INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY
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RICHARD BAKER, CHAIR

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Good afternoon Chairman Baker, Congressman Kanjorski and Members of the Subcommittee. My name is Michael Phillipus. I am the Vice-President of Communications and External Affairs for the Risk and Insurance Management Society (RIMS), the largest professional organization for the risk management community. I appreciate the opportunity to appear before you today on the issue of insurance regulation and competition for the 21st century.

RIMS member companies, which comprise over 4,000 consumers of commercial insurance, support the advancement of efficient insurance purchasing abilities. RIMS membership spans the country and consists of entities of all different industries and size, including 84 percent of the Fortune 500 companies, as well as approximately 950 companies with less than 500 employees.

The job of a risk manager is to protect and preserve physical, financial, and human resources. One of the primary means of accomplishing this job is through the purchase of insurance. Risk managers, therefore, must become experts in the various insurance vehicles available to determine which will provide the best coverage at the most reasonable price. The first hard market of the 21st century has made this job even more difficult, and risk managers are forced to be more creative in minimizing risks to their employer. Sometimes, traditional insurance coverage is inadequate or simply unaffordable for all or part of a company's holdings. More and more often, risk managers are turning to alternative markets to procure necessary coverage. According to the *Risk Retention Reporter*, A.M. Best expects that in 2003, the alternative market will comprise nearly 50 percent of the U.S. commercial insurance market.[1]

Captive insurance companies are an important part of the alternative insurance market. Captives are closely held insurance companies whose insurance business is primarily supplied and controlled by it owners, who are also the principal beneficiaries. Captives are crucial because they allow a sophisticated insured to control their risk/insurance destiny in a manner that provides stability and emphasis on loss control and risk integration.[2]

Captives are formed in jurisdictions that have specific laws for their formation, which are different from laws governing other traditional insurance companies. There are many different types of captives, including single-owner captives, group captives, association captives, insurance agency captives, rent-a-captives, protected cell companies, virtual captives, captive pools, and risk retention groups.

Captives may be created in domestic or foreign jurisdictions. According to the 2000 A.M. Best Captive Directory, there were 4,199 active captives in 1999.[3] Of the total number of captives, 678 were organized in the United States. According to the 1999

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[1] *Risk Retention Reporter*, May 2002.
[2] ARM 54, "Essentials of the Risk Management Process," and ARM 56, "Risk Finance," CPCU Institute.
[3] 2000 A.M. Best Captive Directory.

statistics, Vermont, Hawaii, and Colorado have the largest numbers of U.S. captives; Vermont dominates with 368. Many states are adopting captive laws to attract captives, the latest being Nevada, South Carolina, and the District of Columbia.

There are a number of advantages for establishing captive insurance companies:

1. Operating costs can be reduced; thereby permitting increased profits to be utilized by the captive. As compared to a traditional insurer, captives can generate a bottom-line expense savings of 5 to 25 percent.[4]
2. Since they are subject to fewer restrictions, captives can also provide more flexibility in the coverage offered to their participants. They can develop their own policies and forms, so that they can offer coverages that are not available from traditional insurers.
3. Captives provide their owners with direct access to reinsurance, which is far more cost efficient than through the traditional insurance market. Generally, an insured cannot access the reinsurance market directly without the use of a captive.
4. Captives can lessen the volatility of the traditional market on their participants. Participants also have some assurance of stability of premiums, amount of deductibles, and retentions and coverage terms.
5. Captives have to deal with fewer regulatory restrictions than the heavily regulated traditional insurers. This is because the policyholders are owners of the captive

[4] Risk Financing, International Risk Management Institute, Inc., Dallas, TX.

and there is no reason to protect the policyholders from themselves. This results in significant cost savings for captives and flexibility in policy terms.

Risk retention groups are a form of captive insurance companies. These groups provide certain insureds with a casualty approach on a homogeneous basis that removes their risk from volatile industry cycles, as well as focused service customized to their exposures. Authorized by federal law, they are incorporated under state law and governed by the law of the state of domicile.[5] The federal authorizing statute was approved originally in 1981 to address the inability of companies to purchase product liability insurance.[6] The law was amended in 1986 to broaden the purposes for which risk retention groups and risk purchasing groups could insure to include all lines of liability coverage except personal lines and statutory workers' compensation coverages.[7]

Companies having a common risk exposure may form risk retention or risk purchasing groups. While capital and other requirements for forming a risk retention group are governed by its state of domicile, states in which a risk retention group does business may conduct financial examinations and require evidence of solvency, and the risk retention groups are subject to state unfair claims settlement laws.

There are approximately 75 operational risk retention groups. The annual premium written by risk retention groups in 2001 was almost 1 billion dollars.[8]

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[5] 15 USC, Section 3901.
[6] Product Liability Risk Retention Act of 1981.
[7] Liability Risk Retention Act of 1986.
[8] *Risk Retention Reporter*, May 2002.

Risk retention groups continue to grow rapidly and fulfill an important part of the alternative market.

The Liability Risk Retention Act (LRRA) does not permit risk retention groups to underwrite property insurance. This limitation reduces the number of insurers that could underwrite property insurance at a time when market restrictions from terrorism threats, combined with a hard market, have driven prices up and reduced availability.

RIMS urges Congress to expand the LRRA to permit risk retention groups and risk purchasing groups to write all coverages except personal lines and direct statutory workers' compensation coverage.

In order to adequately insure unique, difficult-to-place or high capacity insurance risks, risk managers frequently use the surplus lines (sometimes called the excess lines) market.

The surplus lines market is formed by a provision found in every state's (including the District of Columbia) insurance code that allows risk managers or other insurance buyers access, through specially licensed insurance brokers, to non-admitted (unlicensed) insurance companies when the state's licensed or admitted insurers are unable to fulfill the buyer's insurance needs.

Rather than an alternative market, the surplus lines market is better described as a "supplemental market" to the licensed/admitted market. The surplus lines market, in effect, serves as an outlet or "safety valve" market to be utilized by risk mangers and their brokers when the desired coverage cannot be found among the state's admitted/licensed insurers or when market forces or conditions in the admitted/licensed market cause voids and gaps to occur in coverage for certain types of risks.

The key element or defining characteristic of the surplus lines market is its "freedom of rate and form," (i.e. the ability of the non-admitted surplus lines insurers to provide policies and coverage free of state rule, rate and form requirements). Freedom of rate and form is essential for the surplus lines market to have the flexibility to quickly and adequately respond to the risk manager's insurance needs particularly for hard-to-place, distressed, unique and high capacity (high limit) risks.

Historically, the surplus lines market has served as a crucible for the development of new and innovative insurance products. Coverages such as umbrella liability, difference in condition (DIC), claims-made professional liability, asbestos abatement liability, liability coverage for radon testers, employer practices liability insurance, and e-commerce liability coverages, many of which are now standard products in the licensed/admitted market, were first developed, tested and sold in the surplus lines market.

It is frequently stated that the surplus lines market is "unregulated." This is not the case. While the market is free from rate and form regulation, the surplus lines market is a regulated marketplace.

Although regulated differently than the licensed/admitted market, there are a number of rules, requirements and protections surrounding a surplus lines placement. In fact, the regulation of a surplus lines transaction can, on occasion, entail time delays and inefficiencies that make the surplus lines market unattractive to a buyer who may then resort to other mechanisms or alternatives to obtain coverage.

The focus of surplus lines regulation is on the specially licensed surplus lines (or excess lines) broker. Access to the group of non-admitted carriers that form the surplus lines market can only be obtained through the specially licensed surplus lines (or excess lines) broker. The licensed surplus lines broker is restricted to using non-admitted insurers that meet certain statutory minimum capital and surplus requirements and other standards. The financial requirements for eligible surplus lines insurers are generally equal to or in excess of similar requirements established for licensed/admitted companies.

In thirty-five states, a surplus lines broker's placements or transactions are restricted to only approved non-admitted companies whose name appears on a list published by the state insurance department. This list is known as an "eligibility list." In the other jurisdictions, the surplus lines broker assumes the responsibility for placing the business with non-admitted carriers that meet the statutory/regulatory requirements established by the state.

Before a surplus lines broker can obtain coverage from a non-admitted carrier, the risk for which the coverage is sought must be submitted to and be declined by the admitted market through what is known as a "diligent search" or "diligent effort" process. It is common for a state to require that a minimum of three companies, which are licensed to write the type of coverage sought, decline to accept the risk before a surplus lines broker can place the coverage with an eligible surplus lines insurer. Moreover, in some states, a surplus lines placement is prohibited if it is done to obtain a lower price or rate than the "average" or lowest-filed rate in the state. Similarly, a surplus lines placement cannot be made, in many states, simply to obtain a more favorable form.

After a surplus lines placement is made, each state requires that the transaction be reported to the insurance department by the placing surplus lines broker, and that the broker remit the taxes due on the transaction. Often these reports can be accomplished on a quarterly or other periodic basis. However, in some states, the report is required on a transaction-by-transaction basis. These reports are usually in the form of an affidavit and, in a few states, the insured or applicant is also required to sign the affidavit.

In all but two states, the surplus lines broker is required to affix a "legend" or "stamp," to the policy containing statutorily specified language. While the language varies from state to state, the purpose of the "legend" is to inform the reader that: 1) the policy is from a non-admitted or surplus lines insurer; 2) the state does not regulate the insurer; and 3) that in the event there is an insolvency of the company, there is no guaranty fund protection for the policyholder.

Except for the state of New Jersey, which in 1983 established a separate guaranty fund for surplus lines, no state offers guaranty fund coverage for surplus lines policies. The reason that surplus lines carriers are not part of state guaranty funds is that as non-admitted or unlicensed insurers, they are not eligible for inclusion in the guaranty funds established for admitted or licensed carriers.

In discussing the surplus lines market, state regulators are always quick to point out the lack of guaranty fund protection in the surplus lines market. From a risk management perspective, this fact should be placed in context.

First, state guaranty funds have "claim caps," of $100,000 to $300,000 per claim. These caps are well below the limits of many commercial insurance policies making the guaranty fund coverage for these policies of lesser importance. Secondly, from a risk manager's perspective, the solvency of the insurer is as significant an issue as is guaranty fund protection. Based upon the A.M. Best *Annual Review of the Excess and Surplus Lines Industry*, which has been published annually since 1994, the solvency of the surplus lines market has been as good as, or better than, the admitted market for the last thirty years.[9]

The first surplus lines law was enacted by the state of New York in 1890. That law focused on regulating a specially licensed broker who would only deal with specified non-admitted carriers, and would have to perform a search of the licensed market before a risk could be insured by a surplus (or excess) lines carrier. The basic concepts contained in the 1890 New York law have been replicated and are contained in virtually all other state surplus lines laws.

At the time the original New York surplus lines law was passed, the major surplus lines insurer was Lloyd's of London and insurers based outside of the U.S. – alien

[9] A.M. Best Company * Special Report (September 1994), Insolvency Study of the Excess & Surplus Lines Industry, p. 14; A.M. Best Company (September 2001), Annual Review of the Excess & Surplus Lines Industry, pp. 21-24.

carriers – dominated the surplus lines market. Today, according to A.M. Best, surplus lines represent over eleven and one-half billion dollars in annual premium with 70 percent of the surplus lines premium flowing to U.S.-based carriers that are regulated for solvency by the company's domiciliary state, as is any other insurer licensed in that state.[10] Lloyd's of London only writes 15 to 25 percent of the annual surplus lines premium volume.

Moreover, in 1890, the drafters of the New York surplus lines law did not contemplate that the surplus lines business would cross state lines. In contrast to 1890, a majority of risks insured through the surplus lines market today, cross state lines and have multi-state exposures.

This multi-state aspect of surplus lines risks poses difficulties for the surplus lines market under current state regulatory laws. First, there is the difficulty of compliance by brokers, with a variety of differing state regulatory laws, should a risk or surplus lines placement cross state lines.

Second, and most problematic, is the difficulty multi-state risks pose for the broker in the remittance and compliance with the state surplus lines tax laws. Under state surplus lines tax laws, the onus is on the surplus lines broker to remit taxes on surplus line premium to the states. Unfortunately, the state surplus lines premium tax laws are inconsistent, conflicting and in some cases, vague as to how the tax is to be determined and paid. For example, in most states the surplus lines broker is expected to allocate

[10] A.M. Best Company (September 2001), Op. Cit. p. 12.

surplus lines premium to the states in which exposures exist, and remit a tax on that portion of the premium. However, there are a few states that demand a tax on the entire premium regardless of where the exposure exists. This creates conflicting demands and the possibility of double taxation. More significantly, however, is the fact that there is no accepted allocation formula among the states, making it difficult to know how to calculate the tax due.

Finally, some states apply their surplus lines tax laws in a manner that appears to be inconsistent with the 1962 U.S. Supreme Court decision in Todd Shipyards that holds that a tax on a wholly out-of-state insurance transaction is invalid.[11] These surplus lines tax issues are of concern to risk managers when dealing in the surplus lines market.

RIMS believes that self-insurance will continue to be a popular coverage choice in the 21st century; in part due to conditions in the insurance marketplace which restrict the purchase of coverages because they are unavailable or priced too high (i.e., terrorism insurance). Companies can calculate expected losses in many areas of operation and then fund those losses through self-insurance, thereby eliminating the cost of traditional insurance (overhead, profits, reserving practices). Excess insurance coverages may increase in the future as coverage is sought for the portion of potential losses that cannot be self-insured or self-funded.

In addition to the alternative markets discussed today, this Congress has the ability to provide another choice, one that is surely not without controversy, yet with the

[11] State Board of Insurance,et al. v. Todd Shipyards Corp., 370 U. S. 451 (1962).

potential to eliminate a significant amount of the costs and time that have driven up prices in the traditional insurance market – an optional federal insurance charter.

RIMS recognizes both the incredible promise, and the inherent hazards, of an optional federal insurance charter. The Society appreciates the serious and complex implications of allowing insurers to obtain a federal license that would allow them to operate nation-wide without regard to individual state laws.

But, despite the significant hurdles that must be overcome in developing an optional federal charter, the goal of all parties involved should be a cost-effective, quality insurance product that is easily obtainable. The current system in the United States is inefficient. Negotiating rate and form regulations in 50 different jurisdictions is expensive and time-consuming. A single regulator to establish risk-based capital and surplus requirements, as well requirements for public disclosure of rates and forms, would reduce costs and restrictions for U.S. purchasers, and act as an incentive for increased participation by foreign companies.

In addition, a federal presence in the insurance industry should not intensify the regulatory burden on U.S. businesses. One of the dangers of an optional federal charter is that the federal mechanism will become just another over-large, Washington bureaucracy. A federal regulatory option should not develop into the 51st state. Also, the state regulation system needs to remain accessible to those insurers who do not choose to participate in a federal option. Ideally, an optional federal charter would spur improvement and innovation at the state level.

Insurance regulation and products should reflect the technology and sophistication of the new millennium and the global market. The 20th century regulatory system in the U.S. cannot adequately compete in the 21st century worldwide insurance marketplace. Gramm-Leach-Bliley, and the subsequent convergence of financial institutions, heralds an unprecedented evolution in U.S. banking and business. Insurance regulation should be a reflection of this advanced, streamlined, and market-based environment.

RIMS supports a consultative role for the National Association of Insurance Commissioners (NAIC) in the creation of an optional federal charter. The NAIC has taken measurable steps to reform state insurance regulation, most notably the adoption of the state certification program, speed-to-market initiatives, and steps to deregulate commercial lines of insurance. By the very nature of state regulation, however, it is almost impossible to achieve uniform laws and regulatory interpretation of those laws. Nevertheless, creation of an optional federal charter should involve the NAIC on a consultative basis to ensure that states' rights and revenue issues are properly addressed. RIMS continues to support the NAIC state accreditation system.

There are many questions surrounding an optional federal charter, and recent proposals provide a starting point for further deliberation. I am optimistic that this hearing and future hearings will begin a serious debate on this issue. RIMS understands that it may be a long road to approve optional federal charter legislation, but we believe that the time for this idea to become reality is now.

In the end, all of these risk-financing options are crucial to risk managers. But there is no one-size-fits-all solution for commercial insurance consumers. While the alternatives discussed today provide some relief, RIMS ultimately favors a system unfettered by over-reaching government regulation, one that has the flexibility to respond to the varied needs of the consumer and the changing marketplace. Certainly, small and mid-sized companies benefit from the oversight protection provided by the state insurance regulation system. But care must be taken that this system does not restrict the movement of product and the ability of consumers to obtain adequate and affordable coverage.

Thank you for the opportunity to speak today. I appreciate your time, interest and leadership.

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