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NAIC Responses to Member Questions

"The McCarran-Ferguson Act and Antitrust Immunity: Good for Consumers?"

Senate Judiciary Committee Hearing
March 7, 2007

Susan Voss, Commissioner

Iowa Insurance Division, State of Iowa

For the National Association of Insurance Commissioners (NAIC)

April 5, 2007

RESPONSE TO CHAIRMAN LEAHY (D-VT)

1. *You emphasized federal-state prosecutorial cooperation in your testimony. You specifically stated that, "[a] ny federal legislation should include provisions that authorize federal-state collaboration to identify, investigate, and prosecute bad actors in the business of insurance who engage in anti-competitive practices." Please elaborate on any and all anti-competitive practices that insurers may currently be engaging in, free of the Department of Justice's oversight.*

The Act does not bar federal investigation of anti-competitive practices. The Act expressly states that federal antitrust law applies to the business of insurance except where the states regulate the practice. 15 U.S.C. §1012(b). The Act does not limit federal investigatory authority of anti-competitive practices; rather, the threshold barrier to federal prosecution is whether a state regulates the identified practice.

The opportunity for federal-state collaboration exists whether a state regulates the practice or not. Where the Department of Justice investigates conduct in the insurance industry and finds anticompetitive behavior, it can inform a state insurance regulator about alleged anticompetitive practices and invite the state to pursue investigation and prosecution under state antitrust or unfair trade practice law. In most situations, however, the limited federal antitrust exception would not apply because the state does not regulate the identified practice, which frees the federal government to prosecute under federal antitrust laws. In its recently-released final report, the federal Antitrust Modernization Commission (AMC) encourages state and federal antitrust enforcers to coordinate activities and to harmonize their substantive enforcement standards. *AMC Report and Recommendations*, at v. (April 2007).

States are vigilant in their efforts to identify and stop anti-competitive practices, but no level of government is omniscient about events before they occur. Through the NAIC, state insurance regulators are making progress together to identify, isolate, investigate,

and eradicate anti-competitive practices in the business of insurance. For instance, in the area of market conduct, the NAIC's Market Analysis Working Group (MAWG) adopted protocols for the coordination and collaboration of market regulatory interventions. MAWG assists states through a peer-review process to identify market activities that have a national impact, offering guidance to states on initiating appropriate regulatory action against insurance companies and producers, and encouraging the examination of key market issues. The states, however, could benefit from additional investigative tools to protect consumers. While states are currently able to obtain access to the FBI database through the adoption of proper legislative authority, federal law prohibits states from sharing criminal history record information with each other. The NAIC continues to seek solutions to enhance states access to the FBI database and resolve the prohibition against the sharing of such information among the states.

RESPONSES TO SEN. SPECTER (R-PA)

1. *You have stated that repeal of McCarran-Ferguson would put a stop to insurance industry practices that benefit consumers and promote competition. As examples of pro-competitive practices, you cite information sharing through ratings and statistical organizations. However, Mr. Hunter argues that such information sharing in many cases reduces competition and raises prices that consumers pay. Do you have any evidence that he's wrong?*

    a. *Mr. Hunter contends that insurance companies use ratings and statistical organizations to signal the market when they want to raise rates or abandon a market. How do you respond to that*?

Economists have long argued that an efficient and effective market for insurance depends upon the sharing of information. Availability of information does exactly the opposite of Mr. Hunter's contention: information increases competition and lowers prices. The more

information available such as losses and claims costs, the less able insurers are to price discriminate based on those costs. Limited availability of critical factual information would invite a monopolistic market and function as a barrier to consumer-centered competition.

In Illinois, for instance, workers' compensation insurance reflects the value of information-sharing organizations. Ratings and statistical organizations are subject to state regulation. The shared information is critical because the price of insurance is prospective, not retrospective or static.

Information regarding a trend aids smaller companies – the vast majority of insurance companies – with less-sophisticated databases or fewer professional staff when that smaller company seeks to compete on price and service or gain an increased market share. Also, this benefits consumers by allowing more accurately priced products. Responsible raising or lowering of rates is a reflection of the collective loss data and legislative reforms in a market that the rating organization develops. Loss data is aggregated to provide the rating organization with a "loss cost" or "expected loss potential" that is then provided to insurance companies. The company has to take into account their own experience for expenses and profit loading to develop the rate that the company will use.

Rate markup beyond rating organization loss cost estimates is a corporate decision. Rating organizations are not involved. It is the actual loss costs, not the entity developing them, that insurers use to make decisions about when and where to write business.

2. *In your testimony, you contend that the use of uniform policy forms or policy language is pro-competitive. However, Mr. Hunter argues that using uniform forms and language permits insurers to collude on terms they will offer to consumers. For example, almost every insurer in Louisiana and Mississippi used identical anti-concurrent causation clauses to deny claims where both wind and*

flooding caused damage to a home. Can you explain how the use of uniform forms and language could be pro-competitive?

The goal of uniform forms and language is to provide a level playing field for consumers so they know what specifically they are buying and can compare one product with another. The primary mission of the state regulator is to protect the consumer and ensure that industry participants follow applicable law and regulation. Uniform forms and language are pro-competitive in that they standardize the products offered to the consumer. For example, an "anti-concurrent causation" clause in an insurance policy excludes certain losses from coverage regardless of whether some other cause or event contributes concurrently or in any sequence to the loss. Regulators approve the language of the clause. Insurers using the anti-concurrent causation clause can price their products according to the level of risk assumed under the uniform clause. Alternatively, in the absence of uniformity, the price variation in the products would be significant, and the benefits and coverage less transparent. Moreover, it would impose even more responsibility on consumers to understand the policy terms before the need to file a claim arises.

3. *Mr. Hunter argues that insurers are using new third parties, including modeling consultants that are beyond the reach of state regulators to exchange information used to make pricing decisions. Do you believe that insurers are using these new entities to avoid scrutiny by your state regulators*?

I see no evidence that insurers use third parties such as modeling consultants to avoid scrutiny by our state's regulators.

Insurers are not driven to fail. To understand the risks of a line of business in a geographic or demographic area, insurers must first know the projected costs of the risk. Failure to consider this information would be irresponsible and reckless because if rates are too low, then consumers suffer because the insurer either cannot renew after a serious event or, worse, becomes insolvent and unable to pay claims in a timely or professional

manner. Conversely, if rates are too high, then consumers suffer because price eliminates choice. It is not surprising that insurers in the same line of business and in the same geographic or demographic region would consider the same factual information. For example, in the Gulf, insurers must consider weather patterns and data offered by modelers. Whether climate change or global warming, the information allows for responsible rate settings.

Iowa law directs the regulators to require evidence from insurers that property and casualty rates are not excessive, inadequate, or unfairly discriminatory. The regulator may require information pertaining to a rating model, if that is necessary to the regulator's analysis, no matter the source of the model. We do not have the major catastrophe exposures that some states have. However, in a slightly different context, some companies use third party vendors for developing credit scores or "insurance scores." The Iowa division has required insurance companies to share under confidentiality the credit and insurance scoring models.

RESPONSES TO SEN. GRASSLEY (R-IA)

1. *What specific business of insurance practices could be at risk of challenge as violations of federal antitrust law absent the McCarran-Ferguson exemption? Which of these at risk business practices currently benefit consumers or create a competitive market? Can you provide some of examples? Which of these hurt or potentially hurt consumers*?

Practices that face exposure to federal antitrust law absent state law and the McCarran-Ferguson's limited antitrust exemption include:

- policy form standardization;
- joint underwriting and residual market underwriting (i.e. high-risk pools);
- sharing loss cost data;

- statistical activities conducted by rating and advisory organization; and,
- operation of state insolvency funds.

Each of these practices benefits consumers and helps foster a competitive market for insurance. Standardized insurance forms and definitions of risk, for instance, can ease comparison shopping for consumers. Also, use of standardized forms allows for improved data sharing pools for calculating loss costs. This sharing of data can help improve product pricing efficiencies. Joint underwriting provides a method for insurers to share risk that no insurer would assume alone such as high-value or high-risk properties. A lead insurer in cooperation with other insurers spread the risk by each insuring a portion. The limited federal antitrust exemption guards these collaborative efforts from charges of anticompetitive behavior. Repealing the limited antitrust exemption would squeeze those collaborations and limit the insurance options available to owners of high-value or high-risk properties. It would likely chill the ability of any single insurer to write a policy that assumes total risk and to secure reinsurance as a backstop at a reasonable rate. Finally, rating and advisory organizations collect and disseminate statistical information, compile aggregated loss cost data helpful in trending analyses, and provide other services that allow small and medium-sized insurers to compete, thereby improving pricing and choices for consumers. Without applicable state law and regulation, the operation of rating and advisory organizations would be subject to federal scrutiny for potential price fixing as either a per se antitrust violation or an unreasonable restraint of trade.

2. *How do entities like National Council on Compensation Insurance (NCCI) and the Insurance Services Organization (ISO) help or hurt a competitive market? Do these entities help or hinder regulators' understanding of what is going on in the insurance market? Do these entities hinder competition or aid anti-competitive practices? Do these entities act as barriers to entry in the insurance markets, or not*?

Entities such as NCCI, ISO and American Association of Insurance Services (AAIS) help improve competition and regulator's knowledge of the industry.

In most states, data is collected and interpreted by rating organizations and transmitted to insurers as aggregated loss cost data, which indicates expected loss potential. Insurers independently determine prices for their products after considering past experiences, market competitiveness, and the aggregated loss cost data. Rate markup beyond rating organization loss cost estimates is a corporate decision. Rating organizations are not involved. Restrictions on sharing information necessary to formulate rates would impair competition by affording larger insurers a competitive advantage over small and medium-sized insurers, reducing over time the number of insurers in the market and providing consumers with far fewer choices.

Competitive markets rely on availability of information. Without rating organizations, small and medium-sized insurers would face a barrier to entry because the lack of available loss cost information available to them would restrict their knowledge about risks they would insure. Forcing small insurers to abandon rating organization services would force them to compete against larger firms with the capacity to generate independent, actuarially-reliable data. This would only serve to further consolidate the insurance industry and reduce competition in the market. Furthermore, the elimination of a common data source that rating organizations provide would segment the data among individual companies and invite price discrimination based on loss costs.

As long as rating organizations are open and accessible to state regulators, they will be useful in identifying and determining when market challenges occur and why. For example, one of the most troubled insurance markets over time has been medical malpractice insurance. Part of the challenge for regulators is the lack of a ratings organization to standardize malpractice claims and loss data because many insurers choose not to participate in the agencies. This prevents regulators from relying upon a uniform, standard source when analyzing and evaluating the medical malpractice market. For this reason, state regulators would support a modification to pending congressional legislation to reform the surplus lines, or “excess carrier” market, to require a medical

malpractice carrier to report to its state of domicile its loss and claims data for each health care specialty.

3. *Would a total repeal of the McCarran-Ferguson antitrust provision affect all companies and markets the same way? Please elaborate.*

The business of insurance is competitive under the state regulatory system. While more companies have been formed in each of the last three decades – and while the number increases – the number of insurers subject to regulatory supervision or receivership proceedings due to financial status is a mere two-thirds of one percent. With the combined boundaries of state regulation and the McCarran-Ferguson limited antitrust exemption, the insurance industry has a competitive structure given the number of competitors and the ease of entry. Although a particular type of coverage may have limited sellers at a given point in time, the number of potential sellers is in the thousands. Additionally, access to the market is relatively simple, as minimal but sufficient capital and licensing are the basic requisites for entry.

Repeal of the limited federal antitrust exemption would not result in the intended benefits but would cause the opposite: diminished competition by reduction of the number and quality of insurers, principally small and medium-sized insurers.

4. *What impact would a repeal of the antitrust exemption have on state efforts towards modernization and uniformity in the regulation of insurance*?

Repeal of McCarran would chill ongoing state modernization efforts because uncertainty and the constant threat of litigation would cloud whether the states or federal government regulate the insurance industry.

Full application of federal antitrust laws may be appropriate for industries in which the business is free from excessive governmental regulation and a product or service is transferred or provided at the time of payment. For reasons that seem counter-intuitive,

the insurance industry does not fit this paradigm. First, because state regulators must ensure insurer solvency, the unfettered acceptance of risk is not permissible for insurance carriers. State regulators focus on the financial soundness and solvency of companies to protect consumers who, in consideration for premiums paid, rely on insurers to pay claims when filed. Insurance involves the payment of a premium today in return for a promise to pay in the future upon the occurrence of certain contingencies which cannot always be precisely projected.

Second, state regulation necessary with respect to pricing, forms, coverage, financial condition and other critical matters, and the need to provide or facilitate the operation of market mechanisms to offer essential coverage, substantially differentiates the insurance industry from other businesses. Assumptions appropriate in other contexts where federal antitrust laws apply in full -- contexts in which the free market permits the business to open and then fail with the impact falling primarily upon owners or shareholders -- do not apply to the regulated insurance market.

The limited federal antitrust exemption for the business of insurance, combined with effective state regulation, has generated competition that has flourished and served the consumer interest. Repeal would not appear to improve insurance affordability or availability but, instead, would inject uncertainty into an industry where stability and predictability are attracting necessary infusions of capital. Effective regulation will be impossible if inconsistent and unpredictable judicial interpretations and legal doctrines are substituted for past experience.

5. *Is there settled precedent on the State Action doctrine in state and federal courts? If not how might this affect the markets and consumers*?

Settled precedent exists on the standards of the State Action doctrine, but not necessarily on its application to specific antitrust matters associated with the business of insurance. The state action doctrine grants antitrust immunity from the Sherman Act for state regulation. *Parker v. Brown*, 317 U.S. 341, 351 (1943) (The Sherman Act does not

"restrain a state or its officers or agents from activities directed by its legislature; however, a state does not give immunity to those who violate" the Act by authorizing them to do so, or by declaring their actions legal). Subsequently, the Supreme Court fashioned a two-prong test to determine when a state was regulating antitrust practices. *California Retail Liquor Dealers Association v. Midcal Aluminum, Inc*., 445 U.S. 97 (1980). State antitrust regulation is immune from the Sherman Act if the state has: (i) clearly articulated and affirmatively expressed" the policy, and (ii) the policy is "actively supervised" by the state. *Midcal*, 445 U.S. at 105. A challenge with applying the state action doctrine is reaching a level of judicial consistency with the "actively supervised" prong. While "active supervision" requires more than a "gauzy cloak of state involvement," (*Midcal* at 106) the inquiry is "not to determine whether the State has met some normative standard…in its regulatory practices." *FTC v. Ticor Title Ins. Co*., 504 U.S. 621. 634 (1992). The late Chief Justice Rehnquist, dissenting in Ticor Title, implied that the application of the *Midcal* test may not be clear-cut, foreshadowing litigation to clarify its parameters. The Chief Justice argued that the majority rule "necessarily puts the federal court in the position of determining the efficacy of a particular State's regulatory scheme" to determine state compliance with *Midcal*. But, the Court's focus on actions taken by state regulators "necessarily requires a judgment as to whether the State is sufficiently active - surely a normative judgment." *Ticor Title*, 504 U.S. at 645.

Years of litigation in multiple jurisdictions – including within the same state where conflicting decisions could arise – would be necessary to develop uniform precedents among the federal and state circuits. Even assuming that courts apply the State Action doctrine uniformly, the likelihood of litigation remains strong because the facts and circumstances of each case are determinative in antitrust matters. Litigation will create sufficient uncertainty to chill the introduction of new insurance products, limit options for consumers, and negatively impact prices. Litigation will also force states, generally, and state departments of insurance, in particular, to reallocate limited staff and financial resources away from more productive uses.

6. *Describe what the Iowa Insurance Department does presently to identify and remediate alleged anti-competitive insurance industry practices against consumers? How might expanded federal involvement impact the State's current efforts*?

In Iowa, rates, rules, and forms used by insurance companies are reviewed by regulators who can identify possible areas of anti-competitive behavior. As an example, companies are allowed to use others' rates in support of their own. The use of others' rates can further competition, such as when a smaller company uses the expertise of a larger company to set a rate appropriate to the risks in the area. It would be uncompetitive for a company with sufficient experience to price a risk appropriately to use another company's rates in order to obtain higher than necessary rates. The regulator would review the filing and determine whether the use of the other companies' rates is appropriate.

The extent and manner of regulatory scrutiny given to the various products and rates is determined in part by the competitiveness of the market. When a market is functioning, tight scrutiny of the rates and available products is not as necessary. Companies will try to improve their rating structures and offer more desirable products in order to attract more customers. Iowa law provides for different treatment of competitive markets in property casualty rate filing procedures and reviews. The law allows the commissioner to make a determination regarding the competitiveness of markets. It specifies factors to consider in making the determination. One of the ways in which the law provides for less scrutiny for competitive markets is that rate filings must be made within 15 days of using the rates instead of the standard requirement of rates needing to be filed 30 days before their intended use for noncompetitive markets. Both personal auto and homeowners insurance have been determined to be competitive in Iowa.

Regulators in Iowa monitor the marketplace for signs that particular markets may be becoming non-competitive. Industry data and communications with companies, agents, and policyholders offer indicators of competitiveness. Company, agent, and policyholder

complaints are researched. Iowa works with other states in monitoring complaints against agents and companies. When the marketplace is becoming less competitive, complaints from agents and policyholders will include more information regarding availability of coverage or high prices. In a more competitive market, complaints will include more concerns from companies and agents about low prices and new product offerings by other companies.

Through public records laws, companies have access to products and rates of competitors and the public has the ability to see what products are available and how rates are developed. This promotes new and innovative products, which gives choices to consumers.

Federal involvement could aid or hinder state regulation depending upon how it is structured. To aid state regulation, federal involvement should be used in conjunction with the regulatory needs of each state, be uniform for all companies within the states but responsive to state differences, and not affect the ability of companies to obtain state approval where needed. Current NAIC activities, such as states' sharing of data and information and working together, help state efforts.

RESPONSES TO SEN. LANDRIEU (D-LA)

1. *Please describe what kinds of practices might constitute an act of boycott*?

The boycott exception incorporated into the limited federal antitrust exemption resulted from conduct alleged against insurers in *United States v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944), the case that prompted adoption of the McCarran-Ferguson Act. In that case, it was alleged, among other things, that insurers that were not Association members were denied access to reinsurance, and agents that represented non-Association insurers were denied the right to represent Association members. "Boycott" was interpreted by the Supreme Court in *St. Paul Fire & Marine Insurance Co. v. Barry*,

438 U.S. 531 (1978), to include boycotts of policyholders. In the *St. Paul* case, it was alleged that three insurers had refused to sell insurance to plaintiffs in order to force them to purchase from a fourth insurer. The Supreme Court found that only refusals to deal involving the concerted actions of multiple parties constitute boycotts. In *Hartford Fire Insurance Co. v. California,* 509 U.S. 764 (1993), where the central allegation was that insurers, reinsurers, and brokers agreed to boycott insurers that used nonconforming forms, the Supreme Court found that a "boycott" occurs when a group coerces a party to participate in a transaction on certain terms by refusing to deal with that party on another unrelated transaction. Under the *Hartford Fire* analysis, refusing to do business with a customer or group of customers except on certain or standardized terms would not be a boycott, because the refusal is not tied to securing favorable terms in an unrelated transaction.

2. *Would an act of boycott include the non-renewal of policyholders in a geographical region or area? Please explain your response*.

The conduct described would likely not constitute a boycott, unless the refusal to renew was done by several insurers pursuant to an agreement among them and with the goal of securing favorable terms from the policyholders on an unrelated transaction.

3. *Would an insurance company's decision to not write new business in a geographical region or area constitute a boycott? Please explain your response*.

No. The act of an individual company does not constitute a boycott.

4. *In your experience as Insurance Commissioner have you ever handled a situation involving a boycott under McCarran-Ferguson? Please describe.*

I have not encountered this situation.