



National Association of Professional Surplus Lines Offices, Ltd.

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**TESTIMONY OF THE NATIONAL ASSOCIATION OF PROFESSIONAL SURPLUS
LINES OFFICES BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES REGARDING H.R._____, THE
NON-ADMITTED AND REINSURANCE REFORM ACT OF 2006**

June 21, 2006

Chairman [Richard] Baker, Ranking Member [Paul] Kanjorski, and Members of the Subcommittee, my name is Richard [Dick] Bouhan and I am the Executive Director and General Counsel of the National Association of Professional Surplus Lines Offices -- NAPSLO -- and I am pleased to be here before you today to offer testimony on H.R._____, the Non-Admitted and Reinsurance Reform Act of 2006.

NAPSLO is a national trade association representing the surplus lines industry and the wholesale insurance marketing system. NAPSLO is the only association to represent both surplus line companies and brokers. Founded in 1974, NAPSLO has concentrated on being a trusted voice on surplus lines issues in all 50 states, as well as in Washington, DC. NAPSLO is a valuable source of information regarding the vital role surplus lines plays in the insurance industry. NAPSLO has over 800 members representing 15,000-20,000 individual brokers, agents, company professionals, underwriters and other insurance professionals in all fifty states and the District of Columbia.

NAPSLO commends the Subcommittee and the leadership of Chairman Richard Baker for taking surplus lines and reinsurance concepts from the original Subcommittee draft of the State Modernization and Regulatory Transparency Act (SMART Act) proposal in an effort to speed the advancement of these concepts through the legislative process. We also appreciate and thank

Representatives Ginny Brown-Waite and Dennis Moore for their foresight in introducing this significant legislation that recognizes the need for pragmatic reform and modernization of the surplus lines and reinsurance markets. This initiative will bring long overdue modernization to regulation of these important segments of the insurance market while at the same time underscoring the need for comprehensive insurance modernization by placing these particular lines of insurance at the forefront of the Subcommittee's insurance reform agenda.

Surplus lines is property and casualty insurance that covers unique, unusual, hard-to-place or non-standard risks for which insurance is not typically offered by insurers operating in the licensed or "admitted" or standard marketplace. Often referred to as "non-admitted" insurance, surplus lines covers risks that state-licensed or "admitted" companies are unable to or will not insure or do not meet the insurance requirements of the buyer.

The need for an insurance buyer to access the surplus lines insurance market can stem from an inability of standard or admitted companies to effectively evaluate a particular risk because of the risk's unique, novel or difficult underwriting characteristics or because of the lack of sufficient statistical information about the risk or that class of risk that would allow standard company underwriters to sufficiently analyze it. The need for surplus lines treatment may also evolve from the fact that a buyer may desire a level or limits of coverage on a risk that exceed that which standard or admitted companies are willing or able to offer.

State legislatures have recognized that these exigencies frequently exist in licensed insurance markets and have provided a statutory framework to allow insurance buyers regulated access to non-licensed or "non-admitted" surplus lines companies, through specially licensed brokers, in order to provide them coverage through the surplus lines market when buyers are unable to secure

the coverage from the admitted or licensed market in their particular state¹. Thus, every state has created a supplemental property/casualty market of eligible surplus lines insurers whose unlicensed or non-admitted status gives them the capability and flexibility to respond to a buyer's specific needs and to the buyer's coverage problems.

Surplus lines coverage frequently involves specialty risks for commercial clients. Some of the risks insured in the surplus lines market include kidnapping and ransom coverage, business interruption, environmental impairment, special events, "hole-in-one" or prize indemnification coverage, amusement park rides, and coastal properties, as well as general, professional and business liability coverage for those risks with unique, difficult or "challenging" underwriting characteristics are all insured in the surplus lines market. The surplus lines market also insures more common or recognizable types of risks that become difficult for the standard market to insure as a result of a volatile and changing legal environment. For example, in the wake of a massive escalation in construction defect lawsuits, in recent years, residential building contractors have relied heavily on the surplus lines market to craft industry specific policies. In the 1980's, day care centers looked to the surplus lines market for coverage. Also, businesses, particularly small businesses that have pollution exposures are found insured in the surplus lines market

The surplus lines market has been and continues to be the incubator for new coverages. Asbestos abatement coverage was first developed and offered in the surplus lines market. The umbrella coverage contract was first created and sold in the surplus lines market. Employment Practices Liability Insurance (EPLI) was nurtured in the surplus lines market. A number of e-commerce and computer software liability coverages are being "tested" in the surplus lines market. It is the freedom of rate and form that surplus lines companies exercise as a result of their unlicensed or

¹ Surplus lines companies and producers must be licensed in their home state or country in order to operate as a non-admitted insurer in other jurisdictions.

non-admitted status that allows them the flexibility to develop new coverages and write difficult to place, unique and high limit risks.

Often, after a new coverage has proven itself in the surplus lines market and sufficient loss data has been established to provide a statistical basis to form credible rates, the coverage becomes a standard product in the admitted or licensed market.

Thirty-five billion dollars in annual premiums are written by surplus lines carriers. This figure represents over 13% of the total annual amount of commercial property/casualty insurance premium.

The surplus lines transaction is regulated, by the states, through the licensed surplus lines broker who assumes special responsibilities to both the state and to the insured. Although not the regulated entities in a surplus lines transaction, the nonadmitted or unlicensed surplus lines insurers that form the surplus lines market in a state must meet specific capitalization, financial and other standards, established by the state, in order to be eligible to do business with licensed surplus lines brokers. In addition, in a surplus lines transaction, it is the licensed surplus lines broker who is responsible for regulatory compliance and it is the surplus lines broker who is solely responsible for remitting the surplus lines premium tax to the state tax collection agencies.

Unfortunately, the current system of state regulation of surplus lines lacks clarity and is fraught with confusion and inconsistencies.

H.R._____ provides relief to the regulatory breakdowns in the non-admitted marketplace that are causing disruptions to the market and the bill takes the appropriate steps to correct them. These problems bring an undue burden on the licensed insurance professionals providing access to this market and the commercial insurance consumers they endeavor to serve.

As noted previously, chief among NAPSLO's concerns is the inconsistent way in which states manage their premium tax allocation and remittance schedules. This problem only exacerbates the mounting confusion experienced by surplus lines producers. The proper allocation and remittance of surplus lines premium taxes to the states on multi-state risks has been a growing problem for decades.

The passage of the Gramm-Leach-Bliley Act in 1999 added to the severity of this burden by increasing the number of non-resident surplus lines broker licenses. GLBA "compelled" states to grant reciprocal licenses through a threat of preemption, and, as more surplus lines brokers obtained nonresident surplus lines licenses, they quickly discovered that state laws fail to provide guidance on which state surplus lines law governs a multi-state surplus transaction.

The failure of the states to establish a uniform and consistent method of remitting surplus lines premium taxes on multi-state surplus lines risks has brought forth confusion and complexity in the market from the standpoint of the consumers as well as the producers.

Industry efforts, over the past two decades, to work with the National Association of Insurance Commissioners (NAIC) to solve the surplus lines premium tax allocation and remittance problems through initiatives to harmonize the inconsistencies have all proved unsuccessful. Over time, however, the severity of this problem has increased, since more and more surplus lines placements have become multi-state risks. The genesis of this problem lies in the contradictory and inconsistent state regulatory and tax laws, which make multi-state surplus lines transactions complicated, confusing, and very costly to all parties.

The inconsistencies and conflicts associated with this problem can be narrowed down to two primary areas. First, there is no universally accepted allocation formula among states: meaning the

broker must determine which state's allocation formula governs the transaction in a multi-state transaction. Second, the taxing provision of each state's surplus lines laws are directed to the broker placing the coverage, requiring that any tax on the portion of the premium allocated to the state be paid to that state. There is no mandate in state laws that the broker remit a tax on portions of the premium allocated to other states. Therefore, there is no true legal authority requiring the broker to remit the premium tax to another state, particularly to a state in which the broker is not licensed.

NAPSLO is pleased that the Committee recognizes that the systemic problems associated with premium tax allocation and remittance have created stumbling blocks in the surplus lines marketplace, and that a common-sense legislative solution has been incorporated into this bill. This legislation establishes a uniform system of premium tax allocation and remittance, creating a system of home state deference for non-admitted insurance; prohibits any other state than the home state of the insured from requiring any premium tax payment for non-admitted insurance; and, authorizes states to enter into a compact as a means of harmonizing allocation and remittance standards. NAPSLO has publicly endorsed the merits of this approach in the past and we are encouraged that this important concept has been included in the underlying bill. A legislative approach requiring adoption of an interstate compact, which is a treaty agreement among those states that adopt it, could succeed with broad industry support. A compact will greatly simplify the formulas used for tax allocation without undermining the authority of the states.

The second regulatory breakdown that NAPSLO has identified is that of licensing standards. The current system has no true safeguards to prevent licensing discrimination against nonresident agents and brokers, and the lack of clarity has created a varying regulatory climate which changes, for better or for worse, according to the jurisdiction in which you operate. This bill addresses this

problem by adopting uniform standards for producer licenses. This provision mandates that no jurisdiction other than an insured's home state may require a surplus lines broker to be licensed in order to sell, solicit, or negotiate non-admitted insurance. This provision has federal preemptive authority over noncompliant states as a means of maintaining a strong enforcement mechanism. NAPSLO also endorses the concept of a national producer database established in the bill, which will assist with the proper collection of licensing fees for non-admitted brokers.

Multiple compliance requirements for surplus lines brokers are fraught with bureaucratic red tape, and NAPSLO has long been a proponent of reciprocal participation across jurisdictions. To illustrate my point, consider a broker who has exposures in 5 different states; does this constitute the application of 5 separate state laws and 5 different tax filings? Does this require 5 diligent searches and 5 different license requirements? Now imagine how this problem would translate nationwide with an exposure in 50 states. This is nothing short of a recipe for disaster, and further demonstrates why the harmonization of varying state laws is sound public policy and the right approach for all stakeholders operating in the non-admitted market.

Finally, NAPSLO is encouraged by the Committee's determination that access to the non-admitted marketplace should be streamlined for sophisticated commercial purchasers. A sophisticated buyer of insurance is, by the standards and definition outlined in the bill, operating at a level that typically exceeds the risk management capabilities provided on the admitted marketplace. While NAPSLO can identify with the important role due diligence plays in assuring there are proper checks and balance between the placement of risk in both the admitted and non-admitted market, sophisticated purchasers are at such a high buying level, forgoing a search for admitted coverage simply eliminates an unnecessary step in the placement process, particularly in states where the commercial market is deregulated. Furthermore, the bill goes so far as to establish safeguards and

disclosure requirements that fully apprise the sophisticated purchaser that their streamlined access to the surplus lines market may or may not inhibit their ability to obtain coverage on the admitted market. NAPSLO commends the Committee for their recognition that many state requirements are burdensome, and involve an unnecessary layer of regulatory oversight for consumers and brokers that do not apply to the admitted market.

This legislation is the right policy at the right time. It provides regulatory relief for a technical and often misunderstood insurance market that is subject to a broad array of unnecessary regulatory requirements of varying degrees. This bill does not undermine the consumers' ability to make informed purchasing decisions, nor does it circumvent any state department of insurance's ability to police the surplus lines activity within their jurisdiction. It does, however, endeavor to create parity and balance for the surplus lines industry at a time when it is needed the most. NAPSLO again commends Chairman Baker for his leadership and for holding this hearing and thanks Representatives Ginny Brown-Waite and Dennis Moore for introducing this important piece of legislation. NAPSLO looks forward to working with the subcommittee, the full Committee as well as with the entire House of Representatives to try and help this important bill move through the legislative process. Thank you for your time and attention to these complex but crucial segments of the insurance industry. I would be pleased to answer any questions you may have.