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Surplus Lines Insurance: Background and Current Legislation

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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 part of H.R. 5637, the Nonadmitted and Reinsurance Reform Act of 2006, introduced by Representative Ginny Brown-Waite. After committee action in both the Financial Services and Judiciary Committees, the bill passed the House 417-0 under Suspension of the Rules on September 29, 2006. It has not been scheduled for action in the Senate. Although not specifically aimed at surplus lines insurance, the National Insurance Act of 2006 (S. 2509 and H.R. 6225) could greatly affect surplus lines insurers by introducing a federal charter that would allow such insurers to essentially bypass state regulation altogether. Senator John Sununu introduced S. 2509 on April 5, 2006, and Representative Ed Royce introduced H.R. 6225 on September 28, 2006. Neither bill has been directly acted on by the committees of jurisdiction. This report will be updated as warranted by future legislative events.

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. Although 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, nongovernmental 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.

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[1] See CRS Report RL32789, *Modernizing Insurance Regulation*, 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.

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 such 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 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 2004, surplus lines premiums for commercial insurance totaled $33.0 billion, 16.4% of the total commercial lines premiums of $262.1 billion.[5] The surplus lines market in the United States has two large groups, AIG and Lloyd's of London, which have 21.3% and 13.9% of the market. The next largest is Zurich/Farmers with 4.9% market share, which is followed by a number of companies in the 2% to 4% range. The 10th largest company has a 2.5% share, while the 20th has a 1% market share.[6]

Current Legislation

Three primary pieces of legislation in the 109th Congress might significantly affect regulation of surplus lines insurance: S. 2509 and H.R. 6225, both entitled the National Insurance Act of 2006, and H.R. 5637, the Nonadmitted and Reinsurance Reform Act of 2006.

S. 2509 and H.R. 6225

The Senate version of the National Insurance Act of 2006 was introduced by Senators John Sununu and Tim Johnson on April 5, 2006, and was referred to the Senate Banking, Housing and Urban Affairs Committee. The committee held two hearings on general insurance regulation in July 2006, where the bill was discussed, but has yet to schedule direct action on S. 2509. While not directly addressing surplus lines insurance, the bill could potentially have a significant impact on the operation of the current surplus lines market. S. 2509 would create a federal charter for insurers and insurance intermediaries and give the choice of operating under the federal system instead of the state system. Holders of a federal license would be able to operate throughout the United States without separate state insurance licenses. In addition, the National Insurance Act would preempt 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 offer the possibility of avoiding the conflicting state regulatory system that surplus lines insurers currently point to as a significant burden.

The House version of the National Insurance Act of 2006, H.R. 6225, was introduced by Representative Royce on September 28, 2006. It was jointly referred to the House Financial Services and House Judiciary Committees. While not identical to S. 2509, the bill is essentially similar and would create the same dual regulatory system with both

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[4] *Excess and Surplus 2005*, A.M. Best Special Report, Sept. 2005, pg. 19

[5] Ibid, p. 7.

[6] Ibid, p. 8.

federal and state charters available for insurers and insurance intermediaries. No committee hearings have been held or scheduled on H.R. 6225.

Passage of either version of the National Insurance Act of 2006 would likely not, however, offer 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 be required to participate in state guaranty funds. In addition, federally chartered insurers would likely have 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.

H.R. 5637

The Nonadmitted and Reinsurance Reform Act of 2006 was introduced by Representative Ginny Brown-Waite with 16 cosponsors on June 19, 2006. It was referred to the House Financial Services Committee 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 Judiciary Committee, 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 has received the bill but has not referred it to committee or scheduled any action on it.

H.R. 5637 is a relatively narrow bill, aimed directly at streamlining and addressing inconsistencies in state regulation in the surplus lines insurance market. It would do this primarily through preempting various state laws. It generally would not, however, replace the preempted state laws with federal standards, but instead would do so with laws from other states or model laws of the NAIC. The bill's first two sections would give 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 is purchasing a surplus lines policy that covered some risks in another state, the only state that would collect taxes on that transaction would be the home state of that company. The bill would, however, allow states to require reports detailing risks that may covered by policies from other states as well as encourage the creation of an interstate compact to develop a uniform formula to allocate surplus lines taxes among the states. H.R. 5637 also would preempt state laws on eligibility requirements. In general, it would preempt any state laws that are different from the NAIC's model law on nonadmitted insurance and requires 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 preempts 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 addresses reinsurance as well as surplus lines insurance. Its reinsurance provisions have a similar approach to addressing inconsistencies of state regulation. The bill would give 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 is given authority for the regulation of solvency of the reinsurer. The bill would require that in order for another state's laws to be preempted, the home state must follow NAIC standards with regard to reinsurance credit and reinsurer solvency.