Consumer Federation of America

TESTIMONY OF

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BEFORE

THE COMMITTEE ON THE JUDICIARY
OF THE
UNITED STATES SENATE

REGARDING

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

JUNE 20, 2006

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

OVERVIEW

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

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

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

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

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

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

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

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

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

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

BACKGROUND[2]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Unfortunately, the courts construing the Act did not make these inferences. When presented with the question of what Congress meant by "regulated," the courts found no standard

in the text of the statute and, declining to search for one in the legislative history, reached the very conclusion that Senator Pepper had anticipated and vainly struggled to forestall.

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

- In 1977, when I was Federal Insurance Administrator under President Ford, the Justice Department concluded, "an alternative scheme of regulation, without McCarran Act antitrust protection, would be in the public interest."[3]

- In 1979, President Carter's National Commission for the Reform of Antitrust Laws and Procedures concluded, almost unanimously, that the McCarran broad antitrust immunity should be repealed.

- In 1983, then FTC Chairman James C. Miller III told the House Subcommittee on Commerce, Transportation and Tourism that he saw no legitimate reason to exempt the insurance industry from FTC jurisdiction.

- In 1994, the House Judiciary Committee issued its report calling for a sharp cutting back of the antitrust exemption and proceeded to pass bipartisan legislation to do so.

ATTORNEY GENERAL SPITZER'S FINDINGS

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

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

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

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

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

WIDE RATE DISPARITY REVEALS WEAK COMPETITION IN INSURANCE

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

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

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

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

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

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

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

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

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

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

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

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

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

Other impediments to competition rest in the market itself:

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

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

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

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

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

There will always be a need for regulation of insurance since it requires the consumer to pay for a service today that is not delivered until later – often much later. Competition and regulation are not mutually exclusive. They seek the same ultimate goal: the lowest possible

price consistent with a fair return to the provider. Competition can be greatly improved by correcting the final two market problems itemized above.

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

COMPETITION CAN BE ENHANCED BY REPEAL OF THE ANTITRUST EXEMPTION

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

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

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

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

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

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

- The rate bureaus guide pricing with their loss cost/multiplier methods.

- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust law exemption.

- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.

- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

INEFFICIENCY HARMS CONSUMERS

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

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

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

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

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

expense ratio of the inefficient insurer were lowered to the average expense ratio of all insurance companies.

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

ELIMINATING THE ANTITRUST EXEMPTION HAS HELPED CONSUMERS IN CALIFORNIA

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

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

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

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

BROOKS HEARINGS

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

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

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

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

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

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

CONCLUSION

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

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

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

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

[14] April 11, 1988.

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

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

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

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

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

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

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

ATTACHMENT A

COLLUSIVE ACTIVITY BY THE INSURANCE SERVICES ORGANIZATION THAT IS ALLOWED BY THE MCCARRAN-FERGUSON ANTITRUST EXEMPTION

The ISO website has extensive information on the range of services they offer insurance companies. The website illustrates the deep involvement that this organization has in helping to set insurer rates, establishing policy forms, underwriting policies and in setting other rules.

Some examples:

- The page "The State Filing Handbook," promises 24/7 access to "procedures for adopting or modifying ISO's filings as the basis for your own rates, rules and forms."

- The page "ISO MarketWatch Cube" is a "powerful new tool for analyzing renewal price changes in the major commercial lines of insurance…the only source of insurance premium-change information based on a large number of actual policies." This price information is available "in various levels of detail – major coverage, state, county and class groupings – for specific time periods, either month or quarter…"

- "MarketWatch" supplies reports "that measure the change in voluntary-market premiums (adjusted for exposure changes) for policies renewed by the same insurer group…a valuable tool for…strategically planning business expansion, supporting your underwriting and actuarial functions…"

- "ISO's Actuarial Service" gives an insurer "timely, accurate information on such topics as loss and premium trend, risk classifications, loss development, increased limits factors, catastrophe and excess loss, and expenses." Explaining trend, ISO points out that the insurer can "estimate future costs using ISO's analyses of how inflation and other factors affect cost levels and whether claim frequency is rising or falling." Explaining "expenses" ISO lets an insurer "compare your underwriting expenses against aggregate results to gauge your productivity and efficiency relative to the average…" NOTE: These items, predicting the future for cost movement and supplying data on expenses sufficient for turning ISO's loss cost filings into final rates, are particularly anti-competitive and likely, absent McCarran-Ferguson antitrust exemption protection, illegal.

- "ISO's Actuarial Services" web page goes on to state that insurers using these services will get minutes and agendas of "ISO's line actuarial panels to help you keep abreast of ratemaking research and product development."

- The "Guide to ISO Products and Services" is a long list of ways ISO can assist insurers with rating, underwriting, policy forms, manuals, rate quotes, statistics, actuarial help, loss reserves, policy writing, catastrophe pricing, information on specific locations for property insurance pricing, claims handling, information on homeowner claims, credit scoring, making filings for rates, rules and policy forms with the states and other services.

Finally, ISO has a page describing "Advisory Prospective Loss Costs," which lays out the massive manipulations ISO makes to the historic data. A lengthy excerpt follows:

> "Advisory Prospective Loss Costs are accurate projections of average future claim costs and loss-adjustment expenses — overall and by coverage, class, territory, and other categories.
> Your company can use ISO's estimates of future loss costs in making independent decisions about the prices you charge for your policies. For most property/casualty insurers, in most lines of business, ISO loss costs are an essential piece of information. You can consider our loss data — together with other information and your own judgment — in determining your competitive pricing strategies.
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> "**The insurance pricing problem –**Unlike companies in other industries, you as a property/casualty insurer don't know the ultimate cost of the product you sell — the insurance policy — at the time of sale. At that time, losses under the policy have not yet occurred. It may take months or years after the policy expires before you learn about, settle, and pay all the claims. Firms in other industries can base their prices largely on known or controllable costs. For example, manufacturing companies know at the time of sale how much they have spent on labor, raw materials, equipment, transportation, and other goods and services. But your company has to *predict* the major part of your costs — losses and related expenses — based on historical data gathered from policies written in the past and from claims paid or incurred on those policies. As in all forms of statistical analysis, a large and consistent sample allows more accurate predictions than a smaller sample. That's where ISO comes in. The ISO database of insurance premium and loss data is the world's largest collection of that information. And ISO quality checks the data to make sure it's valid, reliable, and accurate. But before we can use the data for estimating future loss costs, ISO must make a number of adjustments, including loss development, loss-adjustment expenses, and trend.
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> **"Loss development …**because it takes time to learn about, settle, and pay claims, the most recent data is always incomplete. Therefore, ISO uses a process called *loss development* to adjust insurers' early estimates of losses to their ultimate level. We look at historical patterns of the changes in loss estimates from an early evaluation date — shortly after the end of a given policy or accident year — to the time, several or many years later, when the insurers have settled and paid all the losses. ISO calculates *loss development factors* that allow us to adjust the data from a number of recent policy or accident years to the ultimate settlement level. We use the adjusted — or developed — data as the basis for the rest of our calculations.
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> **"Loss-adjustment expenses –** In addition to paying claims, your company must also pay a variety of expenses related to settling the claims. Those include legal-defense costs, the cost of operating a claims department, and others. Your company allocates some of those costs — mainly legal defense — to particular claims. Other costs appear as overhead. ISO collects data on allocated and unallocated loss-adjustment expenses, and we adjust the claim costs to reflect those expenses.
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> **"Trend –**Losses adjusted by loss-development factors and loaded to include loss-adjustment expenses give the best estimates of the costs insurers will ultimately pay for

past policies. But you need estimates of losses in the future — when your new policies will be in effect. To produce those estimates, ISO looks separately at two components of the loss cost — claim *frequency* and claim *severity*. We examine recent historical patterns in the number of claims per unit of exposure (the frequency) and in the average cost per claim (the severity). We also consider changes in external conditions. For example, for auto insurance, we look at changes in speed limits, road conditions, traffic density, gasoline prices, the extent of driver education, and patterns of drunk driving. For just three lines of insurance — commercial auto, personal auto, and homeowners — ISO performs 3,000 separate reviews per year to estimate loss trends. Through this kind of analysis, we develop *trend factors* that we use to adjust the developed losses and loss-adjustment expenses to the future period for which you need cost information.

"What you get – With ISO's advisory prospective loss costs, you get solid data that you can use in determining your prices by coverage, state, territory, class, policy limit, deductible, and many other categories. You get estimates based on the largest, most credible set of insurance statistics in the world. And you get the benefit of ISO's renowned team of actuaries and other insurance professionals. ISO has a staff of more than 200 actuarial personnel — including about 50 members of the Casualty Actuarial Society. And no organization anywhere has more experience and expertise in collecting and managing data and estimating future losses."

ISO's activities extensively interfere with the competitive market, a situation allowed by the provisions of the McCarran-Ferguson Act's extensive antitrust exemption.

2004 EXPENSE RATIOS

ATTACHMENT B

	AVG. FOR ALL INSURANCE COS.			**AN EFFICIENT WRITER WITH AT LEAST 1% OF NATIONAL MARKET**			**AN INEFFICIENT WRITER WITH AT LEAST 1% OF NATIONAL MARKET**			**POTENTIAL RATE SAVINGS***	
LINE	**LOSS ADJUST-MENT**	**UNDER-WRITING**	**TOTAL**	**LOSS ADJUST-MENT**	**UNDER-WRITING**	**TOTAL**	**LOSS ADJUST-MENT**	**UNDER-WRITING**	**TOTAL**	**IF AVERAGE BECAME EFFICIENT**	**IF INEFFICIENT BECAME EFFICIENT**
Fire	5.1%	26.0%	31.1%	0.9%	18.8%	19.6%	5.0%	56.4%	61.4%	-14.3%	-52.0%
Allied	6.3%	31.2%	37.5%	1.9%	21.1%	23.0%	6.6%	49.2%	55.8%	-18.8%	-42.6%
Farmowners	7.2%	31.6%	38.8%	4.4%	15.8%	20.2%	4.1%	63.9%	68.0%	-23.3%	-59.9%
Homeowners	9.9%	28.4%	38.3%	10.8%	19.6%	30.4%	5.6%	41.9%	47.5%	-11.4%	-24.6%
CMP non-liab	9.6%	32.7%	42.3%	3.5%	10.2%	13.7%	7.7%	41.4%	49.1%	-33.1%	-41.0%
CMP liability	25.5%	31.5%	57.0%	5.5%	17.7%	23.2%	41.9%	33.5%	75.4%	-44.0%	-68.0%
Inland Marine	7.0%	32.5%	39.5%	2.2%	22.5%	24.7%	52.8%	33.3%	86.1%	-19.7%	-81.5%
Med Mal	34.0%	15.2%	49.2%	19.4%	22.4%	41.8%	57.6%	12.4%	70.0%	-12.7%	-48.5%
Work Comp	13.5%	21.5%	35.0%	10.6%	15.2%	25.8%	26.4%	18.1%	44.5%	-12.4%	-25.2%
Other Liab	23.5%	27.1%	50.6%	5.5%	25.8%	31.3%	53.8%	26.1%	79.9%	-28.1%	-70.7%
PP Auto Liab	14.0%	23.1%	37.1%	10.8%	12.9%	23.7%	17.5%	26.6%	44.1%	-17.6%	-26.7%
CC Auto Liab	12.7%	28.0%	40.7%	11.3%	20.2%	31.5%	15.8%	32.7%	48.5%	-13.4%	-24.8%
PP Auto Phys	9.8%	23.4%	33.2%	9.4%	12.8%	22.2%	13.6%	26.8%	40.4%	-14.1%	-23.4%
CC Auto Phys	7.1%	28.4%	35.5%	7.4%	19.5%	26.9%	4.4%	41.0%	45.4%	-11.8%	-25.3%
								AVERAGE SAVINGS		-19.6%	-43.9%
All Lines	12.9%	25.4%	38.3%	11.8%	15.0%	26.8%	17.8%	30.9%	48.7%	-15.7%	-29.9%

Source: A.M. Best and Co., Aggregates and Averages, 2005 Edition

* Calculated as follows: (1.000 - expense ratio of inefficient writer/ 1.000 - expense ratio of efficient writer) - 1.000