CEI Working Paper

Will Repealing the Federal Insurance Antitrust Exemption Help Or Hurt Consumers?

McCarran-Ferguson Reform Could Hurt Those It Is Intended To Help

By Lawrence H. Mirel
Wiley Rein LLP[i]

If you listen to certain Congressional critics of the insurance industry, the American people were let down in the wake of Katrina by irresponsible insurers who refused to pay legitimate claims in a timely manner. Insurance companies thought they could get away with such behavior, these critics claim, because they are protected by the antitrust exemptions they enjoy under the McCarran-Ferguson Act. Accordingly, repealing those exemptions will force insurance companies to obey the rules of competition that all other businesses live by and will prevent them from turning their backs on their policyholders in their time of need.

That may sound logical to people who know nothing about insurance, are unaware of how insurers actually responded to Katrina, and do not appreciate how antitrust laws work or the purpose of the partial antitrust exemption applicable to insurers. The argument for McCarran-Ferguson antitrust reform may or may not have merit, but such reform has nothing to do with how insurers responded to the devastating hurricane season of 2005. It is being pushed in large measure to "punish" insurers who refused to pay claims submitted by certain influential Member of Congress. As often happens with punitive legislation, the people who will end up being hurt are the general public.

Background. Katrina was the largest, most expensive disaster in the history of insurance. Some 1.74 million claims were filed by policyholders in six states totaling $40.6 billion. And Katrina was not the only hurricane in 2005. All told, 3.3 million policyholders filed claims for damage by windstorms in the U.S. in 2005, with claims totaling $57 billion.

How did the insurance industry cope with this unprecedented demand on its financial reserves and its people? As of August 2006, one year after Katrina, more than 95% of the 1.1 million homeowners' claims in Mississippi and Louisiana had been settled. Less than 2% of the claims were disputed. The state insurance departments in both states had set up no-cost mediation services to deal with those disputes. About half of the claimants who were not satisfied with what their insurers paid took advantage of the mediation offer, and more than 80% of the claims that went to mediation were successfully resolved.

Of the millions of hurricane damage claims filed in the Gulf states, only a tiny fraction—far less than 1%--have been or are being litigated. [ii]

One of those who sued, however, was Republican Senator Trent Lott of Mississippi, who lost a beach front home to Katrina. He was angry when his insurer, State Farm, refused to pay the claim because, the company said, it was caused not by wind, which was covered under the policy, but by flood, which was not. Senator Lott is represented in his lawsuit by his brother-in-law, Richard "Dickie" Scruggs, a well-known Mississippi plaintiffs' attorney who has also filed a large class action suit against State Farm on behalf of Gulf coast claimants.

Senator Lott has vowed to take State Farm to task for refusing to pay his claim. According to an article in the *Wall Street Journal,* he placed a phone call to the head of the National Association of Mutual Insurance Companies (NAMIC), of which State Farm is a member, and informed him that he, Senator Lott, would "dedicate [his] next term in office to bringing down State Farm and the industry through all means available to [him]."[iii]

Since the McCarran-Ferguson Act provides that insurance is regulated by the states, and not by Congress, Senator Lott has only limited options to strike back at State Farm, one of which is to amend the McCarran-Ferguson Act. That is what he vowed to do, specifically to remove the limited exemption of insurers from Federal antitrust laws contained in that act.

He was joined in that effort by Democratic Congressman Gene Taylor ~~(D)~~ of Mississippi, who also lost a house to the storm and has also filed a suit against State Farm. Mr. Taylor called State Farm "the poster child for corporate greed, for abuse of citizens," during a public hearing on February 28.[iv] According to Representative Taylor his number one objective is to take away the antitrust exemption of the insurance industry. "No one should be above the law."[v]

History of McCarran-Ferguson. Insurance companies that follow McCarran-Ferguson are not acting above the law, of course: they are following it. So what is the McCarran-Ferguson Act, and why did Congress allow an antitrust exemption for insurers under that law?

Congress enacted the McCarran-Ferguson law in 1945 in response to a ruling by the U.S. Supreme Court the previous year declaring for the first time that insurance contracts are interstate commerce and therefore subject to federal law and federal regulation.[vi] The Supreme Court's decision reinstated federal criminal indictments against a number of insurers and their executives for allegedly violating federal antitrust laws by sharing information on losses. Prior to that decision insurance had been regulated for more than

75 years by the states because of an 1869 Supreme Court ruling that insurance is not interstate commerce.[vii] (Whether or not the Supreme Court decided correctly in 1869, there is little doubt that by 1945 insurance was interstate commerce). With the Court's reversal of this 75-year-old precedent, insurers, which were regulated primarily by the states until then, suddenly found themselves subject to federal regulation. The main thrust of the McCarran-Ferguson Act[viii] was to declare Congress's intent that the existing system of state regulation of insurance would continue despite the ruling of the Court that Congress had authority to regulate insurance. In other words Congress decided not to exercise the authority the Court said it had to regulate insurance, but to leave it with the states.

A Narrow Exemption. The Act included a narrow and limited exemption for insurers from federal antitrust laws. An action by insurers is exempt if it meets three conditions: first, the activity has to be "the business of insurance," second, it must be regulated by state law, and third, it cannot be designed to boycott, coerce or intimidate.[ix] Subsequent court decisions have emphasized just how narrow the exemption is, as the courts have held that business conducted by an insurance company is not the "business of insurance" unless it involves activities unique to insurance, such as transferring risk; ordinary corporate activity that does not involve specific insurance aspects is not exempt from federal antitrust laws.[x] For example, the merger of two insurers does not constitute the "business of insurance" and is therefore subject to the Federal Trade Commission's review.[xi] Similarly, attempts by insurers to divide up an insurance market are not the "business of insurance," and insurers which attempted to do so would be subject to the federal antitrust laws.[xii]

Note that the Act does not exempt insurers from *state* antitrust laws. In fact almost all states have antitrust laws that prohibit businesses, including insurers, from conspiring together to fix prices or otherwise restrict competition. And, of course, for the exemption to apply in the first place, state government must regulate the relevant activity.

So what does the McCarran-Ferguson antitrust exemption actually allow insurers to do? Its primary use is to permit insurers to pool past loss data and project future losses on a collective basis. It also allows insurers to jointly develop standard policies, which helps consumers compare prices, and to participate in various pooling arrangements designed to protect policyholders whose insurers become insolvent.

But if the federal antitrust laws prevent other businesses from sharing pricing and cost information, why shouldn't those limitations also apply to the business of insurance?

The answer is that insurance is a unique product. Consumers pay for it up front but it takes years to know its actual cost to the insurer~~.~~ What is being purchased by the consumer is a *promise*—a promise that if a covered event occurs in the future, the insurance company will pay for financial losses due to that event. Insurers hire actuaries to look at similar losses that have occurred in the past and project those losses into the future. . Predicting the future is not easy or certain, of course, but the more data an actuary has to work with, the better the prediction is likely to be. By allowing companies to pool loss experience, actuarial predictions can be made more accurate.

It is important to consumers that insurance companies price their products accurately and maintain proper reserves. It benefits nobody when insurers run out of money to pay claims because they did not charge enough in the first place for the risks they undertook. From the point of view of an insurance regulator, the ability of companies to pool data provides greater assurance that the prices being charged are sufficient to allow companies to reserve enough money to pay future claims. It also helps avoid overpricing by letting companies know the amount they must prudently set aside for future claims, without reserving more than necessary.

Even those who argue most fervently in favor of abolishing the McCarran-Ferguson limited antitrust exemption agree that pooling past loss experience is valuable. What they object to is using the past data to project future losses---so-called "trending." They claim that "trending," which is what rating organizations such as the Insurance Services Office (ISO) and the National Commission on Compensation Insurance (NCCI) do, amounts to price fixing, because all insurers will have the same basis for pricing their products and therefore will not compete on price.

Fair Pricing. The fact is, however, that insurance is one of the most competitive industries in the nation. Even though all companies have access to collective loss experience, they vary widely as to how they sell their products, how they service their customers, and even as to how well they are managed. But they develop their prices with a reasonably accurate knowledge of how much they will likely be required to pay in future claims, and they know that they must charge enough to be able to pay those claims.

The largest insurers probably have enough of their own data to accurately project future losses, and therefore to know how much they need to charge for their products. If they cannot share that data with their competitors, however, smaller or newer companies will not be able to properly project future claims and therefore will be at a great disadvantage in determining how to price their products. They might price their products too high, believing that they need to maintain more in reserves than they actually do. More likely they will price their products too low, in order to undersell the competition; if they do that they may find that they do not have sufficient reserves to pay future claims. That means that sooner or later they will fail, and persons who purchased their policies—who bought their promises—will be out of luck. Not being able to pool loss data, then, may have the effect of *reducing* competition by making it harder for smaller insurers to compete. Would having fewer choices benefit consumers?

The ability to share collective loss data by virtue of the McCarran-Ferguson antitrust exemption does not allow companies to fix prices. It just lets them know the limits of how little they can charge before they run the risk that they will not be able to pay future claims. Some opponents of the antitrust exemption argue that its elimination would result in lower prices for consumers. That may or may not be true. But it is fair to ask whether consumers are better or worse off if they pay lower prices for their insurance today and run a higher risk that their insurance company will not have the money to pay their future claims. The reserves that insurance companies maintain are particularly important when catastrophic events, such as a Hurricane Katrina, occur. Without knowing how likely such future catastrophic events are, and what the losses from those events are likely to be, insurance companies will have a much harder time knowing how much they must maintain in reserves to remain solvent and thus able to pay the claims when they are made. At the same time, without the benefit of the pooled data they may decide they need to maintain higher reserves than necessary, which could result in higher prices for consumers.

A greater harm to consumers is the practice of some state regulators to artificially hold down prices, thus keeping insurers from charging sufficient premiums to assure their solvency in the event of future catastrophic events. In insurance, as in life, there is no free lunch. The premiums collected from policyholders are the source of the money used to pay claims. If not enough is charged for the risk, or if courts rewrite policies after events have occurred to require payment for losses that were not intended to be covered, companies will simply run out of money to pay legitimate covered claims. Conversely, if insurers do not have access to information to better set premiums, many will, conservatively, set premiums higher than they need be.

How does any of that benefit consumers?

Notes

[i] Commissioner of Insurance, Securities and Banking for the District of Columbia from 1999 to 2005.
[ii] All statistics cited in this article are from written testimony of Robert Hartwig, President and Chief Economist of the Insurance Information Institute submitted to the U.S. House Financial Services Committee Subcommittee on Oversight and Investigations on February 28, 2007.
[iii] Conversation with Chuck Chamness, CEO of NAMIC, as reported in *The Wall Street Journal*, February 23, 2007.
[iv] Reported in *Congress Daily* on February 28, 2007.
[v] Transcript of a press conference held by Rep. Taylor on October 19, 2006, by CQ Transcriptions, Inc.
[vi] *United States v. South-Eastern Underwriters Ass'n,* 322 U.S.533, 552-53 (1944).
[vii] *Paul v. Virginia,* 75 U.S. (8 Wall) 168 (1868).
[viii] 15 U.S.C. § 1011 *et seq*.
[ix] 15 U.S.C. §§ 1012(b), 1013(b).
[x] *Group Life & Health Ins. Co. v. Royal Drug Co,* 440 U.S.205 (1979).
[xi] *Am. Gen. Ins. Co. v. FTC*, 359 F. Supp. 887, 896-97 (S.D. Tex. 1973), *aff'd*, 496 F.2d 197 (5th Cir. 1974).
[xii] *Garot Anderson Marketing, Inc. v. Blue Cross and Blue Shield United of Wisconsin*, 772 F. Supp. 1054, 1062-63 (N.D. Ill 1990).