The McCarran-Ferguson Act

Anticompetitive or Procompetitive?

Patricia M. Danzon

The McCarran-Ferguson Act provides a limited exemption to the insurance industry from the federal antitrust laws. The act provides that the Sherman Act, the Clayton Act, and the Federal Trade Commission Act apply to the business of insurance "to the extent that such business is not regulated by state law." That limited exemption from federal antitrust law does not extend to "any agreement to boycott, coerce or intimidate, or act of boycott, coercion, or intimidation." The act also declares that the business of insurance shall be subject to regulation and taxation by the states. After passage of the act in 1945, all states enacted some form of rate regulation to qualify for the exemption. The practical import of the antitrust exemption has been eroded in recent years as courts have narrowed the definition of the business of insurance and broadened the definition of boycott and as an increasing number of states have subjected the industry to state antitrust law.

Proposals to repeal the McCarran-Ferguson Act have been a familiar feature of the Washington scene for many years. But pressure has mounted recently, precipitated by the so-called liability insurance "crisis" of the mid-1980s, and repeal or fundamental change have now become a real possibility. The liability insurance crisis was characterized by very sharp increases in insurance rates for commercial general liability, which covers product liability and other tort liabilities faced by corporations, municipalities, not-for-profit, and other corporate entities. Between 1984 and 1986 premium volume for general liability grew by over 70 percent per year, and some classes of insureds faced rate increases of several hundred percent, while lack of availability was reported for other coverages, notably for pollution and very high limits of "excess" coverage. Attempts by the industry to change certain provisions of the standard insurance contract precipitated the filing of a suit by nineteen state attorneys general, alleging boycott by the major insurers, international reinsurers, and the Insurance Services Office. At the same time the rising cost of automobile insurance, particularly in a few states such as California and New Jersey, has made the cost of liability insurance an inflammatory consumer issue.

Proponents of repeal contend that the McCarran-Ferguson Act has permitted insurers to collusively set prices above competitive levels.

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Although insurance commissioners in every state retain the right to review rates, those rights are not actively exercised in states that have adopted competitive rating or "use and file" laws. The allegation is that state regulation has lacked real teeth and has been no substitute for antitrust enforcement.

Collusion has allegedly been facilitated by the operation of rate service organizations, in particular, the Insurance Services Office, which has for many years been the leading rating bureau for property-liability insurance lines other than workers' compensation. The primary function of the Insurance Services Office has been to pool loss data from contributing insurers, analyze trends, and project expected losses for each line of insurance and rating territory for a standard type of policy with specified limits of coverage. Until 1990 the Insurance Services Office also added an expense factor, published advisory rates, and filed and obtained regulatory approval for those rates in every state where Insurance Services Office filings were permitted. Affiliated firms that subscribed to Insurance Services Office rating services could then in many states meet regulatory requirements either by simply filing a plan to use Insurance Services Office rates or deviations from or modifications to those base rates, or could refer to the Insurance Services Office filing to support their own rate and forms filing. In 1990 the Insurance Services Office ceased publishing advisory rates. It now publishes loss costs only and leaves to each insurer the task of adding a mark-up for expenses and return on capital to arrive at a final rate.

Pressure to repeal the McCarran-Ferguson Act has not abated, however. In November 1991 the House Judiciary Committee passed the so-called Insurance Competitive Pricing Act (H.R. 9), usually referred to as the Brooks bill after its sponsor, House Judiciary Committee Chairman Jack Brooks. The full House is scheduled to consider that bill this year. The Brooks bill would prohibit insurers from "price-fixing," a term the bill leaves undefined, would forbid the allocation of regions or customers among competitors, would forbid monopolization of any part of the insurance industry, and would prohibit the tying of the sale of insurance to the sale of any unrelated product.

Proponents of repeal of the McCarran-Ferguson Act are basing their case on the unproven assertion that with the current exemption, the insurance industry can and does collude to fix prices. Commenting on the likelihood of the Brooks bill's being enacted in 1992, Bob Hunter, president of the National Insurance Consumer Organization, predicted, "I think the House will take it up and it will pass. . . . Who's going to vote for price-fixing?"

The issue has thus been very cleverly cast as if a vote against repeal of the act is a vote for price-fixing. The presumption is thereby created that collusive pricing by the insurance industry contributes significantly to the cost of liability insurance. But the assertion of price-fixing is unproven. Indeed, the consensus of several careful analyses of the evidence is that the overwhelming cause of the rising cost of liability insurance is the rising cost of the underlying tort system, including the number of claims, the size of awards, and the costs of litigation. Unanticipated and retroactively applied increases in insurer liabilities eroded the capital of the insurance industry in the first half of the 1980s, which contributed to the sharp premium increases in 1985 and 1986. Declining interest rates were another contributing factor. In the late 1980s the growth of claim costs abated in general liability and medical malpractice, and insurance rates have fallen. In general, the price of insurance must rise to reflect the expected cost of the losses against which policyholders are insured. The allegation of price-fixing is a clever means of deflecting attention from the underlying problems of the civil justice system that are at the heart of rising costs of liability insurance. Repeal of the McCarran-Ferguson Act also promises to open the way to a new, vast, profitable area of litigation.

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The case for repeal might seem to draw support from simple economic theory. The argument is that the purpose of antitrust law is to protect consumers from anticompetitive practices and that evidence from other industries shows that substituting regulation for competition tends to reduce rather than enhance efficiency, which often results in prices above competitive levels and wasteful service

competition. There seems little justification for extending special treatment to the insurance industry. That reasoning, which repeal proponents fully exploit, draws credibility from the early experience under the McCarran-Ferguson Act. Following its enactment in 1945, all states moved to impose some form of insurance regulation, which thus extended to the industry the antitrust exemption. During the early years under the act, rating bureaus probably were effective cartelizing agencies, using rate regulation to enforce adherence to bureau rates.

Repeal would likely reduce competition, increase the cost of insurance, and reduce the availability for some high-risk coverages as the threat of antitrust litigation would reduce participation in efficiency-enhancing cooperative activities.

By the 1970s, however, the natural competitive forces within the industry became stronger with the development of the direct writers and the adoption in many states of competitive rating laws. The Insurance Services Office moved to selling its services on a piecemeal basis that gave insurers the freedom to purchase as many or as few services as they wished. For example, insurers could purchase actuarial information without buying rate filing services. The enactment of the Risk Retention Act in 1981, with amendments in 1986, has enabled commercial policyholders to turn to quasi self-insurance alternatives to commercial insurance. That has further undermined any potential monopoly power of the insurance industry. A significant and growing fraction of general liability insurance is now written through captives, risk retention groups, or other self-insurance options. For medical malpractice, physician-owned mutuals now write over half the market for physicians; for hospitals, self-insurance through captives is an even larger factor. The evidence, developed in more detail below, is that insurance is now a highly competitive industry, despite the McCarran-Ferguson Act. Repeal of the act is thus not necessary to assure competition in insurance markets.

Are Collective Activities Anticompetitive or Procompetitive?

In fact, it is highly likely that repeal would actually reduce competition, increase the cost of insurance, and reduce the availability for some high-risk coverages, because the threat of antitrust litigation would make insurers unwilling to engage in efficiency-enhancing cooperative activities.

Insurers are in the business of assuming risk. Collective activities that increase information or spread risk among insurers tend to reduce the price of insurance. Collective action is most important for loss forecasting and pricing accuracy. The fair or competitive price of an insurance policy is equal to the present value of expected losses (including claim adjustment or litigation expense), discounted to reflect expected investment income and adjusted for taxes and a normal return on capital. Forecasting expected losses on a pool of policies is relatively simple for stable lines of insurance such as life insurance, where losses across policyholders are uncorrelated and trends over time are stable. For any pool of risks, the predictive accuracy achieved with a given number of policies is lower, the larger the variance of the underlying loss distribution, the higher the correlation between losses for individual policyholders in the pool, and the less certain the estimates of the parameters of the underlying loss distribution.

All of the factors that tend to undermine predictive accuracy for insurers apply more to liability insurance lines than to life insurance and are most severe for general liability, because general liability losses are highly dependent on the trends in tort law. The fact that both the frequency of claims and the size of awards against policyholders are influenced by trends in tort law induces a positive correlation of outcomes for individual risks in the pool. Differences in judicial rulings across jurisdictions and changes over time mean that the parameters of the underlying loss distribution cannot be estimated with precision.

Unpredictability is greater, the longer the duration of the liability. The so-called long tail of liability is more extreme for general liability than for other lines because in most states the statute of limitations for product liability does not begin to run until the discovery of the injury giving rise to the complaint, which may be many years after the insurance policy was written. The average lag between pricing the policy and paying out on

claims is around five years for general liability and may be as long as twenty years or more for coverage of long-lived capital equipment and products that may be linked to cancers with very long gestation periods.

In addition to the uncertainty created by a long exposure period during which rules of tort law may undergo dramatic change, general liability is characterized by a huge range in possible losses for any policyholder. Although most policyholders will have no claims in a particular policy year, there is a small chance of a multimillion dollar loss in the event of a severe personal injury with a large pain and suffering award, multiplied manyfold if there are multiple claims from the same product line. Interstate differences in tort regimes and the potential for forum-shopping by plaintiffs exacerbate the uncertainty.

Those characteristics of the underlying loss distribution—high variance, high correlation, and imprecise parameter estimates because of dependence on tort regimes that differ across states and over time—mean that the experience of any single insurer typically gives a very imprecise estimate of expected losses for a given class of insureds in a single state. Precision in loss forecasts can be increased by pooling the loss data of multiple insurers, provided that the losses reflect similar policy provisions. Because the losses for a particular policy year are paid out over many years, the accuracy of loss forecasts requires tracking and analyzing payout patterns (loss development) and trends over time in the underlying loss distribution. Thus, as long as the underlying tort system remains unpredictable, loss forecasts for liability insurance will remain imprecise and there will be gains from using common policy forms and pooling loss experience, including estimation of loss development and trends over a period of years.

Improving precision of loss forecasts is not simply of concern to owners of insurance equity. Insurer risks that are not readily diversifiable must in the long run be reflected in higher prices or reduced coverage availability for policyholders. In the short run shocks to insurer capital that result when realized losses greatly exceed anticipated losses, as occurred in the mid-1980s, lead to shocks in the price and availability of coverage. Imprecision in insurer loss forecasts also contributes to the rate of insurer insolvencies, the costs of which are ultimately borne by policyholders, unsatisfied claimants, or solvent insurers that are assessed to cover payouts through state guaranty funds.

Those functions—of standardizing policy forms, pooling and analyzing data, and estimating loss development and trends—have traditionally been performed by rate service organizations. Obviously, the information gains from data pooling are greatest for small insurers. But even the largest insurers benefit from data pooling in unpredictable lines, particularly in states and lines where their own experience is relatively thin. In commercial lines there are advantages for large buyers with nationwide operations in obtaining coverage for all their exposures in all states from a single insurer. By using Insurance Services Office rates or loss costs as a benchmark, insurers can satisfy those demands at reasonable risk even in states or lines where they do not have a large market share. In addition, use of Insurance Services Office rate-filing services greatly reduces the costs of meeting state regulatory requirements. Because compliance with regulatory requirements is essentially a fixed cost, independent of the volume of business that is written in the state, those costs might deter the entry of small-volume insurers, if they could not spread the costs through the Insurance Services Office rate-filing process.

As long as the underlying tort system remains unpredictable, loss forecasts for liability insurance will remain imprecise. There will be gains from using common policy forms and pooling loss experience.

Another form of cooperative activity that insurers engage in is pooling risk through underwriting pools, which parcel out the risk for very large and uncertain losses among insurers. Here the function of pooling is simply to limit the exposure of any single insurer and thus to make available coverage that no single insurer would be willing to assume alone.

The Policy Options

Even proponents of McCarran-Ferguson repeal generally recognize efficiency gains from some of those cooperative activities of insurers. Pooling of

historic loss data is generally accepted in principle; but some would not permit pooling of data on losses incurred but not reported, or collective trending. For example, a proposed amendment to the Brooks bill would have permitted joint trending only for very small insurers. But such a solution is unworkable even for small insurers because they cannot be sure in advance that individually and collectively their market share is small enough to qualify for the exemption. Moreover, that solution does not address the problem of large insurers with small volume in particular markets.

Some cooperation on the design of policy forms is generally considered acceptable because it facilitates price comparisons for consumers. Perhaps more important but less widely acknowledged, use of common forms is essential for meaningful pooling of data. Some risk sharing through risk pools is also generally acknowledged to increase the availability of coverage. That, however, could clearly be threatened under the Brooks bill, if interpreted as "allocating customers among competitors" or "monopolizing or attempting to monopolize part of the insurance business."

If collective activities are protected by increased state rate regulation, proponents of competitive insurance markets would have won the battle but lost the war.

Proponents of repeal argue that those joint activities would be protected under general antitrust protections, reinforced by the state action doctrine. The state action doctrine preempts federal antitrust surveillance of activities that are regulated by the individual states. There is considerable uncertainty as to just how detailed the state regulation must be to qualify for the exemption. Thus, one likely outcome of repeal is that at least some states would adopt more stringent regulation of rates. But the experience with state regulation is that it has generally been harmful to competition, with alternating periods of excessive and inadequate rates and, increasingly, pressure to effect cross subsidies across groups of consumers. Thus, if collective activities are protected by increased state rate regulation, proponents of competitive insurance markets would have won the battle but lost the war.

A third alternative that some large insurers support is modifing McCarran, replacing the blanket exemption with a much more limited exemption for a specified list of cooperative activities, including joint data collection, joint analysis, and reporting of historical data, loss development, and trending. Insurers would be allowed to develop collective data on the likelihood of fire loss through information gathered from building inspections. In addition, they could develop and use standardized policy forms and could make joint underwriting and pooling arrangements. Despite months of negotiations between industry representatives and Rep. Brook's staff, those protections were not included in the bill that the Judiciary Committee ultimately approved.

Thus, Congress now has three options. The first is a bill, such as the Brooks bill, that proscribes a list of activities that are presumptively anticompetitive, with the proscribed activities undefined and with only an implicit presumption that procompetitive collective activities would be unaffected. Under that option some increase in state rate regulation is likely and indeed might be encouraged by the bill. The second option is a modification that would explicitly create safe harbors for a limited list of collective activities. The third is no change.

In Defense of the Status Quo

The main argument for no change is that repeal of the McCarran-Ferguson Act is neither necessary nor sufficient to assure competition in the insurance industry. The assertion that the McCarran protection permits insurers to collude effectively and set prices above the competitive level has not been substantiated and is implausible on its face because it ignores the highly competitive structure of the industry. Since the Insurance Services Office moved to selling services on a piecemeal basis, with no requirement that subscribers use the advisory rates, both theory and evidence indicate that the availability of those services has increased the number of firms in the market and has increased rather than reduced competition. The most serious impediment to competitive pricing has been state rate regulation, which is likely to increase rather than decrease in importance if the act is repealed.

The compromise alternative of repeal with safe harbor protections could in theory preserve the gains from efficiency-enhancing collective activities. But in practice the risk of costly litigation

over what activities are and are not protected may significantly reduce the willingness of insurers to engage in such activities. That is particularly true if the Brooks bill is interpreted to make certain activities per se illegal and to eliminate the traditional rule-of-reason analysis that applies in other industries. Faced with the threat of antitrust litigation that could apply to thousands of policies if a single rate is challenged for policyholders, large insurers are likely to be less willing to contribute data, and the accuracy of any loss pooling is likely to suffer. That in turn will increase forecast errors, reduce the number of small insurers in the market, and reduce the willingness of large insurers to write classes of business for which they have little experience. Thus, the cost of insurance will rise and the availability of insurance will decrease.

Of course, if an Insurance Services Office benchmark loss forecast is not available, some insurers that are too small to develop credible rates based on their own experience may continue to operate simply by pegging their own rates to those charged by large insurers. Such parallel action allegedly already exists and is hardly surprising. Large insurers cannot avoid partially revealing their loss forecasts by the prices that they charge. But the pricing strategies of competitors can only be used to infer their private information under a fairly strong set of assumptions that are unlikely to apply generally in liability insurance markets. Thus, even if some small firms survive by such parallel action, that outcome hardly achieves the increase in competition forecast by proponents of repeal. Moreover, the real information available to both price setters and imitators is reduced if the pooling activities of the Insurance Services Office are reduced or eliminated. Some increase in risk and in forecast errors is therefore to be expected.

The Evidence on Competition under McCarran-Ferguson

To measure the extent of competition, the natural starting point is the "structure-conduct-performance" paradigm of industrial organization economics. By any reasonable measure of market concentration, such as the ease of entry and exit, the insurance industry is structurally competitive, except in those heavily regulated states that impede withdrawal by insurers. There is no "right" measure of the market. Although state licensure requirements may act as a temporary barrier to entry, because the delay is at most temporary, there is a strong case for viewing liability insurance as a national market, at least within broad related lines of insurance such as private individual lines and commercial lines. Even at the state and line level, most lines pass normal structural tests based on concentration ratios or Herfindahl indexes. Concentration may appear high at any point in time in a few commercial lines such as medical malpractice. But low costs of entry and exit make those markets highly contestable. Moreover, for commercial lines the availability of self-insurance options through risk-retention groups, captives, and mutuals severely constrains the potential for noncompetitive pricing by insurers.

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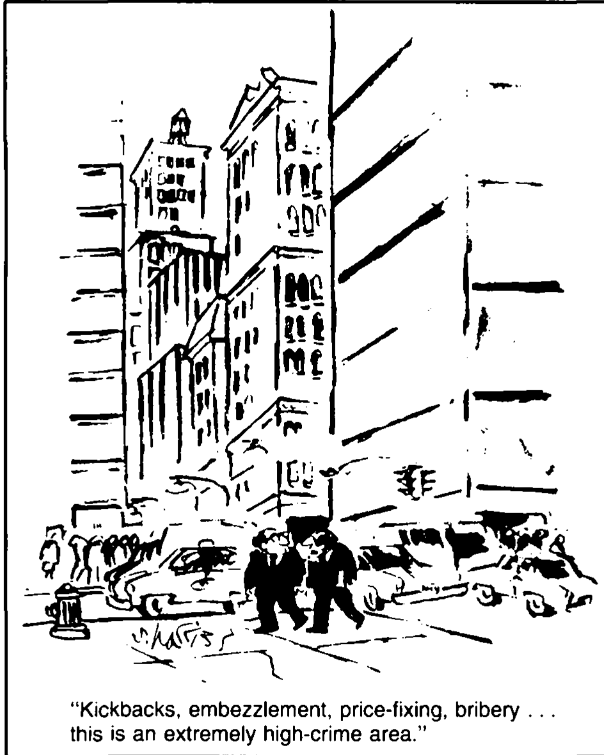
A second potential indicator of competition is price dispersion. Unfortunately, relevant price data for liability insurance are not routinely available. It is extremely costly to collect information on rates filed by insurers in most states. Moreover, even if the task were undertaken, it would seriously understate the true degree of price competition because filed rates are not transactions prices. In the days when the Insurance Services Office filed rates, insurers often filed rate deviation and rate modification plans that gave them the discretion of deviating from the filed rates within certain limits. Thus, actual prices charged to any consumer might be quite different from the filed rate on the basis of the underwriter's judgment about the individual risk. The limited evidence available from occasional surveys strongly refutes the charge that all or most firms adhere to the Insurance Services Office rate, although it does act as a benchmark in the market. Moreover, the pattern of deviations is inconsistent with the cartel hypothesis.

Measures of insurers' profitability are even more problematic and, even if available, would be inconclusive. Many insurers are not publicly traded, and those that are tend to be multiline,



"Kickbacks, embezzlement, price-fixing, bribery . . . this is an extremely high-crime area."

multistate firms, some affiliated with holding companies with activities not related to insurance. Most studies that have attempted to measure profitability conclude that insurers have not earned rates of return above the competitive level. That does not dispose of the charge of noncompetitive pricing, however, because competition on nonprice dimensions of the product could eliminate any potential excess profits that might have been earned had prices been set above competitive levels.

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Thus, the structural evidence on the number of actual and potential competitors and on patterns of entry and exit together with the evidence on price dispersion remains the main basis for concluding that the industry is competitive.

The Role of Rate Service Organizations

Unconcentrated structure would be a misleading indicator of competition if the industry were able to use rate service organizations to set and maintain prices above the competitive level under the umbrella of the McCarran-Ferguson Act. Given the large number of actual and potential competitors, however, any attempt to maintain supracompetitive rates would be futile without any mechanism to enforce adherence and with the cost of filing deviations from bureau rates dropped to a minimal level. In addition to the large number of firms, the ease of entry, and the lack of economies of scale, the liability insurance industry lacks the other product characteristics proposed by George Stigler as predisposing an industry to cartelization. Cheating on a cartel price would be easy because transactions prices are unobservable in advance and may be adjusted afterwards by rebates, dividends, and other retroactive adjustments. Even if the nominal price could be observed, the multidimensional nature of the insurance product makes it easy to chisel by adjusting the nonprice dimensions of the contract, particularly in lines that are commonly sold as a package. Since there are no significant diseconomies of scale or regulatory obstacles to expanding market share, a strategy of cutting below the cartel price would offer much greater potential profit than a strategy of adhering as long as other firms adhere; but since that is true for each firm, any attempt to cartelize is likely to collapse.

Although collective activities may have been used to maintain noncompetitive prices historically, with the present competitive structure of the industry collective activities can continue to survive only to the extent that they reduce costs for subscribing firms. An insurance firm must perform multiple functions. They include the actuarial functions of forecasting and setting rates, publishing rates and policy forms and distributing them to sales personnel and agents, underwriting and selecting policyholders, processing claims, filing rates, and meeting other regulatory requirements. The minimum efficient scale for performing those different functions varies. There are significant scale economies in estimating loss costs, producing rate manuals and forms, and dealing with regulators, whereas the minimum efficient scale for dealing with policyholders may be quite small. Moreover, even a very large firm may have small premium volume in many states

and lines, particularly in commercial lines where there are advantages to both the policyholder and the insurer if all coverages in all states are written through a single insurer.

Rate service organizations permit firms to pool those functions for which their own scale of operations is less than the minimum efficient size. That not only allows small firms to survive, but also enables large firms to operate efficiently in more states and lines. The common argument that rating bureaus permit the survival of inefficient, small firms is misleading. It ignores the multifunctional nature of firms. More fundamentally, it ignores the fact that minimum efficient scale is not an absolute but depends on institutional factors that determine the relative costs of contracting out services versus performing them in-house. Because rate service organizations reduce the costs of contracting out those services that are optimally performed on a large scale, they reduce the minimum efficient scale of operation for the individual firm and thereby increase the number of potential competitors in any market and facilitate entry.

Not surprisingly, small firms are most strongly opposed to repeal of the McCarran-Ferguson Act. A short-sighted view is that the act permits large firms to collude in setting prices above the competitive level so that the more efficient large firms can earn excess profits and the inefficient small firms that would not survive if the larger firms priced at competitive levels can stay in business. But that view is hard to reconcile with the fact that the largest firms that are allegedly making excess profits are the most willing to modify the McCarran-Ferguson Act in favor of safe-harbor legislation. In addition, the evidence simply does not support the allegation that large firms have adhered to the advisory rates promulgated by the Insurance Services Office, which is essential behavior for an effective cartel.

Of course, in setting recommended rates, bureaus may well recommend rates at levels that maximize expected profits for members. But the profit-maximizing price will not differ significantly from the competitive price because the demand facing bureau firms is highly elastic as long as there are no adherence requirements and the regulatory costs of deviating from filed rates are minimal.

In an earlier study I examined empirical evidence to test which of the two models of rating bureaus—the cartel model and the service model—was most consistent with the facts. The cartel model predicts that large firms would be more likely than small firms to adhere to bureau rates and that bureaus would only survive if a dominant market share of firms writes policies at bureau rates. By contrast, the service model predicts that small firms would be more likely than large firms to file bureau rates (or large firms in markets where they have small volume) and that a dominant market share at bureau rates is not critical to the survival of bureaus. Both models predict greater use of Insurance Services Office rates in states with prior approval rating laws than in those with competitive rating laws. Under the cartel model rate regulation is a device for enforcing cartel rates; under the service model bureau rating services are more valuable in heavily regulated states because the costs of making an independent filing are higher.

A review of data from several sources on pricing for automobile insurance concluded that the evidence was much more consistent with the service model than with the cartel model of rating bureaus. Large firms were more likely to deviate than small firms, and significantly less than half of premium volume was written at bureaus rates, even in prior approval states. Furthermore, a substantial fraction of the deviations were upward, not downward, from bureau rates, which is not predicted if the bureau rates are at joint-profit-maximizing levels. That result is not hard to reconcile with the service model in which the bureau rate simply acts as a useful benchmark from which firms deviate upward or downward, depending on how they assess their own information and experience relative to the market average.

Although rate bureaus may recommend rates that maximize expected profits for members, the profit-maximizing price will not differ significantly from the competitive price.

Robert Bork argues that concerted action, including horizontal price-fixing, may be socially efficient if it is ancillary to some other purpose (in this case cost reduction). He points out that it is inconsistent for antitrust policy to outlaw actions in concert by two or more firms if the same actions

would be legal if the firms were to merge. If the principles applied to mergers are also applied to concerted action, then the threat from Insurance Services Office cartelization is trivial: the market share of firms writing at Insurance Services Office rates was typically under 30 percent in the auto markets for which data were available.

The increase in insurer losses—exacerbated by a decline in interest rates that tends to increase the fair premium for long-tailed lines of insurance—was the overwhelming contributing factor to the crisis in liability insurance.

The only other study that has attempted to test empirically the impact of bureau rates on market prices, rather than simply assert collusion, is a recent study of pricing in workers' compensation by Ann Carroll. Although the study lacked direct data on the fraction of the market written at bureau rates, the general conclusion was that there was no evidence that the operation of rating bureaus contributed to prices or profits above the competitive level. Thus, the empirical evidence tends to support the theory that cartelization of the insurance industry is impractical even when bureaus publish advisory rates.

Evidence of Excessive Prices?

Did noncompetitive practices of insurers contribute to the crisis in liability insurance? As already noted, careful analyses of trends in claim costs during that period conclude that the increase in insurer losses was the overwhelming contributing factor—exacerbated by a decline in interest rates that tends to increase the fair premium for long-tailed lines of insurance. Further evidence that the problem was rising liability costs rather than inappropriate insurance practices is the fact that premium increases were at least as dramatic for medical malpractice written by physician-owned mutuals, which no one has accused of being out to gouge their policyholders.

The issues that were the subject of the antitrust suit filed by the attorneys general were the proposal to change the standard policy from an occurrence to a claims-made form, to exclude coverage of pollution from standard coverages, and to include legal defense in the limits of the policy. The switch to a claims-made form is consistent with an optimal sharing of risk when risk is largely undiversifiable: it is a rational response when trends in liability rules become highly uncertain, and it has been adopted widely for medical malpractice, including by some of the physician-owned mutuals. The pollution exclusion was again a rational attempt to limit the insurer's exposure once the courts began to interpret the more modest restrictions on pollution coverage as if they were nonexistent. Essentially the only way to control exposure for pollution was to exclude it entirely from the policy. Finally, given the rising costs of legal defense and the weak incentives of policyholders to cooperate in controlling defense costs if they are fully covered by the insurance contract, it is a rational sharing rule to include those expenses in the limits of the coverage under the contract.

Are Customers Crazy or Colluders?

The position taken by the Risk and Insurance Management Society, Inc., an organization representing over 4,000 corporate, governmental, and nonprofit consumers of insurance, further supports the service model rather than the cartel model of rate service organizations. In August 1988 the society opposed the repeal of the McCarran-Ferguson Act. It asserted that while it shares the free-market philosophy, when state regulatory supervision is adequate, the limited antitrust immunity the act affords insurers can enhance competition and benefit the consumer. The society also noted that modification of the act might suppress the small carrier's independence and thus reduce competition.

The Risk and Insurance Management Society asserted: "To the extent that price gouging occurred in the last market cycle, advisory rates promulgated by the insurance industry had no bearing. With the collapse of capacity . . . individual insurers with any precious capacity left had tremendous leverage to exact huge premium increases. However, while the industry has rarely adhered to advisory rates in either hard or soft markets, these rates are a valuable benchmark for consumers and regulators to determine whether a premium charged by an individual carrier is overpriced or underpriced for the risk underwritten."

Although the society strongly opposed the introduction of the claims-made policy form that was the focus of the antitrust suit filed by the attorneys general, the group urged that no modification of the act be made that would discourage the development of common policy forms. If insurers used different forms, "even the most sophisticated insureds would be confused as to what they were buying." The society also noted that coverage litigation involving benchmark forms has settled the meaning of many contract terms.

In addition to its desire to preserve common forms and advisory rates, the society has opposed modification of the act because of the regulatory uncertainty that it would introduce. Pointing out that operating a nationwide insurance program through regulatory compliance in over fifty jurisdictions is no easy task, the group asserted that its greatest fear is "the ad hoc evolution of joint federal-state regulation where the parameters of each one's authority are not defined and carriers, fearful of antitrust ramifications, are afraid to act." The organization also endorsed insurer-initiated underwriting associations that "can improve insurer efficiency and mean the difference between coverage being written or not being available at all." With respect to the liability insurance crisis, the Risk and Insurance Management Society asserted that it could not understand how modifications to the McCarran-Ferguson Act would have mitigated the last crisis or will moderate future insurance cycles.

The Risk and Insurance Management Society's position is far from a blanket endorsement of the status quo. It criticizes the Insurance Services Office for attempting to introduce the claims-made form, to eliminate pollution coverage, and to include litigation expense in the policy limits. It also urges state regulators to "get their own houses in order." But it points forcefully to the value to consumers of the cooperative activities of rate service organizations, including publishing advisory rates. It also points to the threats of legal uncertainty if the act is modified or repealed. The group has concluded that the policyholder will not benefit in terms of the availability, cost, or quality of the insurance product if the act is repealed or modified.

It seems unlikely that an organization such as the Risk and Insurance Management Society, which represents consumers of insurance (as opposed to self-designated consumer advocacy organizations), would favor retaining legislation that facilitates price-gouging by insurers. In 1991 the organization dropped its opposition to change in the McCarran-Ferguson Act, after concluding that continued dispute was deflecting resources and attention from other pressing issues and proving unproductive for the insurance industry and its consumers. It remains to be seen whether proponents of repeal will also be willing to compromise, to preserve those cooperative insurance activities that benefit consumers, and then move on to address the inefficiencies in the liability system that are the real cause of high costs of liability insurance.

It remains to be seen whether proponents of repeal will also be willing to compromise, to preserve those cooperative insurance activities that benefit consumers.

Selected Reading

Carroll, A. "The Determinants of Market Structure for Workers' Compensation Insurance." Ph.D. dissertation, University of Pennsylvania, 1991.