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*Testimony Of*
The National Association Of Professional Surplus Lines Offices

*Before The*
Senate Committee On Banking, Housing And Urban Affairs

*Regarding The*
State Of The Insurance Industry: Examining
The Current Regulatory And Oversight Structure

July 29, 2008
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TESTIMONY OF
THE NATIONAL ASSOCIATION OF PROFESSIONAL SURPLUS LINES OFFICES
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
REGARDING THE "STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE"

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Chairman Dodd, Ranking Member Shelby and Members of the Committee, my name is Richard Bouhan and I am Executive Director of the National Association of Professional Surplus Lines Offices ( NAPSLO). I am pleased to be before you today to offer testimony on the state of the insurance industry with focus on its current regulatory structure and oversight. My particular emphasis will be on the regulatory structure and oversight of the "surplus lines" industry or non-admitted market which NAPSLO represents.

NAPSLO is the national trade association representing the surplus lines industry and the wholesale insurance marketing system. NAPSLO is unique in that both surplus lines brokers and surplus lines companies are full members of the association; thus NAPSLO represents and speaks for the surplus lines wholesale marketplace.

Founded in 1974, NAPSLO is an informed and knowledgeable voice about the surplus lines market and the vital role it plays for consumers. NAPSLO has over 800 broker/agent/producer and insurer members with 1,100 offices representing 10,000 to 15,000 individual brokers, agents, company professionals, underwriters and other industry professionals in all fifty states and the District of Columbia.

NAPSLO commends the Committee under leadership of Chairman Dodd for holding this hearing and examining the state of the regulatory structure and oversight of the insurance industry. Insurance is an essential component to a modern economy. It protects assets, it protects savings and it compensates individuals and business when unforeseen events take a financial toll. The product the insurance industry offers is simple --- it is a "promise to pay." In order to assure that promise is kept by the insurer and that the promise is made to the consumer in a fair and proper manner, insurance has become one the most heavily regulated businesses in the country. But the regulatory structure and process must be efficient and effective and promote, not hinder or prevent, the purchase of the protection insurance offers.

Unfortunately, our current system is neither efficient nor effective. Indeed, as I will explain, today's regulatory system is out of touch with the realities of an increasingly complex, sophisticated, and multi-jurisdictional insurance marketplace. Reform – practical solutions that fix real marketplace problems – is critical for the long-term health of our industry.

Though my colleagues today may discuss a number of legislative option to reform the insurance market, only one bill has the support of the entire insurance industry – the Nonadmitted and Reinsurance Reform Act (NRRA). In support of this legislation, NAPSLO has helped lead the Surplus Lines and Reinsurance Coalition which includes virtually every major insurance company and trade association including the Risk Insurance Management Society (RIMS). Indeed, even the National Association of Insurance Commissioners has taken a positive position on Title I of the Nonadmitted and

reinsurance Reform Act. NAPSLO appreciates the leadership of NAIC Chairwoman Sandy Praeger of Kansas, Commissioner Jim Donelan of Louisiana (chairman of the NAIC's Surplus Lines Task Force), and Illinois Insurance Director Michael McRaith on this important reform for our industry.

Already passed by the House, the NRRA is a legislative solution that can provide immediate relief to an industry burdened by a regulatory inefficiencies. NAPSLO commends Senators Mel Martinez and Bill Nelson of Florida for introducing the NRRA in this chamber and Senator Jack Reed for his support of the bill. NAPSLO encourages the Senate to pass S.929 in recognition of the marketplace need and the industry-wide support for this reform legislation. Before digging into the details of why this reform is so critical today, some background on surplus lines insurance may be helpful.

Background on Surplus Lines Insurance

Surplus lines is a key component of this nation's insurance marketplace. However, surplus lines is not a *type* of insurance such as liability or property or homeowners or automobile insurance. And while found primarily in the commercial arena, surplus lines is not one specific *line* of insurance such as commercial lines or personal lines. Rather, surplus lines is a special *marketplace* in which virtually all lines and types of insurance are available, and it is defined by the regulatory rules and structure that govern access to the marketplace and how the transactions in the marketplace occur.

The surplus lines market is important and vital to the insurance buying public. Surplus lines essentially cover many types of risk which a standard insurer does not focus upon. In theory, surplus lines fills in the gaps when standard insurance is not easily available. When the admitted market withdraws coverage for a certain risk, the surplus lines market steps in and provides coverage. Surplus lines insurance is often referred to as the "safety valve" of the insurance industry because it expands the market by ensuring consumer access to insurance. In this way, surplus lines helps balance out the ebb and flow of the admitted insurance market. Examples of situations in which surplus lines might provide insurance coverage include:

an entrepreneur trying to bring a product to market;

a manufacturing concern looking to insure your product line for products liability;

a drug company wanting coverage for a new and innovative drug;

a financial institution in need of directors and officers liability;

a professional –a doctor or lawyer—in a “high risk” specialty in need of professional liability insurance;

a residential or commercial contractor building a new structure;

the director of a political campaign trying to secure coverage for the campaign;

a municipality, hospital or airport;

a home or commercial property owner in a hurricane or earthquake prone area;

an automobile owner with a “classic” or high performance vehicle.

Further examples include the industry's response to 9/11 and Hurricane Katrina.

There is no one in this room that is not, in some way, impacted by the surplus lines or non-admitted insurance market.

Size and Growth of the Surplus Lines Market

Surplus lines or non-admitted insurance is a significant segment of the property/ casualty insurance industry. Its $40 billion annual premium represents, according to AM Best's most recent report on the industry, nearly fifteen percent of the commercial insurance marketplace.[1]

The surplus lines market has grown dramatically in past few years. In the ten year period from 1996 to 2006, the surplus lines premium grew, again according to AM Best, from $9.2 billion to just under $40 billion., a better than four fold increase.[2] As a percentage of the commercial insurance market, surplus lines has expanded from 6.3 percent to just under 15 percent in that time period.[3] (Surplus lines primarily fill needs for commercial clients, although there are a few instances, such as storm coverage on coastal areas, in which individual consumers may use surplus line coverage.)

The reasons the surplus lines industry has grown so significantly in recent years reflect the growth in our economy and its increasing complexity. As the nation's economy has evolved from one based on large manufacturing and industrial enterprises to an economy that is more diverse with the mix of service, high-tech, financial and construction businesses, many of which are entrepreneurial in nature, there has been more need for a flexible insurance marketplace that can adapt insurance coverage to the needs

[1] *2007 U.S. Surplus Lines Review (Special Report),* AM Best Company, Oldwich, N.J., Oct. 1, 2007, p. 5
[2] Op. Cit., p. 4
[3] Op. Cit., p. 4

of a changing economy and can analyze effectively the growing number of new and unique risks.

The surplus lines market, with its freedom of rate and form, is that market and has expanded to meet the needs of our nation's changing economy. As the nation's economy continues to expand and change, NAPSLO sees a continuing need for the surplus lines market to meet these challenges of providing coverage for a more complex and dynamic economy.

As the surplus lines industry has expanded over the past decade and the risks it insures have become more complex, the interstate nature of the surplus lines business has also expanded. Currently, around one third of the policies written in the surplus lines market have multi-state exposures. Given the current regulatory structure, under which surplus lines works in the states, the compliance with the various state tax and surplus lines regulations is problematic and virtually impossible.

Surplus Lines Regulatory Structure

Surplus line brokers are generally comfortable with the state-based system of insurance regulation. There are, however, two specific contexts, premium taxation and broker licensing, in which the states have been unsuccessful and unwilling to coordinate, despite the direction to do so given by Congress in the Gramm Leach Bliley Act. In those specific areas, Congressional attention is welcome by the surplus lines industry. To understand the difficulty surplus lines brokers have in complying with regulatory

requirements on multi-state surplus lines risks, a description of the surplus lines regulatory structure is necessary.

In contrast to how the standard, admitted or licensed market where the "licensed insurance company" is subject to the state's jurisdiction, its insurance laws and regulations), the regulated entity in a surplus lines transaction is the specially licensed "surplus lines" broker. The insurance company is typically neither licensed nor does it have a presence in the state. It is "non admitted."

As the "regulated entity," the licensed surplus lines broker is responsible for compliance with all state laws including qualifying the risk as eligible for surplus lines placement through: 1) assuring that a "diligent search" for an admitted carrier is properly conducted and processed, 2) assuring that the non-admitted company with which the insurance is placed or procured is an "eligible" surplus lines insurer, 3) providing the insured with the proper statutory notice that the insurance is placed with a surplus lines insurer, 4) filing an affidavit or report of the transaction with the state insurance department and 5) remitting surplus lines premium tax on the transaction to the tax authorities of the state.

Premium Tax Allocation and Remittance Problems

This latter responsibility continues to be a difficult and problematic responsibility for the broker. The difficulty is that the states have inconsistent and often conflicting laws regarding the allocation and remittance of surplus lines premium tax monies. As an

example, while forty-eight states require the broker placing a multi-state risk to allocate the premium based on the exposure in the state and pay the tax on the allocated premium to the state, a few states impose the tax on the entire premium irrespective of the fact the some exposures may be located in another jurisdiction. This conflict can cause a portion of a premium to suffer double taxation.

A more significant problem is that there are no standard and accepted allocation formulas among the states for brokers to use to assure that the calculation of tax due each of the states is proper and accurate. On a particular risk, one state may use a formula based on "square footage" and another state may use "gross receipts." Another state may use a third formula such as "number of employees." A surplus lines broker placing business under his or her license in State A, with exposures in states A, B and C, is faced with a dilemma of which state's formula to use for calculating the tax due in each state when the formulas differ, which is quite often.

As a consequence of this confusion, the allocation and remittance of surplus lines premium tax, which is the surplus lines broker's responsibility on multi-state risks, is replete with confusion and acrimony between states and the brokers as to whether the correct amount of tax has been paid. Since the tax is collected in most cases from the insured, the insured on occasion gets caught in these disputes.

The brokers and insureds are not the only ones that are ensnared in these tax battles. The surplus companies who are not subject to the tax are looked to as source of data in order reconcile the broker filings. As a condition of eligibility, surplus lines

companies are often required to provide detailed premium information to the states regarding surplus lines exposures written by that company in their state.

The problem with this "reconciliation" of broker filings with company premium data is that without any standard or universal rules or accepted allocation formulas among the states as to how exposures are to be allocated for surplus lines premium tax purposes, the reconciliation effort is the classic comparison of "apples and oranges" and is a useless exercise. Without an accepted and universal system of premium allocation and tax remittance there is no way to determine how much each state is truly owed in surplus lines tax on multi-state risks. If such a system were developed, brokers would be able to determine the proper amount of tax due and there would be no need to involve the non-admitted surplus lines companies in the process.

On occasion, states insist that the surplus lines companies make-up any shortfalls in tax monies the states believe were not remitted to them by the brokers. Out of fear of losing their surplus lines eligibility, these companies often comply with these requests.

Simply stated, the premium allocation and tax remittance system for surplus lines premium tax for multi-state risks is dysfunctional and chaotic. This chaos and the constant battles it creates produces inefficiencies which increase transactional costs and make the surplus lines market difficult to use, particularly for multi-state risks.

Over the last two decades numerous efforts to alleviate these problems and create a rational, transparent and auditable system for tax remittance to the states for surplus

lines taxes have failed. The states are just not capable of coming together to create a universal system of tax allocation and remittance for surplus lines that they all can accept. NAPSLO has concluded that only solution is federal legislation that creates a rational system among the states for the proper and fair allocation of surplus lines tax revenues. NAPSLO believes that this system should allow the surplus lines brokers pay all premium tax due on a multi-state surplus lines transaction to one state and direct the states to allocate this tax revenue, among themselves, based upon an accepted formula.

In unanimously passing the Nonadmitted and Reinsurance Reform Act in 2006 and again by voice vote in 2007, the House agreed that federal legislation for reform is needed. NAPSLO hopes that the Senate will also take action and pass S.929.

Multi-State Compliance Problems

In 1999 Congress enacted the Gramm-Leach-Bliley Act.[4] This law dramatically changed the landscape for surplus lines in that it ultimately made non-resident surplus lines licenses available in all states. Prior to the passage of Gramm-Leach-Bliley only six states offered non-resident surplus lines licenses and in half of them, the availability of such licenses was limited to licensed resident surplus lines brokers in contiguous states.

One of the goals of Gramm-Leach-Bliley was to create, among the states, either a uniform or reciprocal system of non-resident licensing for virtually all classes of insurance producer licenses including surplus lines licenses.[5] If such a system was not

[4] Public Law 106-102
[5] Public Law 106-102, Subtitle C, Section 321

created within three years, Congress directed that a separate agency entitled the National Association of Registered Agents and Brokers (NARAB) would be established to facilitate the acquisition of such licenses for the insurance producer community.[6] The states elected, through the National Association of Insurance Commissioners (NAIC), to create a reciprocal system of non-resident licensing for insurance producer licenses including surplus lines licenses.

For a reciprocal system of non-resident licensing to meet Gramm-Leach-Bliley muster and prevent the creation of NARAB, Congress required that the NAIC certify that at least twenty-nine jurisdictions had established, within three years, reciprocal non-resident licensing laws meeting the Gramm-Leach-Bliley requirements. The NAIC made such a certification and in August 2002 announced that as many as thirty-five states had meet the Gramm-Leach-Bliley requirements for reciprocal non-resident producer licensing.[7]

Unfortunately, one of the unintended effects the enactment of non-resident surplus lines licensing laws in all the states, which Gramm-Leach-Bliley fostered, has been to exacerbate the problems surplus lines brokers have in placing multi-state surplus lines risks. Moreover, the promise that Gramm-Leach-Bliley held for surplus lines insurance producers to acquire non-resident surplus lines licenses on a simple and efficient reciprocal basis has not been realized.

[6] Ibid
[7] "Its Official: States Hit Reciprocity goal," *National Underwriter Online News Service*, Aug. 12, 2002

Prior to the advent of non-resident surplus lines licenses in every state, surplus lines brokers would place multi-state risks through their resident surplus lines license and comply with the surplus lines laws of their resident state. The insurance of exposures in the other states were seen as ancillary to the transaction in the resident state or viewed as an "independent procurement" transaction where the insured purchased the coverage independent of the laws of the state where the exposure or risk is located.

While this structure for surplus lines regulation has some difficulties for surplus lines brokers in making surplus lines placements with risk exposures in multiple states, surplus lines brokers only had to comply with the surplus lines laws of one state in procuring the insurance. However, with non-resident surplus lines licenses available in all states, the states now are requiring that the broker not only be licensed in each state where an exposure exists, but also comply fully with each state's surplus lines law. Thus, brokers procuring surplus lines insurance having multi-state exposures must comply with multiple and duplicative surplus lines placement requirements in all states in which an exposure exists.

To illustrate this point, consider a surplus lines broker whose insured is a contractor operating in five different states. Such a placement of surplus lines insurance requires the surplus lines broker to comply with all of the elements of five separate state surplus lines laws. This means that the broker must comply with five different "diligent search" requirements; five different affidavit or regulatory reporting requirements; five surplus lines informational consumer notice requirements, each with different statutory language saying essentially the same thing; five different sets of policy record storage

requirements and five different tax filing reports and procedures. In addition, the surplus lines broker has to assure that the insurance company is an eligible surplus lines insurer in each of the five states under five different sets of eligibility standards as well as having to hold (and maintain) at least ten licenses (a general agents or brokers license and a surplus lines license in each state).

All of this is for a single surplus lines policy placement in five states. If the surplus lines broker has a national or nationwide account with exposure in all fifty states the problems, costs and inefficiencies of multiple state compliance must be multiplied five fold.

NAPSLO recognizes the need for oversight and regulatory compliance for surplus lines placements. It is the regulatory structure that defines surplus lines. But, the cost and inefficiency created by multiple compliance requirements when placing a multi-state surplus lines risk, we believe, is unnecessary and NAPSLO sees no consumer benefit by perpetuating such a costly, burdensome and overlapping system of multiple state compliance.

Unfortunately, history has shown that the states are unable to harmonize and create, among themselves, an efficient regulatory system for these multi-state surplus lines risks. Consequently, NAPSLO believes that the best answer to this problem lies in federal legislation. Such legislation would direct that on surplus lines risks, one state, the "home state" of the insured, be designated as the one state to control and regulate the placement surplus lines insurance. NAPSLO believes that regulation of surplus lines

placements should be the responsibility of one state and that the "home state" of the insured would have the strongest nexus to assert regulatory authority on behalf of the insured. The NRRA as passed by the House and as introduced by introduced by Senators Mel Martinez and Bill Nelson of Florida in this chamber does just that, thereby creating a sensible, efficient regulatory system for multi-state surplus lines risks.

Surplus Lines Licensing Issues

In setting forth the standards for an acceptable reciprocal non-resident insurance producer licensing system for the states, Congress, in Gramm-Leach-Bliley, set forth four, and only four, requirements that a state could impose on a non-resident applicant. These requirements are that the non-resident license applicant submit: 1) a completed application for licensure with the state; 2) a copy of the applicant's original application for licensing filed in the producer's home State; 3) proof the producer is licensed in good standing in his or her home State, and 4) payment of any required fees.[8] The expectation was that once a licensee applicant submitted and fulfilled these requirements, the requested non-resident license would be expeditiously issued.

As the era of non-resident surplus lines broker licenses has progressed, NAPSLO broker members report that the non-resident licensing process between states the NAIC has certified as "reciprocal" is much more difficult than expected, often with lengthy licensure application forms and detailed "backup" material being required as well as long delays in the issuing of the non-resident license. However, what is more problematic for

[8] Public Law 106-102; Subtitle C- Subsections C (1) (A-D)

surplus lines brokers seeking non-resident licenses in reciprocal states is that each state requires the non-resident applicant to have (and maintain) a non-resident agent or broker license as a condition of issuing a non-resident surplus lines license.

The requirement that an applicant for a reciprocal non-resident surplus lines license must have a non-resident agent or broker license as pre-requisite for the issuance of the non-resident surplus lines license, NAPSLO believes violates the requirements in Gramm-Leach-Bliley for reciprocity. NAPSLO sees nothing in the four requirements for reciprocal licensing that gives a state authority to demand an applicant have a non-resident agent or brokers licensing as a pre-condition to securing a non-resident surplus lines license.

To our knowledge every state certified by the NAIC as reciprocal requires a non-resident agent or broker license as a precondition to issuing a non-resident surplus lines license. To the extent non-resident agent and broker licenses are required by a reciprocal state before a non-resident surplus lines license is issued, the NAIC's certification that the state is reciprocal is incorrect. We urge Congress to take action to assure that the promise in Gramm-Leach-Bliley of the establishment of an efficient reciprocal licensing system for insurance producers is truly fulfilled.

Better Access to the Surplus Lines Market for Large, "Sophisticated" Commercial Buyers

The surplus lines marketplace offers consumers a marketplace where their difficult insurance requirements can be addressed in a flexible and innovative manner.

However, before it can enter surplus lines market, the risk must pass over a regulatory hurdle of being rejected by the "admitted market." This process is known as a "diligent search" and this regulatory requirement is generally considered fulfilled if three admitted / licensed insurers reject the risk for coverage. The obvious purposes of this requirement is to not only protect the licensed market, but also assure that the buyer, even a large commercial buyer, is not insured by a surplus lines carrier unless there is failure of the licensed market to accept the risk for coverage.

Sixteen states have modified their "diligent search" requirement by creating an "export list" process whereby the state insurance commissioner places certain coverages or identifies certain risks for which there is no available admitted insurance company or admitted market in the state writing the coverage. These coverages or risks are placed on the "export list" and can be insured directly in the surplus lines market, by a licensed surplus lines broker, without a "diligent search."

While this is helpful for situations where the admitted market is demonstrably unable or unwilling to provide coverage, the "diligent search" requirement creates a significant impediment for the "sophisticated" commercial insurer and its broker representative, with knowledge and resources of insurance coverages and markets, to quickly and efficiently enter the surplus lines market and take advantage of the market's flexibility and innovation. In fact, it may eliminate that buyer's ability to enter the surplus lines market altogether.

NAPSLO believes that insurance marketplace and insurance availability would be enhanced if the “diligent search” requirement or barrier would be eliminated for the larger, “sophisticated” commercial buyers so that they or their broker representatives can access and use the surplus lines market on the same basis as the admitted market. Having immediate and unfettered access to both the admitted and surplus lines market would enhance these larger, “sophisticated” buyers’ access to insurance markets and provide them with more options for their difficult to insure insurance risks. To note, NAPLSO supports revising the S.929 definition of "sophisticated commercial purchaser" to be consistent with the language passed by the House in 2007. Any federal reform of the insurance regulatory structure, NAPSLO believes should include the elimination of the “diligent search” requirement for large, “sophisticated,” commercial insurance buyers.

Conclusion

Again, I want to thank the members of the Committee and Chairman Dodd and Ranking Member Shelby for holding this important hearing on the current structure of insurance regulation and oversight and for the opportunity to present NAPSLO’s views on the subject.

Surplus lines market is an important and vital segment of the property / casualty insurance industry. It is the part of the industry to which consumers turn to find coverage when the standard markets or sources of insurance are unable to meet the insured’s needs. Unfortunately, the current regulatory process for surplus lines, surplus lines brokers

cannot easily and efficiently comply with the premium tax remittance obligations they have when insurance policies cover risks that are in multiple states, and such policies are a growing portion of the surplus lines market. Moreover, with the arrival, in the last decade, of non-resident surplus lines licenses in every state, surplus lines brokers are faced with costly, burdensome and duplicative multiple compliance requirements on multi-state risks. This makes placement of policies with multiple state exposures problematic and unnecessarily difficult and surplus lines placements for "national accounts" a nightmare of fifty state compliance.

There are those who might see some future federal action that creates a federal regulatory system as a reason for Congress to delay considering a federal solution to the problems I have presented. Surplus lines is part of the state system of regulation and to the extent that state regulated companies and the state regulatory systems exist, surplus lines will continue to be an important part of the state system. NAPSLO urges the Senate to consider these problems of surplus lines taxation, compliance and licensing and solve them by passing S.929. Given the marketplace need, the favorable political posture, and the industry-wide support for this legislation, NAPSLO believes this bill is ripe for Senate action. Most importantly, insurance consumers who need the surplus lines market and the professionals that work in the marketplace will all benefit from such action.