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Surplus Lines Insurance: Background and Current Legislation

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June 27, 2007

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Summary

In general, insurance is a highly regulated financial product. Every state requires licenses for insurance companies and most closely regulate both company conduct and the details of the particular insurance products sold in the state. This regulation is usually seen as important for consumer protection; however, it also creates barriers to entry in the insurance market and typically reduces to some degree the supply of insurance that is available to consumers. Rather than requiring consumers who may be unable to find insurance from a licensed insurer to simply go without insurance, states have allowed consumers to purchase insurance from non-licensed insurers, commonly called nonadmitted or surplus lines insurers. While, theoretically, any sort of insurance could be sold by a surplus lines insurer, most such transactions tend to be for rarer and more exceptional property/casualty risks, such as art and antiques, hazardous materials, natural disasters, amusement parks, and environmental or pollution risks.

Although surplus lines insurance is sold by insurers who do not hold a regular state insurance license, it is not unregulated. The sale of this insurance is regulated and taxed by the states largely through requirements placed on the brokers who usually facilitate the insurance transactions. The varying state requirements for surplus lines insurance has led to calls for greater harmonization between the states' laws and for federal intervention to promote uniformity. Such federal intervention is the central focus of the Nonadmitted and Reinsurance Reform Act of 2007 (H.R. 1065 and S. 929). In addition, the National Insurance Act of 2007 (S. 40), whose central focus is creation of an optional federal charter for the insurance industry, includes provisions aimed at harmonizing state laws regarding surplus lines insurance. These bills were originally introduced in the 109th Congress, although the National Insurance Act's provisions specifically addressing surplus lines insurance were not included in the previous version. The House passed H.R. 1065 on June 25, 2007, but the Senate has not acted on surplus lines legislation in the 110th Congress. This report will be updated as warranted by legislative events.

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Background on Insurance Regulation[1]

Unlike the other primary sectors of the financial services industry, banking and securities, insurance is regulated almost exclusively at a state level. While the Supreme Court has ruled that Congress has the power to regulate insurance, the 1945 McCarran-Ferguson Act[2] devolved this power to the individual states and this was specifically reaffirmed in the 1999 Gramm-Leach-Bliley Act.[3] It has long been recognized that some uniformity in insurance regulation is desirable as it allows greater efficiencies in the insurance market. This argument has grown stronger as insurers compete more with banks and securities firms, who do have uniform regulation, and as capital markets have become more globalized. Insurers rely increasingly on global capital markets both as a place to invest premiums that are not quickly paid out in claims and as a source of funding, particularly after a catastrophe that causes large losses.

Recognizing the need for relatively standardized regulation, the individual states have developed model rules and regulations through the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL). Harmonization efforts by the states, however, have been hampered by the lack of authority invested in either the NAIC or NCOIL. Although both are made up of public officials, both organizations themselves are voluntary, non-governmental associations and can not require that any states enact their models. As consequence, there is significant variation in how different states regulate insurance and there have been various calls for Congress to act through a federal charter or some other kind of federal intervention.

Regulation of Surplus Lines Insurance

Surplus lines insurance regulation differs both in the substance of that regulation and in who is the primary focus of the regulation. In regulating regular insurance transactions, much of the state's focus is on the insurer itself. States have specific requirements for financial solvency, including how much capital an insurer must hold, and how the insurer can invest this capital. In cases of insolvency, states have established guaranty funds, funded by the rest of the insurers in the marketplace, to pay off the insolvent insurer's claims. The states also regulate both the substance of an insurance policy and the price of that policy, with many states requiring specific state approval before policy terms or prices can be changed. In surplus lines insurance, states have some oversight on the solvency of insurers, generally requiring that financial information be filed by surplus lines insurers in order to judge whether or not the insurers are sufficiently capitalized. There is, however, no participation in state guaranty funds by surplus lines insurers, nor state oversight of policy terms and prices charged.

Most surplus lines transactions revolve around an intermediary, typically an insurance broker, many of whom specialize in the unusual risks that require such coverage. Because they have relatively little oversight on surplus lines insurers themselves, the states generally focus their attention in regulating surplus lines insurance on the these intermediaries. To operate as a surplus

[1] See CRS Report RL32789, *Insurance Regulation: Issues, Background, and Current Legislation*, by Baird Webel, for a more complete overview of insurance regulation.

[2] 15 U.S.C. Sec. 1011 *et seq.*

[3] P.L. 106-102, 113 Stat. 1338.

lines broker, most states require an additional license on top of the license required for insurance brokers in general. To retain this license, surplus lines brokers are required to take various steps with surplus lines transactions that are not required in regular insurance.

The first step in a surplus lines transaction is generally a state-required "diligent search" of the regular insurance marketplace to establish that there is no licensed insurer available to offer the required coverage. Typically, this requirement is satisfied by having some number, usually three to five, licensed insurers decline to offer coverage with the broker being responsible for an affidavit describing the search and certifying that no coverage is available in the licensed market. In some cases, states have established lists of coverages that are almost always placed in the surplus lines market and thus are exempt from the diligent search requirements.

Once the consumer's eligibility to use the surplus lines marketplace is established following whatever state rules are in place, the broker would then approach various surplus lines insurers seeking the desired coverage at a suitable price. At this point, while the consumer is outside of the regular insurance market, the states generally continue to establish standards to protect consumers against surplus lines insurers who might be unable to pay claims that are made. Some states establish a list of eligible surplus lines insurers, and state-licensed brokers are only allowed to transact with insurers on that list. Others take the opposite approach and issue a list of ineligible insurers that may not be used by state-licensed brokers. A third approach is to make the brokers responsible if a surplus lines insurer refuses to, or is unable to, pay legitimate claims; this is seen as causing the broker to be more cautious as to which insurance companies are used. States also generally require that brokers provide specific disclosure statements to clients purchasing surplus lines insurance detailing that the insurance is not subject to the same regulatory oversight as insurance bought from state licensed insurers.

All states levy specific premium taxes on insurance and generally require a licensed insurer to collect and remit these taxes as a condition of licensure. With the absence of licensure requirements on surplus lines insurers, the requirement to remit taxes is placed on the state-licensed broker. The precise amount of the tax depends on individual state laws. The situation becomes somewhat unclear, however, when the consumer, the broker, or the insured property are in different states. Such a multi-state situation requires apportioning the premium taxes among the different states. State laws, however, differ significantly not only on the amount of such taxes but also on what exactly is to be taxed and how that tax should be apportioned among the multiple states.

The Surplus Lines Marketplace

The property/casualty insurance market has been marked by the so-called insurance cycle, a tendency to have alternating periods of high prices and short supply ("hard markets") with periods of low prices and plentiful supply ("soft markets"). The size of the surplus lines market has been significantly affected by these cycles, with surplus lines growing faster than the entire market in hard markets and more slowly in soft markets. In the past 30 years, there have been generally hard markets in four periods: the late 1970s, the middle1980s, the early 1990s, and the early 2000s. Growth in net premiums for U.S. professional surplus lines insurers in three of these four periods has reached 70% at the peak and then dropped to nearly zero or below within a few years afterwards.[4] In 2005, surplus lines premiums for commercial insurance totaled $33.3 billion, 12.7% of the total commercial lines premiums of $263.1 billion.[5] The surplus lines market in the United States has two large groups, AIG and Lloyd's of London, which had 21.0% and 14.0% of the market respectively. The next largest is Zurich/Farmers with 5.2% market share, which was followed by a number of companies in the 2% to 4% range. The 10th largest company had a 2.4% share, while the 20th had a 1.1% market share.[6]

Legislation

109th Congress

The National Insurance Act of 2006

Senators John Sununu and Tim Johnson introduced S. 2509 on April 5, 2006, and it was referred to the Senate Committee on Banking, Housing, and Urban Affairs. The committee held two hearings on general insurance regulation in July 2006 where the bill was discussed, but it did not take other action on S. 2509. While not directly addressing surplus lines insurance, the bill potentially could have had a significant impact on the operation of the current surplus lines market. S. 2509 would have created a federal charter for insurers and insurance intermediaries and given them the choice of operating under the federal system instead of the state system. Holders of a federal license would have been able to operate throughout the United States without separate state insurance licenses. In addition, the National Insurance Act would have preempted state laws requiring product and price approvals for federally chartered insurers. A federal charter as envisioned in S. 2509 would thus offer many of the same freedoms currently enjoyed by surplus lines insurers, namely, the ability to sell insurance across the country without individual state licenses and with product and rate flexibility. At the same time, S. 2509 would have offered the possibility of avoiding the conflicting state regulatory system that surplus lines insurers currently point to as a significant burden.

Representative Ed Royce introduced H.R. 6225 on September 28, 2006. It was jointly referred to the House Committees on Financial Services and on the Judiciary. While not identical to S. 2509, the bill was essentially similar and would have created the same dual regulatory system with both federal and state charters available for insurers and insurance intermediaries. No committee hearings were held on H.R. 6225.

Passage of either version of the National Insurance Act of 2006, however, would not have offered a uniformly positive federal option from the viewpoint of surplus lines insurers. Unlike current state laws for surplus lines insurers, insurers with a federal charter would have been required to participate in state guaranty funds. In addition, federally-chartered insurers would likely have had more stringent financial oversight than the states currently undertake with surplus lines insurers. It is difficult to predict whether large numbers of surplus lines insurers would actually opt out of the state system until the details of a federal chartering system were put in place. The largest

[4] A. M. Best, *Excess and Surplus 2006*, September 2006, p. 19.

[5] Ibid, p. 7.

[6] Ibid, p. 8.

surplus lines insurer, A.I.G., would seem very likely to become a national insurer as its then-chairman testified before Congress supporting an optional federal charter in 2002.[7] A.M. Best's 2006 survey of the surplus lines industry concluded, however, that " ... whether or not the National Insurance Act becomes a reality, surplus lines insurers will continue to play a major role in providing specialty coverage to commercial insurance consumers."[8]

The Nonadmitted and Reinsurance Reform Act of 2006

Representative Ginny Brown-Waite, along with 16 cosponsors, introduced H.R. 5637 on June 19, 2006. It was referred to the House Committee on Financial Services where hearings were held and the bill marked up. The bill as amended was ordered to be reported on July 26, 2006, and reported (H.Rept. 109-649) on September 12, 2006. H.R. 5637 was jointly referred to the House Committee on the Judiciary which held a subcommittee hearing on September 19, 2006. On September 27, 2006, the full House took up the bill under Suspension of the Rules and passed it 417-0. The Senate received the bill and referred it to the Committee on Banking, Housing, and Urban Affairs, but took no further action.

H.R. 5637 was a relatively narrow bill, aimed directly at streamlining and addressing inconsistencies in state regulation in the surplus lines insurance market. It would have done this primarily through preempting various state laws. It generally would not, however, have replaced the preempted state laws with federal standards, but instead would have done so with laws from other states or model laws of the NAIC. The bill's first two sections would have given preeminent regulatory and tax authority to the home state of the insured, preempting the tax and regulatory laws of other states who might have a claim on the insurance transaction such as the home state of the broker or the location of some of the insured risk. Thus, for example, if a company in one state were purchasing a surplus lines policy that covered some risks in another state, the only state that could collect taxes on that transaction would be the home state of that company. The bill would, however, have allowed states to require reports detailing risks that may covered by policies from other states as well as encouraged the creation of an interstate compact to develop a uniform formula to allocate surplus lines taxes among the states. H.R. 5637 also would have preempted state laws on eligibility requirements. In general, it would have preempted any state laws that are different from the NAIC's model law on nonadmitted insurance and required states to follow the NAIC's listing of alien insurers in allowing brokers to place insurance with companies from outside of the United States. It also specifically would have preempted state diligent search requirements for surplus lines purchases by "exempt commercial purchasers" as defined in the bill.

As indicated by the title, H.R. 5637 addressed reinsurance as well as surplus lines insurance. Its reinsurance provisions had a similar approach to addressing inconsistencies of state regulation. The bill would have given preeminence to the home state of the insurer purchasing reinsurance with regard to the regulation of credit for reinsurance and other aspects of the reinsurance contract, while the home state of the reinsurer was given authority for the regulation of solvency of the reinsurer. The bill would have required that in order for another state's laws to be

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[7] See the statement of M. R. Greenberg before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 18, 2002, at http://financialservices.house.gov/media/pdf/061802mg.pdf.

[8] A.M. Best, *Excess and Surplus 2006*, September 2006, p. 27.

preempted, the home state must follow NAIC standards with regard to reinsurance credit and reinsurer solvency.

110th Congress

The Nonadmitted and Reinsurance Reform Act of 2007

Representative Dennis Moore, along with 43 cosponsors, introduced H.R. 1065 on February 15, 2007, Representative Moore was a lead cosponsor of H.R. 5637 in the 109th Congress. Representative Ginny Brown-Waite, the sponsor of H.R. 5637 is a lead cosponsor of the current bill. H.R. 1065 is nearly identical to the bill that passed the House in the previous Congress. The only change is to the credentials necessary to be considered a “Qualified Risk Manager,” which is required for a company to be considered an “exempt commercial purchaser.” The bill was considered under Suspension of the Rules on June 25, 2007, and passed the House by voice vote.

S. 929, also entitled the Nonadmitted and Reinsurance Reform Act of 2007, was introduced in the Senate on March 20, 2007, by Senator Mel Martinez and Senator Bill Nelson. S. 929 is identical to H.R. 5637 as it passed the House during the 109th Congress. It was referred to the Committee on Banking, Housing, and Urban Affairs as was H.R. 1065 once it was received in the Senate. Neither bill has been scheduled for committee action at the date of this report.

The National Insurance Act of 2007

Senators John Sununu and Tim Johnson introduced S. 40 on May 24, 2007, and it was referred to the Senate Committee on Banking, Housing, and Urban Affairs. S. 40 is substantially similar to S. 2509 from the 109th Congress. It would create an optional federal charter for the insurance industry, potentially offering surplus lines insurers the choice of continuing to operate under the state system or to do so under the new federal system. While S. 2509 did not specifically address surplus lines insurance, S. 40 includes provisions doing so. In particular, S. 40 includes surplus lines insurance under the definition of an “insurance producer” and allows a national agency to sell surplus lines insurance. Thus, an individual surplus lines broker or an agency specializing in surplus insurance could hold a national license and be exempt from the various requirements, such as diligent search, placed by the states on surplus lines brokers or agencies. In addition, S. 40 allows only the state in which an insured resides or maintains its principal place of business to tax a surplus lines transaction. S. 40 also specifically exempts surplus lines insurers from a national guaranty fund should one be created.

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