Testimony of

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State Regulation of Insurance Under
the McCarran-Ferguson Act

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Chairman Specter, Senator Leahy, and Members of the Committee, thank you for inviting me to testify before the Committee on the McCarran-Ferguson antitrust exemption.

My name is Michael McRaith. I am the Director of Insurance in Illinois, and I serve as Chair of the Broker Activities Task Force of the National Association of Insurance Commissioners (NAIC). Prior to becoming Director of Insurance, I was personally involved for fifteen years as a private attorney with complex commercial litigation, including antitrust and insurer financial issues. I am pleased to be here today on behalf of the NAIC and its members to provide the Senate Committee on the Judiciary with our views concerning the efficacy of state regulation of insurance and the antitrust exemption for insurance activities granted by the McCarran-Ferguson Act. In addition, my testimony will highlight how the NAIC continued its tradition of collaborative leadership last year to address broker compensation practices and related misconduct.

Today, I will make four basic points:

? First, insurance is a unique, complex and personal product that is much different from other financial services, such as banking and securities. Whereas other financial products--either debt or equity--are about taking risk in order to make money, insurance is precisely the opposite. The insurance consumer seeks to protect what he or she has by transferring risk to another. A fundamental precept of financial planning is: (1) buy insurance (to protect what you have) and then (2) invest (to get more). Regulating insurance is therefore fundamentally different from regulating banking and securities products because its focus is on protecting the underlying interest of consumers--their property, their health, their businesses, and their lives. The value of these assets and the cost to protect them from risk depends greatly upon local demographics, geography, and individual needs. Although insurer solvency is our central concern, the overall purpose of insurance regulation is protecting the lives and property of consumers and businesses rather than monitoring the profits of insurers.

? Second, the NAIC believes the limited federal antitrust exemption for the "business of insurance" has worked well for decades to maintain a vigorous and competitive marketplace. Congress recognized the unique nature of insurance when it enacted the McCarran-Ferguson Act in 1945 to authorize continued state-supervised sharing of loss-related information among competing insurers. As the true cost of insurance is not known at the time the product

is sold, insurers need to have collective data about loss experience and claims before they price their products. This type of data sharing, which would be illegal under the Sherman Act absent the exemption, also allows new insurers to enter markets for which they have no independent data. Ultimately, the competition fostered by the exmption benefits both individual consumers and businesses, from large multi-national corporations to small firms in every rural county.

? Third, state insurance officials and attorneys general play complementary roles in monitoring insurers, agents, and brokers to prevent and punish activities prohibited by state antitrust and unfair trade practices laws. Supervision of the "business of insurance" by state insurance departments involves careful review and regulation of solvency and policy terms to assure the public that insurers will meet their promises. It also involves monitoring and investigating anti-competitive, unfair, and deceptive trade practices--and taking enforcement action, where appropriate. State attorneys general likewise take action under state antitrust and unfair trade practices laws when evidence of insurer or agent wrongdoing arises.

? Fourth, the state system continues to operate as Congress intended when it enacted McCarran-Ferguson--it prevents and punishes anti-competitive practices. A recent example of effective state-based regulation is our effort over the past two years to address wrongdoing and potential conflicts of interest by insurance brokers and carriers. The attorneys general in several states pursued enforcement actions and investigations with assistance from their state insurance departments. At the same time, the NAIC developed and implemented a reasoned but aggressive program to better protect consumers by: (1) adopting a new model language on broker disclosure of compensation arrangements to consumers, (2) coordinating multi-state information requests, investigations, and analyses of business practices by brokers and insurers, and (3) launching an online system that permits anonymous reporting of "tips" to alert state regulators about a carrier's or agent's unlawful or unscrupulous business practices.

Insurance: A Unique Financial Product that Requires State Supervision

Paying for insurance products is one of the largest and most important consumer expenditures for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure transfers to an insurer the risk of financial loss, thereby protecting consumers' health, families, homes, and businesses. Consumers clearly have an enormous financial and personal stake in making sure that insurers keep their promises.

For state regulators, protecting consumers must start with a basic understanding that insurance is a business offering distinctly different products from banking and securities. Banks give consumers the immediate benefit of up-front loans based upon a straight-forward analysis of a customer's collateral and ability to pay, whereas securities can be bought by anyone willing to pay the price set by open markets. In contrast, insurance is a risk transfer product that consumers--either personal or commercial--buy in advance in exchange for a financial guarantee of future benefits when specified events occur. For personal lines, insurers take into account each customer's potential loss claims, depending on personal characteristics such as gender, age, financial situation, place of residence, type of business, "risk management" preparations, or lifestyle choices.

Insurance thus is based upon a series of constant but unique business analyses: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy terms? All of these considerations add up to one absolute certainty--insurance products can generate a high level of consumer confusion and dissatisfaction that require focused regulatory expertise and resources.

Every day, state insurance departments ensure that insurers meet the reasonable expectations of American consumers--including those who are elderly or low-income--with respect to financial safety and fair treatment. Nationwide in 2004, state insurance departments handled approximately 3.7 million consumer inquiries and complaints regarding the content of the policies and the treatment of consumers by insurance companies and agents. Many of those calls were resolved successfully at little or no cost to the consumer.

The states also maintain a system of financial guaranty funds that cover personal losses of consumers in the event of an insurer insolvency. The entire state insurance system is authorized, funded, and operated without cost to and without involvement by the federal government.

State Supervision of Insurer Pricing and Sales Practices Is Long-standing

Competitive forces generally produce the lowest prices and broadest array of goods and services for insurance consumers. However, Congress and state legislatures a century ago recognized that the benefits of vigorous competition are undermined by unfair market manipulation and monopolies. Federal and state antitrust laws promote fair and free competition by defining, prohibiting, and punishing unfair trade practices that corrupt the marketplace. A large body of antitrust case law has developed to further define illegal anti-competitive practices.

General antitrust law is often adequate to protect competition in the marketplace. Certain industries, however, require more direct government involvement and more specific performance standards. States proactively began regulating the business of insurance in the 1850s--decades prior to congressional enactment of federal antitrust laws--because they realized the unique commercial and personal benefits of insurance posed unique opportunities for fraud and mismanagement. In addition to the marketplace problems addressed by the Sherman and Clayton antitrust laws, state regulators learned that insurance products carried additional risks of failure due to insolvency. Customers pay for an insurance policy in exchange for a promise of benefits that may be needed months or even years later, if at all, meaning that promised benefits may not be paid if an insurer mishandles policyholder premiums entrusted to its care.

The danger of insurer insolvency and a failure to pay legitimate policyholder claims is very real for reasons distinct from other financial products. Furthermore, the ability of customers to protect themselves against unfair trade practices is complicated by the nature of insurance products and the way they are sold. First, an insurance policy is simply a written promise to pay benefits at a later date in exchange for premium money received up front. Since an insurance policy does not require a physical product, manufacturing plant, or investment in resources that can be inspected by consumers, insurance is sold on the basis of sales promises and the reputation of the insurer, making it an attractive target for fraudulent behavior and mismanagement. Second, insurance is a product whose actual cost is uncertain at the time it is sold, which means poor underwriting and low-ball pricing can lead to insurance company failures. Third, because insurers are permitted to offer policies and set prices for different customers based on a host of individual personal criteria, detecting unfair trade practices is much more difficult. Fourth, the coverage terms and conditions of insurance policies are often very difficult for consumers to understand and compare at the time of purchase, meaning that unfair trade practices may not be detected until later when insurance claims are not paid or other evidence of impropriety comes to light.

As a result of the unique challenges associated with the insurance business, every state has laws that require regulators to monitor and intervene to make insurance markets more stable and fair. These laws prohibit insurance rates that are excessive, inadequate, or unfairly discriminatory. Most people instinctively see the need for states to prohibit price-gouging and discriminatory red-lining by insurance companies, but states also must take action against low-ball pricing because prices that are unjustifiably low will cheat consumers just as much as excessively high prices if an insurer's ability to pay claims is jeopardized. State regulators understand that an insurance policy that fails to pay legitimate claims is not insurance.

As Congress considers the impact of antitrust laws and unfair trade practices on the American economy and individual consumers, NAIC members believe that state supervision and intervention in insurance markets is absolutely critical to maintaining and improving the current highly competitive market. State action to mandate certain types of coverage, maintain market stability, and protect the rights of consumers is an essential part of the American insurance market--the most vigorous, respected, and trusted in the world. The insurance regulatory system in the United States is a model for developing countries around the world. Our nation's insurance system rests on consumer confidence, and the expertise and focus of state insurance officials ensure that the confidence of the insurance-buying public is justified.

The Federal Antitrust Exemption for Insurance Has Worked Well

Since 1945, the McCarran-Ferguson Act has permitted state supervision of anti-competitive activities by insurance companies without interference from the federal government. During that time, the insurance industry in the United States has grown exponentially, while remaining financially strong and highly competitive in offering a broad array of policies to consumers. The vast majority of insurers competing in the market are relatively small and may not be directly heard or seen in Washington, D.C. Economic census data from 2002 shows there were over 5,000 insurers

with combined revenues of $1.2 trillion operating in the United States. Only 296 of those insurers had more than 500 employees, yet they accounted for more than 90 percent of total revenues. Thus, the delegation of authority to states contained in McCarran-Ferguson has been both successful and well tested by time and market changes.

Congress passed the McCarran-Ferguson Act in direct response to the U.S. Supreme Court's decision in United States v. Southeast Underwriters Association, 322 U.S. 533 (1944). The Supreme Court held, contrary to 70 years worth of precedent, that insurance transactions constitute interstate commerce, and thus are subject to federal regulation under the Commerce Clause of the United States Constitution. Following S.E. Underwriters, the NAIC became concerned that state insurance rate regulation would be found to violate the Sherman Act, and therefore lobbied Congress for a limited antitrust exemption. The NAIC's fundamental concern in the 1940s, a concern that continues to define the NAIC position on antitrust reform, is that the competitive benefits of collectively developing loss costs and policy language would be jeopardized by the insertion of federal antitrust authority in the insurance markets. The jeopardized benefits include: (1) standardized risk classifications and policy form language that make data more credible; (2) consolidated collection and analysis of data improve quality and aid smaller insurers with responsible rate-setting; and (3) publication of advisory loss costs and common policy forms make it less costly for competitors to enter or expand in the market.

In recognition of the counterintuitive fact that the limited antitrust exemption promotes competition, the McCarran-Ferguson Act includes this preemption clause: "the business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business, unless such act specifically relates to the business of insurance." In addition to the regulatory responsibility assigned to the states, McCarran-Ferguson exempts certain limited insurance activities from federal antitrust laws.

This limited exemption allows insurers to share loss data, which promotes healthy insurance markets by increasing the number and competence of the competition. Advisory organizations collect statistical information from many insurers and provide compiled information on loss costs to all their members. This, in turn, makes it much easier for small and medium-sized insurers to compete. Those insurers do not generate sufficient business volume to predict the future loss costs of policies they sell. Loss costs published by advisory organizations are absolutely vital to their ability to price policies effectively; without published loss costs, many of these smaller insurers would have to limit policy offerings or even leave the business to the much larger insurers.

Additionally, the antitrust exemption is central to other cooperative functions, such as residual market mechanisms and joint underwriting associations, which provide an important "safety net" for individuals and businesses unable to secure coverage in the voluntary market. This is especially important to satisfy state mandatory insurance requirements for automobile insurance, medical malpractice insurance, and workers' compensation.

It is important to emphasize that the current federal antitrust exemption is limited. Indeed, judicial rulings confirm the applicability of antitrust laws to insurance companies. To the extent that insurance companies engage in anticompetitive conduct not related to the business of insurance, federal antitrust authorities are unrestrained. For example, an anticompetitive agreement between an insurance company and a pharmacy would not likely be protected by the exemption.

The Two Tiers of State Insurance Supervision: Regulation and Law Enforcement

State insurance departments are not law enforcement agencies, but we effectively prevent unfair trade practices as part of our proactive mission to assure that insurers are solvent and treat consumers fairly. Every state has an Unfair Trade Practices Act that gives its insurance regulator power to investigate a variety of unfair practices and to impose fines and require corrective actions if a violation is found. As an example, the Unfair Methods of Competition and Unfair and Deceptive Acts and Practices law in Illinois prohibits boycotts, coercion and intimidation, discrimination on the basis of race or other protected class, misrepresentations of policy costs and benefits, unfair claims handling procedures, and various other fraudulent practices. In Illinois, as in other states, laws specifically prohibiting unfair trade practices are enforced by the insurance commissioner through a broad array of administrative powers.

State regulators' primary responsibility is to maintain the stability of insurance markets and products for the benefit of consumers. Every day conscientious and highly skilled regulatory professionals monitor business activities related to the two major obligations insurers owe to consumers--issuing sound policies and paying claims on time.

Market conduct exams are part of the monitoring system. State insurance officials supervise the market conduct of industry participants by reviewing their business operations through market analysis, periodic examinations, and investigation of specific consumer complaints. When consumers have complaints about homeowners, health, automobile, and life insurance, they readily contact their state insurance departments. State officials earn consumer trust, in part, because they know the towns, cities and communities in which consumers live, and the nuances of the local insurance marketplace. Insurance products are difficult for many consumers to understand. Consumers expect state governments to have appropriate safeguards and an effective local response if problems arise.

Insurers, agents, and brokers also must accept responsibility for maintaining a competitive and fair marketplace by reporting business practices that appear to be harmful, anti-competitive, or unethical to state regulators. Preventing and correcting market conduct problems requires that regulators and responsible business participants work together toward a common goal of strengthening stability and fairness in the marketplace. We achieve such stability through extensive daily monitoring of solvency, review of rates and policy forms, and evaluating market behavior.

In addition to being subject to these extensive regulatory and enforcement powers, insurers are subject to state attorneys general enforcement of state antitrust laws. Some state laws contain a limited exemption for certain insurance activities. A 50-state table of antitrust insurance exemptions is attached as an appendix to this testimony.

Given their primary role in the protection of insurance consumers, state insurance commissioners take pride in the historical fact that state-based regulation works very well to provide consumers with a healthy marketplace and confidence that the basic obligations set forth in their insurance policies will be met. When the marketplace functions without significant problems, it means that we are working successfully to protect consumers by maintaining competitive and stable insurance markets.

State Action to Address Broker Compensation Abuses and Conflicts of Interest

A recent example of the state system working successfully is our effort over the past two years to address wrongdoing and potential conflicts of interest associated with broker compensation. In October 2004, New York Attorney General Eliot Spitzer filed a civil complaint against a large brokerage firm that was preceded by months of investigation by the attorney general and more than a year of analysis by the New York Insurance Department. The civil complaint, which included claims based on violations of New York antitrust law, unfair business practice law, and common law fraud, has resulted in a number of guilty pleas on criminal charges of fraud related to bid-rigging. At least 17 guilty pleas and eight indictments have been entered based on related charges.

The charges stemmed from contractual and implied arrangements between insurers and brokers in which the insurer pays extra commissions to the broker based on a number of factors, such as the loss ratio or retention of business placed through the brokerage firm. These commissions were in addition to regular sales commission, and were often based on the performance of the insurer's entire book of business with an individual broker. Although these types of contingent commissions have been commonplace for more than a century, certain brokers and carriers were alleged to have "rigged" the competition. For example, a broker would steer a particular piece of business to one insurer based on a favorable commission structure. In some cases other insurers participated by offering less-attractive prices, called "B quotes," to steer a policyholder to the pre-selected insurer. It also was alleged that brokers would freeze out insurers with less favorable commission arrangements, regardless of whether the insurers fit a customer's needs. In terms of law enforcement and insurance regulation, this conduct constitutes fraud, an unfair business practice, and a violation of state antitrust law.

The system has worked because existing state consumer protection, antitrust, and unfair trade practice laws provide the necessary tools to stop anti-competitive conduct. Without admitting or denying the allegations against them, five of the nation's top brokers entered into consent agreements with a number of attorney generals and state insurance departments. The agreements establish settlement funds ranging from $27 million to $850 million, which are available

to policyholders who release the brokers from any liability associated with the settlements. The NAIC applauds these broker settlements and advises consumers to consider agreeing to their terms.

When the original allegations surfaced in October 2004, the NAIC also appointed a 15-state task force to quickly develop a three-pronged national plan to coordinate multi-state action on broker compensation issues. The first prong of the NAIC's national action plan was to amend its existing Producer Licensing Model Act to require greater transparency of producer compensation in certain circumstances. The NAIC followed an accelerated time frame, adopting the amendment in December 2004 in order to have it available for 2005 state legislative sessions.

The focus of the NAIC model disclosure amendment is consumer protection. It does not prohibit payment of contingent commissions or restrict the ability of producers to receive appropriate compensation for the services they provide. Instead, it requires insurance agents and brokers to disclose their compensation arrangements, which in turn allows consumers to fully evaluate their own options. This approach respects business realities and market-driven forces, while at the same time putting a priority on consumer protection. To date, seven states have adopted all or part of the reforms in the NAIC amendment, and others are considering them. Four more states have issued bulletins since the allegations arose. These measures are in addition to existing statutory limitations or related disclosure regulations already on the books in many states. For example, one state barred contingent commissions in the mid-1980s. Also, by virtue of numerous settlements with brokers and carriers, written disclosure is becoming an effective industry standard.

The second prong of the NAIC's national action plan was to facilitate consistent regulatory action among the states, starting with the distribution of uniform templates for states to use in investigating broker compensation issues. Based upon the findings and monetary relief produced by the New York Insurance Department's settlement with Marsh & McLennan, the nation's largest broker, the NAIC's Broker Activities Task Force coordinated a multi-state regulatory settlement that has been joined by at least 33 other insurance departments. In exchange for releasing related regulatory claims, the signatory regulators can enforce the settlement's terms locally and receive compliance reports directly from Marsh & McLennan, while maintaining their ability to continue ongoing investigations. The Task Force released a similar settlement with the nation's second largest broker, Aon Corporation, and is currently working on similar multi-state agreements with other large national brokers. In addition, regulatory staff from six states, including Illinois, together with attorneys general from 10 states reached a settlement with insurer Zurich North America arising out of bid-rigging allegations and resulting in $151 million in restitution to Zurich policyholders. The Task Force is leading the NAIC's collaborative efforts to reach settlement agreements with other brokers and commercial insurance carriers, where appropriate.

As the third prong of its national plan to improve consumer protections, the NAIC launched an online fraud reporting mechanism in January 2005. It allows consumers, employees, or others who witness wrongdoing to anonymously report their suspicions for investigation by state enforcement authorities. Collective state action through the NAIC on broker issues is important because the brokers and insurers involved operate across the nation and throughout the world. Business practices in one state may be connected directly to problems being identified in other states. Continued regulatory collaboration avoids duplicative and excessive data requests that delay responses from the brokerage and insurance industry and hinder state action.

Conclusion

The NAIC and its members ask that Congress carefully consider the unintended consequences and potential pitfalls of amending the McCarran-Ferguson Act. State regulation of the "business of insurance" under the limited federal antitrust exemption granted by the McCarran-Ferguson Act has protected consumers for over 60 years, as it did for many years preceding the Supreme Court's decision in the Southeast Underwriters case. We have used that time to sharpen market supervision and enforcement tools to promote a lawful and competitive marketplace for insurance companies. Although insurance products generally have been widely available and competitive throughout the United States, state regulators will continue to act when necessary to correct market imbalances by using our authority to mandate insurance coverage and appropriate rates.

The first priority of state insurance regulators is to protect consumers. We recognize that insurance is a unique financial guarantee product that is essential to protecting not just the American economy, but also the most cherished

personal effects of individual consumers. It is part of the social fabric and financial safety net that enables citizens, small businesses, and global corporations to move forward each day with confidence. NAIC members look forward to continuing our work with federal and state officials, consumers, the insurance industry and other interested parties to prevent and punish anti-competitive activities within the insurance industry.

ATTACHMENT: STATE ANTITRUST LAWS AND EXEMPTIONS
(Contact NAIC)