Testimony of

The Honorable Marc Racicot

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"THE MCCARRAN-FERGUSON ACT: IMPLICATIONS OF REPEALING
THE INSURERS' ANTITRUST EXEMPTION"

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Good morning, Mr. Chairman. My name is Marc Racicot. I am president 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 committee'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 congressional 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. 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. 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. We have been privileged to participate in both 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.

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 stateregulated 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 and has an essentially anti-marketplace competition orientation. 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.

Although anti-McCarran forces often assert that insurance is the only economic activity, other than baseball, with a significant antitrust exemption, that, of course, is not true. In addition to the exemptions that exist for regulated industries generally, there are exemptions - to name a few - for newspapers, joint research and production ventures, farm cooperatives, utilities and labor unions. All of these exemptions were created for important policy reasons, just like the McCarran-Ferguson Act.

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.

The McCarran Debate in the Public Arena

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 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 must be the reason that those very same prices went down.

When this committee last 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.

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.

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

1. McCarran does not 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, including with regard to medical malpractice insurance. 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.

As a result, a repeal of McCarran can not be justified as a matter of law. Nor would it be sound public policy.

The McCarran-Ferguson Act and Insurance Regulatory Reform.

Mr. Chairman, although we oppose 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 controls as its primary regulatory tool, which we believe is a mistake that both distorts the marketplace and injures consumers.

In light of these concerns, AIA worked very hard in the early 1990s to see if legislation might be developed that would retain the essential McCarran antitrust exemptions through specifically identified safe harbors, while leaving all other activity to be judged under generally applicable antitrust principles. The result of that work - from several years of negotiations with then-House Judiciary Committee Chairman Brooks - was carefully crafted legislation supported by AIA and favorably reported by that committee.

After the 1994 mid-term elections, the McCarran issue was not revisited, and interest gradually changed from amending McCarran to enacting wide-ranging insurance regulatory reform. Today, we believe that the regulatory reform route is the way to go. This route, however, also has McCarran ramifications.

Senators Sununu and Johnson's recently introduced ground-breaking legislation, titled the National Insurance Act of 2006, would allow both life insurers and propertycasualty insurers - as well as insurance agents and brokers - to opt into a federal regulatory system. S. 2509 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 federallychartered insurers operating under federal law. Therefore, federal antitrust laws would apply to federally-chartered insurers under S. 2509 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. However, we do not believe it is appropriate to repeal McCarran-Ferguson in the context of insurance pricing without initiating the paradigm shift that would result from S. 2509.

If Congress decides to take this approach, we can perhaps solve several market challenges at the same time. We look forward to working with Congress to do just that.

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