Statement of

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on behalf of

The Council of Insurance Agents + Brokers

Before

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Insurance and Government Sponsored Enterprises

of

The House Financial Services Committee

Regarding

Commercial Insurance Modernization

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Good morning, Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee. Thank you for the opportunity to testify before you today on behalf of the Council of Insurance Agents and Brokers (The Council) and thank you, Representative Brown-Waite and Representative Moore, for introducing the Nonadmitted and Reinsurance Reform Act of 2006 (the Reform Act). Commercial insurance regulatory modernization is essential if we are to have a dynamic commercial insurance marketplace that addresses the needs of commercial insureds for the 21st century. The Council believes the proposed legislation constitutes a significant step toward that end and supports it wholeheartedly.

The Council represents the nation's largest, most productive and most profitable commercial property and casualty insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place more than 80 percent – well over $90 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

My testimony today will focus on insurance sold by non-admitted insurance carriers which encompasses "surplus lines" products placed through brokers and "independently procured insurance" in which the coverage is purchased directly by the insured without the aid of a broker. I will explain what these types of insurance are, describing the Byzantine State regulatory requirements that currently burden the surplus lines marketplace, and I will explain that the Reform Act will address those issues primarily by dictating that only an insured's home State's laws apply to such a placement, hugely benefiting surplus lines consumers, the insurance industry and the insurance marketplace as a whole, without sacrificing one iota of consumer protection.

Introduction

The members of the Council commend you for holding this hearing and considering this important legislation. Broad-based insurance regulatory reform is critical for the long-term health of the industry and for maintaining a strong, vibrant insurance sector for the benefit of policyholders. Surplus lines and reinsurance are essential elements of the insurance marketplace and we support your efforts to initiate insurance regulatory modernization by focusing on these areas.

Although the State insurance regulators, through the National Association of Insurance Commissioners (NAIC), have attempted to institute regulatory reforms in surplus lines and other areas of insurance without federal involvement, the reality is that today's marketplace demands far more dramatic action than the States alone are able to provide. The pace of financial services convergence and globalization are far outstripping the pace of reform efforts by State regulators and legislatures.

Competition and efficiency in the insurance industry lags behind other financial services sectors due to the regulatory inefficiencies and inconsistencies in the State insurance regulatory system, inefficiencies and inconsistencies that must be addressed if the insurance sector is going to be able to keep up with the pace of change in the rapidly-evolving global marketplace and thereby expand the insurance marketplace for the benefit of insurers, producers and consumers.

The Council regards itself as a pioneer within our industry with respect to regulatory modernization, though reform is a frustratingly long process. We formed our first internal committee to address the problems of interstate insurance producer licensing more than 60 years ago. Our efforts were finally rewarded, thanks to the leadership of this committee, with the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act a few years ago – a first step on the road to insurance regulatory reform. The Reform Act is the next step on the road to modernization.

I want to emphasize at the outset that we are not advocating de-regulation of the non admitted insurance marketplace or any sort of reduction in consumer protections. What we are advocating – as we did with NARAB and producer licensing reform – is streamlining the current burdensome system of regulation, thereby doing away with the overlapping, conflicting rules that inhibit the non admitted marketplace and harm consumers. We believe that consolidating regulatory oversight into a single State – the insured's home State – makes eminent good sense, as opposed to the current system in which 55 jurisdictions, some with only remote connections to the transaction, dictate how – and whether – a transaction is completed. The long-term effects of such reform on the marketplace will ultimately benefit the consumer. Easing regulatory burdens – without sacrificing protections – will increase surplus lines insurers' capacity and improve availability of coverage for hard to insure risks such as national catastrophes and terrorism.

I. "Non admitted" insurance provides an alternative to the traditional insurance marketplace but current regulatory requirements are preventing this marketplace from fully realizing its potential.

Non admitted insurance provides coverage for unique, unusual or very large risks for which insurance is unavailable in the admitted market. A surplus lines product is an insurance product sold by an insurance company that is not admitted to do business in the State in which the risk insured under the policy is located. In essence, the insured goes to wherever the insurance company is located to purchase the coverage. The insurer may be in another State, or it may be in Great Britain, Bermuda or elsewhere. Potential insureds can procure this insurance directly, but they generally do so through their insurance brokers. In short, "surplus lines" are: (1) insurance products sold by insurance carriers that are not admitted (or licensed) to do business in a State, (2) to sophisticated commercial policyholders located in that State, (3) for insurance coverages that are not available from insurers admitted (or licensed) to do business in that State.

Although surplus lines is considered to be "unregulated," in reality the surplus lines marketplace is subject to extensive State statutory and regulatory requirements that impede the effectiveness of the market and increase costs to surplus lines consumers. As described more fully below, updating these regulations and laws and encouraging use of alternative insurance markets would help to increase options and decrease costs for insurance consumers.

Surplus lines insurance is universally recognized as an important component of the commercial property and casualty insurance marketplace in all States, and commercial property and casualty business is done increasingly through the surplus lines marketplace. Surplus lines products tend to be more efficient and a better fit for commercial coverages because they can be tailored to the specific risk profiles of insured with specialized needs. This is particularly true during hard markets, like the one we have experienced for the last several years, in which high premium rates for property and casualty insurance posed serious problems for many mid-sized and larger commercial firms. Hard markets cause availability to decrease and the cost of coverage to increase. During these periods, insureds – notably sophisticated commercial insureds – are increasingly drawn to the appeal of alternatives to the traditional, regulated marketplace to expand their coverage options and hold down costs. Surplus lines insurance is just such an alternative.

Although the purchase of surplus lines insurance is perfectly legal in all States, the regulatory structure governing such coverage is a morass. When surplus lines activity is limited to a single State, regulatory issues are minimal. When activity encompasses multiple States, however, full regulatory compliance is difficult, if not impossible. And I should note that multi-State surplus lines policies are the norm rather than the exception because surplus lines coverage is uniquely able to address the needs of insureds seeking coverage in more than one State. Thus, the difficulty of complying with the inconsistent, sometimes conflicting requirements of multiple State laws is a real problem. Simply keeping track of all the requirements can be a Herculean task. For example: Maryland and the District of Columbia require a monthly "declaration" of surplus lines business placed, but only require payment of premium taxes on a semi-annual basis; Virginia, in contrast, requires that a declaration be filed and taxes be paid quarterly; New Jersey has 36 pages of instructions for surplus lines filings, including a page discussing how to number the filings and a warning not to file a page out of sequence because that would cause a rejection of the filing and could result in a late filing.

As a general matter, State surplus lines regulation falls into five categories: (1) taxation; (2) declinations; (3) insurer eligibility; (4) regulatory filings; and (5) producer licensing and related issues.

1. ***Taxes:*** States have inconsistent and sometimes conflicting approaches regarding the allocation of premium taxes, which can lead to double taxation and confusion when a surplus lines policy involves multi-State risks.

- Single situs approach – 100% of the premium tax is paid to the insured's State of domicile or headquarters State. This approach is imposed by some States regardless of what percentage of the premium is associated with risks insured in the State. Virginia, for example, utilizes this rule.
- Multi-State approach – Premium tax is paid to multiple States utilizing some method of allocation and apportionment based upon the location of the risk(s). Because there is no coordination among the States on allocation and apportionment, determination of the amount of tax owed to each State is left to brokers and insureds. If a policy covers property insured in a single situs State and in an apportionment State, double taxation also is unavoidable. A majority of the States utilize this basic rule but the manner in which it is implemented (including the allocation formula) can vary wildly.

- No clear requirement – More than a dozen States that impose surplus lines premium taxes do not have statutory or regulatory provisions indicating the State's tax allocation method, leaving it up to the insured and the insured's broker to determine how to comply with the State law. In such States, determination as to whether any tax should be paid and whether the allocation of any such tax is permissible and appropriate is often based on informal guidance from State insurance department staff.

In addition to the near-impossibility of determining the correct allocation for surplus lines premium tax in a way that does not risk paying too much or too little tax, the differences among the States with respect to tax rates, tax exemptions, taxing authorities, and the timing of tax payments impose huge burdens on surplus lines brokers (who are responsible for paying the taxes if they are involved in the placement) and on commercial consumers, who must navigate these requirements on their own for placements that do not involve a broker and who ultimately bear the costs of not only the tax but the administrative costs of compliance in any event.

For example, State surplus lines premium tax rates range from about 1% to about 6%. In one State, Kentucky, surplus lines taxes are levied not at the State level but at the municipality level. Aon, a member of the Council, reports that in order to properly rate taxes in Kentucky, they have to access electronic maps to determine the city and county in which a risk is located. There are hundreds of cities and counties in the State. Some counties charge a tax in lieu of the city tax, some charge it in addition to the city tax, some charge the difference between the city and county taxes, and some do not charge a city or county tax.

The due dates for premium taxes vary even more widely across the States. Surplus lines premium taxes are due:

- annually on a date certain in some States; the dates vary from State to State, but include: January 1, January 31, February 15, March 1, March 15, April 1 and April 16;
- semi-annually in some States; again the dates vary, but include: February 1 and August 1, February 15 and August 15, and March 1 and September 1;
- quarterly in some States (generally coinciding with the standard fiscal quarters);

- monthly in some States; and
- 60 days after the transaction in some States.

The States also differ with respect to what is subject to the tax, what is exempt from the tax, whether governmental entities are taxed, and whether brokers' fees are taxed as part of or separately from the premium tax (if they are taxed at all). As you can see, determining the proper surplus lines tax payment for the placement of a multi-State policy is a daunting task.

2. Declinations: Most States require that an attempt be made to place coverage with an admitted insurer before turning to the surplus lines market. Some States specifically require that one or more licensed insurers decline coverage of a risk before the risk can be placed in the surplus lines market. If it is determined that a portion of the risk is available in the admitted market, many States require that the admitted market be used for that portion of the risk.

State declination requirements are inconsistent and conflicting, however, and the methods of proving declinations vary tremendously – from specific requirements of signed affidavits to vague demonstrations of "diligent efforts." For example, Ohio requires 5 declinations, but does not require the filing of proof of the declinations. New Mexico requires 4 declinations and submission to the insurance department of a signed, sworn affidavit. Hawaii does not require declinations but prohibits placement of coverage in the surplus lines market if coverage is available in the admitted market. Further, Hawaii does not require filing of diligent search results, but requires brokers to make such information available to inspection without notice by the State insurance regulator. In California, prima facie evidence of a diligent search is established if the affidavit States that three admitted insurers that write the particular line of insurance declined the risk. In Alabama, the requirement is much more vague. The broker is required only to demonstrate "a diligent effort" but no guidance is provided suggesting what constitutes such an effort. In Connecticut, the broker must prove that only the excess over the amount procurable from authorized insurers was placed in the surplus lines market.

3. Insurer Eligibility: Most States require that a surplus lines insurer be deemed "eligible" by meeting certain financial criteria or having been designated as "eligible" on a State-maintained list.

Although a majority of the States maintain eligibility lists (also called "white lists"), in many of the remaining States the surplus lines broker is held responsible for determining if the non-admitted insurer meets the State's eligibility criteria. In addition, although the NAIC maintains a list of eligible alien (non-U.S.) surplus lines insurers that is referenced by four States, this does not seem to have any bearing on the uniformity of the eligible lists in the remaining States. As one would expect, as a result of differing eligibility criteria from State to State – and changes in individual States from year to year – the insurers eligible to provide surplus lines coverage varies from State to State. This can make it exceedingly difficult to locate a surplus lines insurer that is "eligible" in all States in which placement of a multi-State policy is sought.

The flip side of insurer eligibility is also an issue: that is, when multi-State surplus lines coverage is placed with an insurer that is an admitted (not surplus lines) insurer licensed in one of the States in which part of the risk is located. This is problematic because surplus lines insurance cannot be placed with a licensed insurer. In these situations, more than one policy will have to be used, or the insured will have to use a different surplus lines carrier – one that is not admitted, but "eligible" in all States in which the covered risks are located.

4. Filings: Most States require one or more filings to be made with the State insurance department in connection with surplus lines placements. These may include filings of surplus lines insurer annual statements, filings regarding diligent searches/declinations, filings detailing surplus lines transactions, and filings of actual policies and other informational materials. Some States that do not require the filing of supporting documentation require brokers to maintain such information and make it available for inspection by the regulator.

Like other surplus lines requirements, State filing rules vary widely. Some States require signed, sworn affidavits detailing diligent search compliance; some require such affidavits to be on legal sized paper, others do not; some States require electronic filings, others require paper; some States have specific forms that must be used, others do not; some States require the filing of supporting documentation, some do not – although some of those States place the burden on the broker, who is required to store the information in case regulatory inspection is required. In addition, although most filings are required to be submitted to the State insurance regulator, in at least one State, Kentucky, municipalities also require submission of surplus lines materials. There are hundreds of cities and counties in the State and each requires a separate quarterly and annual report by the licensee. As with the tax situation, this creates a terrible burden on surplus lines insurers and brokers, and unnecessarily increases consumer costs.

Depending on the State in question, filings can be required annually, quarterly, monthly or a combination thereof. For example, several States require the filing of surplus lines information in the month following the transaction in question: Colorado requires such filings by the 15th of the month; and the District of Columbia by the 10th. Other States peg the filing date to the date of the transaction or the effective date of the policy: Florida requires filing within 21 days of a transaction; Idaho within 30 days; Kansas within 120 days; Missouri requires filing within 30 days from the policy effective date and New York 15 days from the effective date; Illinois and Michigan require semi-annual filings of surplus lines transactions. Although Illinois does not require filing of affidavits, carriers must maintain records of at least three declinations from admitted companies for each risk placed in the surplus lines market. Some States have different deadlines for different filings. Louisiana, for example, requires quarterly filings of reports of all surplus lines business transacted, and "diligent search" affidavits within 30 days of policy placement. North Dakota, in contrast, requires a single annual filing of all surplus lines transactions, and allows 60 days for the filing of "diligent search" affidavits.

In addition, some States treat "incidental exposures" – generally relatively small surplus lines coverages – differently from more substantial coverages with respect to filing requirements. States have differing definitions of what constitutes incidental exposures and who has to make required filings for such an exposure: some States require the broker to make the filings; others the insured; and some require no filings at all for incidental exposures.

5. Producer Licensing and Related Issues: In addition to the substantial issues outlined above, there are other vexing regulatory issues facing the surplus lines marketplace:

- Producer Licensing: All States require resident and non-resident surplus lines producers to be licensed, and all States have reciprocal processes in place for non-resident licensure. Nevertheless, there remain significant differences among some States with respect to producer licensing that can delay the licensure process, particularly for non-residents. For example, most States require that an individual applying for a surplus lines broker license be a licensed property and casualty producer. The States vary, however, as to how long the applicant must have held the underlying producer license. In addition, some, but not all, States exempt from licensure producers placing multi-State coverage where part of the risk is located in the insured's home State. In States without such an exemption, the laws require a producer to be licensed even for such incidental risks.
- Sophisticated Commercial Policyholders: Some States exempt "industrial insureds" from the diligent search, disclosure, and/or filing requirements. The definition varies among the States, but generally industrial insureds are analogous to the concept of sophisticated commercial insureds. They are required to have a full time risk manager, minimum premium requirements for selected lines of coverage, and a minimum number of employees. If an insured meets a State's criteria, the insured's surplus lines transaction is exempt from the surplus lines requirements, as provided for by the State.
- Automatic Export: A number of States allow certain risks to be placed directly in the surplus lines market. This is called "automatic export" because no diligent search is required before the risk is exported from the admitted market to the surplus lines market. As with every other surplus lines requirement, however, the States are not uniform in their designation of the risks eligible for automatic export.
- Courtesy Filings: A courtesy filing is the payment of surplus lines tax in a State by a surplus lines broker who was not involved in the original procurement of the policy. Courtesy filings are helpful when a broker places a multi-State filing that covers an incidental risk in a State in which the broker is not licensed. The problem is that most States either prohibit courtesy filings or are silent as to whether they will be accepted. This uncertainty essentially requires surplus lines producers to be licensed even in States where they would otherwise be exempt.

II. Congressional action is needed to address the unnecessarily burdensome and overlapping State regulatory requirements imposed on the surplus lines marketplace. The Reform Act achieves that goal without in any way diminishing consumer protections or regulatory effectiveness.

The current surplus lines regulatory structure is not working. The overlapping, redundant, sometimes inconsistent State regulatory requirements described above fail to recognize current market realities – the great majority of surplus lines policies are placed on a multi-State basis and purchased by sophisticated commercial insureds who have unique risks that are not readily covered in the admitted market. The regulatory roadblocks erected by some States do nothing to improve the availability or affordability of insurance, nor do they protect surplus lines consumers. Indeed, we believe the current system causes significant disruptions in the surplus lines marketplace and increases costs for consumers.

The proposed Reform Act would fix the system. The legislation would streamline regulation and ease regulatory burdens, but without sacrificing consumer protections or a financially sound surplus lines marketplace, which is the most important consumer protection of all. The proposed legislation would provide an effective resolution to the current regulatory morass by focusing on the home State of the insured: all premium taxes would be payable to the insured's home State and surplus lines insurance transactions would be governed by the rules of the insured's home State.

This home State focus accomplishes several things:

- Home State regulation ensures that the insured is protected by the laws of its home State and the regulator with the greatest interest in its welfare. It is common sense to assume that a regulator will spend more time and effort on the needs of in-State constituents rather than non-residents with little or no stake in the State or its economy.
- Home State regulation is logical because the risks covered in the non admitted market are generally commercial lines and are not compulsory. We are not talking about auto or homeowners or individual life coverage. These are unique risks that the insured is not required to protect with insurance but chooses to do so to protect the corporate treasury. The corporate treasury, in turn, is not located in the multiple States where the insured has risks, but in the State in which the insured itself is located – generally its state of domicile.

- Home State regulation completely does away with the inconsistent, redundant, burdensome obligations that the current system imposes in connection with multi-State placements. All the regulatory issues described above – taxes, filings, diligent searches, insurer eligibility requirements, producer licensing and more – will be governed by the rules of a single State rather than being subject to multiple State rules.

On one level, the effect of this change is significant – it will eliminate mountains of red-tape and administrative costs, ultimately saving consumers time and money, and expanding the availability of coverage for unusual or extreme risks such as natural catastrophes and terrorism. On another level, however, the change will be minimal. The Reform Act does not alter the basic elements of State surplus lines regulation. Indeed, all of the substantive provisions in the proposed legislation can be found in current State laws and regulations. The beauty of the proposal is that it enables surplus lines producers to look to a single standard in a single State for each transaction. Although the standard may differ from transaction to transaction depending upon the home State of the insured, each individual transaction will have a single standard, rather than being subject to the standards of 55 different jurisdictions. Clearly, this will make multi-State compliance significantly less daunting.

The Reform Act would fix the current tax allocation problems by establishing a clear requirement that all surplus lines premium taxes be paid to the insured's home State. Surplus lines producers would pay the full amount of premium tax owed on an insurance transaction to the insured's home State. In addition to the tax, the home State could require the filing of an allocation report denoting the location of the covered risks. The States are then free to allocate the premium tax among themselves as they so determine. The contrast in approaches – from the convoluted, burdensome approach of the States to the simple straightforward approach in the Reform Act could hardly be greater.

Finally, the exemption for sophisticated commercial policyholders is a victory for common sense. The State regulators, in many of their model rules and regulations, recognize that streamlined processes make sense for sophisticated commercial policyholders, who have a greater understanding of their needs and the insurance marketplace than individual consumers. In addition, sophisticated commercial policyholders are more likely to have unique or large risks for which surplus lines coverage is necessary. For these reasons, it only makes sense to allow such policyholders to access the surplus lines market without jumping through all the regulatory hoops that are currently imposed by some States.

Conclusion

In closing, I would once again like to thank you for taking on this important, if unglamorous, issue. As my testimony has demonstrated, reform of the surplus lines insurance regulatory system is badly needed to maintain a competitive marketplace and, more importantly, to enable insurers and producers to provide insurance consumers with the coverages they need to protect themselves and their businesses from the risks inherent in today's world. As I said at the outset, the Reform Act will get the job done and the Council looks forward to working with you to get it enacted into law.

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