

Issue Analysis

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The Assault on the McCarran-Ferguson Act and the Politics of Insurance in the Post-Katrina Era

By Lawrence S. Powell, Ph.D.

Executive Summary

Seven of the ten most costly hurricanes in the history of the United States occurred in a 14-month period spanning parts of the 2004 and 2005 hurricane seasons. In response to perceived problems related to insurance industry claims and underwriting practices following these storms, some policymakers are offering legislation that would repeal a provision of the McCarran-Ferguson Act of 1945 that gives insurers a limited exemption from federal antitrust laws.

This *Issue Analysis* describes the problems associated with repealing the McCarran-Ferguson Act (“McCarran”). Specifically, the author develops and presents evidence supporting four important conclusions regarding the proposed repeal of McCarran: 1) insurance markets currently exhibit healthy and vigorous competition; 2) the limited antitrust exemption does not lead to collusion among insurers that is harmful to consumers; 3) repealing McCarran would impede competition and the operation of insurance markets to the detriment of consumers; and 4) there are several viable options that policymakers could pursue to increase the availability and lower the price of property/casualty insurance that do not involve repealing McCarran.

Insurance Markets Are Competitive

Competitive markets commonly exhibit four characteristics. First, they include multiple independent sellers with low to moderate market shares. Second, there are multiple consumers with enough information to determine the value of the product. Third, the product is relatively homogeneous, allowing consumers to differentiate value across offered prices and expected levels of service. Finally, barriers to entry and exit are low, allowing new suppliers to enter the market if prices rise above the fair-market price, or exit the market if they cannot produce the product at the fair-market price.

The insurance industry exhibits all four of the characteristics listed above. First, there are many companies participating in the market. In 2006, a total of 2,783 companies were licensed to sell property and liability insurance in the United States. There are obviously many consumers as well, given that most homes, automobiles and businesses are insured. In personal lines (homeowners and automobile) especially, insurance products are quite homogeneous. Homogeneity is a product of policy form standardization. Most policies differ only slightly, if at all, from the standard policies created by insurance advisory organizations such as the Insurance Services Office (ISO) and the American Association of Insurance Services (AAIS).

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If policymakers repeal McCarran, consumers will suffer substantial negative consequences resulting from a combination of weakened competition in the insurance industry and a myriad of regulatory, legal and operational problems generating costs that consumers must ultimately bear.

This allows consumers to compare insurance products across companies based on price and expected service. Finally, insurers frequently enter and exit state insurance markets, showing that barriers to entry and exit are not prohibitive. From 1996 to 2006, insurers entered every state's market for homeowners insurance. On average more than eight companies entered each state per year.

The Limited Antitrust Exemption Does Not Harm Consumers

Insurance markets exhibit all of the characteristics of competitive markets, yet questions continue to arise regarding collusion in pricing, underwriting and claims practices. Therefore, examining market outcomes is a worthwhile exercise. Market competition works to preclude firms in any competitive industry from consistently earning excess profits. One way to determine if a given market is competitive is to compare its performance to that of other industries. We compare performance of the insurance industry to commercial banking and a composite index representing all industries. The most common performance measure is return on equity (ROE). It is equal to profits (net income after taxes) divided by the value of the firm. From 1996 to 2006, the ROE of the property/casualty insurance industry was roughly half of that of commercial banks and the all-industry index.

Perhaps the most perplexing accusation recently brought against insurance carriers is that the limited antitrust exemption provided in McCarran somehow facilitates unethical market conduct in claims settlements. No one would deny that such behavior is wrong, which probably explains why it is currently illegal in every state. In fact, McCarran does not protect such behavior in the claims handling process, as it does not shield insurers from actions against

unfair and deceptive trade practices. Unfair Claims Practice statutes exist in every state. These laws give the state's insurance regulator and attorney general complementary and mutually supportive authority to monitor, investigate and punish insurers that fail to pay valid claims. States also have market conduct regimes where regulators can examine the behavior of insurers and take corrective action if needed. Moreover, federal consumer protection statutes, including the Fair Credit Reporting Act, also apply to insurance companies.

Repealing McCarran Would Harm Consumers

If policymakers repeal McCarran, consumers will suffer substantial negative consequences resulting from a combination of weakened competition in the insurance industry and a myriad of regulatory, legal and operational problems generating costs that consumers must ultimately bear.

Insurance pricing information, or advisory loss costs, provided by statistical agents are available to insurers for a fee. However, the benefits of advisory loss costs vary inversely with market share, company size, and age of insurers. Small and new insurers have less in-house data to analyze than do large insurers.

Competition from insurers with relatively small market shares appears especially important in the homeowners insurance line. Collectively, insurers writing less than \$5 million in direct premiums in a given state hold market share that varies substantially across states. For example, in 2006, the homeowners insurance market share of these smaller insurers ranged from less than one percent in California, to 37 percent in South Dakota. If these companies were forced to exit insurance markets due to increased cost of estimating losses, consumers would have fewer choices and markets would be less competitive.

Finally, absent McCarran, joint underwriting arrangements among insurers and insolvency guaranty mechanisms would be subject to antitrust scrutiny. This would affect several common insurer practices that benefit consumers. The most important of these are residual markets, which make mandatory insurance coverage available to all consumers, and guaranty funds, which protect consumers from insurance company insolvency.

Regulatory Reform Is Key To Increasing Availability And Affordability

Following nearly every significant *loss-related* event affecting insurance markets, proposed regulatory responses have involved changes in rating and underwriting practices, rather than addressing the underlying element that affects affordability and availability of insurance — *losses*. In many instances, regulation of underwriting and rating practices actually has the unintended effect of exacerbating problems of affordability and availability of insurance. Only recently have some states begun to address the underlying problems leading to affordability and availability issues. These include the factors driving the cost of losses such as coastal development; nonexistent or poorly enforced building codes; and factors hampering the speed with which insurers can respond to major events such as rate regulation and underwriting restrictions.

Certain reforms would directly advance an agenda of enhanced competition, greater availability of insurance coverage and more consumer choice. They include enhancing freedom and innovation in insurance ratemaking and risk-based underwriting practices, making cross-subsidies transparent and explicit, and spurring regulatory competition among states to improve states' regulatory environments.

Conclusion

The McCarran-Ferguson Act of 1945 was enacted to protect certain activities in the insurance industry that enhance market competition and financial strength. Insurers have traditionally become a popular target for the anger and frustration of consumers when prices increase or availability becomes more limited. Such irritation increased following the hurricanes of 2004 and 2005. Some members of Congress have responded in part by mounting a well-intentioned, albeit misguided, effort to repeal the McCarran-Ferguson Act and subject insurers to further federal antitrust scrutiny.

The evidence presented in this *Issue Analysis* supports the conclusion that McCarran benefits insurance consumers and that repealing it would harm consumers. It shows that insurance markets are characterized by vigorous competition, and moreover, that insurance companies are not earning excessive returns as would an industry that successfully colludes to inflate prices. In fact, insurers exhibit quite small returns when compared to other industries. Finally, this *Issue Analysis* describes the operational obstructions and prohibitive legal costs associated with repealing McCarran. The proposal to repeal McCarran appears to stem from a fundamental misunderstanding of insurance markets and insurance regulation.

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Introduction

So for more than six decades, the insurance industry has operated largely beyond the reach of federal competition laws. I truly believe that the McCarran-Ferguson Act's antitrust exemption has allowed insurers to engage in anticompetitive conduct, and I can find no justification to exempt the insurance industry from federal government oversight. Such oversight could help make certain that the industry is not engaging in anticompetitive conduct such as price fixing, agreements not to pay and market allocations.

— Sen. Trent Lott (R-MS)
Statement before the U.S. Senate
Committee on the Judiciary hearing
entitled “The McCarran-Ferguson Act
and Antitrust Immunity:
Good for Consumers?”
March 7, 2007

The 110th Congress is considering legislation that would repeal a provision of the McCarran-Ferguson Act (hereafter referred to as “McCarran”) that gives insurers a narrowly targeted limited exemption from federal antitrust laws.¹

This *Issue Analysis* will examine the effort to repeal the limited insurance antitrust exemption as part of a broader political movement to “reform” the business of insurance, largely in response to contentious issues arising from the catastrophic hurricane season of 2005. In addition to the McCarran repeal initiative, the movement has spawned a variety of government proposals intended to expand the scope of property insurance coverage in catastrophe-prone areas, while at the same time increasing the supply and reducing the cost of insurance in these areas.² Because insurance regulation in the United States is highly decentralized, the movement is being driven by a diverse group of actors that includes members of Congress,

state legislators, governors, insurance commissioners, state attorneys general, judges and consumer activists.

Congress has considered legislation to repeal or modify the McCarran-Ferguson Act's insurance antitrust exemption on at least two other occasions since the law was enacted in 1945.³ Then as now, the repeal effort was triggered by a perceived crisis in the property/casualty insurance industry that critics claimed was the result of anticompetitive insurer collusion facilitated by the industry's exemption from federal antitrust rules. Proponents of the current repeal effort have asserted that in the aftermath of Hurricanes Katrina, Rita and Wilma, insurers colluded with respect to price, market allocation, and claim settling practices under the protection from antitrust scrutiny afforded by the Act.

Today, insurers are facing the formidable challenge of assessing risk in an era of increased coastal development and heightened climate volatility. The powerful statistical tools they use to meet this challenge require large amounts of accurate historical data. For several decades, insurers have been allowed to share loss data through third-party statistical agents for estimating future losses. In these circumstances, applying the federal antitrust laws to insurers could threaten the very cooperative behavior that makes it possible for companies to compete in catastrophe-prone insurance markets. The McCarran repeal effort could thus produce a result that is the opposite of what its proponents intend.

This *Issue Analysis* develops and presents evidence supporting four important conclusions regarding the proposed repeal of McCarran: 1) insurance markets currently exhibit healthy and vigorous competition; 2) the limited antitrust exemption does not lead to collusion among insurers that is harmful to consumers; 3) repealing McCarran would impede competition and the operation of insurance markets to the detriment of consumers; and 4) there are several viable options that policymakers could pursue to increase the availability and lower the price

of property/casualty insurance that do not involve repealing McCarran.

Background and Context: The McCarran-Ferguson Act of 1945

The history of insurance regulation has been shaped by several landmark court decisions and legislative acts. In 1869, the U.S. Supreme Court decided in *Paul vs. Virginia*⁴ that insurance was not interstate commerce and should be regulated at the state level. However, the Court overturned the *Paul* decision in 1944, ruling in *United States vs. South-Eastern Underwriters Association*⁵ that the business of insurance constitutes interstate commerce and is therefore subject to federal jurisdiction under the U.S. Constitution.⁶ Among other things, the ruling effectively meant that federal antitrust laws, including the Sherman Act,⁷ the Clayton Act,⁸ and the Federal Trade Commission Act,⁹ would henceforth be applied to the insurance industry.¹⁰

Congress immediately recognized that application of the antitrust laws would prevent insurers from jointly collecting and disseminating information that is necessary to facilitate competitive ratemaking. Thus, in the year following the *South-Eastern Underwriters* decision, the 79th Congress enacted Public Law 15, better known as the McCarran-Ferguson Act of 1945.¹¹ The Act provides a narrow exemption from federal antitrust laws, and pertains only to activities that (1) constitute the “business of insurance”; (2) are “regulated by State law”; and (3) do not constitute “an agreement to boycott, coerce or intimidate or an act of boycott, coercion or intimidation.”

In practice, McCarran permits several activities conducted by insurance companies that would otherwise be prohibited or subjected to scrutiny under the federal antitrust laws. Perhaps the most significant consequence of the Act is that it permits insurers to pool data through independent statistical agents that produce advisory loss costs to aid insurers in the ratemaking

process.¹² It also allows standardization of risk classification and policy forms, and joint underwriting ventures. Each of these functions benefits consumers by promoting financial strength, efficiency and competition in insurance markets.

Catastrophic Risk and the McCarran Antitrust Exemption

The devastating hurricane season of 2005 has greatly increased the level of interest in insurance regulatory reform among policymakers at both the state and federal levels. With notable exceptions, however, the “reforms” have been limited and targeted in nature.¹³ The outlier is Florida, where lawmakers meeting in special session in January voted for rate rollbacks and further rate suppression, more extensive coverage mandates, and further displacement of the private insurance market by state-subsidized insurance and reinsurance entities.¹⁴ Meanwhile, federal judges presiding over lawsuits involving Katrina-related coverage disputes invoked the “ambiguity doctrine” to void anti-concurrent causation clauses in insurance contracts, effectively forcing insurers to provide retroactive coverage for which they collected no premium.¹⁵ It was against this backdrop that key members of the U.S. House and Senate introduced the “Insurance Industry Competition Act” (H.R. 1081/S. 618).¹⁶

Homeowners and their insurance carriers faced substantial challenges in the wake of back-to-back active hurricane seasons in 2004 and 2005. Seven of the ten most costly hurricanes in U.S. insurance history occurred in the 14 months from August 2004 to October 2005: Hurricanes Katrina, Rita, Wilma, Charley, Ivan, Frances and Jeanne. Insured losses for the seven storms totaled \$79.1 billion.¹⁷ Nonetheless, insurance companies responded with remarkable efficiency and effectiveness. Approximately 99 percent of the 1.2 million homeowners insurance claims from Hurricane Katrina, including those in hard hit Louisiana and Mississippi, have been settled. Claims

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Policymakers at the state and federal levels are now trying to implement legislation they hope will improve consumer satisfaction related to insurance. However, the proposal to repeal the McCarran-Ferguson Act threatens the viability of competition in insurance markets – the opposite of its intended effect.

payments to homeowners in affected states exceeded \$16 billion, approximately 93 percent of which went to Katrina victims in Louisiana and Mississippi.

In Louisiana, approximately 688,000 homeowners claims, totaling \$10.8 billion, have been settled. In Mississippi, more than 350,000 homeowners claims, totaling \$5.4 billion, have been settled. Effectively all of the nearly 350,000 claims from damaged vehicles, totaling \$2.2 billion, have been settled. In Louisiana, only 537 out of more than 1,000 suits filed in U.S. District Court remain on the docket. The state-sponsored mediation program in Mississippi has settled 3,034 of 3,687 cases in that state.¹⁸

Perceived customer service problems were exacerbated by the volume of claims and a pervasive misunderstanding of flood peril coverage. At the same time, insurance prices increased due to a shift in the distribution of expected losses caused by the storms. The combination of increased premiums, availability issues and consumer satisfaction impediments thrust insurance regulation into the political arena.

Policymakers at the state and federal levels are now trying to implement legislation they hope will improve consumer satisfaction related to insurance. However, the proposal to repeal the McCarran-Ferguson Act threatens the viability of competition in insurance markets — the opposite of its intended effect. Further, the repeal of McCarran would generate huge legal costs regarding whatever new, untested legislation replaces McCarran, while doing nothing to increase the availability and affordability of property insurance. It is therefore imperative that lawmakers understand the real causes of insurance problems, while recognizing the salutary effects of the limited insurer antitrust exemption afforded by McCarran.

This section of the *Issue Analysis* develops the following conclusions:

1. Insurance markets are competitive.

2. The limited antitrust exemption provided by McCarran does not lead to collusion among insurers that is harmful to consumers.
3. Repealing McCarran would impede competition and the operation of insurance markets to the detriment of consumers.

Market Competition

Consumers desire insurance premiums that are adequate, but not excessive. If premiums are too low (i.e., not adequate) the insurer will not have enough money to pay the insured's claims or provide other services such as loss control and claim processing. If premiums are excessive, consumers' economic disadvantages are obvious. In other words, consumers are best served by insurance coverage at the "fair-market premium."¹⁹

The fair-market premium is the premium that will be offered and accepted in a competitive market. It includes the present value of expected claim payments, expected administrative and operating costs (including distribution costs, taxes, and regulatory fees), and capital costs, also known as a fair profit. These elements ensure that the company will have enough money to pay claims and provide services, and create an adequate incentive for participation in insurance markets.

Competitive markets commonly exhibit four characteristics.²⁰ First, they include multiple independent sellers with low to moderate market shares. Second, there are multiple consumers with enough information to determine the value of the product. Third, the product is relatively homogeneous, allowing consumers to differentiate value across offered prices. Finally, barriers to entry and exit are low, allowing new suppliers to enter the market if prices rise above the fair-market price or exit the market if they cannot produce the product at the fair-market price. Competition among sellers is the most important safeguard for consumers of

any product, including insurance. When consumers have choices among insurance carriers, the carriers are forced to compete for the consumers' business. For example, assume that two insurers, Company A and Company B, offer the same insurance policy to identical consumers. If Company A charges more than Company B, consumers will buy from Company B.²¹ Company A must either lower its price or exit the market. If insurers in a given market were to collude and fix prices at a level above the fair premium, a new company could enter the market, charge the fair-market price and take away the colluding insurers' market share.

Insurance Markets Are Competitive

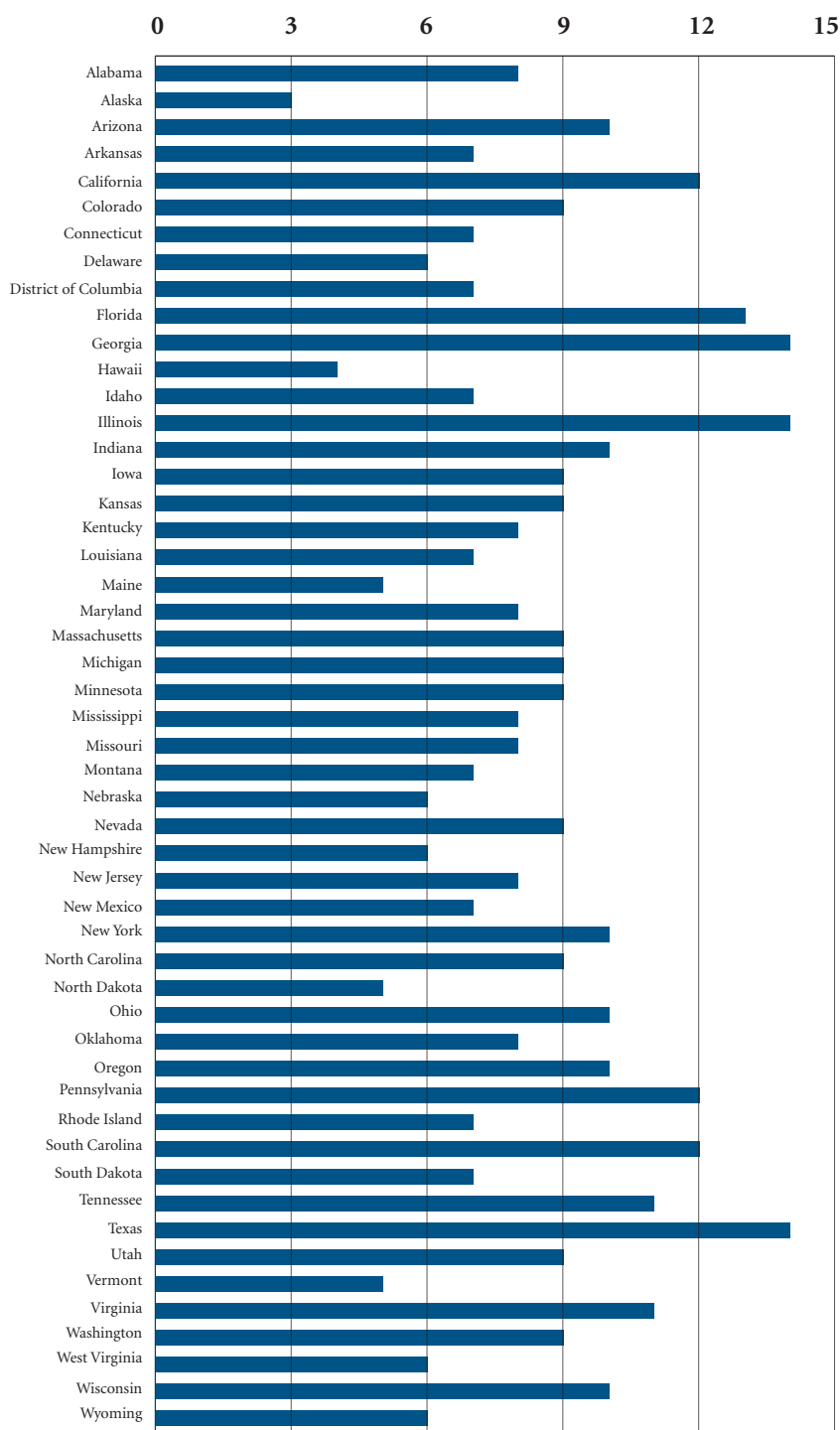
The role of the limited antitrust exemption provided by the McCarran Ferguson Act is to *increase* competition by promoting the characteristics of competitive markets described above. From all indications, the law has been remarkably successful in achieving this objective. Numerous studies conducted by academic and government researchers find that insurance markets are highly competitive.²²

The number of sellers in the insurance market is consistent with vigorous competition. In 2006, there were 2,783 companies licensed to sell property and liability insurance in the United States.²³ Of these, 928 underwrote homeowners insurance.²⁴ Furthermore, insurer formation and expansion activity shows that barriers to entry are not excessive. Figure 1 displays the annual average number of companies entering each state's market for homeowners insurance from 1996 to 2005. The averages range from three per year in Alaska to about 14 companies per year in Illinois.

These numbers leave little room for doubt that insurance markets are competitive. Even if the 928 carriers writing homeowners insurance somehow managed to agree to an artificially high price in a state or region, observed behavior shows that no excessive barrier prevents other companies from entering the region. However, without

Figure 1
Average Annual Market Entries by State
1996 – 2006

New market entries defined as a company selling homeowners insurance in a state where it did not sell this cover in the preceding year.



Source: NAIC InfoPro Property and Casualty Database, 1996 – 2006.

the limited antitrust exemption provided by McCarran, carrier formation and expansion would be all but impossible because they would not have access to prior loss data. Commercial lines of insurance, especially those covering small businesses, would also be affected similarly given the heavy reliance of most carriers on advisory loss costs in these lines.

Legal Cooperation Among Insurers Does Not Harm Consumers

Insurance companies share information via statistical agents for the purpose of ratemaking. Therefore, it is correct to

say that insurance companies cooperate in estimating loss costs. However, the economic implications of this cooperation are either misunderstood or deliberately misrepresented by some insurance industry critics.

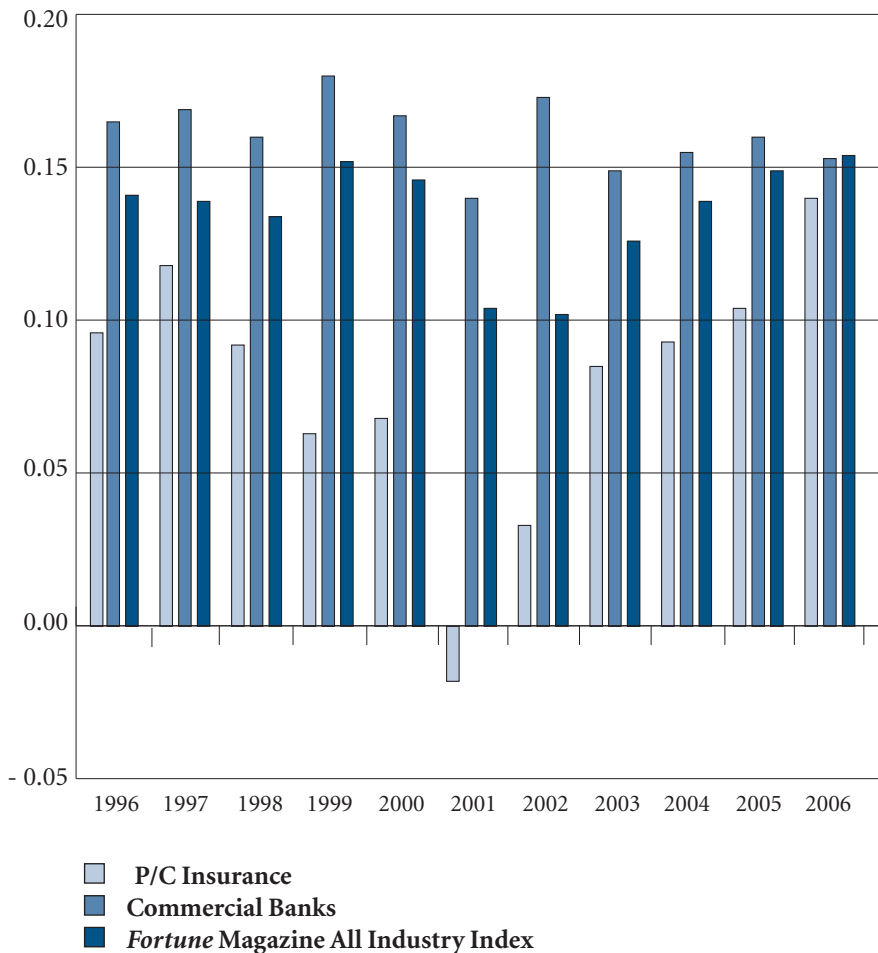
If an industry is colluding to hold prices above the fair-market price, we should expect it to exhibit extraordinarily high returns when compared to other, more competitive industries. This is certainly not the case for property/casualty insurance companies. To the contrary, insurance industry returns are substantially lower than those of the banking industry and a composite index. Figure 2 compares U.S. property/casualty insurance

industry return on equity (ROE)²⁵ to that of U.S. banks and a composite index created by averaging industrial and service sector returns reported in *Fortune* magazine. Insurance industry ROE averaged less than eight percent from 1996 to 2006. During the same period, commercial banking ROE averaged 16 percent, and a composite index of ROE for multiple industries averaged almost 14 percent — roughly twice that of insurers. If insurers are colluding to raise prices unfairly, they are doing a very poor job. Of course, the more logical conclusion is that insurance markets are competitive, and onerous regulation suppresses insurance industry returns.

The McCarran-Ferguson Act And Market Conduct Of Insurers

Perhaps the most perplexing accusation recently brought against insurance carriers is that the limited antitrust exemption provided in McCarran somehow facilitates unethical market conduct in claims settlements. For example, in testimony before the U.S. House of Representatives Committee on Financial Services, Rep. Gene Taylor (D-MS) declared:

**Figure 2
Comparing Return on Equity Across Industries
1996 – 2006**



Source: Insurance Information Institute, *Fortune Magazine*

I'd like you to look into the antitrust. Again, they are exempt from the antitrust laws, so is it really fair that State Farm can call up Allstate and call up Nationwide and call up USAA and say, "You know what, if you don't pay claims, and you don't pay claims, then I won't have to pay claims"? Under the existing law, that is allowed. It's wrong as all get out, and it should be illegal.²⁶

No one would deny that such behavior is wrong, which probably explains why it is currently illegal in every state.²⁷ In fact, McCarran does not protect such behavior in the claims handling process, as it does not shield insurers from actions against unfair and deceptive trade practices. Unfair Claims Practice statutes exist in every state.²⁸ These laws give the state's insurance regulator and attorney general complementary and mutually supportive authority to monitor, investigate and punish insurers that fail to pay valid claims. States also have market conduct regimes where regulators can examine the behavior of insurers and take corrective action if needed. In addition, consumer protection laws in every state apply to insurance transactions. Moreover, federal consumer protection statutes, including the Fair Credit Reporting Act, also apply to insurance companies.²⁹

Repealing McCarran Would Harm Consumers

If policymakers repeal McCarran, consumers will suffer substantial negative consequences resulting from a combination of weakened competition in the insurance industry and a myriad of regulatory, legal and operational problems creating costs which they must ultimately bear.

Advisory loss costs provided by statistical agents are available to insurers for a fee. However, the benefits of advisory loss costs vary inversely with market share, company size and age of insurers. Small and new insurers have less in-house data

to analyze than do large insurers. Also, even if statistical agents provided raw historic loss data for insurers to analyze, the cost of analyzing loss data represents a much larger proportion of a small insurer's revenue than that of a large insurer. Experts claim these costs would be prohibitive for small insurers, effectively eliminating the important competition they bring to markets.³⁰ Indeed, empirical evidence suggests that when McCarran became law in 1945, its effects differed across insurers based on the types of insurance they underwrote and company size. Current analysis by Randy Dumm, Rob Hoyt and the author shows that enactment of McCarran increased the value of small property/casualty insurers and decreased the value of large insurers.³¹

Competition from insurers with relatively small market shares appears especially important in the homeowners insurance line. Collectively, insurers writing less than \$5 million³² in direct premiums in a given state hold market share that varies substantially across states. In 2006, the market share of smaller insurers varied from less than one percent of homeowners insurance in California³³ up to 37 percent in South Dakota. Because smaller insurers rely more heavily on advisory loss costs than do larger insurers, repealing McCarran poses a substantial threat to states where a large percentage of its insurance market would face substantial increases in cost.

Benefits of Pooling Loss Data, Standardizing Forms

McCarran permits several activities conducted by insurance companies that would otherwise be prohibited or subject to costly litigation under federal antitrust laws. As mentioned above, perhaps the most important of these is to permit insurers to pool data via statistical agents, which produce advisory loss costs that aid insurers in the ratemaking process. Insurers are often required by states to report loss information for this purpose because advisory loss costs promote competition in insurance markets. Without advisory loss costs, credible ratemaking information would

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It is not practical to craft safe harbor provisions that would provide adequate protection for present or future pro-competitive activities; rather, “safe harbors” would simply introduce uncertainty into the insurance marketplace and invite costly and protracted litigation.

not be available to many small to mid-sized insurers whose own loss experience is not adequate for estimating loss distributions. Of course, this argument can be extended to start-up insurance companies, and companies entering new markets or offering new lines of coverage as well. With no loss data of their own, these companies would have limited means by which to responsibly enter the market and compete for premiums.

A related function of the limited antitrust exemption is to encourage standardization of risk classification and policy language. The broad use of standard policy forms serves at least four functions that benefit consumers. First, it ensures that data reported to statistical agents are consistent across insurance companies and can thus be accurately pooled to create advisory loss costs. This reduces insolvency risk and encourages competition from smaller or new companies. Second, consistent policy language simplifies price comparison for consumers, thereby creating a more competitive market. Third, standardization makes coverage more reliable by facilitating uniformity in judicial interpretations of policy contracts. If all insurance contracts differed substantially, there would be more uncertainty for insurers and consumers regarding the outcomes of coverage disputes. This would reduce market efficiency and increase the cost of insurance. Finally, it would increase the cost of regulatory compliance related to approval of policy forms required in most states.

Absent McCarran, joint underwriting arrangements among insurers would be subject to antitrust scrutiny. This would affect several common insurer practices. Currently, insurers are allowed to form inter-company pools or syndicates in which multiple insurers combine to underwrite very large exposures. This function increases market capacity for large risks such as commercial property. It also fosters competition by allowing smaller insurers to underwrite sections of large accounts that would otherwise face a very thin market.

Residual market mechanisms represent

another form of joint underwriting arrangement. The purpose of involuntary (or residual) markets is to make insurance coverage available to individuals who cannot obtain coverage in the voluntary market. Residual markets are often formed via regulation for coverage required by law or common contracts (e.g. automobile liability, workers’ compensation, and property insurance).³⁴ It is not clear that antitrust laws would permit this practice in the absence of McCarran.

Participation in guaranty funds would also be threatened if McCarran were repealed. Guaranty funds exist in every state to protect consumers when an insurer becomes insolvent. If an insurer does not have the financial capacity to pay claims, the state takes control of the insurer to guide it through liquidation — the process of dividing the insurer’s assets among claimants. Once the insurer’s assets are exhausted, the guaranty fund assesses the remaining insurers in the state to cover remaining unpaid losses.

In response to these concerns, some policymakers have suggested so-called “safe harbors” in federal antitrust laws to permit pro-competitive cooperative activities. Discussion of safe harbors is not new and has been consistently rejected by scholars and policymakers. It is not practical to craft safe harbor provisions that would provide adequate protection for present or future pro-competitive activities; rather, safe harbors would simply introduce uncertainty into the insurance marketplace and invite costly and protracted litigation.

In light of the information presented in this *Issue Analysis*, it seems clear that the safe harbor that would be most effective in protecting insurers from pro-competitive antitrust scrutiny is the one that has been in place for the last 62 years — the McCarran-Ferguson Act itself. There is little room for doubt that changing the existing insurer antitrust exemption — with or without safe harbors — will generate huge legal costs, as insurers would be forced to contend not only with government lawsuits but hundreds

of private actions as well. Given the strong evidence supporting the current federal law, these costs represent inefficient, dead weight imposed on an effective and relatively efficient extant system. Some large insurers could regard the costs as prohibitive, giving them a powerful incentive not to report data or participate in other cooperative activities that facilitate competition.

Regulation of Insurance Markets: Reform is Key to Increasing Availability and Affordability

Writing in 1991, Kenneth J. Meier, a professor of political science at the University of Wisconsin-Milwaukee, made the following observation:

Insurance is a highly complex industry; many politicians are unwilling to invest their own personal resources to learn the nuances of insurance regulation. Although there are ways to reduce such information costs, the politician has a variety of issues to choose from and, as a result, issues other than insurance are likely to be more attractive to most politicians.³⁵

As Meier suggests, lack of insurance expertise on the part of policymakers explains, at least in part, the prevailing misconceptions about McCarran's effect on insurance markets. It also contributes to the creation and persistence of misguided laws and regulations governing the business of insurance. But other factors play a role as well. The economic principles of insurance regulation are riddled with idiosyncrasies differentiating public policy related to insurance from that of other industries. In terms derived from the *Chicago Theory* of regulation and applied specifically to insurance by Meier, insurance is a "complex" product that is infrequently "salient." William T. Gormley, a professor of government and public policy at Georgetown University, offers the following

definitions of salience and complexity in the context of regulation:

A highly salient issue is one that affects a large number of people in a significant way. Expressed a bit differently, salience is low unless the scope of conflict is broad and the intensity of conflict is high. In contrast, a highly complex issue is one that raises factual questions that cannot be answered by generalists or laypersons. High complexity does not necessarily mean that technical considerations are paramount or that political considerations are unimportant. It does mean that specialized knowledge and training are needed if certain factual questions are to be satisfactorily addressed.³⁶

Insurance is complex in that it is difficult for laypersons to understand the process of setting insurance prices. While insurance consumers are quick to notice when prices are increasing, only a small number of individuals are able to express an informed opinion as to whether observed insurance prices are truly excessive (or inadequate). Insurance tends to be salient to consumers only when they experience an upward spike in premiums and/or a downward spike in availability. Because neither of these events occurs frequently, salience is intermittent, while complexity remains constant. The result is that the factors that influence insurance prices are ignored or misunderstood by most people outside of the insurance industry. Policymakers, for their part, have powerful incentives to acquiesce in the populist call to "do something" about the rising cost of insurance.

Unfortunately, the outcome can be to improperly address complexity with oversimplified assumptions or overly broad legislative proposals that do little to address the fundamental issue at hand.

The public statements of leading senators in support of the "Insurance Industry Competition Act" are consistent with the behavior predicted by the model described

Insurance tends to be salient to consumers only when they experience an upward spike in premiums and/or a downward spike in availability. Because neither of these events occurs frequently, salience is intermittent, while complexity remains constant.

Shortages in the supply of insurance and lack of product innovation, where they occur, are direct consequences of the inefficiencies wrought by excessive regulation.

above. For example, according to Sen. Patrick Leahy (D-VT), chairman of the Senate Judiciary Committee and sponsor of the Senate version, the bill would “simply give the Department of Justice and the Federal Trade Commission the authority to apply the antitrust laws to anticompetitive behavior by insurance companies.” Like the bill’s co-sponsors, Sen. Leahy emphasized the supposed linkage between the McCarran antitrust immunity and “concerns that insurers have been too often denying claims and delaying payouts to residents along the Gulf Coast instead of honoring their contractual commitments to their customers and helping rebuild that region.”³⁷

Sen. Arlen Specter (R-PA) cited “the collusive atmosphere that exists in the insurance industry” as the reason why “too many consumers are paying too much for insurance.” This cost-inflating collusion, he averred, “has become a particular problem along the Gulf Coast, where insurers have shared hurricane loss projections, which may result in double-digit premium increases for Gulf Coast homeowners.”³⁸ Senate Minority Whip Trent Lott (R-MS) described his amazement at discovering, upon “coming out of Katrina,” that “the insurance industry is not subject to antitrust laws,” and that “price fixing in this industry [is] not covered by the federal government.”³⁹

Accusations of collusion to effect price fixing and unfair claim outcomes follow exactly Meier’s model of misinformed policymakers promoting populist opinions about insurance pricing at a time when insurance becomes salient. However, upon closer inspection there is no evidence that suggests, nor even a valid reason to suspect, that insurers have engaged harmful collusion.

It is time to break this pattern of subjecting insurers — and ultimately, consumers — to additional unnecessary and onerous regulation when markets react to substantial new information such as catastrophic property damage from natural or man-made disasters.

Policy Recommendations

While insurance markets are made more efficient and competitive by the McCarran-Ferguson Act, other laws and regulations governing insurance markets are less benign. For years, insurance economists and other industry experts have made a consistent and persuasive case for changing the way insurance markets are regulated in the United States. In dozens of books and articles, these analysts have argued that rate regulation, coverage mandates, and restrictions on the use of risk-based underwriting criteria distort insurance markets to the detriment of most consumers. Modern property/casualty insurance markets, they repeatedly point out, exhibit none of the characteristics that warrant the market interventions endemic in the insurance regulatory framework of most states. To the contrary, insurance markets are characterized by robust competition and relative ease of entry and exit. Shortages in the supply of insurance and lack of product innovation, where they occur, are direct consequences of the inefficiencies wrought by excessive regulation.⁴⁰

Yet progress toward market-based regulatory reform has been modest at best, particularly in several of the most populous states.⁴¹ Frustration over the apparent inability or unwillingness of many state legislatures and insurance regulators to effect meaningful reform has produced a schism among opponents of excessive regulation, with some favoring a partial transfer of insurance regulatory authority to the federal government from the states, where it has traditionally resided. Members of Congress have introduced legislation to create an optional federal charter that would allow insurers to choose to be regulated by a newly-created federal insurance regulator, thereby escaping the debilitating effects of hyper-regulation by the states.⁴² Skeptics of this approach doubt that federal regulation would produce the desired reforms, and warn that an “optional” charter could

eventually metastasize into a comprehensive national regulatory regime every bit as burdensome and dysfunctional as those in the most problematic states.⁴³ Yet despite their disagreement over means, proponents of insurance regulatory reform share the common goal of greater market freedom, enhanced competition, and increased consumer choice.

A complete litany of measures that policymakers could take to mitigate current regulatory shortcomings is beyond the scope of this *Issue Analysis*. However, certain reforms would directly advance an agenda of enhanced competition, greater availability of insurance coverage and more consumer choice. They include deregulation of insurance rates and risk-based underwriting practices, making cross-subsidies transparent and explicit, and spurring regulatory competition among states to improve states' regulatory environments.

Following nearly every significant *loss-related* event affecting insurance markets, proposed regulatory responses have involved changes in rating and underwriting practices, rather than addressing the underlying element that affects affordability and availability of insurance — *losses*. In many instances, regulation of underwriting and rating practices actually has the unintended effect of exacerbating problems of affordability and availability of insurance. Only recently have some states begun to address the underlying problems leading to affordability and availability issues. These include the factors driving the cost of losses such as coastal development, nonexistent or ineffectual building codes, and the factors hampering the speed with which insurers can respond to major events such as rate regulation and underwriting restrictions.

Insurance rates and underwriting practices are currently regulated to varying degrees in most states.⁴⁴ The stated purpose of this regulation is to ensure that rates are not inadequate, excessive or unfairly discriminatory. In practice, inadequacy is largely ignored and the operative definitions

of “excessive” and “unfairly discriminatory” often are arbitrarily based on interest group pressure rather than objective evidence. In a competitive market, excessive premiums are not feasible and discrimination will only occur based on objective risk measures, making it, by definition, fair.

One problem caused by rate regulation is sometimes referred to as “sticky” rates because regulation prevents insurers from changing rates to match expected costs. Insurers in some states where prior approval rate regulation is especially stringent are not able to respond swiftly to changes in expected losses and economic conditions. When expected loss costs decrease, they are inhibited from lowering rates because they reasonably fear that regulators will not allow them to raise rates when loss costs rise above levels that lower rates would support.

Suppression of insurance rates via regulation for some high-risk classes also has unintended negative consequences. Because insurance companies must price coverage to pay for all expected losses out of premiums they collect, they are forced to charge low-risk insureds a higher premium than their expected costs warrant to make up for the deficits from insufficient rates charged to high-risk insureds. Not only is this scenario inherently unfair, it decreases low-risks' incentives to purchase insurance, and decreases high risks' incentive to exercise caution, further exacerbating the problem. Regulatory reform aimed at enhancing underwriting and pricing freedom will change insurance markets in ways that benefit consumers and society. Specifically, such regulatory changes will result in optimal levels of risky activity (i.e. coastal development, safety enhancements, and driving) and insurance prices reflecting insureds' true expected loss costs. If policymakers' intent is to subsidize some (generally high-risk) insurance consumers that complain about high prices, this should be made clear in the law and to voters.

Regulatory reform aimed at enhancing underwriting and pricing freedoms will change insurance markets in ways that benefit consumers and society.

Summary and Conclusion

The McCarran-Ferguson Act of 1945 was enacted to protect certain activities in the insurance industry that enhance market competition and financial strength. Insurers have traditionally become a popular target for the anger and frustration of consumers when prices increase or availability becomes more limited. Such irritation increased following the hurricanes of 2004 and 2005. Some members of Congress have responded in part by mounting a well-intentioned, albeit misguided, effort to repeal the McCarran-Ferguson Act and subject insurers to further federal antitrust scrutiny.

The evidence presented in this *Issue Analysis* supports the conclusion that McCarran benefits insurance consumers, and that repealing it would harm consumers. It shows that insurance markets are characterized by vigorous competition, and moreover, that insurance companies are not earning excessive returns as would an industry that successfully colludes to inflate prices. In fact, insurers exhibit quite small returns when compared to other industries. Finally, this *Issue Analysis* describes the operational obstructions and prohibitive legal costs associated with repealing McCarran. The proposal to repeal McCarran appears to stem from a fundamental misunderstanding of insurance markets and insurance regulation.

Endnotes

¹ See “Insurance Industry Competition Act of 2007” (H.R. 1081/S. 618).

² Some of the catastrophe insurance-related proposals introduced in the 110th Congress as of this writing include H.R.3355, which would create a National Catastrophe Risk Consortium that states could join for the purpose of transferring catastrophe risk through the issuance of risk-linked securities or through reinsurance contracts; H.R.3121, which, as drafted initially, contained provisions to increase

the borrowing authority of the National Flood Insurance Program as well as funding for mitigation and updating maps, but now contains a provision that would include windstorm coverage as part of the NFIP; and S.292, which would establish a bipartisan commission on natural disasters and would require the commission to present a report and recommendations to Congress by December 2008.

³ Proposals to repeal the McCarran-Ferguson Act surfaced in the mid-1980s during the so-called liability insurance “crisis,” amid allegations that insurers collusively set prices above competitive levels. While the uproar did not result in any substantive legislative proposals, the Insurance Services Office in 1990 ceased publishing advisory rates and instead began publishing loss costs only. This left each insurer to add a mark-up for expenses and return on capital to arrive at a final rate. In 1991, Rep. Jack Brooks (D-TX) introduced H.R. 9, the “Insurance Competitive Pricing Act,” which attempted to replace the general McCarran antitrust exemption with a set of targeted “safe harbor” antitrust exemptions. Negotiations on the issue continued over three years and eventually resulted in an agreement in the summer of 1994. H.R. 9 was reported favorably out of the House Judiciary Committee, but the effort ultimately stalled when control of the House shifted in that year’s mid-term elections. For a concise history of the McCarran-Ferguson Act, see Patricia M. Danzon, “The McCarran-Ferguson Act: Anticompetitive or Procompetitive?” *Regulation*, Vol. 15, No. 2, Spring 1992. Also see Craig A. Berrington, “Congress, Once Again, Debates Insurers’ Antitrust Exemption Under McCarran-Ferguson Act,” *Legal Backgrounder*, Washington Legal Foundation, Vol. 22, No. 17, May 25, 2007.

⁴ *Paul v. Virginia*, 75 US 168 (1868).

⁵ *United States v. South-Eastern Underwriters Association*, 322 U.S. 533, 64S. Ct. 1162, 88 L.Ed. 1440 (1944) rehearing denied 323 U.S. 811, 65 S.Ct. 26, 89 L.Ed. 646 (1944).

⁶ Constitution of the United States, Article 1, Sec. 8.

⁷ Sherman Act, 15 U.S.C. §§ 1-7 (1890).

⁸ Clayton Act, 15 U.S.C. §§ 12, 13, 14-19, 20, 21, 22-27 (1914).

⁹ Federal Trade Commission Act, 15 U.S.C. §§ 41-58.

¹⁰ The Sherman Act prohibits restraint of trade and monopolistic practices. The Clayton Act prohibits anti-competitive practices. The Robinson-Patman Act (an amendment to the Clayton Act) prohibits price discrimination among customers who compete against each other. The Federal Trade Commission Act prohibits unfair methods of competition and deceptive practices.

¹¹ McCarran-Ferguson Act, 59 Stat. 33, 34 (1945), U.S.C.A. §1012 (1958).

¹² Five independent statistical agents prepare data for the property/casualty industry. They include: the Insurance Services Office (ISO), the Independent Statistical Service (ISS), the National Independent Service (NISS), the American Association of Insurance Services (AAIS) and the Mutual Service Office (MSO).

¹³ Two states that adopted a market-based approach this year were Louisiana and South Carolina. In Louisiana, lawmakers enacted HB 678, which creates a \$100 million incentive program for property insurers who commit new capital to write in the state and take policies out of the Louisiana Citizens Property Insurance Corporation. South Carolina lawmakers, meanwhile, enacted HB 3820, which provides incentives to insurance

companies that provide coverage within the state's wind pool territory and tax incentives for consumers who set up Catastrophe Savings Accounts or retrofit their homes.

¹⁴ House Bill 1a, which took effect on January 25, 2007, contains several provisions that many industry observers consider punitive. They include a provision prohibiting formation of new Florida domestic subsidiaries of a national company (commonly called a "pup company"); prohibiting insurers from writing auto insurance in Florida if the insurer writes property insurance in another state but does not write property insurance in Florida; requiring the Insurance Consumer Advocate to provide an annual report card for each property insurer using a letter grade; and requiring an insurer's senior officer for Florida business to sign a sworn statement of certification under oath, with penalty of perjury, for rate filings.

¹⁵ See, *Tuepker v. State Farm Fire & Cas. Co.*, 2006 WL 1442489 (S.D. Miss.); *Leonard v. Nationwide Mutual Insurance*, 2006 No. 1:05CV475 (S.D. Miss.); and *Broussard v. State Farm Fire & Cas. Co.* 2006 No. 1:06cv6-LTS-RHW (S.D. Miss.).

¹⁶ The "Insurance Industry Competition Act" (H.R. 1081/S. 618) was introduced on February 15, 2007. Sen. Patrick Leahy (D-VT), who chairs the Senate Judiciary Committee, is the bill's chief sponsor in the Senate. Co-sponsors include: Senate Majority Leader Harry Reid (D-NV); Sen. Mary Landrieu (D-LA); Senate Minority Whip Trent Lott (R-MS); and Sen. Arlen Specter (R-PA). Rep. Peter A. DeFazio (D-OR) introduced the House version, H.R. 1081. Its six co-sponsors include Rep. Rodney Alexander (R-LA), Rep. Bobby Jindal (R-LA), Rep. Charlie Melancon (D-LA), Rep. Bruce Braley (D-IA), Rep. Walter B. Jones, Jr. (R-NC) and Rep. Gene Taylor (D-MS).

¹⁷ Insurance Information Institute, Katrina Fact File.

¹⁸ See Insurance Information Institute, “Hurricane Katrina and Insurance: Two Years Later \$40.6 Billion in Insurance Claim Dollars Aid Recovery,” August 6, 2007.

¹⁹ See Scott E. Harrington and Greg Niehaus, *Risk Management and Insurance*, Second Edition (New York: McGraw-Hill/Irwin, 1998). Chapter 8 contains a thorough discussion of fair insurance premiums.

²⁰ Competition is defined as “workable competition” in the sense suggested in J.M. Clark, “Toward a Concept of Workable Competition,” *American Economic Review* Vol. 30, No. 2, (1940), pp. 241-256.

²¹ Of course, consumers should also consider service and financial strength of the insurer, but this stylized example assumes all other characteristics are equal. It may help to think of the price of insurance as the difference between cost and expected benefits (including service and probability of continuing insurer financial strength).

²² See Paul Joskow, “Cartels, Competition and Regulation in the Property-Liability Insurance Industry,” *Bell Journal of Economics and Management Science*, Vol. 4 No. 2 (1973), pp. 275-427.

²³ This sample is based on all insurers for which data are available on the NAIC Data Tapes. These data tapes contain the statutory annual statement accounting data that are filed with the NAIC by virtually all insurers in the United States. These data are used with permission of the NAIC. The National Association of Insurance Commissioners does not endorse any analysis or conclusions based upon the use of its data.

²⁴ Some companies are affiliated with other companies in a holding company structure. Combining affiliated carriers yields 217 unaffiliated entities writing homeowners insurance.

²⁵ Return on Equity is equal to net income after taxes divided by the net worth of the firm (assets – liabilities). It is a common measure of performance.

²⁶ Statement of Rep. Gene Taylor (D-MS) before the Subcommittee on Oversight and Investigations of the Committee on Financial Services, U.S. House of Representatives, 110th Congress, First Session, February 28, 2007.

²⁷ The crime of “collusion” involves (i) a secret agreement among two or more persons, and (ii) the committing of a fraudulent act. Collusion is an actionable offense under federal and state deceptive and unfair trade practices laws.

²⁸ Current information on state unfair claims practices settlement laws can be found on NAMIC Online at www.namic.org/compliance/ClaimsSettlement.pdf.

²⁹ See Lawrence H. Mirel, “Will Repealing the Federal Insurance Antitrust Exemption Help or Hurt Consumers?” Competitive Enterprise Institute Working Paper, May 8, 2007 available from www.cei.org/5906.pdf.

³⁰ See testimony of Kevin B. Thompson, FCAS, MAAA before the U.S. Senate Committee on the Judiciary hearing on “The McCarran-Ferguson Act: Implications of Repealing the Insurers’ Antitrust Exemption,” June 20, 2006.

³¹ Randy E. Dumm, Robert E. Hoyt, and Lawrence S. Powell, “Measuring the Effects of Insurance Regulation with Stock Price Data: The McCarran-Ferguson Act,” University of Georgia Working Paper, July 2007.

³² The \$5 million figure is consistently adjusted to real 2006 dollars over the 12-year sample period using the Consumer Price Index (CPI).

³³ It is noteworthy that California exhibits such low levels of small company participation given Proposition 103 substantially narrowed exemptions provided by the McCarran Act for California insurers in 1988.

³⁴ Residual markets are mostly the result of ill-advised rate regulation. Without the burden of rate regulation, residual markets would affect far fewer consumers; however, their purpose would be more easily justified.

³⁵ Kenneth J. Meier, "The Politics of Insurance Regulation," *The Journal of Risk and Insurance*, Vol. 58, No. 4. (Dec., 1991), pp. 700-713.

³⁶ William T. Gormley, "Regulatory Issue Networks in a Federal System," *Polity*, Vol. 18 (1986), pp. 595-620.

³⁷ See Statement of Senator Patrick Leahy (D-VT) before the U.S. Senate Committee on the Judiciary hearing on "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption," June 20, 2006.

³⁸ See Statement of Senator Arlen Specter (R-PA) before the U.S. Senate Committee on the Judiciary hearing on the McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption, June 20, 2006.

³⁹ See Statement of Senator Trent Lott (R-MS) before the U.S. Senate Committee on the Judiciary, March 7, 2007. Lott became infuriated with the property/casualty insurance industry after State Farm, Lott's insurer, determined the homeowners policy covering his home in Pascagoula, MS., covered only wind damage and not flood damage. As a result, Lott enlisted his brother-in-law, Dickie Scruggs, a renowned trial attorney, to file a lawsuit against State Farm. When Lott made his comments before the Judiciary Committee, his lawsuit had not yet been resolved. To learn more about Lott's

animosity towards the insurance industry, see Kimberly A. Strassel, "Senator Lott Floods the Zone," *Wall Street Journal*, February 23, 2007, p. A 10.

⁴⁰ See David J. Cummins, *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency* (Washington, D.C.: Brookings Institution Press, 2002) and Scott E. Harrington, *Insurance Deregulation and the Public Interest* (Washington, D.C.: AEI Press, 2000).

⁴¹ The difficulty in getting states to consider more market-based regulatory reforms may best be exemplified by the actions of Florida lawmakers. In 2006, they enacted HB 1980, a comprehensive property insurance package which, beginning in July 1, 2007, would allow insurers to increase or decrease rates by up to a five percent statewide average, or 10 percent for any territory, without approval by the Office of Insurance Regulation as long as the rate was not excessive or unfairly discriminatory. However, with the election in November 2006 of Charlie Crist as Governor and his relentless campaign to blame insurers for the state's insurance woes, the flex-band provision was rescinded during a special legislative session in January, 2007.

⁴² S.40 was introduced on May 24, 2007 by Senators John Sununu (R-NH) and Tim Johnson (D-SD). H.R. 3200 was introduced on July 26, 2007 by Reps. Melissa Bean (D-IL) and Ed Royce (R-CA).

⁴³ See, for example, National Association of Professional Insurance Agents, "Federal Interference in the State-Based Insurance Regulatory System, March 2007. Available at www.pianet.com.

⁴⁴ Current information on state rating laws can be found on NAMIC Online at www.namic.org/compliance/04Rate.pdf.

Notes

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