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United States Government Accountability Office
Washington, DC 20548

July 28, 2005

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
House of Representatives

Subject: *Ultimate Effects of McCarran-Ferguson Federal Antitrust Exemption on Insurer Activity are Unclear*

This letter transmits to you our briefing slides describing the potential effects of the federal antitrust exemption included in the McCarran-Ferguson Act (McCarran)[1] on insurer activities. On May 26, 2005, we briefed committee staff on the results of our review. Specifically, we assessed existing insurance practices that might violate federal antitrust law absent the McCarran exemption and identified current state authorities related to antitrust laws applicable to insurance. In a separate GAO legal opinion, *Legal Principles Defining the Scope of the Federal Antitrust Exemption for Insurance*, published in March 2005, we assessed the types of insurance-related activities that courts have found to be exempt from federal antitrust provisions under the McCarran exemption.[2]

We focused our analysis on property/casualty insurance, including workers compensation, because insurers in these areas participate in many joint activities. We consulted relevant literature, including prior congressional and state hearings on the topic, and met with experts from state insurance departments, attorneys general offices, insurance companies, trade associations, rating organizations, law firms, and academia. We met with knowledgeable staff at the National Association of Insurance Commissioners, the Department of Justice, and the Federal Trade Commission. We limited our review of states' insurance regulation and antitrust authorities to five states with large insurance markets that had varying degrees of rate regulation and differences in state antitrust exemptions—California, Illinois, New Jersey, New York, and Texas. We conducted our work from February 2005 through July 2005 in accordance with generally accepted government auditing standards.

[1]Pub. L. No. 79-15, ch. 20, 59 Stat. 33, codified as amended at 15 U.S.C. §§ 1011-1015.

[2]GAO, *Legal Principles Defining the Scope of the Federal Antitrust Exemption for Insurance*, B-304474 (Washington, DC: March 4, 2005).

Background

Congress passed the McCarran-Ferguson Act (McCarran) in 1945, following a Supreme Court decision that determined that insurance is interstate commerce which Congress could regulate and subject to federal antitrust laws.[3] McCarran reaffirmed the power of the states to regulate and tax insurance companies and exempted certain insurance practices from federal antitrust laws, including the Sherman, Clayton, and Federal Trade Commission Acts. The insurance exemption applies to those activities that (a) constitute the "business of insurance;" (b) are "regulated by State law;" and (c) do not constitute an agreement or act "to boycott, coerce, or intimidate." Our legal opinion discusses court decisions concerning the types of activities covered by the exemption. Among other things, the courts have found that, generally speaking, joint rate-making among property/casualty insurers is the "business of insurance" and thus exempt from federal antitrust laws under McCarran.

Besides McCarran, there are other, more general sources of immunity from federal antitrust laws, including the *state action doctrine* and the *Noerr-Pennington Doctrine*. The *state action doctrine* allows for anticompetitive conduct provided that the conduct is both (a) part of a clearly articulated policy by a state to displace competition in a regulated area and (b) actively supervised by state regulators with statutory authority to review the conduct. The *Noerr-Pennington Doctrine* provides immunity for certain joint efforts by competitors to petition the government. Both of these immunities may be applicable to insurance. States also have their own antitrust authorities, which may or may not include exemptions for insurance.

Effects of McCarran Exemption Uncertain, but without the Exemption Some Insurer Activities Could Raise Antitrust Concerns

Because the courts have not considered which activities within the "business of insurance" might violate federal antitrust laws, it is difficult to determine which insurer activities would withstand antitrust scrutiny if the exemption were removed. Decisions involving antitrust law are typically based on the facts and circumstances of each case. With insurance activities, if the court decides that the McCarran exemption applies, it generally conducts no further analysis of the activities. Unsure about how courts would decide insurance cases, when eliminating or proposing to eliminate antitrust immunities, legislators at both the state and federal levels have included "safe harbors" for certain insurance activities such as the collection of historical data.[4]

Some experts have suggested that absent the McCarran exemption, activities in the property/casualty area, especially joint rate-making, might violate federal antitrust

[3]*See United States v. Southeastern-Underwriters Ass'n*, 322 U.S. 533 (1944).

[4]California's Proposition 103, codified at Cal. Ins. Code §§ 1861 *et seq.*, had "safe harbors" embedded in its repeal of the state antitrust exemption for insurance, and congressional proposals to modify the McCarran exemption under the Insurance Competitive Pricing Act of 1994, H.R. 9, as amended, 103d Congress (1994), also carved out certain activities to avoid further litigation in these areas.

laws, citing concerns over the collective projection of insurer losses into the future. To price insurance policies, property/casualty insurers need to project loss costs—the amount insurers use to cover claims and the costs of adjusting those claims—into the future. Projecting loss costs requires large amounts of data on historical losses and actuarial expertise, and single insurers are not likely to have sufficient data or expertise in all of the insurance lines they sell. Thus, for a significant portion of rate-making, property/casualty insurers rely on rating organizations.[5] Rating organizations standardize risk classifications and products to facilitate the gathering and aggregation of data on past losses and their costs. Then, they bring this historical data up to the present by estimating loss costs for events that have occurred but have not yet been reported. Finally, rating organizations issue "advisory prospective loss costs" by projecting loss costs into the future. They do this by trending—analyzing past data trends and using actuarial judgment about the future.

According to industry representatives, regulators, and other experts, this rate-making process has certain benefits, but also raises antitrust concerns. Generally, they believe the process reduces the costs associated with pricing and regulating insurance, makes it easier for new firms to enter the insurance market, and allows consumers to better compare products. However, some experts believe that under some circumstances joint trending might constitute price fixing absent the McCarran exemption, and that standardized risk classifications and products might restrict new insurers or products from entering the market, thus limiting innovation, consumer choice, and competition. Further, according to most experts, courts are more likely to find joint trending a violation of federal antitrust laws than the joint collection of historical data.

For some, the McCarran exemption raises the issue of insurance industry uniqueness—that is, whether insurance warrants a federal antitrust exemption that most other industries do not have. Some industry representatives said that insurance is different from other industries because when it is sold the insurer does not know what the cost of a policy will be. In addition, insurer insolvencies can pose significant social costs. Some state regulators told us that lack of certainty about future costs leads some insurers to underestimate their future costs and significantly underprice their policies, potentially leading to costly insolvencies. They said that joint rate-making provides more information and greater certainty to insurers. Other experts have suggested that insurance is not unique and that other industries—such as banking— face uncertainty about future costs, but do not have antitrust immunity.

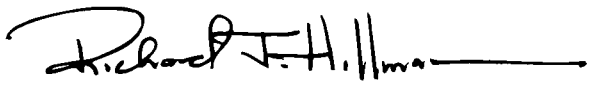
[5]States authorize rating organizations, sometimes called statistical or advisory organizations, to assist in the rate-making process. Nationally, two of the largest rating organizations are the Insurance Services Office in personal and commercial lines and National Council on Compensation Insurance in workers compensation.

Application of State Antitrust Authorities to Insurance Varied Across the Five States We Visited

Although insurance is immune from federal antitrust laws, insurers in the states we visited were subject to state antitrust and related authorities to varying extents. In New York, property/casualty insurers' rate-making activities are exempt from the state antitrust laws, but the insurance code prohibits insurers from participating in unfair methods of competition. In Texas, where certain other regulated industries have exemptions, insurance has no general antitrust immunity. California and New Jersey both had periods of time in the late 1980s and 1990s when they prohibited insurers from joint trending in some lines of insurance.[6] However, state officials do not view these periods as valid experiments of how an insurance market would behave absent McCarran because of other factors influencing the market at that time. In addition, we also found that all five states had some provisions in their codes to prohibit insurers from engaging in unfair or deceptive acts or practices in their states. The states we visited also regulated property/casualty insurance rates to varying degrees. For example, California requires prior approval for many of its rates, while Illinois relies on the market to determine most rates. The degree of state rate regulation could have significant effects on the applicability of federal antitrust laws to insurance if the McCarran exemption were amended or repealed. In those states that actively regulate and enforce rates, insurers might seek and might be granted immunity from federal antitrust laws under the *state action doctrine* in the absence of the McCarran exemption.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs and the Ranking Minority Member of the House Committee on Financial Services. We will also make copies of this report available to other interested parties and others upon request. In addition, it will be available on GAO's home page at http://www.gao.gov. If you or your staff have questions regarding this report, please contact me at (202)-512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Lawrence D. Cluff, Nancy S. Barry, Katherine C. Bittinger, and Tania L. Calhoun made key contributions to this report.

Sincerely yours,



Richard J. Hillman
Director, Financial Markets and Community Investment

Enclosure

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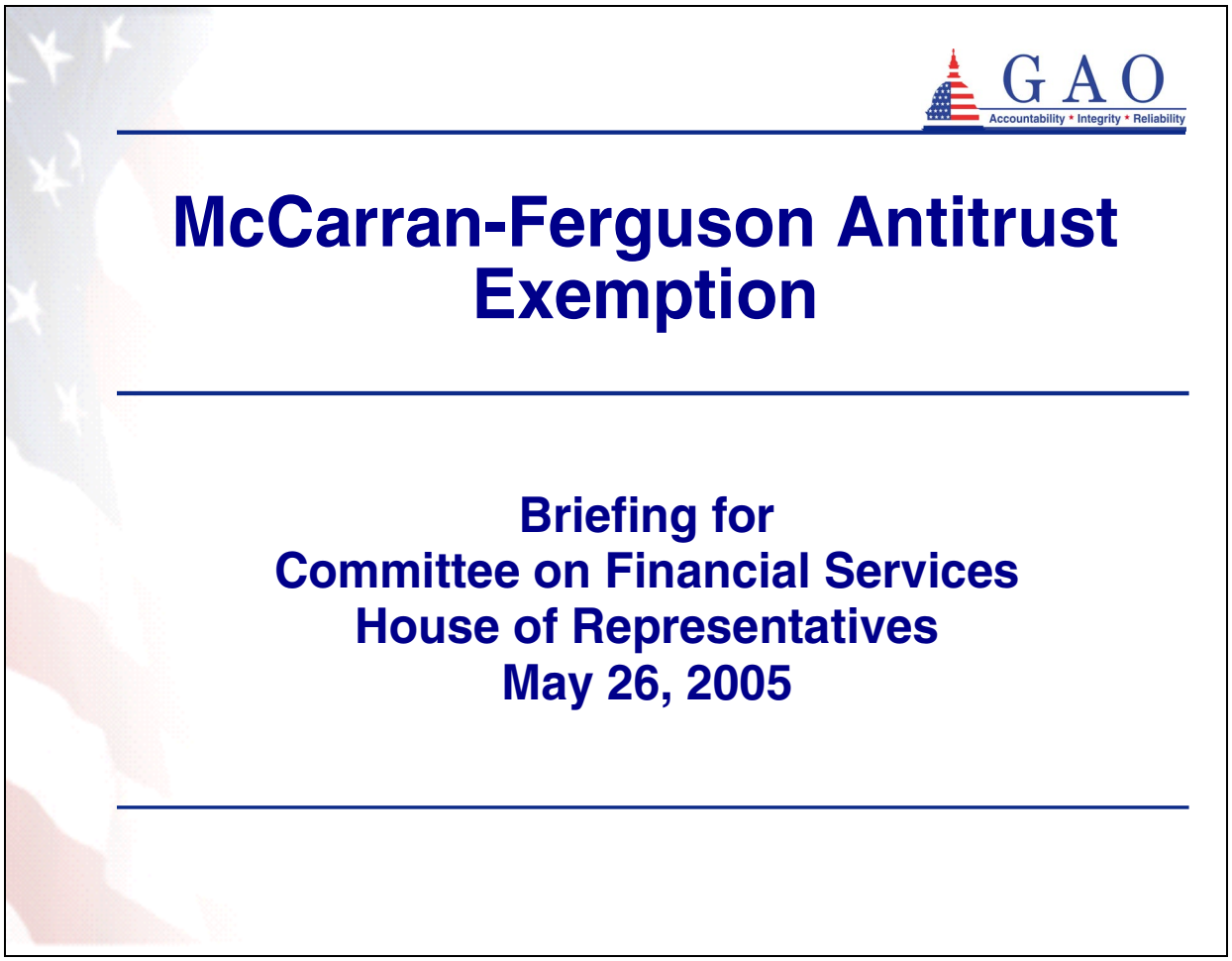
[6]In New Jersey, the state passed legislative changes only for the personal auto market.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McCarran-Ferguson Antitrust Exemption
Briefing for
Committee on Financial Services
House of Representatives
May 26, 2005

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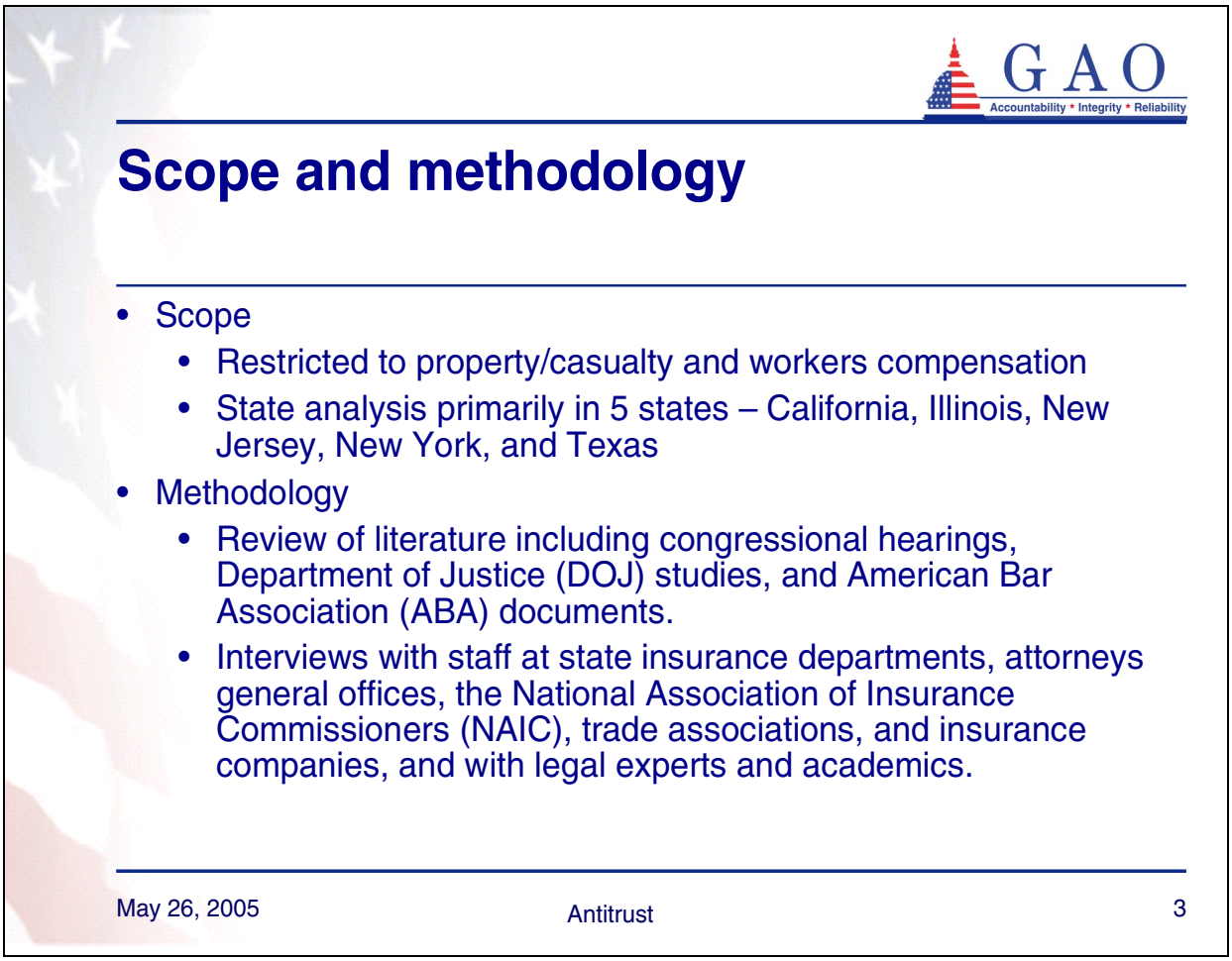
Overview

- Background
  - Federal antitrust laws whose application is affected by the McCarran-Ferguson (McCarran) exemption
  - Other possible sources of federal antitrust immunity
  - State antitrust authorities
- Insurance activities that might require McCarran exemption
- Insurance regulation and antitrust authorities in selected states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Scope and methodology
• Scope
• Restricted to property/casualty and workers compensation
• State analysis primarily in 5 states – California, Illinois, New Jersey, New York, and Texas
• Methodology
• Review of literature including congressional hearings, Department of Justice (DOJ) studies, and American Bar Association (ABA) documents.
• Interviews with staff at state insurance departments, attorneys general offices, the National Association of Insurance Commissioners (NAIC), trade associations, and insurance companies, and with legal experts and academics.
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Background: Federal antitrust laws

- The Sherman Act
  - Section 1: concerted acts or practices in restraint of trade
  - Section 2: monopolization
- The Clayton Act
  - Mergers and acquisitions that may substantially lessen competition or tend to create a monopoly
  - Interlocking directorates
- The Federal Trade Commission (FTC) Act
  - Unfair methods of competition
  - Unfair or deceptive acts or practices

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Background: Court analysis under Section 1 of Sherman Act when exemptions don't apply

- Some types of restraints are considered *per se* unreasonable and can be presumed illegal without inquiry into their purpose or competitive harm. These include
  - Price fixing
  - Market or customer allocation
  - Group boycotts
- Other types of restraints are considered under the rule of reason, which requires analysis of the circumstances to see if the conduct promotes or suppresses competition. These include joint venture arrangements.
- According to DOJ, while technically illegal *per se,* tying is usually considered under the rule of reason.

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Background: Prerequisites for statutory McCarran exemption

- Practices must constitute the "business of insurance."
- Practices must be "regulated by State law."
- Practices must not constitute agreements or acts of boycott, intimidation, or coercion.

See GAO, *Legal Principles Defining the Scope of the Federal Antitrust Exemption for Insurance,* B-304474 (Washington, DC: March 4, 2005) for more information on the prerequisites.

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Background: Some sources of federal immunity other than McCarran

- *State Action Doctrine* - Shields certain anticompetitive conduct when that conduct is part of a clearly articulated state policy and actively supervised by the state.
  - Clear articulation requirement is met if the state clearly intends to displace competition in an area with a regulatory structure.
  - Active supervision requirement is met if state regulators have and exercise statutory authority to review the conduct.
- *Noerr-Pennington Doctrine* - Shields certain joint efforts by groups, such as trade associations and industry groups, seeking to exercise their First Amendment rights to petition the government.

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Background: State antitrust authorities

- According to legal experts, states exempt insurance practices from state antitrust laws in a variety of ways:
  - by exempting specific insurance activities or products,
  - by broadly incorporating federal exemptions into state law, and
  - by exempting regulated industries including insurance.
- In recent years, some states have narrowed their exemptions.
- States have other authorities for targeting practices that might violate federal antitrust laws, including
  - statutory provisions specific to the insurance industry, and
  - generally applicable unfair or deceptive practices statutes.

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A cautionary note

- Application of the federal antitrust laws through court cases is highly dependent on the facts and circumstances of each case.
- Because the McCarran exemption exists, the application of federal antitrust laws to insurance activities has not been fully tested in the courts.
- As a result, it is difficult to reach firm conclusions about the application of the federal antitrust laws to insurance activities.

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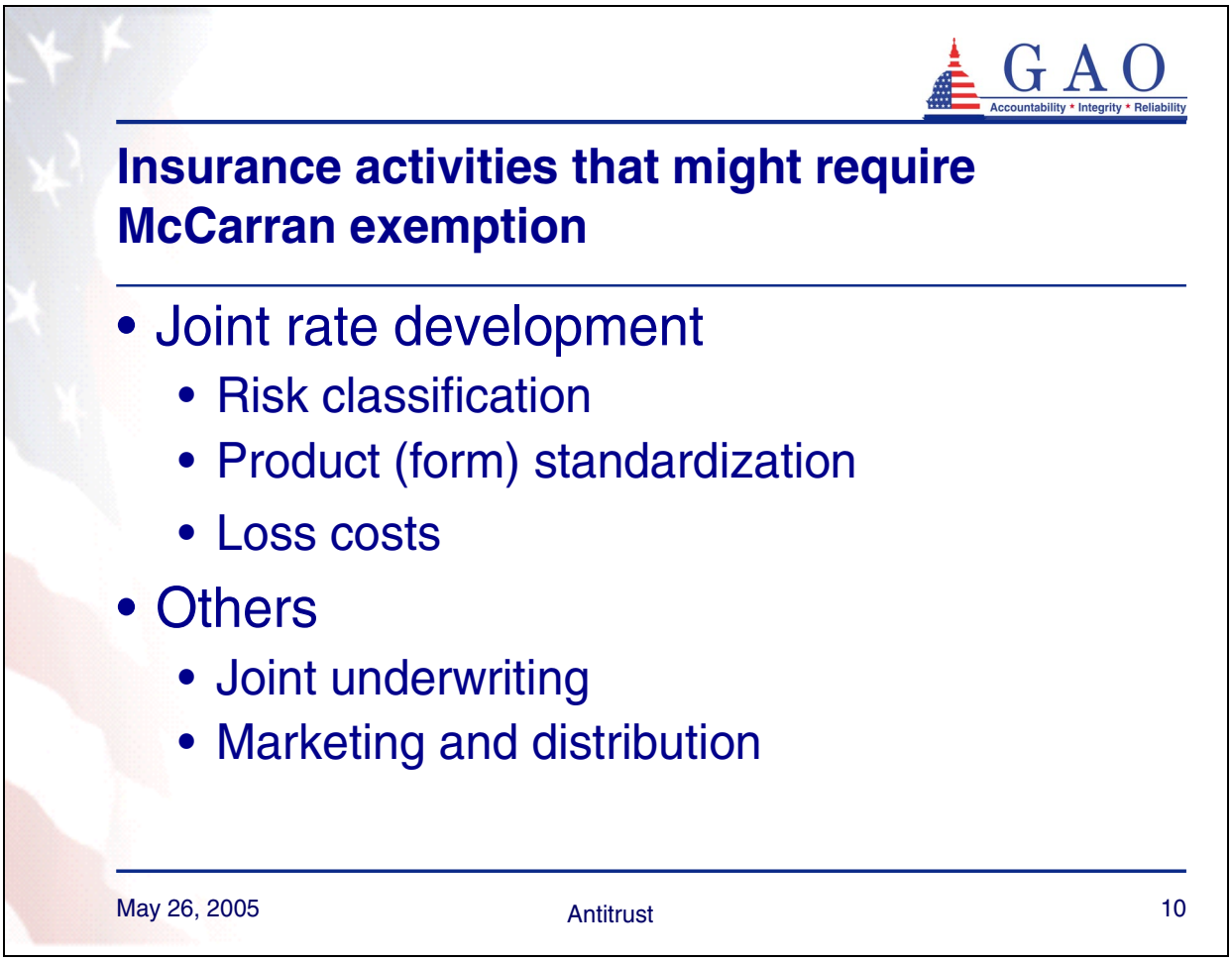
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Insurance activities that might require McCarran exemption
• Joint rate development
• Risk classification
• Product (form) standardization
• Loss costs
• Others
• Joint underwriting
• Marketing and distribution
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Joint rate development: Rating/statistical organizations play a major role

- Establish risk classifications and develop policy forms
- Take actions to ensure that data are reliable
- Aggregate historical data on loss costs
- Develop loss costs for events that have occurred but have not yet been reported
- Trend loss costs to provide advisory prospective loss costs, including
  - analyzing past trends to project them into the future, and
  - using other information such as economic forecasts, perceptions of judicial temperament, and expected changes in medical costs to further refine their projections.
- In some workers' compensation areas, such as residual markets, add expenses, taxes, and profits onto prospective loss costs to produce rates.

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Joint rate development: Types of rating/statistical organizations

- Organizations specialize.
  - Property/Casualty
  - Workers' compensation
- Organizations can be national, regional, or local.
- According to NAIC, there are 25 rating/statistical organizations.
- The rating/statistical organizations are licensed in the states where they provide services.

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Joint rate development: Rating/statistical Organizations - Property/Casualty

- Insurance Services Office (ISO) is the major national rating organization for property/casualty insurance
  - Prior to 1994 owned and operated by insurers
  - Current structure and operations
    - For profit
      - Employees, managers, and directors hold class A stock and elect 10 of 14 directors
      - Insurers hold class B stock and elect 3 of 14 directors
    - Members provide data
      - For personal lines, 35 percent of the market
      - For commercial lines, 60-65 percent of the market
    - Members also provide advice and use forecasts
- Other rating/statistical organizations operate nationally or regionally and provide varied services

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Joint rate development: Rating/statistical Organizations - Workers' Compensation

- National Council on Compensation Insurance (NCCI) is the only multistate organization
  - Not for profit
  - 14 member board, about 2/3 represent insurers
  - Provides some services in 38 states
  - Members provide data and advice and use forecasts
  - Provides residual market services and administers National Workers Compensation Reinsurance Pool
- Some states have their own organizations; however, NCCI provides some services in several of these states.

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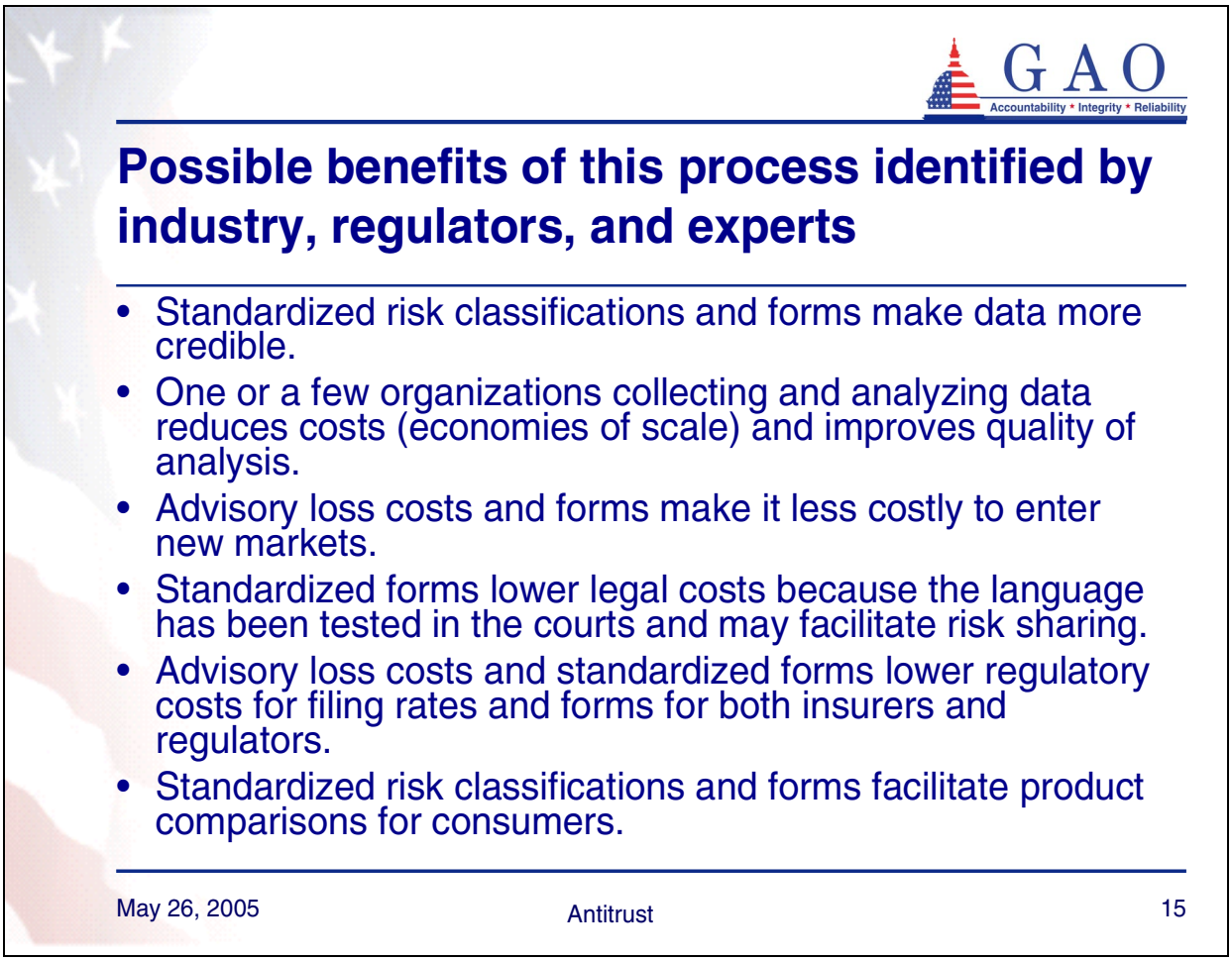
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Possible benefits of this process identified by industry, regulators, and experts
• Standardized risk classifications and forms make data more credible.
• One or a few organizations collecting and analyzing data reduces costs (economies of scale) and improves quality of analysis.
• Advisory loss costs and forms make it less costly to enter new markets.
• Standardized forms lower legal costs because the language has been tested in the courts and may facilitate risk sharing.
• Advisory loss costs and standardized forms lower regulatory costs for filing rates and forms for both insurers and regulators.
• Standardized risk classifications and forms facilitate product comparisons for consumers.
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Possible Issues: Standardized risk classifications and forms

- While standardization exists in other industries, legal experts have said that product standardization in insurance may have a greater impact on price than it has in other industries and may thus be subject to antitrust litigation.
- Standardized risk classifications and policy forms may limit
  - Consumer choice,
  - Competition, and
  - Innovation.
- Standardized risk classifications and policy forms have social implications.

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Possible Issues: Loss costs

- Collection of historical loss costs and loss development
  - Legal experts have said that these activities may not violate federal antitrust laws in the absence of McCarran.
    - Do not in themselves constitute price fixing
    - May make the market more competitive and efficient
  - However, court outcomes are uncertain
- Joint trending to develop advisory, prospective loss costs
  - Legal experts have said that these activities may violate federal antitrust laws in the absence of McCarran.
    - Collective activity establishes a significant portion of final insurance price.
    - Although advisory, sends strong pricing signal to market participants.
    - Relativities constitute element of price fixing.
  - While many legal experts believe potential for collusive behavior outweighs potential for increased efficiency, some experts believe the activity is procompetitive.
  - A dominant trending organization may lead to inaccurate pricing and limit innovation.

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Other Possible Issues

- McCarran exemption is broad relative to almost all other antitrust exemptions, which raises questions about the uniqueness of property/casualty insurance
  - Industry experts say unique because of
    - Uncertainty about costs at time product is sold
    - Long time horizon
    - Insolvency has social costs
  - Some experts do not think that it is so unique as to require federal antitrust exemptions that most other industries do not have.
- Court determinations in non-insurance antitrust cases often depend on whether market participants have power to exert control over the market.
  - Because of exemption, insurance has not been subjected to competitive or unfair practices analysis by federal antitrust agencies
  - NAIC, some states, and academic experts have done limited competitive analyses

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Some sources of federal immunity other than McCarran

- Joint rate and form activities might still be immune from federal antitrust laws under *state action doctrine*
  - Statutes or regulations would need to specify or imply that these regulations are replacing a competitive (market) regime. If firms independently set final rates, questions might be raised concerning this requirement.
  - States would need to supervise and enforce rate and form regulations.
  - The *state action doctrine* was argued in *in re Insurance Antitrust Litigation*.
- To the extent that insurers' applications to states for specific rate and form regulation can be seen as petitioning the state, the *Noerr-Pennington Doctrine* might apply.

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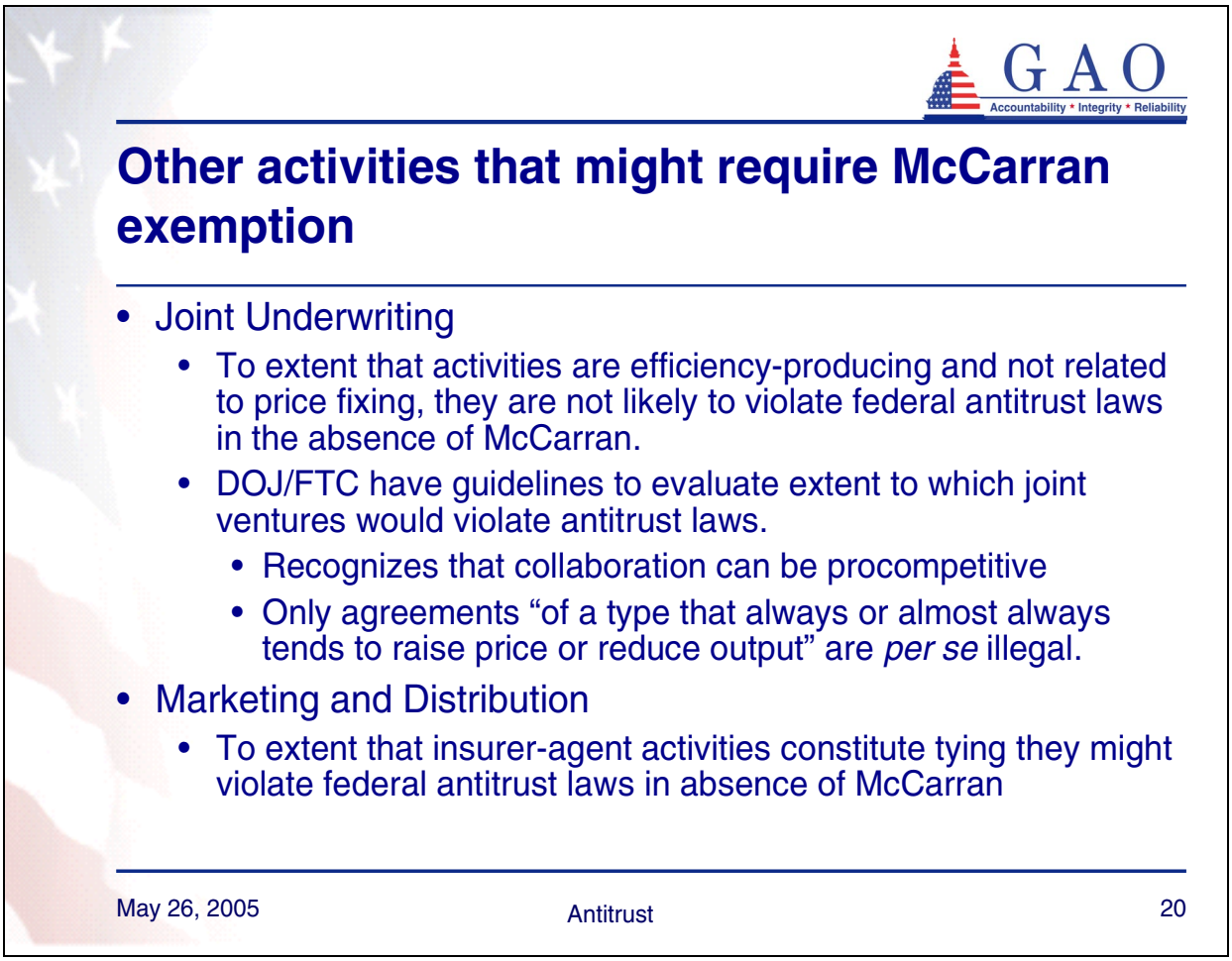
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Other activities that might require McCarran exemption
• Joint Underwriting
• To extent that activities are efficiency-producing and not related to price fixing, they are not likely to violate federal antitrust laws in the absence of McCarran.
• DOJ/FTC have guidelines to evaluate extent to which joint ventures would violate antitrust laws.
• Recognizes that collaboration can be procompetitive
• Only agreements "of a type that always or almost always tends to raise price or reduce output" are *per se* illegal.
• Marketing and Distribution
• To extent that insurer-agent activities constitute tying they might violate federal antitrust laws in absence of McCarran
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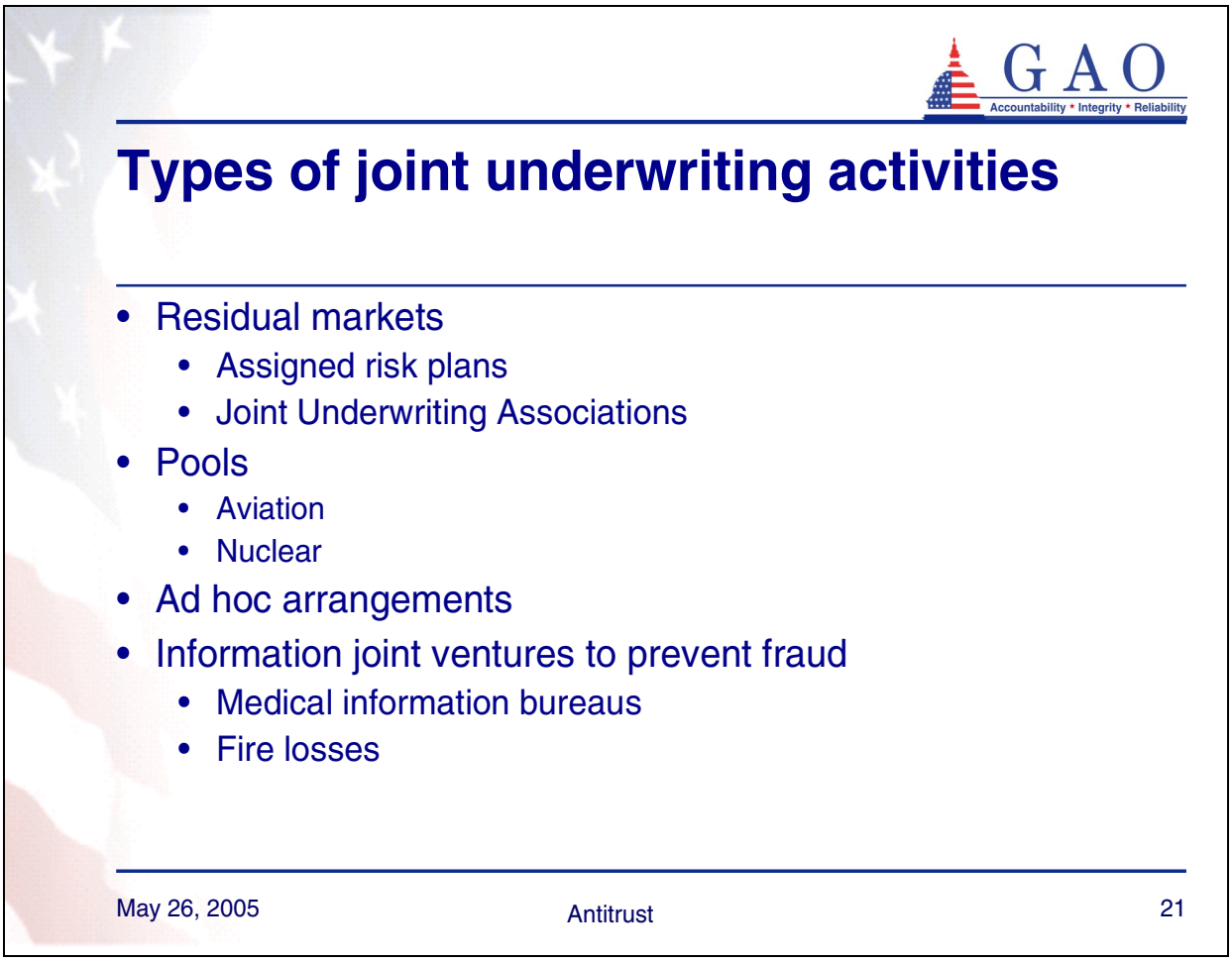
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Types of joint underwriting activities
• Residual markets
• Assigned risk plans
• Joint Underwriting Associations
• Pools
• Aviation
• Nuclear
• Ad hoc arrangements
• Information joint ventures to prevent fraud
• Medical information bureaus
• Fire losses
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Types of marketing and distribution activities

- Agreements among agents or among insurers such as those related to commissions
- Agreements among insurers and independent agents
  - Exclusive agent relationships, where an agent agrees to represent only one insurer
  - Agreements restricting agents to certain products, territories, or customers
  - Agreements related to agent terminations
- Bundling of products (coverages)

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Regulation in five states: rate regulation

State	Property/Casualty	Workers' compensation
California	Prior approval	File & Use: state rating organization
Illinois	Commercial: no filing required Personal: use & file	File & use
New Jersey	Commercial: Use & file unless find that competition does not exist Personal: prior approval	Prior approval: state rating organization
New York	Personal auto: prior approval Commercial liability: flex between bands Other: file &use	Prior approval: state rating organization
Texas	File & use	File & use

Source: NAIC and state regulators in the 5 states

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Regulation in five states: antitrust

State	State antitrust law	Insurance exemption
California	Cartwright Act	Exemption only for collection of historical data, joint trending by rating organizations, and joint arrangements to ensure availability of insurance
Illinois	Illinois Antitrust Act	Exempts activities that are subject to regulation by the Director of Insurance or permitted or authorized by state law
New Jersey	New Jersey Antitrust Act	Exempts activities subject to supervision by commissioner or authorized by state law
New York	Donnelly Act	Exempts activities covered by New York's insurance code regulating property/casualty rates
Texas	Free Enterprise and Antitrust Act	No general immunity; Immunity for activities required by state or federal law.

Source: GAO

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Regulation in five states: Other related state authorities

State	Other related authorities
California	Unfair Practices Act Unfair Competition Law Unfair Insurance Practices Act
Illinois	Consumer Fraud and Deceptive Business Practices Act Insurance code provisions for unfair methods of competition and unfair or deceptive acts and practices
New Jersey	Insurance code provisions for unfair methods of competition or unfair or deceptive acts or practices
New York	Executive law, general business law, and insurance law provisions proscribing repeated fraudulent or illegal acts, restraints of trade and unfair competition, and deceptive acts or practices.
Texas	Deceptive Trade Practices-Consumer Protection Act Insurance code provisions for unfair methods of competition and unfair or deceptive acts or practices

Source: ABA, *State Antitrust Practice and Statutes,* 3rd edition, and state officials in the 5 states

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Summary and conclusions

- As noted, it is difficult to reach firm conclusions about the application of federal antitrust laws to insurance activities because often the courts have not considered these issues.
- Over the years, most experts have said that collection of historical data would likely not violate federal antitrust laws absent McCarran; however, they are less certain that courts would find joint trending to be consistent with federal antitrust law absent McCarran.
- Because of the uncertainty about what the courts will do, “safe harbors” for certain activities such as the collection of historical data have often been used when eliminating or proposing to eliminate immunities for insurance at the state and federal levels.
- Generally, larger carriers expressed less concern about maintaining the McCarran exemption than smaller carriers.

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