

Comments
before the
Antitrust Modernization Commission
regarding
Exemptions and Immunities: The McCarran-Ferguson Act

Julie Leigh Gackenbach
Confere Strategies

on behalf of
The National Association of Mutual Insurance Companies
October 18, 2006

The National Association of Mutual Insurance Companies (NAMIC) offers the following comments concerning the limited antitrust exemption provided for the business of insurance under the McCarran-Ferguson Act. Founded in 1895, the National Association of Mutual Insurance Companies (NAMIC) is a full-service national trade association serving the property/casualty insurance industry with more than 1,400 member companies that underwrite more than 40 percent of the property/casualty insurance premium in the United States. NAMIC members are small farm mutual companies, state and regional insurance companies, risk retention groups, national writers, reinsurance companies, and international insurance giants.

In response to the United States Supreme Court decision in *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944), that insurance was “interstate commerce” and subject to regulation by the federal government, Congress, in 1945, enacted the McCarran-Ferguson Act (15 USC 1011, et seq.). The McCarran-Ferguson Act provided for the continued regulation of insurance by the states and provided a narrow exemption from the general federal antitrust laws.¹ Specifically, the exemption is limited to activities that (1) constitute the “business of insurance,” (2) are “regulated by State law,” and (3) do not constitute “an agreement to boycott, coerce or intimidate or an act of boycott, coercion or intimidation. In addition, like other exemptions from antitrust laws, this exemption is to be construed narrowly.

The application of the McCarran-Ferguson limited federal antitrust exemption has worked well for decades to promote and maintain a healthy, vibrant and competitive insurance marketplace. There are more than 5,000 insurers operating in the United States, the majority of which are relatively small. A number of studies over the years, including those done by the U.S. Department of Justice, state insurance departments and respected economists and academics, have consistently concluded that the insurance industry is very competitive under classic economic tests.

The competitiveness and diversity in the insurance market is evidenced by NAMIC’s membership in terms of size, geographic dispersion, lines of business and corporate structure. The McCarran-Ferguson exemption has contributed to this diversity and increasing the number and competence of insurers by making it easier for small and medium size insurers to compete. The existence of the exemption promotes competition in the insurance marketplace by allowing companies to exchange critical data regarding losses and other factors,

¹ The Sherman Act (prohibits restraint of trade and monopolistic practices), the Clayton Act (prohibits anti-competitive practices), the Robinson-Patman Act (an amendment to the Clayton Act prohibits price discrimination among customers who compete against each other), and the Federal Trade Commission Act (prohibits unfair methods of competition and deceptive practices)

facilitating participation and oversight of state guaranty funds, permitting state control over liquidations and enabling the development and operation of assigned risk plans.

Over the past 60 years a substantial body of case law has developed interpreting the narrow limitations. The McCarran-Ferguson limitations apply only to the “business of insurance,” which is undefined in the statute. Prior to 1969, the courts generally construed the term to include virtually all activities engaged in by an insurance company; however, the Supreme Court narrowed the provision in *SEC v. National Securities, Inc.*, 393 U.S. 453, 459-60 (1969), distinguishing the “business of insurance” from the “business of insurance companies.” In the wake of the *National Securities* decision, the Court developed a three prong test to decide whether an activity constitutes the “business of insurance”: 1) whether the activity transfers or spreads a policyholder’s risk, 2) whether it is an integral part of the policy relationship between the insurer and the insured, and 3) whether the activity is limited to entities within the insurance industry.² The courts have consistently reaffirmed the essential nature of risk transfer to the “business of insurance.”

Similarly, the relationship between the insurer and the policyholder is central to the determination of whether the activity is the “business of insurance.” Activities that revolve around the contract of insurance – the type of policy, interpretation, enforcement, etc. – go to the relationship with the insured. State rules and regulations regulating this relationship, whether directly or indirectly, regulate the “business of insurance.”

Cases involving the determination of whether activities constitute the “business of insurance” are highly fact-specific. However, reflecting the concern of Congress over the difficulty of underwriting risks in an informed and responsible way without intra-industry cooperation, the courts have generally found that activities facilitating the exchange of information necessary to ratemaking constitute the “business of insurance.” Practices not involving ratemaking have been less likely to be construed by the courts as the “business of insurance.”

The ability of insurers to engage in effective ratemaking activities goes to the heart of risk-sharing inherent in the “business of insurance.” Standardized risk classification and policy language make data more credible and enable consumers to better compare offers. Standardization affords consumers greater opportunity to assess competing price and coverage options and reduces litigation over interpretation, streamlining the claims process.

Insurance is fundamentally different from other products, including other financial products, in that insurance is a promise of future financial obligations. As such,

² *Group Life & 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).

insurers lack complete information about the ultimate cost of the product at the time of the sale. Consequently, the policy premium is based on a best estimate of those costs. To develop these best estimates insurers rely on information from a large number of losses over a significant period of time. Few insurers, however, have enough information on their own to evaluate every type of risk they underwrite. These companies are not able to develop actuarially credible rating information through their internal loss experience alone. This is particularly important for smaller and medium sized companies. Without advisory loss cost data, they would be unable to compete with larger companies. In addition, many insurers rely on the availability of supplemental rating information developed by licensed advisory organizations such as the Insurance Services Offices (ISO) in order to administer their rating programs. This information would not be available if all insurance companies did not report data or were constrained from reporting data as the result of antitrust exposure. Even if the data were available, the cost could be prohibitive if statistical agents had fewer companies over which to spread their production costs.

The state regulatory systems respect the value of advisory loss cost and similar data to competition by compelling insurers to report data and authorizing the compilation and publication of the data by licensed organizations and regulators themselves use such data to analyze trends and evaluate the appropriateness of rate and rating plans. It is the McCarran-Ferguson limited antitrust exemption that provides the legal framework under which the statistical agents collect and analyze the data and insurance companies pool and use the aggregated information.

Consolidated collection and analysis of data and publication of advisory loss costs improve the quality of the market by making it easier for smaller insurers to compete, and offer consumers greater choice. The availability and affordability of advisory loss cost data helps to maintain a blend of both large national firms and smaller regional and state level underwriters in the insurance market. In the absence of such data, smaller and medium sized insurers would confront increased operating expenses which over time could threaten their franchise and participation in the market. The absence of data or significantly increased expense of data would also have a chilling effect on the ability of some insurers to expand into new markets or new product lines, further reducing competition and consumer choice.

The limited antitrust exemption also facilitates efficient marketplaces by allowing insurers to form intercompany pools or syndicates to provide high-risk coverage and/or to allow small companies to participate in writing risks that would be unavailable on an individual basis. In addition, the McCarran-Ferguson limited antitrust exemption is key to other cooperative functions such as joint underwriting associations and residual market mechanisms. The development and operation of assigned risk plans, such as those for auto and workers' compensation, with jointly determined rate schedules could be thwarted by

limitation or repeal of McCarran-Ferguson. Similarly, participation in state guaranty funds, including monitoring the economic performance of competitors and distribution of losses, could be threatened. The insurance industry by necessity and design plays a hands-on role in administering state guaranty funds. Guaranty funds do not merely serve to replace funds, but to ensure swift and prudent payment of claims, including fraud prevention. These cooperative industry activities provide a critical safety net for insurance consumers and are essential to efficiently operating insurance markets, filling the gap for individuals and businesses otherwise unable to find coverage and ensuring prompt coverage in the event of insolvency.

Over the years there have been numerous proposals to limit or repeal the McCarran-Ferguson limited antitrust exemption. Proponents often ground their calls for repeal or limitation on unproven assertions that the antitrust exemption has led to collusion within the industry; however, there has been no evidence to support these assertions. The industry is highly regulated by state insurance regulators who monitor not only safety and soundness issues, but also any potential anticompetitive and unfair trade practices.

Others have recommended replacing the limited antitrust exemption with a series of “safe harbors” specifically listing the practices of insurance companies that would be exempt from antitrust laws. The safe harbor approach has been rejected by insurers and by Congress since the early 1990s. While the adoption of safe harbors may seem simple and appealing on the surface, insurers and Congress have consistently recognized the numerous potential pitfalls. First, it is impossible to craft a comprehensive list of safe harbors for all the current and future data and information needs of the industry. Second, the safe harbor provisions would serve as an invitation to litigation. The legal uncertainty could have a chilling effect on insurer’s willingness to engage in pro-competitive, efficiency-enhancing cooperative activities. Finally, no matter how carefully drafted, safe harbor provisions would prove inefficient in protecting current operations and would lack the flexibility to adapt to changing innovations and business practices.

In addition, if safe harbors were crafted or interpreted to “allow” but not “require” certain data reporting additional unattended consequences could occur. If participation in rate advisory organizations would be held to be at the election of individual companies it would threaten the quantity and quality of the underlying data. The data availability issue would not be resolved by merely preserving the ability to exchange information. Current industry-wide reporting and sharing requirements which are essential to the production of credible advisory information must also be preserved.

The existence of the McCarran-Ferguson limited antitrust exemption serves to make the industry more competitive, not less. Proposals to repeal or limit the exemptions would threaten activities that have increased competition and

provided significant benefits to America's consumers. It is highly likely that rather than increasing competition, repeal or limitation of the McCarran-Ferguson limited exemption would perversely reduce competition, increase insurance costs and reduce availability for some high-risk coverages.

The Commission and Congress should be wary of the unintended consequences of changes to the current limited antitrust exemption. Any change that precludes, restricts or even merely discourages the production and exchange of advisory loss costs and supplementary rating information could place smaller and regional firms at a distinct disadvantage, increase consumer costs, reduce consumer choice and seriously undermine competition. There is no credible evidence that the cost, availability or quality of insurance products would be enhanced if the McCarran-Ferguson limited antitrust exemptions were repealed or modified. Any change in the existing antitrust regime and repeal or modification to the current limitations could decrease market stability, reduce affordability and availability of products, stifle innovation and expansion, diminish industry efficiency and ultimately, inhibit rather than increase competition in the insurance marketplace.

NAMIC appreciates the opportunity to appear before the Commission and stands ready to assist the Commission.