureaus still exist, and still publish rates or components of rates, in most lines in most states they no longer require their members to charge those rates. In addition, even where insurers have the same published base rates, they may charge different prices to different risks based on their schedules of debits and credits. Nevertheless, absent McCarran immunity the issuance of advisory rates or components of rates by an insurance rating bureau would almost certainly violate the antitrust laws. See, e.g., American Column & Lumber Co. v. United States, 257 U.S. 377, 410 (1921) ("Genuine competitors . . . do not submit the details of their business to the analysis of an expert, jointly employed, and obtain from him a 'harmonized' estimate of the market as it is and as, in his specially and confidentially informed judgment, it promises to be.") Notably, courts have consistently prohibited trade associations from circulating suggested price lists,[4] even when the list serves only as a starting point for price determination,[5] and when no agreement to adhere to the suggested price exists and prices do substantially depart from the suggested rate.[6]

C. Rates that are excessive as a matter of law, regardless of the rate of return they produce

In virtually all states, the law provides that property/casualty rates may not be "excessive, inadequate or unfairly discriminatory." However, the procedures the states follow in determining whether rates meet that statutory standard vary both by line and by state. Under some statutes insurers must obtain the approval of the insurance

[4] E.g., Northern Cal. Pharmaceutical Ass'n v. United States, 306 F.2d 379 (9th Cir.), cert. denied, 371 U.S. 862 (1962).
[5] Plymouth Dealers Ass'n v. United States, 279 F.2d 128 (9th Cir. 1960).
[6] United States v. Nationwide Trailer Rental Sys., 156 F.Supp. 800 (D. Kan.), aff'd per curiam, 355 U.S. 10 (1957).

commissioner before they can implement rate increases;[7] under some statutes insurers must file their proposed rates with the commissioner and wait a certain number of days before implementing them;[8] and under some statutes insurers can implement rate increases at will but the commissioner can disapprove rates after they take effect if he finds them excessive.[9] Finally, some statutes both permit insurers to implement rate increases at will and define rates in a competitive market as per se non-excessive.[10] Because insurance commissioners have rarely if ever found a line of insurance to be non-competitive, under such statutes rates are non-excessive as a matter of law regardless of the rate of return they produce.

As with insurer price-fixing, the extent to which the antitrust exemption facilitates rates under such statutes is unclear. It is indisputable, however, that the combination of such statutes and the industry's antitrust exemption creates an environment in which rates producing such profits are immune from challenge.

4. The anti-rebate laws

The anti-rebate laws, which exist in all states except California and Florida,[11] prohibit insurance agents from discounting their commissions.[12] Put another way, they

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[7] E.g., Cal. Ins. Code §1861.05.
[8] E.g., Ohio Rev. Code §3937.03.
[9] E.g., Fla. Stat. §627.0651.
[10] E.g., Conn. Gen. Stat. §38a-686(a)(1).
[11] The California rebate law was repealed by Proposition 103 in 1988. The Florida anti-rebate law was struck down on state constitutional grounds in Dep't of Ins. v. Dade County Consumer Advocate's Office, 492 So.2d 1032 (Fla. 1986)
[12] . Missouri's anti-rebate law provides, in relevant part:
"No insurer or employee thereof, and no insurance producer shall pay, allow, or give, directly or indirectly, as an inducement to insurance, or after insurance has been effected, any rebate, discount, abatement, credit or reduction of the premium named in a policy of insurance, or any special favor or advantage in the dividends or other benefits to accrue thereon, or any valuable consideration or inducement whatever, not specified in the policy of insurance, except to the extent provided for in applicable filings. No insured named in any policy of insurance shall knowingly receive or accept, directly or indirectly, any rebate, discount, abatement, credit or reduction of premium, or any special favor or advantage or valuable consideration or inducement." §379.356.1, RSMo.

mandate vertical price-fixing in the insurance industry.

For auto insurance, in connection with which the agent's commission is typically 15%, repealing the anti-rebate laws could produce price competition at the agent level and reduce rates substantially. Repeal of the anti-rebate laws could have an even greater effect in the life insurance business, where first-year commissions can be 30% to 50% and even more.

Different justifications for the anti-rebate laws have been raised over the years. Those most often raised, as set forth in a comprehensive opinion by the Alaska attorney general defending Alaska's anti-rebate law against a state constitutional challenge, include:

* "Rebating will jeopardize the livelihood of a small town producer, opening the door to concentration of business by the big players and monopolistic practices";

* "Rebating will result in a de-emphasis on producer advice and service, to the detriment of consumers";

* "Rebates will result in undue consumer emphasis on price over quality of product"; and

* "Even well-intentioned deregulation in this area will result in unanticipated negative consequences for the general public, including, at minimum, a torrent of sharp business practices by producers."

Letter from Bruce M. Botelho, Alaska Attorney-General, to The Honorable Dave Donley, Alaska State Senate, Apr. 22, 1996, at 8-9.

The arguments against "rebating"--i.e., in favor of vertical price-fixing--are the same arguments that have been made over the years by various antitrust defendants seeking to justify various practices that restrain competition but promote other arguably laudable goals. The Supreme has consistently rejected these arguments, emphasizing that they should be addressed to Congress and not to the courts. See, e.g., National Society of Professional Engineers v. United States, 435 U.S. 679, 692 ("the purpose of [antitrust] analysis is to form a judgment about the competitive significance of the restraint; it is not to decide whether a policy favoring competition is in the public interest, or in the interest of the members of an industry. Subject to exceptions defined by statute, that policy decision has been made by the Congress.")

5. The insurance cycle

The property/casualty insurance industry, and particularly so-called "long-tail" lines like medical malpractice and general liability, is cyclical: rates remain stable or even decline for the greater part of a decade, followed by sharp rate increases for short periods which are labeled "insurance crises." There have been three such "crises" during the last thirty years--one in 1975-76, one in 1986-87, and one in 2002-2004. The cyclicality of the property/casualty industry is caused by various factors, including fluctuations in interest rates and stock market performance, fluctuations in reinsurance rates, and the broad discretion actuaries have in setting reserves. The McCarran-Ferguson Act may well also play a role in the insurance cycle, both because it enables insurers to raise rates collectively, and because insurers' knowledge that they can raise rates collectively may exacerbate price-cutting once rates begin to decline.

It should be emphasized that the role, if any, that the McCarran exemption has played in connection with the sharp medical malpractice rate increases of recent years is not well understood. On the one hand, the many malpractice carriers that were founded by and are affiliated with the state medical associations, and who pay commissions to medical association-affiliated insurance agencies, do not rely on the advisory rate promulgated by the major insurance rating organization, the Insurance Services Office. On the other hand, the agreements made among the state medical associations, the association-affiliated malpractice insurers, and the association-affiliated insurance agencies may well be facilitated by the McCarran exemption.

III. Rationales for McCarran

Three rationales for continuing the McCarran exemption have traditionally been raised. Upon examination, all are without merit.

The first argument is that the antitrust exemption is necessary to enable insurers to pool their loss data, since the more loss data an actuary has on which to base his projection of future costs, the more accurate the actuary's projection is likely to be. This argument is without merit because the courts have clearly held that the antitrust laws do not prohibit the sharing of historical loss data. See, e.g., P. McAvoy, Federal-State Regulation of the Pricing and Marketing of Insurance, at 52-55 (Amer. Ent. Inst. 1977) ("the antitrust laws clearly permit...the collection, compilation, and dissemination of past loss and expense data. On the other hand, the projection of future rates, or any large component thereof, would likely fall within the prohibitions of the Sherman Act."). See also Broadcast Music, Inc. v. Columbia Broadcasting System, 441 U.S. 1 (1979) (joint activities that reduce costs and facilitate efficient marking will be upheld under antitrust laws). Historical loss data could therefore continue to be shared, and rates made independently based on that shared data, if McCarran were repealed.

The second argument is that the antitrust exemption is necessary to enable insurers to use standardized policy forms. As with past cost data, however, the courts have held that the promulgation of standardized policy forms does not violate the antitrust laws: specifically, courts have noted the pro-competitive aspects of industry standardization of forms, in that standardization makes consumer comparison of the price of alternative products easier. See, e.g., Maple Flooring Ass'n v. United States, 268 U.S. 563, 566 (1925) (standardization beneficial to both industry and consumers); Tag Mfrs. Inst. v. FTC, 174 F.2d 452, 462 (1st Cir. 1949) (standardization enables consumers to know what they are buying and make intelligent price comparisons).

Finally, some have argued that antitrust immunity is necessary for so-called "residual markets" to function. The residual market is the market in which risks who are required by law to buy insurance but who insurance companies refuse to voluntarily insure can buy insurance. While the structure of such markets differs, the state either sets or approves the rate for the residual market, and the insurers in the voluntary market participate in the profits or losses of that market in proportion to their market share. Because the state either sets or approves the residual market rate, residual markets either don't raise antitrust problems at all or would be immune from antitrust challenge under the state action doctrine. In either event, McCarran immunity is unnecessary to enable residual markets to function.

IV. Challenges to anti-competitive activities by insurers that can be undertaken under current law, notwithstanding McCarran

A. Challenges to activities engaged in by insurance companies that are not the business of insurance.

The McCarran exemption applies to the "business of insurance," not the business of insurance companies. Under Group Life and Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979), and Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119 (1982), for a practice engaged in by insurance companies to constitute the business of insurance and thus be immune from antitrust challenge, it must meet a three-part test: first, the activity must involve the underwriting or spreading of risk; second, the activity must involve an integral part of the insurer-insured relationship; and third, the activity must be limited to entities within the insurance industry.

Many activities engaged in by insurance companies clearly do not meet this three-part test--in particular, they do not involve-risk spreading--and thus are not immunized by the McCarran exemption. For example, the setting of uniform rates by title insurance companies in Wisconsin and Montana for title searches and examinations was successfully challenged by the FTC in FTC v. Ticor, 504 U.S. 621 (1992). Because those activities did not constitute the business of insurance, the Court evaluated their legality under the state action doctrine rather than under McCarran. Because Wisconsin and Montana did not actively supervise those activities, the Court found that they were not immunized by the state action doctrine and thus did violate the antitrust laws.

It would appear that the establishment of uniform agents' commissions could also be challenged notwithstanding the McCarran Act, since the setting of commissions does not appear to involve the spreading of risk. As with the practices at issue in Ticor, whether or not uniform commissions violated the antitrust laws would thus depend on whether the state actively supervised those activities.

B. Challenges to activities that do constitute the business of insurance but with respect to which even the minimal regulation required to trigger McCarran immunity is absent

It is generally accepted that under McCarran-Ferguson the mere articulation of some regulation relating in some way to insurance is sufficient to immunize any practice constituting the business of insurance from antitrust challenge.

In fact, however, FTC v. National Cas. Co., 357 U.S. 560 (1958), the Supreme Court case setting forth the standard governing the sufficiency of the regulation necessary to trigger McCarran immunity, does not go that far. National Casualty concerned a challenge by the FTC to allegedly unfair and deceptive advertising in violation of section 5 of the FTC Act. The FTC argued that, although the states also had enacted statutes prohibiting unfair and deceptive practices, such a prohibition could not trigger McCarran immunity "until that prohibition has been crystallized into administrative elaboration of these standards and application in individual cases." 357 U.S. at 564. The Court rejected that argument because, the Court explained, "[e]ach State in question has enacted prohibitory legislation which proscribes unfair insurance advertising and authorizes enforcement through a scheme of administrative supervision." Id.

Notably, the National Casualty Court did not hold that any regulation in the area of insurance immunized all activity by insurers under McCarran; it held only that where a statute prohibits certain types of practices, those practices are immunized from challenge. In addition, National Casualty concerned a challenge under the FTC's consumer protection authority, not its antitrust authority. National Casualty therefore leaves room for the FTC to challenge practices, even given the existing McCarran immunity, that constitute either unfair or deceptive practices or unfair methods of competition in a state which has no regulation of those practices.

V. Conclusion

Reasonable people can disagree as to the extent to which the repeal of McCarran-Ferguson is likely to lower insurance rates or result in other pro-competitive benefits. It seems clear, however, based on the evidence of long-run supra-competitive profits in certain lines of insurance, the state statutes which expressly authorize both horizontal and vertical price-fixing, and the state statutes that effectively deem rates *per se* non-excessive, that repeal of the McCarran must necessarily have some pro-competitive benefit. Conversely, there is no principled argument that any legitimately pro-competitive activity currently undertaken by insurers would be struck down as violative of the antitrust laws if McCarran were repealed. The case for such repeal is therefore a strong one.