Testimony of

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Implications of Repealing the Insurers' Antitrust Exemption
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Good morning Mr. Chairman, I am Kevin B. Thompson, Senior Vice President- Insurance Services of Insurance Services Office, Inc. (ISO). I am a Fellow of the Casualty Actuarial Society (CAS) and a Member of the American Academy of Actuaries. I have served in various positions in the CAS leadership, including as a member of its Board of Directors and as Vice President-Admissions. My statement describes the essential role that ISO plays in fostering the competitive marketplace that is the property/casualty insurance business in the United States.

In the course of my remarks, I briefly cover ISO's role as an advisory organization and as a statistical agent of state insurance regulators, how its activities, products and services are regulated by government and how it has evolved over the years into a for-profit corporation that is not controlled by insurers. By making it possible for more insurers to compete in the marketplace, at lower cost, these products and services help reduce prices paid by consumers; give consumers greater choice of insurers; enable consumers to more easily compare prices and coverages; and speed the claims handling process.

In a highly competitive industry characterized by tight profit margins, where an insurer often must use the aggregated data of many others as an aid in estimating the average cost of its own products, it is vital to have a relatively low-cost source of those estimates. Developing prospective cost information from the aggregated data of many insurers is an expensive process and the information's availability can be a crucial factor in an insurer's decision to enter or remain in a market. While we take no position on what laws should regulate the property/casualty insurance industry --state or federal-- we believe insurers' access to vital advisory organization materials deserves to be preserved and protected. Since repeal or substantial modification of the McCarran-Ferguson Act's limited antitrust exemption is likely to create legal uncertainty and have a chilling effect on legitimate insurer use of those materials, no change should be considered without proof that it is needed and that it will help, not harm competition in the property/casualty insurance business.

ISO's role as a state-licensed advisory organization and statistical agent and how it is regulated by the states

ISO is licensed as an advisory organization1 in all fifty states, Puerto Rico and the District of Columbia. As an advisory organization, our company provides statistical, actuarial, policy form development and related products and services to property/casualty insurers, including advisory prospective loss costs2, other prospective cost information,3 manual rules and policy forms. ISO also serves as an officially designated statistical agent of state insurance regulators to collect policy-writing and loss statistics of individual insurers and compile that information into reports used by the regulators.

While the style of regulation varies from state to state, ISO's prospective loss costs, rules and policy forms are typically filed with and are subject to review and/or approval by state regulators. In addition to this state oversight of the materials ISO makes available to insurers,
ISO's operations are the subject of thorough examinations conducted by state regulators. They are typically single-state examinations, but the resulting reports are made available to all states. Currently, we are being examined by New York and a Georgia examination was recently
conducted.4 ISO's operations and its products are subject to many state antitrust statutes within or outside state insurance codes, which are typically enforced by state attorneys general and/or insurance regulators.

How ISO has evolved over the years

From its beginning in 1971, ISO differed from its historical predecessors. In the early to middle twentieth century, there were insurance cartels that had mandatory membership criteria, offered indivisible services, and ran "stamping offices" that enforced adherence to the cartels' rates, rules and forms. But from the outset, ISO had a non-adherence policy and encouraged insurers to make their own decisions on the rates they would charge and the forms and rules they would use. Over the decades that followed its creation, ISO made a series of changes in its operations and structure: stopping the development of rates (1989); eliminating decision-making by insurers
as to the loss costs, rules and forms ISO would develop and distribute (1994); divesting insurers of control of the organization (1994); and becoming an independent for-profit corporation (1997).

ISO's corporate structure assures independence from insurer control; insurers may only own stock in the corporation that has very restricted voting rights, primarily limited to the election of three of the eleven members of the Board of Directors, alteration of its certificate of incorporation, or substantial changes to the corporate structure (i.e., merger or dissolution). As is common in other businesses, ISO hosts user meetings and panels to help improve its services, but those attending have no decision-making powers and are prohibited from discussing the corporate policies or intentions of any insurer. Meeting participants may not discuss insurer rate
levels, insurer loss cost levels, or what ISO advisory loss cost levels ought to be. To assure compliance with ISO policy and the law, ISO lawyers attend all panel meetings.

ISO encourages and facilitates insurers' independent decisions about whether and how to use its material. Its Certificate of Incorporation and By-Laws contain a non-adherence provision, which states that no insurer may be required as a condition of its participation to use any loss costs, rules, forms or anything else that ISO produces. When it distributes advisory prospective cost
information, ISO actively encourages each insurer to take into account its own loss experience and to use the insurer's own actuarial judgments and procedures to determine its rates. A similar statement accompanies the distribution of ISO's manual rules and policy forms.

ISO also makes its material available in ways that permit insurer analysis, modification and adaptation in pursuit of independent business objectives. This includes distributing detailed statistics that underlie prospective loss cost information, providing ancillary services structured to facilitate insurers' analyses of risk and granting insurers the right to use policy form text in
whole or in part. ISO does not publish information supplied by any individual insurance company and no insurer has access through ISO to any other insurer's data that ISO uses to develop prospective loss costs.

ISO's staff of more than 150 actuaries includes approximately 50 Fellows and Associates of the CAS. Its staff of insurance experts includes more than 120 professionals who have received the Chartered Property Casualty Underwriter (CPCU) designation, as well as members of the Insurance Data Management Association (IDMA) and many other professional societies and
associations. ISO's legal and government relations staffs are current with developments in statehouses and courthouses around the country. Each year, ISO reviews thousands of regulations and laws, both proposed and actual, as well as court decisions, to evaluate their effect on ISO's offerings.

ISO's actuaries develop cost-based projections of prospective cost information at various levels of detail--state, territory and class. This information is submitted to state regulators and is made available for insurer use, but they

may elect to accept, adjust, or not use any of it. ISO's actuarial analyses are produced entirely by its professional actuarial staff in accordance with the
Professional Code of Conduct adopted by the CAS and the American Academy of Actuaries, using generally accepted actuarial procedures. These procedures are consistent with the "Statement of Principles Regarding Property and Casualty Insurance Ratemaking" as promulgated by the CAS and the Actuarial Standards of Practice adopted by the Actuarial Standards Board.

ISO's products and services help reduce consumer prices; give them greater choice of insurers; help them to more easily compare prices and coverages; and speed the claims handling process ISO reduces an insurer's operating costs by providing information and services that the insurer
needs to write business at relatively lower costs than would be possible using its own resources. Without the availability of ISO's materials many insurers would have to increase staffing substantially and invest in expensive equipment, significantly increasing costs. In a competitive
insurance market, lower costs of doing business translate into lower prices for consumers.

Also, by enabling insurers to more reliably predict expected losses, the availability of ISO's information permits them to be more confident in making pricing decisions. This increased confidence means less margin for error can be built into rates, leading to lower premiums. Many insurers, especially smaller ones, do not generate enough of their own loss information to predict expected costs reliably. They need this information because, unlike other industries, insurers do not know the ultimate cost of the product that they sell - the insurance policy - at the time of sale. It may take months or possibly years after the policy expires before an insurer knows the policy's costs because, at the time of sale, losses under the insurance policy have not yet occurred. However, by using ISO's products and services small insurers can compete with large ones and large insurers can do business in places in which they have low premium volume or no business at all. Insurance consumers are the beneficiaries when there are many insurers competing to gain market share.

ISO's common policy form language confers several benefits; one of the most important is the facilitation of comparison shopping by policyholders and their representatives. By comparing different insurer coverage forms to common policy language developed by ISO, insurance
buyers and their representatives have the means to assess competing price and coverage offerings. The common language also enables state regulators to assess comparable statistics from insurers. Lastly, common policy form language, which has been interpreted by the courts,
takes on a distinct and more certain legal meaning. This legal certainty reduces the likelihood that the same issues will be litigated time and again. This speeds the claims handling process, producing cost savings which can be passed on to consumers.

ISO's policy forms enhance variety by providing language from which coverage can be tailored by insurers for the purpose of insuring unique risks and targeting specific submarkets. Insurers can and do compete in providing coverage enhancements and developing entirely unique,
proprietary coverage programs.

The availability of prospective cost information based on the independently performed analyses of the combined data of many insurers is essential to the functioning of the highly competitive property/casualty insurance industry market.

There are fundamental differences between the insurance business and other industries. One of the most important differences is the lack of actual cost information about the insurance product at the time that it is offered for sale.

In exchange for a pre-determined premium, insurers provide coverage to their customers, but at the time a policy is sold, an insurer does not know to any significant degree the actual losses it will incur over a policy term. Consequently, the price charged for a policy is based on the insurer's best estimate of what those costs could turn out to be - on average. In most industries, companies are able to develop a greater proportion of the actual cost per production unit from more knowable, predictable, or controllable costs. For example, in the manufacturing sector, most businesses incur the majority of their costs before their products reach the market. As a result, a manufacturer has a great deal of the information it needs to determine a price for a product (i.e., to cover costs of acquiring raw material, manufacturing the product, and delivering it to the retail environment), as well as the profit it hopes to realize

in a competitive market. Thus, at the time of sale or shortly thereafter, the manufacturer will know virtually all of its costs, both fixed and variable. In contrast, property/casualty insurers cannot know the ultimate cost or even the majority of the costs of their production units - insurance policies - at the time of sale.

The insurer is able to accept this risk of loss transferred from the insured if it can rely on the "Law of Large Numbers." The problem is that, for most lines of property/casualty insurance, few insurers have enough information of their own to allow the Law of Large Numbers to work for the purpose of evaluating the risk of loss associated with the types and classes of property/casualty insurance policies that they underwrite in every state.

If an insurer has been writing a given type of policy - a particular coverage grant, sets of exclusions/conditions, etc. - for a specific classification in a particular location for a given period of time, the insurer may have accumulated enough premium and loss data to be of some use. But if the insurer is small, has been in business for only a short time, or is large but is not a major writer for a particular line, class, or state it may not have enough reliable or credible information of its own to enter or remain in a market. It is this problem, unique to insurance, which drives such an insurer to seek from ISO advisory prospective cost information based on the aggregated data of many insurers.

The amount of information that any one insurer has for each of the thousands of individual classes and categories in a line of insurance is more limited than the data for the whole line. For example, commercial general liability insurance can be provided for more than 1,100 classes, ranging from hardware stores to coal mines. Accordingly, having a large aggregate data base available to insurers for each of these subgroups is even more crucial for reliably determining prospective loss costs for each of these classes. Depending on the line of insurance, several years of data often are needed to determine average statewide loss cost levels. But, even with a large pooled database provided by ISO, a larger volume of data is needed to provide reliable estimates of expected prospective costs for the individual classifications. Generally, multiple years of data from all jurisdictions are combined so a broader, more credible body of experience can be used to determine the loss potential for each class.

Although large quantities of data are a prerequisite to a credible database, data collection is only the first step in the process of obtaining information about the future costs of insurance coverage. Historical data can provide a good picture of past costs, but it may provide little insight into the future costs current policies are expected to cover. Additional adjustments to this historical data - loss development, trend, and others- are necessary. These adjustments--including trend-- are needed to place the aggregated historical data on a comparable basis and, because the purpose of the process is to estimate costs on policies yet to be issued, trend also is used to project cost estimates to the time policies will be in effect.

Collecting raw data from insurers and turning it into prospective cost information is a complex and costly process

The production of prospective cost information from a large aggregated database of statistics reported by many insurers is a complex and demanding process, as are many of the processes inherent in the production of ISO advisory information. That is why the process is so expensive. As I noted above, ISO employs a large staff of highly qualified data management and actuarial professionals who are familiar with the composition and nuances of the database. ISO actuaries, using generally accepted actuarial principles, work independently and perform analyses on the "raw data" to develop useful information for insurers, regulators, and others. They use generally accepted actuarial techniques, such as catastrophe procedures (more recently including modeling), loss development and trend to develop prospective loss costs.

Critics might say that it would not be difficult or costly for an insurer or consultant to perform the trend analyses that ISO uses to develop advisory prospective cost information. While the concept of trend is relatively simple, providing a false sense of comfort that the application of trend in the analytical process is also simple, it is not. Trend analysis is not simply a matter of applying the economists' consensus inflation forecast to last year's losses; it requires a careful examination of claim severity changes over time, claim-frequency patterns over time, and changes in exposure patterns. It requires the evaluation of deductibles, policy limits, the effects of non-recurring events, and changing societal conditions, such as the propensity to litigate. It means reviewing data

over both the short term and the long term for some lines of insurance. It often means looking at data countrywide and state-by-state. The data is analyzed line by line and coverage by coverage. This process not only requires focusing on insurance cost data but also
the consideration of external information.

The use of trending in the analysis of data is what makes prospective loss costs prospective, but that is not its sole function. The trending process does not merely involve a projection; it also involves a complex process under which various sets of data are brought to common point in time (past, present or future) for evaluation purposes. 5 Actuaries use trend techniques to combine and analyze multiple sets of data (for example, losses, premiums and exposures) arising from different periods of time and to estimate what experience will be generated by policies written in the future. Actuaries rely on the observed rate of change over time (trend) in the frequency and size of insured losses, and in the number of insured exposures, viewed in the context of current and future events that might affect whether that trend can be expected to continue. This enables them to estimate from the most currently available data what experience was or can be expected for that set of policies written at any different point in time. These estimations are especially dependent on a thorough knowledge of the characteristics underlying the data.

Trend is embedded in many analyses that are used to derive prospective cost information from reported losses, and therefore is calculated and/or applied thousands of times annually by ISO actuaries to analyze costs for the various states, coverages, deductibles and amounts of insurance
for which ISO publishes information. Thousands of separate reviews are performed annually by ISO actuaries. When higher limits reviews are considered along with regional and multistate trends, as well as exposure trends, the number of analyses is even more overwhelming.

The expense of the process needed to produce prospective cost information from the data of many insurers is significant because a small increase in marginal insurer expenses can have a big impact on an insurer's ability to enter or remain in markets

In 2004, average insurer profits were 9.1% of written premium (preliminary data indicate that the 2005 profit margin will be a bit higher). But, profit margins have been variable over the years. From 2000 through 2004, average insurer profit margins ranged from a high of the 9.1% earned in 2004 to a low of a net loss of 2.2% in 2001.

Since ISO provides information to many insurers, the relative cost to any individual insurer is low. Using commercial general liability insurance as an example, for each premium dollar written by insurers that purchase ISO's advisory prospective loss costs, rules and forms, insurers pay less than two tenths of one cent to ISO.

If every insurer had to incur even a fraction of the total ISO cost for providing these services, it would have a significant impact on each insurer's ability to stay in or enter many markets. Forexample, a typical insurer operating in 25 states with an annual general liability insurance premium volume of $50,000,000 pays approximately $75,000 a year for all of ISO's general liability prospective loss costs, rules and forms - less than two tenths of one cent for every dollar of general liability premium the insurer writes. For just one line of insurance, it cost ISO more than $11 million in 2005 to produce those products. That figure represents only ongoing
operating costs for this line of business; ISO has incurred significant expense over the years in
developing the infrastructure, computing power, and expertise to develop these products. If this insurer achieved the average (all-lines industry-wide) profit margin for the 5 years ending 2004, it would have netted nearly $4.4 million. All that profit would have been eaten away if that average insurer incurred expenses approaching only part of ISO's costs to replicate the processes ISO performs. It is important to note that 2004 saw the highest profit margin for the industry in the past five years, the average margin in that period was a little over half of the 2004 figure.

That is why the economies of scale offered by the availability of ISO advisory products and services are so important. In a business where all-lines industry-wide profit margins for insurers have ranged from -2.2% to 9.1% of written premium over the recent past, the benefits of the availability of essential information at low cost are obviously substantial.

Because advisory organization products and services have a beneficial effect on competition, insurers' access to them should be preserved and protected

In the late 1980s Professor Scott Harrington, then of the University of South Carolina now at the Wharton School, observed that the property liability insurance market was characterized by vigorous competition and that there was no evidence that advisory rates had increased prices or
profits. (ISO had not yet fully transitioned to developing only loss costs.) Professor Patricia M. Danzon of the Wharton School wrote in the early 1990s that the availability of advisory organization services (prospective loss costs) increased rather than reduced competition. Studies by the General Accounting Office, the Federal Trade Commission and the U.S. Department of
Justice in the 70s and 80s also concluded that the insurance industry of the time was structured competitively.

In 1996, in an administrative proceeding6 before the California Insurance Commissioner, ISO retained the services of noted antitrust scholar Professor Lawrence A. Sullivan7 to analyze evidence concerning the competitive effect of advisory organization manuals containing
prospective cost information. Professor Sullivan concluded that property/casualty markets both in California and elsewhere are effectively competitive and that "...the circulation in such markets of advisory organization manuals that include prospective cost information does not in other states and would not in California adversely affect competition." Professor Sullivan stated the case for prospective loss costs quite forcefully:

To assume that each insurer could replicate the entire prospective loss cost development and analysis process that an advisory organization undertakes to produce these data, is, on its face, unthinkable. If each insurer individually incurred costs even remotely approaching ISO's costs, all save a few of the largest insurers would be driven from the market... [I]ndividual costs could be cripplingly high even if the advisory organization
provided manual data up to and including, but no further than, class level detail on reported losses for several years from all states - the point at which the trending analysis to attain prospective costs begins for General Liability classification differentials. To complete the process of producing its own prospective loss cost information, each insurer would be obliged to do for itself what the advisory organization now does in modest time with a main frame and a proprietary system developed at substantial cost. Certainly this would entail considerable cost, far more than any savings in payments to the advisory organization. These costs would be passed on to insureds. Moreover, in consequence of the higher cost, some small insurers might withdraw or fail to enter when otherwise they would. Both effects belong on the negative side of the rule of reason scale.
...
The most salient result from forbidding circulation in such markets is to deprive insurers of some scale efficiencies in underwriting in the interest of somewhat more widely scattered and perhaps less expert predictions about anticipated costs from certain prospective losses. In my opinion, to do that would not improve competition. Its primary effect would be increased costs and prices, to the disadvantage, primarily of smaller firms.

Our own studies of the competitive structure of the insurance industry confirm the earlier works, which concluded that the property/casualty insurance market is competitively structured and there is no evidence that the availability of advisory organization information has had an adverse affect on competition. In fact, the data suggest the opposite, that there is a high positive
correlation between the use of ISO's advisory information and competition. For those lines where insurers purchasing ISO services have the highest market shares, industry concentration is the lowest. And, conversely, for those lines where insurers purchasing ISO services have lower
market shares, industry concentration ratios are highest.

We believe that repeal or substantial modification of the insurance industry's limited antitrust exemption is likely to elevate the level of legal uncertainty with which insurers must cope, resulting only in reduced capacity, availability, and competition in the marketplace. Most
practices would be subject to a "rule of reason" analysis, to be performed by courts, on a caseby-case basis, as the practices are challenged. "Rule of reason" cases generally entail complex presentations of statistics and expert witnesses; they are among the most difficult kinds of cases
for juries (and for judges) to decide. The costs of litigating them and the chances of prevailing in them are difficult for even the most experienced lawyers to predict.

For insurance companies, there would undoubtedly be a tendency to question the wisdom of participating even in those activities that would ultimately be sustained as pro-competitive under an antitrust "rule of reason" analysis. This

chilling effect is not likely to be a quick or transitory experience; the evolution of the law interpreting the boundaries of the McCarran-Ferguson Act
has taught us that much. The practical effect could be to deprive insurers of legitimate use of pro-competitive advisory organization products and services.

I have described for you how the products and services that ISO provides to insurers help them operate in the competitive property/casualty insurance market. By improving insurers' knowledge of their true anticipated costs and by introducing economies of scale, ISO confers
benefits to the insuring public through lower costs. The pall that could be cast over these essential operations by the repeal or substantial modification of the already limited McCarran-Ferguson exemption could be enough to severely curtail them. Such a result would be a
disservice not only to insurers, large and small, but to the insuring public as a whole. That is why proponents of repeal or modification should demonstrate the need for change and that any proposed change will help, not harm competition in the property/casualty insurance business.

Thank you for giving me the opportunity to present this statement. I would be pleased to answer any questions you may have.

1 The official designations of such organizations vary under state law and include "rating organization" "rate service organization" and/or "advisory organization."
2 Prospective loss costs are actuarially established estimates of the dollars needed to cover future loss payments and loss adjustment expenses.
3 The term "prospective cost information" as used here includes prospective loss costs, increased limits factors, classification differentials and deductible relativities.
4 The Georgia examination report has not yet been issued.
5 An example would be the combination of data from multiple years needed to develop cost estimates for individual classes. Before several years' data can be combined for analysis, each year's data must be brought to a common point in time, e.g. 2002 and 2003 data might be adjusted to the 2004 level before being combined with data from that year.
6 In Re Regulations Governing the Filing, Contents and Approvals or Disapprovals of Advisory Organization Manuals, Hearing Docket #RH-346, California Department of Insurance, January 12, 1996
7 Professor of Law at Southwestern University School of Law, Earl Warren Professor of Public Law, emeritus, Berkeley, an invited witness before the Senate Committee on the Judiciary Antitrust Subcommittee in 1995 and an appointee of President Carter to the National Commission for Review of Antitrust Laws and Procedures.