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 ***If the McCarran-Ferguson exemption were repealed, what insurance company or rate agency activities currently in practice would no longer be permissible under Federal antitrust laws?***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

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