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ANTITRUST MODERNIZATION COMMISSION

THE MCCARRAN-FERGUSON ACT HEARING

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Good morning. My name is Stef Zielezienski. I am senior vice president and general counsel of the American Insurance Association (AIA). AIA represents major property and casualty insurers doing business across the country and around the world. I appreciate the opportunity to be here, today, to participate in the commission's discussion of the McCarran-Ferguson Act (McCarran).

Enacted in 1945, McCarran is a power-sharing statute that reflects Congress' considered judgment to delegate – not abdicate – its authority over insurance to states that regulate the business of insurance themselves. In doing so, McCarran provides insurers with an antitrust regime that recognizes the insurance regulatory role entrusted to the states. Because of the delicate balance of power contained in McCarran, we believe that discussion of a repeal or limitation of McCarran's antitrust provisions can not be divorced from a corresponding discussion of the nature of state insurance regulation.

In this connection, we believe that a thorough and critical review of the state insurance regulatory system is long overdue, including a frank and honest examination of the economic utility of government price controls and the regulation of insurance policy forms that has become part of the overall legal framework for the business of insurance that flowed from McCarran's enactment.

In addition, we note that there is a growing understanding in Congress about the very real problems associated with the current state-based regulatory regime – and that steps must be taken to improve and modernize the way insurance is regulated. The bipartisan bill (S. 2509) introduced in April by Senators Sununu and Johnson is a first major step forward in the effort to successfully address these challenges, followed closely by the recent introduction of a companion optional federal charter bill in the House by Representative Royce (H.R. 6225). Similarly, the House Financial Services Committee, under Chairman Oxley's and Subcommittee Chairman Baker's direction, has been undertaking its own efforts to fashion a regulatory reform measure, resulting in the recent House passage of H.R. 5637, which establishes federal-based reforms for surplus lines brokers and reinsurers. We have been privileged to participate in all of these efforts and are hopeful that they will ultimately result in broad reform legislation being enacted.

Within this framework, my testimony today will focus on three things:

- First, a brief historical sketch of McCarran;
- Second, some perspective on the McCarran discussion over the years; and,
- Third, the role of McCarran in today's debate over needed reform of the insurance regulatory system.

I. An Historical Introduction to the McCarran-Ferguson Act

The McCarran-Ferguson Act is the outgrowth of two U.S. Supreme Court decisions that defined the course of U.S. insurance regulation. The first was Paul v. Virginia, in 1869. Paul held that the insurance transaction was so intrinsically a local matter that Congress had no constitutional authority under the Commerce Clause to regulate it at all.

As a practical matter, the Paul decision ceded insurance regulation to the states. It remained the law of the land for the next 75 years, until – on the eve of the Normandy invasion in June 1944 – it was overturned by the Court in United States v. South-Eastern Underwriters. South-Eastern Underwriters held that insurance did, in fact, move in interstate commerce and was, therefore, subject to congressional jurisdiction.

The notion that insurance is a product in interstate commerce seems matter-of-fact today. However, at the time, that notion threatened the viability of the insurance system, particularly since Southeastern Underwriters was a "price fixing" case, which immediately made many necessary, collective insurance activities subject to federal antitrust laws. Over the next nine months, there was urgency in Congress to determine the impact of South-Eastern Underwriters. Would it mean the end of state insurance regulation, with the federal government taking it over? Would it mean that the states, which had traditionally taxed insurers, might lose that authority? Would it mean that the insurance industry would be crippled by the application of federal antitrust law, so it could no longer collect and analyze the enormous amounts of data necessary to appropriately price insurance risks? Would it mean that insurers would lose the ability to collaborate on drafting uniform policy forms for many lines of insurance?

As Congress and industry struggled with these questions in 1944, a formula ultimately emerged for dealing with them. That formula became the McCarran-Ferguson Act. McCarran addressed three important goals for the Congress: (1) delegation of authority to the states to the extent that the states regulate the business of insurance; (2) creation and maintenance of a broad insurance regulatory system; and (3) balancing regulatory objectives against antitrust policy objectives.

McCarran's enactment furthered all three congressional goals. It entrusted to the states the authority to regulate and tax "the business of insurance," and said that no federal law should be presumed to interfere with that authority, unless it was clearly designed to do so. It gave the states three years from the 1945 enactment to put their regulatory systems in place. Finally, McCarran said that the federal antitrust laws would apply to the business of insurance "to the extent that such business is not regulated by State Law," or in any case where insurers had engaged in – or attempted to engage in – an act of boycott, intimidation or coercion. (15 U.S.C. Chapter 20, §§ 1012(b), 1013(b).)

During the three years between the 1945 enactment and the 1948 effective date, all states enhanced their regulatory systems by enacting state unfair competition and trade practices laws directed specifically to insurers. Those state laws included what were referred to as "little Federal Trade Commission (FTC)" statutes, because they adopted the FTC's unfair trade practices requirements and placed them on insurers directly through state law. States also adopted their own prohibitions on acts of boycott, intimidation or coercion by insurers, as well as Sherman Act and Clayton Act-type prohibitions on unfair restraints of trade.

In establishing their insurance regulatory systems and adopting unfair competition and deceptive trade practices standards, the states faced the same question that is always raised when dealing with a regulated industry: How do you balance the role of regulation against the role of antitrust policy? Their answer mirrored the one adopted for other industries. Specifically, where there is a regulatory system, antitrust laws can not be used as a way to undercut it. Conversely, where activity takes place outside the regulatory system, antitrust laws will apply. With this approach as their roadmap, the states placed all collective activity by insurers under regulatory control, scrutiny and review – effectively replacing antitrust litigation with regulatory oversight of collective activity, including activity to: (1) gather, analyze, and make predictions about data; (2) establish final prices; and, (3) create standardized insurance policy forms. Over the years, this basic approach has remained unchanged, except that state laws now overwhelmingly prohibit insurers from agreeing on final price, even under regulatory oversight.

Moreover, every organization that engages in data collection and analysis, or in the development of common policy forms, must be registered with the state and is subject to direct regulation by it. Any collective activity by insurers not done through a registered entity (generally called an "advisory organization") is subject to both the antitrust provisions in the state's insurance code and to the state's broad antitrust laws. All insurance activity is thus subject to regulatory supervision or antitrust exposure in the states—and sometimes both.

This balancing of regulatory supervision and antitrust litigation – as noted earlier – is not unique to insurance; it also takes place in other financial services industries (i.e., banks and the securities business) where federal courts have held that understanding the balance is critical and that antitrust scrutiny is inappropriate where the activity is subject to regulation. (See, e.g., Gordon v. New York Stock Exchange, Inc., 422 U.S. 659 (1975).)

If this were not the case, there would be nothing but chaos, with private antitrust litigation – including massive class actions – constantly at war with the federal regulatory systems established by the government. This would create enormous uncertainty for these businesses and their customers, to the benefit of neither.

The difference between banking and securities regulation, on the one hand, and insurance regulation, on the other, is that the banking and securities businesses are principally regulated by the federal government, while insurance is principally regulated by the states. This is a particularly important difference when looked at from an antitrust perspective. When federal antitrust law is balanced against federal regulation for a specific industry, the courts have a long and appropriate history of giving precedence to the specific regulatory system that Congress has set up for that industry over the broad, non-specific language of the antitrust laws that did not have that specific industry in mind.

Since insurance regulation, however, resides primarily at the state level, McCarran is necessary to provide the kind of balance of "regulation vs. antitrust" for insurance as exists for federally regulated banking and securities businesses. This central point in understanding the true role of McCarran merits special emphasis, and is worth repeating: The McCarran-Ferguson Act balances regulation and antitrust for state regulated insurance, just as that same type of balance has been established for the other two legs of the financial services sector, federally regulated banks and securities firms.

If McCarran did not exist, then the balance between state insurance regulation and federal antitrust law would be quite different. It would be governed by the "state action" doctrine – an antitrust principle first adopted by the courts in the years immediately prior to McCarran taking effect.

Under the "state action" doctrine, federal antitrust laws take precedence over "state" regulation, unless that state regulation is particularly intrusive. Even in these circumstances, the primacy of the state regulation is dependent on whether the regulatory oversight meets an "active supervision" test, which can be determined only through litigation and which, therefore, means that there will be much litigation. Perhaps constant litigation. Creating an environment that pits constant litigation against regulatory oversight does not lead to stability or certainty in that marketplace.

So, for the member insurance companies that comprise the American Insurance Association, the issue is not whether a balance needs to exist between antitrust principles and regulation, but where that balance ought to be drawn. For the purposes of state insurance regulation, that balance would be dangerously imperiled if McCarran were repealed.

II. <u>The McCarran Discussion in the Public Arena</u>

The McCarran-Ferguson Act has been periodically controversial over its 61-year life. Ironically, whenever there is an affordability/availability problem in any specific line of insurance, industry critics, including legislators, argue that this problem results from the alleged ability of insurers to collectively fix prices under McCarran. Their misguided "solution" is to call for the repeal of McCarran.

However, when the problem subsides in that particular line of insurance, the call for repeal generally also subsides, with those who had argued that McCarran was the cause of the problem never saying that perhaps McCarran should now be credited for curing the problem, as well. If insurer activities under McCarran were the reason that prices went up, then insurer activities under McCarran surely must be the reason that those very same prices went down.

When the Senate Judiciary Committee held McCarran hearings in 1989, the issue was the cost of commercial liability insurance and the limited availability of certain types of insurance; these problems long ago were resolved in the marketplace, with McCarran remaining on the books. When that Committee again held hearings on McCarran this past June, the issue was alleged activity involving contingent commissions. Yet, again, as we learned from that hearing, the state regulators, in coordination with the state attorneys general, were well along in resolving these issues, armed appropriately with state law, including state antitrust law. And, equally important, the marketplace has adapted accordingly.

The reality is that insurance is like the canary in the mine. When an insurance price spikes or availability shrinks, it is because an underlying problem (e.g., a particular cost driver) needs to be addressed. To be fair to all customers – not to mention to be able to stay in business – insurers must be able to price their policies to cover their likely losses. If they can not do that, because of government price controls, they will be forced to pull back from the marketplace. This reaction is as inevitable as Newton's apple finding its way from tree to ground. Instead of looking at insurer activity under the McCarran-Ferguson Act as the issue, it would be better to look at the underlying problems and fix them.

There also seems to be a persistent misperception that McCarran provides a blanket exemption for insurers from federal antitrust law application, allowing insurers an unfettered right to engage in anticompetitive behavior. Perhaps a brief examination of the law will help clear up the misperception, and avoid a result that will upset the balance between regulation and antitrust policy, or shift the focus away from needed regulatory modernization.

Here is the law today (some of which picks up themes explored above):

(1) McCarran does <u>not</u> provide a blanket exemption from the antitrust laws for insurers. It is a targeted exemption that balances the goals of regulation with the goals of antitrust law. It works exactly the same way as those two goals are balanced for the two other federally regulated financial services industries, the banking and securities industries. Congress has enacted significant antitrust exemptions for public policy reasons in a variety of other areas. So, it is simply not accurate to single out insurance, especially since the exemption is so clearly limited to those insurance activities that government regulates.

(2) There is a significant body of state antitrust statutes that apply to insurers. Every state provides some form of antitrust regulation of insurers, whether through broad state laws based on the federal Sherman and Clayton Acts, antitrust provisions in their insurance codes, or language barring unfair competition in the little FTC acts. Often, states have multiple avenues to address alleged anticompetitive behavior. So there is no lack of state antitrust authority with regard to insurers.

(3) Contrary to what some may say, McCarran provides no exemption from state antitrust or

insurance laws for any bid-rigging behavior, which is fully subject to state law. Since bid rigging is not a state-authorized activity, it enjoys no exemption under state antitrust laws, and indeed has been prosecuted vigorously under them.

(4) Private allocation of markets by insurers among themselves would be subject to state antitrust and unfair practices laws, just as bid-rigging would be. It is true that, under McCarran, the states themselves have established fallback risk-sharing mechanisms called "residual markets" to provide insurance to those who otherwise would not be able to find coverage. However, we suspect that the states, not insurers, would be most troubled by attempts to change McCarran to erode (and perhaps outlaw) use of those mechanisms.

(5) While measures to repeal McCarran have called for removal of so-called McCarran protection for price fixing, the truth is that states acting under McCarran do not allow insurers to privately agree on price. Moreover, except in the limited number of jurisdictions that have state-administered pricing for discrete lines of business such as workers' compensation, today, insurers are not allowed to agree on price even under regulatory scrutiny. What the states do permit and regulate is data collection and analysis through state-approved "advisory organizations." In each case, however, this only is done within a state's regulatory law and is subject to regulatory scrutiny.

(6) Repeal of McCarran might impact legitimate information gathering undertaken pursuant to state law and regulation, thus undercutting the ability of the states to decide the types of information they want to allow insurers to collect, share and analyze under state supervision.

A repeal of McCarran can not be justified as a matter of law. Nor would it be sound public policy. Because of the relative absence of judicial decisions on the applicability of the federal antitrust laws absent the McCarran exemption, it is impossible to determine with precision what current insurance practices no longer would be permissible under those laws. In the final analysis, the federal courts would be responsible – through litigation – for determining the legality of any such conduct based on the factual circumstances and the application of federal antitrust law to those circumstances.

A limited repeal, involving the legislative creation of so-called federal antitrust "safe harbors," would not be an adequate alternative to the current McCarran framework unless coupled with true reform of the outdated regulatory system. Indeed, the American Bar Association's suggestion to repeal McCarran-Ferguson, with safe harbors to permit certain activities to continue, does not strike the necessary balance, and amounts to a full repeal of McCarran that should be rejected by the commission. The ABA policy on the McCarran antitrust exemption describes the "safe harbor" protections as follows:

(1) Insurers should be authorized to cooperate in the collection and dissemination of past loss-experience data so long as those activities do not unreasonably restrain competition, but insurers should not be authorized to cooperate in the construction of advisory rates or the projection of loss experience into the future in such a manner as to interfere with competitive pricing.

(2) Insurers should be authorized to cooperate to develop standardized policy forms to simplify consumer understanding, enhance price competition and support data collection efforts, but state regulators should be given authority to guard against the use of standardized forms to unreasonably limit choices available in the market.

(3) Insurers should be authorized to participate in voluntary joint-underwriting agreements and, in connection with such agreements, to cooperate with each other in making rates, policy forms, and other essential insurance functions, so long as these activities do not unreasonably restrain competition.

(4) Insurers participating in residual market mechanisms should be authorized in connection with such activity to cooperate in making rates, policy forms, and other essential insurance functions so long as the residual market mechanism is approved by and subject to the active supervision of a state regulatory agency.

(5) Insurers should be authorized to engage in any other collective activities that Congress specifically finds do not unreasonably restrain competition in insurance markets.

(See Statement of Donald C. Klawiter on behalf of the American Bar Association, before the United States Senate Committee on the Judiciary, at 6 (June 20, 2006).)

These are not true safe harbors, but merely the illusion of safe harbors. The ABA safe harbors are illusory because they do not provide protection against uncertainty and litigation. In particular, the ABA's so-called principal safe harbors for pricing, forms development and joint underwriting condition the protection on the activity not resulting in an "unreasonable restraint of competition." This is no protection at all, but, rather, a backdoor application of the antitrust laws. The "exemption" would only become available if there were first a finding that the practice would not violate the antitrust laws in the absence of an exemption. In effect, with this type of limitation, the safe harbor is merely restating antitrust litigation standards and inviting litigation over whether the activity has met those standards. In antitrust litigation, that is at the heart of the parties' dispute; specifically, whether the challenged activity is a reasonable or unreasonable restraint of competition. The ABA "safe harbors" thus would be little different from a complete repeal of McCarran protection.

Moreover, the ABA position does not account for the fact that state insurance departments exercise a great deal of rate and policy form regulation already, which substantially narrows the opportunity for the competitive market to operate. For example, ABA Safe Harbor #2 suggests that state insurance regulators be given the authority to "guard against" the use of standardized forms that can be used to limit market choices. Yet, government product controls are designed to accomplish the exact opposite: to perpetuate use of increasingly commoditized products and to discourage and delay innovation. Thus, more state regulatory authority is not the answer to decreased product differentiation.

In addition, in other areas such as participation in state residual markets, the safe harbors mimic the state action doctrine's "active supervision" test and therefore do not provide any additional antitrust protection than would otherwise be provided in the absence of the McCarran-Ferguson Act.

Because the ABA safe harbors do not provide any protection for insurers, allowing federal oversight without regulatory relief in the form of an optional federal charter would guarantee that any collective activity by insurers could be open to constant, duplicative and overlapping enforcement actions.

At one time, AIA did support the adoption of McCarran safe harbors, but we reject that option now unless accompanied by fundamental changes in state regulation. During 1994, the House Judiciary Committee favorably reported a version of H.R. 9 that maintained McCarran safe harbors in several areas of collective insurance activity. Those areas were:

- Data Collection: Joint conduct to collect, compile, classify, or disseminate historical data, including development of procedures with respect to handling of historical data, and verification of accuracy and completeness of such data.

- Loss Development: Joint conduct to determine and disseminate loss development factors or developed losses.

- Common Policy Forms: Joint conduct to develop and disseminate standard insurance policy forms, provided there was no joint agreement to adhere to the forms, and the parties developing a form made their own decisions whether or not to use them.

- Manuals: Joint conduct to develop and disseminate manuals filed with a state that provide information, explanations and instructions relating to data, statistics, losses, policy forms, or any other matter otherwise protected by McCarran, as long as there was no agreement to adhere to the manual.

- Residual Market Pooling Arrangements: Joint conduct for participation in plans designed to make insurance available to persons who would not otherwise be able to purchase it in the voluntary market.

- Historic Voluntary Pooling Arrangements: Providing insurance pursuant to one of the insurance industry's historic pooling arrangements.

- Administration of Residual Markets: Administering a state residual market, as long as authorized and supervised by the states.

- Inspection of Commercial Buildings and Fire Protection Facilities: Joint conduct to develop and participate in programs to evaluate building codes or inspect commercial buildings and fire protection facilities for the purpose of determining likelihood of loss, pursuant to state law.

- ► Workers' Compensation Experience Rating Programs: Participation in joint efforts to measure employer experience with respect to work-related accidents and illness against comparable experience of other employers, and to make modifications for that employer based on the comparison.

- ► Trending: During the 2-year transition period following enactment, joint conduct to determine and disseminate trend factors, to the extent regulated by state law. After the transition period, general antitrust principles, including the "state action" doctrine, would govern use of collective trending. In addition, independent purchase of a trend factor by an individual insurer from "a person not engaged in providing insurance" would be presumed not to be an antitrust violation.

At the time, these safe harbors were included in H.R. 9 because of an agreement that they represented necessary collective activity by insurers that might be subject to federal antitrust litigation if McCarran's antitrust exemption were simply repealed. We continue to believe that all of these areas – importantly including the collection and analysis of data – represent pro-competitive collective activities and that they should pass antitrust scrutiny under normal antitrust rules, but we also know that we should assume that there will be potentially disruptive litigation over these issues. Therefore, today, AIA believes that merely amending McCarran is not enough. Rather, AIA believes that the question of the application of federal antitrust laws can not be divorced from reform of the overall insurance regulatory system.

For this reason, AIA does not today support adoption of antitrust safe harbors within the current state system; instead, AIA supports enactment of optional federal charter legislation that relies on the market to regulate insurance rates for federally chartered insurers. As a part of the market-based system, the pricing activities of those insurers would be subject to federal antitrust law, to the extent that those activities are not regulated under state law.

III. <u>The McCarran-Ferguson Act and Insurance Regulatory Reform</u>

Although AIA opposes repeal of the McCarran-Ferguson Act, AIA long has recognized that McCarran is likely to be a target from time to time for the reasons just described and refuted. Moreover, McCarran is associated with a state regulatory system that uses government price and product controls as its primary regulatory tools, which we believe is a mistake that distorts the marketplace, injures consumers, and runs counter to one of the core purposes of insurance – to manage risk in a way that makes advances in society possible.

Market-driven optional federal charter legislation is the best tool to eliminate these dysfunctional elements of the current insurance regulatory system. The National Insurance Act of 2006, now introduced in both the Senate and the House of Representatives, would allow both life insurers, property-casualty insurers, and reinsurers – as well as insurance agents and brokers – to opt into a federal regulatory system. The Act is patterned on the current dual banking system, which provides for both federally and state-chartered banks. The new national insurance regulatory system would focus on tough financial and market conduct regulation; however, unlike the state insurance regulatory system, the national system would dispense with government price controls. Rather, the bill opts for price competition in the open market among insurers.

Since the McCarran-Ferguson Act only applies to the business of insurance regulated by the states, it obviously would not apply to pricing activities of federally chartered insurers that opt to operate under federal law. Therefore, federal antitrust laws would apply to collective pricing actions of federally-chartered insurers under the Act to the extent that the states no longer regulate their activities. AIA members are willing to take the risks inherent in this approach on the antitrust side because we so strongly believe that a competitive market, without government rate and price controls, is critical to being able to serve their customers in the years ahead. Thus, we are willing to shift McCarran's current balance between regulatory supervision and antitrust policy to one that reduces the role of regulation and returns that role to the federal government, and increases the role of the federal antitrust laws. If Congress decides to take this approach, we can perhaps solve several market challenges at the same time.

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Thank you very much for giving us the opportunity to appear before you today. I would be pleased to answer any questions.